

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact:

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Refer Reply To:

CC:PSI:B04

PLR-154099-05

Date: DECEMBER 12, 2006

In Re:

Legend:

Decedent =

Date 1 =

Child 1 =

Child 2 =

Child 3 =

Grandchild 1=

Grandchild 2 =

Grandchild 3 =

Grandchild 4 =

Grandchild 5 =

Grandchild 6 =

Will =

Trust =

State =

Bank =

Date 2 =

Date 3 =

Date 4 =

Individual 1 =

Year 1 =

Court 1 =

Court 2 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

Date 10 =

Date 11 =

Date 12 =

Date 13 =

Date 14 =

Date 15 =

Date 16 =

Date 17 =

Date 18 =

Guardian Ad Litem =

Individual 2 =

State Statute =

Date 19 =

Dear _____ :

This is in response to a letter dated October 14, 2005, and other correspondence, requesting rulings on behalf of Trust, regarding the estate 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. Decedent was survived by 3 children, Child 1,

Child 2, and Child 3, as well as the 4 children of Child 2, Grandchild 1, Grandchild 2, Grandchild 3, and Grandchild 4. Subsequently, Child 3 married and had two children, Grandchild 5 and Grandchild 6.

Article V of Decedent's Will provided for the establishment of a residuary trust (Trust) for the benefit of his children and their issue. Article V provides for the payment of income as follows:

My trustees shall pay the net income therefrom in equal shares at reasonable intervals to my children, [Child 1, Child 2, and Child 3]. Upon the death of any of said children, the income to which such child so dying had been entitled shall be paid in equal shares to the issue of all of said children living at the time of payment thereof. Upon the death of any issue, who had been receiving payment of income, leaving issue then surviving, such surviving issue shall be entitled to share in income of the trust estate equally with all other issue of my said children.

(emphasis added). Article V authorizes the trustees to distribute principal as follows:

My trustees shall have the power in their uncontrolled discretion to use and apply such part of the principal of the trust estate as they may consider suitable or necessary in the event of sickness or accident to any life beneficiary or remainderman or in the event any life beneficiary or remainderman requires the use of such principal in order to maintain the standard of living to which such person is accustomed. In the event that a portion of the principal is so used for the benefit of a remainderman, there shall be deducted upon ultimate distribution the portion of principal so used from the distributive share of such person.

Article V provides that Trust will terminate on the death of the last survivor among Child 1, Child 2, and Child 3. The remaining assets will be distributed in equal shares to the then surviving issue of Child 1, Child 2, and Child 3, "per capita and not per stirpes;" and if none, to Decedent's then living heirs at law under the State laws of succession. Further, Article V defines "issue" as follows:

The word, "issue", when used in the Article shall not include a lineal descendant whose lineal ancestor is living at the time of any payment hereinbefore provided to be made and which lineal ancestor is a lineal descendant of mine.

Article V provides that the trustees may carry out its provisions through multiple trusts or through a single trust, "or as they may determine."

Under Article II, Child 1, Child 2, Child 3 and Bank were named, and served, as initial trustees of Trust.

On Date 2, Child 1 died without issue. Following his death, the trustees initially distributed Child 1's one-third share of the income of Trust equally between Child 2 and Child 3. However, within two years of Child 1's death, upon advice from counsel for Bank, the trustees determined that Child 1's one-third share of the income should be distributed in equal shares to Decedent's six then living grandchildren. The trustees adjusted income distributions to effect this change retroactively to the date of Child 1's death.

On Date 3, in response to a petition by the then acting individual trustees, Court 2 issued an order approving the removal of Bank as trustee and modifying Trust to permit each individual trustee to appoint a successor trustee. The court order further modified Trust to require that, "if practical," at least one descendant of each child of Decedent will be acting as a trustee and that there will always be an uneven number of individual trustees.

On Date 4, Child 3 died, survived by her spouse and her two children, Grandchild 5 and Grandchild 6. After Child 3's death, the trustees continued distributing one-third of the income of Trust to Child 2 and began distributing two-thirds of the income (the shares of Child 1 and Child 3) in equal shares to Grandchildren 1-6.

Several years after Child 3's death, in Year 1, Grandchild 5 and Grandchild 6 informed the trustees that they disagreed with the manner in which the trustees had been distributing income since the death of Child 1. At that time Child 2, Grandchild 2, and Child 3's surviving spouse, Individual 1, were serving as trustees and these same individuals are currently serving as trustees.

Child 2 and Grandchildren 1, 2, 3, and 4 retained the same counsel. Individual 1 obtained separate counsel. Grandchildren 5 and 6 each obtained separate counsel.

On Date 5, the trustees filed a petition in Court 1 for an order: (1) construing the trust; (2) passing upon the acts of the trustees; and (3) instructing the trustees. In the petition, the trustees sought court approval of their method of distributing Trust income.

On Date 6, Grandchildren 5 and 6 filed in Court 2 a petition seeking, inter alia, a court order removing of the trustees and appointing an independent successor trustee and an order compelling the trustees to account, surcharging the trustees, and awarding damages. The petition alleged that the trustees had misinterpreted the income distribution provisions of Trust and had never properly provided appropriate accountings to Grandchildren 5 and 6. On Date 7, the trustees filed accountings for Date 8 through Date 9. On Date 10, Grandchild 6 filed in Court 2 Objections to Account and Petition to

(1) Subject the Trust to Probate Court Supervision; (2) Suspend the Powers of the Trustees; and (3) Appoint a Temporary Trustee.

On Date 11, Court 1 resolved a venue dispute among the parties by issuing an order to consolidate the proceedings in Court 1. Thereafter, the parties filed cross-motions for summary judgment and memoranda of points and authority supporting their competing interpretations of the income distribution provisions of Trust.

Grandchildren 1, 2, 3, and 4 contended that under the express terms of Article V, on the death of a child of Decedent prior to termination of the Trust, the deceased child's share of Trust income is to be paid "in equal shares to the issue of all of [Decedent's] children living at the time of payment thereof." Accordingly, after the respective deaths of Child 1 and Child 3, the trustee properly paid that deceased child's one-third share of Trust income equally to Grandchildren 1-6, the then living issue of Decedent's children.

On the other hand, Grandchildren 5 and 6 argued that Article V also expressly provides that the term "issue" as used in the Article "shall not include a lineal descendant whose lineal ancestor is living at the time of any payment. . ." (emphasis added.) Since Grandchildren 1-4's parent, Child 2 is still living, they are not entitled to any portion of the income previously paid to Child 1 and Child 3. Rather, after the death of Child 1 followed by the death of Child 3, each deceased child's one-third share of Trust income should have been paid solely to the children of Child 3, Grandchildren 5 and 6, the only issue of Decedent's children whose lineal ancestor (Child 3) was not living at that time. Grandchild 6 also objected to the trustees' manner of investing Trust assets.

Grandchildren 1, 2, 3, and 4 maintained that this construction of Article V was incorrect. Further, they maintained that the applicable statute of limitations, among other rules, barred any claim that the interpretation of the Will, consistently applied by the trustees for over 10 years, was incorrect.

On Date 12, Court 1 issued an order granting summary judgment in favor of the Trustees and Grandchildren 1, 2, 3, and 4 and against Grandchildren 5 and 6. Court 1 entered its judgment on Date 13. Grandchildren 5 and 6 each filed timely notices of appeal from the judgment and related orders.

The parties participated in court-ordered mediation on Date 14, and, on the same day, the following parties executed a Settlement Agreement: Child 2, individually and as trustee; Grandchild 1; Grandchild 2, individually and as trustee; Grandchild 3; Grandchild 4; Grandchild 5; Grandchild 6; Individual 1, individually and as trustee. The spouses, and in one case, the former spouse, of Child 2 and Grandchildren 1, 2, 3, 4, 5, and 6 also executed the agreement.

The Settlement Agreement is conditioned upon issuance by the Internal Revenue Service of a favorable ruling regarding the GST tax consequences of the Settlement Agreement. The Settlement Agreement provides that the claims raised in the litigation (the Pending Claims) will be stayed until the Action Date (the date the Internal Revenue Service issues a favorable ruling regarding the GST tax consequences) or the Cancellation Date (the date the Internal Revenue Service issues an adverse ruling), when the stay will be dissolved. The Pending Claims will be dismissed with prejudice upon the earlier of the death of Child 2 or the Action Date. Under the terms of the Settlement Agreement, if Child 2 dies before the Internal Revenue Service issues a ruling, the Trustees will distribute the remaining balance of Trust under the terms of Trust immediately before the date the Settlement Agreement was executed; and the Pending Claims will be dismissed with prejudice.

On Date 15, the Guardian Ad Litem, who represents the minor and unborn contingent remainder beneficiaries of Trust, issued a report to Court 1, supporting the Settlement Agreement and approving the petition for an order approving the Settlement Agreement. On Date 16, Court 1 approved the Settlement Agreement and authorized and directed the trustees to modify, reform, and divide Trust under the terms, and subject to the conditions, provided in the agreement.

Under the Settlement Agreement, Trust will be modified as follows. On the Action Date, the trustees will divide Trust into seven shares, one share for each among Child 2 and Grandchildren 1, 2, 3, 4, 5, and 6. The assets of Trust will be allocated to these shares as follows: one-third of every asset to Child 2's share; one-sixth of every asset to the share for each of Grandchild 5 and Grandchild 6; one-twelfth of every asset to the share for each of Grandchildren 1, 2, 3, and 4. Each share will be held as a Separate Trust by the trustee named for that trust. The trustees will be as follows: for Child 2's Separate Trust, Child 2 and Grandchild 2; for Grandchild 1's Separate Trust, Grandchild 1 or Grandchild 2; for Grandchild 2's Separate Trust, Grandchild 2 or Individual 2; for Grandchild 3's Separate Trust, Grandchild 3 or Grandchild 2; for Grandchild 4's Separate Trust, Grandchild 4 or Grandchild 2. Grandchild 5 and Grandchild 6 will each serve as sole trustee of the respective Separate Trust held for that Grandchild. Each Grandchild will serve as the sole trustee of the Separate Trust held for that Grandchild, unless the Internal Revenue Service denies the ruling requested under § 2041; in that case, the other trustee named will serve.

The terms of Trust will be modified to provide for Child 2's Separate Trust to be administered as follows. The net income of the Separate Trust for Child 2 will be paid at reasonable intervals to Child 2. During Child 2's life, principal may be distributed as follows:

The trustee of [Child 2's] trust shall have the power in the trustee's uncontrolled discretion to use and apply such part of the principal of this trust estate as the trustee may consider suitable or necessary in the event of sickness or accident to [Child 2] or in the event [Child 2] requires the use of such principal in order to maintain the standard of living to which [Child 2] is accustomed.

Child 2's Separate Trust will terminate at Child 2's death. Upon termination, the remaining balance of the Separate Trust will be distributed in equal shares among Child 2's children. The share of a child who predeceases Child 2, but who has then living issue, will be distributed by right of representation to such then living issue. The share of a child who predeceases Child 2, but who has no then living issue, will be distributed to that predeceased child's estate.

The terms of Trust will be modified to provide for each Grandchild's Separate Trust to be administered as follows. The net income of the Grandchild's Separate Trust will be paid at regular intervals to the Grandchild, and at the Grandchild's death, to the Grandchild's then living issue by right of representation, and if none, to the Grandchild's estate. Principal may be distributed during the term of the Separate Trust as follows:

The trustee of this trust shall have the power in the trustee's uncontrolled discretion to use and apply such part of the principal of this trust estate as the trustee may consider suitable or necessary in the event of sickness or accident to [Child 2], or to any income beneficiary or remainderman of this trust or in the event [Child 2] or any income beneficiary or remainderman of this trust requires the use of such principal in order to maintain the standard of living to which such person is accustomed. In the event that a portion of the principal is so used for the benefit of a remainderman, there shall be deducted upon ultimate distribution the portion of principal so used from the distributive share of such person.

The Separate Trust held for a Grandchild will terminate at Child 2's death and will be distributed to the Grandchild, if then living, but if not, to the Grandchild's then living issue, by right of representation; and if none, to the Grandchild's estate.

The Settlement Agreement further provides that the provisions of the Date 3 Order Removing Trustee and Modifying Trust to Allow Appointment of Successor Trustees in Court 2 will apply to the appointment of successor trustees for each of the Separate Trusts except that successor trustees need not be descendants of Decedent and there need not be an uneven number of individual trustees.

Except as modified by the Settlement Agreement, all of the original provisions of Trust will apply to each Separate Trust.

Until the earlier of the division of Trust on the Action Date or the distribution of Trust at the death of Child 2, all current Trust distributions to income beneficiaries, which the trustees have been making on a monthly basis, will continue to be made one-third to Child 2 and one-ninth to each of Grandchildren 1-6. Upon the earlier of the division of Trust on the Action Date or the distribution of Trust at the death of Child 2, Grandchildren 1, 2, 3, and 4 will each pay to Grandchild 5 one-seventy-second of the total amount paid to income beneficiaries from Date 17 through the Action Date plus \$75,000; and Grandchildren 1, 2, 3, and 4 will each pay to Grandchild 6 one-seventy-second of the total amount paid to income beneficiaries from Date 17 through the Action Date plus \$75,000. These payments are intended to compensate Grandchild 5 and Grandchild 6 for the additional income (in addition to the one-ninth share) they are entitled to receive under the terms of the Settlement Agreement that will not be paid to them prior to the Action Date.

Under subsection 7(h) of the Settlement Agreement, the term “remainderman” as used to apply to the Separate Trust for Grandchild 6 refers to Grandchild 6 and to the issue and estate of Grandchild 6. The term “remainderman” as used to apply to the Separate Trust for each other Grandchild refers only to the Grandchild for whom the trust is held and to that Grandchild’s issue. On Date 18, the trustees petitioned Court 1 to request approval of an amendment to the Settlement Agreement signed by the parties to the agreement adding a new subsection 7(l) that provides as follows:

[N]otwithstanding subsection 7(h) above or any other provision [of the agreement], during the lifetime of [Child 2] no distribution of principal from any separate trust may be made to a great-grandchild (or remote issue) of [Decedent] during any time that the great-grandchild’s (or more remote issue’s) ancestor who is a descendant of a child of [Decedent] is living.

On Date 19, Court 1 approved the amendment and authorized and directed the trustees to modify, reform, and divide Trust under the terms and conditions of the Settlement Agreement as amended on that date.

It is represented that no additions, actual or constructive, have been made to Trust since its creation.

The taxpayers have requested the following rulings:

1. Implementation of the provisions of the Settlement Agreement pursuant to which Child 2 serves as co-trustee, and could serve as sole trustee, and pursuant to which each of the six Grandchildren of Decedent serve as sole trustees of their respective separate trusts will not cause Child 2 or any of the six Grandchildren to be deemed to have a general power of appointment over his or her separate trust under § 2041.

2. Implementation of the Settlement Agreement will not cause Trust, or the seven separate trusts into which Trust will be divided, to lose their status as trusts that are exempt from the generation-skipping transfer (GST) tax by reason of § 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.

Ruling Request # 1:

Section 2041(a)(2) provides that the value of the gross estate shall include the value of all property to the extent of any property with respect to which the decedent has at the time of death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under §§ 2035 to 2038, inclusive.

Section 2041(b)(1) provides that the term "general power of appointment" means a power which is exercisable in favor of the individual possessing the power, his estate, his creditors, or the creditors of his estate. Section 2041(b)(1)(A) provides that a power to consume, invade or appropriate property for the benefit of the possessor that is limited by an ascertainable standard relating to the health, education, support or maintenance of the possessor is not a general power of appointment.

Under § 20.2041-1(c)(2) of the Estate Tax Regulations, a power to consume, invade, or appropriate income or corpus, or both, for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support or maintenance of the decedent is, by reason of § 2041(b)(1)(A), not a general power of appointment. A power is limited by such a standard if the extent of the holder's duty to exercise and not to exercise the power is reasonably measurable in terms of his needs for health, education, or support (or any combination of them). As used in this subparagraph, the words "support" and "maintenance" are synonymous and their meaning is not limited to the bare necessities of life. A power to use property for the comfort, welfare or happiness of the holder of the power is not limited by the requisite standard. Examples of powers which are limited by the requisite standard are powers exercisable for the holder's "support," "support in reasonable comfort," "maintenance in health and reasonable comfort," "support in his accustomed manner of living," "education, including college and professional education," "health," and "medical, dental, hospital and nursing expenses and expenses of invalidism."

Under the Settlement Agreement, Grandchildren 1, 2, 3, 4, 5, and 6 will each be the sole trustee and the income beneficiary of a separate trust for his or her own benefit.

Child 2 and Grandchild 2 will be trustees of a separate trust of which Child 2 is the income beneficiary.

Under the terms of each separate trust, the trustee has discretion to use or apply any amount of principal the trustee considers suitable or necessary in the event of sickness or accident to an income beneficiary or in the event an income beneficiary of the trust requires the use of such principal to maintain the standard of living to which the income beneficiary is accustomed. Under Rev. Rul. 77-60, 1977-1 C.B. 282, a power to use property to enable the donee of the power to continue an accustomed mode of living, without further limitation, is not an ascertainable standard under § 2041(b)(1)(A). However, under State Statute, a person who is a beneficiary of a trust that permits the person as trustee, or cotrustee, to make discretionary distributions of income or principal to or for that person's own benefit may exercise that power only for that person's health, education, support, or maintenance within the meaning of § 2041 of the Internal Revenue Code. If a power to make discretionary distributions of income or principal is conferred upon two or more trustees, the power may be exercised by any trustee who is not a current permissible beneficiary of that power. If there is no trustee who is not a current permissible beneficiary of that power, any party in interest may apply to a court of competent jurisdiction to appoint a trustee who is not a current permissible beneficiary of that power, and the power may be exercised by the trustee appointed by the court. Thus, under State Statute, Child 2 and Grandchildren 1, 2, 3, 4, 5, and 6, acting as trustee of his or her respective separate trust, may each make discretionary distributions of principal from that separate trust only for his or her own health, education, support, or maintenance. Cf., Rev. Rul. 54-153, 1954-1 C.B. 185. See also, Rev. Proc. 94-44, 1994-2 C.B. 683.

Accordingly, based on the facts submitted and the representations made, we conclude that implementation of the portion of the Settlement Agreement pursuant to which Child 2 serves as co-trustee, and could serve as sole trustee, and pursuant to which each of the six Grandchildren of Decedent serve as sole trustees of their respective separate trusts will not cause Child 2 or any of the six Grandchildren to be deemed to have a general power of appointment over his or her separate trust under § 2041.

Ruling Request # 1:

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.

Section 26.2601-1(b)(4)(i)(D) provides that a modification 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 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 of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer.

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, Trust is currently exempt from GST tax.

A bona fide issue has been presented regarding the proper construction of Article V as it pertains to the distribution of Trust income since the death of Child 1, and the

subsequent death of Child 3. The issue has been the subject of protracted litigation. The Settlement Agreement is the product of arm's length negotiation between the parties to the agreement. The Settlement Agreement represents a compromise between the positions of the parties and reflects the parties' assessments of the relative strengths of their position. The Settlement Agreement has been approved by the guardian ad litem appointed for the minor, unborn, and unascertained contingent beneficiaries of Trust. Finally, the Settlement Agreement has been approved by the appropriate local court.

Further, to the extent the Settlement Agreement modifies the distribution of the Trust remainder interest on the termination of the trust on Child 2's death, the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation 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.

Accordingly, based on the facts submitted and the representations made, we conclude that implementation of the Settlement Agreement will not cause Trust, or the seven separate trusts into which Trust will be divided, to lose their status as trusts that are exempt from the generation-skipping transfer (GST) tax by reason of § 1433(b)(2)(A) of the Tax Reform Act of 1986 and § 26.2601-1(b)(1)(i).

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,

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

Enclosure

Copy for section 6110 purposes