

Internal Revenue Service

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Re:

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

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PLR-121371-17

Date:
December 13, 2017

LEGEND

Grantor =
Trust =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
State =
Spouse =
Child 1 =
Child 2 =
Child 3 =
Child 4 =
Grandchild =
Court =

Foundation =
Statute 1 =
Statute 2 =
Statute 3 =

Dear :

This letter responds to your authorized representative's letter dated July 7, 2017, requesting income, gift, and generation-skipping transfer (GST) tax rulings with respect to the proposed modification of Trust.

FACTS

The facts and representations submitted are summarized as follows:

Grantor established an irrevocable trust, Trust, on Date 1 (a date after September 25, 1985). Grantor made an initial transfer of cash to Trust on Date 1. No transfers have been made to Trust since Date 1. Trust is administered under the laws of State. Child 2 is the current trustee (Trustee) of Trust.

It is represented that sufficient generation-skipping transfer (GST) tax exemption was allocated to Trust so that Trust has an inclusion ratio of zero. No assets have been directly or constructively added to Trust since the allocation of Grantor's GST exemption to Trust. It is also represented that Grantor has retained no ownership interest in Trust or its assets and no aspects of ownership over Trust or its assets.

Under Article I of Trust, the Trustee is to pay income and principal of Trust to or for the benefit of Spouse for her maintenance in health and reasonable comfort, and to pay income and principal to or for the benefit of Child 1 or Child 1's descendants for their maintenance in health and reasonable comfort and education. Under Paragraph 1.6 of Article I, upon the death of survivor of Spouse and Child 1, Trust assets are to be distributed pursuant to a limited power of appointment held by Child 1 to or for the benefit of any of Grantor's descendants (excluding Child 1) or the spouses of such descendants. Under Paragraph 1.7 of Article I, any part of Trust not effectively appointed is to be distributed to the then living descendants of Child 1 or, if none, then *per stirpes* to Grantor's descendants. Any assets to be distributed to either Child 2 or Child 4 are to be distributed to the separate trusts created contemporaneously for their respective benefit by Grantor with terms nearly identical to Trust. Any assets distributed to Child 3 are to be held in further trust under the same terms as for Child 1.

Article II directs the Trustee to administer assets held in trust for a grandchild of Grantor as a separate trust. Under Paragraph 2.1 of Article II, the Trustee is to pay income to the grandchild not less frequently than annually, except while the grandchild is under age 21, the Trustee is to pay income to or for the benefit of the grandchild for the grandchild's maintenance in health and reasonable comfort and education, and any income not so paid will be added to principal. Under Paragraph 2.2 of Article II, the Trustee also is to pay principal to or for the benefit of the grandchild as the Trustee deems necessary for the grandchild's maintenance in health and reasonable comfort and education.

Under Paragraph 2.3 of Article II, the grandchild has the right to withdraw up to one-half of the principal upon written request after reaching age 25, and all of the remaining Trust assets after reaching age 30.

Under Paragraph 2.4 of Article II, upon the death of the grandchild, any remaining Trust assets subject to the grandchild's right of withdrawal are to be distributed pursuant to the grandchild's testamentary general power of appointment. Any remaining Trust assets not subject to the grandchild's right of withdrawal are to be distributed pursuant to the grandchild's testamentary limited power of appointment to or for the benefit of any of Grantor's descendants (excluding the grandchild) or the spouses of such descendants. Notwithstanding the foregoing, if any portion of the Trust assets is otherwise subject to GST tax, then such portion of the Trust assets is to be distributed pursuant to the grandchild's testamentary power of appointment to or for the benefit of any of Grantor's descendants (excluding the grandchild), the spouses of such descendants, and the creditors of the grandchild's estate.

Under Paragraph 2.5 of Article II, any part of Trust not effectively appointed is to be distributed *per stirpes* to the then living descendants of the grandchild or, if none, then *per stirpes* to the descendants of the grandchild's parent who is also a descendant of Grantor, or if none, then *per stirpes* to Grantor's descendants. Any assets to be distributed to either Child 2 or Child 4 are to be distributed to the separate trusts created contemporaneously for their respective benefit by Grantor with terms nearly identical to Trust. Any assets distributable to Child 3 are held in further trust under the same terms as for Child 1.

Pursuant to Paragraph 6.8 of Article VI, Trust shall not continue for more than the limited period permitted by the applicable rule against perpetuities. Any property still held in trust at the expiration of that period shall immediately be distributed to the income beneficiaries in the proportions to which they are entitled. On the date of Trust's formation, Date 1, the applicable State law regarding the rule against perpetuities provided that a nonvested property interest was invalid unless, at the time the interest was created, it was certain to vest or terminate no later than 21 years after the death of an individual then alive, or the interest either vests or terminates within 90 years after its creation. Statute 1. Thus, as of Date 1, the termination date of Trust, if not terminated earlier by the death of all of Grantor's descendants, was 90 years from the date of creation, or Date 2.

Spouse and Child 1 predeceased Grantor. Child 1 was survived by one child, Grandchild. Grandchild's mother is also deceased. Grandchild recently attained 18 years of age and until Grandchild's 18th birthday, Child 4 served as guardian of the person and property of Grandchild. Grandchild has no descendants. Grandchild was diagnosed with a medical condition which makes Grandchild not capable of managing specific financial matters, such as managing money, budgeting, or tracking expenses, without assistance.

Child 3 is an incapacitated adult and is a resident at a medical facility. Grantor and Child 4 serve as the guardians of the person and property of Child 3. Child 3 has no descendants.

On Date 3, the Trustee submitted a petition to Court, seeking modification of certain terms of Trust to ensure that Trust serves Grantor's primary purpose of preserving Trust assets for Grantor's descendants and protecting trust assets from the claims of creditors. A *guardian ad litem* was appointed by Court to represent Grandchild.

The petition seeks to modify the terms of Trust (Reformed Trust) as follows: (1) convert Grandchild's mandatory income distribution beginning at age 21 to a discretionary distribution of income standard; (2) provide that the Trustee will set aside any income not distributed to Grandchild beginning at the age of 21 years in a separate account and distribute the entire amount remaining in such separate account to Grandchild's estate at the death of Grandchild; (3) remove Grandchild's unilateral right to withdraw up to one-half of the value of the Trust principal after reaching the age of 25 years but prior to reaching age 30 years; (4) grant Grandchild a testamentary general power of appointment to appoint up to one-half the value of Trust principal to the creditors of Grandchild's estate if Grandchild dies after reaching the age of 25 years but prior to reaching age 30 years; (5) remove Grandchild's unilateral right to withdraw up to the entire value of the Trust principal after reaching the age of 30 years; and (6) grant Grandchild a testamentary general power of appointment to appoint up to the entire value of the Trust principal after reaching the age of 30 years.

Specifically, Paragraph A of Article III of Reformed Trust provides:

The Trustee, at any time and from time to time, in the exercise of the Trustee's discretion, may pay or distribute to or for the benefit of [Grandchild], so much, if any, of the income, and so much, if any, of the principal of the trust as the Trustee deems necessary or advisable to provide for [Grandchild]'s proper health, education, maintenance and support. In addition, the Trustee (excluding, however, [Grandchild], if he is serving as a Trustee), at any time and from time to time, may pay or distribute to or for the benefit of [Grandchild] as much of the net income and/or principal of the trust as the Trustee, in the Trustee's sole and absolute discretion, deems advisable in [Grandchild]'s best interest.

Paragraph B of Article III of Reformed Trust provides:

Any undistributed income of the trust at the end of each calendar year shall be retained in a separate account together with the earnings thereon (such separate account and the earnings thereon shall hereafter be

referred to as the “Accumulated Net Income Account”). The Trustee shall retain the right to make distributions from the Accumulated Net Income Account to or for the benefit of [Grandchild] in such amounts, as the Trustee deems necessary or advisable, to provide for [Grandchild]’s proper health, education, maintenance and support. In addition, the Trustee (excluding, however, [Grandchild], if he is serving as a Trustee), at any time and from time to time, may make distributions from the Accumulated Net Income Account to or for the benefit of [Grandchild] in such amounts as the Trustee, in the Trustee’s sole and absolute discretion, deems advisable in [Grandchild]’s best interest. The Trustee is prohibited from commingling any of the assets in the Accumulated Net Income Account with any other Trust assets.

The petition also seeks to modify Child 3’s contingent remainder interest in Trust from being held in a trust under the same terms that would apply to Child 1, to being held in a separate special needs trust for Child 3’s primary benefit to allow Child 3 to qualify for government and private benefits.

Specifically, Article IV of Reformed Trust provides:

Subject to the restrictions in subsections 1 through 3 below, during the life of [Child 3], the Trustee may, at any time and from time to time, pay to, or apply for the benefit of [Child 3], so much, if any, of the income and principal of the trust as the Trustee, in the Trustee’s sole discretion, deems necessary to provide for those needs of [Child 3] that are not satisfied through any government or private program of financial entitlements, services, or other benefits. All distributions from the trust shall be paid directly to the provider of the services and not directly to [Child 3]. Any income not distributed shall be added to the principal of the trust. No part of the principal or undistributed income of the trust shall be considered available to [Child 3].

The petition also seeks to change the distribution of the Trust assets upon the death of Child 3 to provide that “the remaining undistributed income and principal of [the special needs trust for the benefit of Child 3] shall be distributed outright and free of trust to Foundation.”

The termination date under Paragraph E of Reformed Trust is the same as Trust and any remaining undistributed income and principal shall be distributed outright and free of trust to the primary beneficiary of such trust.

Statute 2 provides that upon the application of a trustee of the trust or any qualified beneficiary, a court at any time may modify the terms of a trust that is not then revocable if: (a) the purposes of the trust have been fulfilled or have become illegal,

impossible, wasteful, or impracticable to fulfill; (b) because of circumstances not anticipated by the settlor, compliance with the terms of the trust would defeat or substantially impair the accomplishment of a material purpose of the trust; or (c) a material purpose of the trust no longer exists, then, in modifying a trust under this section, a court may amend or change the terms of the trust, including terms governing distribution of the trust income or principal or terms governing administration of the trust.

Statute 3 provides that upon application of any interested person, to achieve the settlor's tax objectives the court may modify the terms of a trust in a manner that is not contrary to the settlor's probable intent. The court may provide that the modification has retroactive effect.

On Date 4, Court issued an order modifying the terms of Trust in accordance with the terms of Reformed Trust pursuant to State law, contingent upon the receipt of a favorable letter ruling from the Internal Revenue Service.

The Trustee requests the following rulings:

1. The modification of the terms of Trust will not cause Trust's inclusion ratio to change and will not adversely affect the exemption of Trust from GST tax.
2. The modification of the terms of Trust will not cause any beneficiary of Trust to have made a gift for gift tax purposes under § 2501.
3. The modification of the terms of Trust will not cause any beneficiary of Trust to recognize gain or loss from the sale or disposition of property under § 61 or 1001.

LAW AND ANALYSIS

Ruling 1

Section 2601 of the Internal Revenue Code imposes a tax on every generation-skipping transfer. The term "generation-skipping transfer" is defined in § 2611 as a taxable distribution, a taxable termination, and a direct skip.

Under § 1433(a) of the Tax Reform Act of 1986 (Act) and § 26.2601-1(a) of the Generation-Skipping Transfer Tax Regulations, the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i), the GST tax does not apply to a 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)(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 § 26.2601-1(b) will not cause the trust to lose its exempt status.

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 § 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 § 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. 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.

No guidance has been issued concerning the modification of a trust that may affect the status of a trust that is exempt from GST tax because sufficient GST exemption was allocated to the trust to result in an inclusion ratio of zero. At a minimum, a modification that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status of such a trust.

In this case, before the modification, Grandchild is entitled to a mandatory distribution of income beginning at age 21. As a result of the modification, Grandchild's income interest will be subject to a discretionary distribution of income standard. However, the Trustee will set aside in a separate account any income not distributed to Grandchild beginning at age 21 and distribute all assets remaining in such separate account to Grandchild's estate at the death of Grandchild. Thus, all of the income that Grandchild would have received after age 21 under the mandatory distribution standard will still be included in Grandchild's gross estate for estate tax purposes, and Grandchild will be treated as the transferor of that income for GST tax purposes upon his/her death.

Moreover, before the modification, Grandchild has the unrestricted right to withdraw up to one-half of the Trust assets after reaching age 25 and to withdraw the entire value of the Trust assets after reaching age 30. As a result of the modification, Grandchild will no longer have the right to withdraw the Trust assets, but Grandchild will have a testamentary general power of appointment over one-half of the value of the assets if Grandchild dies after reaching age 25 and over all of the Trust assets if Grandchild dies after reaching age 30. Thus, the new general powers of appointment will cause the value of the Trust assets (to the extent of one-half of the Trust assets if Grandchild dies after age 25 and all of the Trust assets if Grandchild dies after age 30)

to be included in Grandchild's gross estate, and Grandchild will be treated as the transferor of the Trust assets for GST tax purposes upon Grandchild's death.

Section 26.2601-1(b)(4)(i)(E), *Example 7*, considers the following fact pattern: In 1980, Grantor established an irrevocable trust for the benefit of Grantor's grandchildren, A, B, and C. The trust provides that income is to be paid to A, B, and C, in equal shares for life. The trust further provides that, upon the death of the first grandchild to die, one-third of the principal is to be distributed to that grandchild's issue, *per stirpes*. Upon the death of the second grandchild to die, one-half of the remaining trust principal is to be distributed to that grandchild's issue, *per stirpes*, and upon the death of the last grandchild to die, the remaining principal is to be distributed to that grandchild's issue, *per stirpes*. In 2002, A became disabled. Subsequently, the trustee, with the consent of B and C, petitioned the appropriate local court and the court approved a modification of the trust that increased A's share of trust income. The modification does not shift a beneficial interest to a lower generation beneficiary because the modification does not increase the amount of a GST under the original trust or create the possibility that new GSTs not contemplated in the original trust may be made. In this case, the modification will increase the amount payable to A who is a member of the same generation as B and C. 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 as modified will not be subject to the provisions of chapter 13. However, the modification increasing A's share of trust income is a transfer by B and C to A for federal gift tax purposes.

Before the modification, Child 3 has a contingent remainder interest in Trust. Thereafter, Trust will be modified so that Child 3 will continue to have a contingent remainder interest in Trust, which is to be held for Child 3 in a separate special needs trust for Child 3's benefit to allow Child 3 to continue to qualify for government and private benefits. Under the terms of the special needs trust, the Trustee may make distributions for the benefit of only Child 3. Upon Child 3's death, the remainder of Trust will be distributed to Foundation. As before the modification, Trust will terminate no later than Date 2.

The proposed modification of Trust will not result in a shift of any beneficial interest in the trusts to any beneficiary who occupies a generation lower than the persons holding the beneficial interests. Further, the proposed modification of Trust will not extend the time for vesting of any beneficial interest in the modified Trust beyond the period provided for in Trust. Accordingly, based on the facts submitted and the representations made, we conclude that the proposed modification of Trust will not cause Trust's inclusion ratio to change and will not adversely affect the exemption of Trust from GST tax.

Ruling 2

Section 2501(a)(1) imposes a tax for each calendar year on the transfer of property by gift during such calendar year by any individual.

Section 2511(a) provides that the gift tax applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2512(a) provides that if the gift is made in property, the value thereof at the date of the gift is considered the amount of the gift.

Section 2512(b) provides that where property is transferred for less than adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration is deemed to be a gift, and is included in computing the amount of gifts made during the calendar year.

In this case, the modification to Grandchild's income distribution provisions and withdrawal provisions do not change or transfer the interests of Grandchild or any other beneficiary of Trust, nor do they confer any new rights to any beneficiaries. Rather, the modifications result in the increased discretion of the Trustee over distributions to Grandchild. Grandchild retains the same interest in Trust and, in fact, could receive the same distributions that Grandchild could have received before the modifications were made under the Trustee's discretion under the original Trust.

Moreover, the modification to Child 3's contingent remainder does not change or transfer the interests of Child 3, nor do they confer any new rights to Child 3.

Accordingly, based on the facts submitted and the representations made, we conclude that the modification of Trust will not cause any beneficiary of Trust to have made a gift for gift tax purposes under § 2501.

Ruling 3

Section 61(a)(3) of the Internal Revenue Code provides that gross income includes gain derived from dealings in property.

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in § 1011 for determining gain, and the loss is the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized. Under § 1001(c), the entire amount of gain or loss must be recognized, except as otherwise provided.

In this case, the Trust modification will result in increased trustee discretion and will not confer new rights to the beneficiaries or result in any relative shifting of interests between beneficiaries. Accordingly, based on the facts submitted and the

representations made, we conclude that the proposed modification of Trust will not result in the realization of gain or loss under §§ 61 and 1001 to either Trust or any beneficiary.

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

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.

Sincerely,

Leslie H. Finlow

Leslie H. Finlow
Senior Technician Reviewer, Branch 4
Office of the Associate Chief Counsel
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Enclosures (2)

Copy for § 6110 purposes

Copy of letter