

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:4/PLR-129044-00
Date:

October 02, 2001

Attn:

In Re:

Legend:

- Husband -
- Wife -
- Daughter -
- Son -
- Trust #1 -
- Trust #2 -

- Trust #3 -

- Trustees -

- Date 1 -
- Date 2 -

Dear :

This is in reference to your letter dated November 21, 2000, and subsequent correspondence, requesting rulings regarding the effect of the proposed judicial construction of the trust instrument for federal generation-skipping transfer tax purposes.

Background

The facts submitted are as follows:

On Date 1, Husband and Wife (collectively, the Trustors) created and funded Trust #1, an irrevocable trust governed by the law of California, primarily for the benefit of Trustors and their issue. Trust #1 had three trustees, one of which was Husband.

Under the terms of Trust #1, during the joint lifetime of the Trustors, the net income and principal would be accumulated or distributed in the discretion of the

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trustees. During any time that Husband was serving as trustee, Husband would have the sole discretion to make distributions. Trust #1 provides that, upon the death of the first Trustor to die, after payment of debts, expenses, taxes, and any other charges, the corpus of Trust #1 would be divided into two separate shares, one share for the surviving Trustor to be held in trust (Survivor's Trust) and the other share for the remaining beneficiaries (Primary Beneficiaries share). Trust #1 further provides that the Primary Beneficiaries share be divided into two equal shares to be held in separate trusts: Trust #2 and Trust #3. The terms of Trust #2 and Trust #3 are substantially similar except that Trust #2 is to be held for the benefit of Daughter and her issue and Trust #3 is to be held for the benefit of Son and his issue.

Article 4.01.1 of Trust #1 provides that, after the death of the first Trustor to die, income of the Survivor's Trust is to be paid to the surviving Trustor, at that Trustor's request. The independent trustee may make discretionary distributions of principal from the Survivor's Trust, Trust #2 and Trust #3 to the surviving Trustor for that Trustor's reasonable care, maintenance and support. The surviving Trustor has a limited power during life to appoint the principal and undistributed income to that Trustor's living issue, the spouse of any issue, and any charity. The surviving Trustor also has a testamentary power to appoint the principal and undistributed income to anyone, including his or her estate.

Article 4.01.2(a) of Trust #1 provides that, after the death of the first Trustor to die and during the life of the surviving Trustor, the Independent Trustee may, in its discretion, pay the net income of Trust #2 and Trust #3 to or for the benefit of the Trustor's living issue who are the beneficiaries of Trust #2 and of Trust #3, respectively, for that beneficiary's proper care, maintenance, support and education after taking into consideration other resources available to that beneficiary. Likewise, Article 4.01.2(b) provides that the Independent Trustee may, in its discretion, make distributions of principal of Trust #2 and Trust #3 to or for the proper care, maintenance, support and education of the respective beneficiaries of Trust #2 and Trust #3 after the death of first Trustor to die and during the life of the surviving Trustor.

Upon the death of the surviving Trustor, Article 4.03.1(a) of Trust #1 provides that during the lifetime of the primary beneficiary (Daughter) of Trust #2, the Independent Trustee has the discretion to pay the net income and principal of Trust #2 to Daughter and her living issue for the proper care, maintenance, support and education of the Daughter and her issue after taking into account the beneficiary's other resources. Likewise, during the lifetime of the primary beneficiary (Son) of Trust #3, the Independent Trustee has the discretion to pay the net income and principal of Trust #3 to Son and his living issue for the proper care, maintenance, support and education of the Son and his issue after taking into account that beneficiary's other resources.

Article 4.03.1(c) of Trust #1 states that:

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Following the demise of Surviving Trustor, each Primary Beneficiary who is legally competent to do so shall have the power to appoint the remaining principal and any undistributed income of his or her Child's Trust to such of Trustors' issue and/or to the spouse of any one or more of Trustors' issue (other than to such Primary Beneficiary's own spouse during such Primary Beneficiary's lifetime), in such amount or amounts, as such Primary Beneficiary shall appoint, from time to time, during his or her lifetime by an instrument, or at his or her death by his or her Last Will or Codicil thereto meeting the requirements of a Will or Codicil in force in the State of execution thereof at the date such Will or Codicil is executed, in which instrument, Will or Codicil specific reference to such power of appointment, and the specific intention to exercise said power, is expressed.

Article 4.03.2 provides that, upon the last to occur of the death of the Surviving Trustor, the death of the Primary Beneficiary, and the death or remarriage of the Primary Beneficiary's spouse, the principal and undistributed income of Trust #2 and Trust #3, respectively, except as appointed by the Primary Beneficiary as described in Article 4.03.1(c) above, shall be distributed outright to or held for the benefit of the then living issue of the Primary Beneficiary of each respective trust.

Appendix B.13.2 of Trust #1 defines an Independent Trustee as “. . . each institution and each individual other than Husband and Wife and other than a person who is or may become entitled to the distribution of income or principal from any trust created hereunder who serves as Trustee of a trust created herein.”

Subsequent to the execution of Trust #1, the attorneys who drafted the trust contacted Husband to inform him of a possible error in the trust instrument. As set forth above, Article 4.03.1(c) of Trust #1 provides that, after the death of the Surviving Trustor (Wife), the Primary Beneficiary of Trust #2 (Daughter) shall have the power to appoint the remaining principal and any undistributed income of that trust to “. . . such of Trustors' issue and/or to the spouse of any one or more of Trustors' issue (other than to such Primary Beneficiary's own spouse during such Primary Beneficiary's lifetime)” As drafted, this provision indicates that, upon Wife's death, Daughter would have the power to appoint the principal of Trust #2 to herself, as an issue of Husband and Wife. As such, this power would constitute a general power of appointment held by Daughter.

Husband and Wife planned to make other changes to Trust #1, and they decided to amend Article 4.03.1(c). During discussions of the changes, Husband stated that he did not intend to give Daughter a general power of appointment. Husband, however, was in poor health and died on Date 2, before amending Trust #1 to incorporate the change. Husband was survived by Wife, Daughter and Son. Wife, as surviving

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Trustor, subsequently exercised her general power of appointment over the Survivor's Trust pursuant to Article 4.01.1 of Trust #1. Wife is now deceased.

Trustees, which consist of Daughter, another individual and an independent corporation, are the current trustees of Trust #2. Trustees believe that the language in Trust #1 with respect to the powers held by Daughter to appoint the principal and undistributed income of Trust #2 as set forth in Article 4.03.1(c) of Trust #1 is a result of scrivener error. Trustees have submitted extensive documentation detailing discussions between Trustors and their attorneys concerning the execution of Trust #1. That documentation shows that, when Husband and Wife established Trust #1, they intended that Daughter have a limited power to appoint the trust property during her life and after her death.

To rectify the effect of the scrivener's error, the Trustees propose to file a petition in the appropriate local court. The petition will request that the court conclude that the Trustors intended that, under the terms of Trust #1, Daughter and Son have only a limited lifetime power and a limited testamentary power to appoint their respective trusts, Trust #2 and Trust #3, to his or her spouse, his or her issue, or the spouses of his or her issue. In addition, the petition will request that the court reform the provisions of Article 4.03.1(c) of Trust #1, effective *ab initio*, to read as follows:

Following the demise of Surviving Trustor, each Primary Beneficiary who is legally competent to do so shall have the power to appoint the remaining principal and any undistributed income of his or her Child's Trust to such of such Primary Beneficiary's spouse, issue and/or spouses of such issue (other than to such Primary Beneficiary's own spouse during such Primary Beneficiary's lifetime), in such amount or amounts, as such Primary Beneficiary shall appoint, from time to time, during his or her lifetime by an instrument, or at his or her death by his or her Last Will or Codicil thereto meeting the requirements of a Will or Codicil in force in the State of execution thereof at the date such Will or Codicil is executed, in which instrument, Will or Codicil specific reference to such power of appointment, and the specific intention to exercise said power, is expressed. No Primary Beneficiary shall have the power to appoint any portion of his or her Child's Trust to himself or herself, to his or her estate, to his or her creditors, or to the creditors of his or her estate.

Trustees have represented that no additions, actual or constructive, have been made to Trust #1 after September 25, 1985.

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Rulings Requested

You have requested the following rulings:

1. As a result of the proposed judicial reformation, Daughter does not possess and never has possessed a general power of appointment with respect to Trust #2 that would cause the corpus of Trust #2 to be includible in Daughter's gross estate for federal estate tax purposes.
2. As a result of the proposed judicial reformation, Daughter will not be treated as having released a general power of appointment for federal gift and estate tax purposes under § 2514(e) and § 2041(b)(2), respectively.
3. As a result of the proposed judicial reformation, the exempt status of Trust #2 for generation-skipping transfer tax purposes will not be affected and the judicial reformation will not result in a transfer of property that will subject Trust #2, or distributions thereunder, to the generation-skipping transfer tax imposed under § 2601.

Law and Analysis

Rulings #1 and #2:

Section 2041(a)(2) of the Internal Revenue Code provides that, for federal estate tax purposes, the value of the gross estate shall include the value of all property to the extent of any property with respect to which the decedent has at the time of death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment.

Section 2041(b)(1) defines the term "general power of appointment" as a power that is exercisable in favor of the decedent, the decedent's estate, the decedent's creditors, or the creditors of the decedent's estate.

Section 2041(b)(2) provides that the lapse of a power of appointment created after October 21, 1942, during the life of the person possessing the power shall be considered the release of such power.

Likewise, for gift tax purposes, § 2514(b) provides that the exercise or release of a general power of appointment created after October 21, 1942, is deemed a transfer of property by the individual possessing the power. Section 2514(e) provides that the lapse of a power of appointment created after October 21, 1942, during the life of the person possessing the power is considered a release of the power. For gift tax purposes, a general power of appointment is defined in § 2514(c) as a power that is exercisable in favor of the individual possessing the power, his estate, his creditors, or

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the creditors of his estate.

Section 17200 of the California Probate Code provides, in part, that:

(a) Except as provided for in Section 15800 [pertaining to revocable trusts], a trustee or beneficiary of a trust may petition the court under this chapter concerning the internal affairs of the trust or to determine the existence of the trust.

(b) Proceedings concerning the internal affairs of a trust include, but are not limited to, proceedings for any of the following purposes:

(1) Determining questions of construction of a trust instrument.

(2) Determining the existence or nonexistence of any immunity, power, privilege, duty, or right.

Cal. Prob. Code § 17200 (West 2000).

Further, the California Civil Code, in addressing the revision of contracts, provides at § 3399:

When, through fraud or a mutual mistake of the parties, or a mistake of one party, which the other at the time knew or suspected, a written contract does not truly express the intention of the parties, it may be revised on the application of a party aggrieved, so as to express that intention, so far as it can be done without prejudice to rights acquired by third persons, in good faith and for value.

Cal. Civ. Code § 3399 (West 2000).

Under California law, “[T]he paramount rule in the construction of wills, to which all other rules must yield, is that a will is to be construed according to the intention of the testator as expressed therein, and this intention must be given effect as far as possible.” In re Estate of Russell, 70 Cal. Rptr. 561, 564 (Cal. 1968); Adams v. Cook, 15 Cal. 2d 352, 361 (1940). The primary duty of the court in construing all documents is to give effect to the intention of the maker, and that duty applies to inter vivos instruments, as well as testamentary instruments. Wells Fargo Bank, National Ass’n v. Huse, 129 Cal. Rptr. 522, 524 (Cal. Ct. App. 1976). Extrinsic evidence may be admitted in order to give effect to the intent of the maker. See Ike v. Doolittle, 70 Cal. Rptr. 2d 887 (Cal. Ct. App. 1998); Estate of Anderson, 65 Cal. Rptr. 2d 307 (Cal. Ct. App. 1997); Burch v. George, 27 Cal. Rptr. 2d 165 (Cal. Ct. App. 1994); Wells Fargo

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Bank v. Marshall, 20 Cal. App. 4th 235 (1993). Extrinsic evidence may also be admitted to reform the dispositive provisions of a trust in order to correct errors made in drafting the instrument when such reformation will conform to the intent of the settlor. Lissauer v. Union Bank & Trust Co., 45 Cal. App. 2d 468, 472 (1941).

Further, under California law, the rules set forth under § 3399 of the California Civil Code regarding revision of a contract where, due to fraud or mistake, the instrument does not express the intent of the parties, also apply to the reformation of a trust instrument. In Getty v. Getty, 232 Cal. Rptr. 603 (Cal. App. 1986), the court, in applying the rules under § 3399 to the reformation of a trust, stated that “[T]he sole purpose of the reformation doctrine is to correct a written instrument in order to effectuate a common intention of the parties which was incorrectly reduced to writing.” The court stated that California Civil Code § 3399 codifies the equitable action for reformation, the purpose of which is to permit a court in equity to do equity. Reformation of the instrument to conform to the intent of the parties at the execution of the instrument relates back to the date that it was executed. Bank of America National Trust and Savings Ass’n v. Craig, 14 Cal. Rptr. 476, 481 (Cal. Ct. App. 1961).

In this case, the documentation submitted by the Trustees strongly indicates that Husband and Wife intended to provide Daughter with only the authority to appoint the principal of Trust #2 to family members other than herself. Furthermore, terms in Article 4.03.1(c) of Trust #1, which allowed Daughter to appoint the property to herself because she is the issue of the trustors, were the result of a scrivener’s error.

Consequently, we conclude that the reformation by the court, as proposed, based on scrivener’s error is consistent with applicable California law that would be applied by the highest court of that state.

Further, we conclude that, if the court determines, as set forth in the proposed petition, that Trustors intended that Article 4.03.1(c) of Trust #1 confer upon Daughter a limited, nongeneral power of appointment over the assets of Trust #2, Daughter has never had a general power of appointment over the assets of Trust #2 that would be included under § 2041(a)(2) in Daughter’s gross estate for federal estate tax purposes and that there was no lapse of a general power of appointment held by the Daughter under Article 4.03.1(c) of Trust #1 that would be considered a release of the power under § 2514(e).

Ruling #3:

Section 2601 imposes a tax on every generation-skipping transfer (GST) made after October 26, 1986.

A generation-skipping transfer is defined under § 2611(a) as (1) a taxable

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distribution, (2) a taxable termination, and (3) a direct skip. Section 2612(a) provides that the term taxable termination means a termination (by death, lapse of time, release of a power, or otherwise) of an interest in property held in trust where the property passes to a skip person with respect to the transferor of the property. Section 2612(b) provides that the term taxable distribution means any distribution from a trust to a skip person other than a taxable termination or a direct skip. Under § 2612(c)(1), a direct skip is a transfer subject to federal estate or gift tax made by a transferor to a skip person.

Under § 1433(b) of the Tax Reform Act of 1986 and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the GST tax does not apply to any generation-skipping transfer under a trust that was irrevocable on September 25, 1985. However, this exemption does not apply to additions (actual or constructive) that are made to the trust after September 25, 1985.

Section 26.2601-1(b)(1)(iv) states that, if an addition is made after September 25, 1985, to a trust which was irrevocable on September 25, 1985, a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the GST tax provisions. If an addition is made, the trust is thereafter deemed to consist of two portions, a portion not subject to the GST tax and a portion subject to the GST tax.

Section 26.2601-1(b)(1)(v)(B) provides that the release, exercise, or lapse of a power of appointment (other than a general power) is not treated as an addition to a trust if (1) the power was created in an irrevocable trust that is not subject to the GST tax because it was irrevocable on September 25, 1985, and (2) in the case of an exercise, the power was not exercised in such a way that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period beyond the rule against perpetuities measured from the creation of the trust.

Section 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the generation-skipping transfer tax will not cause the trust to lose its exempt status.

Section 26.2601-1(b)(4)(i)(C) provides that a judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct scrivener's error will not cause an exempt trust to lose its exempt status provided the judicial action involves a bona fide issue, and the construction is consistent with applicable state law that would be applied by the highest court of the state.

In the present case, Trust #1 was irrevocable on September 25, 1985. Trustee has represented that no additions, actual or constructive, have been made to the trust

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after that date.

In this case, assuming that, pursuant to the petition, the court concludes that the Trustors never intended that Daughter hold a general power of appointment (the power to appoint the assets of Trust #2 to herself, her estate, her creditors, or the creditors of her estate), and that the court reforms Article 4.03.1(c) of Trust #1, as set forth in the proposed petition, we conclude that the court's reformation of Trust #1 would be consistent with applicable state law that would be applied by the highest court of the state.

Accordingly, based on the facts submitted and the representations made, the judicial reformation of Trust #1, as proposed, will not affect the exempt status of Trust #2 for generation-skipping transfer tax purposes, and will not result in a transfer of property that will subject Trust #2, or distributions thereunder, to the generation-skipping transfer tax imposed under § 2601.

A copy of this letter should be attached to any gift, estate, or generation-skipping transfer tax returns that you may file relating to these matters.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by the appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination. Except as specifically ruled above, no opinion is expressed as to the federal tax consequences of the facts described above under the cited provisions or any other provisions of the Code or regulations.

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

Sincerely yours,
James Hogan
Senior Technician Reviewer, Branch 9
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure
Copy for section 6110 purposes