Internal Revenue Service

Number: **201642030**
Release Date: 10/14/2016

Index Number: 2601.03-01, 2501.01-00, 2041.03-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:

Telephone Number:

Refer Reply To:
CC:PSI:B04
PLR-141557-15

Date:
June 22, 2016

<u>Legend</u>

Husband	=
Wife	=
Grandchild 1	=
Grandchild 2	=
Grandchild 3	=
Grandchild 4	=
Daughter	=
Trust 1	=
Trust 2	=
Trust 3	=
Trust 4	=
Trust 5	=
Year	=
Successor Trust	=
Trust A	=
LP1	=
LP2	=
LP3	=
Corporation 1	=
Corporation 2	=
State	=
<u>Citation</u>	=

State Court =
Settlement Agreement =
State Statute =
a =
b =
c =
d =
e =
Individual 1 =
Individual 2 =
Individual 3 =
Individual 4 =
Individual 5 =
Individual 6 =
Bank =
Date 1 =
Date 2 =
Date 3 =

Dear :

This letter responds to your authorized representative's letter dated December 7, 2015, requesting income, gift, estate, and generation-skipping transfer (GST) tax rulings with respect to the proposed modifications of Trust 1.

The facts and representations submitted are summarized as follows:

On Date 1, a date prior to September 25, 1985, Husband and Wife created five irrevocable trusts with substantively similar terms for different beneficiaries. Trust 1 was created for the primary benefit of Grandchild 1, Trust 2 was created for the primary benefit of Grandchild 2, Trust 3 was created for the primary benefit of Grandchild 3, Trust 4 was created for the primary benefit of Daughter, and Trust 5 was created for the primary benefit of Grandchild 4.

Article I of Trust 1 provides that the trustees are to pay to or for the benefit of Grandchild 1 so much of the net income from Trust 1 as the trustees in their sole discretion shall determine to be necessary and desirable to provide for the health, education, maintenance, and support (HEMS) of said beneficiary. In the event that net income is not sufficient to provide for the health, education, maintenance, and support of said beneficiary, then the trustees may use such part of the principal as, from time to time, in their sole discretion, they may determine to be necessary for such purposes.

Article II of Trust 1 provides that, upon the death of Grandchild 1, the trustees are to pay to or for the benefit of the issue of Grandchild 1 such part of the net income from Trust 1 as the trustees in their sole discretion shall determine to be necessary and desirable to provide for the health, education, maintenance, and support of such issue. In the event that the trustees determine that the net income is not sufficient to provide for the health, education, maintenance, and support of any one or more of such issue, then the trustees may use such part of the principal as, from time to time, in their sole discretion, they may determine to be necessary for such purposes.

Article III of Trust 1 provides that, in the event that Grandchild 1 and all issue of Grandchild 1 shall die prior to the final distribution of Trust 1 properties, the remaining Trust 1 properties, principal, and any accumulated income, shall be paid over and delivered in equal shares among the other trusts (Trust 2, Trust 3, Trust 4, and Trust 5) then in existence.

Article XII of Trust 1 provides that Trust 1 will terminate 21 years after the last to die of Grandchild 1, Grandchild 2, Grandchild 3, Daughter, or Grandchild 4. Upon termination, all of the properties remaining in Trust 1 shall be distributed to the then living beneficiaries of Trust 1, share and share alike.

Trust 1 appoints seven initial individual trustees and Article VIII of Trust 1 identifies seven successor individual trustees of Trust 1. Article VIII of Trust 1 additionally provides that when fewer than four trustees are currently serving, the remaining trustees shall have the power and authority to appoint one or more individuals as trustees, so that at least four and not more than seven individuals may serve as trustees. Further, Article VIII of Trust 1 grants the trustees then serving the power to appoint a bank as successor trustee, to serve thereafter as the sole trustee.

Grandchild 4 died in Year without issue. Pursuant to the terms of Trust 5, the assets remaining after the death of Grandchild 4 were distributed equally among Trust 1, Trust 2, Trust 3, and Trust 4.

Currently, Trust 1, Trust 2, and Trust 3 (the GC Trusts) hold limited partnership interests in LP1 and LP2 and shares of Corporation 1 and Corporation 2. Corporation 1 is a bank holding company and Corporation 2 is a closely-held corporation. Each of the GC Trusts' interests in LP2 and Corporation 2 is a significant percentage (approximately a percent) of the GC Trusts' net value, with the remaining assets consisting of cash and marketable securities.

Currently, Individual 1, Individual 2, Individual 3, Individual 4, Individual 5, and Individual 6 (the current individual trustees) serve as co-trustees of Trust 1, Trust 2, Trust 3, and Trust 4.

On Date 2, Grandchild 1 petitioned State Court, pursuant to State Statute, to modify Trust 1, specifically requesting the appointment of a corporate trustee to replace the current individual trustees. Grandchild 2, Grandchild 3, and Daughter filed similar petitions for modifications to the respective trust of which each is a beneficiary. The petitions allege that the current individual trustees failed to sufficiently communicate with the beneficiaries of the trusts concerning the investment strategies for each of the respective trusts and the respective beneficiary's needs in relation to his or her health, education, support, and maintenance. In addition, the petitions filed by Grandchild 1, Grandchild 2, and Grandchild 3 allege that the current individual trustees failed to sufficiently diversify trust assets and made questionable investments despite the potential for conflicts of interests. The current individual trustees denied the allegations in the petitions and opposed the request to appoint a corporate trustee for each trust.

After an extended period of negotiations, including mediation, Grandchild 1, Grandchild 2, Grandchild 3, Daughter, and the current individual trustees entered into Settlement Agreement, which State Court approved by order dated Date 3. Settlement Agreement is contingent on the receipt of favorable rulings from the Internal Revenue Service.

Settlement Agreement provides for similar modifications to apply to each of Trust 1, Trust 2, and Trust 3. In regard to Trust 1, Settlement Agreement provides as follows: (1) Trust 1 will be divided into Successor Trust and Trust A ; (2) Bank will be appointed to serve as the sole corporate trustee of Successor Trust; (3) Individual 1, Individual 2, and Individual 3 will be appointed to serve as co-trustees of Trust A; (4) Successor Trust and Trust A will have the same beneficiaries in the same proportions as Trust 1; (4) Successor Trust will be funded with the balance of Trust 1 assets after the funding of Trust A; (5) Trust A will be funded with Trust 1's partnership interests in LP1 and LP2 and shares of Corporation 1 and Corporation 2, and $b in cash or other liquid assets; (6) Successor Trust and Trust A will be governed by the same terms found in the Trust 1 instrument, except as modified by Settlement Agreement. Trust 4 will not be divided, but Bank will be appointed to serve as the sole corporate trustee of Trust 4.

Settlement Agreement provides that the trustee provision of Trust 1 will be modified in the trust instrument governing Successor Trust to provide the "distributees" of Successor Trust, upon application to and order of State Court at State Court's discretion, the power to remove at any time and without cause any then-serving corporate trustee of Successor Trust by written notice delivered to such trustee, and the power to replace such trustee with another corporate trustee that—(1) has the power to act as a trustee under the laws of the state governing the administration of the trust; (2) has at least $c in assets under management; and (3) is not related or subordinate, within the meaning of § 672(c), to the "distributees" of Successor Trust. Further, the trustee provision of Trust 1 will be modified in the trust instrument governing Successor Trust to provide the "distributees" of Successor Trust, in the event the then-serving

corporate trustee resigns or can no longer serve as trustee, the power to appoint a successor corporate trustee, without application to and approval by State Court, that—(1) has the power to act as a trustee under the laws of the state governing the administration of the trust; (2) has at least $c in assets under management; and (3) is not related or subordinate, within the meaning of § 672(c), to the "distributees" of Successor Trust. The term "distributees" refers to a majority of the competent adult beneficiaries who are at the time authorized to receive distributions of principal or income from the trust.

Settlement Agreement provides that the trustee provision of Trust 1 will be modified in the trust instrument governing Trust A so that the number of individuals serving as co-trustees of Trust A shall be three as of the date of the division of Trust 1 into Successor Trust and Trust A. Upon the first of Individual 1, Individual 2, or Individual 3, to die, resign, become incapacitated, or otherwise fail to serve, the distributees of Trust A will be empowered to select one individual to serve as successor trustee of Trust A. The trustee selected by the distributees will be subject to the approval of the other two then-serving trustees. Succession to the office of trustee for the other two trustees shall continue to be determined by the co-trustees.

Under Settlement Agreement, the beneficiaries of Trust A agree to look to, and the trustees of Trust A agree to utilize, the income and principal of Successor Trust first for the beneficiaries' HEMS distributions. Settlement Agreement provides that the governing instrument of Trust A will provide that in making distributions in accordance with the HEMS standard, the trustees are to take into consideration a beneficiary's distributions of income and principal received from Successor Trust and other sources of income.

Settlement Agreement provides that the beneficiaries of Trust A and the beneficiaries of Successor Trust are and will be the same and each beneficiary has an identical interest in Trust A as he or she has in Successor Trust. However, Settlement Agreement provides that the trustees of Trust A will make all transfers and distributions to the trustee of Successor Trust in order to satisfy any transfers or distributions the trustees of Trust A may be required to make to Successor Trust or its beneficiaries under the governing instrument of Trust A, by law, or under Settlement Agreement, so that no distributions will be made directly from Trust A to the beneficiaries.

The termination date of Successor Trust is the termination date of Trust 1, which is 21 years after the last to die of Grandchild 1, Grandchild 2, Grandchild 3, Daughter, or Grandchild 4. Settlement Agreement provides that the governing instrument of Trust A will provide for a termination date d years after the effective date of Settlement Agreement, unless trustee of Successor Trust elects, after consultation with the distributees of Successor Trust, to extend the termination date of Trust A for an additional e years. Since the sum of d years and e years is less than 21 years, and Grandchild 1, Grandchild 2, Grandchild 3, and Daughter were all alive on the effective

date of Settlement Agreement, the termination date of Trust A will be before the termination date of Successor Trust. Upon termination of Trust A, the assets of Trust A will be distributed to the trustee of Successor Trust to form part of the corpus of Successor Trust.

After the modification, both Successor Trust and Trust A continue to be subject to the rule in Article III of Trust 1, which provides that in the event that Grandchild 1 and all issue of Grandchild 1 all predecease the required termination date, the remaining trust assets will be distributed equally to the other trusts (Trust 2, Trust 3, Trust 4, and Trust 5) then in existence.

Under Settlement Agreement, attorneys' fees and expenses incurred by the trustees and beneficiaries relating to the litigation and the Settlement Agreement will be paid or reimbursed by Trust 1, Trust 2, Trust 3, and Trust 4. The direct payments and reimbursements shall be made from each of Trust 1, Trust 2, Trust 3, and Trust 4, pro rata, in relation to the total value of each trust.

Finally, Settlement Agreement includes several provisions that concern the trustees' administration of Successor Trust and Trust A, such as provisions addressing communications with beneficiaries and conflicts of interest.

The current individual trustees of Trust 1 represent that no other additions have been made to Trust 1 since September 25, 1985.

Under the law of State, in administering a distribution standard tied to the needs of a beneficiary, a trustee will consider all income enjoyed by the beneficiaries from any and all sources, so long as it is available for support of the beneficiary. Citation.

You have requested the following rulings:

1. The division and modification of Trust 1 pursuant to Settlement Agreement will not cause Trust 1 or the resulting trusts, Successor Trust and Trust A, to be subject to the provisions of chapter 13.

2. None of the terms or trust modifications set forth in Settlement Agreement will result in a gift under chapter 12 by any beneficiary or any trustee of Trust 1, Successor Trust, or Trust A.

3. None of the terms or trust modifications set forth in Settlement Agreement will cause any assets of Trust 1, Successor Trust, or Trust A to be includible in any beneficiary's or trustee's gross estate under § 2036, § 2037, or § 2038.

4. None of the powers granted to any of the beneficiaries of Trust 1, Successor Trust, or Trust A will cause the assets of any such trust to be included in any beneficiary's gross estate under § 2041(a).

5. The division of Trust 1 into Successor Trust and Trust A pursuant to Settlement Agreement will not result in either (i) a distribution under § 661 from Trust 1 or (ii) gross income to Successor Trust or Trust A pursuant to § 662.

6. A transfer from Trust A to Successor Trust pursuant to Settlement Agreement that is made for a purpose other than to facilitate a HEMS distribution to a beneficiary will not result in either (i) a distribution under § 661from Trust A or (ii) gross income to Successor Trust pursuant to § 662.

7. A transfer from Trust A to Successor Trust for an immediate HEMS distribution to a beneficiary will result in (i) a deduction pursuant to § 661 for Trust A (to the extent of Trust A's distributable net income) and (ii) inclusion of an equivalent amount in the recipient beneficiary's gross income pursuant to § 662.

8. A payment by Trust 1, Successor Trust, or Trust A to a beneficiary of Trust 1, Trust 2, Trust 3, Trust 4, or one of the resulting divided trusts as reimbursement for the beneficiary's prior payment of attorney's fees and expenses will not result in a deduction under § 661 for the reimbursing trust or gross income to the recipient beneficiary under § 662, but such payment will result in a deduction for the reimbursing trust under § 212.

Ruling 1

Section 2601 imposes a tax on every GST made after October 26, 1986. A GST is defined under § 2611(a) as (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Section 2612(a) provides that the term "taxable termination" means a termination (by death, lapse of time, release of a power, or otherwise) of an interest in property held in a trust unless (A) immediately after such termination, a non-skip person has an interest in such property, or (B) at no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person.

Section 2612(b) provides that the term "taxable distribution" means any distribution from a trust to a skip person (other than a taxable termination or a direct skip).

Under § 2612(c)(1), a direct skip is a transfer subject to federal estate or gift tax of an interest in property to a skip person.

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 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). Under § 26.2601-1(b)(1)(ii), any trust in existence on September 25, 1985, will be considered irrevocable unless the settlor had a power that would have caused inclusion of the trust in his or her gross estate under § 2038 or § 2042, if the settlor 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) (hereinafter referred to as an exempt trust) will not cause the trust to lose its exempt status. In general, unless specifically provided otherwise, the rules contained in § 26.2601-1(b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for 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)(D)(1) 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)(D)(2) provides that for purposes of § 26.2601-1, 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. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is measured against the effect of the instrument in existence immediately before the modification. If the effect of the modification cannot be immediately determined, it is deemed to shift a 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 modification. 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 5, considers a situation in which, 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 state 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 distribution 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 states 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 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.

Section 26.2601-1(b)(4)(i)(E), Example 10 considers the following situation. In 1980, Grantor established an irrevocable trust for the benefit of Grantor's issue, naming a bank and five other individuals as trustees. In 2002, the appropriate local court approves a modification of the trust that decreases the number of trustees which results in lower administrative costs. The modification pertains to the administration of the trust and 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. In addition, 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. Therefore, the trust will not be subject to the provisions of chapter 13.

In the present case, Trust 1 became irrevocable prior to September 25, 1985. The trustee represents that there have been no additions, actual or constructive, to Trust 1 after September 25, 1985.

With regard to the proposed modifications of Trust 1, we conclude:

a. The division of Trust 1 pursuant to the terms of Settlement Agreement will not shift any beneficial interest in Trust 1 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 will not extend the time for vesting of any beneficial interest in Trust 1 beyond the period provided for in the original trust. Therefore, the two trusts resulting from the division, Successor Trust and Trust A, will not be subject to the provisions of chapter 13.

b. The modification of Trust 1 pursuant to the terms of Settlement Agreement to provide for a change in trustee and to modify the trustee succession procedures is viewed as pertaining to the administration of the trust, comparable to the administrative modification in Example 10 of § 26.2601-1(b)(4)(i)(E).

c. In addition, all other terms and trust modifications set forth in Settlement Agreement (including the trustee procedures regarding HEMS distributions, the payment of attorneys' fees, trustee communications with beneficiaries, and conflicts of interest) are viewed as administrative in nature and, under § 26.2601-1(b)(4)(i)(D)(2), will not be considered to shift a beneficial interest to a lower generation in the trust or extend the time for vesting of any beneficial interest in the trust beyond the period provided for in Trust 1.

Accordingly, based upon the facts submitted and the representations made, we further conclude that after the division and modification of Trust 1 pursuant to Settlement Agreement, Trust 1, Successor Trust, and Trust A will not be subject to the provisions of chapter 13.

Ruling 2

Section 2501(a) imposes a tax for each calendar year on the transfer of property by gift during the calendar year by any individual.

Section 2511 provides, in part, that the 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.

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

Section 2512(b) provides that where property is transferred for less than 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 is deemed to be a gift, and is included in computing the amount of gifts made during the calendar year.

In this case, the beneficiaries of Trust 1 will have the same interests after the proposed modifications that they had prior to the modifications. Because the beneficial interests of the beneficiaries are substantially the same, no transfer of property will be deemed to occur as a result of the modifications. Accordingly, based on the facts submitted and the representations made we conclude that none of the terms or trust modifications set forth in Settlement Agreement will result in a gift under chapter 12 by any beneficiary or any trustee of Trust 1, Successor Trust, or Trust A.

Ruling 3

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 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.

In this case, the proposed modifications to Trust 1 are administrative in nature and do not cause the beneficiary's interest in his trust assets to be includible in the beneficiary's gross estate for purposes of § 2033. Further, the proposed modifications do not constitute a transfer within the meaning of §§ 2036 through 2038. Accordingly, based on the facts submitted and the representations made, we conclude that none of the terms or trust modifications set forth in Settlement Agreement will cause any assets of Trust 1, Successor Trust, or Trust A to be includible in any beneficiary's or trustee's gross estate under § 2036, § 2037, or § 2038.

Ruling 4

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, inclusive.

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.

Section 20.2041-1(b)(1) of the Estate Tax Regulations provides, in part, that a donee may have a power of appointment if he has the power to remove or discharge a trustee and appoint himself. For example, if under the terms of the instrument, the trustee or his successor has the power to appoint the principal of the trust for the benefit of individuals including himself, and the decedent has the unrestricted power to remove or discharge the trustee at any time and appoint any other person including himself, the decedent is considered as having a power of appointment. However, the mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of the fiduciary duties is not a power of appointment.

Rev. Rul. 95-58, 1995-2 C.B. 191, holds that a decedent/grantor's reservation of an unqualified power to remove a trustee and to appoint an individual or corporate successor trustee that is not related or subordinate to the decedent within the meaning of § 672(c), is not considered a reservation of the trustee's discretionary powers of

distribution over the property transferred by the decedent/grantor to the trust. Accordingly, the trust corpus is not included in the decedent's gross estate under § 2036 or § 2038. The ruling notes that the Eighth Circuit in Estate of Vak v. Commissioner, 973 F.2d 1409 (8th Cir. 1992), concluded that the decedent had not retained dominion and control over assets transferred to a trust by reason of his power to remove and replace the trustee with a party that was not related or subordinate to the decedent. Accordingly, the court held that under § 25.2511-2(c), the decedent made a completed gift when he created the trust and transferred assets to it.

Section 672(c) defines the term "related or subordinate party" to mean any nonadverse party who is (1) the grantor's spouse if living with the grantor; or (2) any one of the following: the grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.

In this case, the beneficiaries will have an increased ability to remove and replace the trustees after the modification of Trust 1. The distributees of Successor Trust can replace the corporate trustee with another corporate trustee. The distributees of Trust A can replace the first individual trustee who dies, resigns, becomes incapacitated, or otherwise fails to serve as trustee. The power of the respective trustees of Successor Trust and Trust A to invade income and corpus to distribute funds to the respective beneficiaries is limited by an ascertainable standard relating to the health, education, support, or maintenance of the beneficiaries. Therefore, the power that any trustee has cannot be classified as a general power of appointment. Accordingly, based on the facts submitted and the representations made, we conclude that none of the powers granted to any of the beneficiaries of Trust 1, Successor Trust, or Trust A will cause the assets of any such trust to be included in any beneficiary's gross estate under § 2041(a).

Rulings 5 – 7

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) the amount of income for such taxable year required to be distributed currently, and (2) any other amounts properly paid or credited or required to be distributed for such taxable year.

Section 662 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 currently for such taxable year.

Accordingly, based on the facts submitted and the representations made, we conclude that the division of Trust 1 into Successor Trust and Trust A pursuant to the Settlement Agreement will not result in a distribution under § 661 from Trust 1; and accordingly, will not result in gross income to Successor Trust or Trust A under § 662. Additionally, we conclude that a transfer from Trust A to Successor Trust pursuant to the Settlement Agreement that is made for a purpose other than to facilitate a HEMS distribution to a beneficiary will not result in a distribution under § 661 from Trust A; and accordingly, will not result in gross income to Successor Trust under § 662.

We further conclude that a transfer from Trust A to Successor Trust for an immediate HEMS distribution to a beneficiary will result in a deduction pursuant to § 661 for Trust A (to the extent of Trust A's distributable net income) and (ii) inclusion of an equivalent amount in the recipient beneficiary's gross income pursuant to § 662.

Ruling 8

Section 212(2) states 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(i) of the Income Tax Regulations 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, except to the extent that the expenses are allocated to the production or collection of tax-exempt income.

Section 265(a)(1) provides that expenses that are directly allocable to any class or classes of tax-exempt income shall be allocated to the tax-exempt income. The regulations further provide that if an expense otherwise allocable is indirectly allocable to both nonexempt and exempt income, then a reasonable proportion is allocated to each considering the particular facts and circumstances.

Whether legal fees are deductible expenses under § 212, or are capital expenses under § 263, requires an examination of the origin of the claim giving rise to the legal fees. That analysis requires that prior transactions be examined in order to determine if a cause of action originates from an ordinary or capital event. The origin of the claim doctrine was established by U.S. v. Gilmore, 372 U.S. 39, 49 (1963).

Section 263(a)(1) provides generally that no deduction is allowed for any amount paid out for new buildings or for permanent improvements or betterments. See

§ 1.263(a)-1(a)(1), 1.263(a)-2(a), 1.263(a)-2(h), and 1.263(a)-4 of the Income Tax Regulations.

The Supreme Court has stated that determining whether an expenditure is a current expense or a capital expenditure entails a facts and circumstances analysis with material distinctions being of degree and not of kind. In Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345, 354 (1971), the Court stated that a "payment that serves to create or enhance . . . a separate and distinct additional asset" is a capital expenditure. Accordingly, the capitalization rules were initially understood to require that expenditures be capitalized only if they resulted in separate and distinct assets. However, in INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 86-87 (1991), the Court clarified Lincoln Savings by stating that creation of a separate and distinct asset is a sufficient, but not a necessary, condition to classification as a capital expenditure. In INDOPCO, the Court established the future benefit test and stated that a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization.

Section 1.263(a)-4 provides rules for applying § 263 to amounts paid to acquire or create intangibles. Section 1.263(a)-4(b)(1) provides that, except as otherwise provided in § 1.263(a)-4, a taxpayer must capitalize an amount paid to: (i) acquire an intangible (see § 1.263(a)-4(c)); (ii) create an intangible described in § 1.263(a)-4(d); (iii) create or enhance a separate and distinct intangible asset within the meaning of § 1.263(a)-4(b)(3); (iv) create or enhance a future benefit identified in the Federal Register or the Internal Revenue Bulletin as an intangible for which capitalization is required; and (v) facilitate (as defined in § 1.263(a)-4(e)(1)) the acquisition or creation of an intangible.

Section 1.263(a)-4(d)(2) provides, in relevant part, that a taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew or renegotiate with that party any ownership interest in a corporation, partnership, trust, estate, limited liability company or other entity.

Legal fees relating to the proper investment of trust assets are a function of the management of the trust property and are deductible if they are ordinary and necessary. Trust of Bingham v. Commissioner, 325 U.S. 365, 376 (1945). In Herman A. Moore Trust v. Commissioner, 49 T.C. 430 (1968), acq., 1968-2 C.B. 21, the Service challenged the trustee's deduction of certain attorneys' fees in computing the trust's income. These fees arose from an action brought by the testator's children to accelerate their beneficial interests in the trust. Pursuant to state law, the court ordered that the attorneys' fees for the trust, the beneficiaries and the guardian ad litem be paid from trust income. The court decided that (1) the state court decision aided the trustee in its management of the trust property, and (ii) the trust benefitted by the involvement of the beneficiaries and the guardian ad litem in the litigation. Thus, the court held that

all of the litigants' attorneys' fees paid from trust income were deductible under § 212(2).

In the present case, the legal fees paid by beneficiaries seeking to change the trustee of the trust are not payments to acquire, create, or facilitate the acquisition or creation of an intangible. The litigation involved only the proper administration of the trust and not the beneficiaries' ownership interests in the trust. The beneficiaries already had an ownership interest in the trust and were not seeking a redetermination of that ownership interest, but rather, merely a change in the administration of the trust. Therefore the legal fees are not subject to capitalization under § 1.263(a)-4.

Based on the facts submitted and the representations made, we conclude that the purpose of the action brought by the beneficiaries of Trust 1 was to improve the investment of the assets of the trust. Further, Trust 1 benefited by the involvement of the beneficiaries in the proceedings. Thus, subject to allocations under § 1.265-1, we conclude that the attorneys' fees paid by Trust 1, Successor Trust, or Trust A to a beneficiary of Trust 1, Trust 2, Trust 3, Trust 4, or one of the resulting divided trusts pursuant to Settlement Agreement as reimbursement for the beneficiary's prior payment of attorney's fees and expenses will result in a deduction for the reimbursing trust under § 212. Since the attorney's fees and expenses are deductible under § 212, it is implicit that those expenses are not deductible under § 661 or includible by the beneficiaries under § 662.

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,

Karlene M. Lesho
Karlene M. Lesho
Senior Technician Reviewer, Branch 4
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures
Copy for § 6110 purposes
Copy of this letter

cc: