

## Internal Revenue Service

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## Department of the Treasury

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**CC:DOM:P&SI:7 - PLR-119237-98  
PLR-119243-98**

**Date:**

**March 24, 1999**

Legend:

Trust 1 =

A =

a =

Trust 2 =

B =

b =

Daughter 1 =

Daughter 2 =

C

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=

Court =

Bank =

d =

e =

f =

g =

h =

i =

j =

Dear Sir:

In a letter, dated \_\_\_\_\_, you requested several rulings concerning the gift and generation-skipping transfer (GST) tax consequences of a court ordered mediated settlement agreement. This letter responds to you request.

The information submitted and the representations made are summarized as follows: Trust 1 is a testamentary trust created under the will of A, who died on a. Trust 2 is a testamentary trust created under the will of B, who died on b. Daughter 1 and Daughter 2 are the only children of A and B.

The terms of the Trusts are summarized a follows:

Trust 1:

Paragraph III(A) of Trust 1 provides that the trustee shall pay all of the net income of Trust 1 in equal shares to Daughter 1 and Daughter 2 as long as they live. Paragraph III(B) of Trust 1 provides that on the death of the first of Daughter 1 and

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Daughter 2 to die, her share of the income is to be payable to her surviving issue, if any, but if none, to the surviving daughter.

On the death of both daughters, Paragraph III(C) of Trust 1 provides that Trust 1 is to terminate, and at that time the entire estate is to vest *per capita* in all A's grandchildren then living and in the issue of any grandchildren who have died, the issue to represent the parent and take the share which the parent would have taken if living.

With respect to principal, Paragraph III(E) of Trust 1 provides as follows:

If at any time my trustee shall determine that the income payable to any beneficiary is not sufficient to meet such beneficiary's reasonable needs, considering such beneficiary's other income and property, if any, and such other factors as my trustee shall deem to be relevant, as to which my trustee shall be the sole judge in the exercise of its absolute discretion, my trustee shall have the power to invade the corpus of the estate to the extent reasonably necessary to meet such needs, and its decision shall be final. During the lifetime of my daughters, during which time the corpus will remain undivided for their joint benefit, any unequal invasion of corpus for either of my daughters shall not be charged to her in any way and shall not affect her share of the income from the corpus still remaining in the trust. Without placing any limitation upon the power of my trustee to exercise its absolute discretion in a determination of the need to invade corpus on behalf of any beneficiary, I hope that my trustee will follow a liberal policy which is commensurate with the size of my estate and the needs of the particular beneficiary in order that my loved ones will derive from the estate the greatest good which is fair to all of them.

#### Trust 2:

Paragraph III(B) of Trust 2 provides that during A's lifetime, the trustee is to pay annually to A so much of the net income from Trust 2 as the trustee deems reasonably necessary for A's support, comfort, and maintenance. Paragraph III(C) of Trust 2 provides that after A's death, the trustee is to pay the income from Trust 2 annually, in equal amounts, to Daughter 1 and Daughter 2.

Paragraph III(D) of Trust 2 provides that after the death of that daughter that dies first, her share of the income is to be paid to the child or children, if any, who survive her, otherwise to the surviving daughter during the lifetime of the latter. Paragraph III(E) of Trust 2 provides that after the death of both daughters, the trust is to terminate and is to vest *per capita* in those of B's grandchildren who are living on the date of the death of that daughter who dies last, provided that if prior to the termination of Trust 2 one or more grandchildren have died, leaving issue, then that great-grandchild or great-grandchildren are to receive the share or shares that their parent or parents would have taken, if living, *per stirpes*.

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Paragraph III(F) of Trust 2 provides that on the termination of Trust 2, any accumulated and undistributed profits from Trust 2 are to be paid by the trustee to those persons who become entitled to the corpus of Trust 2 in proportion to their interests.

Daughter 1, who suffers from a serious medical condition and has sought both conventional and unconventional medical treatment, filed a complaint in the Court seeking removal of Bank as trustee, compensatory and punitive damages, and a court liquidation of certain allegedly unprotective assets. The complaint alleged that Bank, in its capacity as trustee of the Trusts, breached its fiduciary duty by failing to invest the trust assets in a manner designed to produce a reasonable amount of income. Daughter 1 also maintained that Bank breached its fiduciary duty and abused its discretion as trustee of Trust 1 by failing to honor numerous requests for principal distributions to provide for her living expenses that were not met from her income and property, and to reimburse her for medical and related expenses. Bank maintained that the Trusts produced a reasonable and fair total rate of return. Bank further maintained that its fiduciary duty extended not only to the current income beneficiaries but also to protecting the interests of the remainder beneficiaries. Bank maintained as well that it had honored all requests for principal distributions that were clearly authorized by the terms of Trust 1, and that it denied other requests that either clearly were not authorized by the terms of Trust 1, or were unrelated to the reasonable needs of Daughter 1, considering the nature of the expenditures for which reimbursement was sought, or considering the request in the context of Daughter 1's "other income and property, if any, and such other factors as the trustee shall deem to be relevant."

The parties reached a Settlement Agreement as a result of a Court ordered mediated settlement conference. In its order, dated c, approving the Settlement Agreement, the Court found that as a matter of law the terms of the Trusts do not give the trustee clear guidance as to its investment responsibilities, as they relate to the production of net income consistent with the needs of the principal beneficiaries. The Court further concluded that the terms of Trust 1 are unclear and ambiguous as they relate to the trustee's discretionary authority to make distributions of principal to Daughter 1, there being no ascertainable standard to guide the trustee in the exercise of its discretion.

The Court determined that the terms of the Settlement Agreement are a reasonable, and fair interpretation and construction of the terms of Trust 1 as they relate to the trustee's duty and responsibility to invade principal in response to the needs that Daughter 1 has maintained that she has now and will have in the future. The terms of the Settlement Agreement fairly and equitably accomplish the intent and purpose of A and B in establishing their respective testamentary trusts to provide for the welfare of their children and grandchildren in a way that is fair to all of them, and are consistent with the terms of the Trusts.

Pursuant to the terms of the Settlement Agreement, the trustee is to pay to Daughter 1 from the principal of Trust 1 the sum of d, which is the amount of the

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medical and related expenses that Daughter 1 incurred in e. Beginning in f, the trustee is to pay to Daughter 1 for her remaining life an aggregate annual amount from the Trusts equal to g. For years after f, the g is to be adjusted each year for cost of living increases. The annual payment is to be made first from one half of the annual income from each Trust, and then from the principal of Trust 1, if necessary. Daughter 1 will release all other interests she has in the Trusts as consideration for the guaranteed annual payment.

At the time the litigation was commenced, Trust 1 had approximately h in principal assets and i Trust 2 had approximately j in principal assets. During the last several years, the Trusts have produced a combined annual net income averaging approximately j.

It is represented that Daughter 1's interest in the Trusts under the Settlement Agreement will be at least equal to the value of her interest before the litigation. The Settlement Agreement is not intended to confer additional rights upon Daughter 1, but to provide certainty to her existing rights.

It is further represented that A's will was in existence on October 21, 1986, (without any modifications thereafter) and that A died prior to January 1, 1987. It is also represented that Trust 2 was irrevocable on September 25, 1985, and there have been no additions to Trust 2 since that date.

You have requested the following rulings:

1. The terms of the Settlement Agreement, particularly, the annual payment to and the release of other interests in the Trusts by Daughter 1, will not cause Trust 1 to lose its "grandfathered" exemption for purposes of the GST tax.

2. The terms of the Settlement Agreement, particularly, the annual payment to and the release of other interests in the Trusts by Daughter 1, will not cause Trust 2 to lose its "grandfathered" exemption for purposes of the GST tax.

3. The terms of the Settlement Agreement, particularly, the annual payment to and the release of other interests in the Trusts by Daughter 1, will not be deemed to create a constructive addition to Trust 1 for purposes of § 2601 of the Internal Revenue Code and the regulations thereunder.

4. The terms of the Settlement Agreement, particularly, the annual payment to and the release of other interests in the Trusts by Daughter 1, will not be deemed to create a constructive addition to Trust 2 for purposes of § 2601 of the Internal Revenue Code and the regulations thereunder.

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5. The terms of the Settlement Agreement, particularly, the annual payment to and the release of other interests in the Trusts by Daughter 1, will not be deemed to create any gift subject to tax under § 2501.

Generation-Skipping Transfer Tax Rulings:

Section 2601 imposes a tax on every generation-skipping transfer made by the "transferor" to a "skip-person."

Section 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax regulations provides that the tax does not apply to any generation-skipping transfer under a trust (as defined in § 2652(b)) that was irrevocable on September 25, 1985. The rule of the preceding sentence does not apply to a pro rata portion of any generation-skipping transfer under an irrevocable trust if additions are made to the trust after September 25, 1985.

Section 26.2601-1(b)(1)(ii) provides that, except as provided in § 26.2601-1(b)(1)(ii)(B) or (C), any trust in existence on September 25, 1985, is considered an irrevocable trust.

Section 26.2601-1(b)(1)(iv)(A) provides that if an addition is made after September 25, 1985, to an irrevocable trust that is excluded from chapter 13 by reason of § 26.2601-1(b)(1), a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to chapter 13. If an addition is made, the trust is thereafter deemed to consist of two portions, a portion not subject to chapter 13 (the non-chapter 13 portion) and a portion subject to chapter 13 (the chapter 13 portion), each with a separate inclusion ratio (as defined in § 2642(a)). The non-chapter 13 portion represents the value of the assets of the trust as it existed on September 25, 1985. The applicable fraction (as defined in § 2642(a)(2)) for the non-chapter 13 portion is deemed to be 1 and the inclusion ratio is deemed to be 0. The chapter 13 portion of the trust represents the value of all additions made to the trust after September 25, 1985. The inclusion ratio for the chapter 13 portion is determined under § 2642. This paragraph (b)(1)(iv)(A) requires separate portions of one trust only for purposes of determining inclusion ratios. For purposes of chapter 13, a constructive addition under § 26.2601-1(b)(1)(v) is treated as an addition.

Section 26.2601-1(b)(2)(i) provides that the provisions of chapter 13 do not apply to any generation-skipping transfer under a will or revocable trust executed before October 22, 1986, provided that—

(A) The document in existence on October 21, 1986, is not amended at any time after October 21, 1986, in any respect that results in the creation of, or an increase in the amount of, a generation-skipping transfer;

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(B) In the case of a revocable trust, no addition is made to the revocable trust after October 21, 1986, that results in the creation of, or an increase in the amount of, a generation-skipping transfer; and

(C) The decedent dies before January 1, 1987.

Section 26.2601-1(b)(2)(vi) provides that any addition made after October 21, 1986, but before the death of the settlor, to a revocable trust subjects all subsequent generation-skipping transfers under the trust to the provisions of chapter 13. Any addition made to a revocable trust after the death of the settlor (if the settlor dies before January 1, 1987) is treated as an addition to a revocable trust.

Section 2611(a) defines the term "generation-skipping transfer" as (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Section 26.2611-1 provides that a generation-skipping transfer is an event that is either a direct skip, a taxable distribution, or a taxable termination. The determination as to whether an event is a generation-skipping transfer is made by reference to the most recent transfer subject to the estate or gift tax.

Section 2612(c)(1) defines the term "direct skip" to mean a transfer subject to a tax imposed by chapter 11 or 12 of an interest in property to a skip person.

Section 2613(a) defines the term "skip person" to mean --

(1) a natural person assigned to a generation that is two or more generations below the generation assignment of the transferor, or

(2) a trust --

(A) if all interests in such trust are held by skip persons, or

(B) if --

(i) there is no person holding an interest in the trust, and

(ii) at no time after such transfer may a distribution (including distributions on termination) be made from such trust to a non-skip person.

Because A's will was in existence on October 21, 1986 (without any modifications thereafter) and because A died prior to January 1, 1987, Trust 1 has been exempt from the GST tax. Because Trust 2 was irrevocable of September 25, 1985, and there have been no additions to it since that date, Trust 2 has also been exempt from the GST tax.

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An amendment to an exempt trust that modifies or otherwise changes the quality, value, or timing of any of the powers, or beneficial interests, rights, or expectancies originally provided under the terms of the trust will cause the trust to lose its exemption from the GST tax.

We have examined the Settlement Agreement in the context of relevant case law addressing the issues. We believe that the terms of the Settlement Agreement in this case fairly reflect the relative merits of the positions of the respective parties to the dispute. The interests received by the parties under the Settlement Agreement, both with respect to the nature of the interests and their economic value, are consistent with the relative merits of the positions of the parties. Therefore, the Settlement Agreement does not alter the intended quality, value, or timing of the interests A and B created in the Trusts. Accordingly, we conclude that: (1) The terms of the Settlement Agreement will not cause Trust 1 to lose its “grandfathered” exemption for purposes of the GST tax; (2) The terms of the Settlement Agreement will not cause Trust 2 to lose its “grandfathered” exemption for purposes of the GST tax; (3) The terms of the Settlement Agreement will not be deemed to create a constructive addition to Trust 1 for purposes of § 2601 and the regulations thereunder; and (4) The terms of the Settlement Agreement will not be deemed to create a constructive addition to Trust 2 for purposes of § 2601.

Gift Tax Ruling:

Section 2501 imposes a tax for each calendar year on the transfer of property by gift during the calendar by any individual, resident or nonresident.

Section 2511(a) provides that, subject to certain limitations, the tax imposed by § 2501 applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Based on the information submitted and the representations made, we conclude that the Settlement Agreement does not result in the transfer of property by gift within the meaning of §§ 2501 and 2511. Accordingly, the terms of the Settlement Agreement will not be deemed to create any gift subject to tax under § 2501.

Except as expressly ruled in this letter, we express or imply no opinion concerning the federal tax consequences of any aspect of any transaction or item discussed or referenced in this letter under the cited provisions of the Code or any other provision of the Code.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(j)(3) provides that it may not be used or cited as precedent.



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

Sincerely,

Christine E. Ellison

Christine E. Ellison  
Chief, Branch 7  
Office of Assistant Chief Counsel  
( Passthroughs and Special Industries)