Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:4 - PLR-122398-00
Date: March 13, 2001

Re:

Legend

Settlor =
Spouse =
Trust 1 =
Date 1 =
Trust 2 =
Date 2 =
Year 1=
Date 3 =
Court =
State =

Dear :

This is in response to a letter dated October 17, 2000, and subsequent correspondence submitted on behalf of the taxpayers, in which rulings were requested concerning the federal gift and estate tax consequences of a court order reforming Trust 1 and Trust 2.

Facts

The facts submitted and representations made are as follows:

Settlor and his Spouse created two irrevocable trusts, Trust 1, executed on Date 1, and Trust 2, executed on Date 2.

Under the terms of both Trust 1 and Trust 2, during Settlor's life, the trustee may distribute any amount of income and principal among Spouse, the then-living issue of Settlor, and Spouse's parents. After Settlor's death, the trustee may distribute any amount of income and principal among Spouse, the then-living issue of Settlor and

Spouse, and Spouse's parents. At Spouse's death, the trust assets will be distributed as Spouse appoints by will among the issue of Spouse and Settlor, excluding Spouse's estate or creditors. Any part of the trust assets not so appointed will be retained in trust until the death of the last to die among Spouse's parents and Settlor and then continued in trust for the benefit of any then-living children of Settlor under the age of 25. While the trust assets are held for such children, the trustee has discretion to distribute income and principal among Settlor's children under specified circumstances. At the twenty-fifth birthday of Settlor's youngest child, the trust will continue for the benefit of Settlor's then-living issue.

A bank is named as the initial trustee of both trusts. Article IX of each trust provides for the removal and replacement of the trustee with "a corporation qualified to administer trusts" by Settlor during his lifetime, by Spouse after his death, and, after both of their deaths, by the income beneficiaries (or their personal guardians) acting unanimously.

Both Spouse and Settlor represent that they intended, and understood from the attorney who drafted the trusts, that none of the assets held by either trust would be includible in the gross estates of either Spouse or Settlor. In a March 29, 1976 letter to Settlor and Spouse, the scrivener stated that Trust 1 was created:

> so that you can make gifts to it to remove property from your estate for federal estate tax purposes. This trust could, for example, be the owner of any insurance policies on either [Settlor's] or [Spouse's] life.

Trust 1 owns one life insurance policy on Settlor's life and Trust 2 owns five life insurance policies on Settlor's life.

The scrivener died soon after drafting Trust 2. In Year 1, Settlor's estate planner and one of his life insurance agents examined the provisions of the trusts. Each of them discovered the following provisions which, they believed, could cause the trust assets to be includible in the gross estate of Settlor or of Spouse.

Section 1:01 of Article I of Trust 1, names Settlor among the beneficiaries to whom the trustee may make discretionary distributions of income and principal during Settlor's life and states that such distributions "shall be limited to those distributions necessary in the Trustee's sole and absolute discretion to support the Settlor's present standard of living. . . ."

Section 2:02 of Article II of Trust 1 and Section 2:02 of Article II of Trust 2 provide Spouse with a testamentary power to appoint the assets held in each trust among the issue of Settlor and Spouse and further state, "provided however, that this power of appointment may not be exercised for appointment to or for the benefit of her estate or her creditors."

Section 7:13 of Article VII of Trust 1 provides:

> The Trustee is directed to pay any and all charitable pledges made by Settlor and/or Settlor's wife and not paid or paid in full by Settlor and/or Settlor's wife during his or her lifetime, and to pay any and all charitable bequests made by Settlor and/or Settlor's wife in his or her Will which bequests are not paid by Settlor's estate and/or Settlor's wife's estate, notwithstanding that such charitable pledges or bequests might not be enforceable against the Settlor and/or Settlor's wife or against Settlor's estate and/or Settlor's wife's estate.

Section 7:15 of Article VII of Trust 1 and Section 7:14 of Article VII of Trust 2 provide:

> The Trustee may in its sole and absolute discretion pay any and all Federal or State, Estate or Inheritance Taxes or administration costs, incurred because of or arising as a result of Settlor's death and/or Settlor's wife's death from the assets or income that are a part of the [Trust] hereinabove defined. The Trustee may also in its sole and absolute discretion pay any and/or all last debts or debts existing at the time of the death of the Settlor and/or Settlor's wife, whether or not matured, if the payment of such debts shall be of advantage to the Trust Estate or to any of the beneficiaries hereunder.

On Date 3, Spouse, as beneficiary of Trust 1 and Trust 2, filed petitions with Court, requesting reformations of both Trusts. The petitions state that the trusts were established for the purpose of owning life insurance policies on Settlor's life and that Settlor intended that these policies would not be includible in the gross estates of Settlor or Spouse for federal estate tax purposes. Further, the petitions allege that Settlor recently learned that specific provisions in each trust agreement might cause inclusion of the value of the policies or of the death benefits in the gross estates of Settlor or Spouse and that, had he understood the estate tax consequences of these provisions, Settlor would not have signed the trust agreements.

The petition regarding Trust 1 requests that the trust be reformed as follows:

1. All mention of Settlor should be omitted from Section 1:01 of Article I which provides for a class of beneficiaries to whom income and principal may be paid during Settlor's life.

2. Section 2:02 of Article II should be reformed to state, "provided however, that this power of appointment may not be exercised for appointment to or for the benefit of herself, her estate, her creditors, or the creditors of her estate."

3. Section 7:13 and Section 7:15 of Article VII should be deleted in their entireties.

The petition regarding Trust 2 requests that the trust be reformed as follows:

1. Section 2:02 of Article II should be reformed to state, “provided however, that this power of appointment may not be exercised for appointment to or for the benefit of herself, her estate, her creditors, or the creditors of her estate.”

2. Section 7:14 of Article VII should be deleted in its entirety.

The following rulings have been requested:

1. Neither Settlor nor Spouse will make a taxable gift for federal gift tax purposes as a result of the reformations of Trust 1 and Trust 2.

2. The reformations of Trust 1 and Trust 2 will not cause any part of the value of any property of Trust 1 or Trust 2 to be included in the gross estate of Settlor or of Spouse for federal estate tax purposes.

Law and Analysis

Section 2501(a)(1) imposes a tax, for each calendar year, on the transfer of property by gift by any individual, resident or nonresident. Section 2511 provides that the tax imposed by § 2501 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 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 exceeds the value of the consideration is deemed a gift.

Section 2001(a) imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States. Under § 2031, the decedent’s gross estate includes the value of all property to the extent provided for in §§ 2033 through 2045. Section 2033 states that the value of a decedent’s gross estate includes the value of all property to the extent of the interest therein of the decedent at the time of his death.

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.

Generally, if, due to a mistake in drafting, the instrument does not contain the terms of the trust that the settlor and the trustee intended, the settlor 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, § 991 (revised 2d ed. 1983). The law in State recognizes that instruments may be reformed if the written agreement does not express the intent of the parties. Colbo v. Buyer, 134 N.E.2d 45 (Ind. 1956).

Based on the facts submitted and the representations made, we believe that the reformations of Trust 1 and Trust 2 are consistent with applicable state law as it would be applied by the highest court of State. Therefore, based on the facts submitted and the representations made, we conclude that neither Settlor nor Spouse will make a taxable gift for federal gift tax purposes as a result of the reformations of Trust 1 and Trust 2 and that the reformations of Trust 1 and Trust 2 will not cause any part of the value of any property of Trust 1 or Trust 2 to be included in the gross estate of Settlor or Spouse for federal estate tax purposes.

Except as specifically ruled herein, we express no opinion on the federal tax consequences of the transaction under the cited provisions or under any other provisions of the Code.

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

Sincerely yours,
Associate Chief Counsel
(Passthroughs and Special Industries)
By James F. Hogan
Assistant to the Chief
Branch 4

Enclosure
Copy for section 6110 purposes