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Person To Contact: _____, ID No.

Telephone Number: _____

Refer Reply To:
CC:PSI:B09 / PLR-165188-02

Date:
April 30, 2004

Legend

- Grantor =
- Original =
- Trust
- Date 1 =
- Date 2 =
- x =
- Date 3 =
- Child 1 =
- Child 2 =
- Date 4 =
- Trust A =

- Trust B =

- Date 5 =
- Court =
- Date 6 =
- Date 7 =
- State =
- Date 8 =
- Date 9 =
- Trust C =
- Trust D =
- Date 10 =

Dear Sir:

This is in response to your letter, dated April 16, 2004 and prior correspondence, requesting rulings under §§ 1001, 2501, and 2601 of the Internal Revenue Code.

Grantor created Original Trust, an inter vivos trust, on Date 1. Original Trust was restated in its entirety by an amended trust agreement on Date 2. No additions, actual or constructive, have been made to Original Trust after September 25, 1985.

Article First of the Original Trust agreement provides that the trust income shall be paid to Grantor during Grantor's life.

Article Third, paragraph 6 of the Original Trust agreement provides that, after the distribution of certain specific bequests, discretionary distributions of the trust income may be payable to Grantor's children, in equal parts, up to \$x per year until the child reaches the age of thirty. After that, the child is entitled to her proportionate share of the entire Trust income. In no event may the amount paid to a child exceed her proportionate share of the income as long as other children of the Grantor are living or have died leaving issue surviving. At the end of the calendar year, any portion of the trust income not paid shall be added to the trust principal. On the death of the last survivor of Grantor's children, all the income of the trust estate shall immediately become principal of the trust estate.

Article Third, paragraph 8 of the Original Trust agreement provides that, on the death of the last survivor of Grantor's children, the residue of the trust estate shall be distributed to the lawful issue then living of the Grantor's children then deceased, equally and by representation. In default of issue as to any of Grantor's children, the interest of the child shall accrue equally to the brothers and sisters of the deceased child living at the time of distribution and to the lawful issue of any brother or sister who shall have theretofore died.

Article Third, paragraph 9 of the Original Trust agreement provides that, anything contained to the contrary notwithstanding, the trustee, with the consent and approval of the advisers to the trustee, is authorized and directed at any time and from time to time during the continuance of the trust to expend part of the income and of the principal of the share or shares of the trust estate to which any remote issue of the Grantor for the time being shall be presumptively entitled, as the trustee, with the consent and approval of the advisers to the trustee, in their uncontrolled discretion, shall deem proper for the support, maintenance, education, use and benefit of the presumptive beneficiary and/or pay the same to the beneficiary or his or her parent or guardian without being liable to see to the application thereof; and, except as above provided, the part of the trust estate as the trustee shall see fit may be accumulated and at any time or from time to time thereafter be distributed and paid out as income, or, in its discretion, added to and invested with the principal.

Grantor died on Date 3 survived by Child 1 and Child 2. Original Trust became irrevocable on her death. On Date 4, after Grantor's death, the trustee divided Original Trust into two separate shares that were subsequently separately administered: Trust A and Trust B. Trust A was administered for the benefit of Child 1 and Trust B was administered for the benefit of Child 2. The trustee obtained separate tax identification numbers for the shares and filed separate tax returns. No principal was ever distributed from either trust. Child 1 died on Date 5.

After Child 1's death, the trustee petitioned Court for instructions because it concluded that the provisions of paragraph 6 under Article Third may require some portion of the Trust A income be accumulated for later distribution to the issue of both children. The parties to the petition, which included guardians ad litem for minor and unborn beneficiaries, filed cross motions for summary judgment. The matter was fully briefed, and argued in Court. Court issued its decision on Date 6 and its final order on Date 7 holding that the separate trust accounts created on Date 4, constitute one trust account, namely the Original Trust. The Original Trust should be administered and ultimately distributed as a single trust. Accordingly, one-half of the income from the account should be distributed to Child 2 at the end of each calendar year during her lifetime. The other half of the income, must, under the language of the Original Trust agreement, be added back into the principal of the trust, for the ultimate benefit of the issue of both Child 1 and Child 2. Finally, the Court held that the trustee may, with the approval and consent of the advisers to the trustee, distribute income and principal from the Original Trust to the presumptive beneficiaries of the Original Trust during Child 2's lifetime. Court's decision was affirmed by the State Supreme Court on Date 8.

The parties disagreed as to the appropriate way to implement Court's Date 7 order and subsequently entered into lengthy negotiations to avoid additional litigation. In particular, the questions of who is a presumptive beneficiary and how is a presumptive beneficiary's share to be calculated for purposes of discretionary principal distributions were left open. As a result of the negotiations, the parties reached a settlement agreement. Among other things, the settlement included the formal division of the trust into two separate trusts, one each for the benefit of Child 1 and Child 2 and their respective issue. Court approved the settlement agreement on Date 9. Court's Date 9 order, however, prevents implementation of the settlement agreement until a private letter ruling has been received from the Internal Revenue Service that the implementation will not result in adverse income, gift, estate or generation-skipping transfer tax consequences to the trust or the beneficiaries. Additional changes were made to the settlement agreement during the private letter ruling process. The terms of the new settlement agreement are reflected in the proposed amended order discussed below. Each of the parties to the settlement agreement has agreed to the changes made during the private letter ruling process.

The terms of the settlement agreement are described in the proposed amended order. Paragraph 1 of the proposed amended order provides that the Original Trust will be divided into two separate trusts: Trust C and Trust D. Trust C will benefit Child 1's

family and Trust D will benefit Child 2 and her family. Each separate trust shall be equal in value as of Date 10.

Paragraph 2 of the proposed amended order provides that the income from Trust D will be paid to Child 2 during her lifetime. Upon Child 2's death, Trust D will be distributed to the then living issue of Child 2 by right of representation. In the event that there are no living issue of Child 2 at the time of her death, Trust D shall be distributed to the then living issue of Child 1 by right of representation.

Paragraph 3 of the proposed amended order provides that the income from Trust C will be accumulated and added to Trust C principal during Child 2's lifetime. There shall be an annual distribution to Trust D from Trust C equal to one-half of the income from Trust C (the "Distribution Amount"). Upon the death of Child 2, Trust C shall be distributed to the then living issue of Child 1 by right of representation. In the event that there are no living issue of Child 1 at the time of Child 2's death, Trust C shall be distributed to the then living issue of Child 2 by right of representation.

Paragraph 4 of the proposed amended order provides that the trustee has determined that in order to provide Child 2's family with a reasonable income in accordance with State law, the trustee will distribute from the principal of Trust C such amount, if any, as may be necessary in order for the Distribution Amount to be not less than one percent of the fair market value of Trust C determined as of the last business day of the year preceding the year in which distribution of the Distribution Amount occurs, and Trustee is authorized to make distributions accordingly. Nothing in this paragraph or in any future State legislation that might afford the trustee a so-called power to adjust, shall be interpreted to require the trustee to take any action in regard to the Distribution Amount other than authorized herein, nor shall anything in this paragraph preclude the trustee from taking such other or further action in regard to the Distribution Amount.

Paragraph 6 of the proposed amended order provides that during Child 2's lifetime, Grantor's remote issue may receive discretionary distributions of principal solely out of the trust for the benefit of the child of Grantor who is the remote issue's ancestor.

Paragraph 7 of the proposed amended order provides that except as may be otherwise provided in the order or by further order of the Court, each of Trust C and Trust D shall be held, administered and distributed under the terms of the Original Trust.

The trustees of Original Trust have requested the following rulings: (1) Division of the Original Trust into Trust A and Trust B in accordance with the terms of the proposed amended order will not affect the status of Original Trust or the resulting trusts as exempt from the generation-skipping transfer tax under § 1433(b)(2)(A) of the Tax Reform Act of 1986; (2) No taxable gift will be made by any party as a result of the implementation of the proposed amended order; and (3) neither the Original Trust nor

any beneficiary will realize gain or loss as a result of compliance with the terms of the proposed amended order.

Ruling 1

Section 2601 imposes a tax on every generation-skipping transfer.

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, but only to the extent that the 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)(ii)(A) provides that, except as provided in § 26.2601-11(b)(1)(ii)(B) or (C), any trust in existence on September 25, 1985, is considered an irrevocable trust except as provided in §§ 26.2601-1(b)(ii)(B) or (C), which relate to property includible in a grantor's gross estate under §§ 2038 and 2042.

Potential beneficiaries include individuals who are two or more generations below the grantor's generation, therefore, distributions from Original Trust may be subject to the generation-skipping transfer tax. In the present case, Original Trust is considered to have been irrevocable on September 25, 1985, because neither § 2038 nor § 2042 applies. The trustees represent that no additions have been made to the Original Trust after September 25, 1985. Original Trust, therefore, is exempt from the generation-skipping transfer tax pursuant to § 26.2601-1(b)(1)(i).

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 a 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 litigating parties and reflects the parties' assessments of the relative strengths and their positions is a settlement that is within the range of reasonable outcomes.

The interests of all the parties to the settlement agreement, including the interests of any unborn heirs, have been represented in the litigation and negotiations that preceded the proposed settlement agreement. The terms of the proposed settlement agreement are based on arms-length negotiations among all the interested parties to a bona fide controversy and fairly reflect the relative merits of the claims made by the parties.

Based on the facts submitted and the representations made, and pursuant to § 26.2601-1(b)(4)(i)(B), we conclude that the settlement agreement, as proposed, will not affect the exempt status of the Original Trust or cause the resulting trusts, Trust A and Trust B, to lose exempt status for generation-skipping transfer tax purposes. Furthermore, implementation of the settlement agreement will not result in a transfer of property that will subject Original Trust or the resulting trusts, or distributions thereunder, to the generation-skipping transfer tax imposed under § 2601.

Ruling 2

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 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, 774-75 (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 information submitted and the facts, as described in the various court documents, a bona fide controversy existed between the parties pertaining to the administration of Original Trust during the time period between the death of Child 1 and the death of Child 2. The Date 6 Court opinion held that presumptive beneficiaries were eligible to receive discretionary distributions during that time, but acknowledged that ambiguity existed as to who was a presumptive beneficiary and how a presumptive beneficiary's share should be calculated.

As stated above, all the parties who hold an interest in the Original Trust, including any unborn heirs, have been represented in the litigation and negotiations that preceded the proposed settlement agreement. The terms of the proposed settlement are based on arms-length negotiations among all the interested parties.

Based on the information submitted, a bona fide controversy existed between the parties pertaining to the administration of the Original Trust between the death of Child 1 and Child 2. Specifically, it is unclear which remote beneficiaries were eligible to receive discretionary distributions as presumptive beneficiaries and how each presumptive beneficiary's share should be calculated. The parties have agreed to divide the trust into a share for each child of Grantor and that child's remote issue. Distributions will be made from Trust C to Trust D in order to comply with the requirements of the Date 7 Court order. After the division of the Original Trust, the remote issue of Child 1 will be eligible to receive discretionary distributions of principal from Trust C during Child 2's lifetime. The remote issue of Child 2 will be eligible to receive discretionary distributions of principal from Trust D during Child 2's lifetime. The terms of the settlement agreement are reflective of the rights of the parties under applicable State law 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 will not cause the parties to the settlement agreement to have made a taxable gift for purposes of the federal gift tax under § 2501.

Ruling 3

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

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss is the excess of the adjusted basis provided in § 1011 over the amount realized. Section 1001(c) provides that, except as otherwise provided in subtitle A, the entire amount of gain or loss determined under § 1001 on the sale or other exchange of property shall be recognized.

Section 1.1001-1(a) of the Income Tax Regulations provides, as a general rule, that the gain or loss realized from the conversion of property into cash, or from the

exchange of property for other property differing materially either in kind or in extent, is treated as income or loss sustained. For purposes of § 1001, in an exchange of property, each party to the exchange gives up a property interest in return for a new or additional interest. Such an exchange is a disposition under § 1001(a).

An exchange of property results in the realization of gain only if the properties exchanged materially differ. Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991). A material difference exists when the exchanged properties embody legal entitlements “different in kind or extent” or if they confer “different rights and powers.” Id. at 565. The critical determination is whether there is a change in the actual legal entitlements. See also Rev. Rul. 56-437, 1956-2 C.B. 507.

In the present case, under the terms of the Original Trust and on the basis of other information submitted by the trustee’s representative – as well as specific representations made by the trustee, we conclude that there is no significant or material change in the actual legal entitlements of the original trust as compared to the contemplated altered administration of that trust.

The language in the proposed amended order does not affect the entitlements of the parties in kind or extent. Child 2 and the respective issue of Child 1 and Child 2 will possess the same income and remainder interests before and after establishment of the “new” court-ordered trust arrangements. Consequently, because the interests of the beneficiaries will not materially change, no gain or loss will be realized under §§ 61 or 1001.

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

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.

Pursuant to the Power of Attorney on file with this office, a copy of this letter is being sent to your attorney.

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

Sincerely,

James F. Hogan

James F. Hogan
Acting Chief, Branch 9
Office of Associate Chief Counsel

(Passthroughs & Special Industries)

Enclosure

Copy for § 6110 purposes

cc: