percent shareholders acquired D's stock by purchase during the five-year period. Accordingly, D may presume that section 355(d) does not apply to the distribution of C.

*Example 2. Publicly traded corporation; schedule filed.* The facts are the same as those in *Example 1,* except that D determines that, as of 10 days after the distribution, only one schedule has been filed with respect to its stock. That schedule discloses that X acquired 15 percent of the D stock one year before the distribution. Absent contrary knowledge, D may rely on the presumptions in paragraph (f)(3) of this section and so may presume that X is its only shareholder that is or was not a less-than-five-percent shareholder during the five-year period. D may not rely on the presumption in paragraph (f)(4) of this section with respect to X. In addition, D may not rely on the presumption in paragraph (f)(4) of this section with respect to any less-than-five-percent shareholder that, at any time during the five-year period, is related to X under section 355(d)(7)(A), acted pursuant to a plan or arrangement with X under section 355(d)(7)(B) and paragraph (c)(4) of this section with respect to acquisitions of D stock, or holds stock that is attributed to X under section 355(d)(8)(A). Accordingly, under paragraph (f)(1) of this section, to determine whether section 355(d) applies, D must determine: whether X acquired its directly held D stock by purchase under section 355(d)(5) and paragraphs (d) and (e)(2) and (3) of this section during the five-year period; whether X is treated as having purchased any additional D stock under section 355(d)(8) and paragraph (e)(1) of this section during the five-year period; and whether X is related to, or acquired its D stock pursuant to a plan or arrangement with, one or more of D's other shareholders during the five-year period under section 355(d)(7)(A) or (B) and paragraph (c)(4) of this section, and if so, whether those shareholders acquired their D stock by purchase under section 355(d)(5) or (8) and paragraphs (d) and (e) of this section during the five-year period.

*Example 3. Acquisition of publicly traded corporation.* The facts are the same as those in *Example 1,* except that P acquires all of the D stock in a section 368(a)(1)(B) reorganization that is not also a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E), and D distributes C to P one year later. Because D was widely held, P applies statistical sampling procedures that involve less than 50% of D's outstanding shares, to estimate the basis of all shares acquired, instead of surveying each shareholder. Under the deemed purchase rule of section 355(d)(5)(C) and paragraph (e)(2) of this section, P is treated as having acquired the D stock by purchase on the date the D shareholders acquired the D stock by purchase. Even though D has no less-than-five-percent shareholder immediately after the distribution, D may rely on the presumptions in paragraphs (f)(3) and (4) of this section to determine whether and to what extent the D stock is treated as purchased during the five-year period in P's hands under the deemed purchase rule of section 355(d)(5)(C) and paragraph (e)(2) of this section. Accordingly, D may presume that section 355(d) does not apply to the distribution of C to P. This result would not change even if the statistical sampling that involves less than 50 percent of D's outstanding shares indicated that more than 50% of D's shares were acquired by purchase during the five-year period.

*Example 4. Non-publicly traded corporation.* D is owned by 20 shareholders and has a single class of stock that is not reporting stock. D knows that A owns 40 percent of the D stock, and D does not know that any other shareholder has owned as much as five percent of the D stock at any time during the five-year period. D may not rely on the presumption in paragraph (f)(3) of this section because its stock is not reporting stock. D may not rely on the presumption in paragraph (f)(4) of this section with respect to A. In addition, D may not rely on the presumption in paragraph (f)(4) of this section for any less-than-five-percent shareholder that, at any time during the five-year period, is related to A under section 355(d)(7)(A), acted pursuant to a plan or arrangement with A under section 355(d)(7)(B) and paragraph (c)(4) of this section with respect to acquisitions of D stock, or holds stock that is attributed to A under section 355(d)(8)(A). D may rely on the presumption in paragraph (f)(4) of this section for less-than-five-percent shareholders that during the five-year period are not related to A, did not act pursuant to a plan or arrangement with A, and do not hold stock attributed to A. Accordingly, under paragraph (f)(1) of this section, to determine whether section 355(d) applies, D must determine: that A is its only shareholder that is (or was at any time during the five-year period) not a less-than-five-percent shareholder; whether A acquired its directly held D stock by purchase under section 355(d)(5) and paragraphs (d) and (e)(2) and (3) of this section during the five-year period; whether A is treated as having purchased any additional D stock under section 355(d)(8) and paragraph (e)(1) of this section during the five-year period; and whether A is related to, or acquired its D stock pursuant to a plan or arrangement with, one or more of D's other shareholders during the five-year period under section 355(d)(7)(A) or (B) and paragraph (c)(4) of this section, and if so, whether those shareholders acquired their D stock by purchase under section 355(d)(5) or (8) and paragraphs (d) and (e) of this section during the five-year period.

(g) *Effective date.* This section applies to distributions occurring after December 20, 2000, except that they do not apply to any distributions occurring pursuant to a written agreement which is (subject to customary conditions) binding on December 20, 2000, and at all times thereafter.

**Robert E. Wenzel,**

*Deputy Commissioner of Internal Revenue.*

Approved: December 11, 2000.

**Jonathan Talisman,**

*Acting Assistant Secretary of the Treasury.*

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## DEPARTMENT OF THE TREASURY

## Internal Revenue Service

## 26 CFR Part 26

**[TD 8912]**

**RIN 1545–AX08**

## Generation-Skipping Transfer Issues

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final regulations.

**SUMMARY:** This document contains final regulations relating to the application of the effective date rules of the generation-skipping transfer (GST) tax imposed under chapter 13 of the Internal Revenue Code (Code). These regulations provide guidance with respect to the type of trust modifications that will not affect the exempt status of a trust. In addition, these regulations clarify the application of the effective date rules in the case of property transferred pursuant to the exercise of a general power of appointment. These regulations are necessary to provide guidance to taxpayers so that they may properly determine if chapter 13 of the Code is applicable to a particular trust.

**DATES:** These regulations are effective December 20, 2000.

**SUPPLEMENTARY INFORMATION:**

### Background

On November 18, 1999, the Treasury Department and the IRS published in the **Federal Register** (64 FR 62997) a notice of proposed rulemaking (REG–103841–99) relating to the application of the GST tax provisions where the terms of a trust that was irrevocable before the effective date of the statute are changed or modified after that date. The IRS received comments on the notice of proposed rulemaking. In addition, a public hearing was held on March 15, 2000. This document adopts final regulations with respect to the notice of proposed rulemaking. A summary of the principle comments received is provided below.

*1. The Regulatory Approach*

In general, under the effective date rules accompanying the GST statutory provisions, a trust that was irrevocable on September 25, 1985, is not subject to the GST tax provisions, unless a GST transfer is made out of corpus added to the trust after that date. Section 1433(b)(2)(A) of the Tax Reform Act of 1986 (TRA), Public Law 99–514 (100 Stat. 2085, 2731), 1986–3 (Vol. 1) C.B. 1, 634. Such trusts are hereinafter referred to as exempt trusts for GST tax purposes. The proposed regulations provide a number of safe harbors with respect to changes that can be made to the terms of an exempt trust that will not result in the loss of exempt status.

Commentators argued that the approach set forth in the proposed regulations is inconsistent with the statutory effective date provisions. They contend that, under the TRA, with the exception of additions to principal, modifications or other actions with respect to a trust should not affect the trust's exempt status. Rather, any change should have GST tax consequences only if the change subjects the trust principal to a current gift tax. In that case, the individual making the gift will be treated, to the extent of the gift, as the transferor of the trust for GST tax purposes and the trust, to the extent of the gift, will be subject to the GST tax regime.

This approach was not adopted. The statutory effective date provision protects generation-skipping trusts that were irrevocable before the GST tax was enacted and presumably could not be changed to avoid the imposition of the tax. The Treasury Department and the IRS believe that the approach adopted in the regulations is consistent with Congressional intent to protect these trusts and that most of the modifications that will not affect the exempt status of a trust will be covered by the safe harbors in the final regulations.

*2. Trustee Discretionary Actions*

Under the proposed regulations, where there is a distribution of trust principal from an exempt trust to a new trust, the new trust will be an exempt trust if the terms of the governing instrument of the old trust authorize the trustee to make distributions to the new trust without the consent or approval of any beneficiary or court and the terms of the new trust do not extend the time for vesting of any beneficial interest in the trust beyond the applicable perpetuities period.

In response to comments, the final regulations clarify that the retention of property in a continuing trust, as well as the distribution of property to a new trust, will not cause loss of exempt status, assuming the requirements of the regulations are satisfied.

In response to comments, the final regulations provide that distribution to a new trust or retention in a continuing trust will not cause the loss of exempt status, even if the governing instrument does not specifically authorize the action, if state law, at the time the exempt trust became irrevocable, permitted such distribution or retention in a continuing trust.

One comment suggested that the final regulations provide that a discretionary distribution that otherwise satisfies the regulatory requirements should not cause the trust to lose exempt status if the trustee, although not required to do so, seeks approval of a court or the trust beneficiaries before taking action. This change was deemed unnecessary. An action that satisfies the requirements of the regulations will not cause loss of exempt status even if, for whatever reason, the trustee seeks a court's or a beneficiary's approval of such action.

Comments suggested that the period for measuring the appropriate perpetuities period for the new trust should be the date the original trust became irrevocable under local law. The comments noted that the perpetuities period is properly measured from the date the trust becomes irrevocable, which is not always the date the trust was created (the date referenced in the proposed regulations). The regulations have been revised accordingly.

*3. Settlements and Judicial Constructions*

Under the proposed regulations, a court-approved settlement of a bona fide issue regarding the administration of the trust or the construction of terms of the trust will not cause the trust to lose exempt status if the settlement is the product of arm's length negotiations, and the settlement is within the range of reasonable outcomes under the governing instrument and applicable state law. A judicial construction of a governing instrument resolving an ambiguity in the terms of the instrument or correcting a scrivener's error will not cause loss of exempt status if the judicial action involves a bona fide issue, and the construction is consistent with applicable state law that would be applied by the highest court of the state.

One comment suggested that the standard applicable for recognition of settlement agreements should also apply for court decrees, such that one standard would govern both actions. Thus, the commentator suggested that a settlement agreement or court decree should be binding on the Service (and not cause loss of exempt status) if the result is within the range of reasonable outcomes and the agreement or court decision is the product of adversarial proceedings. The suggestion was not adopted. The standard applied in the regulations for court decrees was enunciated by the Supreme Court in *Commissioner* v. *Estate of Bosch,* 387 U.S. 456 (1967), and has been continuously and repeatedly applied by the IRS and the courts. The adoption of a different standard at this time is not appropriate.

Another comment addressing the rule for settlements stated that the requirement that the settlement fall within the range of reasonable outcomes under the governing instrument and state law could be read to deny protection to a settlement that reaches a result that a court could not reach. However, the purpose of this rule is not to restrict safe harbor protection to only those settlements that reach the result a court could reach if the issue was litigated. Rather, the rule is intended to afford the parties a greater degree of latitude to settle a case than would be available if a court had to decide the issue. Thus, a settlement ''within the range of reasonable outcomes'' would include a compromise that reflects the parties' assessment of their relative rights and the strengths and weaknesses of their respective positions. The settlement need not (and it is anticipated that in most cases it would not) resolve the issue in the same manner as a court decision on the merits. Language has been added to the final regulations emphasizing this point. On the other hand, as illustrated in the preamble to the proposed regulations, a settlement that, for example, creates beneficial interests that did not exist under a reasonable interpretation of the instrument will not satisfy the regulations.

One comment suggested that the scope of the judicial construction rule should be expanded to cover not only ambiguities and scrivener's error, but any request for court instructions or any similar proceedings such as requests to modernize the trust instrument, or adapt the instrument to unforeseen changed circumstances. This suggestion was not adopted. The Treasury Department and the IRS believe that these and similar actions are properly addressed under the safe-harbor ''shift in beneficial interest'' rule provided in the regulations, and a separate category to address these items is not needed.

*4. Other Changes*

Under the proposed regulations, a modification that does not satisfy the regulatory rules for trustee distributions, settlements, and constructions will not cause a trust to lose exempt status, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 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.

Comments suggested that the regulations should provide additional guidance on when a modification shifts a beneficial interest in a trust. In response to these comments, the final regulations provide that a modification to an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in an increase in a GST transfer or create a new GST 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 section 2651) than the person or persons who held the beneficial interest prior to the modification.

In conjunction with this change, the final regulations remove *Example 7* contained in § 26.2601–1(b)(2)(vii)(B). This example had illustrated the transition rule contained in § 26.2601–1(b)(2) for generation-skipping transfers under wills or revocable trusts executed before October 22, 1986. Under this rule, the GST tax does not apply to transfers made under a will or revocable trust executed before October 22, 1986, if the decedent dies before January 1, 1987, and the instrument is not amended after October 21, 1986, in any respect that results in the creation of, or increase in the amount of, a generation-skipping transfer. In *Example 7,* trust income is to be distributed equally, for life, to A, B, and C who are skip persons assigned to the same generation. The trust is amended to increase A's share of the income. The example concludes that the trust is subject to GST tax because the amendment increases the amount of the generation-skipping transfers to be made to A. The amendment to the trust, however, does not increase the amount of a generation-skipping transfer when viewed in the aggregate. The amendment merely shifts an interest from one beneficiary to another beneficiary assigned to the same generation. *Example 7* in § 26.2601–1(b)(4)(i)(E) considers a substantially similar fact pattern involving a trust that is irrevocable on or before September 25, 1985, and concludes that the modification will not result in an increase in a generation-skipping transfer.

The standard contained in § 26.2601–1(b)(2) (relating to wills and revocable trusts executed before October 22, 1986) is similar to the standard contained in § 26.2602–1(b)(4)(i)(D)(relating to a modification to a trust that was irrevocable on September 25, 1985). The Treasury Department and the IRS believe that the two provisions should be applied in a consistent manner. Therefore, *Example 7* in § 26.2601–1(b)(2)(vii)(B) has been eliminated.

In response to comments, the final regulations specify that changes that are administrative in nature (such as a change in the number of trustees) will not cause the trust to lose its exempt status. An example has been added illustrating this point.

Several comments indicated that many states have adopted, or are considering adopting, section 104 of the Revised Uniform Principal and Income Act. Unif. Principal and Income Act § 104, 7B U.L.A. 141 (1997) (Act). The Act allows a trustee to adjust between principal and income to the extent necessary to produce an equitable result, if the trustee invests and manages trust assets pursuant to the state's prudent investor statute and the trustee is unable to administer the trust fairly and reasonably under the general statutory rules governing the allocation of income and principal. In addition, the comments noted that some state legislatures are contemplating revising their state principal and income act to define trust *income* as a unitrust amount (a fixed percentage of the trust principal determined annually). The comments suggested that the regulations provide additional safe harbors to the effect that the administration of an exempt trust pursuant to a state statute adopting the Act, or the conversion of an income interest to a unitrust interest pursuant to a court order or a state statute redefining trust income, would not cause the trust to lose exempt status.

A guidance project considering the tax consequences of these state law changes in a broader context is currently under consideration. Accordingly, these regulations do not specifically address this issue. However, two examples have been added to the regulations illustrating circumstances under which a trust will not lose exempt status where an income interest is converted to an interest that pays the greater of trust income or a unitrust amount, and a trust is modified to allow allocation of capital gain to income.

In response to a comment, the facts presented in § 26.2601–1(b)(4)(i)(E) *Example 5,* have been changed to clarify that after the trusts are partitioned, if either beneficiary should die without descendants surviving, the principal of their partitioned trust will pass to the other partitioned trust.

*5. Effective Dates and Other Matters*

Comments requested clarification regarding the status of exempt trusts that were modified or subject to other actions (for example, judicial constructions or settlements) prior to the effective date of these regulations, December 20, 2000. The IRS will not challenge the exempt status of a trust that was, prior to December 20, 2000, subject to any trustee action, judicial construction, settlement agreement, modification, or other action, if the action satisfies the requirements of the regulations.

Finally, with respect to the deletion of § 26.2601–1(b)(2)(vii)(B) *Example 7,* discussed above, the IRS will not follow that example when applying the rule in § 26.2601–1(b)(2).

## Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

## Drafting Information

The principal author of these regulations is James F. Hogan, Office of the Chief Counsel, IRS. Other personnel from the IRS and the Treasury Department participated in their development.

## Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 26 is amended as follows:

## PART 26—GENERATION-SKIPPING TRANSFER TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1986

**Par. 1.** The authority citation for part 26 continues to read in part as follows:

**Authority:** 26 U.S.C. 7805 * * *

**Par. 2.** In § 26.2600–1, the table is amended under § 26.2601–1 by revising the entry for paragraph (b)(4) and adding an entry for paragraph (b)(5) to read as follows:

### § 26.2600–1 Table of contents.

* * * * *

### § 26.2601–1. Effective dates.

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(b) * * *

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(4) Retention of trust's exempt status in the case of modifications, etc.

(5) Exceptions to additions rule.

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**Par. 3.** Section 26.2601–1 is amended as follows:

1. Adding four sentences to the end of paragraph (b)(1)(i).

2. Paragraph (b)(2)(vii)(B) is amended by revising the heading, removing *Example 7,* and redesignating *Examples 8* and *9* as *Examples 7* and *8,* respectively.

2. Redesignating paragraph (b)(4) as paragraph (b)(5).

3. Adding a new paragraph (b)(4).

4. Paragraph (c) is amended by adding a new sentence to the end of the paragraph.

The additions read as follows:

### § 26.2601–1 Effective dates.

* * * * *

(b) * * * (1) * * * (i) * * * Further, the rule in the first sentence of this paragraph (b)(1)(i) does not apply to a transfer of property pursuant to the exercise, release, or lapse of a general power of appointment that is treated as a taxable transfer under chapter 11 or chapter 12. The transfer is made by the person holding the power at the time the exercise, release, or lapse of the power becomes effective, and is not considered a transfer under a trust that was irrevocable on September 25, 1985. See paragraph (b)(1)(v)(B) of this section regarding the treatment of the release, exercise, or lapse of a power of appointment that will result in a constructive addition to a trust. See § 26.2652–1(a) for the definition of a transferor.

* * * * *

(2) * * *

(vii) * * *

(B) *Facts applicable to Examples 6 through 8.*

* * * * *

(4) *Retention of trust's exempt status in the case of modifications, etc.*—(i) *In general.* This paragraph (b)(4) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the generation-skipping transfer tax under paragraph (b)(1), (2), or (3) of this section (hereinafter referred to as an exempt trust) will not cause the trust to lose its exempt status. The rules contained in this paragraph (b)(4) are applicable only for purposes of determining whether an exempt trust retains its 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 section 1001.

(A) *Discretionary powers.* The distribution of trust principal from an exempt trust to a new trust or retention of trust principal in a continuing trust will not cause the new or continuing trust to be subject to the provisions of chapter 13, if—

(*1*) Either—

(*i*) The terms of the governing instrument of the exempt trust authorize distributions to the new trust or the retention of trust principal in a continuing trust, without the consent or approval of any beneficiary or court; or

(*ii*) at the time the exempt trust became irrevocable, state law authorized distributions to the new trust or retention of principal in the continuing trust, without the consent or approval of any beneficiary or court; and

(*2*) The terms of the governing instrument of the new or continuing trust do not extend the time for vesting of any beneficial interest in the trust 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 the original trust became irrevocable, extending beyond any life in being at the date the original trust became irrevocable plus a period of 21 years, plus if necessary, a reasonable period of gestation. For purposes of this paragraph (b)(4)(i)(A), the exercise of a trustee's distributive power that validly postpones or suspends the vesting, absolute ownership, or power of alienation of an interest in property for a term of years that will not exceed 90 years (measured from the date the original trust became irrevocable) will not be considered an exercise that postpones or suspends vesting, absolute ownership, or the power of alienation beyond the perpetuities period. If a distributive power is exercised by creating another power, it is deemed to be exercised to whatever extent the second power may be exercised.

(B) *Settlement.* A court-approved settlement of a bona fide issue regarding the administration of the trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to the provisions of chapter 13, if—

(*1*) The settlement is the product of arm's length negotiations; and

(*2*) The settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. A settlement that results in a compromise between the positions of the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes.

(C) *Judicial construction.* A judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause an exempt trust to be subject to the provisions of chapter 13, if—

(*1*) The judicial action involves a bona fide issue; and

(*2*) The construction is consistent with applicable state law that would be applied by the highest court of the state.

(D) *Other changes.* (*1*) 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 section 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.

(*2*) 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 GST transfer or the creation of a new GST 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 section 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.

(E) *Examples.* The following examples illustrate the application of this paragraph (b)(4). In each example, assume that the trust established in 1980 was irrevocable for purposes of paragraph (b)(1)(ii) of this section and that there have been no additions to any trust after September 25, 1985. The examples are as follows:

*Example 1. Trustee's power to distribute principal authorized under trust instrument.* In 1980, Grantor established an irrevocable trust (Trust) for the benefit of Grantor's child, *A*, *A*'s spouse, and *A*'s issue. At the time Trust was established, *A* had two children, *B* and *C. A* corporate fiduciary was designated as trustee. Under the terms of Trust, the trustee has the discretion to distribute all or part of the trust income to one or more of the group consisting of *A*, *A*'s spouse or *A*'s issue. The trustee is also authorized to distribute all or part of the trust principal to one or more trusts for the benefit of *A*, *A*'s spouse, or *A*'s issue under terms specified by the trustee in the trustee's discretion. Any trust established under Trust, however, must terminate 21 years after the death of the last child of *A* to die who was alive at the time Trust was executed. Trust will terminate on the death of *A*, at which time the remaining principal will be distributed to *A*'s issue, per stirpes. In 2002, the trustee distributes part of Trust's principal to a new trust for the benefit of *B* and *C* and their issue. The new trust will terminate 21 years after the death of the survivor of *B* and *C*, at which time the trust principal will be distributed to the issue of *B* and *C*, per stirpes. The terms of the governing instrument of Trust authorize the trustee to make the distribution to a new trust without the consent or approval of any beneficiary or court. In addition, the terms of the governing instrument of the new trust do not extend the time for vesting of any beneficial interest 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 Trust, extending beyond any life in being at the date of creation of Trust plus a period of 21 years, plus if necessary, a reasonable period of gestation. Therefore, neither Trust nor the new trust will be subject to the provisions of chapter 13 of the Internal Revenue Code.

*Example 2. Trustee's power to distribute principal pursuant to state statute.* In 1980, Grantor established an irrevocable trust (Trust) for the benefit of Grantor's child, *A*, *A*'s spouse, and *A*'s issue. At the time Trust was established, *A* had two children, *B* and *C. A* corporate fiduciary was designated as trustee. Under the terms of Trust, the trustee has the discretion to distribute all or part of the trust income or principal to one or more of the group consisting of *A*, *A*'s spouse or *A*'s issue. Trust will terminate on the death of *A*, at which time, the trust principal will be distributed to *A*'s issue, per stirpes. Under a state statute enacted after 1980 that is applicable to Trust, a trustee who has the absolute discretion under the terms of a testamentary instrument or irrevocable inter vivos trust agreement to invade the principal of a trust for the benefit of the income beneficiaries of the trust, may exercise the discretion by appointing so much or all of the principal of the trust in favor of a trustee of a trust under an instrument other than that under which the power to invade is created, or under the same instrument. The trustee may take the action either with consent of all the persons interested in the trust but without prior court approval, or with court approval, upon notice to all of the parties. The exercise of the discretion, however, must not reduce any fixed income interest of any income beneficiary of the trust and must be in favor of the beneficiaries of the trust. Under state law prior to the enactment of the state statute, the trustee did not have the authority to make distributions in trust. In 2002, the trustee distributes one-half of Trust's principal to a new trust that provides for the payment of trust income to *A* for life and further provides that, at *A*'s death, one-half of the trust remainder will pass to *B* or *B*'s issue and one-half of the trust will pass to *C* or *C*'s issue. Because the state statute was enacted after Trust was created and requires the consent of all of the parties, the transaction constitutes a modification of Trust. However, the modification does not shift any beneficial interest in Trust to a beneficiary or beneficiaries who occupy a lower generation than the person or persons who held the beneficial interest prior to the modification. In addition, the modification does not extend the time for vesting of any beneficial interest in Trust beyond the period provided for in the original trust. The new trust will terminate at the same date provided under Trust. Therefore, neither Trust nor the new trust will be subject to the provisions of chapter 13 of the Internal Revenue Code.

*Example 3. Construction of an ambiguous term in the instrument.* In 1980, Grantor established an irrevocable trust for the benefit of Grantor's children, *A* and *B,* and their issue. The trust is to terminate on the death of the last to die of *A* and *B,* at which time the principal is to be distributed to their issue. However, the provision governing the termination of the trust is ambiguous regarding whether the trust principal is to be distributed per stirpes, only to the children of *A* and *B*, or per capita among the children, grandchildren, and more remote issue of *A* and *B.* In 2002, the trustee files a construction suit with the appropriate local court to resolve the ambiguity. The court issues an order construing the instrument to provide for per capita distributions to the children, grandchildren, and more remote issue of *A* and *B* living at the time the trust terminates. The court's construction resolves a bona fide issue regarding the proper interpretation of the instrument and is consistent with applicable state law as it would be interpreted by the highest court of the state. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

*Example 4. Change in trust situs.* In 1980, Grantor, who was domiciled in State *X,* executed an irrevocable trust for the benefit of Grantor's issue, naming a State *X* bank as trustee. Under the terms of the trust, the trust is to terminate, in all events, no later than 21 years after the death of the last to die of certain designated individuals living at the time the trust was executed. The provisions of the trust do not specify that any particular state law is to govern the administration and construction of the trust. In State *X,* the common law rule against perpetuities applies to trusts. In 2002, a State *Y* bank is named as sole trustee. The effect of changing trustees is that the situs of the trust changes to State *Y,* and the laws of State *Y* govern the administration and construction of the trust. State *Y* law contains no rule against perpetuities. In this case, however, in view of the terms of the trust instrument, the trust will terminate at the same time before and after the change in situs. Accordingly, the change in situs does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the transfer. Furthermore, the change in situs does not extend the time for vesting of any beneficial interest in the trust beyond that provided for in the original trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code. If, in this example, as a result of the change in situs, State *Y* law governed such that the time for vesting was extended beyond the period prescribed under the terms of the original trust instrument, the trust would not retain exempt status.

*Example 5. Division of a trust.* 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*'s0 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 section 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 of the Internal Revenue Code.

*Example 6. Merger of two trusts.* In 1980, Grantor established an irrevocable trust for Grantor's child and the child's issue. In 1983, Grantor's spouse also established a separate irrevocable trust for the benefit of the same child and issue. The terms of the spouse's trust and Grantor's trust are identical. In 2002, the appropriate local court approved the merger of the two trusts into one trust to save administrative costs and enhance the management of the investments. The merger of the two trusts does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the merger. In addition, the merger 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 that resulted from the merger will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

*Example 7. Modification that does not shift an interest to a lower generation.* 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 of the Internal Revenue Code. However, the modification increasing *A*'s share of trust income is a transfer by *B* and *C* to *A* for Federal gift tax purposes.

*Example 8. Conversion of income interest into unitrust interest.* In 1980, Grantor established an irrevocable trust under the terms of which trust income is payable to *A* for life and, upon *A*'s death, the remainder is to pass to *A*'s issue, per stirpes. In 2002, the appropriate local court approves a modification to the trust that converts *A*'s income interest into the right to receive the greater of the entire income of the trust or a fixed percentage of the trust assets valued annually (unitrust interest) to be paid each year to *A* for life. The modification does not result in a shift in beneficial interest to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. In this case, the modification can only operate to increase the amount distributable to *A* and decrease the amount distributable to *A*'s issue. 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 will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

*Example 9. Allocation of capital gain to income.* In 1980, Grantor established an irrevocable trust under the terms of which trust income is payable to Grantor's child, *A*, for life, and upon *A*'s death, the remainder is to pass to the *A*'s issue, per stirpes. Under applicable state law, unless the governing instrument provides otherwise, capital gain is allocated to principal. In 2002, the trust is modified to allow the trustee to allocate capital gain to the income. The modification does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. In this case, the modification can only have the effect of increasing the amount distributable to *A,* and decreasing the amount distributable to *A*'s issue. 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 will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

*Example 10. Administrative change to terms of a trust.* In 1980, Grantor executed an irrevocable trust for the benefit of Grantor's issue, naming a bank and five other individuals as trustees. In 2002, the appropriate local court approves a modification of the trust that decreases the number of trustees which results in lower administrative costs. The modification pertains to the administration of the trust and does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. 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 will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

(ii) *Effective date.* The rules in this paragraph (b)(4) are applicable on and after December 20, 2000.

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(c) * * * The last four sentences in paragraph (b)(1)(i) of this section are applicable on and after November 18, 1999.

**Robert E. Wenzel,**

*Deputy Commissioner of Internal Revenue.*

Approved: December 7, 2000.

**Jonathan Talisman,**

*Acting Assistant Secretary of the Treasury.*

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## DEPARTMENT OF DEFENSE

## Department of the Navy

## 32 CFR Part 706

## Certifications and Exemptions Under the International Regulations for Preventing Collisions at Sea, 1972

**AGENCY:** Department of the Navy, DOD.

**ACTION:** Final rule.

**SUMMARY:** The Department of the Navy is amending its certifications and exemptions under the International Regulations for Preventing Collisions at Sea, 1972 (72 COLREGS), to reflect that the Deputy Assistant Judge Advocate General of the Navy (Admiralty and Maritime Law) has determined that certain prior entries in 32 CFR part 706 are no longer applicable or that administrative corrections are required. The intended effect of this rule is to warn mariners in waters where 72 COLREGS apply.

**EFFECTIVE DATE:** December 20, 2000.

**FOR FURTHER INFORMATION CONTACT:** Commander Gregg A. Cervi, JAGC, U.S. Navy, Deputy Assistant Judge Advocate General (Admiralty and Maritime Law), Office of the Judge Advocate General, (Code 11), 1322 Patterson Avenue SE., Suite 3000, Washington Navy Yard, DC 20374–5066, Telephone number: (202) 685–5040.

**SUPPLEMENTARY INFORMATION:** Pursuant to the authority granted in 33 U.S.C. 1605, the Department of the Navy amends 32 CFR part 706. This amendment provides notice that the