

**Internal Revenue Service**

Department of the Treasury  
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Person To Contact:

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Telephone Number:

Refer Reply To:

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Date:

December 04, 2003

Re:

**LEGEND**

Decedent =

Trust =

Date 1 =

Bank =

Wife =

Daughter =

Hospital =

Date 2 =

Date 3 =

x =

State A =

Date 4 =

State B =

- y percent =
- Child 1 =
- Child 2 =
- Child 3 =
- Child 4 =
- State B Statute =
- State A Citation 1 =
- State B Citation 1 =
- State A Citation 2 =

Dear :

This is in response to your letter dated April 11, 2003, requesting rulings concerning the estate, gift, and generation-skipping transfer (GST) tax consequences of a non-judicial agreement to an irrevocable trust.

The facts submitted and representations made are as follows: Decedent created Trust, an irrevocable trust, on Date 1, a date prior to September 25, 1985. The Decedent named Bank as the trustee of Trust.

Paragraph 1 of Trust provides that, subject to the provisions of Paragraph 2 of Trust, the net income from the trust shall be distributed to Wife during her lifetime, and after her death, to Daughter, if she is then living. Upon the death of the last survivor of Wife and Daughter the property then constituting the trust fund shall be distributed equally to the issue of Daughter living at the time of the death of the last survivor, and if upon the death of the last survivor of Wife and Daughter there are no living issue of Daughter, then to the nearest blood relation or relations of Daughter (other than Decedent) living at the time of the death of the last survivor. In the event there is no blood relation of Daughter (other than Decedent) living at the time of the death of the last survivor, the property then constituting the trust fund shall be distributed to Hospital.

Paragraph 2 of Trust provides that notwithstanding anything in the instrument to the contrary, the trustee is authorized, in the exercise of discretion, to withhold distribution of any part or all of the income from the trust estate if the trustee determines that the income to be withheld is not reasonably required by the beneficiary then entitled to the income under Paragraph 1 of Trust to enable her to maintain the standard of living to which she is accustomed. Any income withheld by the trustee shall be added to and become a part of the principal of the trust.

Paragraph 3 of Trust authorizes the trustee to make withdrawals of principal from the trust and pay over such withdrawals to the beneficiary if the trustee, in the exercise of discretion, shall determine that the income distributed under paragraph 1 of Trust is insufficient to enable her to maintain the standard of living to which she is accustomed.

Paragraph 4 of Trust provides the trustee with general powers to invest the trust funds, but further provides that notwithstanding the general provisions of Trust, the trustee shall not make any investment in stock of Bank. However, the trustee may retain as an asset of the trust fund for so long as it may deem expedient any shares of such stock that may be transferred to the trust by the trustor or the beneficiaries, together with any shares that may be received as a stock dividend upon such stock, and the trustee may also in its discretion purchase and retain additional stock through the exercise of stock rights issued upon any of the retained stock. Paragraph 4 further provides that before exercising the investment powers conferred therein, the trustee shall, if it can conveniently do so, confer with Daughter, if living and not under any legal disability.

Paragraph 9 of Trust provides that Decedent, Wife or Daughter may add to the property included in the trust estate.

Decedent died on Date 2 and Wife died on Date 3. After the initial contribution of property to Trust, which included  $x$  shares of stock of Bank, no additional contributions were made to Trust. Trust was administered in State A from its inception until Date 4, when the situs and administration of Trust was transferred to State B.

In the administration of Trust, several issues have arisen. First, Bank stock comprises  $y$  percent of the market value of Trust. Each time Bank has conferred with Daughter with regard to Bank's investment powers, Daughter has consistently maintained her desire that the trustee retain all Bank stock until the ultimate distribution of the trust assets at her death. Bank is concerned that holding its own stock as a large portion of the trust estate may be considered to be a conflict of interest or that it may result in a failure to diversify the assets of the trust estate in violation of federal and state law.

Second, an issue has arisen as to whether the language in Paragraph 1 results in a distribution of the trust assets on a per capita basis or a per stirpes basis after the death of Daughter. Daughter has four living children, Child 1, Child 2, Child 3, and Child 4. Child 1 has no children. Child 2 has three children. Child 3 has one child. Child 4 has two children. Bank obtained two legal opinion letters, one opining on the distribution language of Trust as interpreted under the law of State A, and one opining on the distribution language of Trust as interpreted under the law of State B. Both letters conclude that the distribution language calls for a per capita distribution to the children and grandchildren of Daughter after her death.

Bank, Daughter, Daughter's children, and Daughter's grandchildren have entered into a nonjudicial binding agreement pursuant to State B Statute that is contingent upon receipt of a favorable private letter ruling from the Internal Revenue Service. The parties have made the following agreements:

- A. Although the situs of Trust was moved to State B, the law of State A will continue to apply with respect to the determination of the substantive rights of the beneficiaries, including, but not limited to, a determination of the beneficial interest of a lower generation and the time for vesting of beneficial interests.
- B. Bank, in its role as trustee, shall be directed to retain all Bank stock without the duty to diversify such stock holdings or the duty to exercise due care and prudence in the disposition or retention of Bank stock. Bank agrees to comply with this direction. This agreement may be withdrawn, at any time, as to all or any part of the Bank stock then held in Trust by a written document delivered to Bank that is signed by a majority of the parties to the agreement (other than Bank) who are then living and competent adults.
- C. Any conflict of interest of Bank resulting from such stock holdings is waived and the beneficiaries agree unconditionally and jointly and severally to fully and completely indemnify and to hold the trustee harmless from any liability or loss of any nature whatsoever resulting from such conflict of interest.
- D. The trust instrument and state law require that the distribution of the trust assets upon the death of Daughter shall be made in equal shares (per capita) among all of Daughter's children, grandchildren and other lineal descendants surviving at her death, including any adopted descendants.
- E. Daughter relinquishes her right, set forth in Paragraph 9 of Trust, to make contributions of additional property to Trust.

The trustee of Trust requests the following rulings:

1. The nonjudicial agreement will not result in any of the beneficiaries making a gift for federal gift tax purposes.
2. The nonjudicial agreement will not result in the inclusion of the value of the trust assets in any beneficiary's estate for federal estate tax purposes.
3. The nonjudicial agreement with respect to the agreements contained in agreements B, C, and D above, will not cause Trust or any distributions from Trust to be subject to the GST tax under chapter 13 of the Code.

### RULING REQUEST 1

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

Section 2511(a) 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.

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

Section 2512(b) provides that where property is transferred for less than adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration is deemed to be a gift, and is included in computing the amount of gifts made during the calendar year.

Under the law of State A and the law of State B, the use of the term "equally" to describe the manner of distribution to a particular class of beneficiaries requires a per capita distribution, or a distribution to each member of the class in equal shares. State A Citation 1; State B Citation 1. In both State A and State B, the term "issue" is typically construed to include all of the lineal descendants of whatever generation. See State A Citation 2; State B Citation 1.

Agreements A, B, C, and E of the nonjudicial binding agreement in the present case are administrative in nature and do not change the beneficial interests of the beneficiaries of Trust. Likewise, agreement D does not change the beneficial interests of the beneficiaries of Trust because it provides an interpretation of the trust language that is consistent with the law of State A and State B, as applied by the highest court of each state. Because the beneficiaries of Trust have the same beneficial interest in Trust after entering into the nonjudicial binding agreement as they had before entering into the agreement, no transfer of property will be deemed to occur. Accordingly, we

conclude that the execution of the nonjudicial binding agreement will not result in a transfer of property that will be subject to gift tax consequences under § 2501.

## RULING REQUEST 2

Section 2001 imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

Section 2033 provides that the value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.

Section 2035(a) provides that, (1) if the decedent transferred an interest in property or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death, and (2) the value of the property (or interest therein) would have been included in the gross estate under §§ 2036, 2037, 2038, or 2042 if the interest or power had been retained by the decedent on the date of death, then the value of the gross estate shall include the value of any property (or interest therein) that would have been so included. Under § 2035(b), the gross estate shall be increased by the amount of any gift tax paid by the decedent or his estate on any gift made by the decedent or his spouse during the three year period ending on the date of decedent's death.

Section 2036(a) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period that does not in fact end before his death, (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income from the property.

Section 2037(a) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, if (1) possession or enjoyment of the property can, through ownership of such interest, be obtained only by surviving the decedent, and (2) the decedent has retained a reversionary interest in the property, and the value of such reversionary interest immediately before the death of the decedent exceeds 5 percent of the value of such property.

Section 2038(a)(1) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at

any time made a transfer (except in case of a bona fide sale for adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke, or where the decedent relinquished any such power during the 3-year period ending on the date of the decedent's death.

Under the law of State A and the law of State B, the use of the term "equally" to describe the manner of distribution to a particular class of beneficiaries requires a per capita distribution, or a distribution to each member of the class in equal shares. State A Citation 1; State B Citation 1. In both State A and State B, the term "issue" is typically construed to include all of the lineal descendants of whatever generation. See State A Citation 2; State B Citation 1.

In order for §§ 2035-2038 to apply, the decedent must have made a transfer of property or any interest therein (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth) under which the decedent retained an interest in, or power over, the income or corpus of the transferred property. Agreements A, B, C, and E of the nonjudicial binding agreement in the present case are administrative in nature and do not change the beneficial interests of the beneficiaries of Trust. Agreement D does not change the beneficial interests of the beneficiaries of Trust because it provides an interpretation of the trust language that is consistent with the law of State A and State B, as applied by the highest court of each state. Thus, the execution of the nonjudicial binding agreement will not constitute a transfer by any beneficiary within the meaning of §§ 2036-2038. Accordingly, we conclude that the execution of the nonjudicial binding agreement will not cause the interests of the beneficiaries to be includible in their respective gross estates under §§ 2035-2038. In addition, we conclude that the execution of the nonjudicial binding agreement will not cause the interests of the beneficiaries to be includible in their respective gross estates under § 2033.

### RULING REQUEST 3

Section 2601 imposes a tax on every generation-skipping transfer, which is defined under § 2611 as a taxable distribution, a taxable termination, or a direct skip.

Section 1433(b)(2)(A) of the Tax Reform Act of 1986 (the Act) and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations provide that the GST tax shall not apply to any GST under a trust that was irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added).

Section 26.2601-1(b)(1)(ii)(A) provides that any trust in existence on September 25, 1985, will be considered an irrevocable trust except as provided in §§ 26.2601-1(b)(ii)(B) or (C), which relate to property includible in a grantor's gross estate under §§ 2038 and 2042. In the present case, Trust is considered to have been irrevocable on September 25, 1985, because neither § 2038 nor § 2042 applies.

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), (2), or (3) (hereinafter referred to as an exempt trust) will not cause the trust to lose its exempt status. The rules contained in § 26.2601-1(b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for GST tax purposes. The rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of § 1001.

Section 26.2601-1(b)(4)(i)(D)(1) provides that a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy § 26.2601-1(b)(4)(i)(A), (B), or (C) of this section) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided in the original trust.

Section 26.2601-1(b)(4)(i)(D)(2) provides that, for purposes of this section, a modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is measured against the effect of the instrument in existence immediately before the modification. If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification.

The nonjudicial binding agreement is authorized by the law of State B. Agreements B and C of the nonjudicial binding agreement are administrative in nature and will not result in a shift in a beneficial interest to a lower generation beneficiary nor



will it extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

Under the law of State A and the law of State B, the use of the term “equally” to describe the manner of distribution to a particular class of beneficiaries requires a per capita distribution, or a distribution to each member of the class in equal shares. State A Citation 1; State B Citation 1. In both State A and State B, the term “issue” is typically construed to include all of the lineal descendants of whatever generation. See State A Citation 2; State B Citation 1. In this case, Agreement D of the nonjudicial binding agreement provides an interpretation of the trust language that is consistent with the law of both State A and State B, as it would be applied by the highest court of the state. Accordingly, agreement D will not result in a shift in a beneficial interest to a lower generation beneficiary nor will it extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

Based on the facts submitted and the representations made, we conclude that agreements B, C, and D of the nonjudicial binding agreement comply with the provisions of § 26.2601-1(b)(4)(i)(D)(1) and will not cause Trust to be subject to the tax on generation-skipping transfers under chapter 13 of the Code.

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

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

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely,

James F. Hogan

James F. Hogan  
Acting Branch Chief, Branch 9  
Office of Associate Chief Counsel

PLR-137188-03

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(Passthroughs and Special Industries)

Enclosure

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