

Operating Agreement =

PLR-134734-04

<u>a</u>	=
<u>b</u>	=
<u>c</u>	=
State 1	=
State Court	=

State Law 1	=
State Law 2	=
State Law 3	=
State Law 4	=
State Law 5	=
State 2	=

Dear :

This is in response to your letter dated June 22, 2004, and subsequent correspondence, concerning the generation-skipping transfer (GST) status of Trust.

The facts and representations submitted are summarized as follows: A died testate in Year 1, prior to September 25, 1985. Under the terms of Paragraph First (11) of A's will, a trust was established for the benefit of A's child, B, pursuant to which, trust income and corpus was to be paid to B in the trustee's discretion. On B's death, the remaining corpus was to be distributed pursuant to B's exercise of a testamentary special power to appoint the trust corpus among B's children. In default of appointment, the corpus was to pass to B's children. B died testate on Date 1, prior to September 26, 1985. Under the terms of Article Tenth of B's will, as added by codicil, B exercised the special power by appointing one-half of the trust corpus to be divided and held in separate trusts for the benefit of each of B's grandchildren. Pursuant to this exercise, Trust was established for the benefit of Grandchild 3. B's child, Son, the parent of Grandchild 3, was designated as the initial trustee of Trust (as well as all trusts established pursuant to the exercise of the power). B's exercise of the power of appointment was approved by Court Order.

Under the terms of Article Tenth, A.2. of B's will, as set forth in the codicil, the trustee of Trust is to pay to Grandchild 3, at least annually the entire net income and so much of the principal as the trustee determines is necessary for Grandchild 3's support, education, and medical care.

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Upon the death of Grandchild 3, the trustee is to distribute the balance of the trust estate to B's issue pursuant to Grandchild 3's exercise of a testamentary limited power to appoint the corpus among B's issue. Any of the trust estate not effectively appointed by Grandchild 3, is to be distributed to Grandchild 3's living issue, by right of representation.

Trust further provides that Son may resign from the office of trustee without leave of court at any time and for any reason by filing a written instrument of resignation with the clerk of the court having jurisdiction of B's estate. Son may also appoint any individual or corporation qualified to act as trustee in State 1, if Son resigns or for any other reason fails or ceases to act as trustee, by filing a written instrument of appointment. If Son resigns or fails to act as trustee and does not appoint a successor to act in his place, Bank is to act as trustee. No successor trustee has the right to appoint a successor.

By an instrument dated Date 2, Son appointed Grandchild 2 as successor trustee of Trust in the event that Son failed or ceased to act as trustee. Son died on Date 3 and Grandchild 2 accepted his appointment as trustee on Date 4.

On or about Date 5, Grandchild 3 petitioned State Court to obtain instructions regarding the trustee's power to make discretionary distributions whenever the current beneficiary is acting as trustee, and order regarding the appointment of successor trustees. If the petition is granted, Trust would instruct the trustee as follows:

Whenever a person is a beneficiary of the Trust and also is acting as trustee of the Trust, such person shall exercise the trustee's discretionary distribution powers (set forth in paragraph [Tenth, A.]2.a. of the Trust) only for his or her support, education and medical care within the meaning of sections 2041 and 2514 of the Internal Revenue Code of 1986, as amended.

Grandchild 3 further requested State Court to accept the resignation of Grandchild 2 and to modify Trust to appoint successor trustees as listed in the following order of priority: Grandchild 1; then any person designated by written instrument signed by Grandchild 3; then Bank. Bank, as the current successor trustee named in Trust, has consented to the proposed State Court order changing the trustee succession. In a written instrument dated Date 6, Grandchild 1 has consented to act as trustee of Trust.

On Date 7, LLC was formed under the laws of State 2. The initial managers of LLC are Grandchild 1, Grandchild 2, and X. On Date 7, Trust contributed the majority of its assets, a shares of Company stock, to LLC in exchange for an ownership percentage. LLC is owned by 12 members, all which are trusts established for the benefit of individuals related to Grandchild 3.

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Paragraph 4.4.1 of the LLC Operating Agreement defines the LLC's distribution policy as follows:

Initial Income Amount. In each calendar year, the [LLC] shall distribute to the Interest Holders (all distributions in proportion to the Interest Holder's Percentage and made quarterly or at such time or times during the year as the Board of Managers shall determine) an "Initial Income Amount" equal to the greater of the "[Company] Dividend Equivalent" or "Trust Accounting Equivalent," each as defined below.

(a) [Company] Dividend Equivalent. For purposes of this instrument, for calendar year Year 2 the term "[Company] Dividend Equivalent" shall be an amount equal to [\$b] multiplied by each share of Common Stock of Company initially contributed to the [LLC] by the Members as listed on Exhibit A (as in effect on the date of execution of this Agreement). For purposes of this instrument, for each calendar year subsequent to Year 2, the term "[Company] Dividend Equivalent" shall be an amount equal to the prior year's [Company] Dividend Equivalent as determined under this Section 4.4.1(a) and increased by [c] percent ([c]%).

(b) Trust Accounting Equivalent. For purpose of this instrument, in each calendar year the term "Trust Accounting Equivalent" shall be an amount equal to the sum of the following:

(i) The net amount that would be treated as the [LLC's] "trust accounting income" if the books and records of the [LLC] were maintained as a trust under the [State 1] Uniform Principal and Income Act; plus

(ii) An additional amount, determined by the Managers, such that the amount distributed to the Member taxable at the highest marginal tax rates is approximately equal to such Member's hypothetical aggregate federal and state income tax liabilities for such year for income of the [LLC] allocated to the Member, such hypothetical tax liability to be determined as if each Member were taxable as a simple trust under the principles of Subchapter J of the Internal Revenue Code of 1986 as amended.

Section 4.4.2 directs the LLC to distribute additional amounts in certain circumstances. Specifically, if in any year a member's taxable income attributable to the LLC exceeds the member's share of the Initial Income Amount, then LLC is to distribute an additional amount to the member such that the member receives an amount approximately equal to the federal and state income tax liability on the difference between the member's taxable income attributable to LLC and the member's share of the Initial Income Amount.

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Section 4.4.3 authorizes LLC to distribute additional discretionary amounts provided that the distributions shall be made in proportion to the Interest Holder's ownership percentage.

Trust and other members of LLC propose to amend LLC Operating Agreement section 4.4.1(b). Specifically, the members of LLC desire to remove section 4.4.1(b) because it imposes an unnecessary administrative burden on the LLC. The proposed section 4.4.1(b) is as follows:

(b) Trust Accounting Equivalent. For purposes of this instrument, in each calendar year the term "Trust Accounting Equivalent" shall be an amount equal to the net amount that would be treated as the [LLC's] "trust accounting income" if the books and records of the [LLC] were maintained as a trust under the State 1 Uniform Principal and Income Act. Provided, however, that for purposes of section 4.4.1(b) there shall be no power to make any adjustment between principal and income as otherwise might be permitted under [State Law 1] (or any successor to such statute).

Grandchild 1, as trustee, anticipates that in some years Trust's taxable income attributable to LLC may not equal the cash distributions received from LLC. In that event, an additional amount will be distributed to Trust by LLC pursuant to section 4.4.2. of the LLC Operating Agreement. Grandchild 1, as trustee, proposes to allocate this additional distribution to corpus under the authority granted pursuant to State Law 2. This amount so allocated will be used by the trustee to pay the income tax liability.

Trust was irrevocable on September 25, 1985. It is represented that no actual or constructive additions have been made to Trust after that date.

You have requested the following ruling requests:

- (1) The issuance of instructions, as contained in the petition, regarding the trustee's power to make discretionary distributions when the beneficiary is acting as trustee, will not cause Trust to lose its GST exempt status.
- (2) The appointment of successor trustees, in accordance with the petition, will not cause Trust to lose its GST exempt status.
- (3) The potential or actual appointment of Grandchild 3 as successor trustee, in accordance with the petition, will not create a general power of appointment and cause the Trust's corpus and any undistributed income of Trust to be included in Grandchild 3's gross estate.

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(4) The Trust's contribution of substantially all of its assets to a limited liability company will not cause the Trust to lose its GST exempt status.

(5) The proposed amendment to the LLC Operating Agreement to modify section 4.4.1(b), "Trust Accounting Equivalent" minimum distribution requirement, will not cause the Trust, a member of LLC, to lose its GST exempt status.

(6) The allocation under State Law 2 of "tax distributions" under section 4.4.2 of the LLC Operating Agreement, to principal, will not cause Trust to lose its GST exempt status.

### Rulings 1 and 2

Section 2601 imposes a tax on every generation-skipping transfer made by a "transferor" to a "skip person". In general, under section 2652(a)(1) and section 26.2652-1(a)(1) of the Generation-Skipping Transfer (GST) Tax Regulations, the transferor for GST tax purposes is the last person with respect to whom the property was subject to the estate or gift tax.

Under section 1433(a) of the Tax Reform Act of 1986, the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under section 1433(b)(2)(A) of the Tax Reform Act and section 26.2601-1(b)(1)(i) of the regulations, the tax does not apply to a transfer from a trust, if the trust was irrevocable on September 25, 1985. The rule does not apply to the extent additions (actual or constructive) were made to the trust after that date. Further, this rule does not apply to a transfer of property after September 25, 1985, pursuant to the exercise, release, or lapse of a general power of appointment that is treated as a taxable transfer for estate or gift tax purposes. Section 26.2601-1(b)(1)(v)(A) provides that, except as provided under section 26.2601-1(b)(1)(v)(B), where any portion of a trust remains in the trust after the post September 25, 1985, release, exercise, or lapse of a power of appointment over that portion of the trust, and the release, exercise, or lapse is treated to any extent as a taxable transfer under chapter 11 or chapter 12, the value of the entire portion of the trust subject to the power that was released, exercised, or lapsed is treated as if that portion had been withdrawn and immediately retransferred to the trust at the time of the release, exercise, or lapse.

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 GST tax under section 26.2601-1(b)(1), (2), or (3) (hereinafter referred to as an exempt trust) will not cause the trust to lose its exempt status. The rules contained in section 26.2601-1(b)(4) are, except as otherwise noted, applicable

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only for purposes of determining whether an exempt trust retains its exempt status for GST tax purposes. The rules do not generally apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of section 1001.

Section 26.2601-1(b)(4)(i)(D)(1) provides that a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy section 26.2601-1(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)(D)(2) provides that for purposes of section 26.2601-1(b)(4)(i)(D)(1), a modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is measured against the effect of the instrument in existence immediately before the modification. If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust to a 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. A modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust.

Section 26.2601-1(b)(4)(i)(E), Example 10, involves a situation where in 1980, Grantor executed an irrevocable trust for the benefit of Grantor's issue, naming a bank and five other individuals as trustees. In 2002, the appropriate local court approves a modification of the trust that decreases the number of trustees which results in lower administrative costs. The modification pertains to the administration of the trust and 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. 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 trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

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State Law 3 provides that if the vacancy in the office of the trustee is not filled as provided in subdivision (b) or (c), on petition of any interested person or any person named as trustee in the trust instrument, the court may, in its discretion, appoint a trustee to fill the vacancy. If the trust provides for more than one trustee, the court may, in its own discretion, appoint the original number or any lesser number of trustees. In selecting a trustee, the court shall give consideration to any nomination by the beneficiaries who are 14 years of age or older.

State Law 4 provides, in part, that if a trust instrument confers "absolute," "sole," or "uncontrolled" discretion on a trustee, the trustee shall act in accordance with fiduciary principles and shall not act in bad faith or in disregard of the purposes of the trust. Moreover, notwithstanding the use of terms like "absolute," "sole," or "uncontrolled" by a settlor or a testator, a person who is a beneficiary of a trust that permits the person, either individually or as trustee or cotrustee, to make discretionary distributions of income or principal to or for the benefit of himself or herself pursuant to a standard, shall exercise that power reasonably and in accordance with the standard. State Law 4 further provides that unless a settlor or a testator clearly indicates that a broader power is intended by express reference to State Law 4, a person who is a beneficiary of a trust that permits the person, as trustee or cotrustee, to make discretionary distributions of income or principal to or for the benefit of himself or herself may exercise that power in his or her favor only for his or her health, education, support, or maintenance within the meaning of sections 2041 and 2514 of the Internal Revenue Code.

In this case, Trust was irrevocable on September 25, 1985. It is represented that no additions have been made to Trust after that date.

Based upon the information submitted and the representations made, the issuance of instructions regarding the trustee's power to make discretionary distributions when the beneficiary is acting as trustee is consistent with the terms of the instrument and State Law 4. Therefore, the instructions do not modify the trust, or result in any shift of a beneficial interest in Trust. Further, State Court's instructions will not extend the time for vesting of any beneficial interest in Trust beyond the period provided for prior to the modification. Therefore, based upon the information submitted and representations made, we conclude that the proposed instruction will not constitute an addition to Trust, or otherwise subject Trust, or distributions from Trust to the GST tax. Accordingly, assuming State Court orders the issuance of instructions regarding the trustee's power to make discretionary distributions when the beneficiary is acting as trustee, such instructions will not cause Trust to lose its GST exempt status.

Grandchild 3 also petitioned State Court to modify Article Tenth of B's will to provide for a new succession of trustees in the following order of priority: Grandchild 1; then any person designated by written instrument signed by Grandchild 3; then Bank.



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State Law 3 provides that an interested person may petition the court, in its discretion, to appoint successor trustees. Based upon the information submitted and the representations made, the proposed modification of Article Tenth of B's will is administrative in nature and does not shift a beneficial interest in Trust to a person or persons who occupy a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. Further, the modification will not extend the time for vesting of any beneficial interest in Trust beyond the period provided for prior to the modification. Therefore, the modification will not cause Trust to lose its exempt status for GST tax purposes.

Further, as discussed below, the actual appointment of Grandchild 3 as trustee of Trust will not result in Grandchild 3 possessing a general power of appointment over Trust corpus and income for purposes of section 2041. Accordingly, the potential or actual appointment of Grandchild 3 as trustee of Trust will not cause Trust, or distributions from Trust to be subject to the GST tax. Moreover, assuming State Court orders the appointment of successor trustees as petitioned, the modification to Article Tenth of B's will, or the potential or actual appointment of Grandchild 3 as trustee, will not cause Trust to lose its GST exempt status.

### Ruling 3

Section 2041(a)(2) provides that the value of the gross estate shall include the value of all property with respect to which the decedent has at the time of his death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under sections 2035 to 2038, inclusive.

A general power of appointment is defined in section 2041(b)(1) as a power which is exercisable in favor of the individual possessing the power, his estate, his creditors, or the creditors of his estate. Under section 2041(b)(1)(A), a power to consume, invade, or appropriate property for the benefit of the decedent relating to the health, education, support, or maintenance of the decedent shall not be considered a general power of appointment.

Section 20.2041-1(b)(1) of the Estate Tax Regulations provides, in part, that if a trust instrument provides that the beneficiary may appropriate or consume the principal of the trust, the power to consume or appropriate is a power of appointment. However, the mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no interest therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment.

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Section 20.2041-1(c)(1) provides, in part, that the term "general power of appointment" as defined in section 2041(b)(1) means any power of appointment exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate, except: (i) joint powers, to the extent provided in sections 20.2041-2 and 20.2041-3; and (ii) certain powers limited by an ascertainable standard, to the extent provided in section 20.2041-1(c)(2). A power of appointment exercisable for the purpose of discharging a legal obligation of the decedent or for his pecuniary benefit is considered a power of appointment exercisable in favor of the decedent or his creditors.

Section 20.2041-1(c)(2) provides that a power to consume, invade, appropriate income or corpus, or both, for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent is, by reason of section 2041(b)(1)(A), not a general power of appointment. A power is limited by such a standard if the extent of the holder's duty to exercise and not to exercise the power is reasonably measurable in terms of his needs for health, education, or support (or any combination of them). The words "support" and "maintenance" are synonymous and their meaning is not limited to the bare necessities of life. A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard. Examples of powers which are limited by the requisite standard are powers exercisable for the holder's "support," "support in reasonable comfort," "maintenance in health and reasonable comfort," "support in his accustomed manner of living," "education, including college and professional education," "health," and "medical, dental, hospital and nursing expenses and expenses of invalidism." In determining whether a power is limited by an ascertainable standard, it is immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised.

Section 2514 provides for a similar definition of a general power of appointment for gift tax purposes, and section 25.2514-1(c)(2) of the Gift Tax Regulations contains provisions similar to section 20.2041-1(c)(2). Section 2514(b) provides that the exercise or release of a general power of appointment created after October 21, 1942, shall be deemed a transfer of property by the individual possessing such power.

In the present case, the actual appointment of Grandchild 3 as trustee of Trust will not cause Grandchild 3, as a beneficiary of Trust acting as trustee, to possess a general power of appointment over Trust. Grandchild 3's power, as trustee, to distribute net income and principal from Trust to himself, is limited by an ascertainable standard relating to health, maintenance, support and education, under the terms of the Trust instrument and State 1 law. Accordingly, pursuant to sections 20.2041-1(c)(2) and 25.2514-1(c)(2), Grandchild 3, as successor trustee, will not possess a general power of appointment that will cause the corpus of Trust to be included in Grandchild 3's gross estate under section 2041. See, Rev. Rul. 78-398, 1978-2 C.B. 237.

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#### Rulings 4 and 5

State Law 5 provides that a trustee shall allocate to income money received from an entity. State Law 5 further provides that an entity includes a partnership or limited liability company.

Under section 4.4.1(b) of the LLC Operating Agreement, as proposed to be amended, the LLC will distribute annually to Trust the greater of a pecuniary amount, or the equivalent of what would constitute trust accounting income under State 1 law (determined without regard to State Law 2) if LLC was a trust. These distributions to Trust will be allocated to income under State Law 5 and distributed to the income beneficiary in accordance with the terms of the Trust. Accordingly, in this case, Trust's contribution of substantially all of its assets to LLC, as described above, will not shift any beneficial interests in Trust to lower generation beneficiaries or delay vesting of any interest in Trust. Cf. section 26.2601-1(b)(4)(i)(E), Example 8. Accordingly, based on the facts submitted and representations made, Trust's contribution of substantially all of its assets to LLC in exchange for an interest in LLC and the amendment of section 4.4.1(b) of the LLC Operating Agreement as described above will not cause Trust to lose its GST exempt status.

#### Ruling 6

As noted above, pursuant to State Law 5, the money received from a limited liability company must be allocated to trust income.

State Law 2 provides that "a fiduciary may make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries that arise from... the ownership by a ... trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or a beneficiary."

Pursuant to the authority granted under State Law 2, the trustee will allocate additional amounts distributed by LLC pursuant to section 4.4.2 of the LLC Operating Agreement to trust corpus. These amounts will be used by the trustee to pay the Trust's income tax liability attributable to LLC income. It is represented that the amount otherwise distributable to the Trust income beneficiary through the LLC and Trust (i.e. the greater of the Trust Accounting Equivalent or the Company Dividend Equivalent) will not be reduced as a result of the exercise of the trustee's authority under State Law 2.

In this case, the allocation pursuant to State Law 2, as described above, will produce the same result, for purposes of determining the amounts distributed to the income beneficiary, that would be obtained if the Trust assets had not been transferred

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to LLC and the Trust continued to own the assets outright. Accordingly, based on the facts submitted and representations made, the allocation under State Law 2, as described above, will not cause Trust to lose its GST exempt status.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely,

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

Enclosures

Copy for section 6110 purposes  
Copy of this letter