

## Internal Revenue Service

Number: **200536018**

Release Date: 9/9/2005

Index Number: 2601.00-00, 2501.00-00;  
0212.00-00

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:B04

PLR-169436-02

Date: JUNE 07, 2005

Re:

### Legend

Trust =

Taxpayer =

Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

Trust 5 =

Child 1 =

Child 2 =

Child 3 =

Child 4 =

Child 5 =

Trustee =

Date 1 =

Date 2 =

Date 3 =

Court =

Amount 1 =

Methodology =



Dear \_\_\_\_\_ :

This responds to your letter dated November 3, 2004, and prior correspondence, requesting rulings regarding the federal income, gift, and generation-skipping transfer (GST) tax consequences of a proposed judicial modification of a trust.

### Facts

The facts submitted and representations made are as follows. On Date 1, after September 25, 1985, Taxpayer established an irrevocable trust, Trust. Taxpayer and Taxpayer's spouse contributed Amount 1 to Trust. Taxpayer and Taxpayer's spouse each allocated their entire \$1,000,000 GST exemption amount to the initial transfer to Trust. Trust currently has an inclusion ratio between zero and one. There have been no additions to Trust since Date 1.

Pursuant to Paragraph 1.1 of Article I of the trust instrument, Trust was divided into five separate trusts, Trust 1, Trust 2, Trust 3, Trust 4, and Trust 5, one each for the primary benefit of Taxpayer's five children, Child 1, Child 2, Child 3, Child 4, and Child 5. The Trustee is directed to pay to or for the benefit of each child all of the net income from the child's trust. The Trustee has the power to use all or part of the principal, as the Trustee deems necessary, for the health, support, maintenance and education of the child for whom the separate trust is administered. Income is being distributed currently, but no distributions have been made from the principal of any of the trusts.

Article I, Paragraph 1.1.b provides that upon the death of the child for whom the separate trust is administered, the remaining trust assets are to be distributed in equal shares to those "grandchildren" of Taxpayer living at the time of the death of such child who are either (1) the children of such child, or (2) the children of another child of Taxpayer who has predeceased such child. However, the amount distributed to the grandchildren is to be adjusted pursuant to a formula provided in Paragraph 1.1.b. Any trust assets remaining after the distribution to the grandchildren pursuant to the formula are to be distributed in equal shares to the trusts established under the Trust instrument. Paragraph 2.8 of Article 2, as modified by court order dated Date 2, provides that the terms "child," "children," "grandchild," and "grandchildren" as used in the trust instrument shall include descendants by birth and any adopted person who lived while a minor as a regular member of the household of the adopting descendant-by-birth.

Currently, Child 1, Child 2, Child 3, Child 4 and Child 5 are all living. In addition, there are currently 10 grandchildren and 4 great-grandchildren of Taxpayer currently living. The parties propose to modify Trust as follows:

- 1) Paragraph 1.1(b) of Article 1 will be modified to provide that if one of Taxpayer's grandchildren predeceases his or her parent survived by a living child

or children (i.e., great-grandchildren of Taxpayer), then such great grandchildren of Taxpayer would succeed to the share his or her deceased parent would have taken if that parent were then living.

- 2) Paragraph 2.8 of Article 2 will be modified to provide that the term "grandchild" shall not include any person born to or adopted by one of the Taxpayer's children after December 31, 2004.
- 3) The distribution formula set forth in Paragraph 1.1.b of Article 1 that is applicable upon the death of a child will be clarified because the formula is ambiguous and it appears to contradict other Trust provisions. A revised formula has been agreed to by the parties.
- 4) The successor trustee provisions in Paragraph 3.4 of Article 3 will be modified to allow each child to act as the trustee of his or her own separate trust.

On Date 3, Court issued an order approving the parties' request to make Modifications (1), (3), and (4). The Court order also instructed the Trustee, in the exercise of the Trustee's prudent discretion, to advance Trust funds for the benefit of the Trust to pay the reasonable and necessary expenses, including attorneys' fees, of the Trustor, beneficiaries and other parties, including reimbursing any party for attorneys' fees and expenses actually incurred in connection with the petition. An additional Petition for Modification of Trust will be filed with Court with respect to the Modification (2).

The parties propose to determine the amount of any taxable gift made by the parties resulting from Modification (1), by utilizing Methodology, and Life Table 90 CM contained in §20.2031-7(d)(7) of the Estate Tax Regulations, and the interest rate prescribed under §7520(a)(2).

You have requested the following rulings with respect to the above modifications of Trust:

- 1) The modifications of Trust will result in taxable gifts from and to the beneficiaries of Trust. Methodology is an acceptable method for determining the amount of each gift.
- 2) If the modification of Trust is determined to cause certain beneficiaries to become transferors of Trust assets for purposes of the GST tax, then if the donor beneficiaries allocate sufficient GST exemption to the Trust equal to the amount of the gift each is treated as making, the portion of Trust contributed by them will have an inclusion ratio of zero for GST tax purposes. The inclusion ratio of the remaining portion of Trust will remain unchanged by the proposed modification.
- 3) The modifications of Trust will not result in a transfer subject to income tax.

- 4) The Trustee's use of Trust funds, whether from income or principal, to reimburse, pay or advance any party to the modifications reasonable and necessary attorneys' fees and related expenses incurred and paid to effect the modification will not give rise to any income tax liability for any Trust beneficiary.

#### Ruling Request No. 1 - Gift Tax

Section 2501 imposes a tax on the transfer of property by gift by an individual. Section 2511 provides that 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.

Section 2512(a) provides that, if a gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift. Section 25.2512-1 provides that the value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. All relevant facts and elements of value as of the time of the gift shall be considered. Section 25.2512-5(d)(1) provides the general rule that the fair market value of annuities, life estates, terms for years remainders and reversions transferred after April 30, 1999, is the present value of such interests determined under § 25.2512-5(d)(2) and by use of standard or special § 7520 actuarial factors. See also, § 25.2512-5(d)(4) regarding a request for a special factor.

Where an interest subject to a contingency is transferred, the donor is deemed to have made a transfer subject to the gift tax even though the donee may not obtain possession or enjoyment of the transferred interest. See § 25.2511-1(h)(6).

Section 7520(a) provides that the value of annuities, interests for life or a term of years, and remainder or reversionary interests is to be determined under tables published by the Secretary of the Treasury and by using an interest rate equal to 120 percent of the applicable federal mid-term rate in effect under § 1274(d)(1) for the month in which the valuation date falls.

Rev. Rul. 69-347, 1969-1 C.B. 227, holds that where a taxpayer enters into a contractual agreement that obligates the taxpayer to make transfers in the future, the effective date of the gift for Federal gift tax purposes is the date upon which the taxpayer becomes legally obligated to perform according to the terms of a contract, rather than the date upon which the actual transfer is made, provided the gift is susceptible of valuation at that time.

In Rev. Rul. 79-238, 1979-2 C.B. 339, A died testate in 1968 and under A's will, the residue of the estate was transferred to a testamentary trust, with income payable to B for B's life. Upon B's death, the trust is to terminate and the corpus divided equally between C and D, the children of A, who are of the same age. If either C or D

predeceases B, then the share of the deceased beneficiary is to pass to the survivor. If both C and D predecease B, then the trust corpus is to pass to a charitable beneficiary. In 1971, C and D entered into an agreement, binding under state law, providing that if either C or D alone predeceased B, then the portion of the trust corpus that the deceased would have been entitled to, if both C and D had survived B, would be transferred to the children of the deceased. The ruling concludes that, under the facts presented, a determinable interest was transferred by C and D when C and D executed the contract in 1971. Therefore, in accordance with Rev. Rul. 69-347, by entering into the contract, C and D made completed transfers of contingent interests subject to the gift tax when the contract was executed. See, §25.2511-1(h)(6).

In the instant case, pursuant to Modification (1), the children and grandchildren of Taxpayer are relinquishing contingent remainder interests in the separate trusts in order to obtain benefits for their grandchildren and children, respectively. In view of Modification (2), the situation presented is similar to that presented in Rev. Rul. 79-238. Accordingly, we conclude that the transfers resulting from Modification (1) will constitute completed gifts for federal gift tax purposes as of the date the agreement is finalized. In addition, we conclude that the amount of the gifts (reflecting Modification (2)), may be determined based on Methodology, which utilizes Table 90 CM and the interest rate prescribed by §7520(a). The computation will be based on the appropriate interest rate under §7520(a) as of the actual date of the proposed modification and will reflect the ages of the beneficiaries as of that date.

#### Ruling Request No. 2 – GST tax

Section 2601 imposes a tax on every generation-skipping transfer made by a “transferor” to a skip person. Under § 1433(a) of the Tax Reform Act of 1986 (Act), the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the tax does not apply to any generation-skipping transfer from a trust, if the trust was irrevocable on September 25, 1985, and no addition (actual or constructive) was made to the trust after that date.

Under § 2602, the amount of tax imposed under § 2601 is determined by multiplying the taxable amount by the applicable rate. The taxable amount of a taxable distribution is the amount received by the transferee (§ 2621), of a taxable termination is the amount of property with respect to which there was a termination (§ 2622), and of a direct skip is the amount received by the transferee (§ 2623).

Under § 2641, the term “applicable rate” means the product of the maximum federal estate tax rate in the year that the generation-skipping transfer occurs and the inclusion ratio. Under § 2642(a)(1), the inclusion ratio with respect to any property transferred in a generation-skipping transfer is 1 minus the applicable fraction. Under § 2642(a)(2), in general, the numerator of the applicable fraction is the GST exemption amount allocated to the property transferred and the denominator is the value of the

property transferred. Under § 2631, every individual is allowed a GST exemption amount which may be allocated by the individual or the individual's executor to any property with respect to which the individual is the transferor.

Section 2652(a)(1) provides that for GST tax purposes, the term "transferor" means the decedent in the case of any property subject to the tax imposed under chapter 11 and the donor in the case of any property subject to the tax imposed under chapter 12. Section 26.2652-1(a)(1) provides that the individual with respect to whom property was most recently subject to federal estate or gift tax is the transferor of that property for purposes of chapter 13.

Section 2654(b)(2) provides that for GST tax purposes, the portions of a trust attributable to transfers from different transferors shall be treated as separate trusts. Section 26.2654-1(a)(2)(i) provides that, if there is more than one transferor with respect to a trust, the portions of the trust attributable to the different transferors are treated as separate trusts for purposes of chapter 13. Additions to, and distributions from, such trusts are allocated pro rata among the separate trusts unless otherwise expressly provided in the governing instrument.

Section 26.2601-1(b)(4)(i) 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 will not cause the trust to lose its exempt status. The regulation provides that the rules contained in the paragraph 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.

Section 26.2601-1(b)(4)(i)(D) provides that a modification will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. A

modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer. A modification that is administrative in nature that only indirectly increases the amount transferred (for example by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust.

Section 26.2601-1(b)(4)(i)(E), Example 7, considers a situation where a trust is modified to increase a beneficiary's share of trust income. The trust provides that income is to be paid to A, B, and C in equal shares for life. A becomes disabled and the trustee, with the consent of B and C, petitioned the appropriate local court and the court approved a modification of the trust that increased A's share of trust income. The modification does not shift a beneficial interest to a lower generation, and does not extend the time for vesting of any beneficial interest. Therefore, the trust as modified will not be subject to the provisions of chapter 13. However, the modification increasing A's share of trust income is a transfer by B and C to A for Federal gift tax purposes.

No guidance has been issued concerning changes that may affect the status of trusts that are exempt from GST tax because sufficient GST exemption was allocated to the trust to result in an inclusion ratio of zero. At a minimum, a change that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status of such a trust.

The proposed modifications to Trust have been approved by Court or Court approval will be requested. Modification (3) clarifies an ambiguity in the trust instrument. The revision to the formula agreed to by the parties resolves a bona fide issue, and is within the range of reasonable outcomes under the governing instrument and state law. Accordingly, the requirements of §26.2601-1(b)(4)(i)(B) are satisfied. Modification (4) revises the successor trustee provisions in Paragraph 3.4 of Article 3 to allow a child of Taxpayer to serve as trustee of that child's separate trust. Under the terms of Trust, all Trust income must be distributed currently, and the trustee's discretion to distribute principal is limited by an ascertainable standard relating to the health, education, maintenance and support of the beneficiary. Accordingly, we conclude that the modification will not result in any shift of a beneficial interest in Trust, nor will the modification extend the time for vesting of any beneficial interest in Trust beyond the period provided for in the original trust. Accordingly, the requirements of §26.2601-1(b)(4)(i)(D) are satisfied.

As discussed above, as a result of Modifications (2) and (3), the Trust beneficiaries will be treated as making completed gifts for federal gift tax purposes of contingent remainder interests in Trust. Therefore, based on the facts and representations, we conclude that, as a result of the gifts from the donor beneficiaries to the donee beneficiaries discussed above, under §2652(a)(1), the donor beneficiaries will be treated as the transferor for GST tax purposes with respect to the portions of the



trusts attributable to these transfers and under §§ 2654(b)(2) and 26.2654-1(a)(2)(i), those portions of the trusts will be treated as separate trusts for GST tax purposes. Accordingly, if the donor beneficiaries allocate sufficient GST exemption equal to the amount of the gift each is treated as making, the portion of the trust for which they are the transferors for purposes of chapter 13 will have an inclusion ratio of zero for GST tax purposes. The inclusion ratio of the remaining portion of each trust is not changed as a result of the proposed modifications.

### Ruling Request No. 3 - Income Tax

Section 61 provides that gross income means all income from whatever source derived. Section 61(a)(3) provides that gross income includes gains derived from dealings in property. Section 102(a) provides that gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.

As indicated above, in the present case the modifications of Trust will result in taxable gifts from certain donor beneficiaries and to donee beneficiaries of Trust. Therefore, the modifications will not result in a transfer subject to income tax.

### Ruling Request No. 4- Attorneys' Fees and Related Expenses

Section 212(2) provides that in the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the year for the management, conservation, or maintenance of property held for the production of income.

Section 1.212-1(e) provides, in part, that § 212 does not allow the deduction of any expenses which are disallowed by any provisions of substitute A of the Code, even though such expenses may be incurred for one of the purposes specified in § 212.

Section 1.212-1(i) provides, in part, that reasonable amounts paid or incurred by the fiduciary of a trust on account of administration expenses, including expenses of litigation, which are ordinary and necessary in connection with the performance of duties of administration are deductible under § 212, notwithstanding that the trust is not engaged in a trade or business.

Section 1.212-1(j) provides that reasonable amounts paid or incurred for the services of a guardian or committee for a ward or minor, and other expenses of guardians and committees which are ordinary and necessary, in connection with the production or collection of income inuring to the ward or minor, or in connection with the management, conservation, or maintenance of property, held for the production of income, belonging to the ward or minor, are deductible.

Section 1.212-1(k) provides, in part, that expenses paid or incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in gross income), or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses.

Section 1.212-1(n) provides, in part, that capital expenditures are not allowable as nontrade or nonbusiness expenses.

Section 1.262-1(a) provides, in part, that in computing taxable income, no deduction shall be allowable, except as otherwise expressly provided in Chapter 1 of the Code, for personal, living, and family expenses.

Reasonable amounts paid or incurred by the fiduciary of a trust on account of administration expenses, including attorneys' fees and related expenses, which are ordinary and necessary in the performance the fiduciary's duties of administration are deductible under § 212. See § 1.212-1(i). If the beneficiaries of a trust incur legal fees with respect to the modification of a trust, the trust may assume financial responsibility for the payment of these fees and may deduct the fees if the fees are ordinarily and necessarily incurred in connection with the performance of administration duties. Section 1.212-1(i).

The determination of whether the fees constitute an expense of administration requires an appraisal of the underlying claim giving rise to the legal fees. See United States v. Gilmore, 372 U.S. 49 (1963). If the origin of the claim is a capital transaction or a personal transaction, then the trust may not deduct the legal fees as an expense of administration. See §§ 1.212-1(k), 1.212-1(n) and 1.262-1(a).

In the instant case, each of the Modifications (1) through (4) listed above must be analyzed separately to determine whether attorneys' fees and related expenses allocable to each modification are deductible under § 212.

#### Modification (3) - Distribution Formula

A trustee has an administrative duty to distribute the income and principal of a trust to its beneficiaries. This modification simplifies the formula, used to calculate income and principal, and correspondingly makes it easier for the Trust to distribute its assets. This modification is a direct benefit to the Trust, and therefore, the Trust may assume financial responsibility for the legal fees incurred by its beneficiaries. The Trust may deduct such legal fees as an expense of administration. See § 1.212-1(i). The payment of these fees does not give rise to income to any party to the Trust modification.

#### Modification (4) - Successor Trustees

A trustee has an administrative duty to invest the assets of the trust. This modification allows the replacement of the trustee with those more knowledgeable about particular investment strategies. The modification enhances the profitability of the assets and the management of them, a clear benefit to the Trust. Because of this benefit to the Trust, the Trust may assume financial responsibility for the legal fees incurred by its beneficiaries. The Trust may deduct legal fees as expenses of administration. See § 1.212-1(i). Further, the payment of these fees does not give rise to income to any party to the Trust modification.

Modifications (1) and (2) – Transfer of Contingent Remainder Interests to Taxpayer's Great-Grandchildren

In general, a trustee has an administrative duty to resolve bona fide questions of ambiguity arising under its trust instrument. A paramount issue calling for resolution would be an ambiguity surrounding the trust beneficiaries, for example, the timing of their interests, and the type of interests they have. There is no bona fide ambiguity under the Trust Agreement regarding the identity of the current and future beneficiaries, the timing of their interests, nor the type of interests they have. The sole purpose of this modification is to pass the trust corpus of each separate trust to great-grandchildren on termination of the trust, in the event the great-grandchildren's parent predeceased termination of the trust. The modification only benefits the interests of these contingent beneficiaries, and not that of the Trust. Consequently, the legal fees are not administrative expenses of the Trust, and as a result, the expenses are not deductible by the Trust. See § 1.212-1(i).

We express no opinion as to whether a payment or reimbursement of fees by Trust constitutes a distribution for purposes of § 661. In addition, we express no opinion on the effects of such payments on the calculations of Trust's distributable net income under § 643.

Except as specifically ruled herein, we express 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 who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely yours,

By \_\_\_\_\_  
George Masnik  
Branch Chief, Branch 4  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosure

Copy for section 6110 purposes  
cc: