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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:4/PLR-133920-02

Date:

DECEMBER 30, 2002

In Re:

Legend:

Grandfather -  
Father -  
Spouse -  
Child 1 -  
Child 2 -  
Child 3 -  
Child 4 -  
Date 1 -  
Date 2 -  
Father's Trust -  
  
Father's Revocable Trust -  
  
GS Trust -  
  
Trustee -

Dear :

This is in reference to your letter dated May 23, 2002, requesting rulings regarding the effect of the proposed settlement agreement for federal gift, income and generation-skipping transfer tax purposes.

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### Background

The facts submitted are as follows:

Grandfather died testate on Date 1, prior to September 25, 1985. Paragraph Ninth(D) of Grandfather's will created and funded Father's Trust, an irrevocable trust governed by the law of California, primarily for the benefit of Father (Grandfather's son) and his issue. Father's Trust had two trustees; Father and Trustee, an independent corporate trustee.

Under the terms of Father's Trust, the net income of the trust was to be paid to Father during his life. In addition, Father had the power, exercisable during his lifetime, to appoint part or all of the trust income to any of his children. Upon Father's death, if he was survived by Spouse (Father's spouse at the time Grandfather's will was executed) and married to Spouse at the time of his death, the net income of the trust would be paid to Spouse during her life. The trust provides further that, upon the death of Father or, if Spouse was married to Father at the time of his death, the survivor of Father and Spouse, the trust property and any undistributed income will "vest in the issue of [Father], in such proportions as he shall appoint by will." In the event that Father does not exercise the testamentary power of appointment, the trust provides that the trust property and undistributed income will vest in Father's issue "by right of representation, provided, however, that the share of each of child of [Father] who has not then attained the age of twenty-five (25) years shall continue to be held in trust" for the benefit of that child.

Father died testate on Date 2 (after September 25, 1985), survived by 4 adult children (Child 1, Child 2, Child 3, and Child 4) and 10 grandchildren, six of whom were adults at the date of Father's death. Father was not married to Spouse at the time of his death and had no other issue. No other issue have been born or have died since Father's death. Under Section 3.1 of Father's will, Father exercised the testamentary power of appointment granted to Father under Paragraph Ninth(D) of Grandfather's will by appointing all of the trust estate of Father's Trust, in further trust, to GS Trust to be administered as a separate trust or trusts in accordance with the terms thereof on the date of Father's death. GS Trust was established under Section 4.5 of Father's Revocable Trust, which was restated by Father on the same date that Father's will was executed.

Under Section 4.5 of Father's Revocable Trust, any property distributed to the trust pursuant to Father's exercise of his limited power of appointment shall be distributed to the issue of Father who survive him; provided, however, that the property otherwise distributable to beneficiaries who are the grandchildren of Grandfather, shall be retained and administered as separate trusts (GS Trusts) for each grandchild. The primary beneficiary of each GS Trust is the respective grandchild of Grandfather (Child

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1, Child 2, Child 3, and Child 4). Under the terms of each separate GS Trust, the trustee has the discretion to pay as much of the net income and principal of each separate trust to the respective grandchild and his or her issue as the trustee deems appropriate. In addition, each grandchild has a testamentary limited power to appoint the trust corpus to one or more issue of Father who is living on the date of death of that respective grandchild. Upon each grandchild's death, any trust corpus not appointed by the grandchild will be distributed to that grandchild's heirs who are issue of Father. In the event that no issue of Father is living at the death of the grandchild, the trust corpus will be distributed to father's heirs. Each GS Trust will terminate no later than 21 years after the death of the last to die of the survivor of the beneficiaries of each trust and qualified relatives of Father who were living on Date 1 (the date of Grandfather's death).

Pursuant to the exercise of the power of appointment by Father, four separate GS Trusts were established, one for each child of Father (Child 1, Child 2, Child 3, and Child 4). Also, pursuant to the terms of Father's Trust, each child had the right to act as the sole trustee of his or her GS Trust. Each of Father's four children exercised this right and each is currently the trustee of their respective separate GS Trust created under Section 4.5 of Father's Revocable Trust for their benefit and the benefit of their issue and Father's heirs.

After Father's death, a dispute arose among Father's children and grandchildren concerning whether Father could validly exercise the power of appointment, created under Paragraph Ninth(D) of Grandfather's will, by appointing the property in further trust, or whether Father could only appoint the property outright. In addition, if the property could be appointed in further trust, the parties disagreed as to whether the trusts could benefit issue of Father who were not in being at Father's death.

In an attempt to avoid protracted litigation, the parties, which included the Trustee, the children and adult grandchildren of Father, and the guardians *ad litem* for the minor grandchildren and the unborn issue of Father, entered into negotiations which resulted in a petition to the local probate court for instructions concerning a proposed settlement agreement. The terms of the proposed settlement provided that the parties would agree as follows:

No Distributions To Persons Not In Being At The Death of [Father]. The Parties agree that no distributions to or from any [GS Trust] established for the benefit of any issue of [Father] shall be made at any time to any person who was not both in being at the death of [Father] and the issue of [Father]. Such distributions shall include, but shall not be limited to, any distributions of income or principal during the life of the child of [Father] for whom such [GS Trust] was established, or any distributions at the death of such child, whether by exercise of a power of appointment or by

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operation of the terms of such trust.

In addition, under the proposed settlement, each child will release and waive claims that may arise under the settlement by any person or successor in interest and any unborn issue of Father. The court instructed the parties to enter into the proposed settlement agreement conditioned upon receipt of favorable rulings from the Internal Revenue Service on the issues requested.

Trustee has represented that no additions, actual or constructive, were made to Father's Trust after September 25, 1985.

### Rulings Requested

You have requested the following rulings:

1. Implementation of the settlement agreement, as proposed, will not result in a transfer that is subject to the gift tax by any party to the settlement agreement.
2. Implementation of the settlement agreement, as proposed, will not affect the exempt status of the GS Trusts for purposes of the generation-skipping transfer tax imposed under § 2601.
3. Implementation of the settlement agreement, as proposed, will not result in the realization of taxable income by any party to the settlement agreement.

### Law and Analysis

#### Ruling #1:

Section 2501 of the Internal Revenue Code imposes a tax for each calendar year on the transfer of property by gift during such 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

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Ahmanson Foundation v. U.S., 674 F.2d 761, 774-775 (9<sup>th</sup> 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.

Section 600 of the California Probate Code provides that, except to the extent that the common law rules governing powers of appointment are modified by statute, the common law as to powers of appointment is the law of this state. Cal. Prob. Code § 600 (Deering 2001).

Section 650(a) of the California Probate Code states, in part, that the donee of a general power of appointment may make an appointment : “. . . (2) Of present or future interests or both. . . . (5) In trust. (6) Creating a new power of appointment.” Cal. Prob. Code § 650(a) (Deering 2001). Section 651 provides that, subject to the limitations imposed by the creating instrument, the donee of a special power may make any of the types of appointment permissible for the donee of a general power under Section 650. Cal. Prob. Code § 651 (Deering 2001).

Section 17200 of the California Probate Code provides, in part, that:

(a) Except as provided for in Section 15800 [pertaining to revocable trusts], a trustee or beneficiary of a trust may petition the court under this chapter concerning the internal affairs of the trust or to determine the existence of the trust.

(b) Proceedings concerning the internal affairs of a trust include, but are not limited to, proceedings for any of the following purposes:

(1) Determining questions of construction of a trust instrument.

(2) Determining the existence or nonexistence of any immunity, power, privilege, duty, or right.

(3) Determining the validity of a trust provision.

(4) Ascertaining beneficiaries and determining to whom property shall pass or be delivered upon final or partial termination of the trust, to the extent the determination is not made by the trust instrument.

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Cal. Prob. Code § 17200 (Deering 2001).

Under California law, “[T]he paramount rule in the construction of wills, to which all other rules must yield, is that a will is to be construed according to the intention of the testator as expressed therein, and this intention must be given effect as far as possible.” In re Estate of Russell, 70 Cal. Rptr. 561, 564 (Cal. 1968); Adams v. Cook, 15 Cal. 2d 352, 361 (1940). The primary duty of the court in construing all documents is to give effect to the intention of the maker, and that duty applies to inter vivos instruments, as well as testamentary instruments. Wells Fargo Bank, National Ass’n v. Huse, 129 Cal. Rptr. 522, 524 (Cal. Ct. App. 1976).

Based on the information submitted and the facts, as described in the court’s instructions, a bona fide controversy existed between the parties pertaining to the construction of the dispositive provisions of Father’s Trust. Specifically, it is unclear whether Father has the authority under the provisions to exercise the limited power by appointing the property in trust, or otherwise, in a manner that may benefit heirs of Father who are not born as of the date of Father’s death. All the parties who hold an interest in the GS Trusts, including any unborn heirs, have been represented in the negotiations that preceded the proposed settlement agreement. The terms of the proposed settlement is based on arms-length negotiations among all the interested parties.

The terms of the settlement agreement are reflective of the rights of the parties under applicable California 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 of the Code.

Ruling #2:

Section 2601 imposes a tax on every generation-skipping transfer (GST) made after October 26, 1986.

A generation-skipping transfer is defined under § 2611(a) as (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip. Section 2612(a) provides that the term taxable termination means a termination (by death, lapse of time, release of a power, or otherwise) of an interest in property held in trust where the property passes to a skip person with respect to the transferor of the property. Section 2612(b) provides that the term taxable distribution means any distribution from a trust to a skip person other than a taxable termination or a direct skip. Under § 2612(c)(1), a direct skip is a transfer subject to federal estate or gift tax made by a transferor to a skip person.

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Under § 1433(a) of the Tax Reform Act of 1986 and § 26.2601-1(a) of the Generation-Skipping Transfer Tax Regulations, the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under § 1433(b)(2)(A) and § 26.2601-1(b)(1)(i), the tax does not apply to a transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that such 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)(v)(A) provides that, except as provided under § 26.2601-1(b)(1)(v)(B), where any portion of a trust remains in the trust after the post-September 25, 1985, release, exercise, or lapse of a power of appointment over that portion of the trust, and the release, exercise, or lapse is treated to any extent as a taxable transfer under chapter 11 or chapter 12, the value of the entire portion of the trust subject to the power that was released, exercised, or lapsed is treated as if that portion had been withdrawn and immediately retransferred to the trust at the time of the release, exercise, or lapse. The creator of the power will be considered the transferor of the addition except to the extent that the release, exercise, or lapse of the power is treated as a taxable transfer under chapter 11 or chapter 12.

Section 26.2601-1(b)(1)(v)(B) provides a special rule for certain powers of appointment. Under this section, the release, exercise, or lapse of a power of appointment (other than a general power of appointment as defined in § 2041(b)) will not be treated as an addition to a trust if (1) such power of appointment was created in an irrevocable trust that was 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).

A general power of appointment is defined in § 2041(b)(1), for federal estate tax purposes, as a power that is exercisable in favor of the individual possessing the power, his estate, his creditors, or the creditors of his estate. The definition of a general power of appointment under § 2514(c), for federal gift tax purposes, is generally the same as that provided in § 2041(b)(1). Section 2514(b) provides that the exercise or release of a general power of appointment created after October 21, 1942, is deemed a transfer of property by the individual possessing the power.

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. These rules are only applicable for GST tax purposes. The rules do not

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apply, for example, in determining whether the transaction results in a gift for gift tax purposes, or the realization of gain for income tax purposes under section 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 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.

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

The GST tax would not generally apply to the Father's Trust because the Father's Trust was irrevocable on September 25, 1985, and no additions (actual or constructive) had been made to the Father's Trust since that date. Further, Father's exercise of the power of appointment, appointing the trust corpus to the GS Trusts did not subject that property to the GST tax. Section 26.2601-1(b)(1)(v)(B).

We note that each of Father's children (Child 1, Child 2, Child 3, and Child 4) is the sole trustee of their respective GS Trust established by Father for their benefit and, under the terms of each GS Trust, each trustee has the discretion to distribute as much income and principal to himself or herself as each deems appropriate. However, section 16081 of the California Probate Code provides that:

(a) Subject to the additional requirements of subdivisions (b), (c), and (d), if a trust instrument confers "absolute," "sole," or "uncontrolled" discretion on a trustee, the trustee shall act in accordance with fiduciary principles and shall not act in bad faith or in disregard of the purposes of the trust.

\* \* \*

(c) Unless a settlor or a testator clearly indicates that a broader power is intended by express reference to this subdivision, 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 the benefit of himself or herself may exercise that power in his or her favor only for

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his or her health, education, support, or maintenance within the meaning of Sections 2041 and 2514 of the Internal Revenue Code. . . .

Cal. Prob. Code § 16081 (Deering 2001).

Further, § 16082 of the California Probate Code provides that except as otherwise specifically provided in the trust instrument, a person who holds a power to appoint or distribute income or principal to or for the benefit of others, either as an individual or as a trustee, may not use the power to discharge the legal obligations of the person holding the power. Cal. Prob. Code § 16082 (Deering 2001).

Accordingly, Child 1, Child 2, Child 3, and Child 4 would not be treated as possessing a general power of appointment by virtue of their position as trustee of their respective trusts.

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

Ruling #3:

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

Section 1001(a) provides that gain from the sale or other disposition of property is the excess of the amount realized therefrom over the adjusted basis provided in § 1001 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 exchange of property shall be recognized.

Section 1.1001-1(a) of the Income Tax Regulations generally provides 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.

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

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exemption for property acquired by inheritance applied to a compromise agreement of a claim as an heir, and thus was exempt from taxation under the predecessor of § 102. The Court reasoned that “[s]o far as the will became effective under the agreement it was because of the heirs’ consent and release and in consideration of the distribution they received by reason of their being heirs.” *Id.* at 196.

In this case, the settlement agreement is a compromise between the children, grandchildren and unborn issue of their claims against the Trust. The parties to the agreement will receive distributions from the settlement agreement because of their status as heirs. Also, there was no modification of any beneficial interests in the Trust. Therefore, the terms of the settlement agreement, including the material elements, will not result in the realization of taxable income by any party to the settlement agreement.

Accordingly, the terms of the settlement agreement, including the material elements and its implementation, will not result in the realization of taxable income by any party to the settlement agreement.

A copy of this letter should be attached to any income, gift, estate, or generation-skipping transfer tax returns that you may file relating to these matters.

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 the 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 specifically ruled above, no opinion is expressed as to the federal tax consequences of the facts described above under the cited provisions or any other provisions of the Code or regulations.

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  
Associate Chief Counsel  
(Passthroughs and Special  
Industries)

Enclosure  
Copy for section 6110 purposes