

Internal Revenue Service

Department of the Treasury

Number: **200318064**
Release Date: 5/2/2003
Index No.: 1001.00-00
2511.00-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:ITA:4 – PLR-129513-02
Date: January 28, 2003

LEGEND:

Trust =

Grantor =

Spouse =

Date1 =

Month 1 =

Date 2 =

Attorney =

C1 =

C2 =

C3 =

Dear :

This is in response to your letter dated May 22, 2002, requesting rulings regarding the federal income and gift tax consequences of proposed amendments to a trust. Specifically, you have requested rulings that the amendments to the terms of the trust do not give rise to gain or loss under § 1001 of the Internal Revenue Code or to gift tax consequences under § 2501.

FACTS

On Date 1, Grantor created Trust, an irrevocable trust. Grantor was named as the trustee.

PLR-129513-02

On Date 1, Grantor and Spouse had only one child, C1. Article II of Trust identified C1 as the “initial beneficiary,” and stated that “[a]ny child or children of the grantor and [Spouse] hereafter born or adopted also shall be beneficiaries of the trust.”

Article III of Trust provides as follows:

The initial trust estate shall be held and administered as a separate trust for [C1], and distributed as hereinafter directed. Unless the donor otherwise directs, the trustee shall divide any property subsequently transferred to this trust into separate and equal shares, one share for the separate trust for each living beneficiary. The sole beneficiary of each separate trust shall be the beneficiary for whom it is allocated.

Article V, Paragraph A of Trust provides that while any beneficiary is under the age of thirty years, the trustee shall use so much of the income from his or her trust for his or her education as the trustee in his sole discretion determines to be reasonable and add any income not so used to principal.

Article V, Paragraph B of Trust provides that until distribution of the balance of his or her trust, the trustee may pay to or use for the benefit of any beneficiary for his or her education so much of the principal of his or her trust as the trustee in his or her sole discretion determine to be reasonable for that purpose.

Article V, Paragraph C of Trust provides that when a beneficiary reaches the age of thirty years, the trustee shall distribute to him or her the balance of his or her trust, whereupon the trust shall terminate.

Article V, Paragraph D of Trust provides that upon the death of a beneficiary before he or she becomes entitled to receive the entire principal of his or her trust, the trustee shall distribute his or her trust, or any remaining portion thereof to the deceased beneficiary's descendants, per stirpes, or, if there is no descendant of the deceased beneficiary then living, to the then living beneficiaries of this trust, per stirpes. Subsequently, Grantor and Spouse had two more children, C2 and C3.

Grantor has stated that, after the birth of C3, he “began to question the terms of the Trust in relation to his duties as Trustee.” Grantor also stated that at the time he created Trust, it was his intent for all of his children, including after born children, to share with one another equally in the assets of Trust and that he believed the trust agreement effected this intention. The attorney who drafted the trust agreement, Attorney, stated that the trust agreement was the “normal form” he used for a standard gift trust for minor children and that he intended that the terms be applied in such a manner as to treat all of Grantor's children, including after born children, equally.

PLR-129513-02

To conform the terms of the trust to his original intent, Grantor sought to reform Trust under § 11.96A.220 of the Revised Code of Washington (State Code). Under § 11.96A.220 of the State Code, parties may agree to a resolution of any matter by written agreement signed by all parties. Any such agreement will be binding and conclusive on all persons interested in the estate or trust. Section 11.96A.030(1)(a) of the State Code defines “matter” to include, as relevant here, any issue, question, or dispute involving the determination of any question arising in the administration of an estate or trust, or with respect to any nonprobate asset, or with respect to any other asset or property interest passing at death, that may include, without limitation, questions relating to the construction of wills, trusts, community property agreements, and other writings.

A special representative was appointed to represent each minor child of Grantor and Spouse in accordance with § 11.96A.250 of the State Code. Section 11.96A.250(1)(a) of the State Code provides, in pertinent part, that a trustee may petition the court having jurisdiction over the matter for the appointment of a special representative to represent a person who is interested in the trust and who is a minor. Section 11.96A.250(1)(c) provides that a special representative may enter into a binding agreement on behalf of the beneficiary he or she represents.

In Month 1, Grantor and the special representatives entered into a binding agreement provided for under § 11.96A.220 of the State Code to reform the trust. The reformation will be retroactive to the date the trust was created, but is contingent upon receipt of a favorable ruling from the Internal Revenue Service that the clarified provisions will have no unfavorable income or gift tax consequences.

Pursuant to the reformation, Article III of Trust will be deleted in its entirety. In addition, Article V, Paragraphs A, B, C, and D of Trust will be replaced with amended paragraphs A, B, C, and D, detailed in relevant part as follows:

Article V, Paragraph A of Trust, as amended, will provide that the trustee “shall hold, administer and distribute the income and principal of the entire Trust for the benefit of all the children born or adopted between the Grantor and [Spouse] (hereinafter the “beneficiaries” or “beneficiary,” as the case may be).” Article V, Paragraph A of Trust, as amended, will also provide that once the eldest beneficiary reaches age thirty, the trustee shall divide Trust into equal shares, one share for each beneficiary who is then living and one share for each beneficiary who is then deceased with descendants then living. Article V, Paragraph A of Trust, as amended, will further provide that prior to the eldest beneficiary reaching age thirty, the trustee may distribute income and principal as the trustee deems necessary for a beneficiary’s education, which will be considered an advancement against the ultimate division of shares.

Article V, Paragraph B of Trust, as amended, provides for distributions after the division into shares. Article V, Paragraph C of Trust, as amended, provides for distributions on the death of a beneficiary. Article V, Paragraph D of Trust, as amended, provides for distributions to descendants of a deceased beneficiary.

PLR-129513-02

The parties to the agreement obtained judicial approval of the agreement in a court of competent jurisdiction on Date 2, as provided for under §§ 11.96A.240 and 11.96A.230 of the State Code. Section 11.96A.240 of the State Code provides, in pertinent part, that a special representative may note a hearing for presentation of the written agreement to a court of competent jurisdiction. The court will review the agreement on behalf of the parties represented by the special representative and determine whether or not the interests of the represented parties have been adequately represented and protected, and an order declaring the court's determination shall be entered. If the court determines that such interests have not been adequately represented and protected, the agreement shall be declared of no effect. Section 11.96A.230 of the State Code provides, in pertinent part, that if, under § 11.96A.240 of the State Code, a court has determined that the special representative has adequately represented and protected the parties represented, the agreement may be filed with the court having jurisdiction over the trust and the agreement will be deemed approved by the court and is equivalent to a final court order binding on all persons interested in the trust.

RULING 1

Grantor has requested a ruling that the reformation of Trust by the binding agreement will not result in a transfer in trust under § 2511(a) that is subject to tax under § 2501(a).

Section 2501 provides that a tax is imposed for each calendar year on the transfer of property by gift during the calendar year.

Section 2511(a) provides that the gift tax 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.

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 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.

PLR-129513-02

Generally, if, due to a mistake in drafting, the instrument does not contain the terms of the trust that the grantor and the trustee intended, the grantor or other interested party may maintain a suit in equity to have the instrument reformed so that it will contain the terms that were actually agreed upon. Bogert & Bogert, *The Law of Trusts and Trustees*, section 991 (revised 2d ed. 1983). The law in Washington recognizes that instruments may be reformed if the written agreement does not express the intent of the parties. Geoghegan v. Dever, 30 Wn.2d 877, 194 P.2d 397 (1948); Saterlie v. Lineberry, 92 Wn.App. 624, 962 P.2d 863 (1998).

Based on the facts submitted and the representations made, we conclude that §§ 11.96A.220, 11.96A.230, and 11.96A.240 of the State Code authorize the reformation of Trust and that the reformation is consistent with applicable state law as it would be applied by the highest court in the state of Washington. Therefore, the reformation of Trust by binding agreement will not result in a transfer in trust under § 2511(a) that is subject to tax under § 2501(a).

RULING 2

Section 61(a)(3) provides that gross income includes gains derived from dealings in property. Under § 1.61-1(a) of the Income Tax Regulations, gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services.

Under § 1001(a), 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 shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

Under § 1.1001-1(a), the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially in kind or extent, is treated as income or loss sustained. Properties are viewed as “different” in a sense that is “material” to the Code when their possessors enjoy legal entitlements different in kind or extent from the properties given up. Cottage Savings Association v. Commissioner, 499 U.S. 554, at 564-565 (1991).

As a general matter, a transaction will be a taxable event under §1001 if (1) the transaction is a sale, exchange, or other disposition of property and (2) when there is an exchange, the exchange results in the receipt of property that is “materially different.”

The court has approved the reformation to correct drafting errors and to effectuate the original intent of Grantor. Because the reformation will be retroactive to the date Trust was created, there can be no differences between the beneficiaries’ interests in Trust before and after the reformation agreement. Further, Trust will be the same before and after the reformation agreement. Therefore, the reformation of Trust is not a sale,

PLR-129513-02

exchange, or other disposition of property. Consequently, neither Trust nor the beneficiaries of Trust will realize gain or loss under §1001. Because no gain will be realized, no income will result from the reformation under §61.

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under § 6110 of the Internal Revenue Code.

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

Robert A. Berkovsky
Branch Chief
Office of Associate Chief Counsel
(Income Tax & Accounting)

Enclosures (2)