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PLR-130683-04

Date:

September 29, 2005

In Re:

Legend:

Grantor	=
Trust	=
A	=
Date 1	=
Date 2	=
X	=
Y	=
Z	=

Dear :

This is in response to your letter dated September 16, 2005, and prior correspondence, requesting rulings on the generation-skipping transfer (GST) tax consequences of certain proposed judicial modifications to a trust.

The facts submitted and the representations made are as follows. On Date 1, Grantor created an irrevocable trust ("Trust") for the benefit of the children and grandchildren of 41 named members of the A family. Grantor is not related to the 41 A family members or their children and grandchildren. It has been represented that the children and grandchildren of the 41 A family members belong to a generation that is two or more generations below Grantor pursuant to the definitions set forth in § 2651(d) of the Internal Revenue Code.

Articles III and VII of the Trust provide that a separate trust is to be established for each child of the 41 members of the A family. Article III also names the children of each of the 41 designated members of the A family and provides that each child is to be the primary beneficiary of his or her trust.

Article III further provides that, upon the birth of a child or children to any of the 41 designated members of the A family, the child or children shall have an equal share with each of the other beneficiaries. Each trust in existence shall “open up” and a new trust shall be created by transferring a fraction of the corpus of each existing trust to a new trust for the benefit of each after-born child or children, and a trust corpus of equal size shall exist for each beneficiary.

Article IV provides that each trust established for a child of the 41 designated members shall have the same three trustees. The three trustees are selected by the “electors” as that term is defined in Article V. A trustee may be any person who is mentally competent and at least age 21.

Article V provides that the electors consist of: (1) certain individuals named in the Trust who are either members of the A family or associated with the family; (2) each of the 41 named members of the A family who has attained age 18; (3) the spouses of each of the 41 named members of the A family; and (4) the beneficiaries of any trust established who have attained age 18. This article further provides that the trustees are to be elected by a majority of the electors.

Article VI provides that the term of each of the trusts established under the Trust shall be 50 years after Date 1 (Date 2). Thereafter, any trust established under the Trust may be terminated by a vote of two-thirds or more of the electors. This article further provides that any trust established under the Trust must terminate 21 years after the death of the beneficiaries in being on Date 1. Upon termination, the corpus of each trust is to be distributed to the beneficiary of that trust or his or her legal representative, free of trust.

Article VII provides, in part, that the trust for each beneficiary shall be a separate trust as if each beneficiary had a separate trust operating under separate articles of trust and the account of each beneficiary shall be kept separately at all times. The trustees, however, may operate the trusts collectively as a single trust.

Article XI provides that the trustees shall not make any distribution of the corpus of the separate trusts to any beneficiaries during the term of the trusts, but they may, at their discretion, distribute annually, or at other intervals, all or any part of the net income on any number or all of the trusts. Where there is reasonable doubt as to what constitutes corpus or income, the decision of the trustees shall be final and conclusive.

Currently, there are X separate trusts. It has been represented that the trustees have been operating the X trusts as a single trust. It has also been represented that no additions have been made to any of the separate trusts either actual or constructive since September 25, 1985.

As a result of litigation among the parties associated with the Trust, the local court determined that, pursuant to state law, the Trust's terms should be modified. The proposed modifications are as follows.

First, the Trust will be modified to provide for the creation of a trust to hold the interests in any limited liability companies ("LLC Trust") that have been allocated to each of the X trusts. During the term of the LLC Trust, the trustees shall distribute to the beneficiaries annually, or at other more frequent intervals, all net income of the LLC Trust and its share of all net income of each limited liability company owned in whole or part by the LLC Trust. Any money distributed with respect to a person for whom a separate trust is held under the Trust shall be added to the trust. Where there is reasonable doubt as to what constitutes principal or income, the decision of the trustees shall be final and conclusive. In determining the amount of net income to be distributed, the trustees may in their discretion set aside a reserve to cover future contingencies. The amount set aside as a reserve in any one year shall not exceed 10 percent of the net income in that year, and the total cumulative amount of any reserved shall not exceed \$ Y.

The term of the LLC Trust shall be at least until Date 2. However, the trust may continue thereafter until terminated by a vote of two-thirds or more of the electors. In no event, however, shall the LLC Trust continue for a period longer than the lives of the beneficiaries of the Trust in existence on Date 1, plus 21 years. Upon termination, the trustees shall distribute the corpus of the LLC Trust to the beneficiaries, provided, however, that any corpus distributable with respect to a person for whom a separate trust is then held shall be added to such trust.

Second, the Trust will be modified to create a trust for contingent beneficiaries ("Contingent Beneficiary Trust"). Article III, subparagraph (b) of the Trust will provide that the Contingent Beneficiary Trust shall be funded with Z percent of the corpus of the X trusts (including the rights in the LLC Trust). Article III, subparagraph (b)(1) will provide that the purpose of the Contingent Beneficiary Trust is to facilitate the funding of trusts for children born to any of the 41 named members of the A family after the date the Trust is modified.

Article III, subparagraph (b)(2) will provide that upon birth of a child to any of the 41 named members of the A family after the modification of the Trust, one-third of the then existing trust corpus of the Contingent Beneficiary Trust shall be transferred to a new separate trust for the benefit of that child. Upon the birth of a second after-born child, one-half of the then existing trust corpus shall be transferred to a new separate trust for the benefit of that child. Upon the birth of a third after-born child, the then balance of the corpus of the Contingent Beneficiary Trust shall be transferred to a new separate trust for the benefit of that child, and the Contingent Beneficiary Trust shall terminate.

Article III, subparagraph (b)(3) will provide that, upon the birth of a fourth and any additional child born to any of the 41 named members of the A family after the date the modification becomes final, the child or children shall have an equal share with each of

the other children born after the modification becomes final. The trusts in existence for the existing children born to any of the 41 named members of the A family after the modification becomes final (and the portion of any other trust attributable to a deceased child that was born to any of the 41 named members of the A family) shall open up, and a new trust shall be created by transferring a fraction of the corpus of each existing trust for the after-born children to a new trust for the benefit of each additional after-born child. Regardless how many more than three children are born to the 41 named members of the A family after the modification becomes final, all of those after-born children will share among themselves only the Z percent of the corpus of the X trusts transferred to the Contingent Beneficiary Trust.

Subparagraph (b)(4) will provide that during the term of the Contingent Beneficiary Trust, the trustees shall distribute annually, or at other more frequent intervals, all net income of the trust to the primary beneficiaries and the issue of any deceased primary beneficiary. However, any money distributable to a person for whom a separate trust is held under the terms of the Trust shall be added to the trust.

Subparagraph (b)(5) will provide that unless terminated earlier, the Contingent Beneficiary Trust shall terminate on Date 2. In no event shall this trust continue for a period longer than the lives of the beneficiaries of the Trust in existence on Date 1, plus 21 years.

Subparagraph (b)(6) will provide that, unless earlier terminated, any trust created from the Contingent Beneficiary Trust pursuant to the terms of Article III subparagraph (b) for a child born to any of the 41 named members of the A family after the date that the modification of the Trust becomes final shall terminate on Date 2. However, in no event shall any trust continue for a period longer than the lives of the beneficiaries of the Trust in existence on Date 1, plus 21 years.

Third, Article III will be modified by adding subparagraph (c). Article III, subparagraph (c) will provide that if the beneficiary of one of the trusts created under the Trust dies before the termination of the trust, the trustees shall divide the balance of the trust corpus that existed for that deceased beneficiary (including but not limited to all accrued and undistributed income as well as all beneficial interests in the LLC Trust and the Contingent Beneficiary Trust) into separate shares for the benefit of such beneficiary's then living issue, if any, per stirpes. Each share shall constitute a separate trust. If the beneficiary of one of the trusts dies after the modification becomes final and before the termination of the trust, leaving no issue then living, the trustee shall distribute the balance of the corpus of the trust that existed for that deceased beneficiary, per stirpes, to the then living issue of such beneficiary's closest lineal ancestor who is either a member of the class of the 41 named members of the A family or issue of the class of the 41 named members of the A family as the case may be (whether or not such ancestor is then living). However, any part of the corpus otherwise distributable with respect to a person for whom a separate trust is held shall be added to the trust.

Fourth, Article III will be modified by adding subparagraph (c)(2). Article III, subparagraph (c)(2) will provide that the words “children born and to be born to” the 41 named members of the A family shall mean only the primary beneficiaries named in the trust instrument and any child born to any of the 41 named members of the A family after the modification becomes final, and shall not include any child adopted by any of the 41 named members of the A family. With respect to children of primary beneficiaries and their issue, however, the terms “issue” and “sibling” shall include all children adopted before the modification becomes final and any child adopted before reaching the age of 10 years.

Fifth, Article V will be modified by adding the following. The trustees for each separate trust serving at the time the modification becomes final shall continue to serve until the time as new trustees are elected.

After the date the modification becomes final, successor trustees of each separate trust shall be elected from time to time by the group of eligible electors defined in Article V. The trustees shall be elected by a majority vote of only those electors in the immediate family of the primary beneficiary or beneficiaries of each trust. For purposes of this paragraph, there are 41 separate families with 41 separate groups of electors. Each group of electors shall consist of the parent of the primary beneficiary, the parent's spouse, or surviving spouse, any such parent's living parent who is individually named as an elector in the Trust, and all issue of such parent who are beneficiaries of an individual trust and who have attained the age of 18 years. With respect to the LLC Trust and the Contingent Beneficiary Trust, the successor trustees shall continue to be elected by a majority of all electors.

If a majority of the electors of any separate trust vote to replace the then-serving trustees, the trustees shall deliver the corpus of such trusts and all relevant records to the newly elected trustees as quickly as possible, and in no event more than 60 days after receiving written notice of their replacement.

Article VI will be modified to exclude the Contingent Beneficiary Trust from the provisions of Article VI because this trust and any trusts created pursuant to this trust's terms will terminate on Date 2.

Article VII will be modified to provide that each separate trust can have different trustees, but that it is permissible for two or more of the separate trusts to have the same trustees.

Article XI will be modified to provide that the trustees shall not make any distribution of the corpus of the trust to any beneficiaries during the term of the trust. The trustees shall distribute to the beneficiaries of each separate trust annually or at more frequent intervals, all of the net income of the trust. Where there is reasonable doubt as to what constitutes corpus or income, the decision of the trustees shall be final and conclusive.

The following rulings have been requested:

- (1) The creation of the LLC Trust and the Contingent Beneficiary Trust will not result in the realization of gain or loss under §§ 61 and 1001.
- (2) All of the X trusts are exempt from the GST tax under § 2601 because they are irrevocable, they were created under an irrevocable trust instrument that was in existence on September 25, 1985, and there have been no additions, actual or constructive, to the Trust that would cause the trusts to lose their exemption.
- (3) The proposed modifications of the Trust to create the LLC Trust and the Contingent Beneficiary Trust will not affect their status as trusts that are exempt from the GST transfer tax under § 2601.
- (4) The proposed modification of the Trust to provide that the sibling or siblings (or their issue) of a deceased beneficiary of a separate trust who is not survived by issue will receive the corpus of that trust will not affect the status of the trusts as exempt from the GST transfer tax under § 2601.
- (5) The proposed modification of the Trust to provide that the definition of term “issue” includes certain adopted persons will not affect the status of the trusts as exempt from the GST transfer tax under § 2601.
- (6) The proposed modification to the Trust to change the means by which trustees are elected as the trustees of a separate trust and to provide certain administrative provisions will not affect the status of the trusts as exempt from the GST transfer tax under § 2601.

Law and Analysis – Ruling 1:

Section 61(a)(3) provides that gross income includes gains 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 therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss is the excess of the adjusted basis provided in § 1011 over the amount realized. Section 1001(c) provides that, except as otherwise provided, the entire amount of the gain or loss on the sale or exchange of property is recognized.

Section 1.1001-1(a) of the Income Tax Regulations provides, as a general rule, that except as otherwise provided in Subtitle A, the gain or loss realized from the conversion

of property into cash, or from the exchange of property for other property differing materially in either kind or in extent, is treated as income or as loss sustained.

For purposes of § 1001, in an exchange of property, each party to the exchange gives up a property interest in return for a new or additional property interest. Such an exchange of property is a disposition under § 1001(a). See § 1.1001-1.

Rev. Rul. 56-437, 1956-2 C.B. 507, holds that a partition of jointly owned property is not a sale or other disposition of property where the co-owners of the joint property sever their joint interests in order to extinguish their survivorship interests.

An exchange of property results in the realization of gain under § 1001 if the properties exchanged are materially different. Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991). A material difference exists when the exchanged properties embody legal entitlements “different in kind or extent” or if they confer “different rights and powers.” Id. at 565.

In this case, the LLC Trust and the Contingent Beneficiary Trust will be funded pro-rata out of each of the existing separate trusts. Accordingly, based on the information submitted and the representations made, we conclude that the proposed modifications dividing the existing separate trusts on a pro-rata basis creating the LLC Trust and the Contingent Beneficiary Trust will not cause the interests of the beneficiaries of the separate trusts to differ materially. The beneficiaries will hold essentially the same interests before and after the pro-rata division. Therefore, the proposed modifications of the existing separate trusts to include the LLC Trust and the Contingent Beneficiary Trust will not result in the realization of any gain or loss from a sale or other disposition of property under §§ 61 and 1001.

Law and Analysis – Ruling 2 – 6:

Section 2601 imposes a tax on every GST made after October 26, 1986. A GST 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 a 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.

Under § 1433(b)(2)(A) of the Tax Reform Act of 1986 and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the GST tax provisions do not apply to any GST under a trust (as defined in § 2652(b)) that was irrevocable on

September 25, 1985, but only to the extent that the 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)(1)(ii)(A) provides that any trust in existence on September 25, 1985, is considered an irrevocable trust except as provided in §§ 26.2601-1(b)(ii)(B) or (C), that relate to property includible in a grantor's gross estate under §§ 2038 and 2042.

Section 26.2601-1(b)(4)(i) provides that, in general, unless specifically provided otherwise, the rules contained in § 26.2601-1(b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for GST tax purposes. Thus (unless specifically noted), 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 gain for purposes of § 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 paragraph (b)(4)(i)(A), (B), or (C) of this section) 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.

Section 26.2601-1(b)(4)(i)(D)(2) provides that for purposes of this section, 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 generation-skipping transfer or the creation of a new generation-skipping 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 § 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. In addition, administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial

interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of § 1.643(b)-1.

Section 26.2601-1(b)(4)(i)(E), Example 5 provides as follows. In 1980, Grantor established an irrevocable trust for the benefit of his two children, A and B, and their issue. Under the terms of the trust, the trustee has the discretion to distribute income and principal to A, B, and their issue in such amounts as the trustee deems appropriate. On the death of the last to die of A and B, the trust principal is to be distributed to the living issue of A and B, per stirpes. In 2002, the appropriate local court approved the division of the trust into two equal trusts, one for the benefit of A and A's issue and one for the benefit of B and B's issue. The trust for A and A's issue provides that the trustee has the discretion to distribute trust income and principal to A and A's issue in such amounts as the trustee deems appropriate. On A's death, the trust principal is to be distributed equally to A's issue, per stirpes. If A dies with no living descendants, the principal will be added to the trust for B and B's issue. The trust for B and B's issue is identical (except for the beneficiaries), and terminates at B's death at which time the trust principal is to be distributed equally to B's issue, per stirpes. If B dies with no living descendants, principal will be added to the trust for A and A's issue. The division of the trust into two trusts does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the division. In addition, the division 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 two partitioned trusts resulting from the division will not be subject to the provisions of chapter 13.

Section 26.2601-1(b)(4)(i)(E), Example 7 provides as follows. 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 transfer under the original trust or create the possibility that new GST transfers 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.

Section 2651(d) provides that an individual who is not assigned to a generation by reason of § 2651(b) and (c) shall be assigned to a generation on the basis of the date of such individual's birth with -- (1) an individual born not more than 12½ years after the date of the birth of the transferor assigned to the transferor's generation, (2) an individual born more than 12½ years but not more than 37½ years after the date of the birth of the transferor assigned to the first generation younger than the transferor, and (3) similar rules for a new generation every 25 years.

Ruling 2:

In this case, each of the trusts operating under the Trust is a GST tax trust because distributions may be made to individuals who are two or more generations below the generation of the Grantor. In addition, each of the trusts established under the Trust is considered to have been irrevocable on September 25, 1985, because neither § 2038 nor § 2042 applies and it has been represented that there have been no additions, actual or constructive, to the separate trusts operating under the Trust after September 25, 1985. Accordingly, based upon the facts submitted and the representations made, we conclude that all of the trusts operating under the Trust are exempt from the GST tax under § 2601.

Ruling 3:

The creation of the LLC Trust and the Contingent Beneficiary Trust will not shift a beneficial interest in any trust operating under the Trust to a beneficiary who occupies a lower generation than the persons who held beneficial interests prior to the creation of these trusts. In addition, these trusts will terminate at the same time or earlier than the trusts that operate under the Trust will terminate. Therefore, the creation of these trusts will not extend the time for vesting of any beneficial interest beyond the period provided in the Trust. Accordingly, the modification of the Trust creating the LLC Trust and the Contingent Beneficiary Trust will not affect the status of any trust operating under the Trust as exempt from the GST tax under § 2601.

Ruling 4:

The modification of the Trust providing that the sibling or siblings (or their issue) of a deceased beneficiary of a trust who is not survived by issue will receive the corpus of that trust is similar to the modification described in § 26.2601-1(b)(4)(i)(E), Example 5. Therefore, this modification will not shift a beneficial interest in any trust operating under the Trust to a beneficiary who occupies a lower generation than the persons who held beneficial interests prior to the modification. In addition, this modification will not extend the time for vesting of any beneficial interest in the trusts operating under the Trust beyond the period provided in the Trust. Accordingly, this modification will not affect the

status of any of the trusts operating under the Trust as exempt from the GST tax under § 2601.

Ruling 5:

The modification to the Trust providing that the definition of term “issue” includes certain adopted persons will not shift a beneficial interest in any trust operating under the Trust to a beneficiary who occupies a lower generation than the persons who held beneficial interests prior to the modification. In addition, this modification will not extend the time for vesting of any beneficial interest in the trusts operating under the Trust beyond the period provided in the Trust. Accordingly, this modification will not affect the status of any of the trusts operating under the Trust as exempt from the GST tax under § 2601.

Ruling 6:

The Trust will be modified to provide a procedure by which different trustees for each separate trust operating under the Trust can be elected, and to specify certain administrative rights of the beneficiaries. Currently, all of the separate trusts have the same three trustees pursuant to Article IV. In connection with this modification, Article XI will be modified to provide that the trustees must distribute all of the separate trust's income to the trust's beneficiaries. Currently, this article provides that the trustees have the discretion to distribute the trust's income to the trust's beneficiaries.

The proposed modifications will not result in a shift of any beneficial interest in the Trust to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the proposed modifications. In addition, the proposed modifications will not extend the time for vesting of any beneficial interests in the Trust beyond the period provided for in the Trust.

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 whether the proposed modification to Article XI may result in a gift for gift tax purposes under § 2511. See § 26.2601-1(b)(4)(i)(E), Example 7.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) 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,

James F. Hogan
Senior Technician Reviewer, Branch 9
(Passthroughs & Special Industries)

Enclosures: Copy for § 6110 purposes