Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B04 – PLR-116958-07

Date:
February 22, 2008

In Re:

Legend:

Decedent =
Date 1 =
Will =

Trust =
Child 1 =
Child 2 =
Grandchild 1=
Grandchild 2 =
Date 2 =
Grandchild 3 =

Grandchild 4 =
Grandchild 5 =
Great Grandchild 1 =

Great Grandchild 2 =

Great Grandchild 3 =

Great Grandchild 4 =

Great Grandchild 5 =

Great Grandchild 6 =

Great Grandchild 7 =

Great Grandchild 8 =

Great Great Grandchild 1 =

Great Great Grandchild 2 =

Bank =
Date 3 =
Court =

Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =
Date 9 =

Dear :

This is in response to a letter dated April 3, 2007, and other correspondence, requesting rulings on behalf of Trust, regarding the income and generation-skipping transfer (GST) tax consequences of a modification of Trust under a Settlement Agreement.

Facts

The facts submitted and representations made are as follows. Decedent died on Date 1, prior to September 25, 1985, leaving a holographic will (Will). Decedent was survived by 2 children, Child 1 and Child 2, and by two children of Child 1, Grandchild 1 and Grandchild 2. Subsequently, Child 1 had two other children, Grandchild 3 and Grandchild 4; Child 2 had one child, Grandchild 5.

Article XIII of Will provided for the establishment of a residuary trust (Trust) for the lifetime benefit of Child 1, Child 2, Grandchild 1 and Grandchild 2 (Income Beneficiaries). Under the terms of Trust, each of the Income Beneficiaries received

one-fourth of the net income quarterly for life. Trust terminates at the death of the last surviving Income Beneficiary.

Will provides for the following distributions when Trust terminates:

> [T]he entire principal of [Decedent's] estate real personal and mixed shall be divided equally between any living children of [Child 1], any living child of [Child 2], any living child or children of [Grandchild 1] and any living child or children of [Grandchild 2]. And in the event that at the time this Trust shall end I have no direct descendants living who are entitled to inherit under the terms of this Will, then, in that case, I empower the last living of my direct descendants to dispose of my residuary estate by his or her last Will and Testament in such manner as to him or her shall seem best.

Grandchild 2, the last surviving Income Beneficiary died on Date 2. Grandchild 4 and Grandchild 5 had died prior to Date 2. On Date 2, the following descendants of Decedent were then living: Grandchild 3 and three children of Grandchild 3; Great Grandchild 1 (the child of Grandchild 1); Great Grandchildren 2 and 3 (the children of Grandchild 2); Great Grandchildren 4, 5, and 6 (the children of Grandchild 4); Great Grandchildren 7 and 8 (the children of Grandchild 5); and Great Great Grandchildren 1 and 2,(the children of a predeceased child of Grandchild 5).

On Date 3, Bank, as Trustee of Trust, filed a Verified Complaint for Advice and Direction with Court (Verified Complaint). The complaint states that a dispute had arisen among the parties in interest regarding the proper interpretation of Article XIII of Will directing distribution of Trust assets at termination.

All of the parties in interest listed in the attachment to Verified Complaint, (except the three children of Grandchild 3 who determined that their interests would be adequately represented by Grandchild 3), filed pleadings, briefs, and motions with Court in response to the Court's Order to Show Cause dated Date 4. The parties advocated several different interpretations of the Will provision regarding distribution of the remaining assets of Trust upon termination.

Grandchild 3 and Great Grandchild 1 argued that the language of Will requires the division of Trust at termination among four classes of beneficiaries, the then living children of Child 1, Child 2, Grandchild 1, and Grandchild 2. Under state law, the term "child" excludes a grandchild or more remote descendant. None of Child 2's children survived the date of termination. Therefore, under state law, the corpus should be distributed one-third to Grandchild 3, one-third to Great Grandchild 1 (the child of Grandchild 1), and one third to be divided between Great Grandchild 2 and Great Grandchild 3 (the children of Grandchild 2). Great Grandchild 2 and 3 advanced similar

arguments, except that they concluded that the corpus should be divided on a per capita basis, equally between Grandchild 3, Great Grandchild 1, Great Grandchild 2 and Great Grandchild 3.

Great Grandchildren 4, 5, and 6 argued that the Court had previously determined that trust income was to be distributed per stirpes to the issue of a predeceased Grandchild, thus construing the term "living child" to include "issue" and "descendants." Further, they argued that while Decedent used the term "living child" in the termination provision of Trust, elsewhere in the Trust provisions, she employed "child" and "issue" interchangeably. Further, the last sentence of the clause at issue provides for the ultimate disposition of the corpus if there are no "direct descendants" then living which language indicates that the Decedent equated "living child" and "descendants." They also maintained that Decedent did not intend to exclude them as beneficiaries. Accordingly, they concluded that one-fifth of the remaining Trust assets would be distributed to each then living grandchild (Grandchild 3) or to the then living issue of a deceased grandchild, per stirpes.

Great Grandchildren 7 and 8 and Great Great Grandchildren 1 and 2 argued that under the Article XIII termination provision, Trust assets are to be "divided equally" among Decedent's descendants. This language could be construed to provide that Trust assets are to be distributed on a per stirpes basis to the issue of each of the four original Income Beneficiaries. Alternatively, the language could be viewed as a direction to distribute the corpus per stirpes to the issue of Child 1 and the issue of Child 2 living on the termination date. Finally, the language could be construed to mean Trust assets are to be distributed per capita among all of Decedent's descendants living at the termination of Trust.

On Date 5, Court deemed the matter a contested case and issued a Case Management Order, scheduling discovery. On Date 6, Court issued a Supplemental Case Management Order, submitting the matter to mediation upon the consent of the parties. On Date 7, the parties and their counsel appeared for mediation. After three days of mediation, the parties executed Settlement Agreement on Date 8. On Date 9, Court issued Consent Order, approving Settlement Agreement and incorporating the agreement into the order.

Settlement Agreement as incorporated in Consent Order provides that all of the income earned since the termination of Trust and all of the principal remaining in Trust at termination will be distributed as follows: 19 percent to Grandchild 3's revocable trust (to which he assigned his interest before the settlement); 19 percent to each of Great Grandchildren 1, 2, and 3; 2 percent to each of Great Great Grandchildren 1 and 2 and 4 percent to each of Great Grandchildren 7 and 8; 4 percent to each of Great Grandchildren 4, 5, and 6. Court also ordered that Trust assets may be distributed in kind to the extent feasible. Court further ordered that one-half of the assets would be

distributed upon entry of Consent Order and the balance will be distributed upon Trustee's receipt of a favorable letter ruling from the Internal Revenue Service. Court required Trustee to submit its request for a letter ruling to the Internal Revenue Service within 10 days of Date 9, and Trustee complied.

It is represented that no additions, actual or constructive, have been made to Trust since September 25, 1985.

The taxpayer has requested a ruling pursuant to § 26.2601-(b)(4) that the allocation and distribution of Trust assets among the beneficiaries under the court-approved Settlement Agreement will not cause Trust to lose exempt status for GST tax purposes and will not result in a transfer that will subject Trust or distributions from Trust to the GST tax imposed under § 2601.

Law and Analysis:

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

Under § 1433(a) of the Tax Reform Act of 1986, the generation-skipping transfer tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under § 1433(b)(2)(A) of the Tax Reform Act and § 26.2601-1(b)(1)(i), the tax does not apply to a transfer from a trust, if the trust was irrevocable on September 25, 1985, and no addition (actual or constructive) was made to the trust after that date. Under § 26.2601-1(b)(1)(ii), any trust in existence on September 25, 1985, will be considered irrevocable unless the settlor had a power that would have caused inclusion of the trust in his or her gross estate under §§ 2038 or 2042, if the settlor had died on September 25, 1985.

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. The regulation provides that the rules contained in the paragraph are generally applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. Unless noted otherwise, 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 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.

In this case, Trust was created and irrevocable before September 25, 1985. It is represented that no additions, actual or constructive, have been made to Trust since it was created. Consequently, based on these representations, before any distributions were made under Settlement Agreement on Date 9, as ordered under Consent Order, Trust was exempt from GST tax.

We conclude that a bona fide issue has been presented regarding the proper construction of Article XIII of Will as it pertains to the distribution of Trust corpus on termination of Trust (and income accrued after the termination date). The issue has been the subject of litigation and the parties in interest have advanced several different interpretations of the termination provision. The Settlement Agreement is the product of arm's length negotiation between the parties to the agreement and represents a compromise between the positions of the parties that reflects the parties' assessments of the relative strengths of their position. The Settlement Agreement has been approved by the appropriate local court.

Accordingly, based on the facts submitted and the representations made, we conclude that pursuant to § 26.2601-(b)(4)(i) the allocation and distribution of Trust assets among the beneficiaries under the court-approved Settlement Agreement will not cause Trust to lose exempt status for GST tax purposes and will not result in a transfer that will subject Trust or distributions from Trust to the GST tax imposed under § 2601.

Except as specifically ruled herein, we express no opinion on the federal tax consequences of the proposed modifications of Trust pursuant to the Settlement Agreement under the cited provisions or under any other provisions of the Code.

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,

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

Enclosure
Copy for section 6110 purposes

cc: