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Department of the Treasury

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Date:

August 9, 2001

Legend:

Taxpayers

Settlor
Trust Agreement

A
B
C

Petition 1
Petition 2

Order 1
Order 2

Court 1
Court 2

Bank

State
State Code 1
State Code 2

Date 1
Date 2
Date 3

Year 1
Year 2

Dear

This is in response to your letter dated March 30, 2001, and prior correspondence requesting, on behalf of Taxpayers, rulings under §§ 61, 1001, and 2601 of the Internal Revenue Code.

Settlor created Trust B and divided Trust B into three separate trusts under Trust Agreement on Date 1. The trust established for the benefit of C is not at issue because the interests in the assets of that trust were vested in the sole remainder beneficiary of that trust after C's death. The two remaining trusts, one for the benefit of A and the other for the benefit of B, have been exempt from the Generation-Skipping Transfer (GST) tax.

Article VII (c) of Trust Agreement provides that the Trustees shall place all the remaining property listed and described in Schedule A, attached hereto, in Trust B and shall divide such Trust B into three (3) equal shares for the benefit of the Donor's three (3) children, A, B, and C, and for their children. The Trustees shall each year collect the income from each share and shall pay over and distribute each year to the child of the Donor for whom such share is set aside, for and during his natural life, such portions of the income from said share (and such portions of the principal of said share when the income is inadequate) as may be necessary or desirable in the sound discretion of the Trustees for the maintenance, care and support of said child, bearing in mind the circumstances and standard of living to which he shall have become accustomed.

Article VII (d) of Trust Agreement provides that upon the death of a child of the Donor, the Trustees shall divide his said share into as many equal parts as there are children of said child surviving him, shall collect each year the income from each part, and shall pay over and distribute each year to the child of his (grandchild of the Donor) for whom said part is set aside until said child of his shall reach the age of thirty (30), such portion of the income from said part (and such portion of the principal of said part when the income is inadequate) as may be necessary or desirable in the sound discretion of the Trustees for the education, care and support of said child. Upon said child's reaching the age of thirty (30), the Trustees shall pay over and distribute all of the property with all accumulations thereon then remaining in said part to said child (grandchild of the Donor) to be his absolutely and forever. If said grandchild should die before reaching the age of thirty (30) and without leaving any child of his surviving him, the Trustees shall divide his said part of said share equally among the other parts of said share or, if there are no other children and no grandchildren of said child of the Donor then surviving, equally between the other two (2) trusts.

Article VII (e) of Trust Agreement provides in part that if said grandchild should

die before reaching the age of thirty (30) and should leave a child or children of his surviving him, the Trustees shall divide his said part of said share into as many equal sub-parts as there are children of said grandchild surviving him, shall collect each year the income from each sub-part, and shall pay over and distribute each year to the child of his (great-grandchild of the Donor) for whom said sub-part is set aside until said child shall reach the age of twenty-one (21), such portion of the income from said sub-part (and such portion of the principal of said sub-part when the income is inadequate) as may be necessary or desirable in the sound discretion of the Trustees for the education, care and support of said child.

Article VII (j) of Trust Agreement provides that the Trustees shall hold each share, each part of a share, and each sub-part of a part of a share set up under this Article VII as a separate trust.

Article X (c) of Trust Agreement provides in part that the Trustees, acting jointly and in concert, shall have full power and authority, in their sole discretion, and without being required to apply to any court for prior authority or subsequent approval in respect thereof, and without being subject to the laws of any state or nation in respect of the investment of trust funds or the management of trust property to manage, hold, improve, sell, convey, exchange or lease, perpetually or for any term even extending beyond the duration of any trust, with or without privilege of purchase, the whole or any part of the property or assets of the trust, real or personal, including any property that may be substituted for or added to property originally held, for such prices, and on such terms and conditions, as the Trustees may deem advisable, and invest and reinvest any of the trust funds held hereunder, in such amounts as the Trustees may see fit, in such stocks, bonds, insurance on any beneficiary's life or other investments or property, real or personal, as they may in their discretion deem advisable without being bound by the laws of any state restricting the types or proportions of securities or other property in which investments may be made by trustees and without applying to any court for prior authority therefor or for subsequent approval thereof.

Article VII (e) of Trust Agreement provides for the distribution of the share of Settlor's grandchild who dies before attaining the age of thirty and leaving a child or children surviving. In that case, the share of Settlor's grandchild passes in equal shares to the children of Settlor's grandchild. However, no similar provision is made in Article VII (d) of Trust Agreement for the share of Settlor's grandchild who dies after attaining the age of thirty but before the death of his or her beneficiary parent. In that case, the share of Settlor's grandchild passes not to his or her children, but instead to Settlor's other grandchildren. Taxpayers represent that this is an arbitrary distinction and one that Settlor did not intend.

Recognizing that Trust Agreement contained a significant drafting error, the former Trustees, one of whom had drafted or supervised the drafting of Trust Agreement, filed Petition 1 in Court 1 in Year 1.

On Date 2, Court 1 signed Order 1. Court 1 found that under Article VII (e), as written, if a grandchild of Settlor should predecease his parent (a child of Settlor) after reaching the age of 30 with children surviving, those children would not take any distribution from the respective trusts. It was not Settlor's intention that this should occur, but it was her intention that the surviving child or children of such a grandchild should receive the grandchild's part of a share of the Trust.

Under Order 1, Article VII (e) of Trust Agreement was modified in relevant part to read as follows (changes underlined):

(e) If said grandchild should die before reaching the age of 30, or having reached the age of 30, should predecease his parent (the child of Donor) leaving a child or children surviving, the Trustees upon the death of said parent shall divide the grandchild's part of said share that he would have taken had he survived into as many equal sub-parts as there are children of said grandchild surviving him, shall collect each year the income from each sub-part, and shall pay over and distribute each year to the child of his (great-grandchild of the Donor) for whom said sub-part is set aside until said child shall reach the age of twenty-one (21),

In Year 2, Bank, as independent successor trustee, determined that Court 1 did not have subject matter jurisdiction to enter an order modifying Trust Agreement. Because Court 1 did not have jurisdiction to enter Order 1, Order 1 is void under State law. The taxpayers represent that none of the parties to Order 1 was aware that it was void based on lack of subject matter jurisdiction.

The remainder beneficiaries (grandchildren and great-grandchildren of Settlor) of the trusts created under Trust Agreement have filed Petition 2 in Court 2. In Petition 2, the remainder beneficiaries have requested the court to enter a judgment constructing and reforming Trust Agreement under State Code 1 in order to correct a drafting error and to avoid the defeat and substantial impairment of the intended purpose and accomplishment of Trust Agreement. Under the reformed Trust Agreement, if a grandchild of Settlor dies before the death of his beneficiary parent, the surviving child or children of that grandchild would be entitled in equal shares to the share that the grandchild would have received if he had survived his beneficiary parent.

In Petition 2, the remainder beneficiaries have requested Court 2 to enter a judgment partitioning each of the two trusts, one for the benefit of A and the other for the benefit of B, into two separate trusts as follows:

(a) As to the trust for the benefit of A, one partitioned trust is to consist of a fractional share of the entire trust determined by multiplying the value of the entire trust by a fraction, the numerator of which is \$16,000,000 and the denominator of which is the value of the entire trust as of the date of such partition, and the other partitioned trust is to consist

of the balance of the entire trust. Both partitioned trusts are to have identical beneficiaries and terms.

(b) As to the trust for the benefit of B, one partitioned trust is to consist of a fractional share of the entire trust determined by multiplying the value of the entire trust by a fraction, the numerator of which is \$16,000,000 and the denominator of which is the value of the entire trust as of the date of such partition, and the other partitioned trust is to consist of the balance of the entire trust. Both partitioned trusts are to have identical beneficiaries and terms.

The remainder beneficiaries also have requested that Court 2, pursuant to State Code 2, authorize the trustee to allocate assets to the partitioned trusts on a non-pro rata basis, in accordance with the trustee's discretion. Each partitioned trust is to have a specified fractional share of the value of the entire trust prior to the partition.

The taxpayers represent that the remainder beneficiaries are informed and believe that A or B or both may elect later to relinquish his or her entire beneficial interest as to a portion of his or her respective trust. In order to facilitate such a renunciation or relinquishment, the remainder beneficiaries have requested Court 2 to enter an order (a) partitioning both trusts, one for the benefit of A and the other for the benefit of B, into two separate (but otherwise identical) trusts and finding that it is or would be prudent and in the best interests of the trusts and their beneficiaries to do so or, alternatively, providing that the trustee has the authority to partition both trusts under State Code 2; and (b) finding that it is or would be prudent and in the best interests of the trusts and their beneficiaries to do so.

The remainder beneficiaries requested Court 2 delete Article VII (e) of Trust Agreement and modify Article VII (d) to read as follows:

(i) Upon the death of a child of the Donor, the Trustees shall divide his or her said share into as many equal parts as there are children of such child of the Donor (i.e., a grandchild of the Donor) then surviving and children of such child of the Donor then deceased leaving a child or children then surviving (i.e., a great-grandchild of the Donor). Each part for a deceased grandchild of Donor shall be further divided into as many sub-parts as there are children of such deceased grandchild of Donor then surviving.

(ii) Each part created for a grandchild who has reached the age of thirty (30) years at the time said part is created shall be distributed outright to such grandchild. Each part created for a grandchild who has not reached the age of thirty (30) years at the time said part is created shall be retained in trust as follows: The Trustees shall collect each year the income from such part, and shall pay over and distribute each year to the

grandchild for whom said part is created until said grandchild shall reach the age of thirty (30) such portion of the income from said part (and such portion of the principal of said part when the income is inadequate) as may be necessary or desirable in the sound discretion of the Trustees for the education, care, and support of said grandchild. Upon said grandchild reaching the age of thirty (30), the Trustees shall pay over and distribute all of the property with all accumulations thereon then remaining in said part to said grandchild to be his or hers absolutely and forever. If a grandchild for whom a part is held hereunder should die before reaching the age of thirty (30) and should leave a child or children surviving him or her, the Trustees shall divide the balance of that grandchild's part into as many sub-parts as there are children of said grandchild of the Donor (i.e., a great-grandchild of the Donor) then surviving, with such sub-parts held and distributed pursuant to (d)(iii) below. If a grandchild for whom a part is held hereunder should die before reaching the age of thirty (30) and should not leave a child or children surviving him or her, the Trustees shall divide and distribute the balance of that grandchild's part equally among the other parts of said share or, if there are no other children or grandchildren of said child of the Donor then surviving, equally between the other two (2) shares of Trust B.

(iii) Each sub-part created for a great-grandchild who has reached the age of twenty-one (21) years at the time said sub-part is created shall be distributed outright to such great-grandchild. Each sub-part created for a great-grandchild who has not reached the age of twenty-one (21) years at the time said sub-part is created shall be retained in trust as follows: The Trustees shall collect each year the income from such sub-part, and shall pay over and distribute each year to such great-grandchild for whom said sub-part is set aside until said great-grandchild shall reach the age of twenty-one (21), such portion of the income from said sub-part (and such portion of the principal of said sub-part when the income is inadequate) as may be necessary or desirable in the sound discretion of the Trustees for the education, care, and support of said great-grandchild. If a great-grandchild for whom a sub-part is held hereunder should die before reaching the age of twenty-one (21), the Trustees shall divide and distribute the balance of his or her sub-part equally among the other sub-parts of said part of said share or, if there are no other children of said grandchild of the Donor then surviving, equally among the other parts of said share or, if there are no other children or grandchildren of said child of the Donor then surviving, equally between the other two (2) shares of Trust B.

On Date 3, Court 2 issued Order 2 approving the proposed modification of the terms of Trust Agreement concerning the predeceased grandchild issue, the proposed partition of the relevant trusts, the proposed non-pro rata allocations of the assets of the

relevant trusts, and the proposed empowerment of the trustees to make loans to the beneficiaries of the trusts according to the prudent person standard under the law of State.

You represent that 1) Trust Agreement became irrevocable as of the date of its execution on Date 1, 2) There have been no additions to the trusts since Date 1, constructive or otherwise, and 3) There has been no other effective modification of the trusts or any construction, or amendment to, Trust Agreement.

You have requested, on behalf of Taxpayers, the following rulings:

- (1) The trusts, one for the benefit of A and her issue and the other for the benefit of B and his issue, will retain their GST tax exempt status:
 - (a) After the proposed judicial construction and reformation of the trusts concerning the predeceased grandchild issue;
 - (b) After the partition of the trusts;
 - (c) After the non-pro rata allocations of trusts assets to the resulting trusts;
 - (d) If the trustee elects to make one or more loans to the beneficiaries who are descendants of A or B pursuant to Article X(c) of Trust Agreement, provided that such loans are adequately secured and subject to a market rate of interest.

- (2) Any non-pro rata allocation of assets to the partitioned trusts would not cause the trusts or any beneficiary to recognize gain or loss from a sale or other disposition under §§ 61 and 1001.

Law and Analysis

Section 2601 imposes a tax on every generation-skipping transfer.

Under section 1433 of the Tax Reform Act of 1986 (the 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 § 26.2601-1(b)(1)(i) of the GST tax regulations, the tax does not apply to a transfer under a trust that was irrevocable on September 25, 1985, and no addition (actual or constructive) was made to the trust after that date.

Section 2611(a) provides that, for purposes of the GST tax, the term “generation-skipping transfer” means (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Section 2612(a)(1) provides that, for purposes of the GST tax, the term “taxable termination” means the termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in a trust unless –

(A) immediately after such termination, a non-skip person has an interest in such property, or

(B) at no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person.

Section 2612(b) provides that, for purposes of the GST tax, the term “taxable distribution” means any distribution from a trust to a skip person (other than a taxable termination or a direct skip).

Section 2612(c)(1) provides that, for purposes of the GST tax, the term “direct skip” means a transfer subject to a tax imposed by chapter 11 or 12 of an interest in property to a skip person.

Section 2613(a) provides that, for purposes of the GST tax, the term “skip person” means

(1) a natural person assigned to a generation which is 2 or more generations below the generation assignment of the transferor, or

(2) a trust –

(A) if all interests in such trust are held by skip persons, or

(B) if –

(i) there is no person holding an interest in such trust, and

(ii) at no time after such transfer may a distribution (including distributions on termination) be made from such trust to a non-skip person.

Section 2613(b) provides that, for purposes of the GST tax, the term “non-skip person” means any person who is not a skip person.

Section 26.2601-1(b)(1)(i) of the GST Tax Regulations provides in part that the GST tax does not apply to any generation-skipping transfer under a trust (as defined in § 2652(b)) that was irrevocable on September 25, 1985. The rule of the preceding sentence does not apply to a pro rata portion of any generation-skipping transfer under an irrevocable trust if additions 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 (as defined in § 2652(b)) in existence on September 25, 1985, is considered an irrevocable trust.

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)(D) provides that

(1) A modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A), (B), or (C) of this section) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

(2) For purposes of this section, a modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is measured against the effect of the instrument in existence immediately before the modification. If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification. A modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust.

Section 26.2601-1(b)(4)(i)(E), Example 5, illustrates a situation where a trust that is otherwise exempt from the GST tax is divided into two trusts. Under the facts presented, the division of the trust into two trusts does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the division, and the division does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Accordingly, the two partitioned

trusts will not be subject to the provisions of chapter 13.

In this case, the proposed division of the trusts by the trustees is substantively analogous to the facts presented in Example 5 of § 26.2601-1(b)(4)(i)(E). The proposed division of the trusts will not result in a shift of any beneficial interest in the trusts to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the division. Further, the proposed division will not extend the time for vesting of any beneficial interest in the trusts beyond the period provided for in the original trusts. Accordingly, based on the facts submitted and the representations made, we conclude that the trusts, one for the benefit of A and her issue and the other for the benefit of B and his issue, will retain their GST exempt status after the partition of the trusts. Further, under the reformation and the court order, the proposed non-pro rata allocation of trust assets to the resulting trusts by the trustee must equal the outcome of the fraction of the total value allocated to each partitioned trust. Accordingly, after the proposed non-pro allocation, the trusts will retain their GST tax exempt status.

Generally, if, due to a mistake in drafting, the instrument does not contain the terms of the trust that the settlor and 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 or intended. Bogert & Bogert, *The Law of Trusts and Trustees*, section 991 (revised 2d ed. 1983). State law recognizes that, if by mistake, an instrument written fails to express the true intention or agreement of the parties, equity will grant reformation of the instrument so as to make it correctly express the agreement actually made. The rule applies to express inter vivos trusts as well as to other written instruments. Any mistake of the scrivener which could defeat the intention may be corrected in equity by reformation whether the mistake is one of fact or law. Brinker v. Wobaco Trust Limited, 610 S.W.2d 160, 163 (Tex. Civ. App. Texarkana 1980). Upon consideration of the facts and applicable case law, we conclude that the proposed reformation concerning Article VII(e) corrects a scrivener's error and is consistent with applicable state law and, therefore, the trusts will retain their GST exempt status following the reformation of the Trust Agreement to correct this error.

Article X(c) confers administrative powers of the trustee to invest and manage the trust assets. Petitioners requested and the court found that Article X(c) of Trust Agreement should be construed to permit the trustee to make loans to beneficiaries as long as the loans were made under the prudent person standard under the law of State. For GST tax purposes, as long as loans made to beneficiaries of the trusts are secured and at a market rate of interest, the trusts will not lose their GST tax exempt status.

Based on the facts submitted and representations made, we conclude that the trusts, one for the benefit of A and her issue and the other for the benefit of B and his issue, will retain their GST tax exempt status: (a) After the proposed judicial construction and reformation of the trusts concerning the predeceased grandchild issue; (b) After the partition of the trusts; (c) After the non-pro rata allocations of trusts

assets to the resulting trusts; and (d) If the trustee elects to make one or more loans to the beneficiaries who are descendants of A or B pursuant to Article X(c) of Trust Agreement, provided that such loans are adequately secured and subject to a market rate of interest.

Section 61(a)(3) provides that gross income includes gains derived from dealings in property.

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 over the amount realized.

Section 1001(b) provides 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.

Section 1001(c) provides that, 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 a conversion of property into cash or from an exchange of property for other property, differing materially in kind or extent is treated as income or as loss sustained.

An exchange of property results in the realization of gain or loss under § 1001 if the properties exchanged are materially different. Cottage Sav. Assoc. v. Commissioner, 499 U.S. 554 (1991). There is a material difference if the exchanged properties embody legal entitlements “different in kind or extent” or if they confer “different rights and powers.” Id. at 565.

Each of the two trusts, one for the benefit of A and the other for the benefit of B, will be partitioned into two successor trusts and will distribute its assets to each successor trust on an in-kind, non-pro-rata basis. Each successor trust will have the same current beneficiary and remainder beneficiaries as that of the original trusts. Further, other terms and conditions of each successor trust will be the same as those of the original trusts. Accordingly, the sum of a beneficiary’s property rights under the original trusts will equal the beneficiary’s combined sum of such rights under the two successor trusts. As no material difference in the rights and powers of a beneficiary will result from the partition, a beneficiary will sustain no gain or loss under § 61 or § 1001 from the partition.

This ruling is based on the facts presented and the applicable law in effect on the date of this letter. If there is a change in material fact or law (local or federal) before the

transactions considered in this ruling take effect, the ruling will have no force or effect.

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

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

Sincerely,
Lorraine E. Gardner
Acting Senior Technician Reviewer
Branch 4
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure: Copy for § 6110 purposes