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- Date 1 =
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- Year 1 =
- Company 1 =
- Company 2 =
- Company 3 =
- State =
- Statute =
- Court =
- Amount 1 =
- a =
- b =
- c =

Dear _____ :

This responds to your letter dated January 16, 2004, and prior correspondence, requesting rulings regarding the federal income, gift, and generation-skipping transfer (GST) tax consequences of a proposed judicial modification of a trust.

Facts

The facts submitted and representations made are as follows. Decedent created a revocable trust, Trust, on Date 1 for the benefit of his children and grandchildren. Trust was amended on Date 2, and amended and restated on Date 3. Decedent died on Date 4, and pursuant to Article V of the trust instrument, Trust became irrevocable on that date.

At the time of this ruling request, Decedent has a children, b grandchildren (Grandchild 1 through Grandchild b), and c great-grandchildren (Great-Grandchild 1 through Great-Grandchild c). Under Section 2 of Article III of Trust, at Decedent's death, \$1,000,000 was set aside in a "grandchildren's trust share" and subdivided into equal shares for each of grantor's grandchildren (with the exception of Grandchild 12 who was specifically excluded). The net income from each grandchild's share is required to be distributed at least annually to the grandchild for whom it was set aside. There is no provision made for distribution of principal of a grandchild's share. In addition, in the event a grandchild dies before the termination of Trust, the income of the deceased grandchild's share would accumulate because no provision is made for such a contingency. Upon Trust's termination, a grandchild's share will be distributed to the grandchild for whom it was set aside, or if he or she is not then living, to the lineal descendants of such deceased grandchild, or if none, such share will lapse and equally increase the remaining shares in the grandchildren's trust share.

The remainder of Trust's assets were divided into five equal shares for each of the grantor's children, Daughter 1, Daughter 2, Daughter 3, Daughter 4, and Son. The net income from a child's share is required to be distributed at least annually to the child for whom it was set aside.

There is no provision in the trust instrument for distribution of the principal of a child's share in Trust. If a child dies before the termination of Trust, the net income of his or her share would be distributed to those persons appointed by such child in his or her Last Will and Testament. In the event a child dies before the termination of Trust and fails to appoint a person to receive the income from his or her share, the income of the deceased child's share would accumulate because no provision is made for that contingency. Upon termination, the remaining principal and undistributed income of a child's share will be distributed to those persons appointed by such child in his or her Last Will and Testament, or in default thereof, to the then living lineal descendants of such deceased child, per stirpes, or if none, to the then living lineal descendants of Decedent, per stirpes.

Pursuant to Section 4 of Article III, Trust will terminate on the latter of the death of all of the Decedent's children or the expiration of twenty years from the date of Decedent's death.

On Schedule R of Decedent's Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, the executor allocated Decedent's \$1 million GST exemption to Trust which had assets of \$1 million set aside under Trust's instrument. You represent that there have been no additions to Trust since Decedent's death.

Son is the Trustee of Trust. As of Date 7, Trust primarily consisted of Amount 1 shares of Class B voting common stock of Company 1, along with certain other assets.

Starting in Year 1, Decedent's four daughters brought suit against the Trustee for breach of fiduciary duty as the sole trustee of Trust. Since that time, the parties have engaged in extensive litigation, lengthy mediation, and proposed settlement agreements. The parties entered into a settlement agreement on Date 5. Concurrent with this litigation, additional disputes arose and separate litigation occurred with respect to Daughter 1, Son (individually and as Trustee of Trust), Company 1, Company 2, and Company 3. A separate settlement agreement was reached to resolve those matters on Date 8. These settlement agreements, along with a petition for reformation of Trust in order to comply with the terms of those agreements, was submitted to Court for approval.

State Statute provides that if the purposes of a trust have been fulfilled or have become illegal or impossible to fulfill or, if because of circumstances not known to or anticipated by the settlor, compliance with the terms of the trust would defeat or substantially impair the accomplishment of a material purpose of the trust or, if a material purpose of the trust no longer exists, upon the application of a trustee of the trust or any beneficiary a court at any time may modify the terms of a trust which is not then revocable to: (a) amend or change the terms of the trust, including terms governing distribution of the trust income or principal, or terms governing administration of the trust; (b) terminate the trust in whole or in part; (c) direct or permit the trustee to do acts that are not authorized or that are prohibited by the terms of the trust; or (d) prohibit the trustee from performing acts that are permitted or required by the terms of the trust. The taxpayer representatives assert in its Petition for Reformation of Trust and Appointment of Trustees that Court has the authority to modify the terms of Trust pursuant to Statute.

On Date 6, Court approved the following modifications to Trust, subject to a Court order being entered:

1. Trust will be modified to provide that the separate and independent share in Trust of each child and grandchild shall be held as a separate trust and that, except with respect to a grandchild under twenty-five years of age, each child and grandchild shall serve as trustee of his or her respective trust. If a grandchild is under twenty-five, such grandchild's parent who is a lineal descendant of Decedent shall serve as trustee until such grandchild attains

the age of twenty-five. Each child and grandchild shall have the right to appoint an individual or bank or trust company to serve as a co-trustee of his or her separate trust, and each child and grandchild shall have the right to name a successor trustee of his or her trust.

2. Trust will be modified to provide that in the event a grandchild dies before termination of Trust, the income from that deceased grandchild's separate trust shall be distributed, until termination of Trust, to his or her lineal descendants, per stirpes, or in default thereof, to his or her then living siblings and the living lineal descendants of his or her deceased siblings, per stirpes, or in default thereof, the separate trust shall terminate and its assets shall be added to the other grandchildren's separate trusts.
3. Trust will be modified to provide that in the event a grandchild dies before termination of Trust and leaves no living lineal descendants, his or her separate trust shall be distributed, upon the termination of Trust, to such deceased grandchild's then living siblings and the then living lineal descendants of his or her deceased siblings, per stirpes.
4. Trust will provide that, if a child is not living at the time of distribution of income from such child's separate share and the child has not exercised his or her general power of appointment, then the income shall be distributed to his or her then living lineal descendants, per stirpes, or in default there, to the then living lineal descendants of the Decedent, per stirpes.

RULINGS REQUESTED

1. That Son, in his capacity as Trustee of Trust, a child or a grandchild will not be treated, for federal income tax purposes, as the grantor of such child's or grandchild's separate trust created as a result of the judicial reformation of Trust because the Trustee and such child or grandchild consented to that action which will convert such child's or grandchild's separate and independent share in Trust into a separate trust.
2. The judicial reformation of Trust will not cause Trust, the separate shares of the children and grandchildren in Trust, or the children and grandchildren to realize gain or loss for federal income tax purposes.
3. That neither Son, in his capacity as Trustee, nor a child will be treated as having made a gift for federal gift tax purposes due to the judicial reformation of Trust, or the Son's consent, in his capacity as Trustee, or a child's consent thereto.

4. That a grandchild will not be treated as having made a gift for federal gift tax purposes to his or her lineal descendants, his or her siblings or the lineal descendants of his or her deceased siblings because they could receive the income from such grandchild's separate trust in the event that such grandchild dies before the termination of Trust.
5. That a grandchild will not be treated as having made a gift for federal gift tax purposes to his or her siblings or the lineal descendants of his or her deceased siblings because they could receive the remaining principal and undistributed income of such grandchild's separate trust upon the termination of Trust in the event such grandchild dies before the termination of Trust and leaves no living lineal descendants.
6. That the judicial reformation of Trust (and subsequent termination of Trust) will not result in a gift for federal gift tax purposes occurring among the grandchildren because a grandchild's contingent remainder interest, which would vest if another grandchild dies before the termination of Trust leaving no living lineal descendants, becomes less likely to vest.
7. That the judicial reformation of Trust (and subsequent termination of Trust) will not result in a gift for federal gift tax purposes occurring between the great-grandchildren and the grandchildren and children because a great-grandchild's contingent remainder interest, which would vest if a grandchild dies before the termination of Trust becomes less likely to vest.
8. That a grandchild's separate trust will have an inclusion ratio of zero under § 2642 of the Internal Revenue Code, provided that the grandchildren's separate trust share has an inclusion ratio of zero immediately before each share set aside for a grandchild converts to a separate trust for such grandchild.

Ruling Request No. 1 – Grantor Trust

Section 671 provides that where it is specified in subpart E of Part I of subchapter J that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

Sections 673 through 678 specify the circumstances under which the grantor or a person other than the grantor is treated as the owner of a portion of a trust.

Section 678(a) provides, in general, that a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or (2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of §§ 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

Section 1.671-2(e)(1) of the Income Tax Regulations provides that for purposes of subchapter J, a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer of property to a trust.

Section 1.671-2(e)(2)(i) provides that a gratuitous transfer is any transfer other than a transfer of property for fair market value. A transfer of property to a trust may be considered a gratuitous transfer without regard to whether the transfer is treated as a gift for gift tax purposes.

Based solely on the facts and representations submitted, we conclude that the proposed judicial reformation of Trust will not cause any of the separate trusts to be treated as grantor trusts or cause Son (in his capacity as Trustee) or any of the children or grandchildren of the Decedent to be treated as the grantors or owners of any of the separate trusts.

Ruling Request No. 2 – Gain or Loss

Section 61 provides that gross income means all income from whatever source derived. Section 61(a)(3) provides that gross income includes gains derived from dealings in property.

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 such section for determining loss over the amount realized. Section 1001(b) provides 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. Section 1001(c) provides that, except as otherwise provided in subtitle A, the entire amount of the gain or loss, determined under §1001, on the sale or exchange of property shall be recognized.

Section 1.1001-1(a) 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 as loss sustained.

Rev. Rul. 69-486, 1969-2 C.B. 159, involved two beneficiaries of a trust who by mutual agreement, requested that the trustee distribute all of the trust corpus consisting of notes to one of the beneficiaries and all of the trust corpus consisting of common stock to the other beneficiary. The trust instrument as well as local law was silent regarding whether the trustee had the authority to make such a non-pro rata distribution of property in kind. Because the trustee was not specifically authorized to make an allocation of specific property in kind, the beneficiaries were treated as having an absolute right to a ratable in-kind distribution. Rev. Rul. 69-486 treated the beneficiaries as receiving the notes and common stock pro rata, followed by an exchange between the beneficiaries giving all of the common stock to one and all of the notes to the other. Since, in substance, an exchange between the beneficiaries was deemed to occur, Rev. Rul. 69-486 held that the beneficiaries recognized gain under §§1001 and 1002.

The present case is distinguishable from Rev. Rul. 69-486 because the assets of Trust currently allocated to the separate shares will convert into subtrusts. In addition, the proposed reformation of the trust will only occur if the reformation is expressly permissible under applicable state law and approved by a state court.

In Cottage Savings Ass'n. v. Commissioner, 499 U.S. 554 (1991), the Supreme Court addressed whether a sale or exchange has taken place that results in a realization of gain or loss under §1001. The Court stated that an exchange of property gives rise to a realization event under §1001(a) if the properties exchanged are materially different. Consequently, the Court held that an exchange of mortgages constituted a realization event under §1001(a) because the exchanged interests - loans that were made to different obligors and secured by different homes - were legally distinct entitlements.

In the present case, the issue is whether the children and grandchildren would have the same property interests and legal entitlements as they had before the judicial reformation of Trust. Dividing each separate share in Trust into a subtrust and distributing the assets of the separate shares to subtrusts will not materially affect the children's and grandchildren's interests because although each beneficiary will be entitled to receive income from only one subtrust, the amount of the distributions will be the same as the amount that he or she would have been entitled to receive under Trust.

Additionally, allowing each child and grandchild to serve as trustee of their subtrust is merely a change in the way that the new trusts are administered. The reformation of Trust will not otherwise change the legal entitlements and property interests of any beneficiary because the amounts that will be paid to the beneficiaries will continue to be controlled by the terms of Trust, and the children and grandchildren will be required to continue to exercise the same standard of fiduciary responsibility as the trustee previously exercised with respect to Trust. Consequently, the modification relating to trustees is not a material difference for purposes of §1001 or Cottage Savings.

Thus, the judicial reformation of Trust will not be considered a sale, exchange, or other disposition of property of Trust and the children and grandchildren will not realize income under § 61 or gain or loss under §1001.

Ruling Requests No. 3, 4, 5, 6 and 7 – Gift Tax

Section 2501 imposes a tax on the transfer of property by gift by an individual. Section 2511 provides that the tax imposed by § 2501 applies 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.

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. United States, 674 F.2d 761, 774-775 (9th Cir. 1981). Thus, state law must be examined to ascertain the legitimacy of each party's claim. A settlement that fairly reflects the relative merits and economic values of the various claims asserted by the parties and reaches a settlement that is within a range of reasonable settlements will not result in a transfer for gift tax purposes.

We have examined the settlement agreements, in the context of Trust and State law. In applying these standards, we conclude that the terms of the agreements, as approved by the Court order, are within a range of reasonable settlements. Further, the beneficial interests of the beneficiaries are the same, both before and after the proposed transaction, and, accordingly, no transfer of property will be deemed to occur for federal gift tax purposes as a result of the modifications to Trust.

Therefore, based on the facts and representations, we conclude as follows:

1. That neither Son, in his capacity as Trustee, nor a child will be treated as having made a gift for federal gift tax purposes due to the judicial reformation of Trust, or the Son's consent, in his capacity as Trustee, or a child's consent thereto.
2. That a grandchild will not be treated as having made a gift for federal gift tax purposes to his or her lineal descendants, his or her siblings or the lineal descendants of his or her deceased siblings because they could receive the income from such grandchild's separate trust in the event that such grandchild dies before the termination of Trust.
3. That a grandchild will not be treated as having made a gift for federal gift tax purposes to his or her siblings or the lineal descendants of his or her deceased siblings because they could receive the remaining principal and undistributed income of such grandchild's separate trust upon the termination

of Trust in the event such grandchild dies before the termination of Trust and leaves no living lineal descendants.

4. That the judicial reformation of Trust (and subsequent termination of Trust) will not result in a gift for federal gift tax purposes occurring among the grandchildren because a grandchild's contingent remainder interest, which would vest if another grandchild dies before the termination of Trust leaving no living lineal descendants, becomes less likely to vest.
5. That the judicial reformation of Trust (and subsequent termination of Trust) will not result in a gift for federal gift tax purposes occurring between the great-grandchildren and the grandchildren and children because a great-grandchild's contingent remainder interest, which would vest if a grandchild dies before the termination of Trust becomes less likely to vest.

Ruling Request No. 8 – GST tax

Section 2601 imposes a tax on every generation-skipping transfer. Under § 1433(a) of the Tax Reform Act of 1986 (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 tax does not apply to any generation-skipping transfer from a trust, if the trust was irrevocable on September 25, 1985, and no addition (actual or constructive) was made to the trust after that date. 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.

Under § 2602, the amount of tax imposed under § 2601 is determined by multiplying the taxable amount by the applicable rate. The taxable amount of a taxable distribution is the amount received by the transferee (§ 2621), of a taxable termination is the amount of property with respect to which there was a taxable termination (§ 2622), and of a direct skip is the amount received by the transferee (§ 2623).

Under § 2641, the term “applicable rate” means the product of the maximum federal estate tax rate in the year that the generation-skipping transfer occurs and the inclusion ratio.

Under § 2642(a)(1), the inclusion ratio with respect to any property transferred in a generation-skipping transfer is 1 minus the applicable fraction. Under § 2642(a)(2), in general, the numerator of the applicable fraction is the GST exemption amount allocated to the property transferred and the denominator is the value of the property transferred.

Under § 2631, every individual is allowed a GST exemption amount which may be allocated by the individual or the individual's executor to any property with respect to which the individual is the transferor.

Section 2654(b)(2) provides that, for purposes of chapter 13, substantially separate and independent shares of different beneficiaries in a trust are treated as separate trusts. Section 26.2654-1(a) (1) provides that, if a single trust consists solely of substantially separate and independent shares for different beneficiaries, the share attributable to each beneficiary (or group of beneficiaries) is treated as a separate trust for purposes of chapter 13. The phrase "substantially separate and independent shares" generally has the same meaning as provided in § 1.663(c)-3. However, 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. For purposes of this paragraph (a)(1), a trust is treated as created at the date of death of the grantor if the trust is includible in its entirety in the grantor's gross estate for federal estate tax purposes. Further, treatment of a single trust as separate trusts under this paragraph does not permit treatment of those portions as separate trusts for purposes of filing returns and payment of tax or for purposes of computing any other tax imposed under the Code. Also, additions to, and distributions from, such trusts are allocated pro rata among the separate trusts, unless the governing instrument expressly provides otherwise.

Section 26.2654-1(a)(5), Example 1, illustrates a situation where T transfers \$100,000 to a trust under which income is to be paid in equal shares for 10 years to T's child, C, and T's grandchild, GC (or their respective estates). The trust does not permit distributions of principal during the term of the trust. At the end of the 10-year term, the trust principal is to be distributed to C and GC in equal shares. The shares of C and GC in the trust are separate and independent and, therefore, are treated as separate trusts. The result would not be the same if the trust permitted distributions of principal unless the distributions could only be made from a one-half separate share of the initial trust principal and the distributee's future rights with respect to the trust are correspondingly reduced. T may allocate part of T's GST exemption under § 2632(a) to the share held for the benefit of GC.

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 will not cause the trust to lose its exempt status.

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)(C) provides that a judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause an exempt trust to be subject to the provisions of chapter 13, if (1) the judicial action involves a bona fide issue, and (2) the construction is consistent with applicable state law that would be applied by the highest court of the state.

Section 26.2601-1(b)(4)(i)(D) provides that a modification 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 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.

Section 26.2601-1(b)(4)(i)(E), Example 10, considers a situation where a trust is modified by decreasing the number of trustees. 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 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 modification will not subject the trust to the provisions of chapter 13.

No guidance has been issued concerning changes that may affect the status of trusts that are exempt from GST tax because sufficient GST exemption was allocated to the trust to result in an inclusion ratio of zero. At a minimum, a change that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status of such a trust.

Trust was included in Decedent's gross estate for federal estate tax purposes. Based on the facts represented, sufficient GST exemption was allocated to the grandchildren's separate shares of Trust on Decedent's death for such shares to have an inclusion ratio of zero under § 2642. You have represented that no additions have been made to Trust since Decedent's death. The proposed judicial modifications to Trust have been approved by Court in order to comply with certain terms of various settlement agreements relating to extensive litigation among the parties. In addition, the trustee modification pertains to certain administrative provisions. Finally, the modifications to Trust do not shift a beneficial interest in Trust to any beneficiary who

occupies a lower generation 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 Trust beyond the period provided for in the original trust.

Accordingly, based on the facts submitted and the representations made, we rule that a grandchild's separate trust will have an inclusion ratio of zero under § 2642, provided that the grandchildren's trust share has an inclusion ratio of zero immediately before each share set aside for a grandchild converts to a separate trust for such grandchild.

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

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

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely yours,

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

Enclosure
Copy for section 6110 purposes

cc: