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Date: SEPTEMBER 17, 2008

Re:

LEGEND:

Settlor =

A =

B =

C =

D =

E =

Trust A =

Trust B =

Trust C =

Date 1 =

Date 2 =

State =

Court =

Cite 1 =

Cite 2 =

Cite 3 =

Cite 4 =

Cite 5 =

Dear :

This is in response to the March 7, 2008 letter and other correspondence requesting

rulings on the estate, gift, and generation-skipping transfer tax consequences of the proposed judicial modifications of certain trusts.

The facts submitted are as follows. On Date 1 (before September 26, 1985), Settlor created three trusts, Trust A for the benefit of A, Trust B for the benefit of B, and Trust C for the benefit of C (together, the "Trusts" or, for any such trust, the "Trust"). A, B, and C are Settlor's daughters. Except for the designated beneficiary, the terms of each Trust are the same. D and E are the current trustees. The Trusts are administered under the laws of State.

Article 1 of each Trust provides that the net income is to be paid to A, B, or C (the "Respective Beneficiary"), as the case may be, for life. Article 2 provides that principal may be distributed to or for the benefit of the Respective Beneficiary for her health, education, support or other expenses of maintenance.

Under the first and second paragraphs of Article 3, each Respective Beneficiary has the power exercisable during life or at death to appoint trust property to "any person or persons except that such power shall on no account be exercised in favor of herself, the Trustees, her creditors or the creditors of her estate." The third paragraph of Article 3 provides that the appointment may be either outright or in further trust but no appointment is to be made which may postpone vesting or create a suspension of the power of alienation of the trust estate for a period which would terminate later than twenty-one years after the death of the last survivor of all the persons named or described in the trust who are in being at the commencement of the trust.

Under the fourth paragraph of Article 3, if a Respective Beneficiary does not exercise her power of appointment, then, at her death the trustees are to divide the property of her trust into as many shares, of equal value, as she has children then living, plus the number of her children who are then deceased but who have left issue then living. The trustees are to set aside one such share as a separate trust for the benefit of each living child and one such share as a separate trust for the benefit of the issue then living of each deceased child. However, the instrument does not contain any dispositive provisions regarding the separate trusts, such as the terms of the trusts and the termination date.

Settlor represents that the Trusts were established with the intent to provide a Respective Beneficiary with a limited power of appointment and not cause a Respective Beneficiary (or her estate) to incur a federal gift or estate tax by reason of possessing a general power of appointment. Settlor informed her attorneys of these goals and intentions when the Trusts were drafted. Settlor was recently advised that Article 3 does not specifically state that the power can not be exercised in favor of the Respective Beneficiary's estate.

On Date 2, the trustees filed a complaint asking the appropriate local Court to correct a mistake and reform the Trusts based on a scrivener's error. The Court was asked to change the words "the Trustees" in the second paragraph of Article 3 to "her estate." As modified, the second paragraph of Article 3 would read as follows.

Such power to appoint shall be to any person or persons except that such power shall on no account be exercised in favor of herself, her estate, her creditors, or the creditors of her estate.

The judicial reformation will relate back to the date of the creation of the Trusts.

In addition, it is represented that the trustees will file an amended complaint asking the Court to modify the fourth paragraph of Article 3 to provide the terms of the separate trusts to be established for a Respective Beneficiary's children or issue when the Respective Beneficiary has died without exercising her power. Under the modification, the fourth paragraph (and additional paragraphs as necessary) of Article 3 will, in effect, provide as follows.

- (i) If a Respective Beneficiary fails to exercise her power of appointment, then, at her death, the property of her trust is to be divided into equal shares determined by the number of her then living children and deceased children who have left then living issue. A respective share is to be held for each living child and each deceased child's issue, by representation.
- (ii) Regarding a trust held for a Respective Beneficiary's child, the income is to be paid to the child for life. Principal may be distributed, in the trustees' discretion, to or for the child for health, education, support, or other expenses of maintenance. On the child's death, the trust property is to be distributed to the child's issue, per stirpes.
- (iii) Regarding a trust held for the issue of a Respective Beneficiary's deceased child, the income is to be paid to the issue living on the date of each distribution, per stirpes. Principal may be distributed, in the trustees' discretion, to or for any of such issue for health, education, support or other expenses of maintenance. On the respective dates of death of each such issue, a per stirpital share of the trust is to be distributed to that deceased issue's then living issue. If there are no such living issue, the distribution is to be to the deceased issue's estate.
- (iv) Each trust will terminate at the expiration of twenty-one years after the death of the last survivor of all persons named or described in the Trust who were in being on Date 1. The remainder of any such Trust is to be distributed to the beneficiary (or beneficiaries) then eligible to receive income distributions.

You have asked for the following rulings.

- (1) A Respective Beneficiary's power of appointment, created in Article 3, as judicially modified, will not constitute a general power of appointment under § 2041 of the Internal Revenue Code.
- (2) The proposed judicial modification of the power of appointment will not constitute an exercise, release, or lapse of a general power of appointment that would result in a taxable gift under § 2514.
- (3) The proposed judicial modification of the Trusts will not cause any Trust to lose the exemption from the generation-skipping transfer tax or otherwise to become subject to the generation-skipping transfer tax.

Issues 1 and 2

Section 2001(a) provides that a tax is imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

Section 2041(a)(2) provides that the value of the gross estate includes 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, or with respect to which the decedent has at any time exercised or released the power of appointment by a disposition which is of the nature that if it were a transfer of property owned by the decedent, the property would be includible in the decedent's gross estate under sections 2035 to 2038 inclusive.

Section 2041(b)(1) provides that the term "general power of appointment" means a power 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 during the life of the individual possessing the power shall be considered a release of the power.

Section 2501 imposes a tax on the transfer of property by gift.

Section 2511 provides that the gift tax shall 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 2514(b) provides that the exercise or release of a general power of appointment shall be deemed a transfer of property by the individual possessing the power. Section 2514(c) provides that the term "general power of appointment" means a power that is exercisable in favor of the individual possessing the power, his estate, his creditors, or

the creditors of his estate.

Under applicable State law, a trust instrument may be reformed to conform to the settlor's intent. Cite 1; Cite 2; Cite 3. To ascertain the settlor's intent, the State courts look to the trust instrument as a whole and the circumstances known to the settlor on the date of execution. Cite 4; Cite 5.

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, the documentation submitted strongly indicates that Settlor intended that the powers of appointment created in Article 3 of the Trusts be limited to the extent that a Respective Beneficiary can not exercise the power in favor of herself, her estate, her creditors, or the creditors of her estate. The documentation also strongly indicates that Settlor intended that the provisions for lifetime distributions to a Respective Beneficiary would also apply to lifetime distributions to a beneficiary of a trust created in the event the Respective Beneficiary fails to exercise her power.

Based on the facts submitted and the representations made, we conclude that the court order, described above (changing the words "the Trustees" in the second paragraph of Article 3 to "her estate," and correcting the fourth paragraph of Article 3 to provide for the described administration of the default trusts) will be consistent with applicable State law, as applied by the highest court of State.

Accordingly, provided that Article 3 of the Trusts is reformed pursuant to the terms of a court order, as described above, we conclude that: (1) a Respective Beneficiary's power of appointment, as judicially modified, will not constitute a general power of appointment for purposes of § 2041; and (2) the judicial modification of a Respective Beneficiary's power of appointment will not constitute an exercise, release, or lapse of a general power of appointment that would result in a taxable gift under § 2514.

Issue 3

Section 2601 imposes a tax on every generation-skipping transfer made after October 26, 1986. A generation-skipping transfer is defined under § 2611(a) as (1) a taxable

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 section 1431(a) of the Tax Reform Act of 1986 and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the generation-skipping transfer (GST) tax does not apply to any GST 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)(ii)(A) 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, except as provided in § 26.2601-1(b)(ii)(B) or (C), which relate to property includible in a grantor's gross estate under §§ 2038 and 2042.

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 GST 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 a scrivener's error will not cause an exempt trust to lose its exempt status if 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.

Section 26.2601-1(b)(4)(E), Example 3, provides as follows. In 1980, Grantor established an irrevocable trust for the benefit of Grantor's children, A and B, and their issue. The trust is to terminate on the death of the last to die of A and B, at which time the principal is to be distributed to their issue. However, the provision governing the termination of the trust is ambiguous regarding whether the trust principal is to be distributed per stirpes, only to the children of A and B, or per capita among the children, grandchildren, and more remote issue of A and B. In 2002, the trustee files a construction suit with the appropriate local court to resolve the ambiguity. The court issues an order construing the instrument to provide for per capita distributions to the children, grandchildren, and more remote issue of A and B living at the time the trust terminates. The court's construction resolves a bona fide issue regarding the proper interpretation of the instrument and is consistent with applicable state law as it would be

interpreted by the highest court of the state. Therefore, the trust will not be subject to the provisions of chapter 13.

In this case, the Trusts were irrevocable on September 25, 1985. There have been no additions made after September 25, 1985, and the Respective Beneficiaries have not exercised their powers of appointment. As discussed above, the judicial action involves bona fide issues and 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 a Trust, as proposed, will not cause the Trust to lose its exempt status for purposes of the generation-skipping transfer tax under § 2601.

Except as specifically ruled upon above, we express no opinion as to the tax consequences of the transaction described above under the cited provisions of the Code or under any other provisions of the Code.

The rulings contained in this letter are based upon information and representations submitted by the taxpayers 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.

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

Sincerely,

George Masnik
Chief, Branch 4
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures
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