Internal Revenue Service

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Department of the Treasury

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Person to Contact:

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Refer Reply To:
CC:PSI:4 - PLR-139354-01
Date: JULY 24, 2002

Re:

Legend:

Date 1 =
Settlor =
Trust =

Spouse =
State =
Individual =
Child 1 =
Child 2 =
Child 3 =
Child 4 =
X =
Y =
Child 1 Trust =
Grandchild 1 =
Grandchild 2 =
Grandchild 1 Trust =

Grandchild 2 Trust =

State 1 =
State 2 =

Dear :

This is in response to a letter dated July 24,2002, and prior correspondence, requesting rulings regarding the generation-skipping transfer tax consequences of a proposed exercise of a power of appointment over the assets of a trust.

Facts

The facts submitted and representations made are as follows. On Date 1, prior to September 25, 1985, Settlor created an irrevocable trust (Trust).

Under the terms of Trust, during the lifetime of Settlor's spouse (Spouse), the trustees may distribute any amounts of net income of the trust to any among Spouse, Settlor's lineal descendants, and the spouses of Settlor's lineal descendants as the Disinterested Trustee, in his sole discretion, deems necessary or appropriate for the care, support, maintenance, education, advancement in life and comfortable living of such persons. The trustees may also distribute to Settlor's lineal descendants any amounts of principal as the Disinterested Trustee, in his sole discretion, deems necessary or appropriate for the care, support, maintenance, education, advancement in life and comfortable living of such persons.

Spouse is granted a lifetime power to appoint the principal of Trust to any one or more of a group consisting of Settlor's lineal descendants and their spouses. Spouse is also granted a testamentary power to appoint the assets remaining in Trust at Spouse's death to any lineal descendants of Settlor, in any amounts, in trust or otherwise. Any assets of Trust not so appointed will be apportioned into separate shares among Settlor's then living lineal descendants, per stirpes. If all of the beneficiaries of Trust die before becoming entitled to outright distribution of Trust assets, upon the death of the survivor of those beneficiaries, the remaining assets of Trust will be distributed to Settlor's heirs under State law as if Settlor had then died intestate.

Trust provides that every power granted under the terms of Trust is intended to be a nongeneral power, exercisable only in favor of the objects specified and in no event exercisable in favor of the power holder, the power holder's creditors, the power holder's estate, or the creditors of the power holder's estate.

Trust will terminate 21 years less one day after the death of the survivor of Settlor and all of the beneficiaries of Trust living on the date Trust was executed.

Currently, Spouse is serving as the Interested Trustee and Individual is serving as the Disinterested Trustee. Trust must always have at least one Disinterested Trustee. A Disinterested Trustee must have no vested or contingent interest in Trust and cannot be benefitted by the exercise of the powers vested solely in the Disinterested Trustee. Further, the Disinterested Trustee must be able to possess the powers granted that trustee without causing Trust income or principal to be attributable to a trust beneficiary for federal income, gift, or estate tax purposes before such income or principal is distributed to such beneficiary.

Settlor has four living children, Child 1, Child 2, Child 3 and Child 4.

Spouse plans to exercise his inter vivos power of appointment by appointing all of the assets of Trust as follows. Spouse will appoint Y percent of the assets of Trust to a trust for the benefit of Grandchild 1 (the Grandchild 1 Trust), Y percent of the assets of Trust to a trust for the benefit of Grandchild 2 (the Grandchild 2 Trust), and X percent of the assets of Trust to a trust for the benefit of Child 3 (the Child 3 Trust).

The terms of the Grandchild 1 Trust and of the Grandchild 2 Trust are substantially identical. Under the terms of these trusts, any person may add property to the trust. Any part of the Grandchild 1 Trust and the Grandchild 2 Trust that is exempt from the generation-skipping transfer tax will be held for the benefit of the named grandchild in a separate trust known as a Generation-Skipping Exempt Trust (GSET). Any part of the trust estate that is not exempt from generation-skipping transfer tax will be held in another separate trust known as a Non-Exempt Trust (NET). No assets of a GSET will be combined with the assets of a trust that is not a GSET. The appointed assets will be transferred to the GSETs of the Grandchild 1 Trust and the Grandchild 2 Trust.

Under the terms of each GSET, the beneficiary will receive any amount of income and principal the trustee, in his discretion, deems necessary for the beneficiary's proper health, education, support and maintenance. The trustee will distribute to the named grandchild one-half of the principal of the GSET upon the grandchild's reaching age 30, one-half of the remaining principal upon grandchild's reaching age 40, and the balance of the principal upon the grandchild's reaching age 50.

If a beneficiary dies prior to the termination of the beneficiary's GSET, the trustee must divide the remaining assets among any of the beneficiary's descendants or any charitable organizations, as such beneficiary appoints. The beneficiary may not appoint all or any part of the GSET to the beneficiary, the beneficiary's creditors, the beneficiary's estate or the creditors of the beneficiary's estate. Any part of the GSET not appointed will be divided among, and held as GSETs for, the beneficiary's then living descendants, per stirpes, or if none, the GSET will be divided among the then living descendants of Child 1.

Notwithstanding any other provisions of the Grandchild 1 Trust and the Grandchild 2 Trust, these trusts must terminate 21 years less one day after the death of the last survivor of the beneficiaries of Trust who were living on Date 1. Upon the termination of such trusts, their remaining assets will be distributed to the then income beneficiaries in the proportions the beneficiaries were then entitled to receive income; or if rights to income are not then fixed, distribution of assets will be made to those authorized, in the trustee's discretion, to receive income. However, if no income beneficiaries are then living, the remaining trust assets will be distributed to the persons who would inherit the personal estate of Child 1 under the intestate laws of State 1.

As noted above, the Child 3 Trust will be funded with X percent of the assets appointed by Spouse from Trust. No assets may be added to the Child 3 Trust after Spouse appoints the property to the trust. During the life of Child 3, any amounts of income and principal of the Child 3 Trust may be distributed to any among Child 3, his spouse, his issue and the spouses of his issue, as the trustee in his discretion, deems necessary for their health, support, maintenance and education. In addition, the trustee must distribute any amounts of income and principal as Child 3 appoints, in trust or otherwise, to and among Child 3's spouse, his issue, the spouses of his issue, and charities selected by Child 3.

Upon the death of Child 3, the remaining assets of the trust will be distributed as Child 3 appoints, in trust or otherwise, to and among Child 3's spouse, his issue, the spouses of his issue, and charities selected by Child 3. If Child 3 is survived by his spouse or any issue, any unappointed part of the trust will be held in further trust under the terms of which any amounts of income and principal may be distributed to and among Child 3's spouse, his issue and the spouses of his issue, as the trustee in his discretion, deems necessary for their health, support, maintenance and education.

The Child 3 Trust will terminate at the death of the last survivor among Child 3, Child 3's spouse, and Child 3's issue. The remaining trust assets will be distributed to any charities designated by the majority of adult beneficiaries then authorized by the trustee to receive income distributions. Any part of the Child 3 Trust assets not so appointed will be distributed one-half to the heirs of Child 3 and one-half to the heirs of Child 3's spouse as though Child 3 and his spouse had then died.

Notwithstanding any other provisions in the Child 3 Trust, the trust must terminate 21 years less one day after the death of the last survivor among the beneficiaries of Trust living on Date 1. At that time, the trustee must divide the Child 3 Trust into as many equal shares as there are children of Child 3 then living and children of Child 3 then deceased leaving issue then living. The trustee must distribute one share to each then living child of Child 3 and one share to the then living issue of each deceased child of Child 3, by right of representation. If none of Child 3's issue are then living, the remaining trust assets will be distributed one-half to the heirs of Child 3 and one-half to the heirs of Child 3's spouse. The identity and shares of the heirs will be determined according to State 2 law relating to the succession of separate property not acquired from a predeceased spouse.

It is represented that there have been no additions (actual or constructive) to the Trust since September 25, 1985.

The trustees of Trust have requested the following rulings:

1. The exercise of the power of appointment by Spouse and the payment of Trust assets to the Child 3 Trust and the two GSETs of the Grandchild 1 Trust and Grandchild 2 Trust pursuant to the exercise of the power of appointment will not affect

the grandfathered status of Trust and will not cause constructive additions to be deemed to have occurred for purposes of the generation-skipping transfer tax.

2. The Child 3 Trust and the two GSETs created upon the exercise of the power of appointment by Spouse will be exempt from generation-skipping transfer tax by reason of the effective date rules applicable to irrevocable trusts created before September 25, 1985.

Law

Section 2501(a) of the Internal Revenue Code provides that a gift tax is imposed on the transfer of property by gift. Section 2511(a) provides that the gift tax imposed by § 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Under § 2514(b), 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 such power. Under § 2514(c), the term "general power of appointment" means a power which is exercisable in favor of the individual possessing the power ("the possessor"), his estate, his creditors, or the creditors of his estate. A power of appointment is not a general power if by its terms it is either (a) exercisable only in favor of one or more designated persons or classes other than the possessor or his creditors, or the possessor's estate or the creditors of his estate, or (b) expressly not exercisable in favor of the possessor or his creditors, or the possessor's estate, or the creditors of his estate. Section 25.2514-1(c)(1) of the Gift Tax Regulations.

Section 25.2514-1(b)(2) states that the power of the owner of a property interest already possessed by him to dispose of his interest, and nothing more, is not a power of appointment, and the interest is includible in the amount of his gifts to the extent it would be includible under § 2511 or other Code provisions. For example, if a trust created by S provides for payment of the income to A for life with power in A to appoint the entire trust property by deed during her lifetime to a class consisting of her children, and a further power to dispose of the entire corpus by will to anyone, including her estate, and A exercises the inter vivos power in favor of her children, she has necessarily made a transfer of her income interest which constitutes a taxable gift under section 2511(a), without regard to section 2514. This transfer also results in a relinquishment of her general power to appoint by will, which constitutes a transfer under section 2514 if the power was created after October 21, 1942. See also, Estate of Regester v. Commissioner, 83 T.C. 1 (1984) (holding that a decedent made a taxable gift of her life interest in the income of a trust when she transferred the corpus of the trust through the exercise of a special power of appointment).

Section 25.2514-1(d) states that whether a power of appointment is in fact exercised may depend upon local law. However, regardless of local law, a power of appointment is considered as exercised for purposes of § 2514 if a person holds a

presently exercisable general power of appointment and a presently exercisable nongeneral power of appointment over the same property, the exercise of the nongeneral power is considered the exercise of the general power only to the extent that immediately after the exercise of the nongeneral power the amount of money or property subject to being transferred by the exercise of the general power is decreased.

In Rev. Rul. 79-327, 1979-2 C.B. 342, the Service held that an individual's exercise of a special power to appoint the underlying property in a trust resulted in a gift of the income interest under § 2511, because the individual also possessed an income interest in the property subject to the power. The income interest and special power to appoint the underlying property to other persons are separate rights that may be possessed by an individual. The individual by exercising the power also relinquished the income interest. The ruling also states that, to the extent it is contrary to the regulations, the Service will not follow Self v. United States, 142 F. Supp. 939 (Ct. Cl. 1956), where the court reached a contrary conclusion regarding the gift of a life interest upon the exercise of a special power of appointment.

Section 2601 imposes a tax on each generation-skipping transfer (GST). A generation-skipping transfer includes (a) a taxable distribution, (b) a taxable termination, and (c) a direct skip.

Section 2612(c)(1) provides that the term "direct skip" means a transfer subject to a tax imposed by chapter 11 or 12 of an interest in property to a skip person. Section 2612(c)(2) provides that solely for purposes of determining whether any transfer to a trust is a direct skip, the rules of section 2651(f)(2) shall not apply.

Section 2613(a)(2) provides that for purposes of chapter 13, the term "skip person" means a trust if all interests in such trust are held by skip persons, or if there is no person holding an interest in such trust, and at no time after such transfer may a distribution (including distributions on termination) be made from such trust to a non-skip person.

Section 2632(b)(1) provides that if any individual makes a direct skip during his lifetime, any unused portion of such individual's GST exemption shall be allocated to the property transferred to the extent necessary to make the inclusion ratio for such property zero.

Section 2632(b)(3) provides that an individual may elect to have § 2632(b)(1) not apply to a transfer.

Section 2632(c)(1) provides that if any individual makes an indirect skip during such individual's lifetime, any unused portion of such individual's GST exemption will be allocated to the property transferred to the extent necessary to make the inclusion ratio for such property zero. The term "indirect skip" means any transfer of property (other than a direct skip) subject to gift tax that is made to a GST trust. Section 2632(c)(3)(A).

In general, a GST trust is a trust that could have a generation-skipping transfer with respect to the transferor. Section 2632(c)(3)(B).

Section 2632(c)(5) provides that an individual may elect to have § 2632(c)(1) not apply to an indirect skip, or any or all transfers made by such individual to a particular trust.

Under § 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, donor, in the case of any property subject to tax imposed by chapter 12. 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. Section 26.2652-1(a)(1) of the Generation-Skipping Transfer Tax Regulations. Thus, an individual may be a transferor even though there is no transfer of property under local law at the time the federal estate or gift tax applies. Section 26.2652-1(a)(2) states that for purposes of chapter 13, a transfer is subject to federal gift tax if a gift tax is imposed under § 2501(a) (without regard to exemptions, exclusions, deductions, and credits).

Under § 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.

Under § 1433(a) of the Tax Reform Act of 1986 (Act), the GST tax is generally applicable to any generation-skipping transfer made after October 22, 1986. However, under § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i), the GST tax does not apply to any generation-skipping transfer under a trust that was irrevocable on September 25, 1985, and no addition (actual or constructive) was made to the trust after that date. Under § 26.2601-1(b)(1)(ii), any trust in existence on September 25, 1985, will be considered an irrevocable trust unless the settlor had a power that would have caused inclusion of the trust in his gross estate under § 2038 or 2042 if the settlor had died on September 25, 1985.

Section 26.2601-1(b)(1)(iv)(A) provides that, if an addition is made after September 25, 1985, to an irrevocable trust which is excluded from chapter 13 by reason of § 26.2601-1(b)(1), a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the provisions of chapter 13. If an addition is made, the trust is thereafter deemed to consist of two portions, a portion not subject to chapter 13 (the non-chapter 13 portion) and a portion subject to chapter 13 (the chapter 13 portion), each with a separate inclusion ratio (as defined in § 2642(a)). The non-chapter 13 portion represents the value of the assets of the trust as it existed on September 25, 1985. The applicable fraction for the non-chapter 13 portion is deemed to be 1 and the inclusion ratio for such portion is zero. The chapter 13 portion represents the value of all additions made to the trust after September 25, 1985. The inclusion ratio for the chapter 13 portion is determined under § 2642. Separate portions of one trust are so required only for purposes of determining

inclusion ratios. For purposes of chapter 13, a constructive addition under § 26.2601-1(b)(1)(v) is treated as an addition.

Section 26.2601-1(b)(1)(v)(A) provides that, except as provided under § 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 under chapter 11 or chapter 12, 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 creator of the power will be considered the transferor of the addition except to the extent that the release, exercise, or lapse of the power is treated as a taxable transfer under chapter 11 or chapter 12.

Section 26.2601-1(b)(1)(v)(B) provides a special rule for certain powers of appointment. This section provides that the release, exercise, or lapse of a power of appointment (other than a general power of appointment as defined in § 2041(b)) will not be treated as an addition to a trust if -- (1) such power of appointment was created in an irrevocable trust that is not subject to chapter 13 under § 26.2601-1(b)(1), and (2) in the case of an exercise, such power of appointment is 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. If a power is exercised by creating another power, it is deemed to be exercised to whatever extent the second power may be exercised.

In the instant case, Spouse has interests in Trust income and principal as well as an inter vivos power to appoint Trust property to Settlor's lineal descendants and their spouses and a testamentary power to appoint Trust property to Settlor's lineal descendants. Spouse may not exercise the inter vivos or testamentary power in favor of himself, his estate, his creditors, or the creditors of his estate. Thus, under § 2514(c), and § 25.2514-1(c)(1), and for purposes of § 26.2601-1(b)(1)(v)(A) and (B), Spouse's inter vivos and testamentary powers to appoint Trust property to others are not general powers of appointment.

Spouse proposes to exercise his inter vivos special power of appointment to appoint all the principal of Trust to three new trusts, i.e., the Child 3 Trust, the Grandchild 1 Trust, and the Grandchild 2 Trust. As a result of this proposed exercise of Spouse's inter vivos special power of appointment over the Trust principal, Spouse will release his testamentary special power to appoint the Trust principal. See § 25.2514-1(d).

Each of the new trusts provides that any trust created under its terms and any trust created pursuant to a power of appointment granted under its terms must terminate 21 years less one day after the death of the last survivor of all of the

beneficiaries of Trust living on the date Trust was executed. Trust must terminate 21 years less one day after the death of the last survivor of Settlor and all of the beneficiaries of Trust living on the date Trust was executed. Thus, neither Spouse's exercise of his inter vivos power nor the resultant release of his testamentary power will be constructive additions to Trust under § 26.2601-1(b)(1)(v)(A), because, for purposes of § 26.2601-1(b)(1)(v)(B), the exercise and release will be the exercise and release of nongeneral powers of appointment that will not 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. See Example 4 of § 26.2601-1(b)(1)(v)(D). The portion of the principal of each trust appointed by Spouse will comprise the non-chapter 13 portion of each trust.

Pursuant to Trust, Spouse also has interests in the income and principal of Trust. Trust provides that the Disinterested Trustee, in his sole discretion, may distribute to Spouse income and/or principal as the Disinterested Trustee deems necessary or appropriate for the care, support, maintenance, education, advancement of life and comfortable living of Spouse. As a result of Spouse's exercise of his inter vivos special power appointing the Trust corpus to the Child 3 Trust, Grandchild 1 Trust, and Grandchild 2 Trust, Spouse will relinquish his income and corpus interests in Trust. Although Spouse's rights to receive income and principal distributions from Trust are subject to the sole discretion of the Disinterested Trustee, the relinquishment of these interests will be a taxable gift under § 2511(a). See Estate of Regester, supra and Rev. Rul. 79-327, supra. The value of the gift is a question of fact and the Service does not rule on such factual determinations. See Rev. Proc. 2002-1, 2002-1 I.R.B. 1, 20, and Rev. Rul. 75-550, 1975-2 C.B. 357 (illustrating the correct method of computing the value of a decedent's interest in a residuary trust subject to the discretionary power of the trustee to invade corpus for the benefit of others).

Further, because Spouse will have made a taxable gift of his income and principal interests to the three trusts, Spouse will be considered the transferor of the value of the taxable gift for purposes of chapter 13. The beneficiaries of the Grandchild 1 Trust and Grandchild 2 Trust include Spouse's grandchildren, descendants of the grandchildren or charitable organizations. Therefore, the trust is a skip person. Accordingly, the transfer is a direct skip for purposes of chapter 13. Spouse's GST exemption will be deemed allocated to the property transferred by him to the two trusts, unless Spouse elects not to have § 2632(b) apply. The beneficiaries of the Child 3 Trust include Spouse's child, Child 3, Child 3's spouse, Child 3's issue, spouses of Child 3's issue, and descendants of Child 3. The trust could have a generation-skipping transfer with respect to the transferor, Spouse, and the trust does not come within any exceptions contained in § 2632(c)(3)(B)(i). Therefore, the Child 3 Trust is a GST trust. Accordingly, the transfer is an indirect skip for purposes of chapter 13. Spouse's GST exemption is deemed allocated to the property transferred by Spouse to the Child 3 Trust, unless Spouse elects not to have § 2632(c) apply. Each portion of the three trusts of which Spouse is the transferor will comprise the chapter 13 portion of each

trust. The non-chapter 13 portions and the chapter 13 portions of each trust are treated as separate trusts for purposes of chapter 13. Section 26.2654-1(a)(2)(i).

Accordingly, based upon the facts submitted and representations made, we rule as follows: The proposed exercise of the power of appointment by Spouse and the resulting transfer of the appointed assets of Trust to the two GSETs and the Child 3 Trust will not constitute constructive additions to the Trust under § 26.2601-1(b)(1)(v). The proposed exercise of the power of appointment by Spouse will result in a taxable gift of Spouse's income and principal interests under § 2511. For purposes of chapter 13, Spouse will be the transferor of the gifted property transferred by Spouse to the Child 3 Trust and the two GSETs. The gifted property in each trust will comprise the chapter 13 portion of the trusts. The balance of the corpus of each trust will constitute the non-chapter 13 portion of each trust. Spouse's GST exemption will be deemed allocated to the chapter 13 portions of each trust, unless Spouse elects not to have § 2632(b) and (c) apply. The chapter 13 portion of each trust will have an inclusion ratio determined under § 2642. The non-chapter 13 portions of each trust will be exempt from GST tax under § 26.2601-1(b)(i).

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

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,

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Lorraine E. Gardner
Assistant to the Branch Chief, Branch 4
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure
Copy for section 6110 purposes
cc: