

Internal Revenue Service

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Telephone Number:

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Date:

May 04, 2006

Legend

Grantor =
Trust =

Wife =

Child 1 =

Date 1 =

Child 2 =

Child 3 =

Child 4 =

State =

Date 2 =

Date 3 =

Grandchild 1 =

Grandchild 2 =

Grandchild 3 =

Grandchild 4 =

Grandchild 5 =

Grandchild 6 =

Grandchild 7 =

Grandchild 8 =

Grandchild 9 =

Court =

Date 4 =

Date 5 =

State =

Statute

Dear :

This letter responds to your letter, dated October 6, 2005, and prior correspondence requesting rulings relating to the income, gift, and generation-skipping transfer (GST) tax consequences of a proposed settlement agreement.

Grantor created Trust for the benefit of Wife and Grantor's descendants on Date 1. During her life, the Trust agreement provides for discretionary payments of income to Wife, Child 1, and Child 1's descendants. After Wife's death, the Trust agreement provides for discretionary payments of income to Child 1, Child 2, Child 3, Child 4, and each child's lineal descendants. Under the terms of the Trust agreement, Trust will terminate twenty-one years after the death of the last to die of Wife, Child 1, Child 2, Child 3, and Child 4 (each of whom was living on Date 1). Upon termination, the Trust assets shall be distributed to the living lineal descendants of Child 1 in equal shares, per stirpes. If there are none, the Trust assets shall be distributed to the living lineal descendants of Grantor in equal shares, per stirpes. The Trust agreement provides that State law governs Trust.

Date 1 is prior to September 25, 1985. The trustees represent there have been no additions, constructive or actual, to Trust since September 25, 1985. Wife died on Date 2. Child 1 died on Date 3 leaving no lineal descendants. The current income beneficiaries of Trust are: Grandchild 1 and his four children, Grandchild 2 and her three children, Grandchild 3 and his three children, Grandchild 4 and her four children, Grandchild 5, Grandchild 6, Grandchild 7, Grandchild 8 and his three children, and Grandchild 9 and his three children (collectively "the beneficiaries").

The potential remainder beneficiaries contend that the phrase distributing the Trust principal upon termination is capable of more than one interpretation. The primary disagreement centers on whether the shares are divided at the level of Grantor's children or grandchildren. The trustees petitioned Court for a construction of the Trust agreement on Date 4, to resolve this dispute. Court appointed four guardians ad litem to represent the interests of the minor, unborn, and unascertained beneficiaries of Trust. All of the guardians ad litem and most of the current beneficiaries joined the trustees petition for construction. On Date 5, Court found, based on the face of the instrument, that the Grantor intended distribution of the principal to begin at the grandchildren's generational level. Certain beneficiaries appealed Court's decision to the Supreme Court of State arguing that the terms of the instrument are ambiguous and the extrinsic evidence reflects Grantor's clear intent to treat each of his children's families equally.

The individual beneficiaries entered into a settlement agreement on the distribution issue and other issues. The Supreme Court of State approved the settlement conditioned upon the receipt of a favorable private letter ruling from the Internal Revenue Service.

Under the settlement agreement, Trust will first be divided into two equal portions that will fund three subtrusts. Subtrust 1 will benefit Child 2 and her descendants; Subtrust 2 will benefit Child 3 and his descendants; and Subtrust 3 will benefit Child 4 and his descendants. The first portion will be divided among the subtrusts in three equal shares (as if the portion were being divided at the Grantor's children's generational level). The second portion will be divided into nine equal shares (as if the portion were being divided at the Grantor's grandchildren's generational level) and apportioned to the appropriate subtrust. Discretionary income payments from each subtrust will be payable only to the child for whom the subtrust is held and his or her descendants. Each subtrust will continue to be composed, for purposes of tracking income and distributions, of two separate portions. In the event that any one of Grantor's nine grandchildren and all that grandchild's lineal descendants die prior to the termination date, the subtrust portions representing the Trust corpus split at the grandchildren's generational level shall be reapportioned. Similarly, the subtrust portions representing the Trust corpus split at the children's generational level shall be reapportioned in the event that the child for whom a subtrust is held and all of his or her descendants die prior to the termination date. Each subtrust will have different rules for the appointment of successor and co-trustees. All other terms of the subtrusts will be the same as the original Trust, including the required termination twenty-one years after the death of the last to die of Child 2, Child 3, and Child 4.

The trustees of Trust have requested rulings that the division of Trust into three subtrusts and the allocation of the Trust assets under the terms of the settlement agreement (1) will not cause Trust or any of the subtrusts to be subject to the GST tax under § 2601; (2) will not cause any individual beneficiary to be subject to the gift tax under § 2501; (3) will not cause any party to the settlement to realize income under § 61; and (4) will not constitute a taxable sale, exchange, or disposition of an asset under § 1001 by the parties to the settlement.

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 of Trust include individuals who are two or more generations below the grantor's generation, therefore, distributions from Trust may be subject to the generation-skipping transfer tax. In the present case, 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 Trust after September 25, 1985. 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 division of Trust into three subtrusts and the allocation of Trust assets under the terms of the settlement agreement will not affect

the exempt status of the Trust or cause the resulting trusts, Subtrust 1, Subtrust 2, or Subtrust 3, 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 Trust or the resulting trusts, or distributions thereunder, to the GST 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 distribution of Trust upon termination. As stated above, all the parties who hold an interest in 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 distribution of the Trust assets on termination. Specifically, it is unclear whether the assets should be divided in equal shares at the Grantor's children's generational level or the Grantor's grandchildren's generational level. The parties have agreed to divide the trust into a subtrust for the family line of each of Grantor's children. 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(a)(3) provides that gross income includes gains derived from dealings in property.

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized.

Section 1001(b) states that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. Under § 1001(c), 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 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.

State Statute provides that, in absence of a trust provision to the contrary, a trustee has the power "in connection with the setting aside of any portion or any partition...to allocate to any share in or part of the trust estate specific investments at their fair value at the time of allocation as determined by the trustees or trustee acting in good faith."

A partition of jointly owned property is not a sale or other disposition of property where the co-owners of the joint property sever their joint interests but do not acquire a new or additional interest as a result of the transaction. Thus, neither gain nor loss is realized on a partition. See Rev. Rul. 56- 437, 1956-2 C.B. 507.

Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991), concerns the issue of whether a sale or exchange that has taken place results in the realization of gain or loss under § 1001. In Cottage Savings, a financial institution exchanged its interests in one group of residential mortgage loans for another lender's interests in a different group of residential mortgage loans. The two groups of mortgages were considered "substantially identical" by the agency that regulated the financial institution.

The Supreme Court of the United States in Cottage Savings, concluded that §1.1001-1 of the Income Tax Regulations reasonably interprets § 1001(a) and stated that an exchange of property gives rise to a realization event under § 1001(a) if the properties exchanged are "materially different." In defining what constitutes a "material difference" for purposes of § 1001(a), the Court stated that properties are "different" in the sense that is "material" to the Internal Revenue Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent. Cottage Savings, 499 U.S. at 564-65. The Court held that mortgage loans made to different obligors and secured by different homes did embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged interests in the loans. Cottage Savings, 499 U.S. at 566.

In Lyeth v. Hoey, 306 U.S. 188 (1938), the Supreme Court held that property received by an heir from an estate in compromise of his claim that the will was invalid is exempt from Federal income tax as an inheritance. The Court reasoned that the taxpayer obtained his portion of the compromise by reason of his status as an heir. Further, because payments that the taxpayer would have received upon a favorable court ruling would not be taxable, there was no reason to treat proceeds received as the result of a compromise differently.

In the present case, the beneficiaries are clearly heirs. Accordingly, under the principles of Lyeth, the division of Trust pursuant to the terms of the settlement agreement should receive equivalent treatment to that of a court ruling. Interpretation and construction of trust provisions are matters of state law. Thus, provided the court approves the settlement agreement, the settlement agreement merely clarifies Trust to remove the ambiguity and provide definitive interpretation of trust terms.

Trust will initially be apportioned into two equal shares on a non pro-rata basis. Under State law, the trustees have the authority to make this type of non pro-rata apportionment. Subsequently, each share will be divided on a pro-rata basis and distributed to the subtrusts in accordance with the terms of the settlement agreement. Accordingly, under the proposed transaction, Trust will be apportioned and partitioned but the beneficiaries' interests in the property will not change in kind or extent and no new interests will be created. It is consistent with the Supreme Court's opinion in Cottage Savings to find that the interests of the beneficiaries of the subtrusts will not differ materially from their interests in Trust.

Therefore, the proposed apportionment and subsequent division of Trust will not result in a material difference in kind or extent of the legal entitlements enjoyed by the beneficiaries, and no gain or loss is recognized by Trust, the individual beneficiaries, or the subtrusts for purposes of §§ 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.

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.

Pursuant to the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer's representative.

Sincerely,

Melissa C. Liquerman

Melissa C. Liquerman
Branch Chief, Branch 9
(Passthroughs & Special Industries)

Enclosure

Copy for § 6110 purposes