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Department of the Treasury
Washington, DC 20224

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Person To Contact:

Telephone Number:

Refer Reply To:
CC:PSI:B04
PLR-138461-14

Date:
March 26, 2015

In Re:

Legend

Grantor
Trust 1
Date 1
Son
Son's Wife
Year 2
Year 3
State
Daughter
Foundation
Trust A
Trust B
Trust X
Company A
LLC A
Company B
Company C
Company D
Date 4
State Court
Date 5
Trust 2

Grandchild 1
Grandchild 2
Grandchild 3
Grandchild 4
GGC 1

GGC 2
GGC 3
GGC 4
GGC 5
GGC 6
GGC 7
GGC 8
GGC 9
Year 6
Year 7
Date 8
<u>a</u>
<u>b</u>
State Statute 1
State Statute 2
State Statute 3

Dear :

This letter responds to your personal representative's letter of October 3, 2014, requesting income, gift, and generation-skipping transfer (GST) tax rulings regarding the proposed modification of Trust 2.

The facts and representations submitted are summarized as follows:

Grantor created and funded Trust 1 on Date 1 for the benefit of Son, Son's Wife, and Son's descendants. You represent that Trust 1 was irrevocable before September 25, 1985, and that there have been no additions, actual or constructive, since that time. Grantor died in Year 2.

Section A of Article I of Trust 1 provides that Son, in his capacity as initial trustee of Trust 1, shall hold, manage, control and administer the above-described property, and such other money and property as the Grantor may assign, deliver or bequeath to him at any time(s) after the execution of this agreement, in trust, shall collect all the income thereof, out of such income shall pay or provide for all proper taxes, costs, charges and expenses of every kind imposed upon or incurred by Trust 1 (other than those imposed upon or incurred by it upon or by reason of its termination, and other than capital losses), and all gift taxes on whomever imposed payable to State by reason of the execution of this agreement or by reason of any assignments, transfers, or deliveries made by Grantor to the initial trustee at or within six months after the execution of this agreement and thereafter shall distribute the remaining net income and corpus of Trust as hereinafter provided.

Section B of Article I of Trust 1 provides, in part, that the remaining net income of Trust 1 for each calendar quarter shall be divided into equal shares, of which there shall be: (a) one share for Grantor's son, Son, so long as he is living; (b) one share for Grantor's said Son's Wife so long as they both are living and she is his wife; (c) one share for each of Grantor's said Son's lawful children then living; and (d) one share for the then living descendants of each of Grantor's said Son's lawful children then deceased.

Section C of Article I of Trust 1 provides that upon the death of Son, the corpus of Trust shall be distributed to such person or persons within a class including only the Grantor's lineal descendants other than Son, and no other or others whatsoever, particularly and expressly excluding from said class Son, Son's estate, Son's creditors, and the creditors of his estate, and in such shares and proportions and at such time or times and in such manner, absolutely or in trust, as Son, by his will shall appoint or direct, but not in such a way as to postpone the final distribution of this Trust 1 beyond the expiration of 21 years after the death of the last survivor of all of Grantor's descendants living at the time this agreement is executed, and any later final distribution directed by Son shall be accelerated accordingly; or, as to all or any portion of this Trust 1 estate not so effectively appointed by Son, this Trust 1 shall continue until the death of the last survivor of the lawful children of Son, living at the time this agreement is executed, and the corpus shall then be distributed free of trust per stirpes to the then living descendants of Son; or if no such descendants are then living, then free of trust per stirpes to the then living descendants of Grantor's daughter, Daughter; or if none of her descendants is then living, then to Foundation, a charitable corporation.

On Date 4, State Court ordered that Trust 1 be separated into two separate modified trusts with terms identical to Trust 1 except that different individuals may act as successor trustees of each resulting trust to facilitate different investment and management objectives. The court found that the proposed modification of Trust 1 by reason of changed circumstances comported with the intentions of Grantor and would have no effect upon the current or ultimate disposition of Trust 1. In addition, State Court issued an order that authorized the initial trustee to partition Trust into two separate trusts, Trust A and Trust B, with identical terms except that the separate trusts may provide that different individuals may act as successor trustee of each modified trust.

After the partition, Son acted as trustee of Trust A and Trust B, and trustee succession would continue to be governed by the terms of Trust 1. Son transferred all assets from Trust 1 other than common stock of Company A to Trust A, and transferred the common stock of Company A to Trust B. Company A is a corporation which would later be converted into a limited liability company, LLC A. LLC A was a holding company that owned a controlling interest in the business that had previously been spun-off from Company B, and was later operated as Company C.

On Date 5, Son died. In his will, Son exercised the limited testamentary power of appointment (provided under Section C of Article I of Trust 1) over Trust B to create Trust 2, to be held and administered as a separate trust under the terms of Trust X (a revocable trust first established by Son in Year 3, which became irrevocable upon Son's death). You represent that no additions, constructive or otherwise, were made to Trust B or Trust 2 since Date 4. Distributions from Trust 2 are governed by Trust X, while the terms of Trust 1 continue to govern all other matters related to the administration of Trust 2, including termination. Son's Wife, Grandchild 1, Grandchild 2, Grandchild 3, and Grandchild 4 are all the current income beneficiaries of Trust 2. GGC1, GGC 2, GGC 3, GGC 4, GGC 5, GGC 6, GGC 7, GGC 8, GGC 9, and several minors are the remainder beneficiaries of Trust 2. Trust 2 will terminate no later than 21 years after the death of the last to die of Grantor's descendants who were living on Date 1.

In Year 6, LLC A sold its interest in Company C to Company D, a publicly-traded corporation, in exchange for cash and stock in Company D. At the end of Year 6, LLC A made a partial liquidating distribution to its members of cash received from the sale of Company C. A portion of this partial liquidating distribution represented the amounts that Trust 2 was entitled to receive as a preferred distribution and was characterized by the trustee of Trust 2 as trust income. The majority of the partial liquidating distribution was characterized by the trustee of Trust 2 as trust principal.

In Year 7, LLC A sold its stock in Company D. In the same year, LLC A made a final liquidating distribution to its members of cash received from the sale of stock in Company D. This distribution was characterized by the trustee of Trust 2 as trust principal.

As a result of the transactions in Year 6 and Year 7, Trust 2 incurred a significant capital gains tax, which was much greater than the annual income of Trust 2. The dispositive tax charging provision (Tax Charging Provision) for Trust 2, which is contained in Trust 1, solely states that the trustee shall collect all the income from Trust 1 and out of such income the trustee shall pay or provide for "all proper taxes." The trustee believes the language of Trust 1 is ambiguous and incomplete regarding whether the capital gains taxes due as a result of the transactions in Year 6 and Year 7 should be paid from Trust 2 income or Trust 2 principal.

As a result of the ambiguous language and the lack of specific direction regarding payment of taxes for capital gains in the Tax Charging Provision, the trustee of Trust 2 petitioned State Court to construe the Tax Charging Provision to determine how the capital gains tax payment should be charged against Trust 2 principal and Trust 2 income. To avoid costs, fees, and delays associated with litigation, the current income beneficiaries, the adult remainder beneficiaries, and a court appointed *guardian ad litem* (representing the minor and unborn remainder beneficiaries) later entered into a settlement agreement (Settlement Agreement) that modified the Tax Charging

Provision and allocated the Year 6 tax payment as being a percent from principal and b percent from income. Settlement Agreement also provided that all capital gains incurred in Year 7 and later years would be allocated to principal. State Court approved Settlement Agreement on Date 8, conditioned on a favorable private letter ruling from the Internal Revenue Service. The current trustee, the current income beneficiaries, and all adult remainder beneficiaries have each submitted a private letter ruling request, requesting the following rulings:

1. The implementation of Settlement Agreement will not cause any beneficiary of Trust 2 to be treated as having made a taxable gift.

2. The implementation of Settlement Agreement will not cause Trust 2 to lose its exempt status for GST tax purposes.

3. The implementation of Settlement Agreement will not result in gain to Trust 2 or any beneficiary of Trust 2 or otherwise be treated as a taxable exchange for federal income tax purposes.

LAW AND ANALYSIS

Ruling 1

Section 2501 imposes a tax on the transfer of property by gift by any individual.

Section 2511 provides that the gift tax 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.

Section 2512(a) provides that, if the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift.

Section 2512(b) provides that where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift.

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.

The relevant inquiry in determining whether transfers made pursuant to a settlement agreement are exempt from the gift tax focuses on the bona fides and legitimacy of the claims. See Ahmanson Foundation v. United States, 674 F.2d 761 (9th Cir. 1981). Thus, an intrafamily settlement of litigation will be regarded as a bona fide compromise agreement when the parties' claims are bona fide and are satisfied, to the extent feasible, on an economically fair basis.

In the present situation, in determining whether the gift tax applies, it is first necessary to determine if Settlement Agreement properly reflects the economic values of bona fide claims of the respective parties, with appropriate allowance for litigation uncertainty. If the settlement does not so reflect those values, then it will be necessary to consider whether any differences may be justified on the basis of a compromise. Thus, with respect to each gift tax issue, it is pertinent to examine the law of the applicable jurisdiction to determine the legitimacy of the parties' claims in the issues that are under our consideration for gift tax purposes.

State Statute 1 provides that the trustee shall allocate money received in total or partial liquidation of an entity to principal. Furthermore, State Statute 2 provides that a tax required to be paid by a trustee based on receipts allocated to principal must be paid from principal, even if the tax is called an income tax by the taxing authority. However, State Statute 3 provides that in allocating receipts and disbursements to income or principal or between income and principal, a fiduciary shall first administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in the subchapter of State statutes.

Accordingly, under State law, if a trust instrument is clear and unambiguous in designating the payment of capital gain taxes out of income, the fiduciary must administer the trust in accordance with the terms, despite State statutes that are contrary. However, in the absence of a specified direction from the grantor, capital gain taxes are payable from principal.

In this case, the dispositive Tax Charging Provision states that the trustee shall collect all the income from Trust 1 and out of such income the trustee shall pay or provide for "all proper taxes." The Tax Charging Provision did not specifically address capital gain taxes nor is the term "all proper taxes" defined. A court could construe the Tax Charging Provision as providing that the capital gain taxes, and specifically, the significant capital gains taxes incurred here as being extraordinary in nature, and not within the language, "all proper taxes." Therefore, the Tax Charging Provision can be viewed as generally, but not absolutely, requiring the application of income to pay taxes. Because the Tax Charging Provision is ambiguous and incomplete with respect to payment of capital gains taxes, and subject to conflicting legal conclusions, we conclude that the claims of the current income beneficiaries, the trustee, and the remainder beneficiaries regarding the allocation of the taxes are bona fide, with the outcome of the litigation of this issue being uncertain. The allocation in Settlement Agreement represents the economic viability of the claims of the current income beneficiaries and the remainder beneficiaries. Accordingly, based on the facts submitted and the representations made, we conclude that implementation of Settlement Agreement will not cause any beneficiary of Trust 2 to be treated as having made a taxable gift. This ruling is applicable to all current income beneficiaries of Trust 2, the adult remainder beneficiaries of Trust 2, and the minor and unborn remainder beneficiaries of Trust 2.

Ruling 2

Section 2601 imposes a tax on every generation-skipping transfer made after October 26, 1986.

Under § 1433(a) of the Tax Reform Act of 1986 (Act) and § 26.2601-1(a) of the Generation-Skipping Transfer Tax Regulations, the GST tax is generally applicable to GSTs made after October 22, 1986. However, under § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i), the GST tax does not apply to a transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that the transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added). Under § 26.2601-1(b)(1)(ii), any trust in existence on September 25, 1985, will be considered irrevocable unless the decedent had a power that would have caused inclusion of the trust in his or her gross estate under § 2038 or § 2042, if the decedent had died on 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 GST tax under § 26.2601-1(b)(1), (2), or (3) will not cause the trust to lose its exempt status. Under the regulation, unless specifically provided otherwise, these rules are applicable only for purposes of determining whether an exempt trust retains its exempt status for GST tax purposes. Thus (unless specifically noted), 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 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 this case, as stated above, the Tax Charging Provision is ambiguous, incomplete, and subject to conflicting legal conclusions. We conclude that the claims of the current income beneficiaries, the trustee, and the remainder beneficiaries regarding the allocation of the taxes are bona fide, with the outcome of the litigation of this issue being uncertain. The allocation contained in Settlement Agreement is the product of arms-length negotiations and is within the range of reasonable outcomes under the instrument and applicable state law. Accordingly, based on the facts submitted and the representations made, we conclude that the implementation of Settlement Agreement will not cause Trust 2 to lose its exempt status for GST tax purposes.

Ruling 3

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 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.

State Court has approved Settlement Agreement and concluded that it resolves a bona fide legal issue as to the construction of the Tax Charging Provision. Thus, the effect of Settlement Agreement carries out the terms of Trust 1 rather than resulting in a disposition of trust interests. Accordingly, based on the facts submitted and the representations made, we conclude that the implementation of Settlement Agreement, as described, will not result in the realization of gain or loss under §§ 61 and 1001 to Trust 2 or any beneficiary of Trust 2. This ruling is applicable to all current income beneficiaries of Trust 2, the adult remainder beneficiaries of Trust 2, and the minor and unborn remainder beneficiaries of Trust 2.

In accordance with the Power of Attorney on file with this office, we have sent a copy of this letter to your authorized representatives.

Except as expressly provided herein, we neither express nor imply any opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

The rulings contained in this letter are based upon information and representations submitted by the Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

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.

Sincerely,

____
Melissa C. Liquerman
Chief, Branch 4
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures
Copy for § 6110 purposes
Copy of this letter

cc: