

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **200423006**

Release Date: 6/4/04

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

Person To Contact:

ID No.

Telephone Number:

In Re:

Refer Reply To:

CC:PSI:04 – PLR-110119-03

Date:

February 05, 2004

LEGEND:

Trustors =

Trustees =

Trust =

GGC1 =

GGC2 =

GGC3 =

GGC4 =

Attorney =

Bank =

State =

State Statute 1 =

State Statute 2 =

State Court =

Year 1 =

X =

Date 1 =

Date 2 =

Dear :

This is in response to your correspondence dated February 10, 2003, requesting rulings concerning the tax consequences of the proposed reformation of Trust under §§ 1001, 2501, and 2601 of the Internal Revenue Code.

The facts and representations submitted are summarized as follows: Trust was created by Trustors on Date 1, for the primary benefit of their great-grandchildren. Trustors have four living great-grandchildren: GGC1, GGC2, GGC3, and GGC4. At the present time, all four great-grandchildren are under the age of twenty-one (21) years.

Since Date 1, Trust has been modified to authorize the substitution of the original corporate trustee, Bank, with the current individual trustees, Trustees. There have been no other modifications of Trust.

As originally drafted Trust provides, in part, as follows:

Paragraph 4(c) of Trust provides that upon the birth of the first great-grandchild of Trustors and until the oldest living great-grandchild of Trustors attains the age of 21 years, the Trustees may distribute to or apply for the benefit of a class consisting of all the Trustors' living great-grandchildren and the issue or surviving spouse of any deceased great-grandchildren of Trustors, so much of the net income and principal of the trust estate as the Trustees, in their sole discretion, may deem desirable for any reasonable purpose. Any net income not so distributed is to be accumulated and added to the principal of the trust estate. Any payments or applications of principal are to be charged against the ultimate distributive share of the beneficiary who receives principal distributions.

Under Paragraph 4(d), after the oldest living great-grandchild attains the age of 21 years, the Trustees are to pay to or apply for the benefit of the members of the class of beneficiaries described in Paragraph 4(c), the entire annual net income of the trust estate in equal amounts, with the living issue of a deceased great-grandchild taking per stirpes, and the income interest of a surviving spouse of a deceased great-grandchild limited to the terms of the exercise of a testamentary special power of appointment granted to each great-grandchild of Trustors under Paragraph 4(h) of Trust. The class of beneficiaries of great-grandchildren of Trustors is to remain open until the death of the last surviving granddaughter of Trustors who is in being at the time of the execution of Trust or upon the oldest living great-grandchild's attaining age 55 years, whichever occurs first. If the Trustees deem the income payments to be insufficient for any beneficiary in the class, the Trustees may from time to time pay to or apply for the benefit of any beneficiary such sums of principal the Trustees in their absolute discretion deem necessary or desirable for any reasonable purpose. Any payments or applications of benefits of principal to or for any beneficiary shall be charged against the ultimate distributive share of such beneficiary.

Paragraph 4(e) provides that upon the closing of the class of beneficiaries by reason of the death of the last surviving granddaughter of the Trustors who is in being at the time of the execution of the trust agreement or the Trustors' oldest living great-grandchild's attaining the age of 55 years, whichever occurs first, the trust estate is to be divided into as many equal shares as there are great-grandchildren of the Trustors then living and great-grandchildren of Trustors then deceased leaving issue or spouse then living, if the deceased great grandchild exercised his or her testamentary special power of appointment provided in paragraph 4(h) in favor of such spouse. Each share set apart for the issue of a deceased great-grandchild of the Trustors is to be distributed forthwith to such issue, per stirpes, free of trust, provided, however, the share of any beneficiary who has not attained the age of 21 years shall be held in trust until such time, and the income and principal thereof may be distributed to the beneficiary for any reasonable purposes, or in the discretion of the Trustees, retained in Trust; and provided, further, each such share shall be subject to the terms of the exercise of a testamentary special power of appointment granted to each great-grandchild of the Trustors in Paragraph 4(h). Each share set apart for each then living great-grandchild of the Trustors is to be held as a separate trust, and retained or distributed in trust, subject to the terms and conditions provided.

Under Paragraph 4(f), the trustees are to pay to or apply for the benefit of the respective great-grandchild of the Trustors who has attained the age of 21 years the entire annual net income of the separate trust estate and such amounts of the principal as the Trustees, in their absolute discretion, deem necessary or desirable for any reasonable purpose. Until such beneficiary attains the age of 21 years, the Trustees shall have the authority to distribute income or principal to the beneficiary for any reasonable purpose and accumulate the balance thereof.

Paragraph 4(g) provides that after a great-grandchild of Trustors attains the age of 40 years, the Trustees are to pay to the beneficiary from the principal of Trust such amounts of principal as the beneficiary may, from time to time, request in writing, not exceeding in any calendar year an amount equal to five percent of the principal of Trust, determined as of the last day of the preceding calendar year; provided, however, prior to the closing of the class of beneficiaries and the division of the trust estate into separate shares, the amount of the principal of the Trust for purposes of the preceding sentence is to be a fraction of the total Trust estate which corresponds to a fraction, the numerator of which is one and the denominator of which is the number of living great-grandchildren of the Trustors, and deceased great-grandchildren of Trustors leaving living issue, counted as of the last day of the preceding calendar. Any principal distribution made under this paragraph is to be charged against the ultimate distributive share of such beneficiary. In no event shall such payment exceed twenty-five thousand dollars in any calendar year, except as provided. This maximum amount of twenty-five thousand dollars shall be adjusted each year in accordance with computations based upon the Consumer Price Index (all items) calculated for the City and County of X. The right of withdrawal is noncumulative, so that if the beneficiary does not withdraw during any calendar year the full amount to which he or she is entitled under this provision, the right to withdraw the amount not withdrawn shall lapse at the end of that calendar year.

Under Paragraph 4(h), in the event of the death of a great-grandchild of the Trustors before attaining the age of 55 years, and whether or not the trust estate has been divided into separate shares as provided in Paragraph 4(e), the Trustees are to distribute so much of the income and principal of the beneficiary's share of the trust estate, which otherwise would be distributed to or held for the benefit of his issue, to the surviving spouse of the deceased beneficiary, as the beneficiary may appoint by valid will, specifically referring to the power of appointment; provided, if this special power of appointment is exercised, the trust estate subject thereto is to remain in Trust subject to the terms hereof until such time as the deceased great-grandchild of the Trustors would have attained the age 55 years. In no event shall any appointment be made hereunder that will require the vesting of any interest or the suspension of the power of alienation or absolute ownership beyond 21 years after the death of the last surviving lineal descendants of Trustors alive at the time of the execution of Trust. Except and to the extent that the testamentary special power of appointment is exercised in favor of a deceased beneficiary, the deceased great-grandchild's share is to be distributed to the issue of the deceased great-grandchild of the Trustors, per stirpes, free of trust, provided, however, the share of any beneficiary who has not attained the age of 21 years is to be held in trust until such time, and the income and principal thereof may be distributed to the beneficiary for any reasonable purpose or, in the discretion of the Trustees, retained in Trust.

Paragraph 4(i) provides that the trust for each beneficiary is to terminate upon the beneficiary's attaining the age 55 years. The trust estate, and all accumulated income, is to be distributed to the beneficiary at that time and the trust is to thereupon terminate.

Paragraph 4(m) provides that unless sooner terminated in accordance with the provisions of Trust, any trust created hereby shall terminate in any and all events no later than 21 years after the death of the last to die of the Trustors and their lineal descendants who are living at the time of the execution of Trust.

Trustees represent that the provisions of Trust requiring distributions of income of Trust to Trustors' great-grandchildren upon each attaining age 21 are contrary to Trustors' intentions because Trustors did not intend to require the distribution of income to a great-grandchild who is less than age 35. It is represented that the provisions requiring income distributions to beneficiaries less than 35 years were the result of a mistake of law and scrivener's error by Attorney who drafted Trust. Attorney drafted four other trusts for the Trustors benefiting the Trustors' four grandchildren. In those instruments, the trustees were given broad discretion over distributions of income and principal until a grandchild reached age 35, at which time the trustees would be required to distribute all trust income currently. The Trustors asked Attorney to prepare Trust for the benefit of Trustors' unborn great-grandchildren and instructed Attorney that the provisions governing distribution of income in Trust should be similar to the corresponding provisions in the four other trusts. Trustors specifically requested that the trustees of Trust not be required to distribute income to any beneficiary until age 35.

Attorney believed that authorizing the trustees of Trust to accumulate income until a great-grandchild attained age 35 would violate the rule against accumulations under State law, which limits the period during which a trustee may accumulate trust income. As a result of this concern, Attorney advised Trustors that Trust must require the trustees to distribute income currently to any great-grandchild who has attained age 21. Trust was drafted in accordance with and in reliance on Attorney's advice.

It is represented by Attorney and Trustees that if the terms of Trust could have been drafted to permit the accumulation of income while a great-grandchild was under age 35, Trustors would have required that Trust be prepared in this manner. Attorney has acknowledged the advice given to Trustors regarding the rule against accumulations was erroneous and that it would have been possible to fulfill Trustor's intentions that no beneficiary under 35 receive mandatory distributions of trust income.

To conform the terms of Trust to the original intent of Trustors, Trustees sought to reform Trust under State law. Trustees petitioned State Court to reform paragraph 4 of Trust, effective ab initio by deleting paragraph 4(d) and revising paragraphs 4(c), 4(e), and 4(f) to read as follows:

4(c). Upon the birth of the first great-grandchild of Trustors and until the division of Trust into shares as provided in paragraph 4(e), Trustees may distribute to or apply for the benefit of a class consisting of all Trustors' living great-grandchildren and the issue or surviving spouse of any deceased great-grandchildren of Trustors, so much of the net income and principal of the trust estate as Trustees, in their sole discretion, may deem desirable for any reasonable purpose. Any net income not so distributed shall be accumulated and added to the principal of the trust estate. Any payments or applications of principal shall be charged against the ultimate distributive share of the beneficiary who receives principal distributions.

4(e). Upon the death of the last surviving granddaughter of Trustors who is in being at the time of the execution of Trust or upon the Trustors' oldest living great-grandchild attaining age 35 years, whichever occurs first, the trust estate shall be divided into as many equal shares as there are great-grandchildren of the Trustors then living and great-grandchildren of the Trustors then deceased leaving issue or spouse then living, if the deceased great-grandchild exercised his or her testamentary special power of appointment provided in paragraph 4(h) in favor of such spouse. Each share set apart for the issue of a deceased great-grandchild of the Trustors shall be divided into separate shares for such issue, per stirpes, with each such issue's share held as a separate trust, subject to the terms and conditions provided as if the issue were a great-grandchild of Trustors. Each share set apart for each then living great-grandchild of Trustors is to be held as a separate trust, and retained or distributed in trust, subject to the terms and conditions provided.

4(f). The Trustees are to pay to or apply for the benefit of the respective great-grandchild of Trustors who has attained the age of 35 years the entire annual net income of the separate trust estate and such amounts of the principal as the Trustees, in their absolute discretion, deem necessary or desirable for any purpose. Until such beneficiary attains the age of 35 years, the Trustees in their sole discretion shall have the authority to distribute income or principal to the beneficiary for any reasonable purpose and accumulate the balance thereof.

State Court entered an order granting the petition to reform Trust as provided above. The reformation will be retroactive to the date Trust was created, but is contingent upon a favorable private letter ruling from the Internal Revenue Service with respect to the requested rulings.

The following rulings are requested:

1. The proposed reformation of Trust will not cause Trust to lose its exempt status for purposes of the generation-skipping transfer tax.

2. The proposed reformation of Trust will not give rise to any gain or loss nor any income tax liability for any party.

3. The proposed reformation of Trust will not give rise to any gift tax liability for any party.

LAW AND ANALYSIS

Ruling 1. Section 2601 imposes a tax on every generation-skipping transfer (GST), which is defined under section 2611 as a taxable distribution, a taxable termination, or a direct skip.

Section 1433(a) of the Tax Reform Act of 1986 (Act) provides that, except as provided in section 1433(b), the generation-skipping transfer tax applies to generation-skipping transfers made after October 22, 1986. Under section 1433(b)(2)(A) of the Act and section 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations the generation-skipping transfer tax does not apply to any generation-skipping transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that such transfer was not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added).

Section 26.2601-1(b)(4)(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 under section 26.2601-1(b)(1), (b)(2), or (b)(3), will not cause the trust to lose its exempt status. The rules of section 26.2601-1(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 section 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 provision of chapter 13, 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.

State Statute 1 provides, generally, that a trustee or beneficiary of a trust may petition the court concerning the internal affairs of the trust, including determining questions of construction of a trust instrument. State Statute 2 provides that 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.

Under State law, 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 v. Huse, 129 Cal. Rptr. 522, 524 (Cal. Ct. App. 1976). Under State law, the rules set forth in State Statute 2 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. See Ike v. Doolittle, 70 Cal. Rptr. 2d 887 (Cal. Ct. App. 1998). A mistake by the scrivener or draftsman in reducing the intent of the parties to writing is ground for reformation. See California Pacific Title Company v. Moore, 40 Cal. Rptr. 61, 63 (Cal. Ct. App. 1963).

In Commissioner v. Estate of Bosch, 387 U.S. 456 (1967), the 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 state 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 no 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.

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

In this case, State Court determined that there was sufficient evidence to indicate that the Trustors did not intend to require income distributions prior to a great-grandchild reaching age 35. The documentation submitted by the trustees strongly indicates that the Trustors did not intend to require income distributions prior to a great-grandchild reaching age 35 and that the provision requiring income distributions to the great-grandchildren upon reaching age 21 was a scrivener's error. Accordingly, we conclude that the reformation based on scrivener's error is consistent with applicable State law that would be applied by the highest court of State. Accordingly, based on the facts presented and the representations made, the reformation of Trust, as proposed, will not cause Trust to lose its exempt status for purposes of the generation-skipping transfer tax under section 2601.

Ruling 2. Section 61(a)(3) provides that gross income includes gains derived from dealings in property. Section 1.61-1(a) of the Income Tax Regulations provides

that gross income means income all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services.

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss is the excess of the adjusted basis provided in section 1011 for determining loss over the amount realized.

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

For purposes of section 1001, in an exchange of property, each party to the exchange gives up a property interest in return for a new or additional property interest. Such an exchange of property is a disposition under section 1001(a). See section 1.1001-1.

An exchange of property results in the realization of gain under section 1001 if properties exchanged are materially different. Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991). A material difference exists when the exchanged properties embody legal entitlements "difference in kind or extent" of if they confer "different rights and powers." Id. at 565.

State Court has approved the reformation to correct drafting errors and to effectuate the original intent of Trustors to accumulate income until the oldest great-grandchild attains age 35, dividing Trust into equal shares for the members of the beneficiary class at that time. As the reformation will be retroactive to the date the Trust was created, Trust and the beneficiaries' interest in Trust will be the same before and after the reformation. The future division of Trust into separate trusts when the oldest great-grandchild attains age 35 will not cause Trust or the beneficiaries' interest in Trust to differ materially. The reformation of Trust will not be considered a sale, exchange, or other disposition of property differing materially in either kind or extent. Accordingly, neither Trust nor the beneficiaries will recognize any gain or loss from a sale, exchange, or other disposition of property under sections 61 or 1001.

Ruling 3. Section 2501(a)(1) provides that a tax, computed as provided in section 2502, is hereby imposed for each calendar year on the transfer of property by gift during such calendar year by any individual, resident or nonresident.

Section 2511(a) provides that subject to the limitations contained in chapter 12, the gift tax imposed by section 2501 will apply 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 a gift is made in property, the value thereof at the date of the gift shall be 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, the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift.

As discussed above, we have concluded that the reformation based on scrivener's error was consistent with applicable State law and did not change the beneficial interests otherwise provided for under the trust instrument. Therefore, based on the facts submitted and representations made, we conclude that the reformation of Trust will not give rise to any gift tax liability for any party.

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 part of the material submitted in support of the request for rulings, it is subject to verification and examination.

Except has 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 requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

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

Enclosure
Copy of letter for section 6110 purposes

CC:

CC: