

**Internal Revenue Service**

Department of the Treasury

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CC:PA:APJP:1--PLR-106270-00  
Date:  
May 7, 2001

Legend:

Settlor =  
Taxpayers =  
GST Trust =

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Reimbursement Trust =

Law Firm =

State Law =

Grandchildren  
(Beneficiaries) =

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Bank 1 =

Bank 2 =

Year 1 =

Q =

X =

Y =

Z =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Dear \_\_\_\_\_,

This letter responds to your submission of March 13, 2000, and supplemental correspondence, dated May 4, 2000, August 29, 2000, September 19, 2000, December 7, 2000, and April 11, 2001, in which you requested rulings on behalf of Taxpayers. Specifically, you requested rulings concerning the income tax, gift tax, estate tax, and generation-skipping transfer tax consequences of a payment under a proposed settlement agreement.

### **FACTS**

Taxpayers are husband and wife. They have five children and five grandchildren. In Year 1, the husband ("Settlor") established a trust by agreement with Bank 1, [predecessor to Bank 2] ("Trustee") as trustee and funded it with X in cash. Under the trust's terms, until such time as a grandchild of Settlor attains age 21, Trustee may, in Trustee's discretion, distribute the trust income to or among the class of persons consisting of Settlor's children and grandchildren. Once the first grandchild reaches age 21, Trustee is required to pay all the trust income in equal shares to or for the benefit of Settlor's grandchildren. Principal may be distributed in Trustee's discretion to

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or for the maintenance, education and welfare of any beneficiary entitled to trust income. The trust is to terminate on the later of 21 years from the date of its creation or when there is no living grandchild under age 21. At termination, the trust is to be distributed in equal shares to grandchildren, with an equal share for the issue of any deceased grandchild.

It was Settlor's intent, based on the advice from Law Firm that drafted the trust instrument, that Settlor and his spouse would file gift tax returns (Form 709) treating the X amount transferred to the trust as a gift made one-half by each, and that Settlor and his spouse would allocate their respective generation-skipping transfer (GST) exemptions (Y amount of cash each) to the trust.

Settlor's spouse died on Date 1. During the administration of her estate, it was discovered that no gift tax returns were filed with respect to the transfer in trust in 1989, and no allocation of Taxpayers' GST exemptions were made.

By Date 2, the value of the trust assets had slightly more than doubled to over Z amount. Trustee, as authorized by State Law, divided the trust into three separate trusts (collectively "GST Trust"): two GST-Exempt trusts (value of Y each), and one GST-Nonexempt trust (value of slightly more than X). The assets of the original trust were divided on a fractional basis such that each separate trust participated ratably in all appreciation and depreciation of the original trust assets since Year 1. Each new GST Trust continues to have the same terms as the original trust.

On Date 2, Law Firm prepared and filed the Year 1 gift tax returns for Settlor and his spouse, on which late allocations of Taxpayers' GST exemptions were made with respect to the two GST-Exempt trusts.

Following Settlor's death on Date 3, Trustee, in its capacity as trustee of the trust and personal representative of the estates of Taxpayers, and Taxpayers' five children, on behalf of Grandchildren, sued Law Firm for failing to make timely GST allocations on timely filed Year 1 gift tax returns.

A Settlement Agreement, which the Court reached and approved on Date 4, created a new trust ("Reimbursement Trust"). Reimbursement Trust's primary purpose is to indemnify GST Trust and the beneficiaries for the GST tax expected to be incurred in the future. Initial funding of Reimbursement Trust was calculated as an amount substantially equal to the GST tax that the GST-Nonexempt trust would have owed if it had become subject to GST tax on a day shortly after the State Court's approval of the settlement (known as the "Determination Date"), less a sum of Q for a settlement concession and Trustee's waiver of future fees. Law Firm will receive any remaining funds left in Reimbursement Trust after payment of all GST tax liabilities.

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It is represented that no distributions were made from the trust prior to Taxpayers' deaths, and no distributions have been made since the trust was divided into three separate trusts.

GST Trusts, Law Firm and Grandchildren file their income tax returns on a calendar year basis and use the cash receipts and disbursements method of accounting. Reimbursement Trust files its income tax return on a calendar year basis and uses the accrual method of accounting.

You have asked us to rule as follows:

1. Reimbursement Trust is a Qualified Settlement Fund (QSF) under section 1.468B of the Income Tax Regulations, and any additional separate fund established therein in the future as provided in Settlement Agreement will be a QSF.
2. Law Firm's transfer of funds to Reimbursement Trust will constitute economic performance for purposes of section 461(h).
3. Law Firm's transfer of funds to Reimbursement Trust will not be includible in the income of Reimbursement Trust, GST Trust, or Beneficiaries.
4. Law Firm's transfer of funds to Reimbursement Trust will not be deemed a transfer by Settlor or his estate subject to Federal GST tax, gift or estate tax.
5. The severance of the original trust into three separate trusts upon the discovery of the missed allocations will be given effect for GST tax purposes.

Ruling requests 6 and 7 were withdrawn. These rulings concerned the following requests:

6. The transfer of funds from Reimbursement Trust to pay the GST tax liability will not constitute a transfer by Taxpayers subject to the GST tax.
7. Neither GST Trust nor Grandchildren will have income when they are reimbursed for the GST tax liability they incur because Law Firm failed to ensure that Settlor and his spouse filed timely gift tax returns and properly allocated their GST exemptions to trust assets.

LAW AND ANALYSIS:

ISSUE 1: INCOME TAX

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Reimbursement Trust is a QSF under section 1.468B of the Income Tax Regulations, and any additional separate fund established therein in the future as provided in Settlement Agreement will be a QSF.

Section 468B(g) provides that nothing in any provision of law will be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax. Pursuant to the authority of section 468B(g), the Secretary has published sections 1.468B-1 through 1.468B-5 regarding QSFs.

Section 1.468B-1(a) provides that a QSF is a fund, account, or trust that satisfies all the requirements of section 1.468B-1(c). Section 1.468B-1(c) generally provides that the fund, account, or trust is a QSF if:

- (1) it is established pursuant to an order of, or is approved by, a court of the United States or any state (including the District of Columbia) and is subject to the continuing jurisdiction of that authority;
- (2) it is established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event (or related series of events) that has occurred and that has given rise to at least one claim asserting liability arising out of a tort, breach of contract, or violation of law; and
- (3) the fund, account, or trust must be a trust under applicable state law, or its assets must be otherwise segregated from other assets of the transferor (and related persons).

Based on the representations made and the information provided, we rule as follows:

Provided Reimbursement Trust is established pursuant to a court order, is subject to the court's continuing jurisdiction, and is a trust under applicable state law, Reimbursement Trust will meet the requirements for a QSF under section 1.468B-1(c).

In the present case, Reimbursement Trust, which is a trust under State Law, was established, pursuant to court order and subject to its continuing jurisdiction, to satisfy the GST tax liability arising out of Law Firm's failure to ensure that Settlor and his spouse filed timely gift tax returns and properly allocated their GST exemptions to trust assets. Accordingly, Reimbursement Trust meets the requirements for a QSF under section 1.468B-1(c).

Additionally, Reimbursement Trust will continue to qualify as a QSF should any additional funds be contributed in the future pursuant to the Settlement Agreement.

The Settlement Agreement provides that, if Law Firm is unable to obtain a ruling within 18 ½ months following the court's approval of the Settlement Agreement, to the effect that any reimbursement of GST tax from the Reimbursement Trust will not itself be

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subject to GST tax, Law Firm must then make an additional payment to Reimbursement Trust of the specified “gross up” amount. A similar provision requires a “gross up” payment with respect to income tax if Law Firm is unable to obtain an income tax ruling within 18 ½ months following the court’s approval of the Settlement Agreement.

The Settlement Agreement provides that both such “gross up” amounts will be held separate from the basic trust fund, each to be used only for the specific purpose for which it was intended.

Accordingly, because the same circumstances and conditions would be applicable to any GST and income tax “gross up” amounts paid to Reimbursement Trust under that trust’s instrument as are applicable to the assets in the basic fund, each separate “gross up” fund will qualify as a QSF under section 1.468-1(c).

## ISSUE 2: INCOME TAX

Law Firm’s transfer of funds to Reimbursement Trust will constitute economic performance for purposes of section 461(h).

Section 1.468B-3(c)(1) provides, in general, that for purposes of section 461(h), economic performance occurs with respect to a claimed liability of the sort for which a QSF may be established to the extent the transferor makes a transfer to a QSF to resolve or satisfy the claimed liability.

Section 1.468B-3(c)(2) provides that economic performance does not occur (1) to the extent the transferor has a right to a refund or reversion of a transfer which is currently exercisable without the agreement of an unrelated person who is independent or has an adverse interest; or (2) the transfer was made under such conditions that its refund or reversion is certain to occur.

In the present case, Law Firm may become entitled to a reversion of all or a portion of the initial Reimbursement Trust fund or either of the two additional funds (the “gross up” funds) which may subsequently be established under the same trust instrument. In no case, however, will Law Firm be entitled to such reversion except with the agreement of, at least, Trustee (an unrelated and independent party) and then only upon the occurrence of an event which is not certain to occur. Specifically, Law Firm may become entitled to a partial reversion if Trustee’s investment returns for one of more of the Reimbursement Trust funds were higher than for the GST Trust itself, or if the GST Trust were diminished by distributions to Settlor’s children. Otherwise, any reversion to Law Firm will be dependent upon actions outside of its control.

Accordingly, Law Firm’s payment of the initial amount to fund Reimbursement Trust and any payment to create a GST “gross up” or income tax “gross up” fund will constitute economic performance.

## ISSUE 3: INCOME TAX

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Law Firm's transfer of funds to Reimbursement Trust will not be includible in the income of Reimbursement Trust, GST Trust, or Beneficiaries.

Reimbursement Trust

Section 1.468B-2(b)(1) provides that modified gross income of a QSF generally does not include amounts transferred to the QSF by, or on behalf of, a transferor to resolve or satisfy a liability for which the fund is established. However, dividends on stock of a transferor (or a related person), interest on debt of a transferor (or related person), and payments in compensation for late or delayed transfers are not excluded from gross income.

Pursuant to section 1.468B-(d)(1), Law Firm is the transferor. Law Firm's initial transfer to Reimbursement Trust was made in cash in order to satisfy a liability for which Reimbursement Trust was established. Accordingly, provided Reimbursement Trust is established pursuant to a court order and is subject to the court's continuing jurisdiction and, therefore, is a QSF, income of Reimbursement Trust will not include amounts transferred by, or on behalf of, Law Firm to resolve or satisfy a liability for which Reimbursement Trust is established.

GST Trust and Beneficiaries

Section 61 of the Code provides that gross income means income from whatever source derived.

Section 451 of the Code provides that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Section 1.451-1(a) of the regulations provides that gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received.

Section 1.451-2(a) of the regulations provides in part that income, although not actually reduced to a taxpayer's possession, is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to



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substantial limitations or restrictions.

The doctrine of economic benefit requires a determination that the actual receipt of property or the right to receive property in the future confers a current economic benefit on the recipient. Economic benefit applies when assets are unconditionally and irrevocably paid into a fund or trust to be used for a taxpayer's sole benefit. Sproull v. Commissioner, 16 T.C. 244 (1951), aff'd per curiam, 195 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, 1960-1 C.B. 174 (Situation 4).

In Sproull, the court applied the economic benefit doctrine to tax amounts an employer paid to an interest bearing trust as compensation for an employee's past services. No one other than the employee had any interest in or control over the monies in the trust. The employee was required to take no further action to earn or establish his rights to the amounts in trust. The trustee's duties were limited to holding, investing, and paying the amounts in trust to the employee or his estate in the event of his prior death in the two taxable years following the creation of the trust. The Tax Court held that "there is no doubt that such an interest had a value equivalent to the amount paid over for his benefit." Sproull, 16 T.C. at 248.

The economic benefit doctrine does not apply where the beneficiary's ability to obtain trust amounts is subject to a future condition or forfeiture. Drysdale v. Commissioner, 277 F.2d 413 (6<sup>th</sup> Cir. 1960) (Taxpayer did not have economic benefit of funds placed in trust by employer where the use of funds was conditioned upon taxpayer's death, his reaching the age of sixty-five, or his retirement from full time activity); Minor v. U.S., 772 F.2d 1472 (9<sup>th</sup> Cir. 1985) (Taxpayer did not have economic benefit in funds placed in trust under deferred compensation agreement where funds were conditioned upon taxpayer's limiting his practice after retirement and not competing with present employer). The Sproull court noted that "the trust agreement contained no restriction whatever on petitioner's right to assign or otherwise dispose of the interest thus created in him." Sproull 16 T.C. at 248. Other courts have noted that a taxpayer may still have an economic benefit in a trust where there are restrictions on assignment. See U.S. v. Drescher, 179 F.2d 863 (2<sup>nd</sup> Cir. 1950) (Employee received economic benefit of annuity contract purchased by employer in the year such contract was delivered to him, even though such contract was non-assignable). However, there is no economic benefit when the beneficiary's right to receive the income is restricted or conditioned upon future events.

Therefore, in order for a taxpayer to include an amount in income under the economic benefit doctrine, the amount must be set aside irrevocably, for the taxpayer's sole benefit, without restrictions or conditions based upon the occurrence of future events.

In the present case, the funds in Reimbursement Trust have been set aside for the benefit of either the GST Trust or Grandchildren. However, the funds have not been set aside irrevocably, since any remaining sums in the trust that are not used to pay the GST tax revert to Law Firm.

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Furthermore, the funds in Reimbursement Trust may only be used to pay the GST tax. This is a restriction on the right to use the funds. The use of funds is further conditioned upon events that must occur in the future, namely, that Trustee must make a taxable distribution to one or all grandchildren. A distribution may occur anytime at Trustee's discretion, or when one of the grandchildren turns twenty-one. At this point in time, it cannot be determined when and if either of these distributions will take place.

Another condition to the right to use the funds is that someone must be liable to pay the GST tax. The entity responsible for the tax liability is determined by the type of distribution that Trustee makes. In the event of a distribution to one or all Grandchildren, the recipients are liable for the GST tax. See § 2603(a)(1). However, in the case of a distribution due to the termination of the trust, Trustee is then liable for the GST tax. See § 2603(a)(2). Because it is unclear at this point who will be liable to pay the GST tax in the event of a distribution, it cannot be determined who has the benefit of the funds in Reimbursement Trust.

Accordingly, because the funds in Reimbursement Trust have not been irrevocably set aside, without restrictions, or conditions based upon future events, neither the GST Trusts nor the beneficiaries received an economic benefit from the funds in Reimbursement Trust that must be included in income.

#### ISSUE 4: ESTATE AND GIFT TAX

Law Firm's transfer of funds to Reimbursement Trust will not be deemed a transfer by Taxpayers of their estates subject to the gift or estate tax.

Section 2001 imposes a tax on the transfer of the taxable estate of every decedent.

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

Based on the representations made and the information provided, we conclude that the transfer of settlement proceeds to Reimbursement Trust will not constitute a gift by Taxpayers under section 2501. In addition, the value of Reimbursement Trust will not be included in the estates of Taxpayers for Federal estate tax purposes.

#### ISSUE 5: GENERATION-SKIPPING TRANSFER TAX

The severance of the original GST Trust into three separate trusts upon the discovery of the missed allocations will be given effect for GST tax purposes.

Section 2601 imposes a tax on every GST, which is defined under section 2611 as a taxable distribution, a taxable termination, or a direct skip. Section 2603 provides that

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in the case of a taxable termination, the trustee is liable for the payment of the GST tax; in the case of a taxable distribution, the transferee is liable.

Under section 2602, the amount of the GST tax is determined by multiplying the taxable amount by the applicable rate. Under section 2641, the applicable rate is the maximum rate of tax on an estate tax transfer (55%), multiplied by the "inclusion ratio." The inclusion ratio is defined in section 2642 as the excess of 1 over the applicable fraction for the trust from which the transfer is made or for the direct skip. The applicable fraction is a fraction in which the numerator is the GST exemption (allowable under section 2631) allocated to the trust or direct skip and the denominator is the value of the property transferred to the trust or involved in the direct skip reduced by any Federal estate tax or state death tax actually recovered from the trust and any charitable deduction allowed under section 2055 or section 2522 with respect to such property. Under section 2631, for purposes of determining the inclusion ratio, every individual is allowed a GST exemption of \$1,000,000, which may be allocated by the individual (or the individual's executor) to any property with respect to which the individual is the transferor for GST tax purposes.

Section 2654(b) provides that (1) the portions of a trust attributable to transfers from different transferors shall be treated as separate trusts, and (2) substantially separate and independent shares of different beneficiaries in a trust shall be treated as separate trusts. Except as provided in the preceding sentence, nothing in this chapter shall be construed as authorizing a single trust to be treated as two or more trusts. Section 26.2654-1(a)(1) further provides that, in the case of substantially separate and independent shares, a portion of a trust is not a separate share unless such share exists from and at all times after the creation of the trust.

In the present situation, the trustee, as authorized by State Law, divided the original trust into three separate trusts at spouse's death. The assets of the original trust were divided on a fractional basis such that each separate trust participated ratably in all appreciation and depreciation of the original trust assets. Each new trust continues to have the same terms as the original trust. No distributions were made from the trust prior to the division, and no distributions have been made since. After dividing the original trust, allocations of the taxpayers' GST exemptions were made with respect to two of the trusts.

Under these circumstances, we conclude that the division of the original trust into three separate trusts will be respected for GST tax purposes. No conclusion or inference should be drawn from these rulings as to whether the transfer of the funds from Reimbursement Trust to pay the GST tax constitutes a transfer by the taxpayers subject to the GST tax.

Except as we have specifically ruled herein, we express no opinion on the Federal tax consequences of the transaction under the cited provisions of the Code or under any other provisions of the Code.

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

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.

A copy of this letter must be attached to any income tax return to which it is relevant.

In accordance with the power of attorney on file, we are sending a copy of this letter to your authorized representative.

Sincerely,  
PAMELA W. FULLER  
Senior Technician Reviewer, Branch 1  
Administrative Provisions and  
Judicial Practice Division  
(Procedure and Administration)

Enclosures

Copy for section 6110 purposes  
Copies of this letter (5)

cc: