

## Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Third Party Communication: None

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Person To Contact:

, ID No.

Telephone Number:

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Date:

December 11, 2017

RE:

### LEGEND

Date 1 =  
Settlor =  
Trust =

Child 1 =  
Individual =  
Bank =  
Charity =  
State =  
Child 2 =  
Child 3 =  
Grandchild 1 =  
Grandchild 2 =  
Year 1 =  
Year 2 =  
Date 2 =  
State Court =  
Date 3 =  
Citation 1 =  
Citation 2 =  
Citation 3 =

Dear :

This letter responds to your authorized representative's letter of June 26, 2017, regarding the income, gift, and generation-skipping transfer (GST) tax consequences of a judicial construction of Trust.

### FACTS

The facts and representations submitted are summarized as follows. On Date 1, a date prior to September 25, 1985, Settlor established an irrevocable trust, Trust, for the benefit of his lineal descendants. The current trustees of Trust are Child 1, Individual, and Bank (Trustees).

Article FIRST, paragraph B provides, in part, that as much of the net income and of the principal as the trustees may from time to time think desirable "shall be expended for the welfare, comfort, support and education of such one or more of the group composed of my children, their issue and their descendants, and the spouses of [the Settlor's] said beneficiaries, and in such amounts or proportions as the trustees may from time to time, in their sole discretion, think best."

Article FIRST, paragraph C provides that upon the termination of Trust, the then-remaining principal shall be paid *per capita* to Settlor's then living descendants and in default to Charity.

Trust shall terminate twenty-one years after the death of the last survivor of the group composed of the descendants of Settlor's grandfather living on Date 1.

Article ELEVENTH provides that Trust is governed by the law of State.

Settlor has three biological children, Child 1, Child 2, and Child 3. Child 1 has three biological children. Child 2 adopted Grandchild 1 and Grandchild 2, as adults in Year 1. Grandchild 2 had no children and died in Year 2. Child 3 is an adult and has no children.

Trust does not define whether the words "issue," "descendants," and "children" include or exclude adopted individuals.

Settlor is currently living and has attested that at the time Trust was created, and all times thereafter, Settlor intended for Trust to benefit only blood descendants.

On Date 2, Trustees petitioned State Court for a declaratory judgment construing the ambiguous terms of Trust consistently with the intent of Settlor.

On Date 3, State Court entered an order construing the words "issue," "descendants," and "children" in Trust to include only "blood issue," "blood children," and genetic

descendants of Settlor, and not to include any adopted persons. The order is conditioned upon a favorable ruling by the Internal Revenue Service.

You have requested the following rulings:

- (1) The State Court order construing the ambiguous terms of Trust will not affect the exempt status of Trust for GST tax purposes, and will not cause any distribution from, or termination of any interest in, Trust to be subject to the GST tax imposed under § 2601 of the Internal Revenue Code (Code), so that the State Court order may become effective;
- (2) The State Court order construing the ambiguous terms of Trust will not result in a transfer that is subject to gift tax under § 2501 of the Code; and
- (3) The State Court order construing the ambiguous terms of Trust will not constitute a taxable disposition of Trust's assets for purposes of § 1001 of the Code.

## LAW AND ANALYSIS

### Ruling 1

Section 2601 imposes a tax on every GST, which is defined under § 2611 as a taxable distribution, a taxable termination, or a direct skip.

Under § 1433 of the Tax Reform Act of 1986 (the Act), GST tax is generally applicable to GSTs made after October 22, 1986. However, under § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the tax does not apply to a transfer under a trust that was irrevocable on September 25, 1985, except to the extent the transfer is made out of corpus added to the trust by an actual or constructive addition after September 25, 1985.

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 under § 26.2601-1(b) will not cause the trust to lose its exempt status. These rules are applicable only for purposes of determining whether an exempt trust retains exempt status for GST 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.

Section 26.2601-1(b)(4)(i)(E), *Example 3* considers a situation where, 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. According to *Example 3*, 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 GST tax.

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.

Under State common law, it is well settled that the intent of a settlor controls in interpreting the terms of a will or a trust. *Citation 1*; *Citation 2*. If that intent is not evident from the plain meaning of the words of the instrument, then the circumstances and facts surrounding the creation of the trust are consulted; and then only as a last resort are the canons of construction used. *Id.*

At the time Trust was executed, there was a well-established State common law rule that, in the absence of any demonstration of the actual intent of the testator, a presumption arose that the words "child" or "children" excluded adopted children. See *Citation 3*. After Trust was established, a new rule of construction was adopted, reversing the prior State common law precedent. *Id.* Under the new rule of construction, absent contrary intent by the settlor, the word "children" would be read to include adopted persons. *Id.*

In this case, the terms of Trust present a bona fide issue regarding whether an adopted grandchild of Settlor is considered a member of the class of “issue,” “descendants,” or “children” and therefore a beneficiary of Trust. State Court’s order construing the ambiguous terms is consistent with applicable state law that would be applied by the highest court of the state. Accordingly, based on the facts submitted and the representations made, the State Court’s order construing Trust will not affect the exempt status of Trust for purposes of the GST tax and will not result in a transfer of property that will subject Trust or distributions thereunder to the GST tax imposed under § 2601.

### Ruling 2

Section 2501 provides that a tax is 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 the tax imposed by § 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 25.2511-1(c) of the Gift Tax Regulations provides that any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax.

Section 2512(a) provides that, if a gift is made in property, the value thereof at the date of the gift will be considered the amount of the gift. Section 2512(b), provides, in part, 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 shall be deemed a gift.

In this case, State Court’s order clarifies the ambiguous terms “issue,” “descendants,” and “children” in accordance with Settlor’s intent. In addition, as previously discussed, State Court’s construction of Trust is consistent with applicable state law that would be applied by the highest court of the state. Therefore, based on the facts submitted and the representations made, we conclude that the State Court’s order construing the ambiguous terms is not a transfer for gift tax purposes and does not constitute a taxable gift pursuant to § 2501.

### Ruling 3

Section 61(a)(3) and (15) of the Code provides that gross income includes gains derived from dealings in property and income from an interest in a trust.

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

§ 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized.

Section 1001(b) states that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. Under § 1001(c), except as otherwise provided in subtitle A, the entire amount of gain or loss, determined under § 1001, on the sale or exchange of property shall be recognized.

Section 1.1001-1(a) of the Income Tax Regulations provides that 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 loss sustained.

State Court has issued an order clarifying the meaning of the ambiguous terms “issue,” “descendants,” or “children” in Trust consistent with the intent of Settlor. The State Court order resolves an ambiguity as to the construction of Trust. Thus, the State Court order carries out the intent of Trust rather than results in a disposition of Trust’s interests. Accordingly, based on the facts submitted and the representations made, we conclude that the State Court order as described will not result in the realization of gain or loss under §§ 61 and 1001.

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.

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

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

*Karlene M. Lesho*

Karlene M. Lesho  
Senior Technician Reviewer, Branch 4  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)

Enclosures (2)

Copy for § 6110 purposes  
Copy of this letter