

## Internal Revenue Service

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Department of the Treasury

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Refer Reply To:

CC:PSI:04

PLR-102059-23

Date:

July 27, 2023

### LEGEND

Settlor	=
Spouse	=
Child 1	=
Child 2	=
Child 3	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
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	=
Trust A	=
Trust B	=
Trust C	=
Trust D	=

Trust E	=
Trust F	=
Trust D1	=
Trust D2	=
Trust D3	=
Trust D4	=
Trust D5	=
Trust D6	=
Trust A1	=
Trust A2	=
Trust A3	=
Trust A4	=
Trust A5	=
Trust A6	=
Trust BE1	=
Trust BE2	=
Grandchild 1	=
Grandchild 2	=
Grandchild 3	=
Grandchild 4	=
Grandchild 5	=
Grandchild 6	=
Grandchild 7	=
Grandchild 8	=
Adoptee 1	=
Adoptee 2	=
Adoptee 3	=
Trust Company	=
State	=
State Court	=
State Law 1	=
State Law 2	=
<u>a</u>	=
<u>b</u>	=
<u>c</u>	=
<u>d</u>	=
<u>e</u>	=

Dear :

This letter responds to your authorized representative's letter dated December 27, 2022, and subsequent correspondence, requesting rulings concerning the federal gift and generation-skipping transfer tax consequences of a court-approved settlement agreement.

### FACTS

The facts submitted and representations made are as follows. Settlor died testate on Date 1, a date prior to September 25, 1985. Settlor's Will consists of the original instrument dated Date 2, a first codicil dated Date 3, a second codicil dated Date 4, a third codicil dated Date 5, and a fourth codicil dated Date 6 (collectively, Settlor's Will). At his death, Article Fourth of Settlor's Will created separate trusts for the benefit of his three children, Child 1, Child 2, and Child 3 (collectively, Children), their spouses, and their descendants: Trust A for the benefit of Child 1; Trust B for the benefit of Child 2; and Trust C for the benefit of Child 3.

In addition to the trusts for the primary benefit of Children, Article Third of Settlor's Will created a marital trust for Settlor's wife, Spouse, which granted Spouse a testamentary general power of appointment over any trust property remaining in the marital trust at the time of her death. Spouse exercised her power of appointment under Article VII of Spouse's Will, dated Date 7, with a first codicil dated Date 8 (collectively, Spouse's Will). Pursuant to Spouse's Will, upon Spouse's death on Date 9, the remaining property of the marital trust was divided into three separate trusts for the benefit of Children, their spouses, and their descendants: Trust D for the benefit of Child 1; Trust E for the benefit of Child 2; and Trust F for the benefit of Child 3. Section 8 of Article VI of Spouse's Will provides that to the extent not specifically stated otherwise, all trusts created by Spouse's Will would be governed by the provisions of Settlor's Will.

Child 3 died on Date 10, leaving no surviving spouse or descendants. Upon Child 3's death, the property held in Trust C was divided into two equal shares and each share distributed to Trust A and Trust B. Similarly, the property of Trust F was divided into two equal shares and each share distributed to Trust D and Trust E.

On Date 11, pursuant to a State Court order, Trust D for the primary benefit of Child 1 was divided into six separate trusts for the benefit of Child 1's six children and their respective descendants, as well as Child 1 and Child 1's spouse: Trust D1 for the benefit of Grandchild 1; Trust D2 for the benefit of Grandchild 2; Trust D3 for the benefit of Grandchild 3; Trust D4 for the benefit of Grandchild 4; Trust D5 for the benefit of Grandchild 5; and Trust D6 for the benefit of Grandchild 6.

On Date 12, pursuant to a State Court order, Trust A for the primary benefit of Child 1 was divided into six separate trusts for the benefit of Child 1's six children and their respective descendants, as well as Child 1 and Child 1's spouse: Trust A1 for the benefit of Grandchild 1; Trust A2 for the benefit of Grandchild 2; Trust A3 for the benefit

of Grandchild 3; Trust A4 for the benefit of Grandchild 4; Trust A5 for the benefit of Grandchild 5; and Trust A6 for the benefit of Grandchild 6. In a companion State Court order on the same date, Trust B for the primary benefit of Child 2 and Trust E for the primary benefit of Child 2, were divided into two separate trusts for the benefit of Child 2's two children, Grandchild 7 and Grandchild 8 and their respective descendants, as well as Child 2 and Child 2's spouse. The divided trusts were subsequently merged into two trusts known as Trust BE1 for the benefit of Grandchild 7 and Trust BE2 for the benefit of Grandchild 8.

Article Fourth of Settlor's Will governs the distribution provisions of Trust A, Trust B, Trust D, Trust E, Trusts A1 through A6, Trusts D1 through D6, and Trusts BE1 and BE2 (collectively, the Family Trusts). Until a trust for whom a grandchild is named terminates, the Trustee has discretion to make distributions of income from such trust to the grandchild. The portion of income not distributed may be accumulated or may be distributed to the grandchild's spouse, the surviving parents of the grandchild, and the descendants of grandchild, in whole or in part, in the discretion of the Trustee. Trustee has unfettered discretion to make distributions of principal to a grandchild for whom a trust is established. A trust for whom a grandchild is named shall terminate upon the later to occur of the death of the grandchild or the grandchild's spouse, if any, and at such time the share for such grandchild shall be distributed to the descendants of such grandchild, *per stirpes*.

Section 4 of Article Fifth of Settlor's Will provides that any trust established pursuant to Settlor's Will shall cease and terminate upon the expiration of twenty-one years after the death of the last surviving of Settlor's descendants who were in being at the time of Settlor's death, and if at the expiration of this period any property is still held in trust, such property shall immediately be distributed to and among the persons receiving or entitled to have the benefit of the income therefrom in equal shares.

Pursuant to Article Fourth of Settlor's Will, if a grandchild of Settlor dies without a living spouse or descendants, the trust principal of such grandchild's trust will be distributed to Settlor's other descendants.

Section 3 of Article Fifth of Settlor's Will provides as follows:

The words "children" and "descendants" shall be deemed to refer to issue of the body born in lawful wedlock and to children adopted by legal proceedings of public record and to their children and descendants so defined.

Of Settlor's eight grandchildren, Grandchild 5 and Grandchild 7 currently have biological descendants. Grandchild 2 adopted Adoptee 1 and Grandchild 3 adopted Adoptee 2 and Adoptee 3. Each adopted individual was adopted after reaching the age of majority (collectively, Adult Adoptees).

The Trustee of each Family Trust is Trust Company. On Date 13, Trustee filed a petition with the State Court requesting an order construing the terms “children” and “descendants” under Section 3 of Article Fifth of Settlor’s Will to determine whether individuals adopted as adults qualify as “descendants” under Settlor’s Will. A controversy exists among the descendants of Settlor as to whether the Adult Adoptees are “descendants” of Settlor under Settlor’s Will. If the Adult Adoptees are considered descendants of Settlor, the number of potential remainder beneficiaries increases and affects the *per stirpital* shares at the time of final distribution of the Family Trusts.

On Date 14, State Court issued a memorandum opinion and order for evidentiary hearing to determine whether Grandchild 2 and/or Grandchild 3 functioned as parents to the Adult Adoptees before they reached age 18, based on State Law 1, which was enacted after Settlor’s date of death. Grandchild 1, joined by other family members, filed a motion for summary judgment and amendment of the Date 14 order in objection to the State Court’s application of State Law 1 rather than the law at the time of Settlor’s date of death.

State Law 1 provides that in construing a dispositive provision of a transferor who is not the adoptive parent, an adoptee is not considered the child of the adoptive parent unless the adoptive parent functioned as a parent of the adoptee before the adoptee reached 18 years of age. State Law 2 provides that the effective date of the title of State Law 1 is Date 15, a date that is after Settlor’s date of death, and applies to any proceedings in court then pending or thereafter commenced regardless of the time of the death of decedent except to the extent that in the opinion of the court the former procedure should be made applicable in a particular case in the interest of justice or because of infeasibility of application of the procedure of the title.

Over several years, the interested parties engaged in substantial litigation and other proceedings in preparation for trial, including filing cross motions for summary judgment, extensive discovery, and voluntary mediation. Based on the issue before State Court, the outcome of the litigation would be that the Adult Adoptees are determined to be or not be descendants of Settlor. After several attempts to resolve the contested issues, on Date 16 the parties entered into a Settlement Agreement resolving the litigation regarding the status of the Adult Adoptees as descendants of Settlor. The Settlement Agreement was revised on Date 17 (Revised Settlement Agreement). Both the Settlement Agreement and the Revised Settlement Agreement were approved by order of State Court and contingent upon receipt of a favorable private letter ruling from the Internal Revenue Service (IRS). All parties to the agreement were represented by legal counsel.

The Revised Settlement Agreement provides for certain payments to and for the benefit of Adoptee 1. It provides that the amount of \$a will be distributed outright and in cash to Adoptee 1 from Trusts A1 through A6 and Trusts D1 through D6 (each trust distributing \$b). In addition, the amount of \$a will be distributed outright and in cash to Grandchild 2 (adoptive parent of Adoptee 1) from Trust A2 and Trust D2 (each trust for the primary

benefit of Grandchild 2 and each distributing \$c), whereupon Grandchild 2, as settlor and transferor, will immediately establish (and contribute the \$a in cash to) a special needs trust for the primary benefit of Adoptee 1. Finally, the amount of \$d will be distributed outright and in cash to Adoptee 1 from Trust A2 and Trust D2 (each trust distributing \$e). Upon receipt of cash in the amounts of \$a and \$d, Adoptee 1, as settlor and transferor, will immediately establish (and contribute the sum of \$a and \$d in cash to) a revocable trust for his primary benefit.

The Revised Settlement Agreement provides for certain payments to and for the benefit of Adoptee 2 and Adoptee 3. It provides that the amount of \$a will be distributed outright and in cash to each of Adoptee 2 and Adoptee 3 from Trusts A1 through A6 and Trusts D1 through D6 (each distributing \$b). Further, after the cash distributions to Adoptee 2 and Adoptee 3 are made, the assets then making up Trust A3 and Trust D3 (collectively referred to going forward as the Grandchild 3 Settlement Trusts), each for the primary benefit of Grandchild 3 (adoptive parent of Adoptee 2 and Adoptee 3), will be kept separate and segregated from the assets of any other Family Trust. No further additions shall be made to the Grandchild 3 Settlement Trusts from any other Family Trust by reason of the death of any beneficiary of those other Family Trusts. Except for certain excluded property related to agricultural land and business interests in entities whose primary holding is agricultural land (Excluded Property), Adoptee 2 and Adoptee 3 are the named beneficiaries of the Grandchild 3 Settlement Trusts. Upon the death of the survivor of Child 1's spouse, Grandchild 3, and Grandchild 3's spouse, the remaining assets of the Grandchild 3 Settlement Trusts, less the Excluded Property, will be distributed in equal shares to Adoptee 2 and Adoptee 3, or all to the survivor. Adoptee 2 and Adoptee 3 have a testamentary power to appoint such individual's respective share of the Grandchild 3 Settlement Trusts to or for the benefit of such individual's spouse or descendants. If Adoptee 2 or Adoptee 3 does not exercise such power of appointment but has living descendants, the Trustee shall distribute such individual's respective share to such descendants, *per stirpes*. Any asset appointed under the terms of the Revised Settlement Agreement (including the assets of the Grandchild 3 Settlement Trusts) may not extend the time for vesting of that asset beyond a period of twenty-one years after the death of the last surviving descendant of Settlor who was in being on Date 18. Any remaining assets of the Grandchild 3 Settlement Trusts not otherwise distributed (including the Excluded Property) shall be distributed according to Settlor's Will without regard to any surviving Adult Adoptees or their descendants.

Under the Revised Settlement Agreement, all claims by the Adult Adoptees with regard to Settlor and Settlor's Spouse's trusts and estates are resolved and, after obtaining a favorable private letter ruling from the IRS, Trustee will agree to dismiss the petition filed in State Court with prejudice and all parties will agree that State Court can enter the dismissal without awarding costs to any party and without further notice.

It is represented that each Family Trust was irrevocable on September 25, 1985, and that there were no additions, constructive or actual, after that date.

You have requested the following rulings:

1. The Revised Settlement Agreement, the State Court order approving the Revised Settlement Agreement, and the implementation and distributions made in accordance with the Revised Settlement Agreement, will not cause any of the Family Trusts to lose their status as trusts exempt from GST tax for purposes of chapter 13 of the Code.
2. Entering into the Revised Settlement Agreement will not cause any party to the Settlement Agreement to be treated as having made a gift to any other individual for purposes of chapter 12 of the Code.

## LAW AND ANALYSIS

### Ruling 1

Section 2601 imposes a tax on every generation-skipping transfer (GST), which is defined under § 2611 as a taxable distribution, a taxable termination, and a direct skip.

Under § 1433(a) of the Tax Reform Act of 1986 (Act) and § 26.2601-1(a) of the Generation-Skipping Transfer Tax Regulations, the GST tax is generally applicable to GSTs made after October 22, 1986. However, under § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i), the tax does not apply to a transfer under a trust (as defined in § 2652(b)) 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)(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 GST tax under § 26.2601-1(b)(1), (b)(2), or (b)(3) will not cause the trust to lose its exempt status. The rules of § 26.2601-1(b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for GST tax purposes. They 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 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, each Family Trust was created and was irrevocable before September 25, 1985. It is represented that no additions, constructive or actual, have been made to any of the Family Trusts on or after September 25, 1985. Consequently, each Family Trust is currently exempt from GST tax.

In this case, each party was represented by separate legal counsel. The prospective beneficiaries had distinct and adverse economic and administrative interests. The parties were involved in protracted and substantial litigation to resolve the issue of the identity of Settlor's descendants under Settlor's Will. Settlement negotiations were carried out over several years until the Revised Settlement Agreement was reached. The parties have obtained State Court approval of the Revised Settlement Agreement pending the issuance of this private letter ruling.

We conclude that the Revised Settlement Agreement constitutes a settlement of a bona fide issue regarding construction of the terms "children" and "descendants" in Settlor's Will. We further conclude that the terms of the Revised Settlement Agreement are the product of arm's length negotiations. Finally, we conclude that the Revised Settlement Agreement represents a compromise between the positions of the interested parties and reflects the assessments of the relative strengths of their positions; therefore, we additionally conclude that the Revised Settlement Agreement is within the range of reasonable outcomes under the governing instrument and the applicable State law addressing the issues resolved by the Revised Settlement Agreement.

Accordingly, based on the facts submitted and the representations made, we rule that the Revised Settlement Agreement, the State Court order approving the Revised Settlement Agreement, and the implementation and distributions made in accordance with the Revised Settlement Agreement, will not cause any of the Family Trusts to lose their status as trusts exempt from GST tax for purposes of chapter 13 of the Code.

## Ruling 2

Section 2501 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 the tax imposed by § 2501 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 provides 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. United States*, 674 F.2d 761, 774-775 (9<sup>th</sup> Cir. 1981). Thus, state law must be examined to ascertain the legitimacy of each party's claim. A settlement that fairly reflects the relative merits and economic values of the various claims asserted by the parties and reaches a settlement that is within a range of reasonable settlements will not result in a transfer for gift tax purposes.

As discussed above, the Revised Settlement Agreement represents the resolution of a bona fide controversy among the family members as beneficiaries of Settlor's Will. All interested parties have been represented in the proceedings that culminated in the Court Order approving the Revised Settlement Agreement. Further, based on the facts as presented, the terms of the Revised Settlement Agreement are the product of arm's length negotiations among all the interested parties. We conclude that the Revised Settlement Agreement reflects the rights of the parties under the applicable law of State that would be applied by the highest court of State. Accordingly, based on the facts submitted and representations made, we rule that implementation of the Revised Settlement Agreement will not result in a gift under § 2501 by the parties to the Revised Settlement Agreement.

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.

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

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.

Sincerely,

*Karlene M. Lesho*

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Karlene M. Lesho  
Chief, Branch 4  
Office of Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures

Copy for § 6110 purposes

cc: