Routing Slip

Internal Revenue Service

To	Symbol	Room	Action Code	Initial/ Date
Mr. Malloy Mr. Sheldon		4016 4228		
Mr. Kittler Mr. Nelson		4428 5201		
Mr. Peroni Mr. Grosgebauer		3529 5334		
Miss Ryan		5334		
Ms Sullivan		4428		
Mr. Treanor		4013		
Mr Lyden		5315		

- [ ] 1. Per our conversation
- [ ] 2. As requested
- [ ] 3. Approval
- [ ] 4. Comments
- [ ] 5. Information
- [ ] 6. Corrections
- [ ] 7. Signature
- [ ] 8. Initials
- [ ] 9. Note and return
- [ ] 10. Necessary action
- [ ] 11. See me
- [ ] 12. Call me
- [ ] 13. File
- [ ] 14. Prepare reply for signature of ____________
- [ ] 15. Please answer by ____________

Remarks

Re: Getty Trust Ruling Request

Attached is a draft memorandum on the income tax issues.

From	Phone	Room No.
R. Hollander	212 242-3900	
	Date 5/29/86	

Form 1725 (Rev. 9-74)

★U.S. Government Printing Office: 1982—387-556/5033

CC:I-194-85
RHollander

Getty Trust #2

DRAFT

JAMES F. MALLOY

Director: Interpretative Division

Attention: Neal S. Sheldon

By memorandum dated August 16, 1985, you made an early referral of the above referenced cases (Control No. 5I9907) for our consideration.

ISSUES

1. Is the substance of the court approved settlement agreement a termination of the Sarah C. Getty Trust, a distribution of the trust estate in cash to the current beneficiaries, and the creation of new trusts by those beneficiaries?

2. Are the beneficiaries of the Sarah C. Getty Trust the grantors of their respective Family Trusts?

3. Are the grantors of the Family Trusts owners of portions of the trusts under I.R.C. 673, 676, and 677, and thereby subject to the taxes on those portions under section 671.

4. Does the creation of the Family Trusts involve dispositions of beneficial interests that result in taxable gains or deductible losses under section 1001.

CONCLUSION

1. The substance of the court approved settlement agreement is a termination of the Sarah C. Getty Trust, a distribution of the trust estate in cash to the current beneficiaries, and the creation of new trusts by those beneficiaries.

2. The beneficiaries of the Sarah C. Getty Trust are the grantors of their respective Family Trusts.

3. The grantors of the Family Trusts are owners of portions of the trusts under sections 673, 676, and 677, and subject to the taxes on those portions under section 671.

4. Taxable gain or deductible losses result from the disposition of beneficial interests upon creation of the Family Trusts.

FACTS

X = Sarah C. Getty

Y = J. Paul Getty

Z = Getty Oil Company or its predecessor companies

A = Ronald Getty

B = J. Paul Getty Jr.

C = Gordon P. Getty

D = George Franklin Getty II

The trustee-beneficiary and the other beneficiaries of a trust irrevocable under state law have entered into a compromise and settlement agreement in connection with litigation arising from disputes over the administration of the trust by the trustee-beneficiary. The Superior Court of the City of Los Angeles approved the agreement by order dated May 30, 1985. Execution of the agreement is conditioned on the receipt by the parties of favorable rulings from the Service on its tax consequences.

The trust was created by a declaration of trust (trust instrument) dated December 31, 1934. The trustors were X and her son Y. X contributed five promissory notes made by Z Corporation, a publicly-owned company founded by her husband. Y contributed shares of Z Corporation, and sold additional shares, to the trust. The trust instrument named Y sole trustee, and authorized Y to appoint one or more successor trustees in the event of his death or resignation.

The declaration of trust provides that all the net income of the trust would be paid to Y during his lifetime, and after his death, in certain proportions to his wife, W, his children, and their lawful issue. The trust instrument further provided that in the event that Y waived his income interest, the income would be distributed as if Y had died. The instrument authorizes the trustee to accumulate income only when an income beneficiary has not yet attained twenty-five years of age. The trustee must pay income so accumulated to the beneficiary when he or she attains the age of twentyfive. The trustee has no discretion to distribute corpus. The trust instrument also contains a spendthrift clause to which every beneficiary is subject.

The declaration of trust provides for termination of the trust on the death of the last to die of the four sons of Y born prior to the creation of the trust, A, B, C, and D. It further provides that on termination, the corpus will be distributed to the then living lawful issue of Y's sons, in equal shares, per stirpes.

The trust instrument gave broad investment authority to Y as original trustee. However, the instrument subjects successor trustees to two limitations on investment decisions: 1) a prohibition on selling, exchanging or disposing of, or converting into a different investment or form of investment any investment of the whole or any part of the trust estate made by Y as trustee unless the sale, exchange, disposition or conversion is made to save the trust estate from a substantial loss; and (2) a requirement to make investments only in interest-bearing bonds or securities issued by, and which are the direct obligations of, certain national governments.

Article III of the trust instrument provides as follows regarding the allocation of taxes and expenses between trust income and corpus. "From the gross income of the trust estate and/or, if it be necessary, from the trust estate, the trustee shall first pay and discharge when due and payable any and all taxes, assessments and other charges imposed by public authority on the trust estate ... ." The trust instrument contains no other direction regarding the allocation of taxes and expenses between income and corpus.

Article III also provides that the trustee may pay from the gross income of the trust and/or, if it be necessary, from the trust estate: trustee compensation for usual or ordinary services in the administration of the trust at an annual amount equal to five percent of annual gross income; reasonable additional compensation for unusual and extraordinary services, including those involved in litigation. It further provides that the trustee may pay reasonable costs, expenses, charges and liabilities necessarily expended or incurred by the trustee in connection with the collection, care, administration, management or distribution of the corpus or income of the trust from the same source.

Article IV provides that any part of the net income that the trustee would otherwise pay directly to any life beneficiary of the trust can, in the sole judgement and discretion of the trustee, be applied for the proper care, maintenance, support or education of a life beneficiary.

During his lifetime, Y irrevocably waived his income interest in favor of those who, under the trust instrument, would become income beneficiaries upon his death. W's interest had terminated on her divorce from Y, leaving his children as the income beneficiaries of the trust. Since Y's death, the income beneficiaries of the trust, and their shares of trust income, have been:

a. son A, $3,000 per year;

b. sons B and C, $9,000 per year;

c. the balance -

(i) one third to B;

(ii) one-third to C; and

(iii) one-third in equal shares to the children of deceased son D.

From the trust's formation through 1983, the trust corpus had consisted principally of stock of the Z Corporation, and the trust income reflected dividend yield. Cash dividends from 1934 through 1981 ranged from .003% to 2%; the yield was approximately 3% in 1982, and 5% in 1983.

During Y's lifetime, one of the income beneficiaries, son C, had sued Y as trustee, arguing that stock dividends of Z Corporation were properly allocable to trust income. A state appellate court had held that the evidence showed a clear intention on the part of both trustors, X and Y, that stock dividends be allocated to corpus. The appellate court found that their purpose and intention was to preserve the Z Corporation business, and always to build up, consolidate and maintain control of it as a growth enterprise and never by any means to dissipate that control or any part of it.

Y was serving as trustee of the trust at the time of his death on June 5, 1976. Prior to his death, Y had executed an instrument appointing three successor trustees on his death: C, his attorney, and a corporate trustee. On Y's death, C and the attorney became and served as co-trustees, but the corporate trustee did not. The attorney died in 1982, leaving C as the sole trustee.

On January 6, 1984, the corpus of the trust consisted of 40.2 percent of the stock of Z Corporation and a comparatively minor amount of United States Treasury obligations. On that date, C agreed to sell all shares of stock of Z Corporation owned by the trust to a third party. Payment was made in cash, which has since been invested in short term United States Treasury securities and cash-equivalents.

The subject litigation commenced immediately prior to the sale of the Z Corporation stock. On January 4, 1984, while discussions about a possible business transaction between the trustee and one third party relating to the stock were in progress, D's children applied for an order instructing C to refrain from signing legally binding agreements on behalf of the trust. The local court issued a temporary restraining order and set a hearing on the matter. The court subsequently issued an order prohibiting the trustee from entering into specified legally-binding transactions without giving the beneficiaries five days prior notice. The order provided for suspension of the prohibition upon the approval of the representative of one of D's daughters, to permit the sale of the trust's stock to the ultimate third party buyer. The necessary approval was given on the day following issuance of the order, and the trustee then signed an agreement for sale of the stock.

Ten days later a guardian ad litem for the minor, unborn, and unascertained issue of Y's son A filed a petition for an order instructing the trustee not to consummate that sale, and instead to consummate certain agreements with the other third party, in order to prevent a breach of trust. A hearing was held, and the court issued an order restraining the trustee for six days from consummating the agreement he had signed.

The buyer subsequently increased its purchase price. The trustee and the beneficiaries (or their representatives) then signed, and the court approved, a stipulation and agreement of the parties pursuant to which the sale was allowed to proceed. The court order approving the stipulation and agreement provided that the terms, stipulations, provisions and findings of the order were not binding between the trustee and the beneficiaries and were neither res judicata nor collateral estoppel nor usable as evidence in a subsequent proceeding. The sale was consummated on February 17, 1984. The litigation proceeded.

Twenty-six interested parties have been represented in the litigation by ten law firms. The parties include the income beneficiaries, the remainder beneficiaries, and the trustee-beneficiary. Minor, unborn, unknown, and unascertained issue

have been represented by guardians ad litem in accordance with state law. More than thirty-five contested hearings have been held in the local court, which in the course of its proceedings has entered a number of protective orders, injunctions, and other orders and instructions. Three of the orders have been appealed and one opinion has been issued by an appellate court.

None of the principal issues in the case had been resolved prior to the agreement on settlement. However, during the course of the litigation the trustee petitioned the court for instructions on the proper allocation between income and corpus of the substantial capital gain taxes incurred as a result of the sale. A portion of the taxes was paid in 1984, and the balance was paid in 1985. These payments were made from corpus, as an interim measure. As will be discussed, under the proposed settlement, the capital gain taxes are allocated partly to corpus and partly to income.

The parties have conducted extensive discovery in connection with the litigation. In preparation for trial, over 82,000 documents have been examined and catalogued and over fifty-one depositions of family members and other persons in several jurisdictions have been taken. The principal issues raised by the petitions, litigated by the parties, and resolved by the settlement agreement are:

(1) whether the instrument appointing the trustee was valid or void ab initio and, if void, who should be appointed successor trustee;

(2) whether a corporate co-trustee was intended or should be appointed;

(3) whether the trustee should be removed for mismanagement of the trust corpus by selling the Z Corporation stock, and, if so, who should be appointed as successor trustee;

(4) whether the trustee should be surcharged;

(5) whether proper interpretation of the trust requires that the expenses of sale of the Z Corporation stock, including capital gain taxes and other taxes and expenses, should be charged to income or corpus, or both;

(6) whether various expenses and fees should be paid from the trust;

(7) whether an income reserve should be established as a result of the sale of the stock to favor the interests of the remainder beneficiaries; and

(8) whether deviation from the investment restrictions in the trust should be permitted due to changed circumstances resulting from the sale of the stock.

The parties argued at length on the issue whether the capital gain taxes on the sale of the Z Corporation stock should be allocated to income or corpus. Some remainder beneficiaries argued that all of the taxes should be paid from trust income. They argued that Article III of the trust expressly provides that capital gain taxes be paid from income, unless necessary to pay them from corpus. They further argued that "necessity" should be interpreted to mean as a last resort. These parties relied on the finding of the appellate court in prior litigation that the trustors intended to favor the remainder beneficiaries over the income beneficiaries. They also argued that under equitable principles the court should order the taxes paid from trust income, because the sale of stock resulted in a five-fold increase in the trust income stream at the expense of the long-term growth of corpus.

Other parties, including income beneficiaries who also had remainder interests, argued that the trustee should pay capital gain taxes from corpus. Among the arguments advanced was one that Article III of the trust instrument did not control the issue because capital gain taxes were not subsumed in the word "taxes", and that the California Principal and Income Act would therefore control and place the tax burden on corpus. Another argument asserted was that Article III was ambiguous and the intent of the trustors therefore should control. Those advancing this argument pointed to extrinsic evidence of an intent to favor the income beneficiaries, and argued that the finding in prior litigation that the trustors intended to favor the remainder beneficiaries did not bind them in this litigation as a matter of res judicata or collateral estoppel. Certain of these parties advanced the equitable argument that because the gain from the sale of the stock was allocated to corpus, the capital gain taxes should be paid from corpus.

The trustee also made a submission on this issue. The trustee incorporated by reference an opinion of the trustee's counsel that under Article III capital gain taxes should be paid from income. (This opinion had been prepared prior to the start

of this litigation with respect to another possible transaction.) The trustee's submission then challenged the correctness of the opinion of trustee's counsel as prepared. The trustee alternatively argued that the opinion was inapplicable due to the circumstances of the actual sale of stock.

The parties disputed not only whether deviation from the investment restrictions contained in the trust instrument should be permitted but, if permitted, in what manner and to what extent. Certain remainder beneficiaries believed that by reason of the sale and the resultant change in the character and size of the trust as well as changed economic circumstances, all allegedly unanticipated by the trustors on creation of the trust, deviation from the investment restrictions was required in order to carry out the intentions of the trustors. Some remainder beneficiaries, relied on the finding in prior litigation that the trustors intended to preserve and enhance corpus, to argue that investments should favor remainder beneficiaries and assure growth in the trust corpus. Others argued that deviation was required to provide an opportunity for growth to preserve the purchasing power of the trust corpus as the trustors intended, but that investments should be made without bias in favor of either income or remainder beneficiaries.

Those favoring deviation differed in other respects on what investment standards should apply if deviation were permitted. Some argued that only the remaining provisions of the declaration of trust should apply and others argued that the prudent person standard or other more detailed provisions should be adopted in lieu of or in addition to the existing provisions of the declaration of trust.

On the other hand, certain income beneficiaries opposed any deviation from the investment restrictions contained in the trust instrument, contending again that the finding in the prior litigation was irrelevant to the present situation, and again pointing to extrinsic evidence that the trustors always intended to favor income beneficiaries.

In the course of the litigation, other relief was requested: some beneficiaries approved of and some contested the sale of Z Corporation stock. Other disputes related to the interim investment of trust assets after the sale; the notice to be given to the beneficiaries of the trustee's proposed actions; the payment of fees and expenses from the trust; the standing of one of the

parties to litigate; the jurisdiction of the local court over the trust; the effect of an instrument purporting to appoint successor trustees; and various discovery matters.

Settlement negotiations began in early 1984, and collapsed on several occasions. The litigation proceeded unaffected by the settlement negotiations. The settlement was reached after months of extensive negotiations and on the eve of trial. Under the terms of the settlement agreement, discovery and trial preparation have continued. The agreement in effect provides that if the conditions of the settlement, including receipt of favorable tax rulings, are not satisfied, the settlement will terminate, and additional discovery, trial preparation, and a trial requiring up to several months of court time, will resume promptly.

During the settlement negotiations, in addition to the issues listed above, issues arose as to the interpretation of the term "issue" in the trust instrument; the source of payment of fees and expenses arising from the current litigation; the permissible discovery after settlement; the resolution of other pending litigation; the composition of trusteeships and related matters; the requirement of notice to remote contingent beneficiaries of the successor trusts; the grant of releases and indemnification; the settlement of trust accountings; and a variety of matters relating to trust administration.

All issues involved in the litigation, except those that have become moot by occurrence of subsequent events, and certain matters discussed below relating to fees, are resolved by the proposed settlement.

In its order, the superior court made a general finding that it had jurisdiction to partition the trust and to approve the other terms of the settlement agreement under both Section 1138 of the California Probate Code, and in the exercise of its general equitable powers, including its powers to approve settlement of the pending litigation. It further found that the settlement was in the best interests of the trust and its beneficiaries in that it would:

1. settle the pending litigation, including pending and possible appeals, and stop the expenditure of large sums of money in connection with the litigation;

2. bring harmony to the family and minimize the likelihood of further family litigation in the future, arising from the members'

   diverse interests, and from ambiguities, uncertainties and omissions in the trust instrument;

3. provide clear provisions for the appointment and succession of trustees;

4. resolve ambiguities and uncertainties in the trust instrument, including which lawful issue are entitled to income and to whom income is paid if all lawful issue in a family are deceased, the proper allocation of charges for capital gain taxes (including taxes arising from the sale of the Z Corporation stock), and other matters relating to trust administration; and

5. remove the investment restrictions imposed by the trust instrument, thereby providing, without delay, an opportunity for investments with a potential for principal growth.

In addition, in its order, the court found that good cause existed for approving the settlement and the partition. The court stated that it considered the position of the parties, the state of the litigation, the complexity of the issues presented, the time it would take to resolve them by continued litigation, and the settlement, the settlement agreement, the unconditional covenants and the recommendations. In particular the court found that:

1. the settlement, the settlement agreement, the unconditional covenants, and recommendations were entered into in good faith, are fair, just and reasonable to, and confer substantial benefits upon, all the beneficiaries of the trust, and are in the best interests of all parties;

2. the settlement resolves by compromise bona fide existing disputes among the parties in the pending litigation;

3. counsel for the parties negotiated at arm's length and in good faith in reaching the settlement embodied in the settlement agreement, the unconditional covenants, and the recommendations;

4. good cause (within the meaning of California Probate Code Section 1138.1(a)(14)) exists for division of the trust;

5. the facts and circumstances leading up to and surrounding the proceedings have caused a lack of harmony among family members; division of the trust along family lines into separate family trusts will promote family harmony and reduce the likelihood of future family litigation over the trust; and

6. the settlement and partition of the trust will preserve the trust estate by minimizing future payments of legal fees and costs, <u>and facilitate the efficient administration of the trust</u>.

The specific provisions of the settlement agreement and court order approving it are summarized below.

<u>Partition of the trust</u>

The partition is to be made under section 1138.1(14) of the California Probate Code, which was enacted one day prior to the execution of the settlement agreement.

The corpus of the original trust will be partitioned into six successor family trusts: one-fourth to the <u>B</u> family trust for the benefit of <u>B</u> during his lifetime, and upon his death, for his lawful issue; one-fourth to the <u>C</u> family trust for the benefit of <u>C</u> during his lifetime, and upon his death, for his lawful issue; one-fourth to the <u>D</u> family trust for the benefit of the lawful issue of <u>D</u>; and one-fourth, divided equally into three separate trusts known as the <u>A</u> family trust 1, the <u>A</u> family trust 2, and the <u>A</u> family trust 3.

The income beneficiaries of the <u>A</u> family trust 1 will be <u>B</u> during his lifetime and, upon his death, his lawful issue; the income beneficiaries of the <u>A</u> family trust 2 will be <u>C</u> during his lifetime and, upon his death, his lawful issue; and the income

beneficiaries of the A family trust 3 will be the lawful issue of D. A's lawful issue will be the remainder beneficiaries of the three A family trusts. All of the successor trusts will terminate at the time the original trust would have terminated under the declaration of trust, that is, upon the death of the last to die of A, B, and C.

The partition of the trust is to occur as soon as practicable after the receipt of favorable tax rulings from the Service. The court indicated that in ordering the partition of the trust, it was construing the intention of the trustors under circumstances unforseeable to them. It stated that partition was not intended to alter in any substantive manner the trust instrument, as properly interpreted in the order and settlement agreement. The court characterized the partition of the trust as an administrative change, and indicated that partition resolved bona fide disputes among the parties about, among other matters, the proper trustees under the declaration of trust.

For the convenience of the administration of the successor trusts, prior to partition, the current trustee is ordered to purchase three nonrefundable, nontransferable commercial annuities from the income of the original trust: one that will pay $3,000 per year to A during his lifetime and, following his death, to his lawful issue; one that will pay $9,000 per year to B during his lifetime and, following his death, to his lawful issue; and one that will pay $9,000 per year to C during his lifetime and, following his death, to his lawful issue. The three annuities will terminate upon the death of the last to die of A, B, and C. Payments from the annuities will discharge the trustee's obligation to pay the fixed amounts of annual income provided for in the trust instrument.

Otherwise, except for certain provisions relating to trustees, the dispositive provisions of the original declaration of trust will govern the successor trusts. The beneficiaries of the successor trusts will be the beneficiaries of the original trust. Immediately after the partition, each beneficiary will have the same pro-rata portion of the trust income and corpus that he or she was entitled to prior to the partition. For example, D's children, as income beneficiaries, are currently collectively entitled to one-third of the income of the trust (after payment of the fixed annual amounts). After partition, they collectively would be entitled to all of the income of the D family trust, which will at the outset have a corpus equal to

one-fourth of the corpus of the original trust. D's children would also be entitled to all of the income of the A family trust 3, which will at the outset have a corpus equal to one-twelfth of the corpus of the original trust. Thus, immediately after partition, D's children will receive income produced by corpora equal to one-third of the corpus of the original trust. (This result disregards the impact of the payment of expenses related to the litigation from the successor trusts).

As another example, upon routine termination of the original trust, the lawful issue of A, as remainder beneficiaries, would receive one-fourth of the corpus. After the partition, A's lawful issue will receive at termination of the successor trusts the corpora of the A family trusts 1, 2 and 3, which, immediately after partition, will total one-fourth of the corpus of the original trust. A similar analysis applies for the other remainder beneficiaries, the lawful issue of B, C, and D. The amounts actually received by the beneficiaries will vary depending on the administration of the separate trusts by the various trustees.

The successor trusts will be governed by the administrative provisions of the declaration of trust and will be subject to the interpretation of the declaration of trust contained in the court order.

Trustee compensation and appointment of successor trustees

The court found that the arrangements presented to it by the parties, including provisions governing the appointment and removal of the trustees, their voting rights and compensation, and other administrative matters for the trusteeships of the separate family trusts will result in the trustworthy administration of each of the trusts, and that each person nominated as a trustee is worthy and competent to serve as trustee.

The order provides for the appointment and removal of trustees, trustee voting rights, and trustee compensation. The court order interprets the trust instrument as entitling the trustees of each successor trust to receive in the aggregate fees for their usual or ordinary duties of five percent of the annual distributed and undistributed gross income of the successor trust, including income earned on income. It further interprets the original trust instrument as empowering each trustee to waive, forever or from time to time, all or any part of his or her share of trustees fees, and of his or her share of any fees for unusual or extraordinary services to which the trustees may be entitled.

Under the order, C will resign as trustee immediately prior to the partition of the trust. Initial successor trustees will be appointed pursuant to the provisions of the order. Nothing will preclude C or any other income beneficiary or remainder beneficiary of the successor trusts from serving as a successor trustee, except that neither A nor any of his lawful issue are permitted to serve as a trustee of any of the A family trusts while any case brought by them challenging the terms of the original declaration of trust is pending.

The A family trusts 1, 2, and 3, will each have two trustee positions. One position will have two votes. The trustee filling this position will be appointed by and subject to removal by the income beneficiaries of that trust acting as a group by vote of a majority in interest. In the case of the A family trusts 2 and 3, but not the A family trust 1, this trustee position must be filled by an institutional trustee. The other trustee position will have one vote and will be appointed by majority vote of A and his lawful issue (except as noted below). Any number of persons can be appointed to serve as co-trustees at any one time in this trustee position. The trustees will act by majority vote of the trustee positions, except in votes regarding investment advisors, who will be appointed by the unanimous vote of the trustee positions. The five percent trustees' fee for ordinary and usual duties will be allocated one percent to the trustee position having two votes, and four percent to the trustee position having one vote. By letter dated April 8, 1986 from the A family trust representative it was indicated that the institutional trustee (the trustee with the two votes, described above) will also receive an additional amount, up to one percent of gross income, but payable out of corpus, and possibly additional amounts such as for "investment management and investment advisor services and initiating investment recommendations, tax services and performance measurement services." As to the effect of this arrangement, see the discussion at page 31 of this memorandum.

As noted above, while the pending lawsuit involving a challenge to the terms of the original trust by the A family, or any other suit to which such person is a plaintiff party which challenges or seeks to alter the dispositive provisions of the original trust instrument or any provision of the settlement agreement or court order, neither A nor any of his issue may serve as or appoint a trustee of the A family trust 1, 2, or 3. Instead, an institutional trustee satisfactory to A and his issue and to the current income beneficiaries shall be appointed to

serve during such period, and shall be entitled to receive a reasonable negotiated trustees' fee. If the trustees' fee payable to the institutional trustee for usual or ordinary services is less than four percent for trust 1 but less than five percent for trusts 2 and 3 of annual trust gross income, the balance of the four percent or five percent remaining trustees' fee shall not be paid.

The B family trust will have four trustees. Three trustees, having one vote each, will be appointed by B. The remaining trustee position, which will have two votes, will be an S corporation owned by the lawful issue of B. B agrees to serve without fee. B is authorized to delegate an individual who is not a trustee to act on his behalf with respect to all trust matters. B will pay the compensation of the special advisor. Trustees appointed by B will receive reasonable negotiated fees payable from the five percent trustees' fee for ordinary or usual duties. B's two initial appointees each will be paid an annual fee of $250,000, which will be adjusted after two years to reflect annual cost of living increases. The balance of the five percent trustees' fee will be paid to the S corporation trustee owned by the lawful issue of B. Additional annual payments of $50,000 for extraordinary and unusual services will be paid to B's appointees for two years, and $300,000 for extraordinary and unusual services will be paid to the S corporation trustee annually from corpus. The $300,000 paid to the S corporation will be adjusted to reflect annual cost of living increases. In addition, to the above amounts, the S corporation will also receive compensation for services on behalf of the trust that the trustees, in their discretion, direct it to perform. This compensation can be paid from trust income or trust corpus. Reasonable expenses of a trustee are chargeable to the trust, and are not payable out of the trustees' compensation.

C will serve as a trustee of the C family trust until his death or resignation. The trustees will act by majority vote, and C's trustee position will have a controlling vote. If C dies before his eldest child reaches age thirty, his trustee position will be filled by a successor trustee. This successor trustee position will terminate, however, when his eldest child attains the age of thirty years. C retains the right to resign and to appoint and remove successor trustees and/or any number of co-trustees to hold his trustee position.

There will also be a trustee position for each lawful child of C. Any number of persons can be appointed to serve as co-trustes at any one time in each of these trustee positions.

The trustee or co-trustees of each trustee position for adult lawful children will be appointed by the adult lawful child for whom the trustee position is established. Provision is also made for the appointment of trustees to positions created for the minor lawful children of C, until each child reaches majority. Trustee's fees will be shared equally among the trustee positions, subject to deferral of fees payable to each child prior to age twenty-five, or graduation from an educational institution approved by C.

In the event of a timely and effective written waiver of any portion of the trustees' fee by the trustee or co-trustee of any trustee position, the portion of the fee so waived shall be shared equally by each of the other trustees of such trustee position or if all of the trustees of the trustee position waive such portion of the trustees' fee, then it shall be shared equally by each of the other trustee positions. If the payment of any trustees' fee payable to C's issue is deferred, the deferred fees, together with interest accrued on them, shall be paid in a single payment in the year following the year in which he or she attains age thirty years. (The fees may be further deferred by election of the issue.)

The D family trust will have one trustee position for each current income beneficiary. Each trustee position will have voting power equal to the proportionate interest in trust income of the current income beneficiary represented by such trustee position and the trustees will act by majority vote. The trustees' fee will be five percent of annual gross income of the trust, and will be shared equally among the trustee positions unless the trustees agree otherwise.

For each trustee position in the successor trusts, the unrestricted power to remove the trustee and to appoint another trustee, or any number of co-trustees, is given to the beneficiary or beneficiaries originally entitled to serve in, or to appoint to, that position.

All successor family trusts except the B family trust provide an alternate payment method reallocating trustees' fees to account for the burden of any additional individual tax liabilities that may result from the trustees' fee arrangement in each trust. The B family members have agreed that if there is a redetermination of the amount of trustees' fees allocable to the trustees of the B family trust, the trustees' fee provision would be redrafted to provide an alternative method of compensating the trustees.

The Order requires that certain of the Family Trusts retain professional investment advisors. (Paul Family Trust, paragraph 5(b)(ii)(5), p. 38; George Family Trust, Paragraph 5(b)(iii)(4), p. 45; Ronald Family Trusts B and C, Paragraph 5(b)(v)(5) p. 56, and Paragraph 5(b)(vi)(5), p. 61.) Further, the Order interprets Article III of the Declaration of Trust as authorizing the trustees of the several family trusts to charge the fees incurred for investment advice to either principal or income. (Paragraph 5(f), p. 64.) By implication, therefore, the Order does not require that the fees incurred for investment adivce be paid from amounts authorized as compensation to the trustees.

Allocation of capital gain taxes and trust expenses

The court order states that the order and settlement agreement take into consideration the entire compromise and settlement and reflect a compromise and settlement of a bona fide dispute in the pending litigation, as to whether, by proper interpretation of Article III of the declaration of trust, the capital gain tax arising from the sale of the Z Corporation stock should be paid from income, or principal, or partly from both, and whether there should be equitable adjustment.

Under the order, the capital gain tax arising from the sale of Z Corporation stock will be allocated both to income and to corpus. The $1.144 billion in capital gain tax was paid from corpus, but $300 million of this amount will be allocated to income. Beginning in 1986, an income reserve will be established. Up to $50 million per year will be charged to income and credited to corpus, provided that no amount will be charged to income or credited to corpus each year until the income beneficiaries have received $80 million of net income. Any remaining net income is to be paid to the income beneficiaries unless the annual charge has not been satisfied from net income in a prior year. Any shortfall in a charge to income in a prior year is to be paid from such remaining income. 1/ With the approval of the local

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1/ When the trust is partitioned into the successor trusts, the amounts to be charged to income and credited to corpus will be allocated pro rata among the successor trusts. For example, the first $20 million of net income earned by each of the B family trust, the C family trust, and the D family trust, and the first $6,666,667 of net income earned by each of the three A family trusts will be paid to the income beneficiaries. Up to $12.5
(footnote continued on next page)

court, the successor trustees may accelerate the annual charges to income, at a discount to be determined by the court. Income taxes payable on the amount that is charged to income and credited to corpus will be paid out of corpus. If the settlement agreement is terminated, amounts accumulated in the reserve will be paid to the income beneficiaries.

In addition, the order states that it interprets Article III of the declaration of trust. The order indicates that the declaration of trust gives the family trustees discretion to charge expenses and taxes to income or to corpus, or partly to each. In the future, it will not be an abuse of discretion for the trustees to charge capital gain taxes against the capital gain giving rise to the tax. However, no equitable adjustments between income and corpus will be permitted as a result of any actions of the trustee prior to partition of the trust.

The order provides that legal fees and expenses incurred by remainder beneficiaries, if approved for reimbursement and payment by the court, will be allocated to the corpus of the successor trust of which the person or persons on whose behalf such expenses were incurred is a remainder beneficiary, provided, however, that with respect to compensation and costs requested by certain guardians ad litem and their attorneys, the court, if it allows them, may determine, after partition, the successor trust, or successor trusts, from which they are to be paid. Legal fees and expenses incurred by income beneficiaries, if approved for reimbursement and payment by the court, will be allocated to the income of the successor trust of which the persons on whose behalf such expenses were incurred is an income beneficiary. All other expenses, including the original trustee's attorneys' fees, will be paid by the trustee, who will submit an accounting to the court for its approval.

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million of net income earned by each of the B family trust, the C family trust, and the D family trust, in excess of $20 million of net income, will be charged to income and credited to corpus. Up to $4,166,667 of net income earned by each of the three A family trusts in excess of $6,666,667 of net income will be charged to income and credited to corpus. If any successor trust has insufficient income for the annual charge to income in any year, and earns net income in excess of the income required to be distributed and the amount of the annual charge to income in any subsequent year, the shortfall in the early year is to be satisfied to the extent of the excess.

Deviation from investment restrictions

The order provides that to resolve disputes concerning the trustee's authority to sell the Z Corporation stock, the protection of the interests of the remainder beneficiaries, and whether the deviation is proper because of unanticipated circumstances, and to carry out the trustors' purposes and intentions, the court authorizes deviation from the investment restrictions imposed upon successor trustees by the declaration of trust.

The order removes the investment restrictions imposed by the original trust on successor trustees. It states that this is in the best interests of all parties in that it will ". . . provide without delay, an opportunity for investments with a potential for principal growth. The assets of the separate family trusts shall be invested and reinvested with due regard for the respective interests of the income beneficiaries and the remainder beneficiaries." Further, the order finds that:

> This [o]rder and the [s]ettlement [a]greement reflect a compromise and settlement of a bona fide dispute in the [p]ending [l]itigation as to whether the trustee was authorized to sell the stock of [Z Corporation] and whether such deviation should be ordered, among other reasons, because changed economic and other circumstances required such deviation in order to carry out the purposes of the [d]eclaration of [t]rust.

Under the order, the trustees of each successor trust will have the power and authority to invest and reinvest trust assets as they deem proper in their discretion, subject only to the provisions of the trust instrument (other than the reinvestment restrictions) and applicable law, including California Civil Code Section 2261 or its successor provisions. The cited statute recites the obligations of trustees with respect to trust property (a prudent person standard).

Lawful issue

To resolve ambiguities as to which lawful issue are entitled to income and to whom income is paid if all lawful issue in a family are deceased, the order interprets the declaration of trust so that, in substance, the lawful issue living from time to time of Y's sons (excluding the lawful issue of A) will be entitled to receive the net income of the respective successor trusts by right of representation and per stirpes and not per capita.

Other provisions of the settlement

The settlement and order contain other provisions, including that all net income will be paid directly to the life beneficiaries and the trustees will not, in his discretion, be able to apply portions of the net income for the proper care, maintenance, support, or education of the life beneficiary. There are also provisions relating to the continuation of discovery in preparation for trial in case the settlement terminates, the termination of the litigation, the mutual release of all claims relating to the litigation and arising out of the administration of the trust (except for claims relating to the fees of certain attorneys and guardians ad litem), the final accounting of the trustee, and other, transitional matters.

LAW AND ANALYSIS

The tax consequences of a transaction are determined by its substance and not its form. The form utilized by the court approved settlement agreement is a state law partition of the Sarah C. Getty Trust into six trusts, each being a continuation of a fraction of the original trust. This characterization of the transaction is suspect for a number of reasons. First, all the parties benefit taxwise, therefore no one has the impetus to characterize the transaction according to its substance, which may be different from the settlement agreement characterization. Second, the family was apparently instrumental in getting the state law passed that empowered the Superior Court to partition the trust. Third, the settlement agreement creates six different taxable entities. Fourth, some beneficiaries of the family trusts will acquire the authority to appoint trustees that neither the Superior Court nor the original trust instrument could provide. Fifth, the transaction is not considered a partition by the Service. Finally, if the substance of the transaction is a termination of the original trust, a distribution of the trust estate to current beneficiaries, and the creation of new trusts by those beneficiaries, there would be no difference in the practical and economic consequences except for taxes.

Generally speaking, arms length transactions between taxpayers are seldom vulnerable to substance-over-form attacks because they usually involve taxpayers with divergent or conflicting tax interests. While one taxpayer will benefit from one characterization, the other may not, thereby assuring to some degree that the

taxpayers' characterization of the transaction is consistent with its substance. CC:I:Br3 and CC:IND have concluded that the transaction characterized by the settlement agreement is at arms length, but there appears to be a lack of conflicting tax interests since everyone benefits from a tax standpoint. The parties will not realize gain or be considered the owners of any portion of a Family Trust. Without any conflicting tax interests, the taxpayers have no impetus to resist disguising the substance of the transaction, which for tax purposes may be something other than the settlement agreement characterization.

The California statute that authorized the partition of the original trust is apparently an example of private legislation, probably engineered by the Getty attorneys, in order to add credibility to the characterization of the trust's modification as a mere partition. Most states allow the modification of the administrative provisions of a trust when an emergency unforeseen by the settlor occurs and without the modification the settlor's primary intention would be frustrated. A. W. Scott, The Law of Trusts, § 167 (3rd ed. 1967). The California statute, which passed that state's legislature as an emergency law and became law one day before the execution of the settlement agreement, only requires the Superior Court to find good cause and to have the consent of all the beneficiaries in order to partition a trust.

The chief engineer of the legislation, Judge William Newsom, was a childhood friend of Gordon Getty and godfather to one of J. Paul Getty Jr.'s sons. According to Newson, attorney George Stevens told him that the entire Getty family was willing to have the trust divided. But, Gordon was fearful about going through with a division approved by the Superior Court because it might be overturned on appeal for the court having exceeded its authority. If that were to happen, Gordon believed he would be found liable for breaching his fiduciary duties. Conversation with Judge Newson, October 31, 1985. Judge Newson contacted California State Senator Bill Lockyer and told him the Getty family wanted to divide the trust but there existed a concern over whether the Superior Court had such authority; therefore, legislation would be needed to authorize the trust's division. Conversation with Greg Schmidt of Sen. Lockyer's Staff, October 24, 1985. Judge Newsom provided Lockyer's Judiciary Committee and the Senate Rules Committee with

rationales for the legislation. 1/ Senate Judiciary and Senate Rules Committees' Reports on S.B. 596. Newsom's key reason was that the California Law Revision Commission would introduce an identical provision in a year or two, but this would be too late to effect several cases that were then being held up because of the question of the Superior Court's authority to divide trusts under the circumstances of those cases. Senate Judiciary Committee Report on S.B. 596 at 4. Newson argued to the committees that it made sense to clear up any question about the court's authority immediately, rather than wait for the Law Revision Commission's proposal. Id.

The problem with Newsom's key rationale is that his representation of the Law Revision Commission's proposal as being nearly identical to the legislation proposed by Sen. Lockyer is not exactly accurate. The Law Revision Commission's proposal has a tougher standard. It requires good cause and the court must find that dividing the trust will not defeat or substantially impair the accomplishment of the trust's purpose or the interests of the beneficiaries, the consent of all the beneficiaries is irrelevant. California Law Revision Commission Recommendation, The Trust Law, December 1985. Under the commission's proposal, which may be changed by the legislature to conform with the majority rule of modification, above at page 21, the settlor's intent is crucial. Under Newsom's provision, there is no mention of the settlor's intent. Thus, the Newsom legislation gave the Superior Court the authority to partition the Sarah C. Getty Trust without any consideration of J. Paul Getty's intent. Under the Law Revision Commission's proposal and the majority state rule for modifying a trust, the partition of the original trust probably would not be allowed as being inconsistent with J. Paul Getty's intent.

The willingness of the California legislature to the bidding of the Getty family enables the taxpayers to appear as the fortunate beneficiaries of a legitimate state law that, in effect, provides a disguise for what in reality is a group of private individuals, characterizing a transaction in order to conceal its real nature. If the Service is not bound by a taxpayer's

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1/ Sen. Lockyer would have dropped the legislation if any publicity had come out about it prior to its enactment. Conversation with Judge Newson, October 31, 1985.

characterization of a transaction, it should not be bound by a legislative characterization when a taxpayer has used his influence to get such legislation passed.

Federal authorities, including the Service, are not bound by a state trial court's decree that effects the application of the federal revenue acts. Commissioner of Internal Revenue v. Bosch, 387 U.S. 456 (1967) (the Supreme Court upheld a federal appeals court's interpretation of a decedent's will over a state trial court's interpretation because the interpretation effected the size of the marital deduction allowed under the revenue acts). The Superior Court's decree approving the settlement agreement considers the Family Trusts as continuations of the original trust. Typed copy of the Superior Court of California's Order at 10-11. Yet, when the settlement agreement takes effect, the original trust will no longer legally exist; it will have been replaced by six different and independent tax entities. The six new trusts will be taxed and administered separately and the trustees of each will not be accountable to members of the other Getty families who have no interest in a trustee's trust. Id. at 66. Even if the original trust is considered to continue, the Family Trusts cannot simultaneously be part of the original trust as well as separate and independent entities, at least according to common sense. In any event, under Bosch, the Service is not bound by the Superior Court's stamp of approval of the settlement agreement's characterization of the transaction because, as discussed below, such a characterization effects the application of the grantor-owner and disposition of property sections of the Code.

Beneficiaries of a trust have the authority to appoint trustees when an express provision of the trust instrument provides so. G. G. Bogert & G. T. Bogert, Trusts and Trustees, §532 (2nd ed. 1983). If there is no express provision, the power to appoint will not be found by implication. 3/ Id. When there

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3/ Some Service attorneys may argue that because J. Paul Getty appointed a beneficiary, Gordon Getty, as a successor trustee, this implies that J. Paul Getty and his mother intended other beneficiaries to serve as trustees. As indicated in the text, it is unlikely that any state court would find such an implication.

is no express provision in a trust instrument for the appointment of successor trustees, all vacancies will be filled by the court. Id. A state court will not delegate its authority to appoint trustees to new appointees, that is, a court will not authorize trustees it has appointed to in turn appoint their successors. J. W. Perry, Law of Trust & Trustees, §496 (7th ed. 1929). Assuming, for argument sake, that the Family Trusts are a mere continuation of the Sarah C. Getty Trust, the Sarah Trust instrument has no provision for the appointment of successor trustees after the resignation of Gordon Getty. It does not grant any beneficiary, other than J. Paul Getty, the authority to appoint trustees. Only the appropriate state court, therfore, could fill the trustee positions of the Family Trusts or appoint the successor trustees for those positions. Under the settlement agreement, however, the court does not appoint the Family Trustees, rather certain beneficiaries will do the appointing. Since the original trust instrument does not grant any of these beneficiary the authority to appoint trustees and the Superior Court cannot delegate its authority to appoint trustees, there must be some other source that provides the beneficiaries with the appointment authority. The only other source of authority is a wholly new trust instrument, which means the Family Trusts are not a mere continuation of the original trust. If the original trust is considered terminated 4/

4/ When the purpose that the settlor sought to achieve through the trust has become impossible of accomplishment due to a change in circumstances, the courts will hold that the trust has terminated. G. G. Bogert & G. T. Bogert, Trusts and Trustees, §1002 (2nd ed. 1983); See Cal. Civ. Code. §871 (West 1985). In Getty v. Getty, 28 C.A. 3d 996; 105 Cal. Reptr. 259 (1972), the California Court of Appeal found that the purpose and intention of the settlors of the Sarah C. Getty Trust was to preserve the Getty Oil Company, and always to build up, consolidate and maintain control of it as a growth enterprise and never by any means to dissipate the family's control or any part of it. Once Gordon Getty sold the Getty Oil stock held by the trust, the family no longer controlled any part of the Getty Oil company. The purpose of the trust could no longer be accomplished; therefore, the trust automatically terminated. Cal. Civ. Code §871. Even if the taxpayer is correct in arguing that the trust did not terminate under state law, Conversation with Ed Davis and Richard Sideman, Nov. 5, 1985, we believe the Service's characterization of a transaction is not dependent upon the dictates of state law.

and the Family Trusts viewed as new entities that are created by the settlement agreement, which serves as a new trust instrument for each trust, then certain beneficiairies can possess the authority to appoint Trustees because it is granted to them by a trust instrument. Thus, the existence of the authority in certain beneficiaries to appoint trustees under the settlement agreement infers the transaction is, in substance, different from a mere partition and continuation in separate shares of the original trust.

Rev. Rul. 56-437 concerned the serverance of a joint tenancy in stock of a corporation, under a state partition action, which resulted in the issuance of two separate stock certificates, one to each of the former joint tenants. The transaction was held to be nontaxable because there was no sale or disposition of property. 5/ The transaction involved a mere separation of that which the joint tenants already owned. Rev. Rul. 70-401, 1970-2 CB 197, GCM 36276, I-509-73 (May 19, 1975).

In Rev. Rul. 79-44, 1979 CB 265, two unrelated individuals, A & B, respectively owned undivided one-half interests in two separate parcels of land as tenants in common. The two rearranged their interests so that each owned 100 percent of a separate parcel. The revenue ruling held that the transfer of interest by the tenants in common, which resulted in the conversion of two jointly owned parcels into individually owned parcels, was an exchange under section 1001(a).

5/ In the popular sense the word property is often used in reference to those things that are subject to the rights, which we call "ownership". In the strict legal sense, however, property means not the thing itself, but the rights that inhere in it. Ownwership is not a single indivisible concept but a collection or bundle of rights, of legally protected interests. Among the rights that comprise an interest are possession, enjoyment and alienation to the whole, an undivided fraction, or a severed part, for any length of time. One interest as compared to other interests, provides its holder with an additional or lesser right or rights. Interests differ because the rights comprising them differ. Any of these rights can have a significant impact on the holder's use of the object of ownership and a chnage in rights will result in a new or additional interest. Thus, a change in rights will be a material change because different interests are materially different.

We agreed with the holding of Rev. Rul. 79-44 in Laverne P. Corpstein, GCM 37714, I-203-78. Relying on Noble v. Beach, 21 Col. 2d 91, 130 P.2d 426, 430 (1943), the GCM distinguished between the partition of Rev. Rul. 56-437 and a disposition. In a partition, the co-onwers merely sever their joint interest, they do not acquire any new or additional interests as a result. GCM 37714 at 3. In a disposition, each taxpayer receives an interest that he did not have prior to the transaction. Id at 4. His interest before the transaction is materially different from the interest he holds afterwards. See, GCM 37714 at 3-4.

The assets of the Sarah C. Getty Trust will be turned into cash and distributed proportionally to the six Family Trusts in order to assure that the value of each beneficiary's interest 6/ remains the same. As started in footnote 5 at page 25, a property interest is not characterized solely by its value. It can differ

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6/ The Supreme Court held in Blair v. Commissioner of Internal Revenue, 300 U.S. 5 (1937) and Brown v. Fletcher, 235 U.S. 589 (1915) that a life interest in a trust is a present property interest. In Blair the taxpayer assigned to each of his children for their respective lives a portion of his life interest in a testamentary trust. The Court held the taxpayer was not taxable on the trust income received by his children as a result of the assignments because the taxpayer's life interest was alienable like any other property interest. In Brown a trustee and beneficiary were both citizens of New York; the beneficiary assigned his remainder interest to a citizen of Pennsylvania, who brought suit against the trustee for enforcement of the trust in a federal district court in New York. A federal statute provided that no district court shall have jurisdiction over any suit to recover upon any chose in action in favor of any assignee, unless such suit might have been prosecuted in such court if no assignment had been made. The Supreme Court unanimously held that the district court had jurisdiction because the assignment of the remainderman's interest was an assignment of a right, title and estate in and to an object of ownership and not a chose in action.

In Title Ins. & Trust Co. v. Duffill, 218 P. 14, the California Supreme Court also held that the income and remainder interests in a trust are property interests. In that case a husband made a gift to his wife of a portion of the property interest he would receive on his mother's death. The mother's

(footnote continued on next page)

materially from another interest depending upon the rights that comprise it. A new or additional right will materially change the nature of an interest, resulting in a new or additional interest with different economic benefits for the holder.

A bare declaration of trust will give a beneficiary the life and/or remainder beneficial interest that the settlor held. A settlor, however, can place restrictions or limitations on the beneficial interests conveyed, thereby giving the beneficiary an interest with less rights than the settlor had. Such restrictions or limitations are set out in the trust declaration or instrument. Since the Sarah C. Getty Trust assets will be distributed in cash, its fungibility will prevent any change in the beneficial interests, see GCM 37714 at 5, n. 3, unless the Family Trust provisions provide more or less beneficial rights in the assets than were provided under the original trust provisions.

Under the original trust, the following restrictions resulted in the beneficiaries getting less beneficial rights than the settlor had held.

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will created a testamentary trust with the husband as the life and remainder beneficiary. The husband argued that the only property he received, and therefore had to give his wife a portion of, was the income he received from the trust. The court disagreed and said he had a property interest in the corpus of the trust and a portion of this property interest had to be conveyed to his wife.

Where an object of ownership is given to a trustee to hold for the benefit of individuals for their lives with the remainder to their issue, the interests of the life and remainder beneficiaries are equitable, or beneficial, rather than legal interests. G.G. Bogert & G.T. Bogert, <u>Trusts and Trustees</u>, § 182 (2d ed. 1983).

The income and remainder beneficiaries in the Sarah C. Getty Trust hold equitable, i.e., beneficial interests that are property interests. <u>Blair</u>, 300 U.S. at 13; <u>Brown</u>, 235 U.S. at 599. [The beneficiaries, of course, also have rights in personam against the trustee. Bogert, <u>Trusts and Trustees</u>, § 183 (2d ed. 1983)]

~~(footnote continued on next page)~~
The property interests are vested in the assets of the trust because when a trust is created the transaction is regarded in (footnote continued on next page)

1. If the Getty Oil Company stock is sold the corpus of the trust must be invested in interest bearing bonds or securities issued by and which are the direct obligations of the respective governments of the United States, Canada, Great Britain, Norway, Sweden, Denmark or Switzerland provided their credit standing remains at or above their 1935 level.

2. The trust's taxes are to be paid from the gross income of the trust estate and/or, if necessary, from the trust estate.

3. The trustee in his sole judgement and discretion can apply income to the use, proper care, maintenance, support or education of a life beneficiary rather than paying it directly to the life beneficiary.

Under the Family Trusts the restrictions are changed to the following:

1. The right to alienate corpus will no longer be strictly limited, thereby allowing beneficiaries to enjoy equitable interests in a variety of objects of ownership rather than just government bonds.

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part, as a grant to the beneficiary of the beneficiary interest portion of the settlor's complete legal interest. See Scott, The Nature of the Rights of Cestui Que Trust, 17 Col. Law Rev. 269. The beneficiary gets proprietary rights in the trust assets which equity treats the same law treats a complete legal interest. Id.

The trustee, on the other hand, only gets such estate or interest as is necessary to enable him to perform his duties. G.G. Bogert & G.T. Bogert, Handbook of the Law of Trusts, § 32 (5th ed. 1973).

Under Article II of the Sarah C. Getty trust declaration:

> The whole title, legal and equitable, in fee, to the trust estate, is and shall be vested in the trustee as such title in the trustee is necessary for the trustee's due execution of this trust.

(footnote continued on next page)

2. The right to pay taxes out of income or corpus will be within the sole discretion of the trustees, thereby giving the trustees a right as broad as that held by the settlors before they created the original trust. The beneficiaries stand to gain or loose depending upon how they, as trustees, exercise this discretion.

3. The income beneficiaries will have rights of possession and control of trust accounting income that are not defeasible by the trustee's authority to make income payments directly to others for their benefit.

So while the value of the beneficial interests under the original and Family Trusts will be equal, they will differ in nature because the beneficiaries of the Family Trust will have rights they did not previously hold under the original trust. These new or additional rights, and therefore new or additional interests, will give the Family Trust beneficiaries economic benefits not available under the original trust, and prevent the transaction from being considered a partition for tax purposes.

The sentence is consistent with California law that the trustee takes only such an estate in the trust corpus as is necessary to discharge his trust duties. Title Ins. & Trust Co. v. Duffill, 218 P. at 15. The Getty trustee(s), therefore, do not take a fee interest in the corpus, otherwise there would be no trust relationship as required under California law.

The second sentence of Article II states:

> The beneficiaries hereunder take no estate or interest therein and their interests hereunder are personal property only consisting of the right to enforce the due performance of this trust.

Assuming the intent of the settlor governs, the second sentence would seem to prevent the beneficiaries of the subject trust from holding property interests. However, the second sentence is nearly identical to a sentence in section 863 of the California Civil Code which states:

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Extrordinary services are services of a nature not usually required of a trustee and for which he would have a right to employ another person. Baydrop v. Second Nat. Bank, 180 A. 469, 471. Extraordinary means an occurence of a kind other than what normal experience or prudence would foresee. The $300,000 to be paid the S corporation trustee of the Paul Trust for allegedly extraordinary trustee services will be adjusted each year in accordance with the cost of living index. That means the value of the extraordinary services will remain constant from year to year, always equalying 300,000 in 1986 dollars. When a trustee performs certain services that add up to the same value each year, these services are routine and not extraordinary. Otherwise, the dollar value would not be constant from year to year and the exact value for anyone year would be impossible to predict. In addition, the extraordinary services described in the taxpayer's letter of March 6, 1986, appear to be ordinary or usual.

Because the $300,000 is not a payment for extraordinary trustee services and the S corporation is already being compensated for its ordinary trustee services out of the five percent fee, the $300,000 is probably an interest in the trust. Since it is automatically paid each year from the trust's corpus, it probably constitutes a reversionary interest in the corpus. The $300,000

> The beneficiaries take no estate or interest in the corpus but may enforce the performance of the trust.

The proper construction of the above sentence is that it refers to the bare legal interests and estates as distinguished from equitable interests and estates. Lynch v. Cunningham, 21 P.2d 154, 157 (Cal. Dist. Ct. App. 1933). Thus the settlors of the original trust probably intended to incorporate the meaning of the above sentence of § 863 of the Civil Code into the trust instrument, rather than prevent the beneficiaries from holding equitable interests. In addition, in order for a person to create a trust he must comply with certain state laws. Since the settlors intended to create a trust, it is assumed they intended to comply with the state law requirements. One of which is that the trustee takes only such an estate as is necessary to carry out his duties. That estate is a bare legal estate that does not include the equitable estate, therefore the equitable estate must have vested in the beneficiaries.

will be distributed by the S corporation to its shareholders, the remaindermen of the Paul Trust. Under the original trust, none of the remaindermen hold a reversionary interest in corpus that will vest in possession before the death of the last surviving life beneficiary; therefore, the rights they will hold under the Paul Trust will be new or additional and the substance of the transaction will not be treated by the Service as a mere partition.

Subparagraph 5.b.ii.(4)(e) of the settlement agreement provides that the S Corporation may be compensated for necessary trustee services it performs. This compensation is in addition to the S Corporation's share of the five per cent gross income amount for usual or ordinary services and the $300,000 for alleged extraordinary services. We do not believe there is a distinction between necessary trustee services performed by a trustee and the ordinary or extraordinary trustee services it is necessary for a trustee to perform. Thus the compensation of subparagraph (e) appears to be an extra payment for the same services that the five per cent and $300,000 compensate for. Since this compensation is in addition to the allowable trustee fees, it cannot be a trustee fee. The extra compensation will be paid out of trust income or corpus, therefore it is probably an income or corpus interest. The trustees of the Paul Trust will have the authority to pay the extra compensation, and thereby have a power to invade a portion of corpus and to distribute a portion of income to the remaindermen-shareholders via the S corporation. None of the Paul Family trustees have the authority to invade corpus or distribute income under the original trust, therefore the rights they will hold under the Paul Trust are new or additional and the substance of the transaction will not be treated as a mere partition by the Service.

As stated previously, Article III (a) of the Declaration of Trust authorizes payment of trustee fees for usual or ordinary trustee duties in an amount equal to 5 percent of the annual gross income of the trust estate. The Order approving the Setttlement Agreement interprets the provisions of Article III to mean that the trustees of each Family Trust are entitled to receive, in the aggregate, fees for their usual or ordinary duties in an amount equal to 5 percent of the gross income of the trust estate. (Paragraph 5(a)(i), p. 24). However, the specific provisions of the (settlement agreement) concerning the aggregate amount of trustee fees to be paid to the trustees of the three Ronald Family Trusts appear to authorize trustee fees for ordinary or usual duties in an amount in excess of the 5 percent of gross income limit.

The Ronald Family Trust A permits the appointment of an institutional trustee to the trustee position to be filled by the current income beneficiary or beneficiaries. The Ronald Family Trust B and the Ronald Family Trust C require the appointment of an institutional trustee to the position to be filled by the current income beneficiary or beneficiaries.

For each of the Ronald Family Trusts, the settlement agreement directs that the institutional trustee appointed by the income beneficiaries is to be paid an amount equal to 1 percent of the gross income of the trust as a fee for ordinary and usual duties as trustee. In addition, such an institutional trustee may be paid additional compensation 7/ for certain discrete services. The trustee (trustees) to be appointed by Ronald and his issue (acting by majority vote) is (are) to receive an amount equal to 4 percent of the gross income of the trust for ordinary and usual duties as trustees. (Paragraph 5(b)(iv)(3), p. 48, Paragraph 5(b)(v)(3), p. 53, Paragraph 5(b)(vi)(3), p. 58). The prevailing practice of institutional trustees in California indicates that these discrete services 8/ appear to be ordinary and usual trustee duties. In addition, the taxpayer's letter of April 8, 1986, to Mr. Lyden acknowledged that at least some of the services are to be performed by the various institutional trustees in their capacities as trustees. As a result, the additional compensation appears to be for ordinary and usual duties as trustees. When this amount is added to the 4% fee to be paid to the trustee (trustees) to be appointed by Ronald and his issue and the 1% fee to be paid an institutional trustee, the aggregate fee for ordinary and usual duties as trustees will exceed 5 percent of gross income limitation set out in the court approved settlement agreement. Since the limit on usual or

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7/ While some attorneys for the Service may argue that since this additional compensation would only be about .003%, a paltry percentage by any man's standards, of the total corpus of all the Family Trusts, they dismiss as irrelevant the fact that the percentage could easily amount to $500,000, a substantial sum to all but the Department of Defense.

8/ The taxpayer has represented the discrete services as including investment management and advise, bookkeeping, custodial services, tax services, performance measurement services, etc.

ordinary trustee fees is five percent of gross income, any amount over it cannot be a trustee fee. 9/ As between an institutional trustee and the trustee(s) appointed by the Ronald Family, which will probably be the entire Ronald Family, the institutional trustee is more likely to perform the bulk of the trustee duties. Therefore, any excess over the five per cent fee limit should be considered as part of the four per cent fee paid to the trustee(s) appointed by the Ronald Family, rather than part of the fee paid to an institutional trustee. Since the excess is beyond the five per cent limit, it can not be a trustee fee. Because the entire four per cent fee will be paid from either income or corpus, the excessive portion of the four per cent fee, which is not a trustee fee, will probably be an income or corpus interest. Under the settlement agreement, the Ronald Family will have the power to appoint that income or corpus interest to anyone, therefore they will have a power to distribute a portion of trust income and invade a portion of corpus. Under the original trust, they are not vested with such powers, nor do any of them have a present possessary income interest or a present possessory corpus interest; therefore, some of the rights they will hold under the Family Trusts will be new or additional. As a result, the substance of the transaction will not be considered by the Service as a mere partition.

There is no limit under the settlement agreement to the number of trustees that each Family Trust can have because the beneficiaries with the power to appoint trustees can appoint multiple co-trustees. These beneficiaries, however, will probably control the number of trustees in accordance with each family's reproductive rate. Such a multitude of trustees raises the suspicion that the settlement agreement's trustee provisions create a mechanism for providing remainderman with a current income or corpus interest in the disguise of trustee fees. If a recipient does not perform his proportionate share of trustee duties, then to that extent the fees he receives are not trustee

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9/ Some attorneys for the Service may argue that the Service can not recharacterize excessive fees to trustees because, to their knowledge, the Service has lost all the cases in which it recharacterized a corporate executive's excessive fee as other than salary. Strangely, despite the Service's continued failure over this issue, its revenue agents still routinely recharacterize excessive corporate executive fees during audits.

fees but probably a current income or corpus interest. Since certain beneficiaries have the power to appoint this income or corpus interest to any one, they have a power to distribute a portion of income or invade a portion of corpus. Under the original trust none of these beneficiaries are vested with such powers, therefore the rights they will hold under the Family Trusts will be new or additional, and the substance of the transaction will not be considered a mere partition by the Service.

If it is assumed that the Superior Court appoints the Family trustees itself, or is authorized to delegate the appointment power to others, then under California law the number of successor trustee that can be appointed appears to be the number of original trustees or less. Cal. Civil Code §2289. This section apparently limits the total number of trustees for any one Family Trust to the original number of trustees for the Sarah C. Getty Trust. 10/ There are no California cases defining the term "number of original trustees". In two cases, however, Central Savings Bank of Oakland, 257 P. 521 (Cal. 1922), cert. denied, 275 U.S. 571, and Sacremento Bank v. Murphy, 115 P. 232 (Cal. 1910), the courts refer to the original trustee as the person designated to serve at the beginning of the trust by the trust instrument. An inference can be drawn that if the trust instrument names one person to be the initial trustee, then the original number of trustees is one. Further support for this inference comes from a staff counsel to the Law Revision Commission who suggests that where one person is designated intially to serve as trustee then the original number of trustees is one. He, however, believes that in an emergency a California court can appoint more than the original number of trustees, such as where it is run by majority vote and because of an abstention the vote is dead locked, paralyzing the trust. There the courts can appoint one or two trustees to break the

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10/ The California Law Revision Commission has previously been presented with a proposal to replace section 2289 with the common law rule that a court can appoint any number of trustees that is conducive to the administration of the trust. The change was rejected by the Commission because it believed a cap should be kept on the number of trustees a court could appoint.

dead lock, but the courts are not authorized to appoint a "whole hunch" of successor trustees. 11/ Conversations with Stan G. Ulrich.

The trustee designated to serve intially was J. Paul Getty, one person, therefore the original number of trustees is one. If it is assumed that all the Family Trusts will be ineptly managed under one trustee, the court may have the authority to appoint additional trustees. The number, however, would probably be limited to one and at the most two. Any number over three are not trustees because the court does not have the authority to make such appointments and any amounts paid to those excessive "trustees" cannot be trustee fees because the recipients are not authorized trustees. Depending upon whether the amounts are paid from trust income or corpus, they will be an income or corpus interest. Under the court approved settlement agreement, some beneficiaries will have the power to appoint this income or corpus interest to anyone, they therefore have a power to distribute a portion of income and invade a portion of corpus. Under the original trust, these beneficiaries are not vested with such powers; therefore, they will hold rights under the Family Trusts that are new or additional and the substance of the transaction will not be considered by the Service as a mere partition.

It has been held that a trustee cannot normally engage the service of an investment counsel at the expense of the trust, 90 C.J.S. Trusts § 280 (1955), because investment counsel services are generally considered part of a fiduciary's duties. See _In Re Gutman's Estate_, 14 N.Y.S. 2d 473, 474 (1937). A court, however, will look to the prevailing practice among trustees in a geographical area to determine if the general rule applies. See _Stillman v. Watkins_, 3 Mass. App. 175, 325 N.E. 2d 294, 295 (1975). If the prevailing practice indicates investment counsel services are among a trustee's duties, the courts will not allow the trust to be charged for the investment services even where the trustee is not competent in financial matters. To hold otherwise would open the doors to a potential abuse where trustees

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11/ Some attorneys for the Service may argue that if the trust instrument provides for the appointment of an unlimited number of successor trustees, then the original number of trustees is unlimited. The words original and successor are not synonymous.

would collect their full fees but not render a full range of services. If a trustee could pay an investment advisor out of the trust estate, the trust would in effect be paying twice for investment services.

The settlement agreement requires that certain of the Family Trusts retain professional investment advisors. (Paul Family Trust, paragraph 5(b)(ii)(5), p.38; George Family Trust, Paragraph 5(b)(iii)(5), p.45; Ronald Family Trusts B and C, Paragraph 5(b)(v)(5) p. 56, and Paragraph 5(b)(vi)(5), p.61.) Further, the order interprets Article III of the Declaration of Trust as authorizing the trustees of the several family trusts to charge the fees incurred for investment ment advice to either principal or income. (Paragraph 5(f), p.64). By impliciation, therefore, the Order does not require that the fees incurred for investment advice be paid from amounts authorized as compensation to the trustees. But, the prevailing practice among trustees in California is to include investment counsel services among the ordinary or usual duties of a trustee 12/, meaning the fees for investment services should come out of a trustee's ordinary compensation. Investment advisor services for the Family Trusts therefore should be paid out of the five per cent fee that is allowed for a trustee's ordinary or usual services. However, the settlement agreement allows the Family trustees to receive the entire five percent amount and have the trusts pay the investment advisor fees. In effect the Family trustees are being paid for services they are required to render, or at least pay for, but are not. Thus, an amount of the five per cent paid to the Family trustees that equals the investment advisor fees is not compensation for trustee services but is an excessive fee. Since this excessive amount is paid from trust income or corpus, it is probably an income or corpus investment. Under the Family Trusts, those beneficiaries with the power to appoint trustees will have the power to pay them such excessive fees, which in effect is a

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12/ Some attorneys for the Service may argue that some of the individual trustees of the Family Trusts are not astute in financial matters and therefore investment advisory services should not be considered as part of their duties. The courts, however, disagree, saying that if one lacks the time, inclination or competence necessary to run the affairs of a trust, he should refrain from accepting his nomination or resign. In Matter of Grace, 308 N.Y.S. 2d 33 (1970).

power to distribute income and invade corpus to the extent of the fee. Under the original trust, these beneficiaries are not vested with such a power; therefore, the rights they will hold under the Family Trusts will be new or additional and the substance of the transaction will not be considered a mere partition by the Service.

The many new or additional rights that the beneficiaries will hold under the Family Trusts shows that the settlement agreement involves more than the mere severing of joint interests in the original trust. It therefore will not be considered a partition for tax purposes.

Another reason for suspecting the transaction involved in the settlement agreement is not in substance what the agreement represents it to be is that the practical and economic consequences of a partition and termination are, except for tax purposes, identical. A termination, as discussed below, has grantor and disposition tax implications while a partition does not. When a taxpayer selects one of several forms that have identical practical and economic consequences, except for taxes, the Service may disregard the chosen form and tax the transaction according to its substance. B.I. Bittker, Federal Taxation of Income, Estates and Gifts, §4.3.3 (1981).

The preceding part of this draft laid out a number of reasons for concluding that the transaction as described by the settlement agreement is not an accurate characterization for tax purposes.

By characterizing the transaction as a termination of the original trust, a distribution of the trust estate to current beneficiaries, and the creation of new trusts by those beneficiaries, the transaction takes on a realistic, rather than contrived nature. Not all beneficiaries will benefit taxwise; the private legislation that was passed to provide the taxpayers with a seemingly legitimate characterization of the transaction becomes irrelevant; six trusts will not be considered parts of one trust and yet be taxed as seaprate and independent entities; the power of some beneficiaries to appoint trustees will have a legal

source; a state's trial court's characterization will not control the application of the revenue acts; and the transaction will lose the taint of having been entered into for the purpose of tax avoidance.

Under the termination characterization, each beneficiary will constructively receive the present value of his interest in the original trust. Since the assets of the original trust will be liquidated, the distribution will be in cash. The beneficiary of each family will then place their respective cash amounts in trust for themselves and other members of their family. Because the beneficiaries will have control and dominion over the cash they constructively receive, they will be the grantors of their respective Family Trust.

Section 671 provides that where it is specified 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 this chapter in computing taxable income or credits against the tax of an individual. Any remaining portion of the trust shall be subject to subparts A through D.

While section 671 assumes the underlying valid existence of the trust as a dispositive entity under state law, it superimposes on that entity a brand of tax schizophrenia whereby the existing trust is fragmented into two portions: a grantor-owned portion and a remaining portion that will be imbued with the separate taxpayer status normally accorded trusts not tainted with excessive grantor involvement. An examination of the interests held by the grantor-beneficiaries of the Family Trusts will show them to be owners of portions of the trust under sections 673, 676 and 677. Section 671 will attribute the income deductions and credits of these portions to the grantor-beneficiaries.

Section 673 provides that the grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom if, as of the inception of that portion of the trust, the interest will or may reasonably be expected to take effect in possession or enjoyment within 10 years commencing with the date of the transfer of that portion of the trust.

Section 677(a)(2) provides that the grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be held or accumulated for future distribution to the grantor.

The $300,000 that will be paid to the S corporation of the Paul Trust for each year of the trust's existence is, as reasoned above at page 30, a corpus interest. All the corpus interests paid to the S corporation will be possessed or enjoyed by its shareholders because of the conduit nature of an S corporation. Since the shareholders will also be grantor-remaindermen of the Paul Trust, they in effect will hold multiple reversionary interests in the trust's corpus. Each year a reversionary interest of $300,000, adjusted for cost of living, will revert back to the grantor-remaindermen through the S corporation. During the first ten years of the Paul Trust, ten corpus interests will revert into possession or enjoyment of the grantor-remaindermen. They will, therefore, be considered the owners of the ten corpus portions under section 673 while the portions are still part of the trust. Under Treas. Reg. 1.671-3(b)(3) the grantor-remaindermen will be considered the owners of not only the corpus portions but the ordinary income and any other income attributable to those corpus portions. The grantor-remaindermen will be required to take into account in computing their income tax liability all items of income, deduction, and credit (including capital gains and losses) to which they would have been entitled had the trust not been in existence during the period they are treated as owners of portions of the corpus.

For the reversionary interests that vest in possession or enjoyment after ten years from the inception of the Paul Trust, the grantor-remaindermen will not be treated as owning ordinary income attributable to those corpus portions prior to their reverting back because section 673 will not apply. However, items of tax income allocable to a portion corpus either by the trust terms or by local law (such as capital gains) merge into the trust corpus and, by reason of the grantor-remaindermen reversionary interest, are accumulated for future distribution to them. They are therefore treated as owners of a corpus portion under section 677(a)(2) and will be taxed currently on items of gross income allocable to that corpus portion even though they will not actually receive any cash or other property from the corpus portion until it reverts.

Section 676 provides that the grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under any other provision of this part, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a non-adverse party, or both. This includes the power to revoke or return corpus to the grantor.

Section 677 provides in pertinent part that if the grantor has the power to distribute trust income to or for the benefit of the grantor, he is treated as owner of that portion of income.

The extra compensation paid to the S corporation of the Paul Trust, as reasoned above at page 31; the excessive fees paid to legitimate trustees, above at page 32; the fees that are not proportionate to the trustee services rendered, above at page 33; the fees paid to unauthorized trustees, above at page 34; and the investment advisor fees, above at page 35 are income or corpus interests depending upon whether they are paid from trust income or trust corpus. The beneficiaries who have the power to place anyone in a position to receive these dollar amounts in effect have an unrestricted power to invade a portion of the corpus and/or distribute a portion of the income. The powers are alternative and the portion of corpus or income over which they can be exercised is limited by the dollar amount involved. That is, in anyone year both powers can be exercised to pay the particular dollar amount or only one power can be used to pay all of it. Because the powers are alternative and limited to the particular dollar amounts, to the extent one is exercised in a given year, the other is cancelled to that extent. For example, if the total dollar amount is $500,000 and $300,000 is paid from ordinary income, then only $200,000 can be paid from corpus, an additional $300,000 from corpus cannot be paid. So the portion over which certain beneficiaries have an unrestricted power to invade corpus or distribute income depnds upon how these alternative powers are exercised in any one year. In the above example, if the beneficiary were to pay the remaining $200,000 from corpus, then for that year he had a power over a $300,000 portion of ordinary income and a power over a $200,000 portion of corpus. However, if a beneficiary fails to exercise either power, such that the total dollar amount that can be paid out is not paid out, the beneficiary will be considered to still hold a power to invade corpus and distribute income over the remaining dollar amount of the unpaid fee and the Service should be able to determine how much of the unpaid fee is attributable to an income or corpus interest. If the dollar amount has not been otherwise determined, the Service can calculate a reasonable amount and determine how much is attributable to an income or corpus interest.

Because the beneficiaries of the Family Trusts who hold such powers are grantors, sections 676 and 677 consider them owners of the corpus portion and ordinary income portion over which they hold these powers. To the extent a grantor-beneficiary holds power over a dollar amount of ordinary income he first takes into account a portion of those items of income and expense entering into the computation of ordinary income under the trust instrument or local law sufficient to produce income of the dollar amount required. There will then be attributable to him a pro rata portion of other items entering into the computation of distributable net income under subparts A through D, such as expenses allocable to corpus, and a pro rata portion of credits of the trust. Treas. Reg. 1.671-3(c). Where a grantor-beneficiary holds power over a portion of corpus, he includes both ordinary income and other income allocable to corpus in the portion he is treated as owning under section 676. Treas. Reg. 1.671-3(b)(3). When the power is over a dollar amount of corpus, the grantor-beneficiary will have to take into account a pro rata share of each item of income, deductions and credits (both ordinary income and tax corpus items) corresponding to the breadth of his power over corpus. The pro rata share is expressed as a fraction with the numerator the amount which is subject to the control of the grantor and the denominator the fare market value of the trust corpus at the beginning of the taxable year in question. Treas. Reg. 1.671-3(a)(3).

The remaining portion of each Family Trust that has a separate taxpayer status because it is not tainted with excessive grantor involvement will be the result of dispositions of beneficial interests among the grantors.

Section 1001(a) provides that the gain from the disposition of property shall be the excess of the amount realized over the adjusted basis and the loss shall be the excess of the adjusted basis over the amount realized.

Treas. Reg. 1.1001-1(a) provides that gain or loss realized from the exchange of property for other property differing materially in extent is treated as income or loss sustained.

Section 1001(b) provides that the amount realized from the disposition of property shall be the fair market value of the property (other than money) received.

Treas. Reg. 1.1015-1(b) provides that property acquired by gift has a single or uniform basis although more than one person may acquire an interest in such property. The uniform basis remains fixed subject to proper adjustment for items under sections 1016 and 1017. These adjustments yield the adjusted uniform basis which is allocated between the life and remainder interests according to the actuarial tables in Treas. Reg. 20.2031-7 or 20.2031-10. However, the value of the proportionate parts of the uniform basis represented, for instance, by the respective interests of the life tenant and remainderman vary to reflect the change in the relative values of such interests on account of lapse of time. The portion of the adjusted uniform basis attributable to an interest at the time of disposition shall be determined under section 1.1014-5.

Treas. Reg. 1.1014-5(a)(3) provides that the factors set forth in the tables contained in Treas. Reg. 20.2031-7 or 20.2031-10, whichever is applicable of the Estate Tax Regulations, shall be used in the manner provided therein in determining the adjusted uniform basis allocated to the life interest and remainder interest on the date such interest is disposed of. The basis of the life interest and remainder interest is computed by multiplying the adjusted uniform basis by the appropriate factor. In the case of the sale of a life interest or a remainder interest, the factor used is the factor (adjusted where appropriate) which appears in the life interest or the remainder interest column of the table opposite the age (on the date of disposition) of the person at whose death the life interest will terminate.

Section 1001(e) provides that in determining gain or loss from the disposition of a term interest in property that portion of the adjusted uniform basis of such interest which is determined pursuant to sections 1014 or 1015 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded. When the uniform basis allocated to the life interest is disregarded, it alters the adjusted uniform basis of the life interest by that amount. 13/

13/ If the uniform basis allocated to the life interest is subtracted from the adjusted uniform basis of the life interest and the result is a positive number, then that amount is considered the basis which is recovered tax free on a disposition of the life interest. If the result is a negative number or zero, the life interest is consiered as having no basis to recover.

Section 1001(c) provides that the entire amount of gain or loss on the exchange of property shall be recognized unless otherwise provided in subtitle A of the Internal Revenue Code of 1954.

Section 1031(a) provides that no gain or loss shall be recognized on the exchange of property held for investment (or other purposes not applicable here) if such property is exchanged solely for property of like kind which is to be held for investment (or other purposes not applicable here). Subsection (a) shall not apply to any exchange of beneficial interests (and other rights not applicable here).

Upon termination of the Sarah C. Getty Trsut, its beneficiaries constructively receive cash equal to the present value of the interests they held in the trust. When these amounts are placed in trust for the members of the respective family, there is a disposition of beneficial interests between the grantors. For example, assume one Family has a life beneficiary and two remaindermen, A and B, under the original trust and the cash distribution will be $600 million to the life beneficiary and $80 million to each of the remaindermen. When these three place their cash amounts in trust, the legal title to the life beneficiary's $600 million will vest in the trustee(s), the beneficial income interest remains in the life beneficiary, and the beneficial remainder interest vests in the two remainder men as joint owners; the legal title to remainderman A's $80 million will vest in the trustee(s), the beneficial income interest will vest in the life beneficiary, and the two remaindermen will become joint owners of the beneficial remainder interest; the same is true for remainderman B's $80 million. The life beneficiary, who before the trust's creation held the $600 million in fee, afterwards will have a beneficial income interest in $760 million, whereas the two remaindermen, who each held $80 million in fee before the trust was created, afterward, will have an undivided fractional beneficial remainder interest in $760 million. Dispositions have occurred because new or additional beneficial interests have been acquired by each grantor-beneficiary as a result of transfers of beneficial interests in return for other beneficial interests. Laverne P. Corpstein, GCM 37714 at 3.

To summarize, when the life beneficiary places his cash distributions in trust, he transfers the beneficial remainder interest from his portion of the contributed corpus to the two remaindermen in return for a beneficial income interest from the corpus contributed by the remainderman. Each remainderman

transfers the beneficial income interest from his portion of the contributed corpus in return for an undivided fractional beneficial remainder interest in the corpus contributed by the life beneficiary. Each remainderman also transfers an undivided fractional beneficial remainder interest in the portion of the corpus he contributed in return for an undivided fractional beneficial remainder interest in the corpus contributed by the other remaindermen.

Because the transferred life and remainder interests are beneficial interests, any gain or loss on the dispositions will be recognized. Section 1031(a)(2). The taxable gain or deductible loss realized from the dispositions of the remainder interests is the difference between the fair market value of the interest received and the portion of the adjusted uniform basis allocated to the interest transferred. In determining the gain or loss on the dispositions of the income interests, that portion of the allocated adjusted uniform basis as determined under sections 1015 / 1014 is disregarded.

The fair market value of the remainder or life interest is the value of that portion of the corpus the beneficial interest is attributable to at the time of the disposition multiplied by the respective fractional value prescribed by the appropriate actuarial tables. Treas. Reg. 20.2031-7(e).

The gain realized on the disposition of the income interests will be taxed as ordinary income because it is not a capital asset. Section 1221 defines a capital asset as "property held by the taxpayer (whether or not connected with his trade of busienss)," but not including five particular categories of property not relevant here. However, the concept of a "capital asset" is not an expansive one.

> "(I)t is evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset. This Court has long held that the term 'capital asset' is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year." <u>Commissioner of Internal Revenue v. Gillette Motor Transport, Inc.</u>, 364 U.S. 130, 134, 80 S.Ct. 1497, 1500 (1960).

The income interest does not involve the appreciation of property which was held over a long period of time in a risk situation. United States v. Midland Ross Corp., 381 U.S. 54, 57, 85 S.Ct. 1308, 14 L.Ed.2d 214 (1965); Lowndes v. United States, 384 F.2d 635 (4th Cir. 1967). And, In the subject case, there is no threat of an inordiantely large and burdensome tax being levied on accumulated gain. In Commissioner of Internal Revenue v. P.G. Lake, 356 U.S 260, 266, the Supreme court said:

> "the substance of what was assigned was the right to receive future income. The substance of what was received was the present value of income which the recipient would otherwise obtain in the future. In short, consideration was paid for the right to receive future income, not for an increase in the value of income-producing property."

In Rev. Rul. 72-243, 1972-1 CB 233, the Service acquiesed to the holding in Beulah Eaton Mc Allister v. Comms'r, 157 F2d 235 (2d Cir. 1946), there the taxpayer sold for a lump sum her testamentary trust life interest to the remainderman thereby terminating the trust via merger. The court held the life interest was a capital asset, allowing the taxpayer a capital loss for the year. McAllister is distinguishable from the subject case because after the sale of the life interest in McAllister the remainderman held the entire interest in the terminated trusts assets. Any income from the terminated trust's assets would be taxed to the former remainderman because he now held a fee interest in the assets. The remaindermen of the Family Trusts do not convey their entire interests to the life beneficiaries, giving them a fee interest. Thus, unlike in McAllister, potential tax abuse situations exist if the income interest is treated as a capital asset. The life beneficiaries who acquire income interests from the remaindermen are entitled to offset the ordinary income attributable to that interest by an amortization deduction based on the value of the present income interest. (When the life beneficiary receives the income interest, its present value will be included in his gross income but he will be able to deduct the amount of his adjusted uniform basis in the remainder interest he conveyed. The amount left after he deducts out his basis will be capital gains for which he is taxed.) If a remainderman is able to treat his gain from disposing of an income interest as a capital gain, then ordinary income will be converted into capital gains. Such a potential tax abuse did not exist in McAllister and can be avoided

in the subject case by holding that the income interests transferred are not capital assets. In summary, the value that the remainderman receives for transferring his income interests will not be reduced by a basis recovery and will be taxed in its entirety as ordinary income.

The disposition of the remainder interests between the remaindermen will be a disposition of capital assets. And, any gain that results will be taxed as capital gain after a remainderman deducts his basis in the remainder interest conveyed to the other remainderman.

To illustrate, consider the example where there is one life beneficiary who contributed $600 million to the corpus and two remaindermen who each contributed $80 million. The measuring life is a person who is fifty four years old. Each remainderman disposes of his income interest in $80 million of corpus in return for an undivided one-half remainder interest in $600 million of corpus contributed by the life beneficiary. Under Treas. Reg. 1.1014-5, the basis of the income interest in the $80 million portion of corpus is approximately $65 million, assuming there are no section 1016 or 1017 adjustments to the uniform basis. The value of an undivided one-half remainder interest in a $600 million portion of corpus is approximately $57 million. Normally, tax consequences from a disposition depend upon the gain or loss realized as determined by the value received minus the value transferred. Here that formula would result in a loss of $8 million, however, section 1001(e) requires that the basis of the income interest be disregarded; therefore, there is actually a gain of $57 million to the remainderman and that gain is taxed as ordinary income.

The gain or loss realized by the life beneficiary on disposing of his remainder interest in return for an income interest would be the value of the income interest in an $80 million portion of corpus, $65 million, minus the basis in an undivided one-half remainder interest in a $600 million portion of corpus, $57 million, assuming no section 1016 or 1017 adjustments. The life beneficiary will realize a capital gain of $8 million. As the life beneficiary receives payments from the income interest, he will be able to amortize his $65 million basis in that interest.

The disposition between the remaindermen has each of them transferring and receiving an undivided one-half remainder interest in an $80 million portion of corpus. The value of each interest

is approximately $7.5 million and the basis, assuming no section 1016 or 1017 adjustments, is the same; therefore, there is no gain or loss.

In summary, the taxable gain or deductible loss realized by a grantor-life beneficiary on the disposition of the remainder interest in the portion of the corpus he contributed is the difference between the fair market value of the income interest he receives and the adjusted uniform basis allocated to the remainder interest he transferred. Any gain or loss will be capital. The gain or loss from the disposition between the remaindermen will be a capital gain or loss, determined by the same formula. In determining the gain or loss for a grantor-remainderman, the same formula is used, except that a portion of the adjusted uniform basis allocated to the income interest transferred by the remainderman is disregarded and any gain or loss will be ordinary.

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