

# Internal Revenue Service

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Person To Contact:

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Refer Reply To:

CC:PSI:B04 – PLR-120674-03

Date: MARCH 22, 2004

Re:

Legend:

Date 1	=
Date 2	=
Date 3	=
Grantor	=
Trust	=
Trust 1	=
Trust 2	=
Trust 3	=
A	=
Daughter	=
Grandchild 1	=
Grandchild 2	=
Grandchild 3	=
Foundation	=
State	=
State Statute 1	=
State Statute 2	=

Dear :

This is in response to your letter dated December 5, 2003, and prior submissions requesting rulings on the generation-skipping transfer tax effects of the proposed transaction. This letter responds to your request.

The facts and representations submitted are summarized as follows: On Date 1, Grantor established an irrevocable trust (Trust) for the benefit of Grantor's grandchildren. At the time of the creation of Trust, Daughter had one child, Grandchild 1. Subsequently, Daughter

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had two additional children, Grandchild 2 and Grandchild 3. The trust was to be divided into separate, equal trusts for each of Grantor's grandchildren. Subsequently, Trust was divided into three separate trusts, Trust 1 for the benefit of Grandchild 1, Trust 2 for the benefit of Grandchild 2, and Trust 3 for the benefit of Grandchild 3 (Grandchildren's Trusts).

Article I, paragraph 1.4 of Trust provides generally, that the trustee will distribute net income or accumulated income or corpus of each trust for the primary beneficiary's support, maintenance and comfort, in such amounts as the trustee in his sole discretion determines. The primary beneficiary is defined as the child of Daughter for whose benefit a separate trust is established.

Article 1, paragraph 1.5 provides generally, that upon the 25<sup>th</sup> birthday of each primary beneficiary, or upon the 5<sup>th</sup> anniversary date of the death of Daughter, whichever occurs later, the trustee will pay and distribute free and clear of trust an undivided one-third interest in the respective separate trust corpus.

Article 1, paragraph 1.6 provides that upon the death of a beneficiary the trustee will continue to hold all assets in trust for the lineal descendants of the primary beneficiary, brothers or sisters of the primary beneficiary, spouse of the primary beneficiary, Foundation, or other charitable corporations (but never for the estate or creditors of the primary beneficiary, or for the creditors of the estate of the primary beneficiary) in such amounts and interests as the primary beneficiary shall appoint by his last will and testament. The primary beneficiary may release the power during his lifetime as to part or all of the assets. In the absence of the exercise of the power of appointment, the trust assets will continue to be held in trust for the lineal descendants of the primary beneficiary then living; or, if none, for the primary beneficiary's brothers and sisters then living, in equal shares; or, if none, for the lineal descendants of A, per stirpes, or, if none, for Foundation, to be used solely in State X.

Article 1, paragraph 1.7 provides that the trustee will distribute accumulated income or corpus to the succeeding beneficiaries as set forth in paragraph 1.4.

Article 1, paragraph 1.8 provides that each separate trust will terminate twenty-one years after the death of all of Grantor's grandchildren living at the time of execution of Trust. Upon termination, the trustee will distribute the assets of each separate trust to the then beneficiary of the trust.

The initial trustee of Trusts was an individual trustee. The trust document does not specifically address the number of trustees, but implies that one single trustee will administer the Grandchildren's Trusts.

Following Trust's formation in Year 1, and prior to September 25, 1985, multiple persons transferred assets to Trust. Daughter died on Date 2, after September 25, 1985. Under Daughter's last will and testament, all of her property and estate was devised equally to each of the Grandchildren's Trusts.

Grandchild 1, as executor of Daughter's estate, filed a Form 706, United States Estate (and Generation-skipping Transfer) Tax Return. No Schedule R was filed and the executor did

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not allocate any generation-skipping transfer tax exemption to any transfer made at death. Daughter did not allocate any GST exemption to any transfers made during her lifetime.

The trustee proposes to petition the appropriate court to modify Trust. A certified public accountant will trace the origin of all transfers to Trust by various transferors. Each of the original separate Grandchildren's Trusts will be severed on a fractional basis. This fractional severance will be accomplished by using an "allocation fraction" as described in § 26.2601-1(b)(1)(iv) of the Generation-Skipping Transfer Tax Regulations. Pursuant to the proposed modification, each of the Grandchildren's Trusts would be divided into two trusts: a GST Non-Exempt Trust consisting of that fraction of each trust attributable to the post-September 25, 1985, additions to the trusts; and a GST Exempt Trust consisting of that fraction of each trust attributable to the pre-September 26, 1985, additions to the trusts. The severed trusts will be funded either: (1) with a pro-rata portion of each asset held by the original, undivided Grandchildren's Trusts; or (2) on a non pro-rata basis provided the funding is based the fair market value of assets on the date of funding. The severed trusts will have terms identical to the respective Grandchildren's Trust. However, each trust will provide that the extraordinary distribution of one-third of the trust assets made to the primary beneficiary after Date 3, will be made from the severed trusts on a non pro-rata basis, such that distributions may be made selectively first from the GST Non-Exempt Trusts rather than from the GST Exempt Trusts.

In addition, the trustee proposes to modify Trust so that the Advisory Board would have the power to name multiple trustees, in order for each of the separate trusts to be administered by a separate trustee.

You have requested the following rulings:

1. The division of the Grandchildren's Trusts will constitute a "qualified severance" under § 2642(a)(3) of the Internal Revenue Code.
2. Following the severance of each of the Grandchildren's Trusts into two trusts, the extraordinary distribution of one-third of the trust assets may be made to the primary beneficiary from the severed trusts on a non pro-rata basis, such that distributions may be made selectively first from the GST non-exempt trusts rather than from the GST exempt trusts.
3. Following the severance of each of the Grandchildren's Trusts into two trusts, all distributions that are permitted under the trust indenture may be made to the beneficiaries from the severed trusts on a non pro-rata basis, such that distributions may be made selectively first from the GST non-exempt trusts rather than from the GST exempt trusts.
4. A judicial modification of the Trust indenture that authorizes the Advisory Board to name multiple trustees, in order for each of the separate trusts to be administered by a separate trustee, will not cause the GST exempt trusts to become subject to chapter 13, as provided in § 26.2601-1(b)(4)(i)(D).

Section 2601 imposes a tax on every generation skipping transfer (GST) made by a "transferor" to a skip person.

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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 § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the tax does not apply to a transfer from a trust if the trust was irrevocable on September 25, 1985, and no addition (actual or constructive) was made to the trust after that date.

Section 26.2601-1(b)(1)(iv) provides that if an addition is made after September 25, 1985 to a trust which was irrevocable on September 25, 1985, a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the GST tax provisions. If an addition is made, the trust is thereafter deemed to consist of two portions, a portion not subject to the GST tax and a portion subject to the GST tax. The non-chapter 13 portion represents the value of all assets of the trust as it existed on September 25, 1985. The applicable fraction (as defined in section 2642(a)(2)) for the non-chapter 13 portion is deemed to be one and the inclusion ratio (as defined in section 2642(a)(1)) is zero. The chapter 13 portion of the trust represents the value of all additions to the trust made after September 25, 1985. The inclusion ratio of the chapter 13 portion is determined under § 2642.

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 1433(b)(2)(A) of the Tax Reform Act and § 26.2601-1(b)(1), (2) or (3) of the Generation-Skipping Transfer Tax Regulations 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 by judicial reformation, or non-judicial 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.

Under section 2602, the amount of the GST tax is determined by multiplying the taxable amount by the applicable rate. Under section 2641, the applicable rate is the maximum rate of tax on an estate tax transfer, multiplied by the "inclusion ratio." The inclusion ratio is defined in § 2642 as the excess of 1 over the applicable fraction for the trust from which the transfer is made or for the direct skip. The applicable fraction is a fraction in which the numerator is the GST exemption (allowable under § 2631) allocated to the trust or direct skip, and the denominator is the value of the property transferred to the trust or involved in the direct skip, reduced by any Federal estate tax or state death tax actually recovered from the trust and any charitable deduction allowed under § 2055 or § 2522 with respect to such property.

Under § 2631(a), for purposes of determining the inclusion ratio, in the case of estate's of decedents dying prior to December 31, 2003, every individual is allowed a GST exemption of \$ 1,000,000, adjusted for inflation as provided in § 2631(c), which may be allocated by the individual (or the individual's executor) to any property with respect to which the individual is the transferor for GST tax purposes.

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Section 2632(a) provides that any allocation by an individual of his or her GST tax exemption under § 2631(a) may be made at any time on or before the date prescribed for filing the estate tax return for such individual's estate regardless of whether such a return is required to be filed.

Section 2632(e) provides that any portion of an individual's GST exemption which has not been allocated within the time prescribed by § 2632(a) shall be deemed to be allocated: first, to property which is the subject of a direct skip occurring at such individual's death; and second, to trusts with respect to which such individual is the transferor and from which a taxable distribution or a taxable termination might occur at or after such individual's death.

Under § 2642(a)(3)(A), if a trust is severed in a qualified severance, the trusts resulting from such severance will be treated as separate trusts for purposes of generation-skipping transfer tax. Section 2642(a)(3)(B) provides that a "qualified severance" means the division of a single trust and the creation (by any means available under the governing instrument or local law) of two or more trusts if the single trust was divided on a fractional basis, and the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust. If a trust has an inclusion ratio of greater than zero and less than one, a severance is a qualified severance only if the single trust is divided into two trusts, one of which receives a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance. In such case, the trust receiving such fractional share will have an inclusion ratio of zero and the other trust will have an inclusion ratio of one. Under § 2642(a)(3)(C), a qualified severance may be made at any time.

Under section 2652(a)(1), for purposes of chapter 13, the term "transferor" means the decedent, in the case of any property subject to tax imposed by chapter 11 and, the donor, in the case of any property subject to tax imposed by chapter 12. Section 26.2652-1(a)(1) provides that the individual with respect to whom property was most recently subject to federal estate or gift tax is the transferor of that property for purposes of chapter 13.

Under section 26.2654-1(a)(2)(i), if there is more than one transferor with respect to a trust, the portions of the trust attributable to the different transferors are treated as separate trusts for purposes of chapter 13. Section 26.2654-1(a)(4)(i) provides that with respect to a portion of a trust treated as a separate trust under § 26.2654-1(a)(2), an individual's GST exemption is allocated to the separate trust.

State Statute 1 provides that the Trustee may, unless expressly prohibited by the terms of the instrument establishing the trust, divide a trust into two or more separate trusts without a judicial proceeding, if the trustee reasonably determines that the division of the trust could result in a significant decrease in current or future federal income, gift, estate, generation-skipping transfer taxes, or any other tax imposed on property. If the trustee divides the trust, the terms of the separate trusts must be identical to the terms of the original trust, but differing tax elections may be made for the separate trusts.

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State Statute 2 provides that upon the petition of a trustee or beneficiary, a court may order that the terms of the trust be modified, if, because of circumstances not known or anticipated by the settlor, compliance with the terms of the trust would defeat or substantially impair the accomplishment of the purposes of the trust.

In the instant case, each Grandchildren's Trust was irrevocable on September 25, 1985. However, under the terms of Daughter's will her residuary estate was distributed equally to each trust on her death after September 25, 1985, such that under §26.2601-1(b)(1)(iv) a pro rata portion of each Grandchildren's Trust is subject to the GST tax. Under § 26.2654-1(a)(2)(i), that portion of each Grandchildren's Trust attributable to Daughter's bequest is treated, for GST tax purposes, as a separate trust with respect to which Daughter is the transferor. Under § 26.2654-1(a)(4)(i), and § 2632(e), Daughter's available GST exemption was automatically allocated equally to each of these separate trusts, and the inclusion ratio for each separate trust is determined under § 2642.

Each Grandchildren's Trust will be severed into two trusts, a GST Exempt Trust and a GST Non-Exempt Trust. The trusts will be severed on a fractional basis determined in accordance with § 26.2601-1(b)(1)(iv). Each GST Exempt Trust and GST Non-Exempt Trust, will provide for the same succession of interests of beneficiaries as is provided prior to severance. Further, the severance of each trust, as proposed will not result in shifting a beneficial interest in the GST Exempt Trust and GST Non-Exempt Trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person who held the beneficial interest prior to the severance. Further, the proposed severance will not extend the time for vesting of any beneficial interest in the severed trusts beyond the period provided for in the original trust prior to severance.

In addition, the trustee will petition the court to permit the Advisory Board to appoint additional trustees, so that each individual trust may have a separate trustee. The modification is permitted under State law. Further, 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.

Accordingly, we rule as follows:

1. The division of each Grandchildren's Trust into a GST-Exempt Trust and a GST Non-Exempt Trust will not cause the GST-Exempt Trusts to become subject to chapter 13, as provided in § 26.2601-1(b)(4)(i)(D). Further, the severance constitutes a qualified severance for purposes of § 2642(a)(3). The inclusion ratio for each GST Non-Exempt Trust will be determined under § 2642 based on the value of the property transferred to each Grandchildren's Trust as of Date 2, and the amount of Daughter's GST exemption that was automatically allocated to the portion of each Grandchildren's Trust attributable to Daughter's bequest that is treated, for GST tax purposes, as a separate trust under § 26.2654-1(a)(2) (with respect to which Daughter is the transferor).

2. Following the severance of each of the Grandchildren's Trusts into two trusts, the extraordinary distribution of one-third of the trust assets may be made to the primary beneficiary

from the severed trusts on a non pro-rata basis, such that distributions may be made selectively first from the GST Non-Exempt Trusts rather than from the GST Exempt Trusts.

3. Following the severance of each of the Grandchildren's Trusts into two trusts, all distributions that are permitted under the trust indenture may be made to the beneficiaries from the severed trusts on a non pro-rata basis, such that distributions may be made selectively first from the GST Non-Exempt trusts rather than from the GST Exempt Trusts.

4. A judicial modification of the Trust indenture that authorizes the Advisory Board to name multiple trustees, in order for each of the separate trusts to be administered by a separate trustee, will not cause the GST Exempt Trusts to become subject to chapter 13, as provided in § 26.2601-1(b)(4)(i)(D).

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.

Except as specifically ruled herein, we express or imply no opinion on the federal tax consequences of the transaction under the cited provisions or under any other provisions of the Code.

These rulings are directed only to the taxpayers requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

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

Enclosures

Copy for section 6110 purposes

cc: