

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact:

, ID No.

Telephone Number:

In Re:

Refer Reply To:

CC:PSI:B09 – PLR-162122-02

Date:

April 21, 2004

Legend:

| | |
|--------------|---|
| Taxpayer | = |
| Date 1 | = |
| Donor 1 | = |
| Donor 2 | = |
| Son | = |
| Trust 1-A | = |
| Trust 1-B | = |
| Trust 1-C | = |
| Trust 1-D | = |
| <u>A</u> | = |
| Trust 2-A | = |
| Trust 2-B | = |
| Trust 2-C | = |
| Trust 2-D | = |
| Grandchild A | = |
| Grandchild B | = |
| Grandchild C | = |
| Grandchild D | = |
| Trustee | = |
| Date 2 | = |
| <u>B</u> | = |
| Date 3 | = |
| <u>C</u> | = |
| Date 4 | = |
| <u>D</u> | = |
| Date 5 | = |
| <u>E</u> | = |
| Bank | = |
| Trust 1-E | = |

| | |
|-------------------|---|
| Trust 1-F | = |
| Trust 1-G | = |
| Trust 1-H | = |
| Trust 2-E | = |
| Trust 2-F | = |
| Trust 2-G | = |
| Trust 2-H | = |
| Family Trusts | = |
| Grandchild E | = |
| Grandchild F | = |
| Grandchild G | = |
| Grandchild H | = |
| <u>F</u> | = |
| <u>G</u> | = |
| <u>H</u> | = |
| Partnership 1 | = |
| <u>I</u> | = |
| Partnership 2 | = |
| Partnership 3 | = |
| Corporation | = |
| <u>J</u> | = |
| Date 6 | = |
| Successor Trustee | = |
| Date 7 | = |
| Date 8 | = |
| Family 1 | = |
| Date 9 | = |
| Date 10 | = |
| Court | = |
| Date 11 | = |
| <u>K</u> | = |
| <u>L</u> | = |
| Family 2 | = |

Dear :

This is in response to your letter dated August 14, 2003, and prior correspondence, submitted on behalf of Taxpayer, requesting a ruling regarding the generation-skipping transfer (GST) tax consequences of a settlement agreement modifying the terms of trusts that are exempt from the application of the GST tax imposed under § 2601 of the Internal Revenue Code.

The information submitted and representations made are summarized as follows. On Date 1, a date prior to September 25, 1985, Donor 1 and Donor 2 each established

four virtually identical irrevocable inter vivos trusts ("Original Trusts"), one for the benefit of each of their four then living grandchildren. Each of the trusts provides either Taxpayer or Son with a right to a percentage of the yearly net income of the trust. On Date 1, Donor 1 established Trust 1-A, Trust 1-B, Trust 1-C, and Trust 1-D and transferred \$A to each of the trusts. Also on Date 1, Donor 2 established Trust 2-A, Trust 2-B, Trust 2-C, and Trust 2-D and transferred \$A to each of the trusts. Trust 1-A and Trust 2-A were established for the primary benefit of Grandchild A and Grandchild A's issue. Trust 1-B and Trust 2-B were established for the primary benefit of Grandchild B and Grandchild B's issue. Trust 1-C and Trust 2-C were established for the primary benefit of Grandchild C and Grandchild C's issue. Trust 1-D and Trust 2-D were established for the primary benefit of Grandchild D and Grandchild D's issue. It is represented that no additions have been made to any of the Original Trusts subsequent to the initial funding.

The preamble of the Original Trusts provides that Son, Taxpayer, and Trustee shall be the "Original Trustees." Trust 1-A provides, generally, that commencing on Date 2, the trustees shall pay to Son B percent of the yearly trust income. Trust 1-B provides, generally, that commencing on Date 2, the trustees shall pay to Taxpayer B percent of the yearly trust income. Trust 1-C provides, generally, that commencing on Date 3, the trustees shall pay to Son C percent of the yearly trust income. Trust 1-D provides, generally, that commencing on Date 3, the trustees shall pay to Taxpayer C percent of the yearly trust income. Trust 2-A provides, generally, that commencing on Date 4, the trustees shall pay to Son D percent of the yearly trust income. Trust 2-B provides, generally, that commencing on Date 4, the trustees shall pay to Taxpayer D percent of the yearly trust income. Trust 2-C provides, generally, that commencing on Date 5, the trustees shall pay to Son E percent of the yearly trust income. Trust 2-D provides, generally, that commencing on Date 5, the trustees shall pay to Taxpayer E percent of the yearly trust income.

The balance of the net income of the Original Trusts is to be paid to the respective grandchild beneficiary for his or her maintenance, support, education, business needs, and other trustee-approved requirements after the grandchild reaches age sixteen, for so long as both Taxpayer and Son are living and serving as Original Trustees. The Original Trustees, Taxpayer and Son, shall not be required to account to either beneficiaries or representatives of beneficiaries at any time regarding the handling of trust properties or the withholding or distributing of trust income or corpus.

Article Third of the Original Trusts provides, generally, that the Original Trustees and successor trustees shall pay the net income of the trust to the respective beneficiary/grandchild during his or her life, for the purposes and in the amounts set forth above. Upon the death of the respective grandchild beneficiary, if the trust is still operative and in effect, the trustees and successor trustees shall pay the net income first to the issue of the grandchild. Should the grandchild leave no issue, the trustees and successor trustees shall pay the net income in equal shares to Donor 1 and

Donor 2's other grandchildren who may have survived the grandchild, or the issue of Donor 1 and Donor 2's other grandchildren who may have predeceased the grandchild, provided, however, the shares of any deceased grandchildren shall be divided per capita among all the issue of said deceased grandchildren. Upon the death of all of Donor 1 and Donor 2's grandchildren, if such deaths take place during the operation of this trust, the income to be paid to the grandchild shall be paid, should the grandchild leave no issue, per capita to the living issue of Donor 1 and Donor 2's other grandchildren.

The Original Trusts established by Donor 1 and Donor 2 each contain an equalization provision in order to ensure that any grandchild born after Date 1 would be provided for in a manner similar to that of Donor 1 and Donor 2's four then living grandchildren. Pursuant to the equalization provision, upon the birth of any grandchild after Date 1, each of the trusts established by Donor 1 and Donor 2 shall contribute a portion of its income and corpus to a new trust to be held under the same conditions for the subsequently born grandchild.

Article Fourth of the Original Trusts provides, generally, that the trust shall continue to be operative so long as any of the trustees herein named are living. The trust shall terminate only after all of the deaths of the trustees. Upon termination of the trust, the successor trustee shall pay over, deliver and convey the trust estate, with its accumulations and all undistributed net income, to the respective grandchild beneficiary, absolutely, if the grandchild is then living. In the event that the grandchild shall have died prior to the disposition of this trust, the successor trustees shall distribute the trust estate to any living issue of the grandchild. Should the grandchild leave no issue, the successor trustees shall distribute the trust estate in equal shares to Donor 1 and Donor 2's other grandchildren who may have survived the grandchild or the issue of Donor 1 and Donor 2's grandchildren who have predeceased the grandchild; provided, however, the shares of any deceased grandchildren shall be divided per capita among all the living issue of said deceased grandchildren. Upon the death, therefore, of all Donor 1 and Donor 2's grandchildren, if such deaths take place prior to the termination of this trust, the trust corpus herein provided to be paid to the grandchild, should he or she leave no issue, shall be paid per capita to the living issue of Donor 1 and Donor 2's other grandchildren.

Article Fifth of the Original Trusts provides, generally, that there shall not be more than three successor trustees, at least one of which is a national bank with a trust department. The successor trustees shall be unanimously appointed by the Original Trustees, Taxpayer and Son, by means of a written instrument legally effecting such appointment. After the death of either Son or Taxpayer, if no such appointment has been made, it shall be the obligation of the survivor of them within ten days after the death of the other to appoint successor trustees. Any appointment of successor trustees may be revoked at any time by both Son and Taxpayer, if the two of them are living, or either of them if one is deceased, and new successor trustees appointed in the place of the ones removed. Should the Original Trustees for any reason, fail to appoint

specific successor trustees, the Bank shall serve as successor trustee. The appointment of successor trustees shall become effective on the deaths of both Original Trustees, Son and Taxpayer. Should Trustee survive both Son and Taxpayer, the successor trustee shall serve together with Trustee in administering this trust. The appointment of successor trustees shall not become effective so long as either of the Original Trustees, Taxpayer and Son, are living. Taxpayer or Son shall have the right to administer this trust alone.

After the execution of the Original Trusts on Date 1, four additional grandchildren were born. Pursuant to the equalization provisions for after-born grandchildren contained in the Original Trusts, four additional trusts (Trust 1-E, Trust 1-F, Trust 1-G, and Trust 1-H) one for each after-born grandchild, were established by Donor 1, and four additional trusts (Trust 2-E, Trust 2-F, Trust 2-G, and Trust 2-H) were established by Donor 2 (collectively, the "Subsequent Trusts"). Thus, a total of eight trusts were established by Donor 1 and eight trusts were established by Donor 2. Collectively, the parties refer to these sixteen trusts as the Family Trusts.

Trust 1-E and Trust 2-E were established for the primary benefit of Grandchild E and Grandchild E's issue. Trust 1-F and Trust 2-F were established for the primary benefit of Grandchild F and Grandchild F's issue. Trust 1-G and Trust 2-G were established for the primary benefit of Grandchild G and Grandchild G's issue. Trust 1-H and Trust 2-H were established for the primary benefit of Grandchild H and Grandchild H's issue. Trusts 1-E, 1-F, 1-G, and 1-H each provide that the trustees shall pay Taxpayer and Son each E percent of the yearly trust income. Trusts 2-E, 2-F, 2-G, and 2-H each provide that the trustees shall pay Taxpayer and Son each G percent of the yearly trust income. The balance of the net income of the Subsequent Trusts is to be paid to the respective grandchild beneficiary for his or her maintenance, support, education, business needs, and other trustee-approved requirements after the respective grandchild reaches age sixteen, for so long as both Taxpayer and Son are living and serving as Original Trustees.

Each of the Family Trusts invests, directly or indirectly, in publicly held stock and securities, real estate, interests in closely-held entities, and other miscellaneous assets. Each of the Family Trusts owns a H percent limited partnership interest in Partnership 1. Partnership 1 owns a I percent general partnership interest in Partnership 2. Partnership 2 is a Class B limited partner in Partnership 3. Corporation owns a J percent general partnership interest in Partnership 1 and a J percent general partnership interest in Partnership 2. Corporation is wholly owned by Taxpayer.

On Date 6, Taxpayer and Trustee resigned as trustees. Successor Trustee was appointed successor trustee. Successor Trustee resigned in Date 7. Since Date 7, Son has served as the sole trustee.

In Date 8, Taxpayer and members of her family, collectively referred to as

Family 1, retained the services of an attorney because they were unsatisfied with Son's administration of various trusts. Offers and counteroffers of settlement were continually made, however, settlement negotiations broke down around the end of Date 9.

On Date 10, Family 1 filed three complaints in the Court alleging, among other things, that Son breached his fiduciary obligations relating to the investment, administration, management, and use of the Family Trusts' funds, that various related party transactions were improper, and that trust accounts were incorrect. Before the time for filing an answer to these complaints expired, a death in the family led the respective parties to attempt to resolve their disputes again. After lengthy negotiations, a basis for settlement was reached and finally reduced to writing on Date 11 ("the settlement agreement").

As a result of the settlement agreement, the following modifications will be made to the Family Trusts. Article First will be modified, in part, to provide that reference to the term "net income" shall not be deemed to include accumulated but undistributed income of the trust.

Article Second, paragraph A of Trust 1-A and Trust 1-C will be modified to provide, generally, that commencing on Date 2 and Date 3, respectively, the trustees shall pay to Son, at such times and in such amounts as Son in his own discretion might require K percent of the yearly net income of the trust. Upon the death of Son and until the trust terminates, the trustees shall pay K percent of the yearly net income of the trust to Son's then living lineal descendants, per stirpes.

Article Second, paragraph A of Trust 1-B and Trust 1-D will be modified to provide, generally, that commencing on Date 2 and Date 3, respectively, the trustees shall pay to Taxpayer, at such times and in such amounts as Taxpayer in her own discretion might require K percent of the yearly net income of the trust. Upon the death of Taxpayer and until the trust terminates, the trustees shall pay K percent of the yearly net income of the trust to Taxpayer's then living lineal descendants, per stirpes.

Article Second, paragraph A of Trust 2-A and Trust 2-C will be modified to provide, generally, that commencing on Date 4 and Date 5, respectively, the trustees shall pay to Son, at such times and in such amounts as Son in his own discretion might require L percent of the yearly net income of the trust. Upon the death of Son and until the trust terminates, the trustees shall pay L percent of the yearly net income of the trust to Son's then living lineal descendants, per stirpes.

Article Second, paragraph A of Trust 2-B and Trust 2-D will be modified to provide, generally, that commencing on Date 4 and Date 5, respectively, the trustees shall pay to Taxpayer, at such times and in such amounts as Taxpayer in her own discretion might require L percent of the yearly net income of the trust. Upon the death of Taxpayer and until the trust terminates, the trustees shall pay L percent of the yearly net income of the trust to Taxpayer's then living lineal descendants, per stirpes.

Article Second, paragraph A of Trusts 1-E, 1-F, 1-G, and 1-H will be modified to provide, generally, that the trustees shall pay to Taxpayer at such times and in such amounts as Taxpayer in her own discretion might require E percent of the yearly net income of the trust. Upon the death of Taxpayer and until the trust terminates, the trustees shall pay E percent of the yearly net income of the trust to Taxpayer's then living lineal descendants, per stirpes. The trustees shall pay to Son, at such times and in such amounts as Son in his own discretion might require E percent of the yearly net income of the trust. Upon the death of Son and until the trust terminates, the trustees shall pay E percent of the yearly net income of the trust to Son's then living lineal descendants, per stirpes.

Article Second, paragraph A of Trusts 2-E, 2-F, 2-G, and 2-H will be modified to provide, generally, that the trustees shall pay to Taxpayer at such times and in such amounts as Taxpayer in her own discretion might require G percent of the yearly net income of the trust. Upon the death of Taxpayer and until the trust terminates, the trustees shall pay G percent of the yearly net income of the trust to Taxpayer's then living lineal descendants, per stirpes. The trustees shall pay to Son, at such times and in such amounts as Son in his own discretion might require G percent of the yearly net income of the trust. Upon the death of Son and until the trust terminates, the trustees shall pay G percent of the yearly net income of the trust to Son's then living lineal descendants, per stirpes.

Article Second, paragraph B of the Family Trusts will be modified to provide that the trustees shall pay the balance of the net income, including that which is not distributable and that which is not distributed to or taken by Son or his lineal descendants, or Taxpayer and her lineal descendants, as the case may be, to the respective grandchild beneficiary of the trust for so long as either Son or Taxpayer shall be living, in such amounts and at such times after the beneficiary has reached the age of sixteen years, as the trustees shall deem necessary and proper for the maintenance, support, education, business needs, and other trustee-approved requirements of the beneficiary or beneficiaries. All net income not distributed shall be accumulated and added to corpus. In addition, the provision in Article Second, paragraph B that provides that the Original Trustees, Taxpayer and Son, shall not be required to account to beneficiaries at any time regarding the handling of trust properties or the withholding or distributing of trust income or corpus will be deleted.

Article Third of the Family Trusts will be modified in part to provide, generally, that in order to ensure that any grandchildren born after the execution of this trust agreement (an "after-born grandchild") shall be provided for in a manner equal to that of Donor 1 and Donor 2's other grandchildren who are living as of Date 1, Donor 1 and Donor 2 specifically direct as follows: Upon the birth of any after-born grandchild, there shall be allocated to such after-born grandchild as a separate trust, a portion of the assets of this trust determined by multiplying the fair market value of the assets of this trust by a fraction, the numerator being one and the denominator being the total number

of Donor 1 and Donor 2's grandchildren whether then living or deceased. Each trust so set aside for an after-born grandchild shall be held, administered and disposed of for such grandchild as otherwise provided in this trust, subject to the following: (1) Such trust shall be subject to further division upon the birth of additional after-born grandchildren; (2) Each after-born grandchild for whom an additional trust is established pursuant to this paragraph shall be considered the beneficiary of such trust, and after his or her death, his or her issue shall be beneficiaries as provided herein; (3) Separate trusts similarly established for a beneficiary may be combined into one trust by the trustees. In such event, if Son or Taxpayer has any rights to receive a percentage of the income from a separate trust, such rights shall continue as to a combined trust, provided such percentage shall be recomputed for a combined trust based upon the percentage of the assets of the combined trust represented by assets from each separate trust at the time of combination multiplied by the percentage of income to which Taxpayer or Son was entitled from such separate trust, and such products shall be added together to produce the recomputed percentage of income to which Taxpayer or Son is entitled from a combined trust; (4) Whether or not the separate trusts for an after-born grandchild are combined, the date of termination of each trust (or portion of a combined trust) shall be determined by the provisions of the trusts from which such trusts (or portions) were created.

Article Fourth of the Family Trusts will be modified in part to provide, generally, that the trust shall continue to be operative so long as any of the Original Trustees are living. Upon termination of the trusts, the successor trustee shall pay over, deliver and convey the trust estate as then constituted to the respective grandchild beneficiary, absolutely, if the grandchild is then living.

Article Fifth of the Family Trusts will be modified to provide, generally, that in the event of the death, resignation or incapacity of Son to serve as a trustee, his successor shall be that person or persons whom Son designates: (a) through a separate written instrument delivered during his life to the other serving trustee, or (b) in his last will and testament which is admitted to probate. Any written instrument under Article Fifth, clause (a) shall be witnessed by two individuals and notarized. The latest dated written instrument or last will and testament shall control. If a successor trustee is not serving or is not nominated herein, then a successor trustee (the "Family 2 trustee") shall be nominated, appointed, and confirmed by a majority of the then living lineal descendants of Son ("Family 2") who are sui juris. Notwithstanding anything to the contrary or otherwise, after the death of Son, the Family 2 beneficiaries who are sui juris: (1) may, by majority vote, remove the Family 2 trustee, for any reason, and appoint a new Family 2 trustee; and (2) if the then acting Family 2 trustee becomes incapacitated or incompetent, shall replace such trustee. Grandchild A and his successors (the "Family 1 trustee") is the successor trustee to Taxpayer. In the event of the death, resignation or incapacity of the Family 1 trustee, then a successor trustee shall be nominated, appointed, and confirmed by a majority of Taxpayer, if she is then living, and her then living lineal descendants who are sui juris ("Family 1"). Notwithstanding anything to the contrary or otherwise, the members of Family 1 who are sui juris:

(1) may, by majority vote, remove the Family 1 trustee, for any reason, and appoint a new Family 1 trustee; and (2) if the then acting Family 1 trustee becomes incapacitated or incompetent, shall replace such trustee. There shall at all times be: (a) one trustee who is Son or who is selected by either Son or Family 2; and (b) one trustee who is Grandchild A or is selected by Family 1. No trustee shall vote or participate in any manner on any discretionary distribution of income or principal to himself or herself or to a beneficiary to whom such trustee is related to or subordinate to within the meaning of § 672(c) or to a person whom such trustee or beneficiary is legally obligated to support. The trustee who is so restricted in his or her participation in any trustee action under this section shall, by written document delivered to the other then acting trustee, designate a third party, who is not related to or subordinate to (within the meaning of § 672(c)) such restricted trustee or the beneficiary, to act as a "Special Trustee," solely for the purpose of exercising such discretion, and the Special Trustee shall exercise that discretion provided, however, that such Special Trustee shall be subject to the same terms and limitations applicable to any other named trustee.

The settlement agreement has been approved by the Court, conditioned upon a favorable ruling by the Service on the effect the settlement agreement has on the Family Trusts' exemption from the GST tax.

Taxpayer has requested rulings that the following aspects of the settlement agreement will not adversely affect the GST exempt status of the Family Trusts: (1) The modifications and changes to the Family Trusts concerning the appointment and removal of a trustee and the method of appointing successor trustees; (2) The resolution of the issue of the proper construction and application of the equalization provisions of the trusts; (3) The construction of the trusts as to the right to income from the trusts after the death of Taxpayer and/or Son, by continuing Taxpayer's and Son's right to income, upon his or her death, for his or her respective lineal descendants until the termination of the trust, and otherwise continuing the right to discretionary distributions of income to the remainder beneficiaries; (4) The resolution of the issue of the proper construction of the trusts with respect to accumulated, but undistributed net income; (5) The elimination of language regarding trustee accountings; and (6) The resolution of various economic issues between the parties, including, but not limited to: (a) Equalization of the trust corpus between the Family Trusts so that the assets of each trust are identical as of the effective date of the settlement agreement; (b) Equalization of the right to income of the Family Trusts, so that as of the effective date of the settlement and thereafter, the Family Trusts remain equalized; (c) The transfer of stock of Corporation equally to each Family Trust; (d) The purchase and/or redemption of the interests of the Partnership 2 in Partnership 3; and (e) The reimbursement of Family 1's legal fees and costs incurred in the dispute.

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. 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)(ii)(B) or (C), which relates to property includible in a grantor's gross estate under §§ 2038 and 2042. In the present case, the 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.

In the present case, the Family Trusts were created and became irrevocable on Date 1, and there have been no additions made to the Family Trusts after September 25, 1985. Accordingly, the Family Trusts are 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 a bona fide issue, 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 the Court approves the proposed

agreement, the modifications will not violate § 1433(b)(2)(A) of the Tax Reform Act of 1986 and will not affect the exempt status of the Family Trusts.

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. If there is a change in material fact or law (local or federal) before the transactions considered in this ruling take effect, the ruling will have no force or effect. 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. In addition, no opinion is expressed or implied with respect to the income tax consequences of any transaction.

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.

Pursuant to the power of attorney on file with this office, a copy of this letter is being sent to Taxpayer.

Sincerely,

Melissa C. Liquerman
Branch Chief, Branch 9
Office of Associate Chief Counsel

(Passthroughs & Special Industries)

Enclosure:

Copy for section 6110 purposes