

Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:

, ID No.

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Refer Reply To:

CC:PSI:04 – PLR-103029-04

Date: APRIL 26, 2004

Legend

Testator =
W =
Child 1 =
Child 2 =
Trust =

Trust 1 =

Trust 2 =

Date 1 =
Date 2 =
Corporate Trustee =

Court =
x =

Dear :

This is in response to the December 30, 2003, letter submitted by your authorized representative on your behalf requesting a ruling on the generation-skipping transfer (GST) tax consequences of the modification of Trust 2.

The facts and representations submitted are summarized as follows: Testator died on Date 1, prior to September 26, 1985, survived by W, Child 1 and Child 2. Trust was created under Item VII of Testator's will. Under Paragraphs (A) and (B) of Item VII, during W's lifetime, Trust was to be held for the benefit of W and Testator's living descendants. On W's death, the trust property was to be divided into separate equal shares to provide one share for each then living child of Testator and one share for each then deceased child of Testator who died leaving a spouse and/or issue.

Under Item VII, Paragraph (D), a share created for a child living at W's death is to be held in further trust. Under Paragraph (D), subparagraphs 1 and 2, the income from the share is to be paid to or for the benefit of the child for life. The corporate trustee may also pay to or apply for the benefit of the child such sums of principal of the share as deemed necessary or desirable for medical care, comfortable maintenance and welfare, taking into consideration, to the extent the corporate trustee deems advisable any other income or resources of the child known to the corporate trustee. The terms of the trust provide that no individual trustee of the trust is to have any authority to make distributions under this provision. Under subparagraphs 3, 4, and 5, on the death of the child leaving issue, the trustee is to distribute outright to the child's issue per stirpes the undistributed balance of the share along with any accumulated but undistributed income. If the child leaves no issue but leaves a surviving spouse, the share will be retained in further trust with income payable for the spouse's benefit until the spouse's death or remarriage. On the spouse's death or remarriage, the principal is to pass for the benefit of Testator's other child.

Under Item XIV, Paragraphs 1 and 2, W and Corporate Trustee were designated as the co-trustees. If W ceased to act as trustee, Child 1 and Child 2 were to be the co-trustees along with Corporate Trustee.

Trust was established on Testator's death. W died on Date 2 and, pursuant to Item VII, Paragraph (B), on W's death, Trust was divided into equal shares; one such share, Trust 1, was created for Child 1, and one such share, Trust 2, was created for Child 2.

Corporate Trustee has petitioned Court to reform Trust 2. Pursuant to the proposed reformation, Item VII, Paragraph (D), subparagraph 1, will provide that the trustee will pay, distribute, or disburse, to or for the benefit of Child 2, for life, in each calendar year, an amount equal to x percent of the average fair market value of the child's share (Trust 2) as of the close of the last business day of the three previous calendar years, or the net income from the child's share for the calendar year, whichever is greater.

Under the proposed reformation, the corporate trustee will have the authority to petition the Court to change the x percent distribution rate, in appropriate circumstances. Any such change must be approved by Court. Further, no individual trustee shall have any authority to determine if the rate shall be changed.

Under Item VII, Paragraph (D), subparagraphs 2 and 3 of the proposed reformation, all computations of fair market value will include accounting income and principal, but no accruals are required. If Trust 2 includes assets for which there is not a ready market, the trustee will adopt a method of evaluation as the trustee deems reasonable in its discretion under the circumstances. The distribution amount is to be paid first from net accounting income, next from net realized short-term capital gains, then from net realized long-term capital gains and, as necessary, from principal.

In all other respects, the terms of the reformed Trust 2 will be identical to those of the original Trust 2.

You have asked us to rule that the proposed reformation of Trust 2 will not result in Trust 2 losing its grandfathered status for generation-skipping transfer tax purposes.

Section 2601 of the Internal Revenue Code imposes a tax on every generation-skipping transfer, which is defined under section 2611 as a taxable distribution, a taxable termination, or a direct skip.

Under section 1433 of the Tax Reform Act of 1986 (Act), the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under section 1433(b)(2)(A) of the Act and section 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the tax does not apply to a transfer under a trust that was irrevocable on September 25, 1985, except to the extent the transfer is made out of corpus added to the trust by an actual or constructive addition after September 25, 1985.

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 under section 26.2601-1(b) will not cause the trust to lose its exempt status. These rules are applicable only for purposes of determining whether an exempt trust retains exempt status for generation-skipping transfer tax purposes. The rules do not 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) provides that a modification will not cause an exempt trust to be subject to the GST tax 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. A modification of an exempt trust will result in a shift in a beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a generation-skipping transfer or the creation of a new generation-skipping transfer.

Section 26.2601-1(b)(4)(i)(E), Example 8, illustrates a situation where a trust that is otherwise exempt from the GST tax provides that trust income is payable to A for life and, upon A's death, the remainder is to pass to A's issue, per stirpes. In 2002, the appropriate local court approves a modification to the trust that converts A's income interest into the right to receive the greater of the entire income of the trust or a fixed percentage of the trust assets valued annually (unitrust interest) to be paid each year to A for life. The example concludes that the modification does not result in a shift in beneficial interest 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. Rather, the modification can only operate to increase the amount distributable to A and decrease 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 subject the trust to the provisions of chapter 13.

In this case, the modification of Trust 2 to provide for the distribution to Child 2 of the greater of the Trust 2 income for the calendar year or an amount equal to \underline{x} percent of the average fair market value of Trust 2 as of the close of the last business day of the three previous calendar years does not result in a shift of any beneficial interest in Trust 2 to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the modification. See section 26.2601-1(b)(4)(i)(E), Example 8. Further, the modification does not extend the time for vesting of any beneficial interest in Trust 2 beyond the period provided for in the original Trust.

Accordingly, based on the facts submitted and the representations made, the modification to Trust 2, as proposed, will not cause Trust 2 to lose its exempt status for GST tax purposes.

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. We are specifically not ruling on the gift tax and income tax consequences of the transaction.

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 your authorized representative

Sincerely,

George L. Masnik
Chief, Branch 4
Office of Associate Chief Counsel

(Passthroughs & Special Industries)

Enclosure

Copy for section 6110 purposes
Copy of this letter

cc: