

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **200418003**

Release Date: 4/30/04

Index Number: 2601.00-00, 2501.00-00,
1001.00-00, 671.00-00

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:04-PLR-110379-02

Date: DECEMBER 31, 2003

Re:

Legend:

Y's mother =

Y

Y's spouse =

A =

B =

C =

D =

C1 =

C2 =

C3 =

C4 =

C5 =

C6 =

C7 =

C8 =

C9 =

Spouse =

Individual =

Trust =

Trust A-1 =

Trust A-2 =

Trust A-3 =

Trust B =

Trust C =

Trust D =

Trustees of Trust A-1 =

Trustees of Trust C =

X =

W =

E =

F =

G =

H =

\$A =

\$B =

Z =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Year 1 =

Year 2 =

Year 3 =

State =

Court =

Statute =

State Statute 1 =

State Statute 2 =

State Statute 3 =

Citation 1 =

Citation 2 =

Citation 3 =

Dear _____ :

This is in response to your letter of March 20, 2003 and prior correspondence, in which you request rulings concerning the federal income, gift and generation-skipping transfer tax consequences of a court-approved settlement agreement among parties to two trusts.

Facts

On Date 1, Y and Y's mother, created Trust, an irrevocable trust, to benefit Y during Y's lifetime, and Y's children. Date 1 is prior to September 25, 1985. Trust was drafted by an attorney. The place of administration for Trust at its inception was State. Y had four children, A, B, C, and D. D died in Year 1. Y died in Year 2. B died in Year 3. A and C are still living.

Article III of Trust provides that the trustee is to pay first from the gross income of the trust estate and/or, if it be necessary, from the trust estate, any and all reasonable costs, expenses, charges and liabilities necessarily expended or incurred by the trustee in connection with the collection, care, administration, management or distribution of Trust and its defense against legal, equitable and any other attack. Article III(a) provides that compensation equal to five percent of the annual gross income of the trust estate is to be paid to the trustee for trustee's usual or ordinary duties under Trust. Article III(b) provides that the trustee is entitled to a reasonable additional compensation for any unusual or extraordinary services rendered by the trustee, including those involved in litigation.

Article IV provides that Y is to receive all of the net income of Trust during Y's lifetime and, after Y's death, income of Trust will be distributed in certain proportions to his then spouse, A, B, C, and D, and Y's children born after the date of Trust. The interest of Y's spouse was terminated upon her divorce from Y. After the death of Y, A is entitled to receive \$A per year and B and C are each entitled to receive \$B per year. The balance of the trust income was payable share and share alike to B, C, and D, and any lawful child or children born to Y after the date of Trust, and the survivors or survivor of them.

Article IV further provides that, during the existence of Trust, in the event of death of any of Y's children leaving surviving such child any lawful issue of such child, then the share of the net income of Trust which such child would otherwise have been entitled to receive shall be paid to such lawful issue as long as such lawful issue shall continue to live. Such issue shall take by right of representation and per stirpes and not per capita.

Article IV also provides that accumulations of income are permitted only when an income beneficiary has not attained twenty-five years of age and any income so accumulated must be paid to the beneficiary when he or she attains the age of twenty-five. No distribution of corpus to beneficiaries is permitted.

Article VI provides that Trust will terminate upon the death of the last to die of Y's children: A, B, C, and D. Article VII provides that, upon termination of Trust, the corpus will be distributed to the then-living lawful children of Y share and share alike and the lawful issue of Y's children, per stirpes and by right of representation. Article VIII

contains a spendthrift clause which restrains every beneficiary from impairing, encumbering or disposing of his or her rights or interest in Trust.

Article IX grants the trustee the power to make divisions, allotments and distributions to effect payments of principal of the trust estate according to methods and procedures as the trustee may determine, including the determination of the relative values of the property of the trust estate for purposes of such division, allotment, and distribution.

On Date 3, in accordance with an order by State Superior Court (Order), Trust was partitioned into six separate trusts for the benefit of Y's children and their respective lawful issue. Trust was partitioned as follows: one-fourth, divided equally into three trusts, Trust A-1, Trust A-2, and Trust A-3; one-fourth to Trust B; one-fourth to Trust C; and one-fourth to Trust D. The two trusts involved in this private letter ruling request are the Trust A-1 and Trust C.

Under the Order, the entire net income of Trust A-1 is to be paid to C during his lifetime and, following his death, to his lawful issue. Upon the death of the last to die of C and his siblings, Trust A-1 will terminate and the trustees will distribute the principal per stirpes to the then-living lawful issue of A. Trust A has two trustee positions, one appointed by the then-current income beneficiary or beneficiaries, currently C, and one appointed by A, his adult issue, and the legal guardians of his minor issue, acting as a group by majority vote.

Under the Order, the entire net income of Trust C is to be paid to C during his lifetime and, following his death, to his lawful issue. Upon the last to die of C and his siblings, Trust C will terminate and the trustees will distribute the principal per stirpes to the then-living lawful issue of C. During C's lifetime, C has the power to appoint one trustee position, which has 60 percent of the total votes of all trustees. In addition, there is to be a trustee position for each lawful child of C, with each position being entitled to one vote.

On Date 2, the Internal Revenue Service (IRS) issued a private letter ruling determining that the Date 3 partition of Trust into six separate trusts for the benefit of Y's children and their respective lawful issue would not cause Trust or any of the six separate trusts to be subject to income, gift, or generation-skipping transfer taxes and the partition did not alter in any substantive manner the dispositive provisions of Trust, which provisions continue to control the disposition of all income and principal of the successor trusts.

C and his spouse (Spouse) are the natural parents of four children, C1, C2, C3, and C4, all born in wedlock. C and Individual are the natural parents of three children, C5, C6, and C7, all born out of wedlock. C4 is the natural father of C8, who was born out of wedlock. In Year 2, C informed Spouse, C1, C2, C3, and C4 of his other three children, C5, C6, and C7. Following C's disclosure to Spouse, C1, C2, C3, and C4 that

he is the father of C5, C6, and C7, a dispute arose among the two families regarding whether C5, C6, and C7 are the “lawful issue” of C and whether C8 is the “lawful issue” of C4 and C, as the term is used in Trust for identifying contingent income and remainder beneficiaries. C5, C6, and C7 claimed that they are lawful issue of C as the term is used in Trust because C had established a legal relationship with them. C had always provided financial support to C5, C6, and C7. Following C’s disclosure to Spouse, C1, C2, C3, and C4 of his other children, C5, C6, and C7, C publicly acknowledged, treated, and accepted C5, C6, and C7 as his children and as members of the C family. C obtained paternity tests to establish by DNA testing that he is the father of C5, C6, and C7. C paid the legal fees and costs to obtain a court order changing C5, C6, and C7’s surname to that of C. On Date 6, Spouse consented in writing to accept C5, C6, and C7 into her home and, since that date, C5, C6, and C7 have repeatedly visited C and Spouse’s home.

C8 made a similar claim that C8 is lawful issue of C4 and C as the term is used in Trust because C4 had established a legal relationship with C8. C4 is listed as the father of C8 on C8’s birth certificate. C4 has actively participated in C8’s life as a father and welcomed C8 into his home on many occasions. C4 has assumed financial responsibility for C8. C4 is designated in C8’s school records as the parent “financially responsible” for C8’s schooling. C4 has openly acknowledged paternity of C8 to his friends and family. C and Spouse have also acknowledged C8 as their grandchild and C8 is also welcomed into C and Spouse’s home.

The parties retained legal counsel and guardian ad litem were appointed to represent the interests of the minor children and any unborn, unknown or unascertained beneficiaries of the trusts. Individual was appointed as guardian ad litem for C5, C6, and C7, who were all minors at that time. C5 reached the age of majority following submission of this ruling request. X was appointed as guardian ad litem for C9, C2’s minor child, and for any unborn, unknown, or unascertained beneficiaries of Trust A-1 and Trust C. W was appointed as guardian ad litem for C8.

C5, C6, and C7, through their guardian ad litem, Individual, wanted to pursue litigation to obtain a binding judicially enforceable determination of their claims. C1, C2, C3, and C4 also considered litigation to resolve the issue. C, in his capacity as income beneficiary and as trustee, urged the parties to avoid litigation and enter into settlement negotiations which would enable the parties to seek a private letter ruling regarding the tax consequences of treating C5, C6, C7, and C8 as beneficiaries of Trust A-1 and Trust C, prior to finalizing any settlement agreement. In addition, because of sensitive family concerns with respect to the children born out of wedlock, public litigation was not considered desirable. Ultimately, the parties agreed to enter into settlement negotiations.

After three years of settlement negotiations, on Date 4, the parties entered into a settlement agreement (Agreement). The Agreement is conditioned upon the issuance of a favorable private letter ruling from the IRS, and will be effective on the date of the

issuance of an Instruction Order from Court. The parties to the Agreement are: C, C1, C2, C3, C4; C5, C6, and C7, through their guardian ad litem, Individual; C8, through her guardian ad litem, W; C9, through his guardian ad litem, X; the trustees of Trust A-1, the trustees of Trust C; any unborn, unknown, or unascertained beneficiaries, through their guardian ad litem, X; and E, F, G, and H, contingent income and remainder beneficiaries of Trust A-1 and/or Trust C. The Agreement provides that C5, C6, C7, and C8 will be recognized as lawful issue for purposes of determining the contingent income and remainder beneficiaries of Trust A-1 and Trust C.

The Agreement also provides that Trust C will be partitioned into two trusts (Successor Trusts) one for the benefit of C1, C2, C3, and C4, and one for the benefit of C5, C6, and C7. Each Successor Trust will be administered as a separate family trust and will be managed by different trustees in accordance with Trust and Order, and as construed by the Instruction Order. In accordance with Article IV of Trust, the entire net income of each Successor Trust will be paid to C during his lifetime. Following the death of C, the entire net income of each Successor Trust will be paid to the then living lawful issue of C, who are the respective beneficiaries of each Successor Trust. Such issue will share per stirpes and by right of representation and not per capita, in proportion to each beneficiary's relative share in the respective Successor Trust. In accordance with Trust and Order, as construed by the Instruction Order, upon the death of the last to die of C and his siblings, the Successor Trusts shall terminate and the corpus of each Successor Trust will be distributed to the then living lawful issue of C who are the respective beneficiaries of each Successor Trust, in accordance with Trust and Order, and as construed by the Instruction Order. Such issue shall share per stirpes and by right of representation and not per capita, in proportion to each beneficiary's relative share in the respective Successor Trust. If, upon the termination of the Successor Trusts, C has no lawful issue then surviving, the corpus of each Successor Trust which otherwise would have passed to such lawful issue shall be distributed in accordance with Article VII of Trust and Order, as if Trust C had not been partitioned.

The trustees of Trust C represent that the purpose of the partition is to permit separate administration of the respective shares of the children of each family, who are likely to have different financial and personal objectives. The trustees of Trust C further represent that the partition has no tax avoidance purpose; is the result of arm's length negotiations; is intended to avoid further conflicts, and is not intended to alter the dispositive provisions of Trust and Order, as construed by the Instruction Order from Court, all of which will continue to control the disposition of all trust income and principal. Court has the authority under Statute to direct the division of trusts upon a petition by the trustees or beneficiaries.

To carry out the partition, the Agreement provides that to the fullest extent possible, each separate asset of Trust C shall be partitioned or apportioned in kind on a pro-rata basis between the Successor Trusts, according to the Partition Ratio set forth in the Instruction Order. This Partition Ratio, assuming equal beneficial interests for C1,

C2, C3, C4, C5, C6, and C7, would cause the Successor Trust for the benefit of C1, C2, C3, and C4 to receive four-sevenths of each asset of Trust C and would cause the Successor Trust for the benefit of C5, C6, and C7 to receive three-sevenths of each asset of Trust C. As to any separate asset that cannot be partitioned, the trustees of Trust C agree to form a limited liability company, LLC, to hold such asset or assets, and to allocate the total ownership or equity interests in the LLC to the Successor Trusts in accordance with the Partition Ratio. The trustees of Trust C will contribute non-divisible assets to LLC in exchange for 100 percent of the ownership interest in LLC. Approximately $\frac{2}{7}$ percent of the Trust C assets will be transferred to LLC. The LLC will assume or take the transferred assets subject to certain existing liabilities.

The trustees of Trust C represent that the LLC will not elect to be classified as an association, and therefore, as a single member LLC, it will be disregarded as an entity separate from its owner for federal tax purposes. Accordingly, the LLC interests will then become partitionable assets and the Successor Trust for the benefit of C1, C2, C3, and C4 would receive four-sevenths of the equity interest in the LLC and the Successor Trust for the benefit of C5, C6, and C7 would receive three-sevenths of the equity interest in the LLC. The management of the LLC shall be governed by joint decision-making procedures of the trustees of each Successor Trust and an Operating Agreement formatted as specified in the Agreement. The Operating Agreement provides that at such time as the LLC assets become divisible, LLC will be liquidated and the assets transferred to the Successor Trusts. Further, the Operating Agreement provides that the assets are being held in LLC as a matter of convenience, and that the assets in the LLC will be administered and managed as if the partition had not occurred consistent with the dispositive provisions of Trust and Order.

The Agreement provides that the following events will cause the trust estates held by the Successor Trusts to be adjusted (Adjustment Events): (i) a newly ascertained or newly born lawful child of C; (ii) the death of a lawful child of C, who dies without leaving any lawful issue; (iii) the death of a lawful child of C, who dies leaving a lawful issue who is entitled to a Partial Share under the Agreement or otherwise; and (iv) any other event which requires an adjustment of assets between the Successor Trusts in order to implement fully the dispositive provisions of Trust and Order. After the partition of Trust C pursuant to the Instruction Order, upon the occurrence of an Adjustment Event and within six months thereafter, subject to and following the receipt of a favorable IRS private letter ruling, the respective shares of the Successor Trusts shall be adjusted appropriately in recognition of the Adjustment Event by the reallocation of assets and liabilities from one Successor Trust to the other Successor Trust. The value of the assets and liabilities to be reallocated shall be determined by the change in or the new Partition Ratios.

The Agreement further provides that the trustees may exercise their prudent discretion to reimburse the parties for reasonable and necessary attorneys' fees and related costs incurred in implementing the Agreement. Until partition occurs, any reimbursement of attorneys' fees and related costs incurred for the benefit of C1, C2,

C3, C4, C5, C6, C7, and C8 will be charged against the principal of Trust C. Any reimbursement of attorneys' fees and related costs for the benefit of C and the guardian ad litem for any unborn, unknown, or unascertained beneficiaries of Trust C will be charged against the income of Trust C. After partition occurs, any reimbursement of attorneys' fees and related costs incurred for the benefit of C1, C2, C3, C4, C5, C6, C7, and C8 will be charged against the principal of their respective Successor Trusts.

Consistent with the Agreement and pursuant to Article III of Trust, the trustees have exercised their discretion to reimburse the parties for the reasonable and necessary attorneys' fees and related costs incurred in implementing the Agreement. The parties also agreed to a protocol for reimbursement of legal expenses requiring each party to certify the representation agreement with the law firm providing services in connection with the Agreement. Under the protocol, the trustees shall request Court approval of the proposed legal charges and Court approval of reimbursement to the parties after an initial legal expense allowance is exhausted. The trustees, in exercising their discretion under Article III, have allocated expenses incurred by the trustees in connection with the Agreement 50 percent to income and 50 percent to principal of the trusts.

During negotiations of the Agreement, C5, C6, and C7, through their guardian ad litem, claimed that, as beneficiaries, they have the right to investigate the past actions of the trustees in management of the property of the trusts. As part of the Agreement, the trustees desired mutual releases so that the trusts would not become embroiled in costly investigations into the activities of the trusts during the last twelve years. Accordingly, the Agreement provides that in exchange for the mutual promises set forth in the Agreement, each party releases and discharges each other party from any claim arising from any action, decision or omission of the trustees, the trust administrators or agents of Trust A-1 and Trust C, except a failure to create trustee positions pursuant to a court order entered after the effective date of the Agreement or claims based on any theory of each of C5, C6, C7, and C8 to have an interest in Trust and Order.

The Agreement also provides that during the minority of a lawful child of C who has a beneficial interest in Trust C, the trustee for the trustee position created for that child shall be appointed by C during his lifetime, provided such appointment is approved in writing by Individual during her lifetime. For the appointment of the trustee for the trustee position for an adult lawful child of C, that adult lawful child shall have the power to make that appointment.

The Agreement is governed by, construed and enforced in accordance with, the laws of State and any issue addressing the interpretation, construction, application or enforcement of Trust, Order, Trust A-1, or Trust C, are to continue to be governed by the laws of State.

C also entered into two settlement participation agreements with C1, C2, C3, and C4, and C5, C6, and C7, through their guardian ad litem, providing for C to make

monthly payments to his children in exchange for their agreement to forego their respective rights to litigate, to resolve the trust issues pursuant to the Agreement, and to protect C's income distributions from Trust C and Trust A-1. On Date 5, Court issued an order approving the execution of the Agreement.

Rulings Requested

C, C1, C2, C3, C4; C5, C6, and C7, through their guardian ad litem, Individual; C8, through her guardian ad litem, W; the trustees of Trust A-1 and Trust C; C9 and any unborn, unknown or unascertained beneficiaries of Trust A-1 and Trust C, through their guardian ad litem, X; and E, F, G, and H request the following rulings:

1. The (i) recognition and treatment of C5, C6, C7, and C8, as lawful issue for purposes of Trust and Order; (ii) the exchange of mutual general releases; (iii) the partition of Trust C into the Successor Trusts and the allocation of assets pursuant to such partition; (iv) the transfer of assets by Trust C to a limited liability company, LLC, wholly-owned by Trust C, and the management of the LLC in accordance with its Operating Agreement; (v) the distribution of ownership interests in the LLC by Trust C to the Successor Trusts and the conversion of the LLC from a disregarded entity to an entity taxed as a partnership; (vi) the trustees' use of trust funds, from income and principal, to pay and reimburse or advance the parties for reasonable and necessary attorneys' fees and related expenses incurred and paid to effect the Agreement; and (vii) the procedure of appointment of certain trustees to Trust C and the Successor Trusts, provided for in the Agreement, will not cause Trust A-1, Trust C, or the Successor Trusts to be subject to the generation-skipping transfer tax under § 2601 of the Internal Revenue Code.

2. The (i) recognition and treatment of C5, C6, C7, and C8, as lawful issue for purposes of Trust and Order; (ii) the exchange of mutual general releases; (iii) the partition of Trust C into the Successor Trusts and the allocation of assets pursuant to such partition; (iv) the transfer of assets by Trust C to a limited liability company, LLC, wholly-owned by Trust C, and the management of the LLC in accordance with its Operating Agreement; (v) the distribution of ownership interests in the LLC by Trust C to the Successor Trusts and the conversion of the LLC from a disregarded entity to an entity taxed as a partnership; (vi) the trustees' use of trust funds, from income and principal, to pay and reimburse or advance the parties for reasonable and necessary attorneys' fees and related expenses incurred and paid to effect the Agreement; and (vii) the procedure of appointment of certain trustees to Trust C and the Successor Trusts, provided for in the Agreement, will not give rise to a gift under § 2501 by the parties to the Agreement.

3. The (i) recognition and treatment of C5, C6, C7, and C8, as lawful issue for purposes of Trust and Order; (ii) the exchange of mutual general releases; (iii) the partition of Trust C into the Successor Trusts and the allocation of assets pursuant to such partition; (iv) the transfer of assets by Trust C to a limited liability company, LLC, wholly-owned by Trust C, and the management of the LLC in accordance with its Operating

Agreement; (v) the distribution of ownership interests in the LLC by Trust C to the Successor Trusts and the conversion of the LLC from a disregarded entity to an entity taxed as a partnership; (vi) the trustees' use of trust funds, from income and principal, to pay and reimburse or advance the parties for reasonable and necessary attorneys' fees and related expenses incurred and paid to effect the Agreement; and (vii) the procedure of appointment of certain trustees to Trust C and the Successor Trusts, as provided for in the Agreement, will not cause any party to the Agreement to realize income under § 61, and will not constitute a taxable sale, exchange or disposition of an asset, whether or not capital, by the parties to the Agreement.

4. No gain or loss will be recognized by Trust C on the transfer of assets to the LLC in exchange for all of the ownership interests of the LLC and the assumption by the LLC of, or taking of the transferred assets subject to, certain existing liabilities.

5. Upon partition of Trust C, the Successor Trusts will not be grantor trusts under §§ 671-678.

Discussion

State law issue of "lawful issue"

The controversy between the parties involves the question whether the term "lawful issue" includes C5, C6, C7, and C8, for purposes of determining the contingent income and remainder beneficiaries of Trust A-1 and Trust C. The intention of the transferor as expressed in the trust instrument controls the legal effect of the dispositions made in the instrument. Citation 1. If nothing on the face of the instrument or in the circumstances of its execution provides guidance in ascertaining the intent of the trustor with respect to the legal effect of a term, presumptions are applied to aid in construction of the instrument. Citation 1. Under State law, a trustor is presumed to be aware of the public policy reflected in the statutory definitions of the terms used in a trust at the time the trust is executed and to intend that those definitions be followed in construction of the trust unless a contrary intent is expressed in the trust. Citation 2. The presumption is strongest when an attorney has drafted the will. Citation 1.

In this case, nothing on the face of the Trust instrument or in the circumstances of its execution provide guidance in ascertaining the intent of the trustors with respect to the legal effect of the term "lawful issue". Trust was drafted by an attorney. Accordingly, it is appropriate to presume that the trustors were aware of the public policy reflected in statutory definitions of the terms used in Trust at the time Trust was executed and that the trustors intended that those definitions be followed in construction of Trust, unless a contrary intent is expressed in Trust. No contrary intent is expressed in Trust. Accordingly, the relevant statutes, case law, and public policy in effect at the time of the execution of the document may be considered to determine whether C5, C6, C7, and C8 are among the "lawful issue" the trustor intended to benefit.

Trust was executed on Date 1 and the place of administration was State. On Date 1, State Statute 1 provided that children born out of wedlock whose father subsequently acknowledged them as his children are treated as legitimate or lawful for purposes of inheritance or succession. Citation 3. Specifically, State Statute 1 provided that if a father of an illegitimate child, by publicly acknowledging the child as his own, receiving the child, with the consent of his wife, if he is married, into his family, and otherwise treating the child as if it were a legitimate child, thereby adopts the child, and the child is thereupon deemed for all purposes legitimate from the time of the child's birth. Compliance with State Statute 1 made a child born out of lawful wedlock legitimate for all purposes, including inheritance. Citation 3.

In this case, under State law, the trustors of Trust are presumed to have been aware of State Statute 1 and are presumed to have intended that State law apply in construing the term "lawful issue" for purposes of determining the contingent income and remainder beneficiaries of Trust. Accordingly, it is reasonable to conclude that the trustors would have intended lawful issue to include legitimized children. Therefore, if C and C4 have legitimized their children born out of wedlock, then those children would be treated as lawful issue for purposes of Trust A-1 and Trust C.

With respect to current State law, the concept of illegitimacy was abolished in State and replaced with State Statute 2, prior to the parties entering into Agreement. Under State Statute 2, a parent of a child born out of wedlock could establish a legal relationship with that child. State Statute 2 provides that a "parent and child relationship" means the legal relationship existing between a child and the child's natural or adoptive parents incident to which the law confers or imposes rights, privileges, duties, and obligations. The parent and child relationship may be established between a child and the natural father if the father receives the child into his home and openly holds out the child as his natural child. State Statute 3.

In this case, C has always provided financial support to C5, C6, and C7. C acknowledged C5, C6, and C7 as his children and Spouse and C have welcomed them into their home. C paid the legal fees and costs to obtain a court order changing C5, C6, and C7's surname to his surname. Similarly, C4 has acknowledged C8 as his child. C4 is listed on C8's birth certificate as her father. C4 has assumed financial responsibility for C8. C4 has welcomed C8 into his home. Based upon the representations made, we conclude that under State Statute 2, a state court would conclude that C has established a legal relationship with C5, C6, and C7, and that C4 has established a legal relationship with C8. Accordingly, C5, C6, C7, and C8 would be treated as lawful issue for purposes of determining the contingent income and remainder beneficiaries of Trust A-1 and Trust C.

Ruling Request 1

Section 2601 imposes a tax on every generation-skipping transfer (GST) made after October 26, 1986. Section 2611(a) defines the term "generation-skipping transfer" as (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Under section 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 generation-skipping transfers made after October 22, 1986. However, under section 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i), the tax does not apply to a transfer under a trust (as defined in § 2652(b)) 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).

Section 26.2601-1(b)(4) 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), (b)(2), or (b)(3) will not cause the trust to lose its exempt status. The rules of § 26.2601-1(b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for GST tax purposes. They 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 a 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 distribution, settlement, or construction that does not satisfy § 26.2601-1(b)(4)(i)(A), (B), or (C) of this subsection) 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, but only 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.

In this case, Trust was created and irrevocable before September 25, 1985. It is represented that no additions, constructive or actual, have been made to Trust while it

existed or Trust A-1 or Trust C since their creation. Consequently, Trust A-1 and Trust C are currently exempt from GST tax.

Each party was represented by legal counsel. The prospective beneficiaries had distinct and adverse economic and administrative interests. Some of the parties wanted to pursue litigation to resolve the issues. Settlement negotiations were carried out over several years until the Agreement was reached. The parties have obtained Court approval of the Agreement pending the issuance of this private letter ruling. Based upon the facts presented, the Agreement is the product of arm's length negotiations. Under State law, a State court could reasonably conclude that C5, C6, and C7, and C8 are lawful issue for purposes of determining the contingent income and remainder beneficiaries of Trust A-1 and Trust C. Accordingly, the recognition and treatment of C5, C6, C7, and C8 as lawful issue for purposes of Trust A-1 and Trust C is a reasonable outcome under Trust, Order, and State law. The exchange of mutual releases, the trustees' use of trust funds, from income and principal, to pay and reimburse, and advance the parties for reasonable and necessary attorneys' fees and related expenses incurred and paid to effect the Agreement, and the procedure of appointment of certain trustees to Trust C and the Successor Trusts are all terms of the Agreement that are within the range of reasonable outcomes under Trust, Order, and State law.

Trust C and the Successor Trusts will continue to be subject to the dispositive provisions of Trust. Accordingly, the proposed partition of Trust C and allocation of assets, the transfer of assets by Trust C to the LLC, wholly-owned by Trust C, the management of the LLC in accordance with its Operating Agreement, the distribution of ownership interests in the LLC by Trust C to the Successor Trusts and the conversion of the LLC from a disregarded entity to an entity taxed as a partnership, as provided in the Agreement, will 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 does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in Trust C.

Accordingly, we conclude that the recognition and treatment of C5, C6, C7, and C8 as lawful issue for purposes of Trust and Order; the exchange of mutual releases; the partition of Trust C into Successor Trusts and the allocation of assets pursuant to such partition; the transfer of assets by Trust C to the LLC, wholly-owned by Trust C, and the management of the LLC in accordance with its Operating Agreement; the distribution of ownership interests in the LLC by Trust C to the Successor Trusts and the conversion of the LLC from a disregarded entity to an entity taxed as a partnership; the trustees' use of trust funds, from income and principal, to pay and reimburse and advance the parties for reasonable and necessary attorneys' fees and related expenses incurred and paid to effect the Agreement; and the procedure of appointment of certain trustees for Trust C and the Successor Trusts, as provided in the Agreement, will not cause Trust A-1, Trust C, or the Successor Trusts to be subject to the GST tax under § 2601.

Ruling Request 2

Section 2501 imposes a tax for each calendar year on the transfer of property by gift during such calendar year by any individual. Section 2511 provides that the tax imposed by § 2501 applies whether the transfer is in trust or otherwise, direct or indirect, and whether the property transferred 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 Agreement, in the context of Trust, Order, and State law. In applying these standards, we conclude that the terms of the Agreement regarding the treatment of C5, C6, C7, and C8 as lawful issue of Trust A-1 and Trust C reflect a result that a state court would most likely reach based upon the facts regarding the legal relationship of the children to their fathers. Accordingly, the treatment of C5, C6, C7, and C8 as lawful issue for purposes of Trust A-1 and Trust C fairly reflect the relative merits and economic values of the claims asserted by the parties and are within a range of reasonable settlements. The exchange of mutual releases is also within a range of reasonable settlements. Further, the trustees' use of trust funds, from income and principal, to pay and reimburse and advance the parties for reasonable and necessary attorneys' fees and related expenses incurred and paid to effect the Agreement, and the procedure of appointment of certain trustees for Trust C and the Successor Trusts, as provided in the Agreement, are consistent with the terms of Trust and Order and are within a range of reasonable settlements.

Further, after the proposed partition of Trust C and allocation of assets and the transfer of assets by Trust C to the LLC wholly-owned by Trust C, the distribution of ownership interests in the LLC by Trust C to the Successor Trusts, and the conversion of the LLC from a disregarded entity to an entity taxed as a partnership, each beneficiary of the Successor Trusts will have the same beneficial interest as he or she had under Trust and Order. Because the beneficial interests of the beneficiaries are the same, both before and after the proposed transaction, no transfer of property will be deemed to occur as a result of the division.

Accordingly, we conclude that the recognition and treatment of C5, C6, C7, and C8 as lawful issue for purposes of Trust and Order; the exchange of mutual releases; the partition of Trust C into Successor Trusts and the allocation of assets pursuant to such partition; the transfer of assets by Trust C to the LLC, wholly-owned by Trust C,

and the management of the LLC in accordance with its Operating Agreement; the distribution of ownership interests in the LLC by Trust C to the Successor Trusts and the conversion of the LLC from a disregarded entity to an entity taxed as a partnership; the trustees' use of trust funds, from income and principal, to pay and reimburse and advance the parties for reasonable and necessary attorneys' fees and related expenses incurred and paid to effect the Agreement; and the procedure of appointment of certain trustees for Trust C and the Successor Trusts, as provided in the Agreement, will not give rise to a gift under § 2501 by the parties to the Agreement.

Ruling Request 3

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 § 1001 for determining gain, and the loss shall be the excess of the adjusted basis provided in § 1001 for determining loss over the amount realized.

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

A pro rata partition of jointly owned property is not a sale or other disposition of property where the co-owners of the joint property sever their joint interests, but do not acquire a new or additional interest as a result thereof. Thus, neither gain nor loss is realized on a partition. See Rev. Rul. 56-437, 1956-2 C.B. 507.

In Rev. Rul. 69-486, 1969-2 C.B. 159, a non-pro rata distribution of trust property was made in kind by the trustee. The distribution was effected as a result of a mutual agreement between the trustee and the beneficiaries. Because neither the trust instrument nor local law conveyed authority to the trustee to make a non-pro rata distribution, Rev. Rul. 69-486 held that the transaction was equivalent to a pro rata distribution followed by an exchange between the beneficiaries and was subject to the provisions of § 1001.

This case is distinguishable from Rev. Rul. 69-486 because the assets of the Trust C will be allocated among the Successor Trusts, on a pro rata basis, and each account will receive a proportionate share of each asset in the trusts. Accordingly, the proposed transactions will not be treated as a pro rata distribution followed by an exchange of assets among the beneficiaries of the trusts. An exchange of property results in the realization of gain or loss under § 1001 if the properties exchanged are materially different. Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991).

There is a material difference when the exchanged properties embody legal entitlements “different in kind or extent” or if they confer “different rights and powers.” Id. at 565.

After, the partition of Trust C into Successor Trusts, the Successor Trusts will continue to be subject to the dispositive provisions of Trust and Order. Therefore, under Cottage Savings, the properties exchanged are not materially different, and there would be no realization of gain or loss.

The distribution of ownership interests in the LLC by Trust C to the Successor Trusts, as part of the partition of Trust C, and the conversion of the LLC from a disregarded entity to an entity taxed as a partnership will not give rise to income under § 61, and will not cause a capital gain or loss to be realized by C, C1, C2, C3, and C4; the guardian ad litem for C5, C6, and C7; the guardian ad litem for C8; the trustees of Trust A-1 and Trust C, or the guardian ad litem for C9 and any unborn, unknown, or unascertained beneficiaries of Trust A-1 and Trust C.

As a result of the partition of Trust C into Successor Trusts, the Successor Trust for the benefit of C1, C2, C3, and C4 will receive four-sevenths of the equity interest in the LLC and the Successor Trust for the benefit of C5, C6, and C7 will receive three-sevenths of the equity interest in the LLC. Therefore, this partition will cause the LLC to convert from a disregarded entity to a partnership, as described in Situation 1 in Rev. Rul. 99-5, 1999-1 C.B. 434. Under Rev. Rul. 99-5, the Successor Trust for the benefit of C1, C2, C3, and C4 will be treated as owning a four-sevenths interest in each of the LLC's assets and the Successor Trust for the benefit of C5, C6, and C7 will be treated as owning a three-sevenths interest in each of the LLC's assets. Both of the Successor Trusts will be treated as contributing the trusts' respective interests in those assets to a partnership in exchange for ownership interests in the partnership.

Under § 721(a), no gain or loss is recognized by either of the Successor Trusts as a result of the conversion of the disregarded entity to a partnership.

Any distribution from the partnership to either Successor Trust is subject to the disguised sale rules under § 707(a)(2)(B).

Article III of Trust provides that the trustees are to pay first from the gross income of the Trust and/or, if necessary, from the principal of Trust, any and all reasonable costs, expenses, charges and liabilities necessarily expended or incurred by the trustee in connection with the collection, care, administration, management or distribution of Trust and its defense against legal, equitable and any other attack.

Under the Agreement, the trustees will reimburse the parties for reasonable and necessary attorney fees and related costs incurred in implementing the Agreement. Until partition occurs, any reimbursement of attorneys' fees and related costs incurred for the benefit of C1, C2, C3, C4, C5, C6, C7, and C8 will be charged against the

principal of Trust C. Any reimbursement of attorneys' fees and related costs for the benefit of C and the guardian ad litem for any unborn, unknown, or unascertained beneficiaries of Trust C will be charged against the income of Trust C. After partition occurs, any reimbursement of attorneys' fees and related costs incurred for the benefit of C1, C2, C3, C4, C5, C6, C7, and C8 will be charged against the principal of their respective Successor Trust.

Under Order, during C's lifetime, C has the power to appoint one trustee position for Trust C. In addition, a trustee position is established for each lawful child of C for Trust C. Under the Agreement, during the minority of a lawful child of C who has a beneficial interest in Trust C, the trustee for the trustee position created for that child shall be appointed by C during the lifetime, provided such appointment is approved in writing by Individual during her lifetime. For the appointment of the trustee for the trustee position for an adult lawful child of C, that adult lawful child shall have the power to make that appointment.

In this case, the provisions of Trust and Order will apply to each Successor Trust in the same manner and to the same extent as such provisions applied to Trust C. Accordingly, the trustees' use of trust funds of Trust C and Trust A-1 to pay, advance or reimburse the parties for reasonable and necessary attorneys' fees and related expenses incurred and paid to effect the Agreement will not give rise to income under § 61 by C, C1, C2, C3, and C4; Individual, the guardian ad litem for C5, C6, and C7; W, the guardian ad litem for C8; X, the guardian ad litem for C9, and any unborn, unknown, or unascertained beneficiaries of Trust A-1 and Trust C.

We conclude that the recognition and treatment of C5, C6, C7, and C8, as lawful issue for purposes of Trust and Order; the exchange of mutual general releases; the partition of Trust C into Successor Trusts and the allocation of assets pursuant to such partition; the transfer of assets by Trust C to the LLC and the management of the LLC in accordance with its Operating Agreement; the distribution of ownership interests in the LLC by Trust C to the Successor Trusts and the conversion of the LLC from a disregarded entity to an entity taxed as a partnership; the trustees' use of trust funds to pay and reimburse and advance the parties reasonable and necessary attorneys' fees and related expenses incurred and paid to effect the Agreement; and the procedure of appointment of certain trustees to Trust C and the Successor Trusts, as provided for in the Agreement, will not cause any party to the Agreement to realize income under § 61 and will not constitute a taxable sale, exchange, or disposition of an asset, whether or not capital, by the parties to the Agreement.

Ruling Request 4

The trustees of Trust C intend to contribute non-divisible assets to an LLC in exchange for 100 percent of the ownership interest in the LLC. The LLC will assume or take the transferred assets, subject to certain existing liabilities. The trustees of Trust C represent that the LLC will not elect to be classified as an association, and therefore, as

a single member LLC, it will be disregarded as an entity separate from its owner for federal tax purposes.

Section 301.7701-3(a) of the Procedure and Administration Regulations provides, in part, that a business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal income tax purposes as provided in § 301.7701-3. An eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.

Section 301.7701-3(b)(1)(ii) provides that, except as provided in § 301.7701-3(b)(3), unless the entity elects otherwise, a domestic eligible entity is disregarded as an entity separate from its owner if it has a single owner.

The contribution of non-divisible assets to the LLC in exchange for the ownership interest in the LLC will be disregarded for federal tax purposes because the LLC will not elect to be classified as an association, and therefore, will be disregarded as an entity separate from its owner for federal tax purposes. Therefore, we conclude that no gain or loss will be recognized by Trust C on the transfer of assets to the LLC in exchange for all of the ownership interest of the LLC and the assumption by the LLC of, or taking of the transferred assets subject to, certain existing liabilities.

Ruling Request 5

Sections 671 through 678 provide rules for determining when the grantor or another person is treated as the owner of any portion or all of a trust.

Section 678(a) provides that a person other than the grantor is treated as the owner of any portion of a trust with respect to which (1) such person has a power exercisable solely by such person to vest the corpus or the income therefrom in such person, or (2) such person has previously or 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 of the owner thereof.

Y's mother and Y were the grantors of Trust. Trust C, that was created by Order, is a successor trust of Trust. Although Trust C is being divided into the Successor Trusts at the request of the trustees and beneficiaries of Trust C, which parties petitioned the Court for approval, it is the appropriate local court, and not the beneficiaries or trustees, that has the exclusive power to direct the division of Trust C and create the Successor Trusts. A court order will not cause the trust relationship to come into existence; that relationship was created by Y's mother and Y when they executed and transferred property into Trust. While a court order could divide Trust C, the beneficiaries will not acquire possession of, and dominion over, the trust estate, but rather, the trust estate is to continue to be held in trust for their benefit. As a result, we

conclude that the beneficiaries of Trust C will not be treated as grantors of the Successor Trusts and will not be treated as the owners of the Successor Trusts under §§ 671 through 677. Furthermore, under the dispositive provisions of the Successor Trusts, no person will be treated as the owner under § 678 of any portion of the Successor Trusts. Accordingly, upon division of Trust C, each Successor Trust of Trust C will not be a grantor trust under §§ 671-678.

The ruling contained in this letter is 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 the ruling, it is subject to verification on examination.

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. We are specifically not ruling on the gift tax and income tax consequences of payments being made by C to C1, C2, C3, and C4, and the guardian ad litem for C5, C6, and C7 in accordance with two settlement participation agreements under the Agreement. In accordance with the powers of attorney on file with this office, we are sending copies of this letter to the taxpayers.

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.

Sincerely,

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

Enclosures
Copy for section 6110 purposes

cc: