

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:4-PLR-105356-02
Date:
December 04, 2002

Re:

LEGEND:

- Parent =
- Spouse =
- Child A =
- Child B =
- Child C =
- Trust =
- Child A Trust =
- Child B Trust =
- Child C Trust =
- Corporate Trustee =
- Date 1 =
- Date 2 =
- Date 3 =
- Court =
- First Order =
- Second Order =
- State Statute =

Dear :

This is in response to the August 9, 1999 letter and subsequent correspondence requesting a ruling regarding the generation-skipping transfer tax (GSTT) consequences of a judicial construction of Trust.

Facts

The facts submitted and representations made are as follows. Parent and Spouse both died before September 25, 1985. Parent had three children, Child A, Child B, and Child C, each of whom survived Spouse. Parent created Trust, an irrevocable trust, on Date 1, before September 25, 1985, and designated Corporate Trustee as trustee.

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Under Article I, paragraph (a) of Trust, the corpus is to be held for the benefit of Spouse during her life. Under Article I, paragraph (b), on Spouse's death, Trust is to be divided into equal shares, one such share to be held for the benefit of each child of Parent then living. Pursuant to this directive, on Spouse's death, the trustee established Child A Trust, Child B Trust, and Child C Trust. It is represented that no additions, actual or constructive, were made to Trust, or to Child A Trust, Child B Trust, or Child C Trust after September 25, 1985.

Under Article I, paragraph (d), the trustee is to distribute to the child for whom the trust was established so much of the income of the fund created for that child's benefit as the trustee in its discretion deems reasonably necessary for the support and education of the child. The remaining income is to be added to principal.

Under Article I, paragraphs (e) and (f), the trustee may, in its discretion, distribute to a child one-half of the principal of a fund created for that child's benefit when he or she attains age 30, and entire remaining principal when he or she attains age 33. If a child dies before all of the fund held for him or her has been distributed, the child may appoint the fund by will to such of his or her lawful descendants in such proportions and subject to such trusts and conditions as the child directs. To the extent a child fails to exercise his or her testamentary power of appointment, the fund held for him or her is to be distributed equally per stirpes to his or her then living lawful descendants. However, if the child is a son of Parent, and the child leaves a spouse but no lawful descendant then living, the trustee is to distribute the income of the fund to the spouse until her death or remarriage, whereupon the trustee is to distribute the fund equally among Parents' descendants. If any part of the principal of a fund becomes distributable to one who has not attained age 21, the trustee is to hold that portion in trust for that person until he or she attains age 21.

Under Article I, paragraph (m), the trustee has the full power and authority to determine whether and in what proportions any receipts or disbursements are to be credited or charged to or apportioned between trust principal and income.

Under applicable local law governing the ascertainment of income and principal and the apportionment of receipts and expenses, a trust is to be administered with due regard to the respective interests of income beneficiaries and remaindermen. A trust is so administered with respect to the allocation of receipts and expenses if a receipt is credited or an expense is charged to income or principal or partly to each in accordance with the terms of the instrument. State Statute.

Corporate Trustee is now the trustee of the trusts. On Date 2, in response to the trustee's request for instructions relating to its authority to manage and invest the trust assets, Court issued First Order authorizing the trustee to: (1) invest the assets on a joint or pooled basis; and (2) retain professional investment managers having expertise

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in managing the type of investments appropriate to meet the investment objectives of a trust or joint investment fund, if the trustee deems it appropriate in accordance with the exercise of its fiduciary responsibility.

The trustee subsequently petitioned Court for instructions concerning the power to allocate expenses and receipts under Article I, paragraph (m). On Date 3, Court issued Second Order concluding that, pursuant to the express language of Trust, the trustee has the power and authority in the exercise of its fiduciary responsibilities to credit realized capital gains to income and to charge income expenses to principal.

Requested ruling

You have asked us to rule that the exercise of the trustee's discretion to allocate capital gain receipts to income and to charge certain income expenses to principal pursuant to Second Order does not adversely affect the trusts' status as exempt from the generation-skipping transfer tax.

Discussion

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

Section 1433(b)(2)(A) of the Tax Reform Act of 1986 ("the 1986 Act") and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations provide that the generation-skipping transfer tax shall not apply to any generation-skipping transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added).

Section 26.2601-1(b)(1)(ii) provides that any trust in existence on September 25, 1985, will be considered an irrevocable trust except as provided in §§ 26.2601-1(b)(1)(ii)(B) or (C) (relating to property includible in the grantor's gross estate under sections 2038 and 2042).

Section 26.2601-1(b)(1)(iv) provides that if an addition is made after September 25, 1985, to an irrevocable trust, which is excluded from the application of Chapter 13 by section 1433(b)(2)(A) of the 1986 Act, a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the provisions of Chapter 13.

Section 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the generation-skipping transfer tax will not cause the trust to lose its exempt status. The regulation provides that the rules contained in the paragraph are

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applicable only for purposes of determining whether an exempt trust retains its exempt status for generation- skipping transfer tax purposes.

Section 26.2601-1(b)(4)(i)(C) provides that a judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument will not cause an exempt trust to be subject to the provisions of chapter 13 if - (1) the judicial action involves a bona fide issue; and (2) the construction is consistent with applicable state law that would be applied by the highest court of the state.

Section 26.2601-1(b)(4)(i)(D) provides that a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A), (B), or (C)) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

Section 26.2601-1(b)(4)(i)(E), Example 9, considers a situation in which, in 1980, Grantor established an irrevocable trust under the terms of which trust income is payable to Grantor's child, A, for life, and upon A's death, the remainder is to pass to A's issue, per stirpes. Under applicable state law, unless the governing instrument provides otherwise, capital gain is allocated to principal. In 2002, the trust is modified to allow the trustee to allocate capital gain to income. The modification does not shift any beneficial interest in the trust to a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. In this case, the modification can only have the effect of increasing the amount distributable to A, and decreasing the amount distributable to A's issue. In addition, the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the modification will not cause the trust to be subject to the provisions of chapter 13.

In the instant case, Trust and Child A Trust, Child B Trust and Child C Trust were irrevocable on September 25, 1985, and no additions, actual or constructive, have been made to Trust or Child A Trust, Child B Trust or Child C Trust after that date. The judicial construction of Article I, paragraph (m), that the trustee is authorized under the provision to allocate capital gain receipts to income and charge certain income expenses to corpus, is consistent with the language of the provision and applicable state law.

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Accordingly, based on the facts submitted and the representations made, we rule that the entry of the Second Order authorizing the trustee to allocate capital gain receipts to income and charge certain income expenses to corpus, and the trustee's exercise of discretion in accordance with the court order, will not adversely affect the status of Child A Trust, Child B Trust, and Child C Trust as exempt from generation-skipping transfer tax. Section 26.2601-1(b)(4)(i)(C). See also, § 26.2601-1(b)(4)(i)(E), Example 9.

Except as specifically ruled herein, we express no opinion on the federal tax consequences of the modification under the cited provisions or under any other provisions of the Code. Specifically, we express no opinion on the federal income and gift tax consequences of the modification.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely yours,

George L. Masnik
Chief, Branch 4
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure
Copy for section 6110 purposes