

## Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B09

PLR-127668-05

Date:

January 05, 2006

### Legend:

Date 1	=
Decedent	=
Date 2	=
Trustee 1	=
Daughter	=
Grandchild 1	=
Grandchild 2	=
Grandchild 3	=
Trust	=
A	=
B	=
Date 3	=
Date 4	=
Trustee 2	=
Trustee 3	=
Date 5	=
Court	=
Date 6	=
Guardian	=
Date 7	=
Date 8	=
Date 9	=
Year	=
Date 10	=
State	=

Dear :

This is in response to your authorized representative's letter dated May 19, 2005, and subsequent correspondence, requesting rulings regarding the generation-skipping transfer (GST), gift, and income tax consequences of a settlement agreement concerning the construction of the terms of a trust that is 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, Decedent executed her last will and testament that was modified by a codicil dated Date 2. After providing for certain specific pecuniary bequests, Article Six of Decedent's will provides for the disposition of the residue of Decedent's estate.

Article Six provides, generally, that Trustee 1 shall hold, manage and control the residue and remainder of Decedent's estate in trust for the use and benefit of Daughter, Grandchild 1, Grandchild 2, and Grandchild 3. Article Six, paragraph A provides that Trustee 1 shall collect the income from property comprising the trust estate and shall pay the beneficiaries of Trust the following sums: (a) to Daughter, the sum of \$A monthly during her lifetime, such installments to begin 60 days after Decedent's death; (b) to Grandchild 1, the sum of \$B per year, in annual or other convenient installments, with the first installment to be paid one year from the date of Decedent's death; (c) to Grandchild 2, the sum of \$B per year, in annual or other convenient installments, with the first installment to be paid one year from the date of Decedent's death; and (d) to Grandchild 3, the sum of \$B per year, in annual or other convenient installments, with the first installment to be paid one year from the date of Decedent's death.

Article Six, paragraph B provides that upon the death of a beneficiary of Trust, all payments to said beneficiary shall cease and Trust shall continue for the use and benefit of the remaining beneficiaries. Upon the death of the last beneficiary of Trust, or when all corpus and accumulated income of Trust have been exhausted, Trust shall terminate. All corpus and accumulated income remaining, if any, shall be distributed to the issue per stirpes of the beneficiaries of Trust, free and clear of trust. In the event a beneficiary shall have no issue, the corpus and accumulated income of said beneficiary's share of the trust estate remaining, if any, shall be distributed to said beneficiary's heirs at law, free and clear of trust.

Decedent died on Date 3, prior to September 25, 1985. Daughter, who was Decedent's only child died on Date 4. As set forth in Article Six, Trustee 1 was appointed trustee of Trust. Trustee 1 was, through succession, succeeded by Trustee 2, and later Trustee 3. Trustee 3 is the current trustee of Trust.

It is represented that no additions have been made to Trust since Date 3, the date of Decedent's death. It is further represented that since Date 3, the trustee has made timely distributions of the amounts specified to the beneficiaries named in Article Six, paragraph A of Decedent's will ("Named Beneficiaries"). At some point after Date 3, some or all of the Named Beneficiaries corresponded with the trustee and asserted that the terms of Trust were ambiguous. Specifically, the Named Beneficiaries

claimed that the amounts to be paid pursuant to Article Six, paragraph A of Decedent's will are merely minimum distribution amounts and that they should be entitled to receive additional distributions.

On Date 5, the Named Beneficiaries filed a petition for will construction in the Court against Trustee 2 who was trustee of Trust at that time. The petition sought declaratory relief regarding the proper interpretation of the dispositive provisions of Trust.

On Date 6, the Court appointed Guardian as the guardian ad litem for the minor remainder beneficiaries and all unborn remainder beneficiaries.

On Date 7, Trustee 2 filed a motion for summary judgment arguing that Trust unambiguously provides that the payments specified in Article Six are limited to being maximum payments. Additionally, Trustee 2 argued that Trust prohibits distributions to any remainder beneficiaries until all Named Beneficiaries are deceased.

On Date 8, Guardian filed an opposition to Trustee 2's motion for summary judgment with respect to the issue of when the remainder beneficiaries could begin receiving Trust distributions and also joined in Trustee 2's motion for summary judgment with respect to the issue of whether Trust limited distributions to the amounts specified in Article Six.

Grandchild 1 and Grandchild 3, both individually and as attorney-in-fact for Daughter, opposed the motion for summary judgment and argued that the payment amounts in Article Six, paragraph A are merely minimum distribution amounts. In addition, Grandchild 1 and Grandchild 3 argued that upon a Named Beneficiary's death, that deceased beneficiary's share should be paid to such deceased beneficiary's issue.

On Date 9, the Court denied the summary judgment motion. Subsequently, the parties settled other claims against Trustee 2, and Trustee 3 was appointed successor trustee in Year. Once Trustee 3 was appointed, Grandchild 1 and Grandchild 3 filed a new petition for will construction, declaratory relief, and alternately for trust modification with the Court. After additional filings by the Named Beneficiaries, Trustee 3, and Guardian, the Court ordered the parties to mediation. On Date 10, the parties reached a settlement.

Pursuant to the terms of the settlement agreement, the following modifications will be made to Trust. Article Six, paragraph A will be modified, in part, to include a new paragraph that provides that the distributions to the beneficiaries set forth (the "Minimum Amount") shall be paid from income and, to the extent that income is not sufficient, from the corpus of the trust. In addition to the distribution of the Minimum Amount to the beneficiaries, the trustee shall distribute (for the use and benefit of the beneficiaries) the net income of the trust equally to the beneficiaries.

Article Six, paragraph B will be modified, in part, to provide that upon the death of a beneficiary of the trust, all payments (the Minimum Amount and net income) to said beneficiary shall cease and shall thereafter be made to the issue, per stirpes, of that deceased beneficiary or, if there are none, to the heirs at law of that deceased beneficiary.

The settlement agreement has been approved by the Court, conditioned upon a favorable ruling by the Internal Revenue Service. Trustee 3, as trustee of Trust, has requested the following rulings: (1) The settlement agreement will not violate § 1433(b)(2)(A) of the Tax Reform Act of 1986 and will not affect the Trust's GST exempt status; (2) The settlement agreement will not cause Trust or any Trust beneficiary to be subject to federal gift tax under § 2501; and (3) The settlement agreement will not cause Trust or any Trust beneficiary to be treated as making a disposition for purposes of § 1001 and therefore will not result in the recognition of gain or loss.

Ruling Request 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. 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)(1)(ii)(B) or (C), which relates to property includible in a grantor's gross estate under §§ 2038 and 2042. In the present case, 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, Trust was created on Date 1 and became irrevocable on Date 3. There have been no additions made to the Trust after September 25, 1985. Accordingly, Trust is 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 Trust.

#### Ruling Request 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 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. U.S., 674 F.2d 761, 774-75 (9<sup>th</sup> 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 facts presented and the representations made, a bona fide controversy existed between the parties pertaining to the construction of the dispositive provisions of Article Six, paragraph A of Trust. Specifically, it is unclear whether the distributions provided in Article Six, paragraph A are minimum distribution amounts. In addition, it is unclear how distributions are to be made upon the death of a Named Beneficiary. All of the parties who hold an interest in Trust, including any unborn heirs, have been represented in the negotiations that preceded the settlement agreement. The terms of the proposed settlement are based on arm's length negotiations among all the interested parties.

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 and represent an agreement clarifying ambiguous terms of Trust. No money or other property was exchanged between the parties as a condition of execution of the settlement agreement. Accordingly, based on the facts submitted and 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 Request 3:

Section 61(a)(3) provides that gross income includes gains derived from dealings in property and, under § 61(a)(15), from an interest in a trust.

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.

Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991), concerns the issue of when a sale or exchange has taken place that results in 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, 499 U.S. at 560-61, concluded that § 1.1001-1 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 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.

Interpretation and construction of trust provisions is a matter of state law. Provided the Court approves the mediation settlement agreement, the agreement will modify the trust to remove the ambiguity and provide definitive interpretation of the trust terms. Except for the changes described above regarding the ambiguity of the trust terms, all other provisions of Trust will remain unchanged. Therefore, it is consistent with the Supreme Court's opinion in Cottage Savings to find that the interests of the beneficiaries after the division will not differ materially from the interests in the original trust. Accordingly, the proposed transaction 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 the beneficiaries or Trust for purposes of § 1001(a).

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.

Except as specifically ruled herein, we express or imply no opinion on the federal tax consequences of the transaction under the cited provisions or under any other provisions of the Code.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) 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.

Sincerely,

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

Enclosure

Copy of letter for § 6110 purposes