Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **201531003**
Release Date: 7/31/2015

Index Number: 643.00-00, 1001.00-00, 2001.00-00, 2501.00-00, 2601.00-00

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:04
PLR-123149-14
Date: DECEMBER 08, 2014

Re:

LEGEND

Testator =
Trust =

Corporate Trustee A =
Corporate Trustee B =
Corporate Trustee C =
Corporate Trustee D =
Child A =
Child B =
Child C =
Grandchild C =
Grandchild A-1 =
Grandchild A-2 =
Individual =
Trust A =

Trust B =

© 2006-2020, CPC Holdings, LLC. All rights reserved.

Share 1 =

Share 2 =

Date 1 =
Date 2 =
Date 3 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
State =
Court =
State Act =

Cite 1 =
Cite 2 =
Cite 3 =
Cite 4 =

Dear :

This responds to your authorized representatives' letter dated June 10, 2014, and subsequent correspondence, requesting rulings concerning the income, gift, estate, and generation-skipping (GST) tax consequences of a settlement agreement.

FACTS

Testator died testate on Date 1 (prior to September 25, 1985), a resident of State. He was survived by two children, Child A and Child B. A third child, Child C, predeceased Testator. Child C was survived by her child, Grandchild C.

Testator's last will and testament (Will) established a trust (Trust) for the benefit of his lineal descendants. Article First, Paragraph A, of Trust provides that the trustees are to pay the net income quarterly in equal shares to Child A, Child B, and Grandchild C. If

© 2006-2020, CPC Holdings, LLC. All rights reserved.

any of them is not living on an income payment date, the trustees are to pay over his or her share of the income by right of representation to his or her issue then living.

Article First, Paragraph B, provides that Trust is to end upon the death of the survivor of Child A, Child B, and Grandchild C, at which time the trustees are to distribute the Trust principal by right of representation to Testator's then living issue. Article Second provides, in relevant part, that Corporate Trustee A, Child A, Child B, and Grandchild C are to be the trustees.

Child A died in Year 1, survived by two children (Grandchild A-1 and Grandchild A-2). Child B is living. Grandchild C is living. Trust will terminate when the survivor of Child B and Grandchild C has died. Corporate Trustee A and its successor corporation served as a co-trustee until Year 2.

At present, one-third of the Trust income is paid to Grandchild A-1 and Grandchild A-2, as successors to Child A's income interest. Another third of the income is paid to Child B. The last third of the income is paid to Grandchild C. The current presumptive remainder beneficiaries are: (i) Grandchild A-1 and Grandchild A-2; (ii) Child B's three children; and (iii) Grandchild C's four children.

The Trust assets consist primarily of investment assets. It is represented that no actual or constructive additions have been made to Trust since its inception.

In Year 3, Child B and Grandchild C, as co-trustees, petitioned the Court to appoint an institutional co-trustee to restore the trustee structure as originally constituted under the Will. By Court order of Date 2, Corporate Trustee B was appointed co-trustee of Trust. Corporate Trustee B was subsequently acquired by Corporate Trustee C. Accordingly, the current co-trustees are Child B, and Grandchild C and Corporate Trustee C.

Following the Year 3 Court proceedings, the trustees modified the written investment policy of Trust to invest and manage the Trust assets in accordance with the State Act. Under the modification, in part, an independent fiduciary, as a trustee, may equitably adjust between principal and income by allocating an amount of income to principal or an amount of principal to income to the extent the independent fiduciary considers appropriate, if the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income. In deciding whether and to what extent to exercise this power, the independent fiduciary is to consider certain factors, such as the assets held in the trust; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor.

© 2006-2020, CPC Holdings, LLC. All rights reserved.

Pursuant to the modification, Corporate Trustee C exercised its authority to equitably adjust Trust receipts between income and principal. Thereafter, Child B expressed concern and objected to Corporate Trustee C's actions in exercising its adjustment powers. The disagreements over these actions have resulted in a rift in the family and a desire by some family members to have different trustees and separate trusts for some of the beneficiaries.

In Year 4, Child B filed a petition with the Court to divide Trust and administer the divided trusts as separate trusts. Child B's stated reasons for the division were that it would facilitate investment, management and administrative decisions regarding the share for Child B and his family that would be consistent with their investment philosophy.

Child B's petition was met with opposition from the other beneficiaries and Corporate Trustee C. They were concerned that, among other things, the division of Trust violated the testamentary intent of Testator and violated a material purpose of Trust. They were also concerned that the division of Trust into new, smaller trusts would result in the loss of economic efficiencies enjoyed by the existing Trust.

Child B's petition was answered by the other beneficiaries, who raised a counterclaim. They requested that the court construe the words "by right of representation" in the context of Testator's will. They asserted that construction of the term could affect future distributions from Trust, whether or not Trust was divided. That is, depending on the order of deaths, and whether or not there were future births in the family, there were three possible constructions that could produce substantially different distributions of income and principal of Trust. See Cite 1; Cite 2; and Cite 3. See also Cite 4.

After an adversarial process before the Court and extensive settlement negotiations, the trustees and beneficiaries of Trust agreed to a settlement (Settlement Agreement) under which Trust will terminate and its assets will be divided into two trusts, Trust A and Trust B. Trust A, equal in value to one-third of the value of Trust, will be held as a separate trust for Child B and his descendants. Trust B, equal in value to two-thirds of the value of Trust, will be held as a separate trust for Grandchild C and her descendants and Child A's descendants. To the extent it is administratively feasible, the division of assets will be *pro rata*. In addition, the parties agreed that the term "by right of representation" will be construed to require a *per stirpes* distribution of trust assets among the descendants of Testator, with the first division to be made at the "child level" (i.e., at the level of Child A, Child B, and Child C) even if that generation has no living descendants.

On Date 3, the Court issued an order approving and adopting the terms of the Settlement Agreement. The order provides, in part, that beginning on the date of division and continuing until termination, Trust A and Trust B: (i) shall be treated as completely separate and distinct trusts for all purposes, and (ii) shall be governed by the

© 2006-2020, CPC Holdings, LLC. All rights reserved.

existing provisions of Trust, except to the extent modified by certain provisions (as described below).

Trust A

Child B will receive the Trust A income quarterly for his life. After Child B's death, his children will receive the income in equal shares. If any child should die, that child's children will receive the child's share of the income in equal shares. If Child B and all of his issue die before the termination of Trust A, the assets of Trust A will be added to Trust B. On the death of the survivor of Child B and Grandchild C, Trust A will terminate and the Trust A assets will be distributed to the then-living descendants of Child B, by right of representation.

Child B and his three children will be the individual co-trustees of Trust A. Corporate Trustee D will be appointed as a co-trustee by a document signed prior to the effective date of the trust division and effective upon the creation of Trust A. A corporate trustee will remain in service until Trust A terminates. The corporate trustee will have all the powers under State law to exercise the trustee's powers to adjust between income and principal pursuant to the provisions of the State Act.

Trust B

Grandchild A-1, Grandchild A-2, Grandchild C and Individual will be the co-trustees of Trust B. Corporate Trustee C will serve as the corporate trustee.

Trust B will consist of two shares, Share 1 and Share 2. The income of Share 1 will be distributed quarterly to Grandchild C. The income of Share 2 will be distributed quarterly in equal shares to Grandchild A-1 and Grandchild A-2. If any of those persons should die during the term of the trust, his or her income share will be paid to his or her descendants, by right of representation.

On the death of the survivor of Child B and Grandchild C, Trust B will terminate. Share 1 will be distributed to the then-living descendants of Grandchild C, by right of representation, and Share 2 will be distributed to the then-living descendants of Child A, by right of representation.

You have asked for the following rulings:

(1) The terms of the Settlement Agreement, including the Trust division and the construction of the phrase "by right of representation," will not cause a distribution from or the termination of any interest in Trust, Trust A, or Trust B to be subject to the generation-skipping transfer tax.

© 2006-2020, CPC Holdings, LLC. All rights reserved.

(2) The terms of the Settlement Agreement, including the Trust division and the construction of the phrase "by right of representation," will not cause any person to make a gift to any beneficiary of Trust, Trust A, or Trust B.

(3) The terms of the Settlement Agreement, including the Trust division and the construction of the phrase "by right of representation," will not cause the assets held in Trust, Trust A, or Trust B to be included in the gross estate of a beneficiary who dies prior to the termination of such trust.

(4) Following the termination of Trust and the resulting division of Trust pursuant to the Settlement Agreement, Trust A and Trust B will be treated as separate trusts.

(5) The terms of the Settlement Agreement, including the Trust division and the construction of the phrase "by right of representation," will not cause any party to the Settlement Agreement to realize income from the sale or exchange of any Trust assets or interests.

LAW AND ANALYSIS

Ruling 1

Section 2601 of the Internal Revenue Code imposes a tax on every generation-skipping transfer, which is defined under § 2611 as a taxable distribution, a taxable termination, and a direct skip.

Under § 1433 of the Tax Reform Act of 1986 (the Act), 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 a transfer under a trust that was irrevocable on September 25, 1985, except to the extent the transfer is made out of corpus added to the trust by an actual or constructive addition after September 25, 1985.

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 generation-skipping transfer tax under § 26.2601-1(b) will not cause the trust to lose its exempt status. These rules are applicable only for purposes of determining whether an exempt trust retains 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

© 2006-2020, CPC Holdings, LLC. All rights reserved.

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)(C) provides that a judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause an exempt trust to be subject to the provisions of chapter 13, if (1) The judicial action involves a bona fide issue; and (2) The construction is consistent with applicable state law that would be applied by the highest court of the state.

Section 26.2601-1(b)(4)(i)(D) provides that a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy § 26.2601-1(b)(4)(i)(A), (B), or (C)) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, 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.

Section 26.2601-1(b)(4)(i)(E) Example 5, describes a situation where, in 1980, Grantor established an irrevocable trust for the benefit of his two children, A and B, and their issue. Under the terms of the trust, the trustee has the discretion to distribute income and principal to A, B, and their issue in such amounts as the trustee deems appropriate. On the death of the last to die of A and B, the trust principal is to be distributed to the living issue of A and B, *per stirpes*. In 2002, the appropriate local court approved the division of the trust into two equal trusts, one for the benefit of A and A's issue and one for the benefit of B and B's issue. The trust for A and A's issue provides that the trustee has the discretion to distribute trust income and principal to A and A's issue in such amounts as the trustee deems appropriate. On A's death, the trust principal is to be distributed equally to A's issue, *per stirpes*. If A dies with no living descendants, the principal will be added to the trust for B and B's issue. The trust for B and B's issue is identical (except for the beneficiaries), and terminates at B's death at which time the trust principal is to be distributed equally to B's issue, *per stirpes*. If B dies with no living descendants, principal will be added to the trust for A and A's issue. The example concludes that the division of the trust into two trusts does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the division. In addition, the division does not extend the time for vesting of any beneficial interest in

© 2006-2020, CPC Holdings, LLC. All rights reserved.

the trust beyond the period provided for in the original trust. Therefore, the two partitioned trusts resulting from the division will not be subject to the provisions of chapter 13.

In this case, Trust was irrevocable on September 25, 1985. It is represented that there have been no actual or constructive additions to the Trust after September 25, 1985.

The Settlement Agreement and Court order resolve bona fide issues, i.e., the construction of the words “by right of representation,” as intended by Testator, and the administration of Trust under the State Act. The Settlement Agreement is the product of arm's length negotiations and is within the range of reasonable outcomes under Trust and State law. Finally, the Settlement Agreement and Court order construing the term “by right of representation,” and dividing Trust will not shift a beneficial interest in Trust to a lower generation beneficiary and will not extend the time for vesting of any beneficial interest in Trust.

Accordingly, based on the facts submitted and representations made, we conclude that the terms of the Settlement Agreement, including the Trust division and construction of the phrase ”by right of representation,” will not cause distributions from or the termination of any interest in Trust, Trust A, or Trust B to be subject to the GST tax imposed by § 2601.

Ruling 2

Section 2501 provides that a tax is imposed for each calendar year on the transfer of property by gift during such calendar year by any individual resident or nonresident. Section 2511 provides that the tax imposed by § 2501 will apply 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 25.2511-1(c) 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 (9th 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 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.

© 2006-2020, CPC Holdings, LLC. All rights reserved.

As discussed above, the issues resolved by the Settlement Agreement and Court order concerning the construction of Trust and its administration are bona fide issues based upon valid enforceable claims by the interested parties. The Settlement Agreement resolves conflicts concerning distributions of income and principal and is reflective of the rights of the parties under applicable State law that would be applied by the highest court of State. Accordingly, based on the facts submitted and representations made, we conclude that the terms of the Settlement Agreement will not cause any person to make a gift to any beneficiary of Trust, Trust A, or Trust B.

Ruling 3

Section 2001(a) provides that a tax is imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

Section 2033 provides that the value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death. Section 2036(a) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Section 2037 provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time after September 7, 1916, made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, if (1) possession or enjoyment of the property can, through ownership of such interest, be obtained only by surviving the decedent, and (2) the decedent has retained a reversionary interest in the property (but in the case of a transfer made before October 8, 1949, only if such reversionary interest arose by the express terms of the instrument of transfer), and the value of such reversionary interest immediately before the death of the decedent exceeds five percent of the value of such property.

Section 2038(a)(1) provides that the value of the decedent's gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in

© 2006-2020, CPC Holdings, LLC. All rights reserved.

conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the three-year period on the date of the decedent's death.

Section 2041(a)(2) provides that the value of the gross estate shall include the value of all property to the extent of any property with respect to which the decedent has, at the time of his death, a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released a power of appointment by a disposition that is of such nature that if it were a transfer of property owned by the decedent the property would be includible in the decedent's gross estate under §§ 2035 to 2038.

Section 2041(b)(1) provides that a general power of appointment is a power that is exercisable in favor of the decedent, the decedent's estate, the decedent's creditors, or the creditors of the decedent's estate. However, a power to consume, invade, or appropriate property for the benefit of the decedent that is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent shall not be deemed a general power of appointment.

In this case, no person made a transfer to Trust other than Testator at his death on Date 1. The income and terminating distributions from the divided trusts will follow the same pattern as they would have had Trust not been divided. The income beneficiaries will be entitled to distributions quarterly and the remaindermen will be entitled to receive the Trust property only upon surviving termination of the respective trust.

The terms of the Settlement Agreement do not cause any transfers or create any general powers of appointment that would cause any of the Trust property to be included in the estate of a beneficiary under §§ 2036, 2038, or 2041. Consequently, the terms of the Settlement Agreement will not cause any beneficiary of Trust, Trust A, or Trust B, who dies prior to the termination of such trust, to include trust assets in his or her taxable estate other than: (i) trust assets that have been distributed to him or her prior to death, or (ii) such quarterly distributions of income that were past due and not paid in accordance with the trust terms during a beneficiary's life (and to which he or she has a legally enforceable claim at death).

Ruling 4

Section 643(f) provides that, for purposes of subchapter J of chapter 1 of subtitle A, under regulations prescribed by the Secretary, two or more trusts shall be treated as one trust if (1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose of such trusts is the avoidance of the tax imposed by Chapter 1.

© 2006-2020, CPC Holdings, LLC. All rights reserved.

Section 1806(b) of the Tax Reform Act of 1986 provides that § 643(f) shall apply to taxable years beginning after March 1, 1984; except that, in the case of a trust that was irrevocable on March 1, 1984, it shall apply only to that portion of the trust that is attributable to contributions of corpus after March 1, 1984.

The taxpayers represent that, in this case, Trust A and Trust B will have different beneficiaries. The taxpayers also represent that no actual or constructive additions have been made to Trust since its inception (prior to March 1, 1984). Based on the facts submitted and the representations made, we conclude that as long as Trust A and Trust B are separately managed and administered, they will be treated as separate trusts for federal tax purposes.

Ruling 5

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

Section 1001(a) provides that the 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 for determining loss over the amount realized. Under § 1001(b), the amount realized from the sale or other disposition of property is 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 of the Code, the entire amount of gain or loss, determined under § 1001, on the sale or exchange of property must 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.

A partition of jointly owned property is not a sale or other disposition of property if the co-owners of the joint property sever their joint interests, but do not acquire a new or additional interest as a result thereof. Thus, neither gain nor loss is realized on a partition. See Rev. Rul. 56-437, 1956-2 C.B. 507 (conversion of a joint tenancy in stock to a tenancy in common in order to eliminate the survivorship feature and the partition of a joint tenancy in stock are not sales or exchanges).

Similarly, divisions of trusts are also not sales or exchanges of trust interests if each asset is divided pro rata among the new trusts. See Rev. Rul. 69-486, 1969-2 C.B. 159 (pro rata distribution of trust assets not a sale or exchange).

Here, the division of Trust into Trust A and Trust B will not result in any shift in beneficial interest in the assets of Trust. Accordingly, the division of Trust as described will not result in the realization of gain or loss under §§ 61 and 1001. In addition, the

© 2006-2020, CPC Holdings, LLC. All rights reserved.

agreement regarding construction of the term “by right of representation” will not result in the realization of gain or loss under §§ 61 and 1001.

Except as expressly provided 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.

These rulings are directed only to the taxpayers 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 representatives.

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,

Leslie H. Finlow
Senior Technician Reviewer, Branch 4
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosure:
Copy of letter for section 6110 purposes

© 2006-2020, CPC Holdings, LLC. All rights reserved.