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Person To Contact:

Telephone Number:

Refer Reply To:
CC:PSI:4
PLR-110163-06

Date:
May 29, 2007

Re:

Legend:

Settlor	-
Trust	-
Trustee	-
Child A	-
Spouse A	-
Grandchild A-1	-
Grandchild A-2	-
Grandchild A-3	-
Trust A	-
Trust A-S	-
Trust A-1	-
Trust A-2	-
Trust A-3	-
Child B	-
Spouse B	-

Grandchild B-1 -
 Grandchild B-2 -
 Trust B -
 Trust B-1 -
 Trust B-2 -
 Child C -
 Spouse C -
 Grandchild C-1 -
 Grandchild C-2 -
 Trust C -
 Foundation -
 Date 1 -
 Date 2 -
 Date 3 -
 Date 4 -
 State X -
 State Statute -
 Court -

Citation 1 -

Citation 2 -

Citation 3 -

Citation 4 -

Dear :

This is in response to your authorized representative's submission dated January 23, 2006, in which a ruling was requested on the income, gift and generation-skipping transfer tax consequences of a proposed Settlement Agreement.

The submitted facts are as follows:

Settlor died on Date 2, survived by his three children, Child A, Child B and Child C. Child A died on Date 3, survived by his spouse, Spouse A, and his children, Grandchild A-1, Grandchild A-2, and Grandchild A-3. Child B died on Date 4, survived by his spouse, Spouse B, and his children, Grandchild B-1, and Grandchild B-2. Child C is currently living, is married to Spouse C, and has one living child, Grandchild C-2. Child C's other child, Grandchild C-1, is deceased and is survived by one child.

On Date 1, prior to September 25, 1985, Settlor established an irrevocable Deed of Trust (Trust). Under Article ONE, subparagraph (A) of Trust, the trust estate is immediately divided into three separate trusts, Trust A for the primary benefit of Child A and Child A's descendants, Trust B for the primary benefit of Child B and Child B's descendants, and Trust C for the primary benefit of Child C and Child C's descendants. The duration of the trusts is to be "measured by the natural lives of [Settlor's three children], [Settlor's] grandchildren, and the last survivor of [Settlor's] great-grandchildren living at the time of [Settlor's] death, and twenty-one (21) years thereafter."

Subparagraph (A)(1) of Article ONE provides that with respect to each trust, the trustee is to pay or apply the trust income at least semi-annually to for the benefit of the Child for whom the trust was established for that Child's lifetime. On the Child's death, the trust is to continue and the trust income is to be paid to or for the benefit of the issue of the Child, per stirpes. However, the trust instrument states that "as to each beneficiary of any trust created hereunder leaving to survive him or her a spouse, then living with said beneficiary," the trustee is to pay to such spouse, so long as he or she remains unmarried, fifty percent of the trust income. In the event that there is no surviving spouse, or if the surviving spouse dies or remarries, the surviving spouse's share of the income will be paid to the person or persons entitled to receive the remaining fifty percent of the trust income.

Notwithstanding the language of Article ONE, subparagraph (A)(1), discussed above, Article ONE, subparagraph (A)(2) provides that on the death of each child of Settlor, the principal of the trust established for the benefit of the child will be divided into as many equal shares as that child has living children or children deceased with issue then living, "UNDER AND SUBJECT HOWEVER, to the provisions of subparagraph (A)(1) of ARTICLE ONE hereof" (emphasis in original). Article ONE, subparagraph (A)(2)(a) provides that the share set aside for a living grandchild of Settlor and each share set aside for the then living issue per stirpes of a deceased grandchild of Settlor is to be held in a separate trust. The income from the separate trust is to be paid at least semi-annually to or for the benefit of the grandchild for life and then to the grandchild's issue for life, provided, however, that as to each trust created under the provisions of ARTICLE ONE, subparagraph A)(2)(a), if an income beneficiary dies leaving a surviving spouse, the trustee is to pay 50% of the trust income to the surviving spouse, for life or until remarriage, and the remaining 50% is to be paid to the beneficiary or beneficiaries otherwise entitled to receive the trust income.

Article TWO provides that "in addition to the provisions of sub-paragraph (A)(1) of Article ONE", the Trustee may also pay from time to time, from the principal of the separate trusts such amounts to, or for the benefit of, each income beneficiary (excluding however, the surviving spouse of any income beneficiary), as the Trustee in its absolute discretion may deem appropriate, to provide for the health, support, and maintenance of any income beneficiary.

Article THREE provides that upon the death of the last survivor of Settlor's children, grandchildren and great-grandchildren, respectively, and at the expiration of the twenty-one (21) year period (noted above), or should any trust terminate for any reason whatsoever prior to that time, the principal of the trust, with accumulations of income, if any, is to be distributed to Foundation to be used for charitable purposes.

Under Article FOUR, each income beneficiary who attains age fifty, is granted the power to withdraw annually from his or her trust the greater of the sum of \$5,000 or an amount equal to 1% of the principal.

Trustee, an unrelated financial corporation, is the trustee of Trust and each trust created under the terms of Trust. Each trust created under the terms of Trust is governed by the law of State X.

As discussed above, Article ONE subparagraph (A)(1) provides that upon the death of each of Child A, Child B and Child C, the trust established for that child (Trust A, Trust B or Trust C, as the case may be) is to continue as one trust with the surviving spouse of the deceased child and the child's issue as income beneficiaries. On the other hand, Article ONE subparagraph (A)(2) indicates that upon the death of each of Child A, Child B and Child C, the respective trust established for that child is to be divided into separate shares for the benefit of each grandchild and the grandchild's issue. The subparagraph does not expressly provide the child's surviving spouse with any income benefit. However, the provision states that the trust is to be divided "under and subject to" the provisions of Article ONE. Further, whether the child's trust is divided, or continues as one trust impacts on the amount subject to the beneficiaries' withdrawal rights under Article FOUR, and the amount subject to principal invasions under Article TWO.

On Child A's death on Date 3, Trustee determined that under the conflicting provisions of Article ONE, Trust A was to be divided into four separate trusts: one trust (Trust A-S) was created for Spouse A, and was funded with one-half of the Trust A corpus. Spouse A received the income from Trust A-S. The remaining one-half of Trust A was distributed in equal shares to Trust A-1 (for the benefit Grandchild A-1), Trust A-2 (for Grandchild A-2), and Trust A-3 for Grandchild A-3). Further, concerning the operation of Article Four granting the beneficiaries withdrawal rights, the Trustee maintains that with respect to Trust A-1, Trust A-2, and Trust A-3 established on Child A's death, Article Four is to be applied such that upon attaining age 50, each of Grandchild A-1, A-2 and A-3, has the right to withdraw up to one percent of the value of his or her respective Trust A-1, Trust A-2, or Trust A-3, rather than one percent of the combined value of Trust A-1, Trust A-2, Trust A-3 and Trust A-S. Trustee administered the four separate trusts in this manner for several years.

Subsequently, after Child B's death on Date 4, Child B's issue took issue with the Trustee's interpretation of Article ONE. Child B's issue contended that under the terms of the Trust agreement, Trust B was not to be divided; rather, the trust corpus was to continue to be held in a single trust for the benefit of Spouse B, Grandchild B-1, and Grandchild B-2. Spouse B was to receive one-half the trust income, and the balance was paid equally to Grandchild B-1, and Grandchild B-2. Further, Article Four is to be applied such that upon attaining age 50, each of Grandchildren B-1 and B-2 has the right to withdraw up to one percent of the entire trust estate of Trust B.

The interested parties filed a petition with Court, the appropriate local court in State X, for an accounting and to clarify the proper distribution of Trust A, Trust B, and Trust C. In addition, the petition requested that Court resolve certain additional

ambiguities in the dispositive provisions of Trust A, Trust B, and Trust C. Court declined to rule on the petitions and, instead, requested that the parties take positions in order to commence litigation of the issues. In order to resolve the controversy without litigation, the beneficiaries entered into a Settlement Agreement. The Attorney General of State X entered an appearance on behalf of the interests of the Foundation. In addition, a guardian ad litem was appointed to represent minors and unborn beneficiaries.

The pertinent provisions of the Settlement Agreement provide as follows.

1. In view of the terms of Article ONE, subparagraph (A)(1) when read in conjunction with subparagraph (A)(2), upon the death each respective Child of Settlor, a separate trust is established for each of the living children (Grandchildren) of such deceased child, and one trust for the descendants of each deceased Grandchild of Settlor then leaving living issue surviving (with the share of the deceased grandchild being divided into separate trusts on a per stirpes basis). If any Child is survived by his or her spouse, such spouse will be entitled to one-half of the income of each separate trust established for a Grandchild (or for the descendants of a deceased Grandchild), for such spouse's life or until his or her remarriage.

2. The provisions of Article Four of Trust permitting the withdrawal of principal will apply to each separate trust established for a Grandchild, or a descendant of a Grandchild, who is a beneficiary of a separate trust and, who attains age 50, (whether or not the surviving spouse of a deceased child of Settlor is also a beneficiary of one-half of the income of such separate trust). The withdrawal right is not to exceed in the aggregate the greater of the sum of Five Thousand Dollars (\$5,000) or an amount equal to one percent of the appraised value of the principal of such separate trust determined as of the close of business on the last business day of the preceding fiscal year as though such separate trust had been in existence on such last business day.

3. Further, upon the death of any descendant of Settlor for whom a separate trust was established, there shall be established a separate trust for each descendant of

such deceased descendant, per stirpes. The surviving spouse of the deceased descendant will be entitled to 50% of the income of each trust until his or her death or remarriage. In the event that there remains a surviving spouse of an ancestor of the descendant, that ancestor's surviving spouse would continue to receive the share of the income which he or she had been receiving, until his or her death or remarriage. Any descendant of Settlor for whom a separate trust is established will be entitled to the withdrawal rights over such separate trust as provided under Article Four of Trust.

4. Any descendant for whom a separate trust is at any time created will be a permissible beneficiary of principal of such separate trust under Article Two of Trust.

5. The Settlement Agreement will operate prospectively only. Accordingly: With respect to Trust A-S, that was established for Spouse A, Child A's surviving spouse, the trust will be terminated and divided into three equal shares, one share will be distributed to each of Trust A-1, Trust A-2, and Trust A-3, for the benefit of Grandchild A-1, Grandchild A-2, and Grandchild A-3, respectively. Spouse A will be entitled to 50 percent of the income from each of the three separate trusts;

With respect to Trust B, which was not divided upon Child B's death on Date 4, Trust B will be divided into two separate trusts, Trust B-1 and Trust B-2, to be established for the benefit of Grandchild B-1 and Grandchild B-2, respectively. Child B's spouse, Spouse B, who was living at Child B's death, will be entitled to 50 percent of the income from each separate trust until her death or remarriage.

6. The Settlement agreement contains specific provisions describing how trust income is to be distributed, for example, in the event a grandchild dies survived by a spouse and children, and the spouse of a child of the Decedent is still entitled to receive one-half of the trust income.

The Settlement Agreement and the implementation of its provisions are contingent upon: 1) a favorable ruling from the IRS; 2) the receipt of a letter from the State Attorney General, in its capacity as *parens patriae*, stating that there is no objection to the terms of the Settlement Agreement; and 3) the receipt of a Court order approving the terms of the Settlement Agreement.

The following rulings are requested.

1. The implementation of the terms of the Settlement Agreement will not cause any separate trust under Trust or any distribution from a separate trust to be subject to the federal generation-skipping transfer (GST) tax imposed under Chapter 13.
2. The division and operation of Trust A and the distributions made from Trust A-S, Trust A-1, Trust A-2, and Trust A-3 prior to the implementation of the terms

of the Settlement Agreement and the termination and distribution of Trust A-S pursuant to implementation of the Settlement Agreement will not cause any of such trusts or any of the beneficiaries of such trusts to be subject to the federal GST tax.

3. The implementation of the terms of the Settlement Agreement will not cause any beneficiary of a separate trust under Trust to make or to be deemed to have made a transfer that will be subject to the federal gift tax under Chapter 12.

4. The division of Trust A and the income and principal distributions made from Trust A-S, Trust A-1, Trust A-2, and Trust A-3 prior to the implementation of the Settlement Agreement will not cause any beneficiary of such trusts to be deemed to make a transfer that will be subject to federal gift tax.

5. The division of any separate trust into further separate trusts pursuant to the terms of the Settlement Agreement will not cause any trust or any beneficiary to realize gain or loss for federal income tax purposes.

6. The termination and distribution of Trust A-S pursuant to the terms of the Settlement Agreement will not cause Trust A, Trust A-S, Trust A-1, Trust A-2, and Trust A-3 or any beneficiary of such trusts to recognize gain or loss for federal income tax purposes.

Ruling Requests 1 and 2:

Section 2601 imposes a tax on every generation-skipping transfer made after October 22, 1986. Section 2611(a) defines a generation-skipping transfer as a taxable distribution, a taxable termination or a direct skip.

Section 2611(a) defines the term "generation-skipping transfer" as a taxable distribution, a taxable termination, and a direct skip.

Under § 1433(b)(2)(A) of the Tax Reform Act of 1986 and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the generation-skipping transfer tax provisions do not apply to any generation-skipping transfer under a trust (as defined in § 2652(b)) that was irrevocable on September 25, 1985. However, this exemption does not apply if additions (actual or constructive) are made to the trust after September 25, 1985.

Section 26.2601-1(b)(1)(ii)(A) provides that any trust in existence on September 25, 1985, will be considered an irrevocable trust except as provided in § 26.2601-1(b)(1)(ii)(B) or (C), which relates to property includible in a grantor's gross estate under §§ 2038 and 2042. In the present case, Trust is considered to have been irrevocable on September 25, 1985, because neither § 2038 nor § 2042 applies.

Section 26.2601-1(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 § 26.2601-1(b)(1), (2), or (3) (hereinafter referred to as an exempt trust) will not cause the trust to lose its exempt status. The rules contained in § 26.2601-1(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 § 1001.

Section 26.2601-1(b)(4)(i)(B) provides that 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.

Section 26.2601-1(b)(4)(i)(D), provides that a modification will not cause an exempt trust to be subject to the GST tax if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as 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.

State Statute provides that a trustee may, without court approval, divide a trust into separate trusts, allocating to each separate trust either a fractional share of each asset and each liability held by the original trust or assets having an appropriate aggregate fair market value and fairly representing the appreciation or depreciation in the assets of the original trust as a whole. The court, for cause shown, may authorize the division of a trust into two or more separate trusts upon such terms and conditions and with such notice as the court shall direct.

Under State X law, the intent of the settlor is determinative and must prevail; the testator's intent must be gathered from a consideration of the language contained in the four corners of the instrument, the scheme of distribution, and the circumstances surrounding the settlor at the time of execution; and the technical rules of construction should only be resorted to if the language is ambiguous or conflicting and the settlor's intent is uncertain. Citation 1. State X law governing the interpretation of wills also applies to the interpretation of trusts. Citation 2. When the intention of the testator is unknown the law will impute to his words a meaning that will conform to his probable

intention and be most agreeable to reason and justice. Citation 3. “In order to ascertain the actual intent of the settlor or testator, the Court must place itself in his armchair and consider not only the language and scheme of the instrument but also the facts and circumstances with which he was surrounded; and those surrounding facts and circumstances include the condition of his family, the natural objects of his bounty and the amount and character of his property.” Citation 4.

In the present case, Trust was as an irrevocable trust on Date 1. There have been no additions made to Trust after September 25, 1985. Accordingly, Trust is exempt from the GST tax under § 26.2601-1(b)(1).

Based on the facts presented and the representations made, the Settlement Agreement is a settlement of bona fide issues, the product of arm's length negotiations, and is within the range of reasonable outcomes under the governing instrument and applicable state law. Therefore, provided that Court approves the proposed Settlement Agreement, the modifications to Trust will not cause any distributions from Trust or any separate trust established pursuant to the Settlement Agreement to be subject to GST tax under chapter 13.

Further, based on facts submitted and representations made, we conclude that Trust A was divided after Child A's death into Trust A-S, Trust A-1, Trust A-2, or Trust A-3, pursuant to the Trustee's good faith attempt to administer Trust A in accordance with its terms. Further, the division of Trust A and the creation of Trust A-S did not shift any beneficial interest in Trust A to a lower generation beneficiary, or extend the time for vesting of any interest in the trust.

Accordingly, the division of Trust A into Trust A-S, Trust A-1, Trust A-2, or Trust A-3, will not cause any of such trusts to be subject to the GST tax imposed under chapter 13. Further, the termination of Trust A-S pursuant to the terms of the Settlement Agreement and the distribution of the Trust A-S corpus to Trust A-1, Trust A-2, and Trust A-3 will not cause any of such trusts to be subject to the GST tax.

Ruling Requests 3 and 4:

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

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 provides 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, 774-75 (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.

Based on the facts presented and the representations made, a bona fide controversy existed between the parties pertaining to the construction of the dispositive provisions of Trust, as described above. All parties who hold an interest in Trust, including any unborn heirs, have been represented in the negotiations that preceded the Settlement Agreement. The terms of the proposed settlement are based on arm's length negotiations among all the interested parties.

The terms of the Settlement Agreement are reflective of the rights of the parties under applicable State X law that would be applied by the highest court of that state and represent an agreement clarifying ambiguous terms of Trust. No money or other property was exchanged between the parties as a condition of execution of the Settlement Agreement.

Accordingly, based on the facts submitted and representations made, we conclude that implementation of the proposed Settlement Agreement will not cause Spouse A, Grandchild A-1, Grandchild A-2, Grandchild A-3, Spouse B, Grandchild B-1, Grandchild B-2, Child C, Spouse C, Grandchild C-2, and the child of Grandchild C-1 to make or to be deemed to have made a taxable gift for purposes of the federal gift tax under § 2501.

Further, as discussed above, Trust A was divided after Child A's death pursuant to the Trustee's good faith attempt to administer the trust in accordance with its terms. Therefore, the division of Trust A and the income and principal distributions made from Trust A-S, Trust A-1, Trust A-2, and Trust A-3 prior to the implementation of the Settlement Agreement will not cause trust beneficiaries to be deemed to have made a taxable gift for purposes of the federal gift tax.

Ruling Requests 5 and 6:

Section 102(a) provides that gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.

In Lyeth v. Hoey, 305 U.S. 188 (1938), the Supreme Court held that the income tax exclusion for property acquired by inheritance under the predecessor to § 102 applied to a compromise agreement of a claim as an heir, and thus the property was excludible from income. The Court reasoned that the taxpayer obtained his interests under the compromise by reason of his status as heir.

In this case, the Settlement Agreement providing for the division of Trust A into separate trusts, and the termination and distribution of Trust A-S without retroactive application of the terms of the Settlement Agreement is a result of a compromise among the beneficiaries of their claims against Trust. Consistent with Lyeth v. Hoey, the parties to the agreement will receive distributions from the Settlement Agreement because of their status as heirs.

Therefore, the division of any separate trust into further separate trusts will not result in taxable income to any trust created under the terms of Trust, or any beneficiary of such trusts pursuant to § 102. Further, the termination and distribution of Trust A-S without retroactive application of the terms of the Settlement Agreement, will not result in taxable income to Trust A, Trust A-S, Trust A-1, Trust A-2, Trust A-3, or any beneficiary of such trusts pursuant to § 102.

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 an 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 expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

George L. Masnik
Chief, Branch 4
Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures

Copy for 6110 purposes
Copy of this letter