Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Number: **200227022**
Release Date: 7/5/2002
Index Number: 671.00-00, 1361.03-02, 2631.00-00

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:2 - PLR-119229-01
Date:
April 2, 2002

X =

A =

B =

Trust 1 =

Trust 2 =

Dear :

This letter responds to a letter dated March 26, 2001, and subsequent correspondence submitted by the authorized representative of Trust 1 and Trust 2 (collectively, the Trusts), requesting certain rulings under the Internal Revenue Code.

The information submitted states that A and B, husband and wife, intend to execute the Trusts as separate irrevocable trusts. Except for the identities of the grantor and the trustee and the term of the annuity, the provisions of the Trusts will be identical. The grantor of each of the Trusts will also be the initial sole trustee of that trust. A is the grantor of Trust 1, which provides an annuity for the shorter of a term of nine years or A's life. B is the grantor of Trust 2, which provides an annuity for the shorter of a term of seven years or B's life. Each grantor will fund that grantor's trust with nonvoting stock of X, which is represented as being an S corporation.

Article II of the Trusts provides that the trust is irrevocable in all circumstances, unless the trustee determines that the grantor's interest in the trust does not qualify as a qualified annuity interest under § 2702. In such circumstances, the trustee may amend the terms of the trust solely for the purpose of qualifying the trust, under court decree.

Article III, Paragraph A provides for an annual annuity in the amount of 10.29% of the initial fair market value of the assets transferred to the trust, payable to the grantor in quarterly installments on the last day of each quarter following the Effective Date, until the earlier of grantor's death or the fixed term of years of the trust. The annuity amount shall be increased each year so that the Annuity Amount payable to the grantor in that year equals 109.5% of the Annuity Amount paid to the grantor in the

preceding year. The annuity amount shall be paid from income and, to the extent income is insufficient, from principal.

Article III, Paragraph B, provides that (1) in addition to the payment of the Annuity Amount to the grantor, with respect to any year for which the grantor is considered the owner of the trust for state or federal income tax purposes, if the total income taxes owed by the grantor on the net ordinary income and capital gains taxed to the grantor as a result of the trust being a grantor trust exceeds the Annuity Amount paid to the grantor with respect to such year, the trustee shall distribute to the grantor an amount equal to such excess, and (2) any payment made under Article III, Paragraph B, shall be made first from undistributed trust income and, to the extent such income is insufficient, trust principal.

Article III, Paragraph C, provides that no additional contributions may be made to the Trusts.

Article III, Paragraph D, provides that the interests of the grantors in the Trusts shall not be subject to commutation.

Article III, Paragraph E, provides that during the grantors' interests in the Trusts, no payment shall be made to any person other than the grantors.

Article III, Paragraph F, provides that any trust income not distributed as part of the Annuity Amount or under the provisions of Article III, Paragraph B, shall be accumulated and added annually to principal.

Article III, Paragraph G.1.a. provides that if the grantor survives the annuity term, the remaining trust assets shall be distributed equally among grantor's living children, if all of such children are living or if grantor's deceased children have no living issue.

Article III, Paragraph G.1.b. provides that if the grantor survives the annuity term, but one or more of grantor's children is deceased and has living issue, then the remaining trust assets shall be divided equally among grantor's living children and deceased children with issue. The shares created for the living children will be distributed to them outright.

The shares created for the deceased children with living issue will be administered as follows: The remaining trust assets will be divided into two separate trusts: the Exempt Trust and the Non-Exempt Trust. To the extent that the remaining assets are within grantor's available generation-skipping transfer exemption, at the time that the annuity term terminates, it will be held in the Exempt Trust. The balance of the trust assets, if any, will be held in the Non-Exempt Trust. The Exempt Trust then will be divided into equal separate shares for the living issue of deceased children by right of representation.

The Non-Exempt trust will be divided into equal separate shares for the deceased children with living issue. Each deceased child will have a testamentary general power of appointment to designate who is to receive the assets in such Non-Exempt trust. The general power of appointment is exercisable in favor of anyone, including the deceased child, deceased child's estate, deceased child's creditors, and creditors of the deceased child's estate. This power of appointment shall be exercised either by specific reference to the Non-Exempt Trust in deceased child's will or by a duly acknowledged instrument delivered to the trustee that was effective at deceased child's death. If the power of appointment lapses, then the Non-Exempt Trust will be divided into equal separate shares for the living issue of the deceased children by right of representation.

The Exempt Trusts and the Non-Exempt Trusts shall be held in trust for the benefit of the issue of deceased children for the life of each one of such issue. Each beneficiary shall receive distributions of net income payable at least quarterly. There shall be at all times only one income beneficiary of each separate trust. The trustee may invade the principal to provide for the beneficiary's health, education, maintenance, and support. No principal distributions may be made from any separate trust to anyone other than the current income beneficiary of such trust. Upon reaching the age of 21, each beneficiary has the right to all or any portion of the remaining assets of the trust. Upon a beneficiary's death, the trust shall terminate and the remaining assets of the trust shall be distributed to the beneficiary's estate. However, if the beneficiary shall die before the age of 21, the trust shall be distributed to specified family members of the beneficiary. Each of the separate trusts is intended to qualify as a qualified subchapter S trust (QSST) if the beneficiary makes the required election for that trust to be a QSST.

Article III, Paragraph G.2. provides that if the grantor does not survive the annuity term, the remaining trust assets will be subject to the grantor's general power of appointment as provided in grantor's last will and testament. If the trustee is not notified of the exercise of the general power of appointment within six months of the grantor's death, the trustee shall distribute the remaining assets to the grantor's revocable grantor trust, or if the revocable grantor trust is not in existence, to grantor's estate.

RULINGS 1, 2, AND 3

Section 671 provides that where it is specified in subpart E of Part I of subchapter J that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

Section 674(a) provides that the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

Section 674(b)(3) provides that § 674(a) shall not apply to a power, regardless of by whom held, exercisable only by will, other than a power in the grantor to appoint by will the income of the trust where the income is accumulated for such disposition by the grantor or may be so accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

Section 1.674(b)-1(b)(3) of the Income Tax Regulations provides that if a trust instrument provides that the income is to be accumulated during the grantor's life and that the grantor may appoint the accumulated income by will, the grantor is treated as the owner of the trust. Moreover, if a trust instrument provides that the income is payable to another person for life, but the grantor has a testamentary power of appointment over the remainder, and under the trust instrument and local law capital gains are added to corpus, the grantor is treated as the owner of a portion of the trust and capital gains and losses are included in that portion.

Section 677(a)(1) provides, in general, that the grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under § 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor or the grantor's spouse.

Section 1361(c)(2)(A)(i) provides that a trust all of which is treated (under subpart E of part I of subchapter J of chapter 1) as owned by an individual who is a citizen or resident of the United States may be a shareholder of an S corporation.

Rev. Rul. 85-13, 1985-1 C.B. 184, provides that an exchange of assets between a wholly-owned grantor trust and the deemed owner of the trust is not recognized as a sale for federal income tax purposes.

Under the terms of the Trusts, the annuities paid to A and B are to be paid from income of their respective trusts and, to the extent income is insufficient, from principal. Income not distributed is to be accumulated and added to principal. A and B have the testamentary power to appoint the corpus of their respective Trusts. Accordingly, A and B are the owners of the portions of their respective Trusts which consist of the income distributed to A and B under § 677(a)(1). In addition, because A and B have the testamentary power to appoint the corpus of their respective Trusts, including any trust income not distributed to A or B and capital gains which have been accumulated and added to the corpus, they are treated as the owners of the entire corpus under §§ 674(a) and (b)(3). Accordingly, A and B must include in computing their tax liability all items of income, deduction, and credit against the tax of their respective trusts. The Trusts will be qualified S corporation shareholders during the period in which they are

treated as wholly-owned grantor trusts. We further rule that no gain or loss will be recognized by a grantor or the Trusts on the transfer of X stock to the trusts or on the transfer of property from the Trusts to the respective grantors in payment of the annuity amount or the income tax obligations described in Article III, Paragraph B.

RULING 4

Section 2601 imposes a tax on every generation-skipping transfer (GST).

Under § 2631(a), with regard to the GST tax, every individual is allowed a GST exemption that may be allocated by such individual to any property with respect to which such individual is the transferor. Section 2631(b) provides that any allocation under § 2631(a), once made, shall be irrevocable. In general, under § 2632(a) any allocation by an individual of his GST exemption may be made at any time on or before the date prescribed for filing the estate tax return for such individual's estate.

Section 2642(f)(1) provides special rules for certain inter vivos transfers. For purposes of determining the inclusion ratio, if (A) an individual makes an inter vivos transfer of property, and (B) the value of the property would be includible in the gross estate of the individual under chapter 11 if the individual died immediately after making the transfer (other than by reason of § 2035), any allocation of GST exemption to the property shall not be made before the close of the "estate tax inclusion period."

Under § 2642(f)(3), the term "estate tax inclusion period" means any period after the transfer described in § 2642(f)(1) during which the value of the property involved in the transfer would be includible in the gross estate of the transferor under chapter 11 if he died. Such period shall in no event extend beyond the earlier of the date on which there is a GST with respect to such property, or the date of the death of the transferor.

If grantor died immediately after funding the initial trust, the trust would be included in the grantor’s gross estate under § 2036. Therefore, § 2642(f)(1) applies to prevent any allocation of GST exemption to the property before the close of the estate tax inclusion period which, in this case, is the earlier of the end of the trust term or the death of the grantor. Based upon the information submitted and the representations made, we conclude that if A or B is living at the time the fixed term interest in their respective trusts expire, then, commencing at that time A or B may allocate part or all of their respective remaining GST exemptions exclusively to the Exempt Trusts based on the fair market value of the assets allocated to the Exempt Trusts as of the date the Exempt Trusts are funded, so that the Exempt Trusts (and any separate trust created thereunder for the benefit of a grandchild of the A or B) has a zero inclusion ratio for GST purposes.

RULING 5

Section 2041(a)(2) provides, in part, that the value of the gross estate shall include the value of all property to the extent of any property with respect to which the

decedent has at the time of death a general power of appointment created after October 21, 1942.

Section 2041(b)(1) defines the term "general power of appointment" as a power that is exercisable in favor of the decedent, the decedent's estate, the decedent's creditors, or the creditors of the decedent's estate.

Section 20.2041-3(a)(2) of the Estate Tax Regulations provides that if the power is a general power of appointment, the value of an interest in property subject to the power is includible in the decedent's gross estate under § 2041(a)(2) if either (i) the decedent has the power at the time of his death (and the interest exists at the time of his death), or (ii) the decedent exercised or released the power, or the power lapsed.

Section 2652(a)(1)(A) provides, in part, that the transferor for GST purposes is the individual with respect to whom property was most recently subject to federal estate tax.

Section 26.2652-1(a)(1) of the Generation-Skipping Transfer Tax Regulations provides, in part, that an individual is treated as transferring any property with respect to which the individual is the transferor.

Section 26.2652-1(a)(2) provides, in part, that a transfer is subject to federal estate tax if the value of the property is includible in the decedent's gross estate.

The deceased child of A and B will have a testamentary general power of appointment over the assets in the Non-Exempt Trust at the time of that child's death, because the child may appoint the assets to anyone including the child, child's estate, child's creditors, or the creditors of the child's estate. Accordingly, the value of the Non-Exempt Trust will be included in the gross estate of that deceased child regardless of whether the deceased child actually exercises or releases the general power of appointment or lets the power lapse. The deceased child will be treated as the transferor for purposes of § 2652(a)(1)(A). Therefore, based on the facts submitted and the representations made, we conclude that distributions from the Non-Exempt Trust to a grandchild of A and B whose parent is a deceased child of A and B will not be subject to the GST tax.

RULING 6

Section 1361(d)(3) provides that the term "qualified subchapter S trust" (QSST) means a trust (A) the terms of which require that (i) during the life of the current income beneficiary, there shall only be 1 income beneficiary of the trust, (ii) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary, (iii) the income interest of the current beneficiary in the trust shall terminate on the earlier of such beneficiary's death or the termination of the trust, and (iv) upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to such beneficiary, and (B) all of the income (within

the meaning of § 643(b)) of which is distributed (or required to be distributed) currently to 1 individual who is a citizen or resident of the United States.

Based on the facts and representations submitted, we conclude that the separate trusts created for the issue of a deceased child of the grantors of the Trusts under Article III, Paragraph G.1.b. meet the requirements to qualify as QSSTs within the meaning of § 1361(d)(3), and will be treated as QSSTs provided that the current income beneficiary of each trust is a United States citizen and the beneficiary or the beneficiary's legal representative timely makes the required election under § 1361(d)(2).

Except as specifically set forth above, no opinion is expressed or implied as to the federal income tax consequences of the transactions described above under any other provision of the Code.

This ruling is directed only to the taxpayer on whose behalf it was requested. Section 6110(k)(3) provides that it may not be used or cited as precedent. Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to the authorized representative of the Trusts.

Sincerely yours,
J. THOMAS HINES
Chief, Branch 2
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures: 2
Copy of this letter
Copy for § 6110 purposes