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Department of the Treasury

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PLR-146137-04

Date: MARCH 16, 2005

LEGEND:

Date 1 =

Date 2 =

Date 3 =

Trust 1 =

GST Exempt Trust =

Non-Exempt Trust =

Trust 2 =

Wife =

Husband =

Trustee =

Previous Trustee =

State =

a =

Sister =

Brother-in-law =

Charity =

County Court =

Cite 1 =

Cite 2 =

Cite 3 =

Cite 4 =

Dear :

This is in response to your August 3, 2004 letter and other correspondence requesting a ruling concerning the generation-skipping transfer tax consequences of the proposed reformation of the GST Exempt Trust and the Non-Exempt Trust.

The facts submitted are as follows:

On Date 1, after September 25, 1985, Wife and Husband executed Trust 1, an irrevocable trust, for the primary benefit of their children and the issue of their children.

Article II, Section A of Trust 1 provides that upon creation of Trust 1, the trustees are to divide Trust 1 into two shares. The GST Exempt Trust, is to be funded with the value of property equal to the GST exemption available to Husband and Wife at the time of the transfer. The Non-Exempt Trust is to be funded with the balance of the trust property.

Article II, Section B provides that in each calendar year in which a gift of property is made to Trust 1, each descendant of Wife and Husband living at the time of each gift is to have the right by written request to withdraw property from the trust to which the property was so allocated. The amount that each descendant may withdraw is that amount that is equal to the value on the date of the gift of the property so given, divided by the number of donees then living. The donor of any gift may as to each gift limit such withdrawal rights as to any one or more of the donees in amount or negate the withdrawal right entirely. Each donee's right to withdraw is non-cumulative and, to the extent not exercised, will lapse 30 days after the date of the receipt of the written notice of the gift or December 31 of the calendar year when the gift is received, whichever is earlier. The right to withdraw is not to exceed the greater of \$5,000 or 5% of the total value of trusts subject to the right to withdraw.

Article II, Section C provides that the trustees are to have discretion to use so much of the income and principal of Trust 1, as they deem advisable by making payments directly to or by applying payments for any one or more of the descendants of Wife and Husband, at such time or times and in such amounts, proportions and manner as the trustees deem appropriate.

Article II, Section D provides that upon the death of the survivor of Wife and Husband, or earlier if the trustees determine that it is desirable to divide the property, the trustees are to divide the property then remaining in Trust 1 into as many equal shares as there are children of Wife and Husband then living and children then deceased leaving issue then living.

Article II, Section D(1) provides as follows:

Until the distribution date (as defined in Article III below), our Trustees shall continue to hold, manage, invest and reinvest each share set apart for a child of ours then living, and each share set apart for the issue of a then deceased child of ours, as a separate trust and shall distribute to the child and the child's issue (in the case of the share for each child), and the issue of a then deceased child and such issue's further issue (in the case of the share for the issue of a then deceased child) (in each such case the beneficiaries are referred to as "descendants") as much of the net income and principal of the respective shares, including the whole thereof, as they shall in their direction deem advisable for the benefit of our descendants by making payments directly to or by applying the same for any one or more of them, at such time or times and in such amounts, proportions and manner as our Trustees deem appropriate, with full power to accumulate any amounts of income not so paid or applied and to hold the same for future use or to add the same in whole or in part to principal.

Article II, Section G provides that if at any time there shall be no person or estate eligible to take in accordance with the provisions of Trust 1 and there are children or further issue of Sister and Brother-in-law who are then living: (a) the trustees are to pay the remaining property of the GST Exempt Trust and the Non-Exempt Trust to the trustee of Trust 2 (a trust executed by Sister and Brother-in-law for the benefit of their descendants), to be held in accordance with the terms of Trust 2; or (b) if Trust 2 is not in existence at that time, the Trustees are to pay the remaining property in equal shares to the children of Sister. In the event that no children or further issue of Sister and Brother-in-law are living at the time that property is to be paid, the trustees are to pay the remaining property of the GST Exempt Trust and the Non-Exempt Trust to Charity.

Article III provides that each trust, unless sooner terminated in accordance with its terms, is to terminate in all events upon 21 years after the death of the last to die of any of the descendants of the parents of Wife or the mother of Husband who were living on Date 1. Upon termination, the trustees are to pay the then remaining principal and undistributed income of each separate trust then existing, free of all trusts, to the living descendants who are beneficiaries under the relevant trust, per stirpes.

Husband and Wife each transferred property to Trust 1 on Date 2. In accordance with the terms of the trust, the trustee divided the trust into two separate trusts, the GST Exempt Trust and the Non-Exempt Trust. On timely filed federal gift tax returns (Form 709), Husband and Wife each allocated GST exemption to the GST Exempt Trust.

The trustee represents that the primary intention of Wife and Husband in creating Trust 1 was to provide for the issue of Wife and Husband. Accordingly, it was their intent that Trust 1 corpus was to be distributed to Trust 2 only in the event that there are no issue of Wife and Husband then living. However, under Article II, Section G as currently drafted, after the establishment of the separate share trusts in Article II,

Section D, if a child of Wife and Husband were to die leaving no issue, or if the child and all of the child's issue were to die, there would be no remaining current beneficiaries of that particular share trust. Pursuant to the provisions of Article II, Section G, the property held in such share trust would then be distributed to Trust 2 rather than be divided among any other share trusts then in existence under Trust 1. The trustee also represents that Trust 1, as currently drafted, contains an ambiguity that could cause the property held in a particular share trust to continue to be held in that share trust even if there were no beneficiaries eligible to receive income or principal from such share trust.

In order to correct this scrivener's error, the Trustee has brought an action in County Court to reform the provisions of Trust 1 (that is, the GST Exempt Trust and the Non-exempt Trust). On Date 3, County Court reformed Article II, Section D(1) by removing the phrase "[u]ntil the distribution date (as defined in Article III below)" and by adding the following language:

At such time as there are no living beneficiaries of a separate share trust, such trust shall terminate, and any remaining property in such trust shall be divided into as many equal shares as there are children of ours then living and children of ours then deceased leaving issue then living, with the share for a then living child to be held and disposed of as part of the separate share trust established for such child under this Paragraph D(1), and with the share for a then deceased child with then living issue to be held and disposed of as part of the separate share trust established for such deceased child (or such deceased child's issue, as the case may be) under this paragraph D(1), or if such separate share trust is, for any reason, not then in existence, our Trustees shall establish a separate share trust for such then living child or the then living issue of such deceased child in accordance with the provisions of this Paragraph D(1). At such time as there are no living issue of ours, any remaining trust property shall be disposed of pursuant to the provisions of Paragraph G of this Article II.

You have requested a ruling that the proposed reformation of the GST Exempt Trust and the Non-Exempt Trust will not alter the inclusion ratio of the GST Exempt Trust under section 2642 of the Internal Revenue Code.

LAW AND ANALYSIS

Section 2601 imposes a tax on every generation-skipping transfer. Under section 1433(a) of the Tax Reform Act of 1986 (Act), the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, 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 tax does not apply to any generation-skipping transfer from a trust, if the trust was irrevocable on September 25, 1985, and no addition (actual or constructive) was made to the trust after that date. Under section 26.2601-1(b)(1)(ii), any trust in existence on September 25, 1985, will be considered irrevocable unless the settlor had a power that would have caused inclusion of the trust in his or her gross

estate under section 2038 or 2042, if the settlor had died on September 25, 1985.

Under section 2602, the amount of tax imposed under section 2601 is determined by multiplying the taxable amount (the amount involved in the GST transfer) by the applicable rate. Under section 2641, the term "applicable rate" means the product of the maximum federal estate tax rate in the year that the generation-skipping transfer occurs and the inclusion ratio. Under section 2642(a)(1), the inclusion ratio with respect to any property transferred in a generation-skipping transfer is 1 minus the applicable fraction. Under section 2642(a)(2), in general, the numerator of the applicable fraction is the amount of GST exemption allocated to the property transferred and the denominator is the value of the property transferred.

Under section 2631, every individual is allowed a GST exemption amount which may be allocated by the individual or the individual's executor to any property with respect to which the individual is the transferor.

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 by reason of section 1433(b)(2)(A) of the Act 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 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.

Section 26.2642-4(a) provides rules for determining the applicable fraction with respect to a trust whenever additional exemption is allocated to the trust or when certain changes occur with respect to the principal of the trust.

No guidance has been issued concerning changes that may affect the status of trusts that are exempt from GST tax because sufficient GST exemption was allocated to the trust to result in an inclusion ratio of zero. At a minimum, a change that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status of such a trust.

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 execution. Cite 1 quoting Cite 4. In addition, the courts have accepted extrinsic evidence, such as the attorney's affidavit, that demonstrates that there has been a mistake. Cite 2.

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, an examination of the relevant trust instruments and representations of the parties indicate that Husband and Wife intended that trust corpus and income would be distributed from Trust 1 to Trust 2 only in the event there was no longer any issue of Husband and Wife living that could receive Trust 1 distributions. Accordingly, we conclude that the reformation of Trust 1 (The GST Exempt Trust and the Non-exempt Trust) is consistent with applicable State law that would be applied in the highest court of State. Accordingly, based on the facts presented and the representations made, the reformation of the GST Exempt Trust and the Non-exempt Trust, as proposed, will not alter the inclusion ratio of the GST Exempt Trust under section 2642.

In accordance with the Power of Attorney on file with this office, copies of this letter are being sent to your authorized representatives.

Except as expressly provided herein, no opinion is expressed or implied concerning the 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.

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,

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

Enclosure:

Copy of letter for section 6110 purposes