

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **201519012**
Release Date: 5/8/2015

Third Party Communication: None
Date of Communication: Not Applicable

Index Number: 2601.03-06, 2501.00-00, 643.00-00,
662.00-00

Person To Contact:

ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B04
PLR-133314-14

Date:
February 06, 2015

Trust =
Decedent =
Bank =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Date 1 =
Date 2 =
Company =

LLC =
Spouse =
Child 1 =
Child 2 =
Grandchild 1 =
Grandchild 2 =
Grandchild 3 =
Great-grandchild 1 =
Great-grandchild 2 =
Great-grandchild 3 =
Great-grandchild 4 =
Great-grandchild 5 =
Great-grandchild 6 =
Great-grandchild 7 =
Great-grandchild 8 =
Case =

Court =

State =
a =
b =
c =
d =
e =
f =

Dear :

This letter responds to your authorized representative's letter dated September 8, 2014, requesting rulings on the income, gift, and generation-skipping transfer (GST) tax consequences of compliance with a court-approved settlement agreement.

FACTS AND REPRESENTATIONS

The facts and representations submitted are summarized as follows:

Decedent died in Year 1, a year prior to September 25, 1985. Decedent's Will established a testamentary trust (Trust) for the benefit of Decedent's relatives, Decedent's spouse (Spouse), and their issue. Trust was funded primarily with stock in Company. In Year 2, Trust exchanged its shares in Company for an interest in LLC. Great-grandchild 1 and Bank serve as trustees (Trustees) of Trust.

Under Clause I, Item Four of Decedent's Will, Trust will terminate twenty (20) years after the death of the last to survive of Spouse, Child 1, Child 2, Grandchild 1, Grandchild 2, and Grandchild 3.

Clause II(a) provides for the distribution, at least annually, of specific amounts of Trust income to certain named beneficiaries for their lifetimes, but not to exceed the duration of Trust. Clause II(b) limits the total amount of these distributions to one-third of the income of Trust.

Clause II(c)(1) and (2) provide the manner in which the remaining Trust income is to be distributed to Spouse, Child 1, and Child 2 during their lifetimes. Clause II(c)(3) directs that after the death of Spouse, Child 1, and Child 2, Trust income is to be distributed equally to the widow of Child 1 (if there is one), Decedent's living grandchildren, and the issue of any deceased grandchildren of Decedent, *per stirpes*.

Clause II(c)(4) provides that upon the death of Decedent's last surviving grandchild, the income of Trust is to be distributed equally to Decedent's living great-grandchildren and the issue of any deceased great-grandchildren of Decedent, *per stirpes*.

Under Clause III, upon termination of Trust, the assets of Trust are to be distributed to the then income beneficiaries of Trust.

Item Five annuls any bequest made to a beneficiary of Decedent's Will who objects to the probate of Decedent's Will or in any way directly or indirectly contests the Will or any provision of the Will, or the distribution of Decedent's estate under the Will. Item Five provides further that it is the will of Decedent that any such beneficiary be absolutely barred and cut off from any share in Decedent's estate (No-contest Provision).

There are currently eight income beneficiaries of Trust. Decedent's only surviving grandchild, Grandchild 3, receives one-third of the income. The three children of Grandchild 1, Great-grandchildren 1, 2, and 3, each receive one-ninth of the income, and the four children of Grandchild 2, Great-grandchildren 4, 5, 6, and 7, each receive one-twelfth of the income.

Great-grandchild 4 and Great-grandchild 5 filed a number of objections to Trust's annual accountings, petitions, and joinders in Case in Years 3, 4, and 5, and have indicated that they will file objections to future accountings in Case (Objectors' Claims). Objectors' Claims allege that Trustees have breached their duty of impartiality and their fiduciary duties. Great-grandchild 1 and Great-grandchild 8 (a daughter of Grandchild 3) responded by filing claims in Case alleging that certain of Objectors' Claims violate the No-contest Provision in Decedent's Will (No-Contest Claims). The Probate Commissioner ruled that the Objectors' Claims did violate the No-contest Provision.

The litigation in Case has been intensive, has created divisions within the Decedent's family, and has been expensive. The parties have been represented by separate counsel and have incurred substantial legal fees and costs. On Date 1, the parties entered into an agreement to resolve Case (Settlement Agreement). On Date 2, Court issued an order (Order) approving Settlement Agreement.

Under the terms of Settlement Agreement and Order, if the Internal Revenue Service issues a favorable private letter ruling on all of the rulings requested below, the following will occur: (1) the interest of Great-grandchild 4 and Great-grandchild 5 in Trust (including the interests of their issue, if any) will be completely terminated in exchange for a distribution of \$a to each from Trust; (2) to fund the distributions from Trust to Great-grandchild 4 and Great-grandchild 5, LLC will distribute \$e to its members, of which \$f will go to Trust; (3) Great-grandchild 4 and Great-grandchild 5 will dismiss with prejudice the Objectors' Claims and Great-grandchild 1 and Great-grandchild 8 will dismiss the No-Contest Claims; (4) until the death of Grandchild 3, the income of Trust will be distributed b percent to Grandchild 3, c percent each to Great-grandchild 1, or his issue in the event of his death, Great-grandchild 2, or his issue in the event of his death, Great-grandchild 3, or her issue in the event of her death, and d percent each to Great-grandchild 6, or his issue in the event of his death, and Great-Grandchild 7, or her

issue in the event of her death; (5) following the death of Grandchild 3, all distributions to a beneficiary by Trust shall be determined under the terms of Trust assuming for this purpose that both Great-grandchild 4 and Great-grandchild 5 are deceased and not survived by issue.

It is represented that no additions (actual or constructive) have been made to Trust since Date 1.

You have requested the following rulings:

- (1) After implementation of Settlement Agreement, Trust will continue to be exempt from the GST tax provisions of chapter 13 and distributions of \$a from Trust to Great-grandchild 4 and Great-grandchild 5, distributions of Trust income to the other beneficiaries, and distributions of Trust corpus made upon termination of Trust made in compliance with Settlement Agreement are not subject to GST tax.
- (2) The \$a distributions from Trust to Great-grandchild 4 and Great-grandchild 5 made in compliance with Settlement Agreement do not result in gifts for federal gift tax purposes by the other beneficiaries of Trust.
- (3) The \$e distribution from LLC to Trust made in compliance with Settlement Agreement is not income within the meaning of § 643(b).
- (4) The \$a distributions from Trust to Great-grandchild 4 and Great-grandchild 5 are not includible in the income of Great-grandchild 4 and Great-grandchild 5 under § 662.

Ruling 1

Section 2601 of the Internal Revenue Code imposes a tax on every generation-skipping transfer made after October 22, 1986.

Section 2611(a) provides that the term "generation-skipping transfer" means a taxable distribution, a taxable termination, and a direct skip.

Under § 1433(a) of the Tax Reform Act of 1986 (the Act) the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the GST 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 GST tax under § 26.2601-1(b) will not cause the trust to lose its exempt status. In general, these rules are applicable only for purposes of determining whether an exempt trust retains its exempt status for GST tax purposes. The rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of § 1001.

Section 26.2601-1(b)(4)(i)(B) provides that a court-approved settlement of a bona fide issue regarding the administration of the trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to the provisions of chapter 13, if -- (1) The settlement is the product of arm's length negotiations; and (2) The settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. A settlement that results in a compromise between the positions of the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes.

Section 26.2601-1(b)(4)(i)(D) provides that a modification of the governing instrument of an exempt trust (including a trustee's distribution, settlement, or construction that does not satisfy paragraphs (b)(4)(i)(A), (B), or (C) of this section) by judicial reformation, or by 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. A modification of an exempt trust will result in a shift in a 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. Furthermore, 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 a shift in a beneficial interest in a trust.

In this case, Trust is exempt from GST tax because Trust was irrevocable prior to September 25, 1985 and it is represented that no additions (actual or constructive) have been made to Trust on or after September 25, 1985.

The facts provided and representations made indicate that Settlement Agreement represents a compromise between the positions of the litigating parties and reflects the parties' assessment of the relative strengths of their positions. Settlement Agreement is a product of arm's length negotiations and is within the range of reasonable outcomes under the terms of Trust and applicable law.

Upon implementation of Settlement Agreement, the interests of Great-grandchild 4 and Great-grandchild 5 in Trust will terminate. The partial termination of Trust will accelerate the distribution of a portion of the corpus of Trust to these beneficiaries. The partial termination will not shift a beneficial interest in Trust to a beneficiary who occupies a lower generation than the person or persons who held the interest before the division. Moreover, implementation of Settlement Agreement does not extend the time for vesting of any beneficial interest in Trust beyond the period provided for in the original Trust agreement.

Accordingly, based upon the facts submitted and the representations made, we rule that after implementation of Settlement Agreement, Trust will continue to be exempt from the GST tax provisions of chapter 13 and that distributions of \$a from Trust to Great-grandchild 4 and Great-grandchild 5, distributions of Trust income to the other beneficiaries, and distributions of Trust corpus made upon termination of Trust made in compliance with Settlement Agreement are not subject to GST tax.

Ruling 2

Section 2501 imposes a tax 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, subject to certain limitations, the gift tax applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether property transferred is real or personal, tangible or intangible.

Section 25.2511-1(c)(1) 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.

Section 25.2511-1(g)(1) provides that the gift tax is not applicable to a transfer for a full and adequate consideration in money or money's worth, or to ordinary business transactions.

Section 25.2512-8 provides that a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent) will be considered as made for an adequate and full consideration in money or money's worth.

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. U.S.*, 674 F.2d 761, 774-75 (9th Cir. 1981), citing *Commissioner v. 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 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.

As discussed above, Settlement Agreement represents the resolution of bona fide controversies among the parties. All interested parties who hold or may hold an interest in Trust have been represented in the proceedings that culminated in Order approving Settlement Agreement. Further, based on the facts as presented, the terms of Settlement Agreement are the product of arm's length negotiations among all of the interested parties. Court approved Settlement Agreement. Settlement Agreement reflects the rights of the parties under the applicable State law that would be applied by the highest court of State and under federal law. Accordingly, based on the facts submitted and representations made, we rule that the \$a distributions from Trust to Great-grandchild 4 and Great-grandchild 5 made in compliance with Settlement Agreement do not result in gifts for federal gift tax purposes by the other beneficiaries of Trust.

Ruling 3

Section 643(a) defines the term "distributable net income" as the taxable income of the estate or trust computed with certain modifications.

Section 643(a)(4) and the regulations thereunder exclude from the computation of distributable net income (with respect to trusts that qualify under subpart B) those items of gross income constituting extraordinary dividends which the fiduciary, acting in good faith, does not pay or credit to any beneficiary by reason of his determination that such dividends are allocable to corpus under the terms of the governing instrument and applicable local law.

Section 643(b) and the regulations thereunder provide that for purposes of subparts A, B, C, and D, the term "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of the income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law shall not be considered income.

In this case, Court determined that the governing instrument and State law would characterize the \$f distribution from LLC to Trust as a return of corpus. As such, the \$f distribution from LLC to Trust pursuant to Settlement Agreement meets the definition of an extraordinary dividend under § 643(b) and is not considered income within the

meaning of that section. Accordingly, based on the facts submitted and the representations made, we rule that the \$f distribution from LLC to Trust is an extraordinary dividend excluded from the definition of “income” within the meaning of § 643(b).

Ruling 4

Section 61 provides generally that, except as otherwise provided by law, gross income includes all income from whatever source derived, including gains derived from dealings in property.

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, but such deduction shall not exceed the distributable net income of the estate or trust.

Section 1.661(a)-2(f) of the Income Tax Regulations provides that gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of a distribution of property in kind if the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount, of specific property other than that distributed, or of income as defined under § 643(b) and the applicable regulations, if income is required to be distributed currently.

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 to such beneficiary for the taxable year.

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized 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(c), the entire amount of gain or loss must be recognized, except as otherwise provided.

Section 1.1001-1(a) provides that, except as otherwise provided in subtitle A, the gain or loss realized from the exchange of property for cash or for other property differing materially either in kind or in extent is treated as income or loss sustained.

In this case, the distributions of \$a to Great-grandchild 4 and Great-grandchild 5 are extraordinary distributions and are excluded from the definition of “income” under

§ 643(b). These distributions are not part of Trust's distributable net income and, therefore, are not includible in the income of Great-grandchild 4 or Great-grandchild 5 under § 662. Accordingly, based on the facts submitted and the representations made, we rule that the distributions of \$a from Trust to Great-grandchild 4 and Great-grandchild 5 are not includible in the income of Great-grandchild 4 and Great-grandchild 5 under § 662.

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.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer 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 representative.

Sincerely,

Lorraine E. Gardner
Senior Counsel, Branch 4
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2)

Copy of this letter
Copy for § 6110 purposes