

## Internal Revenue Service

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## Department of the Treasury

Washington, DC 20224

Third Party Communication: None

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Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:04

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Date: JULY 05, 2005

### Legend:

Grantor	=
Trust	=
Company	=
Child 1	=
Child 2	=
Child 3	=
Child 4	=
Grandchild	=
Spouse	=
Date 1	=
Date 2	=
Date 3	=
Year 1	=
Year 2	=
<u>U</u>	=
<u>V</u>	=
<u>W</u>	=
<u>X</u>	=
<u>Y</u>	=
<u>Z</u>	=
State	=

Dear :

This letter is in response to a letter dated February 22, 2005 and subsequent correspondence from your authorized representative requesting rulings concerning the federal income and generation-skipping transfer tax consequences of a court-approved settlement agreement among the beneficiaries of Trust.

The facts and representations submitted are summarized as follows:

Grantor created an inter vivos irrevocable trust, Trust, on Date 1 prior to September 25, 1985, for the benefit of Grantor's four children, Child 1, Child 2, Child 3 and Child 4, their spouses, and issue. Trust was funded on same date with U shares of common stock of Company. There have been no modifications or amendments to Trust. No additions, actual or constructive, have been made to Trust subsequent to Year 1.

Under the terms of Trust, prior to Date 2 (which date has passed), the entire net income of Trust is to be distributed to charitable organizations to be selected by the trustees in their uncontrolled discretion. After Date 2, the trustees are to distribute in their absolute discretion, from time to time, such amounts of Trust income and corpus to and among Child 1, Child 2, Child 3 and Child 4, their spouses, and their issue, as the trustees deem to be in the beneficiary's best interests.

Trust is to terminate upon the death of the last to die of Child 1, Child 2, Child 3 and Child 4 and eleven named grandchildren of Grantor (one of which is Grandchild). On termination, the Trust corpus is to be divided into as many equal shares as there are children of Child 1, Child 2, Child 3 and Child 4 then living, or children of Child 1, Child 2, Child 3 and Child 4 who died leaving issue then living. The trustees are to distribute one share outright to each child of Child 1, 2, 3 and 4 then living and one share to the issue of a deceased child of Child 1, 2, 3 and 4, per stirpes.

Commencing in Year 2, an ongoing controversy has been presented regarding whether Grandchild is in fact an issue of Child 3, and thus, whether she and her issue are beneficiaries of Trust. The controversy has resulted in protracted litigation between Grandchild and the other beneficiaries of Trust who have challenged Grandchild's status as a Trust beneficiary.

To date, each of Grantor's grandchildren, except Grandchild, has received partial distributions of cash and common stock of Company. The trustees excluded Grandchild from any partial distributions because of the ongoing controversy regarding Grandchild's status as a Trust beneficiary. Distributions have not been made to any member of a generation below that of Grandchild.

After extensive settlement discussions between counsel for Decedent's grandchildren, counsel for Grandchild, and a guardian ad litem that was appointed for Grandchild's minor and unborn issue (the Settling Parties), an agreement (Settlement Agreement) was reached resolving the controversy.

A proceeding was instituted in State Superior Court requesting the entry of a judgment confirming the authority of the guardian ad litem for Grandchild's minors and unborn issue to participate in the Settlement Agreement, approving the settlement as

provided in the Settlement Agreement, and directing that it is binding on all parties interested or potentially interested in Trust. In connection with this proceeding, the guardian ad litem filed a report concluding that the Settlement Agreement was in the best interest of Grandchild's minor and unborn issue. On Date 3, the State Superior Court entered a judgment confirming the authority of the guardian ad litem to represent Grandchild's minor and unborn issue, approving the settlement as provided in the Settlement Agreement, and directing that the Settlement Agreement is binding on all parties interested or potentially interested in Trust, subject to the receipt of a private letter ruling from the Internal Revenue Service confirming that the implementation of the Settlement Agreement will not negatively affect the exempt status of Trust for purposes of the generation-skipping transfer tax.

Under the terms of the Settlement Agreement, the trustees are to distribute outright to Grandchild, cash in the amount of \$V. In addition, W shares of common stock in Company valued at \$X, is to be distributed to Grandchild and a trust established for the benefit of Grandchild's minor and unborn issue. Of the W shares of Company stock to be distributed, Y shares valued at \$Z, are to be distributed to a trust established for the benefit of Grandchild's issue. Under the terms of this trust, in general, the trustees are to distribute in their absolute discretion, from time to time, such amounts of trust income, and corpus to and among Grandchild's issue as the trustees deem to be in the beneficiary's best interest. The trust is to terminate upon the death of the last to survive of Child 1, Child 2, Child 3 and Child 4 and the eleven named grandchildren of Grantor that are designated as measuring lives for Trust including Grandchild. On termination, the Trust corpus is to be distributed outright to Grandchild's issue, per stirpes.

The balance of the Company shares will be distributed outright to Grandchild. Further, under the terms of the Settlement Agreement, Grandchild, and the guardian ad litem on behalf of Grandchild's minor and unborn issue, waive, relinquish and renounce any further interest in Trust.

The trustees of Trust have requested the following rulings:

1. The implementation of the Settlement Agreement will not result in the loss of Trust's exempt status for generation-skipping transfer tax purposes.
2. The implementation of the Settlement Agreement will not cause Trust to realize any capital gain, and the stock to be distributed under the Settlement Agreement will carry over its basis for income tax purposes.

#### Ruling Request 1

Section 2601 imposes a tax on every generation-skipping transfer (GST) made after October 26, 1986. Under section 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 generation-skipping transfers made after October 22, 1986. However, under section 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 generally applicable only for purposes of determining whether an exempt trust retains its exempt status for GST tax purposes. Unless specified otherwise, 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 the 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 this case, Trust was created and irrevocable before September 25, 1985. It is represented that no additions, actual or constructive, have been made to Trust since its creation. Consequently, based on these representations, Trust is currently exempt from GST tax.

In the present case, a bona fide issue has been presented regarding the status of Grandchild and her issue as beneficiaries of Trust. The issue has been the subject of protracted litigation. The Settlement Agreement is the product of arm's length negotiation between the parties to the agreement including negotiation between Grandchild and the guardian ad litem appointed for her minor and unborn issue. The Settlement Agreement represents a compromise between the positions of the parties and reflects the parties' assessments of the relative strengths of their position. Finally, the Settlement Agreement had been approved by the appropriate local court. Accordingly, we conclude that the implementation of the Settlement Agreement will not cause Trust to lose exempt status for GST tax purposes.

#### Ruling Request 2

Section 61 provides generally that, except as otherwise provided by law, gross income includes all income from whatever source derived, including 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 § 1011 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 excludes from gross income 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 that an amount distributed pursuant to a compromise agreement settling an individual's claim as an heir, constituted property acquired by inheritance that was exempt from income 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." 305 U.S. at 196. However, proceeds received pursuant to an agreement between estate beneficiaries as to how funds should be distributed, notwithstanding the terms of a controlling document, as opposed to a compromise of their claims against the estate, are not exempted from tax by § 102. Such payments would be received by virtue of being a party to the agreement, not by virtue of being an heir to the estate. See Commissioner v. Estate of Vease, 314 F.2d 79, 86-87 (9th Cir. 1963).

In this case, the status of Grandchild and Grandchild's issue as eligible Trust beneficiaries has been a bona fide and ongoing issue in the construction and administration of the Trust. The terms of the Settlement Agreement and proposed distribution to Grandchild and the trust for Grandchild's issue reflect the relative merits of the claims made by the Settling Parties, and do not result in modification of any beneficial interests in the Trust. To date, all beneficiaries of equal degree of descent from the Grantor (except Grandchild) have received distributions from the Trust. Grandchild and Grandchild's issue will receive distributions from the Trust under the Settlement Agreement because of Grandchild's status as an "issue" of Child 3, in accordance with the Trust's provisions and consistent with Lyeth v. Hoey, supra, by gift, bequest, devise or inheritance, rather than by purchase or exchange.

Therefore, implementation of the Settlement Agreement, including the proposed distributions of cash and stock to Grandchild and to the trust for the benefit of Grandchild's issue, will not result in the realization of taxable income by any party to the Settlement Agreement, including the Trust, trustees of Trust, Grandchild, the trust for Grandchild's issue, or the other Trust beneficiaries.

Accordingly, we conclude that the implementation of the Settlement Agreement will not cause the Trust to realize any capital gain. Therefore, the stock to be distributed in accordance therewith will carry over the basis for income tax purposes at which the shares are currently held by the Trust. Grandchild and the trust for Grandchild's issue will receive the stock at the basis for income tax purposes at which the shares are currently held by the Trust.

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.

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.

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

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

Sincerely,

George L. Masnik  
Chief, Branch 4  
(Passthroughs & Special Industries)

Enclosures

Copy for section 6110 purposes  
Copy of this letter