

Internal Revenue Service

Number: **200539024**

Release Date: 9/30/2005

Index Number: 2041.03-00, 2601.04-01,
1001.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

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Refer Reply To:
CC:PSI:B09
PLR-162695-04

Date:
June 09, 2005

LEGEND:

- Trust =

- Date 1 =
- Grantor =
- Bank =

- Son =
- Son's Spouse =
- Child 1 =
- Child 2 =
- Child 3 =
- Year 1 =
- Year 2 =
- Year 3 =
- Court =
- State =

Dear :

This is in response to your representative's letter of December 1, 2004, and supplemental correspondence, in which rulings are requested on the income, estate, and generation-skipping transfer (GST) tax consequences of a proposed modification of Trust.

FACTS

The facts, as represented, are as follows:

On Date 1, a date prior to September 25, 1985, Grantor established Trust, an irrevocable trust. Grantor transferred real property to Trust and appointed Bank and Son as trustees. It has been represented that there have been no actual or constructive additions to Trust for GST tax purposes after September 25, 1985.

Item II of Trust provides that the net income of Trust be paid quarterly to Son for the duration of his life, and upon his death, to Son's Spouse and to Son's children in equal amounts. Upon the death or remarriage of Son's Spouse, her interest shall fully cease, and the trustees are directed to pay to Son's children in equal amounts the net income for the duration of their lives. Upon the death of any child of Son, his or her share of the net income shall be paid by the trustees per stirpes to his or her child or children. Notwithstanding the foregoing, Trust shall fully terminate twenty-one years following the death of the last living child of Son living at the time of execution of the trust agreement.

Item XIII of Trust generally provides that if at any time any of the income beneficiaries should be in need of funds in excess of the net income derived from his or her respective share of the trust estate in order to provide for his or her reasonable care, maintenance, or education, or on account of any illness, infirmity, or other like emergency, then the trustees are authorized to make advances of principal for such purposes.

Item IX of Trust provides Son with the right to appoint by Will the successor individual trustee. If Son fails to name a successor individual trustee, then a court having jurisdiction shall appoint the successor individual trustee, upon the application of any beneficiary of Trust.

The trust instrument includes provisions limiting the sale or exchange of certain real property held by Trust.

The current income beneficiaries of Trust include Son's Spouse, Child 1, and Child 2, each having a 25 percent share of Trust's income, and the three children of Child 3 (deceased), sharing 25 percent of Trust's income.

Pursuant to Item IX of Trust, at Son's death in Year 1, he appointed Child 1 and Child 2 as successor individual trustees of Trust. In Year 2, Bank resigned as a trustee of Trust.

In Year 3, the trustees of Trust petitioned Court for an order to modify Trust. The trustees seek to modify Trust in order to: (1) sever Trust into four separate equal trusts, one for the benefit of Son's Spouse, one for the benefit of Child 1, one for the benefit of Child 2, and one for the benefit of the three children of Child 3; (2) allow the trustees to invest in assets other than the real property transferred to Trust; (3) allow each successor trustee to appoint his or her successor, and; (4) allow the trustees to

distribute principal to a beneficiary to provide for the support of such beneficiary in his or her accustomed manner of living.

The original terms of Trust will apply to each separate trust, with the following modifications.

Item II will be amended to provide that upon Son's death, the trustee shall divide the trust property into four equal shares and the trustee shall hold a resulting share for the benefit of Son's Spouse and each child of Son. Item II will be amended to further provide that upon the death or remarriage of Son's Spouse, her interest shall terminate and the trustee shall distribute the property of such trust to the separate trusts established for each of Son's children and the trustee is directed to pay to such beneficiary the net income, continuing the said payments during the respective lifetime of such descendant.

Item II will be amended to further provide that upon the death of any of Son's children, the trustee of such child's trust shall continue to hold and manage the property in trust and shall pay the net income of the trust to the child or children of such child, per stirpes, for the duration of their respective lifetimes or until the earlier termination of this trust. Item II will be amended to further provide that upon the death of any child of Son who is not survived by any descendants, his or her trust share shall be added, on a per stirpes basis, to the trust shares set apart for the remaining children of Son or their descendants.

Item XIII of Trust will be amended to provide that if at any time any of the income beneficiaries should be in need of funds in excess of the net income derived from his or her respective trust or share of such trust in order to provide for his or her support in his or her accustomed manner of living, then the trustee(s) are authorized to encroach on the principal of such separate trust of such beneficiary, in such amounts as the trustee(s) of such trust shall deem necessary in its judgment to provide for the support of such beneficiary in his or her accustomed manner of living.

Item IX of Trust will be amended to provide that each successor trustee may appoint his or her successor by a written instrument. Item IX will be further amended to provide that if a trustee fails or ceases to serve, the trustee appointed as described above will serve as successor trustee for that terminating trustee. Item IX will be further amended to provide that if a successor trustee is not appointed for the terminating trustee as described above within 15 days of such vacancy, the remaining co-trustee, if any, may continue to serve as the sole trustee. Further, if all of the persons named above and in the written appointments described above fail or cease to serve, and if there is a vacancy in the position of trustee, then the court having jurisdiction shall appoint the successor individual trustee, upon the application of any beneficiary of the trust created for such descendant.

Additional provisions of Trust will be amended to liberalize the requirements for selling or exchanging certain property of the trust.

The following rulings have been requested:

1. The proposed severance and modification of Trust and the previous resignation by Bank as trustee will not cause Trust or the successor trusts to lose their exempt status under § 1433(b)(2)(A) of the Tax Reform Act of 1986 and § 26.2601-1(b)(4)(i)(D) of the Generation-Skipping Transfer Tax Regulations, and will not subject distributions from any of the trusts to the GST tax.
2. The proposed severance and modification of Trust and the previous resignation by Bank as trustee will not cause the individual trustees to be treated as having a general power of appointment for purposes of § 2041.
3. The proposed severance of Trust into successor trusts will not result in the realization of income under § 61 and will not result in the realization of gain or loss under § 1001.

LAW AND ANALYSIS

Ruling 1

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

Under § 1433 of the Tax Reform Act of 1986 (the Act), 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) 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 GST tax under § 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 § 1001.

Section 26.2601-1(b)(4)(i)(D) provides that a modification of the governing instrument by judicial reformation, or nonjudicial reformation that is valid under applicable state law

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 § 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 GST or the creation of a new GST.

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.

In the present case, Trust was irrevocable on September 25, 1985. It is represented that no additions, actual or constructive, have been made to Trust after that date. Trust will be divided on a pro-rata basis into four successor trusts, and, except for the amendments to Item II, Item IX, Item XIII, and the provisions regarding the sale or exchange of certain real property of Trust, the successor trusts will have the same terms as Trust. The changes described in the amended Item II are similar to the changes described in § 26.2601-1(b)(4)(i)(E), Example 5. These changes, as well as the changes described in Item IX, Item XIII, and the provisions regarding the sale or exchange of certain real property of Trust will not result in a shift of any beneficial interest in Trust to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the proposed severance and modification of Trust and the proposed severance and modification of Trust will not extend the time for vesting of any beneficial interest in Trust beyond the period provided for in Trust. In addition, Bank's resignation as trustee in Year 2 did not result in a shift of a beneficial

interest in Trust to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the resignation and the resignation did not extend the time for vesting of any beneficial interest in Trust beyond the period provided for in the original Trust.

Accordingly, based on the facts submitted and the representations made, we conclude that the proposed severance and modification of Trust, and Bank's resignation as trustee, will not cause Trust or any successor trust created by the severance to lose its status under § 1433 of the Tax Reform Act of 1986 as a trust exempt from the application of the GST tax under chapter 13 of the Code.

Ruling 2

Section 2041(a)(2) provides that the value of the gross estate shall include the value of all property to the extent of any property with respect to which the decedent has at the time of death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition that is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under §§ 2035 to 2038, inclusive.

Section 2041(b)(1) provides, in part, that the term "general power of appointment" means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate.

Section 20.2041-1(b)(1) of the Estate Tax Regulations provides that the term "power of appointment" includes all powers that are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and regardless of local property law connotations. Section 20.2041-1(b)(1) also provides that the mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment.

Section 20.2041-1(c)(2) provides, in part, that a power to consume, invade, or appropriate income or corpus, or both, for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent is, by reason of § 2041(b)(1)(A), not a general power of appointment. A power is limited by such a standard if the extent of the holder's duty to exercise and not to exercise the power is reasonably measurable in terms of his needs for health, education, or support (or any combination of them). The words "support" and "maintenance," as used here, are synonymous and their meaning is not limited to the bare necessities of life. A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard. Examples of powers

which are limited by the requisite standard are powers exercisable for the holder's "support," "support in reasonable comfort," "maintenance in health and reasonable comfort," "support in his accustomed manner of living," "education, including college and professional education," "health," and "medical, dental, hospital and nursing expenses and expenses of invalidism." In determining whether a power is limited by an ascertainable standard, it is immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised.

While legal rights and interests in property (such as the creation and the breadth of a power to appropriate or consume the principal of a trust) is a matter of state law, it is Federal law that designates what rights or interests so created shall be taxed. See Morgan v. Commissioner, 309 U.S. 78, 80 (1940). Thus, whether a trustee's power to consume, invade, or appropriate the principal of Trust for his or her own benefit is limited by an ascertainable standard relating to health, education, support, or maintenance is a matter of state law.

A review of State law reveals no statutory or case law authority directly on point as to whether the invasionary power granted to the trustee is limited by an ascertainable standard. Thus, under Commissioner v. Bosch, 387 U.S. 456 (1967), we must forecast what the law of State is likely to be. Under Bosch, state law as announced by the highest court of the state is to be followed, but if there is no decision by the highest court, we must apply what we find to be the state law after giving "proper regard" to relevant rulings of other courts. Id. at 465.

In Budd v. Commissioner, 49 T.C. 468, 469 (1968), acq., 1973-2 C.B. 1, the trust instrument provided for distribution in the event of "sickness, accident, misfortune or other emergency." The Tax Court held that these conditions or circumstances under which the grantor, as trustee, could invade corpus of the trust for an income beneficiary reflected external standards to which a court of equity would give effect. Id. at 475. In Budd, use of the word "other" before the word "emergency" limited the meaning of the "emergency" to the type of emergencies itemized before the word "other."

In the present case, prior to Bank's resignation as trustee, Bank, Child 1, and Child 2 had the power as trustees to advance principal to a class of beneficiaries that included Child 1 and Child 2. This power was exercisable to provide for a beneficiary's reasonable care, maintenance, or education, or on account of any illness, infirmity, or other like emergency. The first half of this standard, "to provide for a beneficiary's reasonable care, maintenance, or education," is an ascertainable standard relating to health, education, support, or maintenance within the meaning of the Estate Tax Regulations. With regard to the second half of this standard which allows the trustee to advance principal "on account of any illness, infirmity, or other like emergency," we believe the highest court of State would find that a trustee's power to advance principal of Trust under Item XIII, prior to the modification, is limited by an ascertainable standard relating to health, education, support or maintenance. Budd, 49 T.C. at 475. Thus, prior to the modification of Trust, the trustees' power is considered limited by an

ascertainable standard relating to the health, education, support, or maintenance of the beneficiaries. The trustees' power to advance principal pursuant to Trust was unchanged by Bank's resignation as trustee. Accordingly, Bank's resignation as trustee will not cause Child 1 and Child 2 to be treated as having a general power of appointment over any portion of Trust for purposes of § 2041.

The proposed modification of Item XIII will provide a trustee with the power to distribute principal to a class of beneficiaries, which may include him or herself, but the power is only exercisable for a beneficiary's "support in his or her accustomed manner of living." A power to appoint to oneself to provide for support in one's accustomed manner of living is an example of a power limited by an ascertainable standard that is provided in § 20.2041-1(c)(2). Accordingly, after the proposed modification to Trust, a trustee's power to distribute principal to him or herself will be considered to be limited by an ascertainable standard, and the proposed severance and modification of Trust will not cause any individual trustee to be treated as having a general power of appointment over any portion of Trust for purposes of § 2041.

Ruling 3

Section 61(a)(3) provides that gross income includes gains derived from dealing in property. Under § 1001(a) 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), and the loss is the excess of the adjusted basis over the amount realized. Section 1.1001-1(a) of the Income Tax Regulations treats as income or as loss sustained the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent.

In Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991), the Supreme Court of the United States examined the issue of what constitutes a material difference in exchanged properties or a disposition of property for purposes of the realization requirement implicit in § 1001(a). In Cottage Savings, a savings and loan association sold 90-percent participation interests in 252 mortgage loans to four other lenders. Simultaneously, the association purchased 90-percent participation interests in 305 mortgage loans held by these lenders. The exchanged properties were derived from loans made to different obligors, secured by different homes, and thus embodied legally distinct entitlements. The association claimed a deduction under § 165(a) for the adjusted difference between the face value of the participation interests the association had traded and the fair market value of the participation interests it had received.

The Supreme Court said the test for determining whether exchanged properties are materially different for purposes of § 1001 is whether the respective possessors enjoy legal entitlements that are different in kind or extent. Cottage Savings, at 565. Because the mortgages had different mortgagors and were secured by different properties, the loans were materially different. The Court therefore held that the taxpayer actually sustained a loss for purposes of § 165(a).

In Rev. Rul. 69-486, 1969-2 C.B. 159, a trust instrument required the trustee to distribute the corpus of a trust, consisting of promissory notes and common stock, one-half to an individual and one-half to a tax exempt charitable organization. The beneficiaries, however, agreed that the individual should receive all of the notes and the charitable organization should receive all of the stock. Although the trustee complied with their request, neither the trust instrument nor local law allowed the trustee to make an allocation of specific property in kind. Thus, the beneficiaries were considered to have received a pro rata distribution of the notes and stock, followed by a deemed exchange between the beneficiaries of their respective shares of stock and notes. Rev. Rul. 69-486 therefore concluded that the individual recognized gain on the disposition of his shares of the common stock in an amount determined under § 1001.

A pro rata partition of jointly owned property is not a sale or other disposition of property if the co-owners of the joint property sever their joint interests but do not acquire a new or additional interest as a result thereof. Thus, neither gain nor loss is realized on a partition. Rev. Rul. 56-437, 1956-2 C.B. 507.

Under the proposed court order, the beneficiaries do not acquire their interests in each of the four successor trusts as a result of an exchange of their property interests in Trust, but rather by reason of the authority granted under state law; the trustees are exercising a right to divide Trust as allowed by state law, and by reason of their existing authority to distribute trust income or principal. Rev. Rul. 56-437. In contrast to the situation in Rev. Rul. 69-486, the division of Trust into four successor trusts will be pro rata and each of the successor trusts will receive an equal share of each asset of the Trust. The interest that each of the beneficiaries will have in the successor trusts is substantially the same as each currently has in Trust. Finally, the successor trusts will be subject to the same trust provisions applicable to Trust.

Accordingly, we conclude that the division of Trust into four successor trusts will not be considered to be a sale or other disposition of trust property, and thus will not cause any beneficiary, the trust, or any of the successor trusts to recognize any gain or loss from a sale or other disposition of the property under §§ 61 or 1001.

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,

Melissa C. Liquerman
Branch Chief, Branch 9
(Passthroughs & Special Industries)

cc: