Internal Revenue Service Department of the Treasury

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Contact Person

Number: **199909016**
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Telephone Number

In Reference to:
CC:DOM:P&SI:4/PLR-119040-97
Date:November 30, 1998

Re:

LEGEND:

Settlor =

Spouse =

Trust =

Bank =
Corporate Trustee =
First Individual Trustee =
Second Individual Trustee =
Policy X =

State =
Statute =

This is in response to your memorandum of July 27, 1998, and prior correspondence submitted on behalf of Trust, in which you request rulings on the application of the gift, estate, and generation-skipping transfer tax to certain powers created under

Trust.

Facts:

The facts, as represented, are as follows:

On date 1, Settlor, while a domiciliary of State, created an irrevocable trust (Trust) to hold insurance policies on his life. At its creation, Trust was funded with $a. At the time Trust was created, the children of Settlor and his wife (Spouse) had reached the age of majority under State law. Settlor designated Trust as beneficiary of an insurance policy on his life (Policy X), which he owned when Trust was created and which he continued to own until his death. Settlor died on date 2, and the proceeds of Policy X were distributed to Trust. The proceeds of Policy X were included in Settlor's gross estate. No estate tax marital deduction was claimed for the Trust assets.

Article Third of Trust provides that upon Settlor's death the trustees shall pay, in their discretion and for any purpose, all or any part of the net income and principal to any one or more of a class of persons consisting of Spouse, the children of Settlor and Spouse, and the issue of Settlor and Spouse, giving primary consideration to Spouse's welfare during her life.

Article Third provides Spouse with a noncumulative power to withdraw in any calendar year the greater of $5,000 or 5 percent of the aggregate value of the principal of Trust (a 5 x 5 power). To the extent the power is not exercised in any given year, it will lapse. On three occasions following Settlor's death, Spouse exercised this power.

Article Third also provides Spouse with an intervivos special power to appoint, at any time, part or all of the principal of Trust to any one or more of Settlor and Spouse's children and issue. Spouse exercised this power on two occasions following Settlor's death: once giving $b to an adult child and once giving $b to another adult child.

Article Third further provides Spouse with a testamentary special power to appoint Trust assets at her death to and among a class of persons consisting of Settlor and Spouse's issue and their spouses. Under Article Third, if Spouse does not fully dispose of Trust property through the exercise of her powers of appointment, Trust will continue for the benefit of Settlor and Spouse's children and their issue, and will ultimately be divided into shares. Income will be distributable as necessary or desirable for the health, maintenance and education of the

beneficiaries. The principal will be distributed when certain of the beneficiaries attain specified ages.

Under Article Fourth of Trust, Spouse has a power to remove any trustee and appoint a successor trustee. In addition, if there is a vacancy in the office of trustee for any reason, Spouse may appoint anyone as successor trustee, including herself. If Spouse is not of full legal capacity, the power to remove and replace the trustees is exercisable by the adult beneficiaries then entitled to receive Trust income. These beneficiaries may appoint themselves as successor trustees.

Settlor designated Bank and First Individual Trustee as the original trustees. Corporate Trustee, the successor in interest to Bank, is still serving as a trustee. First Individual Trustee voluntarily resigned on date 3. Spouse appointed Second Individual Trustee, Spouse's niece by marriage, as his replacement.

Requested rulings:

You have asked us to rule:

(1) that the principles of Rev. Proc. 94-44, 1994-2 C.B. 683, apply to Trust and its trustees and beneficiaries;

(2) that there is not taxable gift by Spouse or by any other Trust beneficiary by virtue of 1) Spouse's appointment of Second Individual Trustee as a successor to First Individual Trustee; 2) the enactment of the 1996 amendment to State Statute; 3) the existence or exercise (past, present, or future) of Spouse's power to remove and/or replace trustees (including the power to appoint herself as trustee); 4) Spouse's intervivos special power to direct distributions to or for her issue; or 5) Spouse's power to withdraw the greater of $5,000 or 5 percent of the aggregate value of trust principal in each calendar year;

(3) that none of the factors listed in ruling request 2 will cause any part of the value of any Trust property to be included in the gross estate of Spouse or any other Trust beneficiary under §§ 2036, 2038, or 2041;

(4) that none of the factors listed in ruling request 2 will cause the Trust or any transfers from it to be subject to the generation-skipping transfer tax; and

(5) that none of the factors listed in ruling request 2 will cause Rev. Rul. 79-353, 1979-2 C.B. 325, or its principles, to be applicable to Trust.

Law and analysis:

Ruling 1

Rev. Proc. 94-44, 1994-2 C.B. 683, provides guidance concerning certain effects on trusts, for federal estate and gift tax purposes, of the enactment of Florida Statutes Annotated (F.S.A.) § 737.402(4), which was effective July 1, 1991. Under the statute, any fiduciary power conferred upon a trustee to make discretionary distributions of either principal or income to or for the trustee's own benefit cannot be exercised by the trustee, except to provide for that trustee's health, education, maintenance, or support, as described under §§ 2041 and 2514 of the Internal Revenue Code. The Florida statute contains prohibitions with respect to the exercise of other fiduciary powers exercisable for the trustee's own benefit, including the power to distribute property in satisfaction of the trustee's legal support obligation.

The Florida statute applies to a trust created under a document executed before July 1, 1991. However, with respect to irrevocable trusts executed before July 1, 1991, the statute does not apply if all parties in interest elect affirmatively not to be subject to the application of the statute. Further, the statute does not apply to any distribution made pursuant to the exercise of a power if the power was exercised prior to July 1, 1991. Finally, the prohibitions on the exercise of fiduciary powers contained in the statute do not apply if the fiduciary power is held by a settlor's spouse with respect to a trust for which a marital deduction was allowed.

In Rev. Proc. 94-44, the Service announced that, in general, it would consider the Florida statute applicable on and after July 1, 1991, to irrevocable trusts which were executed before July 1, 1991. In the case of a lapse, release, or exercise of a power by a trustee-beneficiary of such a trust before July 1, 1991, however, the Service would continue to apply §§ 2514 and 2041 without reference to the statute. Rev. Proc. 94-44 also provides that the statute will not be treated as causing a lapse of a power of appointment of a trustee-beneficiary under an irrevocable trust for purposes of §§ 2041(b)(2) and 2514(e).

In the present case, § 564-A:3 of State's Uniform Trustees' Powers Act (Statute) was amended by the addition of paragraph IV

to that section, effective July 1, 1996. As amended, Statute § 564-A:3IV provides, in relevant part:

> (a)(1) Due to the inherent conflict of interest that exists between a trustee who is a beneficiary and other beneficiaries of the trust, unless the terms of a trust refer specifically to this paragraph and provide expressly to the contrary, any power conferred upon a trustee (other than the settlor of a revocable or amendable trust or a decedent's or settlor's spouse who is a trustee of a testamentary or inter vivos trust for which a marital deduction has been allowed) shall not include the following:
>
> > (A) To make discretionary distributions of either principal or income to or for the benefit of such trustee, except to provide for that trustee's health, education, maintenance, or support as described under Internal Revenue Code sections 2041 and 2514.
> >
> > ***
> >
> > (C) To make discretionary distributions of either principal or income to satisfy any legal support obligations of such trustee.
> >
> > (D) To exercise any other power, including the right to remove or to replace any trustee, so as to cause the powers enumerated under subparagraphs (A)-(C) to be exercised on behalf of, or for the benefit of, a beneficiary who is also a trustee.

Statute § 564-A:3IV(b)(1) provides that paragraph IV applies to any trust created under a document executed on or before July 1, 1996, unless, in the case of an irrevocable trust, all parties in interest elect affirmatively not to be subject to the provisions of the paragraph.

State Statute in the present case is identical in all material respects to the Florida statute considered in Rev. Proc. 94-44. Therefore, the principles of Rev. Proc. 94-44 apply to trusts subject to the provisions of Statute in the same manner as those principles apply to trusts subject to the provisions of the Florida statute.

For purposes of this ruling, you have asked us to assume that the parties in interest will not affirmatively elect not to be subject to the provisions of paragraph IV. Assuming this election is not made and Statute applies to Trust, we conclude that the principles of Rev. Proc. 94-44 apply to Trust, its

trustees, and its beneficiaries.

Rulings 2, 3, and 5

Section 2501 imposes a tax on the transfer of property by gift by an individual. Section 2511 provides that the gift tax applies 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. Thus, any transaction in which an interest in property is gratuitously passed to or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax.

Section 2514(b) provides that, for gift tax purposes, the exercise or release of a general power of appointment created after October 21, 1942, shall be deemed a transfer of property by the individual possessing the power. Section 2514(e) provides that the lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of the power to the extent that the property that could have been appointed by exercise of the lapsed power during the calendar year exceeds the greater of $5,000 or 5 percent of the aggregate value of the assets out of which the exercise of the lapsed power could be satisfied.

Section 2514(c)(1) provides that the term "general power of appointment" means a power that is exercisable in favor of the individual possessing the power, the individual's estate, the individual's creditors, or the creditors of the individual's estate. However, a power to consume, invade or appropriate property for the benefit of the individual that is limited by an ascertainable standard relating to the health, education, support or maintenance of the individual is not a general power of appointment.

Section 25.2514-1(b)(1) of the Gift Tax Regulations provides that the term "power of appointment" includes all powers that are in substance and effect powers of appointment. If a trust instrument provides that the beneficiary may appropriate or consume the principal of the trust, the power to consume or appropriate is a power of appointment. A power in a donee to remove or discharge a trustee and appoint himself may be a power of appointment. For example, if under the terms of a trust instrument, the trustee or his successor has the power to appoint the principal of the trust for the benefit of individuals including himself, and A, another person, has the unrestricted power to remove or discharge the trustee at any time and appoint any other person including himself, A is considered as having a

power of appointment.

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)(A) provides that a general power of appointment is a power that is exercisable in favor of the decedent, the decedent's estate, the decedent's creditors, or the creditors of the decedent's estate. However, a power to consume, invade, or appropriate property for the benefit of the decedent that is limited to the health, education, support, or maintenance of the decedent is not deemed to be a general power of appointment.

Section 2041(b)(2) provides that the lapse of a power of appointment is considered a release of the power.

Section 20.2041-1(b) of the Estate Tax Regulations provides that a power in a decedent to remove or discharge a trustee and appoint himself may be a power of appointment. For example, if under the terms of a trust instrument, the trustee or his successor has the power to appoint the principal of the trust for the benefit of individuals including himself, and the decedent has the unrestricted power to remove or discharge the trustee at any time and appoint any other person including himself, the decedent is considered as having a power of appointment.

Rev. Rul. 95-58, 1995-2 C.B. 191, revoking Rev. Rul. 79-353, 1979-2 C.B. 325, holds that a decedent-settlor's reservation of an unqualified power to remove a trustee and appoint an individual or corporate successor trustee that is not related or subordinate to the decedent within the meaning of § 672(c), is not considered a reservation of the trustee's discretionary powers of distribution over the property transferred by the decedent-settlor to the trust.

Section 672(c) defines the term "related or subordinate party" to mean any nonadverse party who is (1) the grantor's spouse if living with the grantor; or (2) any one of the following: the grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and

the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.

The question of whether a decedent possessed a trustee's discretionary powers when (i) the decedent had an unqualified power to remove and replace the trustee with an individual (other than himself or herself) or corporate trustee, and (ii) the trust instrument fails to require that the successor trustee not be related or subordinate to the decedent within the meaning of § 672(c), is a factual question that is determined by looking at the manner in which the decedent exercised the removal and replacement power and the subsequent distributions made from the trust.

Section 2036(a) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or any period which does not in fact end before his death (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any other person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Section 2038(a)(1) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.

In the present case, prior to July 1, 1996, the effective date of the amendment to Statute, Spouse's power to appoint herself as trustee was a general power of appointment under §§ 2041 and 2514. After July 1, 1996, Spouse's power to appoint herself trustee is not a general power of appointment because Statute limits a trustee-beneficiary's power to make distributions to herself. If Spouse exercises the power to

appoint herself as trustee after July 1, 1996, Statute will limit her discretionary distributions to herself to those based upon an ascertainable standard as described under §§ 2041 and 2514. Therefore, as of July 1, 1996, Spouse's power to appoint herself as trustee is not a general power of appointment and the estate and gift tax do not apply to the power. The same rule applies to the power of the other beneficiaries to remove the trustee and appoint themselves as trustee.

As of July 1, 1996, the effective date of the amendment to Statute, Spouse's power to appoint herself as trustee ceased to be a general power of appointment. However, under the principles of Rev. Proc. 94-44, the enactment of the amendment will not be treated as causing a lapse of a general power of appointment under §§ 2041(b)(2) and 2514(b). This same rule applies to the power of the other beneficiaries to remove the trustee and appoint themselves as trustee.

Spouse's appointment of Second Individual Trustee to replace First Individual Trustee did not affect Spouse's power to remove a trustee and appoint herself trustee. Therefore, Spouse's appointment of Second Individual Trustee did not constitute a lapse of Spouse's power to designate herself as trustee that would constitute a transfer for gift tax purposes under § 2514(b).

Therefore, based on the facts submitted and representations made, and assuming Statute, as amended, applies to Trust, we conclude that there is no taxable gift by Spouse or by any other Trust beneficiary, nor will the value of any Trust property be includible in the gross estate of Spouse or any other Trust beneficiary under § 2041, by virtue of the existence or exercise (past, present, or future) of Spouse's or other beneficiary's power to remove and/or replace the trustees and appoint themselves as trustees, or by virtue of the enactment of the 1996 amendment to Statute.

Rev. Proc. 94-44 and Statute apply only to trustee-beneficiaries of Trusts. Therefore, they would be inapplicable in the situation where Spouse or other beneficiary replaces a trustee with someone other than herself or himself, such as the appointment of Second Individual Trustee by Spouse. Further, Trust does not impose the requirement of Rev. Rul. 95-58 that the successor trustee not be related to or subordinate to the Spouse or other beneficiary who exercises the power. As stated previously, Rev. Rul. 79-353 was revoked by Rev. Rul. 95-58.

In the present case, Second Individual Trustee is not a

"related or subordinate party" within the definition of § 672(c). Moreover, State law imposes a fiduciary duty on a non-beneficiary trustee, in exercising discretionary powers of distribution, to act independently of the beneficiaries. However, whether the trustee does so is a question of fact.

Accordingly, we conclude that Spouse's appointment of Second Individual Trustee will not be considered the exercise of a general power of appointment provided that there is no express or implied understanding between Second Individual Trustee and Spouse that Second Individual Trustee will exercise her discretionary powers other than independently of Spouse and that, in fact, Second Individual Trustee exercises her powers independently of Spouse. Also, provided that there is no express or implied understanding between the successor trustee and the Spouse (or other beneficiary) exercising the removal and replacement power that the trustee will exercise the discretionary powers other than independently of the Spouse (or other beneficiary), the Spouse or other beneficiary possessing the removal and replacement power will not be considered as possessing or exercising a general power of appointment for purposes of §§ 2041 and 2514.

On three occasions, in three separate years, Spouse exercised her noncumulative annual power to withdraw the greater of $5,000 or 5 percent of the Trust assets. In other years, she allowed this power to lapse. Spouse's exercise of her 5 x 5 power for her own benefit is not a transfer for gift tax purposes. Under § 2514(e), the lapse of a power is a release of the power only to the extent that the property which could have been appointed during the calendar year exceeds the greater of $5,000 or 5 percent of the aggregate value of the Trust assets. Therefore, the lapses in each calendar year of Spouse's 5 x 5 power do not result in taxable gifts. Under § 2041(b)(2), at Spouse's death, there will be included in her gross estate the greater of $5,000 or 5 percent of the Trust assets which she is entitled to withdraw for the year in which her death occurs.

On one occasion prior to the effective date of the amendment to Statute, Spouse exercised her lifetime power under Article Third to appoint Trust property, in the amount of $b, to one of her adult children. On another occasion, also prior to the effective date of the amendment to Statute, she exercised her power by appointing the same amount to another adult child. Spouse's lifetime power under Article Third is not a general power of appointment under § 2514(c) because it does not permit her to appoint Trust property to herself, her creditors, her estate, or the creditors of her estate. However, at the times Spouse exercised this power, she was also considered to have a

general power of appointment over the Trust by virtue of her power to appoint herself trustee. Therefore, Spouse's direction to the trustees to distribute $b to each of two adult children is considered a release of her general power of appointment over the property, for purposes of § 2514, rather than an exercise of a limited power of appointment. See section § 25.2514-1(b)(2). However, § 2503(b)(1) excludes from the gift tax the first $10,000 of gifts of present interests to a person in a calendar year. Accordingly, we conclude that Spouse's direction to the trustees to distribute $b to each of two adult children is not subject to the gift tax. After July 1, 1996, the effective date of the amendment to Statute, Spouse does not have a general power of appointment over the Trust assets. Therefore, any exercise of her limited power of appointment after that date will not be subject to the gift tax.

Trust property is includible in a decedent's gross estate under §§ 2036 and 2038 only when the decedent was the transferor with respect to at least a portion of the property transferred to the trust. Accordingly, we conclude that §§ 2036 and 2038 will not apply to any of the above-enumerated powers held by the Spouse or other beneficiary.

Ruling 4

Section 2601 provides that a tax is imposed on every generation-skipping transfer. Section 2611 defines the term "generation-skipping transfer" to mean (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Section 26.2601-1(a)(1) of the Generation-Skipping Transfer Tax Regulations provides that the tax applies to any generation-skipping transfer made after October 22, 1986.

Section 26.2601-1(b)(1)(i) provides that, in general, the tax will not apply to any generation-skipping transfer under a trust that was irrevocable on September 25, 1985. The rule of the preceding sentence does not apply, however, to a pro rata portion of any generation-skipping transfer under an irrevocable trust if additions are made to the trust after September 25, 1985.

In this case, although the Trust was irrevocable in 1984, the insurance proceeds were transferred to the Trust upon the Settlor's death on date 2, which is after September 25, 1985. Therefore, the transfer of insurance proceeds constitutes an addition made to the Trust after September 25, 1985. Consequently, the generation-skipping transfer tax is applicable

to that portion of generation-skipping transfers made from the Trust that reflects the addition of the insurance proceeds. See § 26.2601-1(b)(1)(iv) for determining the portion of the Trust that is subject to the generation-skipping transfer tax.

Except as we have specifically ruled herein, we express no opinion as to the federal tax consequences of any of the transactions or powers described above under the cited provisions or any other provisions of the Code or regulations.

This ruling is directed to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely yours,

Assistant Chief Counsel
(Passthroughs and Special Industries)

By _____
Katherine A. Mellody
Assistant to the Branch Chief
Branch 4

Enclosure
Copy for § 6110 purposes