

PLR-119764-03

CG1 -
GC2 -
GC3 -
GGC3 -
Step-GC1 -
Step-GC2 -
Step-GC3 -
Guardian -
State X -
Year 1 -
Year 2 -
Year 3 -
Date 1 -
Date 2 -
Date 3 -
Date 4 -
Date 5 -
Date 6 -
\$U -
\$V -
\$W -
\$X -
\$Y -
Cite 1 -
Cite 2 -
Cite 3 -

Dear :

This is in reference to the letter dated June 12, 2001, and subsequent correspondence, submitted by your authorized representative requesting rulings regarding the effect of the proposed settlement agreement for federal gift, income and generation-skipping transfer tax purposes.

PLR-119764-03

Background

The submitted facts are as follows:

Settlor created Trust, a revocable trust, on Date 1, and served as the sole trustee. Trust became irrevocable upon Settlor's death on Date 2, prior to September 26, 1985. Trustee, an independent corporation, is the sole trustee of Trust. Trust is governed by the laws of State X. Settlor was survived by Spouse and three children: Child A, Child B and Child C. At the time Trust was created on Date 1, Child A had three children; GC1, GC2, and GC3. Currently, neither GC1 nor GC2 have any children. GC3 has 1 child, GGC3.

Pursuant to Paragraph 4 of Trust, upon Settlor's death, the trustee was directed to distribute certain specific assets and pecuniary amounts. The remaining corpus of Trust was divided into four separate trusts, one trust for the benefit of Spouse and a separate trust for the benefit of Spouse and each of Settlor's three children, Child A Trust, Child B Trust and Child C Trust .

Paragraph 6 of Trust contains the dispositive provisions for Child A Trust, Child B Trust and Child C Trust. Under Paragraph 6(a), Trustee may make discretionary distributions of income and principal from each of the children's separate trusts to Spouse for her comfortable maintenance, health and welfare. In addition, under Paragraph 6(b), the trustee of the Child A Trust is to pay to Child A and to the descendants of Child A:

. . . such part or all of the income and principal of the trust (even though exhausting the trust) . . . as the trustee believes desirable for the comfortable maintenance, health, education and welfare [of Child A and his descendants] . . . considering the desirability of supplementing their respective incomes or assets and all other circumstances and factors the trustee believes pertinent; provided, however, that no payment of principal of the trust shall be made to a child of mine unless that child demonstrates that such payment is needed for the purposes specified above and cannot be provided out of his or her own assets without altering the standard of living of that child.

Under Paragraph 6(c), if Child A dies before the complete distribution of Child A Trust corpus, the principal and undistributed income will be distributed to or for the benefit of persons who are then living or born thereafter and who are descendants of Settlor or married to those descendants "in such proportions and subject to such trusts, powers and conditions," as Child A may appoint by will.

PLR-119764-03

Under Paragraph 6(d), if Child A fails to exercise the testamentary power of appointment, the principal and undistributed income of the Child A Trust is to be divided and allocated per stirpes among Child A's then living descendants. Property so allocated for a beneficiary is to be retained in trust as a separate trust named for that beneficiary and disposed of as provided in Paragraph 6. Paragraph 6(e) of Trust provides that when a grandchild or more remote descendant of Settlor, who is a beneficiary of a trust named for that descendant, reaches age thirty, one-half of any remaining trust corpus will be distributed to such descendant and the remainder will be distributed upon that descendant reaching age forty.

Paragraph 6(g) provides that, despite any other provisions of Trust, each trust created under Trust will terminate no later than twenty-one years after the death of the last to die of Settlor, Spouse, and any of Settlor's descendants living on Date 1 and the trustee shall distribute any property held in trust to the beneficiary for whom the trust is named.

In accordance with Paragraph 14 of Trust, Child A is currently acting as the adviser to Child A Trust. As adviser, Child A has the right to direct purchases and sales of trust property and to direct any reorganization, consolidation, merger, or change in financial structure of a trust asset. However, the rights and duties of the adviser can only be exercised in a fiduciary capacity. An adviser may resign at any time or may waive or delegate to any person any or all such adviser's rights and powers by written notice to the trustee.

Paragraph 17 of Trust provides that the trustee may resign at any time by written notice to such of Settlor's descendants as are then living. Paragraph 19 states that a majority of Settlor's adult descendants who are legally competent may appoint a successor trustee to fill a vacancy in the office of trustee by a written instrument delivered to the corporation appointed.

Paragraph 24 of Trust states that the words "descendant" and "descendants" shall include an adopted child of any person and of his or her descendants by blood or adoption.

On or about Year 1, Child A married for the second time. His second spouse had children (Step-GC1, Step-GC2, and Step-GC3) from a prior marriage. During the 20 year period from the funding of Trust through Year 2, Trustee allegedly distributed approximately \$U of income to Child A and approximately \$V of income to Step-GC1, Step-GC2, and Step-GC3. The Trustee did not inform GC1, GC2, and GC3 of the existence of Trust until Trust had been in existence for nearly twenty years. At that time, Trustee began making distributions of income to GC1 and GC2, and four years

PLR-119764-03

later began making distributions of income to GC3. Distributions of income totaling approximately \$W were made to GC1 and GC2, and approximately \$X to GC3. Child A adopted Step-GC1, Step-GC2, and Step-GC3 on Date 3, which was several years after the commencement of Trust distributions to Step-GC1, Step-GC2, and Step-GC3. Spouse died on Date 4.

In Year 3, GC1 and GC3 commenced legal action contesting the validity of the distributions to Child A, Step-GC1, Step-GC2, Step-GC3, GC1 and GC2. GC3 contended that Child A knowingly and intentionally interfered with GC3's rights as beneficiary of Child A Trust and that Child A knowingly and intentionally induced Trustee to breach its fiduciary duties. As a result of this action, Trustee paid \$Y to Trust as reimbursement for the distributions made to Child A as custodian for Step-GC1, Step-GC2 and Step-GC3, plus income attributable to the distributions. Further, Trustee filed a petition with the appropriate court seeking instructions relating to the propriety of the distributions made to Child A, the propriety of the distributions made to Step-GC1, Step-GC2 and Step-GC3 before they were adopted, and the meaning of the term "comfortable maintenance" as used in Paragraph 6(b). After protracted negotiation, on Date 5, GC3 entered into a settlement agreement with Child A.

Under the terms of the settlement agreement, GC3 and Child A agreed to seek court approval for the division of Trust into two separate trusts; GC3 Trust and Trust B. GC3 Trust will be established for the benefit of GC3, GGC3, and any other descendant of GC3. Trust B will be established for the benefit of Child A, GC1, GC2, Step-GC1, Step-GC2, Step-GC3, and their descendants (other than GC3 and her descendants). In general, one-sixth of the assets of Trust will be distributed to GC3 Trust and the remaining assets will be distributed to Trust B. However, one-third of the funds paid to Trust by Trustee prior to the settlement as reimbursement will be distributed to GC3 Trust and the remaining funds restored by Trustee will be distributed to Trust B. Any additional funds restored by the Trustee, by court order or otherwise, relating to pre-settlement actions regarding Trust will also be divided one-third to GC3 Trust and two-thirds to Trust B. Trustee will continue to serve as trustee of Trust B and will also serve as a temporary trustee of GC3 Trust, until a new corporate trustee is selected by the interested parties.

Both GC3 Trust and Trust B will continue to be governed by the same discretionary standards for distributions set forth in Paragraph 6(b) of Trust and other relevant terms and provisions of Trust, including Paragraph 6(g) regarding the complete termination of any trust created under its terms. With respect to GC3 Trust, during GC3's lifetime, the trustee shall pay to GC3 and her descendants income and principal under terms identical to those contained in Paragraph 6(b) of Trust. On GC3's death, any remaining

PLR-119764-03

principal and accumulated income is to be divided and allocated per stirpes among GC3's living descendants and held in further trust. All trusts must terminate no later than 21 years after the death of Settlor, Spouse and any descendants of Settlor living on Date 1.

Upon division of Trust, Child A will irrevocably exercise his power of appointment, set forth under Paragraph 6(c), with respect to GC3 Trust and direct that on his death, the property is to continue to be held in the GC3 Trust, under the terms as described above. In addition, with respect to GC3 Trust, Child A will delegate to GC3 all his rights and powers as adviser set forth under Paragraph 14 of Trust.

It is represented that GGC3 and the unborn descendants of GC3 are represented by Guardian, a court appointed guardian ad litem, and Guardian would not have approved the settlement unless Child A's power was exercised to appoint the property in further trust for the benefit GGC3 and the unborn descendants of GC3.

The terms of the settlement agreement were approved by the appropriate local court by order on Date 6, conditioned upon receipt of a favorable ruling from the IRS.

You have requested the following rulings:

1. The division of Child A Trust, pursuant to the terms of the settlement agreement, will not result in Child A Trust losing its generation-skipping transfer tax exempt status under § 2601 and will not subject Child A Trust, Trust B or GC3 Trust to the GST tax.
2. The irrevocable exercise by Child A of the power set forth under Paragraph 6(c) of Trust, directing that the amount passing to the GC3 Trust remain in trust for the benefit of GC3 and her descendants upon Child A's death, will not constitute an addition to Child A Trust, Trust B, or GC3 Trust for purposes of the GST tax.
3. The appointment of a new corporate trustee to serve as trustee of GC3 Trust will not subject Child A Trust, Trust B, or GC3 Trust to the GST tax.
4. The appointment of GC3 as the adviser of GC3 Trust will not subject Child A Trust, Trust B, or GC3 Trust to the GST tax.
5. The division of Child A Trust into GC3 Trust and Trust B and the allocation of the assets of Child A Trust between GC3 Trust and Trust B will not constitute a transfer by any trust or beneficiary that will be subject to the gift tax under § 2501.

PLR-119764-03

6. The division of Child A Trust into GC3 Trust and Trust B and the allocation of existing assets between GC3 Trust and Trust B will not be treated as a sale or other disposition that would require any trust or any beneficiary to recognize gain or loss under § 1001.
7. After the division of Child A Trust into GC3 Trust and Trust B, the assets of GC3 Trust and Trust B received from Child A Trust will have the same basis and the same holding periods as the assets had in the Child A Trust.
8. After the division of Child A Trust into GC3 Trust and Trust B, both GC3 Trust and Trust B will be treated as separate taxpayers under § 643(f).

Law and Analysis

Rulings #1 - #4:

Section 2601 imposes a tax on every generation-skipping transfer (GST) made after October 26, 1986.

Under § 1433(a) of the Tax Reform Act of 1986 and § 26.2601-1(a) of the Generation-Skipping Transfer Tax Regulations, the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under § 1433(b)(2)(A) and § 26.2601-1(b)(1)(i), the tax does not apply to a transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added).

Section 26.2601-1(b)(1)(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.

PLR-119764-03

Section 26.2601-1(b)(1)(v)(B) provides a special rule for certain powers of appointment. Under this section, 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 was not subject to chapter 13 under § 26.2601-1(b)(1); and (2) in the case of an exercise, the 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 plus, if necessary, a reasonable period of gestation (the perpetuities period).

A general power of appointment is defined in § 2041(b)(1), for federal estate tax purposes, as a power that is exercisable in favor of the individual possessing the power, his estate, his creditors, or the creditors of his estate. The definition of a general power of appointment under § 2514(c), for federal gift tax purposes, is generally the same as that provided in § 2041(b)(1). Section 2514(b) provides that 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 the power.

Section 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the generation-skipping transfer tax will not cause the trust to lose its exempt status. In general, unless otherwise noted in the regulations, these rules are only applicable for GST tax purposes. The rules do not apply, for example, in determining whether the transaction results in a gift for gift tax purposes, or the realization of gain for income tax purposes under section 1001.

Section 26.2601-1(b)(4)(i)(B) provides that a court-approved settlement of a bona fide issue regarding the administration of a trust or the construction of the 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.

Sections 26.2601-1(b)(4)(i)(D)(1) and (2) provide generally, that a modification of the governing instrument of an exempt trust by judicial reformation 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

PLR-119764-03

defined in § 2651) than the person or persons who held the beneficial interest prior to the modification and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. A modification that is administrative in nature will not be considered to shift the beneficial interest in the trust. See also, §26.2601-1(b)(4)(i)(E), Example 10.

The law of State X provides, at Cite 1, that the trustee has the following power:

Severance and consolidation. To sever any trust estate on a fractional basis into 2 or more separate trusts for any reason. . . . A separate account or trust created by severance or segregation shall be treated as a separate trust for all purposes from and after the date on which the severance or segregation is effective, and shall be held on terms and conditions that are substantially equivalent to the terms of the trust from which it was severed or segregated so that the aggregate interests of each beneficiary in the several trusts are substantially equivalent to the beneficiary's interests in the trust before severance, provided, however, that any terms of the trust before severance that would affect qualification of the trust for any federal tax deduction, exclusion, election, exemption, or other special federal tax status must remain identical in each of the separate trusts created.

In this case, the GST tax would not generally apply to Child A Trust because Child A Trust, which was established under the terms of Trust, was irrevocable at Settlor's death on Date 2, prior to September 25, 1985. Also, no additions (actual or constructive) have been made to Child A Trust since that date.

As stated above, all the parties to the Child A Trust, including GGC3 and any unborn heirs of GC1, GC2, and GC3, have been represented in the negotiations that preceded the proposed settlement agreement. We note that, after the division, both Trust B and GC3 Trust will continue to be administered by corporate trustees and distributions of income and principal from each trust to the current beneficiaries will continue to be subject to the same restrictions and limitations set forth in Child A Trust. We also note that each descendant of Child A, including GGC3, has an interest in the principal and income of the Child A Trust and are all potential appointees under Child A's power of appointment under Paragraph 6(c). Consequently, the interest of GGC3 in the new GC3 Trust is consistent with GGC3's interest in Child A Trust and the guardian ad litem appointed for GGC3 and GC3's unborn descendants would not have approved the settlement in the absence of these provisions for GGC3 and the unborn descendants.

We conclude that the settlement agreement is the product of arm's length negotiation. Further, the terms of the agreement dividing the Child A Trust as described above, and providing for the exercise of Child A's limited power of appointment, as described above, represent a compromise that reflects the parties' assessment of the relative

PLR-119764-03

strengths of their positions. Therefore, the agreement is within the range of reasonable outcomes under § 26.2601-1(b)(4)(i)(B)(2).

Further, Child A's exercise of his limited power of appointment pursuant to the terms of the settlement agreement, in favor of GC3 Trust, 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 plus, if necessary, a reasonable period of gestation (the perpetuities period). Accordingly, Child A's irrevocable exercise of the power of appointment, set forth under Paragraph 6(c) of Trust, appointing the applicable portion of the Child A Trust corpus to the GC3 Trust for the benefit of GC3 and her descendants, will not constitute an addition to Child A Trust, Trust B, or GC3 Trust for purposes of the GST tax. See § 26.2601-1(b)(1)(v)(B).

Accordingly, the division of Child A Trust and the exercise of Child A's power of appointment, pursuant to the terms of the settlement agreement, will not result in Child A Trust losing its generation-skipping transfer tax exempt status under § 2601 and will not subject Child A Trust, Trust B or GC3 Trust to the GST tax.

Further, pursuant to the terms of the proposed settlement, at all times, the trustee of Child A Trust, prior to the division, and of Trust B and GC3 Trust, after the division, will be either Trustee or another independent corporate trustee. At no time will any of the three trusts have a trustee that is not an independent corporate trustee. Also, Child A will delegate all rights and powers as "adviser" with respect to the GC3 Trust to GC3. GC3's powers as trust adviser will be limited as prescribed in Paragraph 14 of Trust, and can only be exercised in a fiduciary capacity.

Accordingly, the appointment of a new corporate trustee to serve as trustee of GC3 Trust and the appointment of GC3 as the adviser with respect to GC3 Trust are modifications that are administrative in nature and will not subject Child A Trust, Trust B, or GC3 Trust to the GST tax. See § 26.2601-1(b)(4)(i)(D)(2).

Ruling #5:

You have requested a ruling that the division of Child A Trust into GC3 Trust and Trust B and the allocation of the assets of Child A Trust between GC3 Trust and Trust B will not constitute a transfer by any trust or beneficiary that will be subject to the gift tax under § 2501.

Section 2501 imposes a tax for each calendar year on the transfer of property by gift during such calendar year by any individual.

PLR-119764-03

Section 2511 provides that, subject to certain limitations, the gift tax applies whether the transfer is in trust or otherwise, direct or indirect, and whether the property transferred is real or personal, tangible or intangible.

Section 25.2511-1(c)(1) of the Gift Tax Regulations states that any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax.

Whether an agreement settling a dispute is effective for gift tax purposes, depends on whether the settlement is based on a valid enforceable claim asserted by the parties and, to the extent feasible, produces an economically fair result. See Ahmanson Foundation v. U.S., 674 F.2d 761, 774-775 (9th Cir. 1981), citing Commissioner v. Estate of Bosch, 387 U.S. 456 (1967). Thus, state law must be examined to ascertain the legitimacy of each party's claim. If it is determined that each party has a valid claim, the service must determine that the distribution under the settlement reflects the result that would apply under state law. If there is a difference, it is necessary to consider whether the difference may be justified because of the uncertainty of the result if the question were litigated.

The law of State X requires that trusts be administered with due regard to the respective interests of income beneficiaries and remaindermen. Cite 2. Exercise by trustees of judgment and care which persons of prudence, discretion and intelligence would exercise in the management of their own personal affairs and under the circumstances then prevailing is a basic duty of the trustee. Cite 3.

Based on the information submitted and the facts, as described in the submitted documents and the court order, a bona fide controversy existed between the parties pertaining to the administration of the dispositive provisions of Child A Trust and the role of Child A as the adviser to Trustee. All the parties who hold an interest in the Child A Trust, including GGC3 and any unborn heirs, have been represented in the negotiations that preceded the proposed settlement agreement. The terms of the proposed settlement is based on arms-length negotiations among all the interested parties.

The terms of the settlement agreement are reflective of the rights of the parties under the applicable law of State X that would be applied by the highest court of that state. Accordingly, based on the facts submitted and the representations made, we conclude that implementation of the proposed settlement agreement dividing Child A Trust into GC3 Trust and Trust B and the allocation of the assets of Child A Trust between GC3 Trust and Trust B, as set forth in the proposed settlement agreement, will not constitute a transfer by any trust or beneficiary of Child A Trust that will be subject to the gift tax under § 2501.

PLR-119764-03

Rulings #6 and #7:

It is the practice of the Service, in the interest of sound tax administration, to answer inquiries of individuals and organizations regarding the tax effects of their acts or transactions, prior to the filing of returns or reports that are required by the revenue laws. However, under section 6.02 of Rev. Proc. 2004-1, 2004-1 I.R.B. 1, 14, the Service will decline to rule when appropriate in the interest of sound tax administration or on other grounds, whenever warranted by the facts or circumstances of a particular case. Pursuant to this provision, we decline to provide rulings with respect to ruling requests #6 and #7.

Ruling #8:

You have requested a ruling that, after the division of Child A Trust into GC3 Trust and Trust B, both GC3 Trust and Trust B will be treated as separate taxpayers under § 643(f).

Section 643(f) provides that, under regulations to be prescribed by the Secretary, two or more trusts shall be treated as one trust if (1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose of such trusts is the avoidance of federal income tax.

The GC3 Trust and Trust B are to be established as a result of the division of the Child A Trust. These trusts are created as of the date of the division and, therefore, are subject to § 643(f).

While the GC3 Trust and Trust B will have the same grantor, the trusts will have different primary beneficiaries. Provided that the GC3 Trust and Trust B are separately managed and administered, the GC3 Trust and Trust B will be treated as separate trusts for federal income tax purposes.

A copy of this letter should be attached to any income, gift, estate, or generation-skipping transfer tax returns that you may file relating to these matters.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by the appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination. Except as specifically ruled above, no opinion is expressed as to the federal tax consequences of the facts described above under the cited provisions or any other provisions of the Code or regulations. This ruling is conditioned on the approval of the division of the Child A Trust under the terms described in the taxpayer's letter and the settlement agreement.

PLR-119764-03

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,

George Masnik
Chief, Branch 4
Associate Chief Counsel
(Passthroughs and Special
Industries)

Enclosure
Copy for section 6110 purposes