

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:  
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Date:  
October 8, 2002

Legend

- Trust =
  
- Decedent =
- Date 1 =
- Date 2 =
- Spouse =
- Bank 1 =
- State Statute =
- Bank 2 =
- Child 1 =
- Child 2 =
- Child 3 =
- Date 3 =
- Grandchild 1 =
- Grandchild 2 =
- Grandchild 3 =
- Grandchild 4 =
- Grandchild 5 =

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- Grandchild 6 =
- Grandchild 7 =
- State =
- Citation 1 =
- Citation 2 =
- Court =
- Date 4 =
- Citation 3 =
  
- Citation 4 =

Dear Sir or Madam:

This is in response to your letter dated June 18, 2002, and prior correspondence, submitted on behalf of Trust requesting rulings under §§ 1001, 2501, and 2601 of the Internal Revenue Code.

Decedent executed his will on Date 1. Decedent died on Date 2. Spouse died after Decedent but before Date 4. Article III of Decedent's will creates and provides for the administration of Trust. Paragraph 1 of Article III provides that all the rest and residue of Decedent's estate is bequeathed to Spouse and Bank 1, as trustees, who shall hold and manage the Trust as they deem best and collect the income therefrom and pay all taxes, fees and other expenses incident and properly chargeable to the Trust.

Paragraph 4 of Article III provides, in part, that, after the death of Spouse, all of the net income of the Trust shall be equally divided among Decedent's children and the lawful issue of deceased children, per stirpes, and the trustees shall expend from time to time such amounts as they may deem proper for the equal benefit of Decedent's children and the lawful issue of Decedent's deceased children, per stirpes, until the death of the survivor of Spouse and Decedent's children, and until each of Decedent's children in turn shall attain the age of twenty-five years and thereafter his or her share of the net income of the Trust shall be paid over to him or her.

Paragraph 5 of Article III provides that so much of the income payable to any descendant of mine who is under the age of twenty-five years as Spouse shall direct shall be paid to her to be expended for that descendant's benefit or, if said descendant

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be over the age of twenty-one years but under the age of twenty-five years shall be paid directly to that descendant if Spouse so directs.

Paragraph 6 of Article III provides that so far as permitted by law, each of Decedent's children who survives Decedent shall have the right to appoint by his or her will how his or her interest in the Trust shall go to his or her descendants, and, on the death of said child, the income of said child's share shall be so distributed until the termination of the Trust, and then said child's share of the corpus shall be also distributed in accordance with the terms of that child's will.

Paragraph 7 of Article III provides that so much of the interest in the Trust of each of Decedent's children who takes under this will but dies without having exercised the power of appointment hereinabove given, and without leaving lawful issue surviving, as remains in the hands of the Trustees at the time of the death of said child shall pass to the surviving beneficiaries (except Spouse) provided for under the terms of this Article of Decedent's will and shall be held and distributed in accordance with those terms. If, however, there be lawful issue surviving, the said interest shall pass to said issue, per stirpes.

Paragraph 8 of Article III provides that the income available for the lawful issue of Decedent's deceased children while the beneficiaries are under the age of twenty-five years shall be subject to the same control by Spouse that the income of Decedent's children is subject to, and any accumulated income payable to said beneficiaries shall be paid over to them as they in turn attain the age of twenty-five years.

Paragraph 10 of Article III provides that on the death of the survivor of Spouse and Decedent's children, whatever remains of the Trust in the hands of the surviving trustee, shall, subject to the power of appointment hereinabove given to Decedent's children, be divided, per stirpes, among the lawful issue of Decedent's children, but the share or shares of those beneficiaries who are minors shall be retained by the Trustee which shall expend so much as it deems best of the income and corpus of each beneficiary's share for his or her benefit until they in turn attain the age of twenty-one years, when they shall receive whatever remains of their respective shares, outright.

Paragraph 11 of Article III provides that if all of Decedent's children die leaving no issue surviving them, then subject to Spouse's estate, whatever remains of the Trust shall pass to Decedent's heirs at law and distributees under the State Statute as in effect at the date of the death of Decedent's last surviving child.

Bank 2 is currently trustee of Trust. Decedent had three Children: Child 1, Child 2, and Child 3. Child 1 died on Date 3. Child 1's share of the net income is currently distributed to his three natural children: Grandchild 1, Grandchild 2, and Grandchild 3 in accordance with the terms of Decedent's will. Child 2 has two natural children: Grandchild 4 and Grandchild 5. Child 3 has two adopted children:

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Grandchild 6 and Grandchild 7. Grandchild 6 and Grandchild 7 were adopted after Decedent's death.

It is unclear by the terms of Decedent's will whether Decedent meant to include adopted persons within the terms "lawful issue" and "descendants." Taxpayer represents that it is a reasonable interpretation of the express language of Decedent's will that Decedent intended to include adopted children as beneficiaries of Trust. See Citation 1 and Citation 2. The current income beneficiaries of Trust, have informed the trustee that they believe that Decedent intended to treat his biological and adopted grandchildren equally. The trustee instituted legal proceedings in Court asking Court to: (a) construe the terms "lawful issue" and "descendants" as used in Article III of Decedent's will to determine whether Decedent intended to include adopted persons as beneficiaries of the Trust; and (b) if Court finds that Decedent intended to include adopted persons within the terms "lawful issue" and "descendants," decree that adopted persons shall take under the terms of Trust as if related by or through birth.

On Date 4 Court issued a decree, in accordance with State case law, that the terms of Decedent's will, including the consistent use of the term "lawful issue," sufficiently indicated that Decedent meant to include legally adopted persons as beneficiaries of Trust.

The trustee has requested rulings that the Date 4 court order interpreting Decedent's will to include adopted persons as beneficiaries of the Trust (1) will not result in a transfer that is subject to gift tax under § 2501, (2) will not cause Trust to lose its grandfathered exempt status for purposes of the generation-skipping transfer tax under § 2601, and (3) will not constitute a taxable disposition of the trust assets for purposes of § 1001.

#### Ruling Request 1:

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

Section 2511(a) provides that the tax imposed by § 2501 applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

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

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

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In Commissioner v. Estate of Bosch, 387 U.S. 456 (1967), the Supreme Court considered whether a state trial court's characterization of property rights conclusively binds a federal court or agency in a federal estate tax controversy. The Court concluded that the decision of a trial court as to an underlying issue of state law should not be controlling when applied to a federal statute. Rather, the highest court of the state is the best authority on the underlying substantive rule of state law to be applied in the federal matter. If there is a decision by that court, then the federal authority must apply what it finds to be state law after giving "proper regard" to the state trial court's determination and to relevant rulings of other courts of the state. In this respect, the federal agency may be said, in effect, to be sitting as a state court.

The Supreme Court of State recognizes the equitable remedy of construction of a will in order to ascertain the intention of the testator. See Citation 3; Citation 4. Under State case law, it is presumed that a testator did not intend to include adopted persons as beneficiaries of class gifts where the class was defined as "issue" or "descendants," unless the intent to include adopted persons was expressed or reasonably implied by the language of the will or could be reasonably inferred from extrinsic evidence properly before the court. Citation 2. The Supreme Court of State found a distinction, however, where a testator defined a class of beneficiaries as including "legal heirs." In that case, the court found that the testator was content to let the law determine the beneficiaries with the knowledge that an adopted child would be a legal heir. Citation 1.

In this case, under State case law, Decedent's reference to "lawful heirs" is sufficient language to evidence an intent to include adopted persons. The court's construction of the terms of Decedent's will, therefore, is consistent with State case law. Accordingly, we conclude Court's Date 4 decree will not cause a transfer, direct or indirect, of property and there will be no gift tax consequences as a result of the decree.

#### Ruling Request 2:

Section 2601 imposes a tax on every generation-skipping transfer.

Section 2611(a) defines the term "generation-skipping transfer" to include a taxable distribution, a taxable termination, and a direct skip.

Section 2612(a)(1) provides that the term "taxable termination" means the termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless (A) immediately after such termination, a non-skip person has an interest in such property, or (B) at no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person.

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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).

Section 2612(c) provides that the term “direct skip” means a transfer subject to a tax imposed by chapter 11 or 12 of an interest in property to a skip person.

Section 2613(a) defines the term “skip person” as (1) a natural person assigned to a generation that is two or more generations below the generation assignment of the transferor, or (2) a trust if all interests in the trust are held by skip persons, or if there is no person holding an interest in such trust, and at no time after such transfer may a distribution (including distributions on termination) be made from such trust to a non-skip person.

Section 2613(b) provides that, for purposes of the generation-skipping transfer tax, the term “non-skip person” means any person who is not a skip person.

Section 2651(a) provides that for purposes of chapter 13, the generation to which any person (other than the transferor) belongs shall be determined in accordance with the rules set forth in this section.

Section 2651(b)(1) provides that an individual who is a lineal descendant of a grandparent of the transferor shall be assigned to that generation which results from comparing the number of generations between the grandparent and such individual with the number of generations between the grandparent and the transferor.

Section 2651(b)(3)(A) provides that a relationship by legal adoption shall be treated as a relationship by blood.

Section 2651(f) provides that, except as provided in the regulations, an individual who, but for this subsection, would be assigned to more than one generation shall be assigned to the youngest such generation.

Section 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations provides that the generation-skipping transfer tax does not apply to any generation-skipping transfer under a trust (as defined in § 2652(b)) that was irrevocable on September 25, 1985. The rule of the preceding sentence does not apply to a pro rata portion of any generation-skipping transfer under an irrevocable trust if additions are made to the trust after September 25, 1985.

Section 26.2601-1(b)(1)(ii) provides that, except as provided in § 26.2601-1(b)(1)(ii)(B) or (C), any trust in existence on September 25, 1985, is considered an irrevocable trust.

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Section 26.2601-1(b)(4) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the generation-skipping transfer tax under paragraph (b)(1), (2), or (3) of this section (hereinafter referred to as an exempt trust) will not cause the trust to lose its exempt status. The rules contained in paragraph (b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. The rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of § 1001.

Section 26.2601-1(b)(4)(i)(C) provides that a judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause an exempt trust to be subject to the provisions of chapter 13, if (1) the judicial action involves a bona fide issue; and (2) the construction is consistent with applicable state law that would be applied by the highest court of the state.

In this case, Trust is a generation-skipping trust because it provides for distributions to more than one generation of beneficiaries below the grantor's generation. Date 2 is prior to September 25, 1985, and Trust was irrevocable on September 25, 1985. Trust, therefore, is exempt from the generation-skipping transfer tax pursuant to § 26.2601-1(b)(1)(i).

The judicial action involves a bona fide issue because there are adopted persons who are potential beneficiaries of Trust. In addition, as previously discussed, Court's interpretation is consistent with State case law as it would be applied by the Supreme Court of State, the highest court of the state. Furthermore, Court's interpretation is consistent with § 2651(b)(3)(A). Therefore, in accordance with § 26.2601-1(b)(4)(i)(C), the Date 4 Court decree will not affect the exempt status of the trusts.

Ruling Request 3:

Section 61(a)(3) provides that the gross income includes gains derived from dealings in property.

Section 1001(a) provides that the gain from the sale or other disposition of property in the excess of the amount realized over the adjusted basis provided in § 1011, and loss is the excess of the adjusted basis over the amount realized. Under § 1001(c), the entire amount of gain or loss must be recognized, except as otherwise provided.

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Section 1.1001-1(a) of the Income Tax Regulations provides generally that gain or loss realized from an exchange of property for other property differing materially either in kind or extent is treated as income or as loss sustained.

In Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991), the Supreme Court addressed the issue of when an exchange of property gives rise to a realization event under § 1001. Under the facts of that case, a financial institution exchanged its interests in one group of residential mortgage loans for another lender's interests in a different group of residential mortgage loans. The two groups of mortgages were considered "substantially identical" by the agency that regulated the financial institutions. The Supreme Court concluded that § 1.1001-1 reasonably interprets § 1001(a) and stated that an exchange of property gives rise to a realization event under § 1001(a) if the properties are "materially different." 499 U.S. at 560-561.

In defining what constitutes a "material difference" for purposes of § 1001(a), the Court stated that properties are "different" in the sense that is "material" to the Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent. 499 U.S. at 564-565. The Court held that mortgage loans made to different obligors and secured by different homes did embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged the loans. 499 U.S. at 566.

The Court, in Cottage Savings, rejected the Service's argument that properties are "materially different" only if they differ in economic substance. Id. at 562. The Service argued unsuccessfully that differences in properties are material for purposes of the Code only when it can be said that the parties, the relevant market, and the relevant regulatory body would consider them material. Id. at 565.

In the present case, the trustee submits that the court order provides a reasonable interpretation of the express language of the will under State case law. Moreover, the trustee has represented that the current income beneficiaries of Trust, who are the natural descendants of Decedent, believe that Decedent intended to treat his biological and adopted grandchildren equally. Thus, the trustee's position is that interpreting the express will language of "lawful issue" and "descendants" to include all issue and descendants of a deceased child, including children who have been legally adopted, will carry out the Decedent's original intentions.

In this case, under applicable State case law, the court order is a clarification of Decedent's original intention expressed in his will. The beneficiaries will not acquire different legal entitlements or exchange interests, rather the court has ascertained the beneficiaries' original legal entitlements. Therefore, we conclude that the court's interpretation will not constitute a taxable disposition for purposes of § 1001.

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

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

Pursuant to the Power of Attorney on file with this office, a copy of this letter is being sent to your attorney.

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

Sincerely,

Melissa C. Liquerman

Melissa C. Liquerman  
Branch Chief  
Office of Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosure

Copy of this letter for § 6110 purposes