Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Number: **200112038**
Release Date: 3/23/2001
Index Number: 1001.02-00, 2601.00-00

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Refer Reply To:
CC:PSI:7 - PLR-116076-99;
PLR-118123-99; PLR-118124-99
Date:
December 20, 2000

LEGEND:

a
Grantor
Trust 1

Trust 2

Trust 3

Son 1
Son 2
Daughter

b
c
d

Spouse

e
f
g

Granddaughter

h
i
j
k
l
m

Dear

In a letter, dated September 29, 1999, and supplemental submissions, dated November 15, 1999, and September 13, 2000, you requested rulings concerning the income, gift, and generation-skipping transfer (GST) tax consequences of a Settlement Agreement and the exercise of a limited power of appointment. This letter responds to your request.

The information submitted and the representations made are summarized as follows: On a, Grantor created Trust 1, Trust 2, and Trust 3 (collectively the Trusts) for the benefit of Grantor's three children, Son 1, Son 2, and Daughter (the beneficiaries). Each of Son 1, Son 2, and Daughter is the named beneficiary of a Trust.

The terms of the Trusts are identical except with respect to the identity of the beneficiaries. The relevant provisions of the Trusts are summarized as follows:

Article II, Paragraph (1) of the Trust provides that during each calendar year, commencing with the calendar year ending b, the sum of c is to be accumulated and added to the corpus of the Trust estate.

Paragraph (2) of Article II of the Trust provides that there is to be paid to the named beneficiary during his or her lifetime, subject to prior termination as herein provided, that portion of the balance of the income as the trustees in their discretion may determine to be for the best interest of the beneficiary; it being intended that the beneficiary is to be given a reasonable allowance to clothe, educate, and care for himself or herself.

Article II, Paragraph (3) of the Trust provides that in case of the death of a named beneficiary leaving children surviving him or her, the trustees may use that portion of the balance of the income for the support and education of that beneficiary's children, as in their discretion may seem best. The payments are to continue as long as the Trust continues to exist, provided, however, that if the beneficiary leaves no children surviving him or her, then the trustees are to pay to the beneficiary's siblings, share and share alike, or to the survivor of them, that portion of the balance of the net income as in the discretion of the trustees is for the best interests of the named

beneficiaries. The payments are to continue so long as the Trust continues in existence. In case either sibling is then dead, leaving issue, or thereafter dies, leaving issue, the issue is to receive the parent's share of the income.

Article II, Paragraph 4 of the Trust provides that the balance of the income, if any, after the trustees have complied with the provisions of either paragraph (2) or paragraph (3) of Article II of the Trust, is to be accumulated and added to the corpus of the Trust estate, the distributable and/or accumulated income is to be determined annually as of d of each year, the first allocation under this subdivision is to be as of b.

Article II, Paragraph 5 of the Trust provides that the trustees may make payments either monthly, quarterly, semiannually, annually, or otherwise as they deem best.

Article III of the Trust provides that the trustees may at any time during the existence of the Trust, by unanimous agreement, expend any portion of the corpus of the Trust for the benefit of the beneficiary, or for the benefit of the beneficiary's children, if any, where in the judgment of the trustees they deem it proper for the benefit of the named beneficiary or for the benefit of the beneficiary's children that a portion of the corpus be so used.

Article IV of the Trust provides that the Trust is to continue during the lives of Grantor, Spouse, Son 1, Daughter, Son 2, and the survivor of them, subject to prior termination thereof, pursuant to the power of appointed granted to the beneficiaries under the Trust. The duration of the Trust in no event, nor by any possibility, is to extend beyond the death of the last survivor of the persons mentioned in Article IV.

If the power of appointment described in Article V is not exercised as authorized in the Trust, then on the death of the last survivor of the persons named in Article IV, the Trust is to terminate and the corpus of the Trust Estate, together with all accumulations, is to be distributed to the then living issue of Son 1, Son 2, and Daughter, the children of any deceased issue taking by right of representation, and if there is no issue surviving them, then to the heirs at law of all of the named beneficiaries.

Article V of the Trust provides that the absolute power of appointment and disposition of the principal of the Trust Estate, or a portion thereof, may be exercised, not by will, but only upon the conditions specified in the Trust and by a written instrument exercising the power filed with the trustees. The power of appointment and disposition of the principal of the Trust Estate, or a portion thereof, may be exercised by the beneficiaries authorized to do so, in the following order and upon the happening of the following events:

(A) The beneficiary may exercise the power of appointment upon reaching the age of e years and having at that time one or more children, but if at that time he has no children, then at any time subsequent thereto after the birth of one or more children.

(B) In the event the beneficiary dies before reaching the age of e years and leaves one or more children surviving him or her, or dies after reaching the age of e and leaves one or more children and the power of appointment has not been exercised as authorized in the Trust, then the surviving child of the beneficiary, or the eldest of any surviving children, may exercise the power of appointment if of age or by its duly qualified guardian if under age, provided the Trust has not then terminated.

(C) In the event the beneficiary dies without leaving any surviving child or children, then the trustees are to apportion the Trust estate into two equal shares, one share as to each of beneficiary's siblings and each of the named children may exercise the power of appointment as to the share allocated to that child, upon the child reaching the age of e years and having at that time one or more children, but if at that time he or she has no children, then at any time subsequent thereto after the birth of one or more children, provided however, that if either of the beneficiary's siblings dies before reaching the age of e years and leaves no children surviving, then the power of appointment may be exercised by the eldest of the surviving children of the deceased sibling if of age, or by its duly qualified guardian if under age, provided the Trust has not then terminated.

The power of appointment may be exercised by the above named beneficiaries, only in the event the beneficiary entitled to exercise the power of appointment has agreed with the trustees of the Trust on the form of a Declaration of Trust and on the personnel of the three trustees under the Declaration of Trust, under which that portion of the corpus of the Trust as to which the power of appointment is exercised, is to be held by the three trustees, under the Declaration of Trust, and under which the income is to be utilized for the education, support, and maintenance of the beneficiaries thereunder. The trust is to continue for such period beyond the life of the person exercising the power of appointment as is agreed upon in the Declaration of Trust, but not longer than lives in being at the time of the creation of the trust. At the time the Declaration of Trust has been agreed to by the trustees and by the beneficiary authorized to exercise the power of appointment, the beneficiary shall, in writing filed with the trustees of the Trust, authorize the trustees to transfer that portion of the Trust estate over which the power of appointment is exercised, to the three trustees named in the Declaration of Trust. When the form of the Declaration of Trust and the personnel of the three trustees has been agreed upon, as provided in the Trust, and upon the filing with the trustees of the Trust of the written exercise of the power of appointment, then the trustees of the Trust are to transfer that portion of the Trust Estate as to which the power of appointment has been exercised to the three trustees named in the

Declaration of Trust, whereupon the Trust is to terminate as to that portion of the Trust Estate over which the power of appointment has been exercised.

Son 1 died survived by f children. Trust 1 currently is being administered for the benefit of the children of Son 1. Son 2 died without issue. Trust 2 currently is being administered one-half for the benefit of Daughter and one-half for the benefit of the children of Son 1. Daughter is still living and has g children. Trust 3 currently is being administered for the benefit of Daughter.

Because Son 1 died after reaching the age of e years and without having exercised his power of appointment, Granddaughter, the eldest child of Son 1, has a power of appointment over Trust 1. Daughter has a power of appointment over one-half of Trust 2. There is no power of appointment over the other half of Trust 2. Daughter has renounced her power of appointment over Trust 3.

If the powers of appointment are not exercised, the Trusts will terminate on Daughter's death. At that time, the corpus of each Trust, together with all accumulations, is to be distributed to the children of Son 1 and the children of Daughter. There is no direction in the Trusts as to whether the Trusts are to be distributed *per capita* or *per stirpes*. If the Trusts are distributed *per stirpes*, the children of Daughter would receive h (each would receive i) and the children of Son 1 collectively would receive h (each would receive j) of the Trusts. If the Trusts are distributed *per capita*, each of the children of Son 1 and the children of Daughter would receive k of the Trusts.

The beneficiaries have entered into a Settlement Agreement, which provides that on the termination of the Trusts, each of the children of Son 1 will receive l percent of Trust 2 and l percent of Trust 3. Each of the children of Daughter will receive receive m percent of Trust 2 and m percent of Trust 3. Daughter will continue to receive distributions from Trust 2 and Trust 3 in accordance with their terms.

Granddaughter and the existing trustees of Trust 1 intend to appoint the assets of the Trust 1 to a new trust, Trust 4. Each of the children of Son 1 will receive l percent of the income of Trust 4 and each of the children of Daughter will receive m percent of the income of Trust 4. Trust 4 may be terminated by a majority vote of the group consisting of the children of Son 1 and the children of Daughter at any time after the issuance of a private letter ruling concluding that none of the terms of the Settlement Agreement will cause any adverse federal income, estate, or GST tax consequences. In no event, however, may Trust 4 terminate later than the death of Daughter. On the termination of Trust 4, each of the children of Son 1 will receive l percent of the assets of Trust 4 and each of the children of Daughter will receive m percent of the assets of Trust 4.

You have requested the following rulings:

Gift Tax:

(1) The terms of the Settlement Agreement, including the material elements, and the implementation thereof, will not result in a taxable gift by any party to the Settlement Agreement.

(2) The exercise by Granddaughter of her power of appointment over Trust 1 does not constitute the exercise of a general power of appointment and therefore does not constitute a taxable gift by Granddaughter or any other party to the Settlement Agreement.

GST Tax:

The terms of the Settlement Agreement, including the material elements, and the implementation thereof, will not result in any of Trust 1, Trust 2, Trust 3, or Trust 4 losing its status as a grandfathered, effective date trust that is exempt from the GST tax.

Income Tax:

The terms of the Settlement Agreement, including the material elements, and the implementation, thereof, will not result in the realization of capital gain, capital loss, or taxable income by any party to the Settlement Agreement.

Gift Tax Rulings:

Settlement of Distribution Rights on Trust Termination:

Section 2501(a) of the Internal Revenue Code imposes a tax for each calendar year on the transfer of property by gift during the calendar year by any individual, resident or nonresident.

Section 2511(a) provides that the tax imposed by § 2501 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.

Section 2512(a) provides that if the gift is made in property, the value thereof at the date of the gift is considered the amount of the gift.

Section 2512(b) provides that where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which

the value of the property exceeds the value of the consideration is deemed a gift, and is included in computing the amount of gifts made during the calendar year.

Based on the information submitted and the representations made, we conclude that the terms of the Settlement Agreement, including the material elements, and the implementation thereof, will not result in a taxable gift by any party to the Settlement Agreement.

Power of Appointment:

Section 2041(b)(1)(B) provides that a power of appointment created on or before October 21, 1942, which is exercisable by the decedent only in conjunction with another person shall not be deemed a general power of appointment.

Section 2514(a) provides, in part, that an exercise of a general power of appointment created on or before October 21, 1942, shall be deemed a transfer of property by the individual possessing the power.

Section 25.2514-2(a) of the Gift Tax Regulations provides that a power created on or before October 21, 1942, which at the time of the exercise is not exercisable by the possessor except in conjunction with another person, is not deemed a general power of appointment.

Granddaughter may exercise the power of appointment of the assets of Trust 1 only in conjunction with the trustees of Trust 1. Therefore, pursuant to § 2041(b)(1)(B), Granddaughter's power of appointment is not a general of appointment. Accordingly, based on the information submitted and the representations made, we conclude that the exercise by Granddaughter of her power of appointment over Trust 1 does not constitute a taxable gift by Granddaughter or any other party to the Settlement Agreement.

Income Tax Rulings

Settlement of Distribution Rights on Trust Termination:

Section 61(a)(3) provides that gross income includes gains derived from dealings in property.

Section 102 excludes from gross income the value of property acquired by gift, bequest, devise, or inheritance.

In Lyeth v. Hoey, 306 U.S. 188 (1938), the Supreme Court held that property received by an heir from an estate in compromise of his claim that the will was invalid is

exempt from Federal income tax under the predecessor of § 102. The Court reasoned that the taxpayer obtained his portion of the compromise by reason of his status as an heir. Further, because payments that the taxpayer would have received upon a favorable ruling would not be taxable, there was no reason to treat proceeds received as the result of a compromise differently. 306 U.S. at 196. However, proceeds received pursuant to an agreement between estate beneficiaries as to how funds should be distributed, notwithstanding the terms of a controlling document, as opposed to a compromise of their claims against the estate, are not exempted from tax by § 102. Such payments would be received by virtue of being a party to the agreement, not by virtue of being an heir to the estate. See Commissioner v. Estate of Vease, 314 F.2d 79, 86-87 (9th Cir. 1963).

In the instant case, the Settlement Agreement's proposed distribution of the corpus of Trust 1, Trust 2, and Trust 3 on termination is a compromise by the children of Son 1 and the children of Daughter of their claims against the estate, consistent with Lyeth v. Hoey. Therefore, the proposed distribution will not result in taxable income, pursuant to § 102.

The administrative provisions of the Settlement Agreement are necessary to effectuate the terms of the Settlement Agreement and do not give rise to a realization event under § 1001(a).

Power of Appointment:

Section 1001(a) states that gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in § 1011, and loss is the excess of the adjusted basis over the amount realized.

Section 1.1001-1(a) of the Income Tax Regulations provides generally that gain or loss realized from an exchange of property for other property differing materially either in kind or extent is treated as income or as loss sustained.

Rev. Rul. 56-437, 1956-2 C.B. 507, holds that the conversion of a joint tenancy into a tenancy in common is a nontaxable transaction. Likewise, the severance of a joint tenancy under a partition action pursuant to state law is a nontaxable transaction. In each situation there is no sale or exchange and the taxpayers neither realized a taxable gain nor sustained a deductible loss.

Rev. Rul. 69-486, 1969-2 C.B. 159, holds that a non-pro rata distribution of trust corpus in kind by mutual agreement of the beneficiaries is subject to gain or loss treatment under § 1001. The trust instrument cited in the ruling did not contain a provision allowing the trustee to make a non-pro rata distribution and local law did not convey authority on the trustee to made a non-pro rata distribution of property in kind.

Where neither the trust instrument nor local law convey authority on the trustee to make a non-pro rata distribution, the beneficiaries are viewed as having an absolute right to a ratable in kind distribution. Accordingly, the distribution was equivalent to a ratable distribution to the beneficiaries followed by an exchange between the beneficiaries that was subject to § 1001.

In Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991), the Supreme Court addressed the issue of when an exchange of property gives rise to a realization event under § 1001. Under the facts of that case, a financial institution exchanged its interests in one group of residential mortgage loans for another lender's interests in a different group of residential mortgage loans. The two groups of mortgages were considered "substantially identical" by the agency that regulated the financial institutions. The Supreme Court concluded that § 1.1001-1 of the Regulations reasonably interprets § 1001(a) and stated that an exchange of property gives rise to a realization event under § 1001(a) if the properties exchanged are "materially different." 499 U.S. at 560-561.

In defining what constitutes a "material difference" for purposes of § 1001(a), the Court stated that properties are "different" in the sense that is "material" to the Code so long as their respective possessors enjoy legal entitlement that are different in kind or extent. 499 U.S. at 564-565. The Court held that mortgage loans made to different obligors and secured by different homes did embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged the loans. 499 U.S. at 566.

Thus, in order for a transaction to result in a § 1001 taxable event, the transaction must be (1) a sale, exchange, or other distribution, and (2) if an exchange, the exchange must result in the receipt of property that is “materially different,” within the meaning of Cottage Savings, from the property that was given up.

Trust 1 authorizes Granddaughter to exercise her power of appointment so as to create Trust 4. Therefore, the instant case is analogous to Rev. Rul. 56-437. In both instances, the beneficiaries are exercising their authority granted in the controlling document or pursuant to state law. For this reason, the exercise of Granddaughter’s power also is distinguishable from the trustee’s distribution in Rev. Rul. 69-486, which was not authorized by the controlling document or by state law. Accordingly, the beneficiaries will not be deemed to have exchanged their interests in Trust 1 for interests in Trust 4. The exercise of Granddaughter’s power of appointment over Trust 1 does not give rise to a realization event under § 1001(a).

GST Tax Rulings:

Section 2601 imposes a tax on every generation-skipping transfer made by the "transferor" to a "skip-person."

Section 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations provides that the provisions of chapter 13 do not apply to any generation-skipping transfer under a trust (as defined in § 2652(b)) that was irrevocable on September 25, 1985. The rule of the preceding sentence does not apply 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.

Section 26.2601-1(b)(1)(ii) provides that, except as provided in § 26.2601-1(b)(1)(ii)(B) or (C), any trust (as defined in § 2652(b)) in existence on September 25, 1985, is considered an irrevocable trust.

Section 26.2601-1(b)(1)(v)(B) provides that the release, exercise, or lapse of a power of appointment (other than a general power of appointment as defined in § 2041(b)) is not treated as an addition to a trust if–

(1) Such power of appointment was created in an irrevocable trust that is not subject to chapter 13 under § 26.2601-1(b)(1); and

(2) In the case of an exercise, 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). For purposes of § 26.2601-1(b)(1)(v)(B)(2), the exercise of a power of appointment 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 of creation of the trust) will not be considered an exercise that postpones or suspends vesting, absolute ownership, or the power of alienation beyond the perpetuities period. If a power is exercised by creating another power, it is deemed to be exercised to whatever extent the second power may be exercised.

Settlement of Distribution Rights on Trust Termination:

Based on the information submitted and the representations made, we conclude that the Settlement Agreement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the Settlement Agreement. Accordingly, we conclude that the Settlement Agreement, will not cause any of the Trusts to be subject to the GST tax.

Power of Appointment:

Granddaughter's power of appointment is a limited power of appointment because it was created on or before October 21, 1942 and it is exercisable by Granddaughter only in conjunction with another person. Granddaughter intends to appoint the assets of Trust 1 to Trust 4. Trust 4 may not terminate later than the death of Daughter. Thus, Granddaughter is not proposing to exercise the power of appointment 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 Trust 1 became irrevocable, extending beyond any life in being at that date plus a period of 21 years. Accordingly, based on the information submitted and the representations made, we conclude that the exercise by Granddaughter of her power of appointment over Trust 1 will not cause constructive additions to be deemed to have occurred for purposes of the GST tax

Except as specifically ruled above, we express or imply no opinion concerning the federal tax consequences of this transaction under the cited provisions or any other provision of the Code.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,
James C. Gibbons
Assistant to the Chief, Branch 7
Office of Associate Chief Counsel
(Passthroughs and Special Industries)