

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:B09-PLR-126410-02

Date:

September 11, 2002

LEGEND:

Father =

Mother =

Daughter =

Corporate
Trustee =

Trust B =

Mother's Trust =

Family Trust =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Dear :

This is in reference to your April 30, 2002 letter, and subsequent correspondence, requesting rulings regarding the effect for federal generation-skipping transfer tax purposes of the proposed exercise of testamentary limited powers of appointment.

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The facts and representations submitted are summarized as follows: Father died testate on Date 1, survived by Mother and their child, Daughter.

Trust B was created under Article Fifth of Father's will. Article Seventh, Section A of Father's will provided that during Mother's lifetime, the trustees shall pay to Mother or apply for her benefit all of the net income from Trust B annually, in quarterly or other convenient installments. Article Seventh, Section B provides that Corporate Trustee shall pay to Mother, in its sole discretion, such sums out of the principal of the trust as it deems advisable for the maintenance, care, and support of Mother and Father's issue, taking into account the then size of Trust B, the station in life to which Mother and the issue have become accustomed, their other assets, and probable future requirements.

Article Seventh, Section C provides that upon the death of Mother, Trust B shall continue for the benefit of Daughter. During Daughter's lifetime, the trustees shall pay to any of Father's issue whatever amount of the net income and principal of the trust as Corporate Trustee shall determine to be proper and necessary for the comfortable support, maintenance and education of the issue.

Article Seventh, Section C, Subsection 2 generally provides that Daughter shall have the right, effective upon the death of Mother, to appoint by her last will and testament the remainder of Trust B in such amounts and proportions, among Father's issue living at the time of the death of Mother and Daughter, provided that no appointment may be made to Daughter's estate, her creditors, or the creditors of her estate. Article Seventh (c)(2) also provides that the duration of any trust created by the exercise of the power may not extend beyond the life of the survivor of Father's issue who were living at the date of his death, together with surviving spouses of deceased issue who were living at the date of Father's death, plus a period of twenty-one years.

Article Tenth provides that no trust created shall continue for a period longer than the lives of all beneficiaries named who are living at the time of Father's death and twenty-one years after the survivor of them.

You represent that there have been no additions to Trust B after September 25, 1985.

On Date 2, Mother created Mother's Trust by a revocable agreement that became irrevocable when Mother died on Date 3. You represent that there have been no additions to Mother's Trust after September 25, 1985.

Article 2.1 of Mother's Trust provides that during Mother's life, Corporate Trustee shall pay Mother an amount equal to all income taxes payable by Mother in any year, and such additional amounts as may be necessary to provide for Mother's health, education, maintenance and support.

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Article 2.2(1) provides that upon the death of Mother, and during the life of Daughter, Corporate Trustee shall pay to or for the benefit of Daughter or her children and their descendants, such amounts as may be necessary in Corporate Trustee's sole discretion to provide for their health, education, maintenance, and support.

Article 2.2(2) provides that upon the death of Daughter, the principal and accumulated net income of Mother's Trust shall pass to such persons other than Daughter, her creditors, or creditors of her estate, in such amounts, proportions, and estates, outright or in trust, upon such terms, conditions and limitations as Daughter shall appoint by her will, referring specifically to the special power of appointment. The duration of any trust created by the exercise of this power of appointment may not extend for a period measured from the date of Mother's death, extending beyond any life in being on that date plus a period of twenty-one years.

Family Trust was created by Daughter on Date 4. At its creation, Daughter allocated an amount of her \$1,000,000 GST exemption sufficient to produce an inclusion ratio (as defined in § 2642(a) of the Code) equal to zero. You represent that there have been no additions to Family Trust since the date of its creation and initial funding.

Section Nine of Family Trust provides that the trust shall not be subject to alteration, amendment, or revocation.

Section One (a)(i) of Family Trust provides that Corporate Trustee shall pay to Daughter's children and their issue, or to any one or more of them, so much of the income only as Corporate Trustee in its sole discretion shall see fit.

Section One (b) provides that, upon the death of Daughter, Corporate Trustee shall divide the trust estate into equal trusts equal to the number of Daughter's then living children plus the number of Daughter's children who are not then living but who leave issue who are then living, and shall designate each such separate trust with the name of the children of Daughter.

Section One (c)(i) provides that in the event a trust holds shares of stock in an "S corporation," or in the event that the trustee deems it in the best interest of the trust to elect S corporation treatment with respect to any shares of corporate stock held or acquired by it, the trustee shall distribute the shares to a separate trust, and shall designate the trust with the name of the child of Daughter from whose separate trust the shares were distributed.

Section One (c)(i)(A) provides that Corporate Trustee shall pay to the child for whom the separate trust is named all of the income of that trust not less frequently than annually. In addition, Corporate Trustee shall pay or apply for the benefit of the child for whom the trust is named so much of the principal as Corporate Trustee in its sole

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discretion shall determine necessary or advisable for his or her care, support, education and maintenance in health and reasonable comfort.

Section One (c)(i)(B) provides that the child for which a trust is named shall have a limited power of appointment to appoint by their will, or by instrument signed by the child and filed with Corporate Trustee, the person or persons to whom and the proportions and manner in which any property remaining in the child's trust shall be distributed at the latter of Daughter's death and the child's death; provided, however, that the person or persons so designated shall be within a class which includes only the issue of Daughter and the spouse of Daughter's child, and excludes such child, their estate, their creditors, and the creditors of their estate. This limited power of appointment may not be exercised in a manner that postpones or suspends the vesting absolute ownership, or power of alienation in an interest in the trust estate for a period measured from the date of this agreement, extending beyond any life in being plus a period of twenty-one years. With respect to any assets of Trust B and Mother's Trust which may be held by Family Trust pursuant to Daughter's limited power of appointment over the property, the limited power of appointment may not be exercised in a manner that postpones or suspends the vesting, absolute ownership, or power of alienation in an interest in the trust estate for a period measured from the date of Father's or Mother's death, respectively, extending beyond any life in being plus a period of twenty-one years.

Section One (c)(ii) provides that after the allocation and distribution authorized by Section One (c)(i), the trustee shall administer each separate trust created under Section One (b) as follows: Section One (c)(ii)(A) provides that the trustee shall pay to the child of Daughter for whom the trust is named and to the issue of such child, so much of the income or principal as the trustee in its sole discretion shall determine necessary for their care, support, education and maintenance in health and reasonable comfort.

Under Section One (c)(ii)(C), there is conferred upon the child for whom a trust is named the power to appoint and designate by such child's will, or by instrument signed and filed with the trustee, the person or persons to whom and the proportions and manner in which property remaining in the child's trust shall be distributed at the latter of the death of Daughter and the child's death. The person or person so designated shall be within a class that includes the issue of Daughter and the spouse of the child for whom the trust is named, and excludes the child, the child's estate, the child's creditors, and the creditors of their estate. This limited power of appointment may not be exercised in a manner that postpones or suspends the vesting absolute ownership, or power of alienation in an interest in the trust estate for a period measured from the date of this agreement, extending beyond any life in being plus a period of twenty-one years. With respect to any assets of Trust B and Mother's Trust which may be held by Family Trust pursuant to Daughter's limited power of appointment over the property, the limited power of appointment may not be exercised in a manner that postpones or

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suspends the vesting, absolute ownership, or power of alienation in an interest in the trust estate for a period measured from the date of Father's or Mother's death, respectively, extending beyond any life in being plus a period of twenty-one years.

Section Five provides, in part, that separate trust shares shall be created to hold and separately identify and administer any assets received by Family Trust upon Daughter's testamentary exercise of the powers of appointment over Trust B and Mother's Trust.

Daughter intends to execute a codicil to her last will and testament in which she exercises her powers of appointment over Trust B and Mother's Trust so that each trust estate will continue to be held in trust after Daughter's death under the terms and conditions contained in Family Trust.

You have requested the following rulings:

1. Daughter's exercise of a testamentary limited power of appointment over the assets of Trust B in favor of Family Trust will not cause the assets of Trust B to lose their "grandfathered" status with regard to the generation-skipping transfer ("GST") tax under § 26.2601-1(b)(1)(i).
2. Daughter's exercise of a testamentary limited power of appointment over the assets of Mother's Trust in favor of Family Trust will not cause the assets of Mother's Trust to lose their "grandfathered" status with regard to the GST tax under § 26.2601-1(b)(1)(i).
3. The zero inclusion ratio for Family Trust as determined under § 2642(a)(1) will remain the same upon Daughter's exercise of the testamentary limited powers of appointment over Trust B and Mother's Trust in favor of Family Trust.

Section 2601 imposes a tax on every GST made after October 22, 1986.

A generation-skipping transfer is defined under § 2611(a) as (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip. Section 2612(a) provides that the term "taxable termination" means the termination (by death, lapse of time, release of a power, or otherwise) of an interest in property held in trust where the property passes to a skip person with respect to the transferor of the property.

Section 2612(b) provides that the term "taxable distribution" means any distribution from a trust to a skip person other than a taxable termination or a direct skip. Under § 2612(c)(1), a "direct skip" is a transfer subject to federal estate or gift tax made by a transferor to a skip person.

Section 1433(a) of the Tax Reform Act of 1986 (Act), provides that the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. Under § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the GST tax does not apply to any generation-skipping

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transfer under a trust that was irrevocable on September 25, 1985. However, this exemption does not apply to additions (actual or constructive) that are made to the trust after September 25, 1985.

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.

Section 2041(b)(1) defines "general power of appointment" as a power that is exercisable in favor of the decedent (the possessor of the power), his estate, his creditors, or the creditors of his estate. The definition of "general power of appointment" under § 2514(c), for federal gift tax purposes, is generally the same as provided in § 2041(b)(1). Section 2514(b) provides that the exercise or release of a general power of appointment created after October 21, 1942, is deemed a transfer of property by the individual possessing the power.

Section 26.2601-1(b)(1)(v)(A) provides that, except as provided in § 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 for estate or gift tax purposes, 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.

The testamentary powers of appointment held by Daughter are not general powers of appointment as defined in § 2041(b)(1) or § 2514(c) because Daughter could not exercise the powers in favor of herself, her estate, or the creditors of either.

Section 26.2601-1(b)(1)(v)(B) provides that the release, exercise, or lapse of a power of appointment (other than a general power of appointment) is not treated as an addition to a trust if (1) the power was created in an irrevocable trust that is not subject to the GST tax because it was irrevocable on September 25, 1985, and (2) in the case of an exercise, the power was not exercised in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period, measured from the date of creation of the trust, extending beyond any life in being at the date of creation of the trust plus a period of 21 years plus, if necessary, a reasonable period of gestation. If a power is exercised by creating another power, it is deemed to be exercised to whatever extent the second power may be exercised.

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Section 26.2601-1(b)(1)(v)(D), Example 4, discusses transfers made after September 25, 1985, pursuant to the exercise of a special power of appointment, from one irrevocable trust to another irrevocable trust where the first trust was in existence prior to September 25, 1985. Where the second trust was created after September 25, 1985, the exercise of the power does not subject future transfers from the second trust to tax under Chapter 13, if the exercise of the power in favor of the second trust does not suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period, measured from the date of creation of the first trust extending beyond any life in being at the date of creation of the first trust plus a period of 21 years.

Section 2631(a) provides that, for purposes of determining the portion of a generation-skipping transfer that is subject to the GST tax, every individual is allowed a GST exemption of \$1,000,000, which may be allocated by such individual (or his executor) to any property with respect to which the individual is the transferor. Section 2632(a) provides that any allocation by an individual of his or her GST exemption under § 2631(a) may be made at any time on or before the date for filing the individual's estate tax return.

Under § 2602(a), the amount of the GST tax with respect to a GST transfer is determined by multiplying the taxable amount by the "applicable rate".

Section 2641(a) defines the "applicable rate" of tax on a generation-skipping transfer to be the product of the maximum federal estate tax rate and the inclusion ratio with respect to the transfer.

Section 2642(a)(1) provides that the inclusion ratio with respect to a transfer is the excess, if any, of 1 over the applicable fraction determined for the trust from which the transfer is made or, in the case of a direct skip, the applicable fraction determined for the skip. Under § 2642(a)(2), the applicable fraction with respect to the trust, is a fraction in which the numerator is the amount of the GST tax exemption allocated to the trust or, in the case of a direct skip, allocated to the property transferred, and the denominator is the value of the property transferred to the trust or transferred in the direct skip, reduced by any federal estate tax or state death tax actually recovered from the trust attributable to the property and any charitable deduction allowed under §§ 2055 and 2522 with respect to the property.

Section 2642(d)(1) provides that if a transfer of property is made to a trust in existence before such transfer, the applicable fraction for such trust shall be recomputed as of the time of such transfer in the manner provided in § 2642(d)(2).

The proposed exercise by Daughter, which will be effective on Daughter's death, of the limited powers of appointment over Trust B and Mother's Trust in favor of Family Trust will not postpone or suspend the vesting, absolute ownership or power of

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alienation of any interest in the original trust property for a period, measured from the date of creation of the original trust, extending beyond any life in being at the date of creation of the original trust plus a period of 21 years. Nor may any testamentary limited power of appointment granted under the terms of Family Trust over the assets of Trust B and Mother's Trust be exercised in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of interests in the assets of Trust B and Mother's Trust, respectively, for periods measured from the respective deaths of Father and Mother extending beyond any life in being at that date plus a period of twenty-one years. Pursuant to § 26.2601-1(b)(1)(v)(B), the exercise of the powers of appointment by Daughter will not be treated as an addition, constructive or otherwise, to either trust.

You represent that the current inclusion ratio with respect to Family Trust is zero. Therefore, we conclude that the proposed transaction will not result in a change in the inclusion ratio of Family Trust and thus, immediately after the exercise of the testamentary limited powers of appointment in favor of Family Trust, Family Trust will have an inclusion ratio for GST tax purposes of zero.

Therefore, based on the facts submitted and the representations made:

1. Daughter's exercise of a testamentary limited power of appointment over the assets of Trust B in favor of Family Trust will not cause the assets of Trust B to lose their "grandfathered" status with regard to the GST tax under § 26.2601-1(b)(1)(i).
2. Daughter's exercise of a testamentary limited power of appointment over the assets of Mother's Trust in favor of Family Trust will not cause the assets of Mother's Trust to lose their "grandfathered" status with regard to the GST tax under § 26.2601-1(b)(1)(i).
3. The zero inclusion ratio for Family Trust as determined under § 2642(a)(1) will remain the same upon Daughter's exercise of the testamentary limited powers of appointment over Trust B and Mother's Trust in favor of Family Trust.

A copy of this letter should be attached to any gift, estate, or generation-skipping transfer tax returns that you may file relating to these matters.

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 the 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 above, no opinion is expressed as to the federal tax consequences of the facts described above under the cited provisions or any other provisions of the Code or regulations.

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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,

Melissa C. Liquerman

MELISSA C. LIQUERMAN
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Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures

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