

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:4-PLR-108860-99
Date:
October 25, 1999

Settlor =

Trust =

Trustees =

Son =

Daughter =

Grandson =

Great-grandchild A =

Great-grandchild B =

Great-grandchild C =

Great-grandchild D =

Great-grandchild E =

Great-grandchild F =

Court =

Settlement Agreement and Order =

Date 1 =

Date 2 =

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Date 3 =

Date 4 =

Date 5 =

Year =

Dear :

We received your letter dated May 5, 1999, in which you request rulings on behalf of the above-referenced taxpayers concerning the federal income, gift, estate and generation-skipping transfer tax consequences of a proposed settlement agreement.

On Date 1, Settlor executed an irrevocable trust agreement, Trust, for the benefit of Daughter. Son was the initial sole trustee. Item FOUR, Article A of the trust agreement provides:

The trust estate shall be held and dealt with as follows: The trust estate shall be held by the Trustee for the benefit of the Settlor's daughter, [Daughter], and said Trustee, in his absolute and uncontrolled discretion, shall use so much of the net income of the principal of such trust as he deems necessary to provide for the support, comfort and maintenance of [Daughter], and if the entire said net income, together with the income received by [Daughter] from other sources, should not be adequate, again in the sole opinion of the Trustee, to provide for the suitable support, comfort and maintenance of [Daughter], the Trustee is authorized to use so much of the principal of the trust as is necessary to make such provision.

In administering Trust, the Trustee made periodic distributions to Daughter of substantially all of Trust's net income. Settlor and Son are deceased.

In Year, the parties ascertained that the provisions regarding the distribution of Trust property upon Daughter's death were ambiguous. Daughter has one child, Grandson, and six grandchildren, Great-grandchild A, Great-grandchild B, Great-grandchild C, Great-grandchild D, Great-grandchild E, and Great-grandchild F. Specifically at issue was the interpretation of Item FOUR, Articles C and D, which provide, in pertinent part, as follows:

Article C. The trust estate, or the balance thereof remaining at the death of [Daughter] shall pass to and vest in her issue surviving her, the said Trustee continuing to administer said trust for the benefit of such issue under the terms and provisions of Item FOUR of this trust agreement.

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* * *

Article D. In the event the circumstances herein elsewhere state require the establishment of a trust or trusts for the benefit of issue of ...[Daughter]..., the Trustee of such trust shall be governed in the administration of his trust by the terms and provisions of this Article D. Item FOUR, as follows: The Trustee shall use so much of the net income of his trust, and if such income is not adequate, then so much of the principal of such trust, as the Trustee may deem necessary for the support, maintenance, education, benefit, and advancement of the issue who are beneficiaries of such trust for a period of twenty-one years after the inception of the beneficial interest in such trust of such issue or until all of such issue have attained the age of twenty-one (21) years, whichever may sooner occur, at which time the trustee shall distribute the principal of such trust in equal shares among such issue as are then living.

On Date 2, the Trustee filed a Petition for Declaratory Judgment in Court. Each of the Trustee and Grandson was represented by separate legal counsel in that proceeding, and a guardian ad litem was appointed by the Court to represent the interests of the Great-grandchildren and any unborn descendants of Daughter. On Date 3 a hearing was held. Testimony was received from Daughter and Grandson regarding their understanding of the Settlor's intentions.

The arguments of all parties were supported by state law decisions. The Guardian ad litem maintained that the express provisions of the trust agreement require Trust to continue after Daughter's death for her issue for an additional twenty-one years or until the youngest issue living at Daughter's death reaches age twenty-one, whichever is earlier, and that, if there is any ambiguity in the trust agreement, it only related to the identity of her issue who would be entitled to beneficial interests. Grandson, on the other hand, took the position that the entire corpus was to be distributed to him at Daughter's death. He argued that the phrase "shall pass to and vest in her issue surviving her" requires a per stirpes division of Trust property at Daughter's death. Grandson also relied upon statements made at the hearing by Daughter and statements attributed to Son as the initial trustee that, upon Daughter's death, Grandson was to receive the remaining corpus. Briefs were submitted by all parties. Daughter died on Date 5.

The parties now propose to settle the dispute. The Settlement Agreement provides that Grandson will receive one-third of the Trust property outright. One-third of the Trust property will be divided equally and held in separate trusts for Daughter's grandchildren (Great-grandchildren of the Settlor) living at her death with principal to be distributed to the grandchild twenty-one years after the establishment of the trust or at such earlier time as there shall be no living issue of Daughter who was living at her death that is less than twenty-one years of age. During the term of these trusts, income and corpus will be distributable to the trust beneficiary under the same standard

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contained in Article D of the trust agreement. One-third of the Trust property will be held in trust for Grandson during his lifetime, with income and principal payable to him in the sole discretion of an independent corporate trustee (based on the distribution standard set forth in Article D of the trust agreement). The remainder is to be divided at Grandson's death equally among Daughter's grandchildren then living who were also living at Daughter's death, with the issue then living of such a grandchild who predeceased Grandson receiving the distribution per stirpes. Property otherwise distributable to a grandchild or more remote issue for whom a separate trust is then held under the Trust shall be added to the existing separate trust. In negotiating, the parties were aware that Court approval would be necessary and the Court would have to be satisfied that the settlement reflected potential judicial resolutions applying the language of Trust and the state court decisions relating to the legal issues. This arrangement is viewed by the parties as giving essentially equal current economic value to the two sides while also recognizing the weight of the legal arguments. The Settlement Agreement also supplies specific provisions to implement the continuing trusts.

You represent that no additions of assets, constructive or otherwise, have been made to Trust subsequent to September 25, 1985. In addition, the trusts were irrevocable as of the date of creation, prior to September 25, 1985.

You have requested the following rulings:

1. Distributions made from Trust as a result of Daughter's death pursuant to the Settlement Agreement and Order, whether outright or in further trust, will not cause the recognition of any taxable income or gain to Trust, the individual distributees, the distributees' trusts or their beneficiaries, except to the extent gains are realized on assets sold by Trust prior to distribution or to the extent said distributions may be deemed to carry out distributable net income (within the meaning of § 643(b)) under § 661 and § 662.

2. Neither the implementation of the Settlement Agreement and Order, nor distributions made from Trust as a result of Daughter's death pursuant to the Settlement Agreement and Order, whether outright or into further trust, will cause any person to be deemed to have made a gift or to be subject to federal gift taxes under Chapter 12 of Subtitle B.

3. Neither the implementation of the Settlement Agreement and Order, nor distributions made from Trust as a result of Daughter's death pursuant to the Settlement Agreement and Order, whether outright or in further trust, will cause any person to be deemed to have made a generation-skipping transfer or to be subject to generation-skipping transfer taxes under Chapter 13 of Subtitle B.

4. The implementation of the Settlement Agreement and Order will not cause

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Trust or any further trust to which property is distributed as a result of Daughter's death to lose its grandfathered status for purposes of the generation-skipping transfer tax under § 1433(b)(2)(A) of the Tax Reform Act of 1986.

5. The implementation of the Settlement Agreement and Order will not cause the inclusion of any property owned by Trust, or property held in further trust pursuant to said Settlement Agreement and Order, in the gross estate of any individual for federal estate tax purposes under Chapter 11 of Subtitle B, except to the extent of property distributed outright to a beneficiary.

Ruling Request No. 1 – Income Taxation of Trust

Section 643(e) provides that in the case of any distribution of property (other than cash) to which an election under § 643(e) applies, gain or loss shall be recognized by the estate or trust in the same manner as if such property had been sold to the distributee at its fair market value, and the amount taken into account under §§ 661(a)(2) and 662(a)(2) shall be the fair market value of such property.

Section 1.661(a)-2(f)(1) of the Income Tax Regulations provides that if property is paid, credited, or required to be distributed in kind, no gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of the distribution, unless the distribution is in satisfaction of a right to receive a distribution in a specific dollar amount or in specific property other than that distributed.

Section 661(a) provides that in any taxable year a deduction is allowed in computing the taxable income of a trust (other than a trust to which subpart B applies), for the sum of (1) any amount of income for such taxable year required to be distributed currently (including any amount required to be distributed that may be paid out of income or corpus to the extent such amount is paid out of income for such taxable year); and (2) any other amounts properly paid out or credited or required to be distributed for such taxable year. However, any such deduction allowed cannot exceed the distributable net income of the trust.

Section 662(a) provides that there shall be included in the gross income of a beneficiary to whom an amount specified in § 661(a) is paid, credited, or required to be distributed (by an estate or trust described in § 661), the sum of the following amounts: (1) the amount of income for the taxable year required to be distributed currently to such beneficiary, whether distributed or not; and (2) all other amounts properly paid, credited, or required to be distributed to such beneficiary for the taxable year.

In Lyeth v. Hoey, 305 U.S. 188 (1938), the Supreme Court held that, for income tax purposes, property received pursuant to the settlement of a bona fide will contest is treated as passing directly from the decedent by inheritance.

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Accordingly, based upon the information submitted, we conclude that the distributions made pursuant to the Settlement Agreement and Order will not cause the recognition of any taxable gain or income to Trust or to Trust's beneficiaries because the distribution is not in satisfaction of a right to receive a distribution in a specific dollar amount or in specific property other than that distributed within the meaning of § 1.661(a)-2(f)(1). However, Trust will recognize gain to the extent realized on assets sold by Trust prior to distribution, and Trust's beneficiaries will have taxable income to the extent such distributions carry out distributable net income (within the meaning of § 643(a)) to the beneficiaries under §§ 661 and 662.

This ruling is subject to the condition that Trust does not elect to recognize gain on in kind distributions pursuant to § 643(e).

Ruling Request No. 2 – Gift Tax

Section 2501 provides for a gift tax on the transfer of property by gift. Section 2511 provides that the gift tax imposed by § 2501 shall 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.

In Commissioner v. Estate of Bosch, 387 U.S. 456 (1967), the Court considered whether a state trial court's characterization of property rights conclusively binds a federal court or agency in a federal estate tax controversy. The Court concluded that the decision of a state trial court as to an underlying issue of state law should not be controlling when applied to a federal statute. Rather, the highest court of the state is the best authority on the underlying substantive rule of state law to be applied in the federal matter. If there is no decision by that court, then the federal authority must apply what it finds to be state law after giving "proper regard" to the state trial court's determination and to relevant rulings of other courts of the state. In this respect, the federal agency may be said, in effect, to be sitting as a state court.

In view of Bosch, whether an agreement settling a dispute is effective for estate and 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, 774-775 (9th Cir. 1981).

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.

We have examined the Settlement Agreement in the context of the state court

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decisions that address the issues presented. In applying these standards, we have concluded that the proposed Settlement Agreement fairly reflects the relative merits of the claims made by the parties to the dispute. We believe that the Settlement Agreement provides an allocation of the trust assets that is within a range of reasonable settlements considering the state court decisions that address the issues. That is, the interests to be received by the parties (both as to the nature of the interests and their economic value) are consistent with the relative merit of the claims asserted by the parties.

Accordingly, we rule that, neither the implementation of the Settlement Agreement and Order, nor distributions made from Trust as a result of Daughter's death pursuant to the Settlement Agreement and Order, whether outright or into further trust, will cause any person to be deemed to have made a gift or to be subject to federal gift taxes under Chapter 12 of Subtitle B.

Ruling Requests Nos. 3 and 4 – Generation-Skipping Transfer Tax

Section 2601 provides that a tax is imposed on every generation-skipping transfer. Section 2611 defines the term "generation-skipping transfer" to mean a taxable termination, a taxable distribution, or a direct skip.

Section 2612(b) defines the term "taxable distribution" to mean any distribution from a trust to a skip person (other than a taxable termination or a direct skip). Section 2613(a)(1) defines the term "skip person" as including a natural person assigned to a generation that is two or more generations below the generation assignment of the transferor.

Trust in this case is a generation-skipping trust because Trust provides for distributions to persons that are two or more generations below the transferors' generation. Thus, unless Trust is excepted from the GST tax provisions by reason of § 1433(b)(2)(A) of the Tax Reform Act of 1986 (Act) and § 26.2601-1(b)(1) of the Generation-skipping Transfer Tax Regulations, transfers from Trust would be subject to the GST tax.

Section 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1) of the regulations provide that the GST tax shall not apply to any GST under a trust 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).

In general, any change to the quality, value or timing of any beneficial interest provided for under a trust that was irrevocable on September 25, 1985, will cause the trust to lose exempt status.

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Trust was irrevocable as of Date 1 which was prior to September 25, 1985, and no actual or constructive additions have been made to Trust after September 25, 1985. Based on the facts presented and representations made, we conclude that because the proposed Settlement Agreement and Order reflect the relative merit of the claims asserted by the parties to the litigation, the Settlement Agreement and Order do not alter the intended quality, value, or timing of any beneficial interests Settlor created in Trust. Accordingly, the implementation of the Settlement Agreement and Order will not cause Trust or any further trust to which property is distributed as a result of Daughter's death to lose its exempt status for purposes of the GST tax under § 2601.

Ruling Request No. 5 - Estate Tax

Under § 2033, the gross estate includes the value of all property to the extent of the decedent's interest in the property at death.

Under §§ 2036, 2037, and 2038, the gross estate includes the value of property to the extent of any interest in the property the decedent has transferred for less than adequate and full consideration in money or money's worth, while retaining a lifetime interest, specified reversionary interest, or the right to affect beneficial enjoyment.

As discussed above, we conclude that the Settlement Agreement is regarded for transfer tax purposes as properly reflecting the substantive rights of the parties. Accordingly, the implementation of the Settlement Agreement and Order will not cause the inclusion of any property owned by Trust, or property held in further trust pursuant to said Settlement Agreement and Order, in the gross estate of any individual for federal estate tax purposes under Chapter 11 of Subtitle B, except to the extent of property distributed outright to a beneficiary.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under the cited provisions or any other provisions of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,
Assistant Chief Counsel
(Passthroughs and Special
Industries)
George Masnik, Chief, Branch 4

Enclosure