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Department of the Treasury
Washington, DC 20224

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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
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Date:
December 19, 2005

Re:

Legend

Grantor -
Spouse -
Child 1 -
Child 2 -
Child 3 -
Trust A -

Trust B -
Trustee -
State X -
Date 1 -
Date 2 -
Citation 1 -
Citation 2 -
Citation 3 -
Citation 4 -

Dear :

This is in reference to your letter dated November 22, 2004, and subsequent correspondence, requesting rulings regarding the effect of the judicial construction of the trust instrument for federal estate and gift tax purposes.

Background

The facts submitted are as follows:

On Date 1, Grantor created Trust A and Trust B. Both Trust A and Trust B are governed by the law of State X. Trust A is an irrevocable trust that is primarily for the benefit of Grantor's spouse (Spouse) and three of Grantor's children (Child 1, Child 2, and Child 3). Trustee, an unrelated corporation that is in the business of administering trusts, is the trustee of Trust A. Among the assets of Trust A are life insurance policies on Grantor's life. Trust A is the owner of the insurance policies and Grantor is prohibited from exercising withdrawal rights in any capacity, including but not limited to a fiduciary capacity. Trust B is a revocable trust. Grantor is the primary beneficiary and trustee of Trust B.

Section 3 of Trust A provides that, whenever a gift is made to the trust during Grantor's life, Spouse and Children shall have the right to withdraw from the trust in the year of the gift an amount of the gift up to the maximum federal gift tax exclusion under § 2503(b) of the Internal Revenue Code. The withdrawal amount shall be cumulative but may not be exercised after the death of the person holding such right and, on January 31 of each year, the total amount which may be withdrawn by each holder of the withdrawal right shall be reduced by and lapse to the extent of the greater of $5,000 or five percent of the assets of Trust A on that date. The trustee, within a reasonable period of time after receipt of a gift, will give written notice of the gift to each person who has a withdrawal right. The insured of any policy is specifically prohibited from exercising a withdrawal right in any capacity.

Section 4 of Trust A provides that, during Grantor's lifetime, the trustee, in its discretion, may distribute the net income and principal to Spouse and Child 1, Child 2, and Child 3 (Children) that is appropriate for their health, education (including higher education) and support in reasonable comfort. Any income not distributed would be accumulated and added to principal.

Sections 5(A) and (B) of Trust A provide that, upon the death of Grantor, specific pecuniary amounts will be distributed to specified beneficiaries and the remainder will be distributed as provided under Section 5(C). Section 5(C) provides that, if Spouse survives Grantor, Trustee may distribute as much of the net income and principal to or for the benefit of Spouse and the Children, as Trustee considers appropriate for their health, education (including higher education), and support in reasonable comfort. Trustee is directed to give Spouse primary consideration in distributions of income and

principal. The distributions may be in equal or unequal amounts and any income not distributed will be added to principal. Paragraph 5(C)(2) of Trust A provides that:

> After [Spouse's] death, but not later than the first day on which federal estate tax can no longer be assessed with respect to [Spouse's] estate (the "Division Date"), Trustee shall distribute the Trust Assets then held and any assets received by Trustee by reason of [Spouse's] death to the then Trustee under [Trust B] dated the date of this agreement or under any revocable trust agreement subsequently executed by Grantor as a successor to or replacement of this agreement (the "Trust Agreement") to be added to and administered under the terms of the Family Trust created thereunder. If as of the Division Date no Family Trust will be established under the terms of the Trust Agreement, Trustee shall administer the Trust Assets as directed in Section 6.

Section 5(D) of Trust A provides that:

> If [Spouse] does not survive Grantor, Trustee shall, not later than the first day on which federal estate tax can no longer be assessed with respect to Grantor's estate, dispose of the Trust Assets then held and any assets received by Trustee by reason of Grantor's death as directed in paragraph C(2) above.

Section 6 of Trust A provides that the trustee will divide the trust assets into equal shares, one share for each of the Children living on the Division Date and one share for each of the Children not living on the Division Date who has a descendant then living. The share for any deceased child who has living descendants will be distributed to those living descendants, per stirpes, or if none, the share will be added to the shares for the living Children or the shares of any Children who are not then living but have descendants living. If Child 1 is then living, the trustee will distribute Child 1's share to a separate trust established by Spouse on Date 1 for the benefit of Child 1. If Child 2 or Child 3 is then living, their shares will be held in separate trusts for their benefit, the income of which will be distributed to them quarterly with the trustee having the discretion to distribute principal for the beneficiary's health, education (including higher education), and support in reasonable comfort. The principal will be distributed to each beneficiary upon that beneficiary reaching age 30.

Section 17(C) provides that, if a trustee resigns or ceases to serve as trustee, a majority of income beneficiaries not under a legal disability and adult persons responsible for any income beneficiaries under a legal disability may appoint any bank or trust company having trust powers to serve as trustee. Section 17(D) provides that Grantor may remove the trustee and appoint another bank or trust company which is authorized to conduct a trust business to serve as trustee.

Under the terms of Trust B, the trustee will dispose of the assets as Grantor directs. During Grantor's life, the income will be distributed to Grantor and, if Grantor is incapacitated, the trustee will spend the income and principal "liberally" for the welfare and comfort of Grantor and Spouse. Grantor may terminate, amend modify or supplement the terms of Trust B at any time.

Article III of Trust B provides that, upon Grantor's death, if Spouse survives Grantor, the trustee will divide the assets into two trusts; a marital trust and a family trust. Upon Spouse's subsequent death, any remaining assets in the marital trust will pass to the family trust. If Grantor survives Spouse and is survived by any descendants, the assets of Trust B will be administered under the terms of the family trust upon Grantor's death. Under the terms of Trust B, while Spouse is living, the income of the family trust will be distributed to Spouse and the trustee may distribute the principal to or for the benefit of the Children and their descendants for their health, education (including higher learning) and support in reasonable comfort. Spouse also has a power to appoint the assets of Trust B to any one or more of the Children or their descendants and their spouses. Upon the death of the survivor of Grantor or Spouse, the assets of Trust B will be divided into equal shares, one share for each of the Children living on the Division Date and one share for each of the Children not living on the Division Date who has a descendant then living. The share for any deceased child who has living descendants will be distributed to those living descendants, per stirpes, or if none, the share will be added to the shares for the living Children or the shares of any Children who are not then living but have descendants living. If Child 1 is then living, the trustee will distribute Child 1's share to the separate trust established by Spouse for the benefit of Child 1. If Child 2 or Child 3 is then living, their shares will be held in separate trusts for their benefit, the income of which will be distributed to them quarterly with the trustee having the discretion to distribute principal for the beneficiary's health, education (including higher education), and support in reasonable comfort. The principal will be distributed to each beneficiary upon that beneficiary reaching age 30 or the Division date, if the beneficiary has attained age 30.

Upon subsequent review of the trust provisions, Grantor, Spouse and their attorneys discovered that an error occurred in the drafting of the dispositive provisions of Trust A. You represent that Sections 5(C)(2) and 5(D) of Trust A mistakenly provided for distribution of the trust assets upon the death of the survivor of Spouse and Grantor to Trust B, the revocable trust, rather than distribution under Section 6 of Trust A to either the family trust or to both the family trust and the marital trust. You represent that this error was a scrivener's error in drafting the instrument and did not reflect the intentions of the Grantor. As drafted, upon Grantor's death, Sections 5(C)(2) and 5(D) would result in the assets of Trust A, the irrevocable trust, passing to Trust B, the revocable trust, and thus, being includible in Grantor's gross estate for estate tax purposes.

Grantor petitioned the appropriate local court to reform Trust A. On Date 2, the court found that the scrivener had made a mistake in drafting Trust A that did not reflect the intentions of Grantor to relinquish all beneficial control of the assets of Trust A and issued an order reforming Trust A. The order reformed Section 5, Paragraphs (C)(2) and (D) of Trust A, effective as of Date 1, to read as follows:

> C.
> . . .
> (2) After [Spouse]'s death, the trustee shall administer the trust assets as directed in Section 6.
>
> D. If [Spouse] does not survive grantor, trustee shall administer the trust assets then held and any assets received by trustee by reason of grantor's death as directed in Section 6.

Rulings Requested

You have requested the following rulings:

1. As a result of the judicial reformation of Trust A, the assets of Trust A will not be includible in Grantor's gross estate for estate tax purposes under §§ 2035, 2036, 2038, 2041, or 2042 of the Internal Revenue Code.

2. The reformation of Trust A does not result in Grantor being deemed to have made a gift of an interest in Trust A for gift tax purposes.

3. The reformation of Trust A does not constitute a release of a general power of appointment by Grantor for gift tax purposes under § 2514.

Law and Analysis

Issue 1

Section 2001(a) provides that a tax is imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

Section 2031(a) provides, generally, that the value of the gross estate of the decedent shall be determined by including to the extent provided for in §§ 2031 through 2046, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated.

Section 2033 provides that the value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.

Section 2035(a)(1) and (2) provide that if the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death, and the value of such property (or any interest therein) would have been included in the decedent's gross estate under §§ 2036, 2037, 2038, or 2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death, the value of the gross estate shall include the value of any property (or interest therein) which would have been so included.

Section 2036(a) provides, generally, that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death: (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Section 20.2036-1(b)(3) of the Estate Tax Regulations provides that the phrase "right . . . to designate the person or persons who shall possess or enjoy the transferred property or the income therefrom" includes a reserved power to designate the person or persons to receive the income from the transferred property, during the decedent's life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death. With respect to such a power, it is immaterial (i) whether the power was exercisable alone or only in conjunction with another person or persons, whether or not having an adverse interest; (ii) in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent; and (iii) whether the exercise of the power was subject to a contingency beyond the decedent's control which did not occur before his death (e.g., the death of another person during the decedent's lifetime). The phrase, however, does not include a power over the transferred property itself which does not affect the enjoyment of the income received or earned during the decedent's life. Nor does the phrase apply to a power held solely by a person other than the decedent. But, for example, if the decedent reserved the unrestricted power to remove or discharge a trustee at any time and appoint himself as trustee, the decedent is considered as having the powers of the trustee.

Section 20.2036-1(b)(2) provides that the term "use, possession, right to the income, or other enjoyment of the transferred property" is considered as having been retained by or reserved to the decedent to the extent that the use, possession, right to

the income, or other enjoyment is to be applied toward the discharge of a legal obligation of the decedent, or otherwise for his pecuniary benefit.

Section 2038(a)(1) provides that the value of the gross estate includes the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of death to any change through the exercise of a power by the decedent to alter, amend, revoke, or terminate the interest in the property or where the decedent relinquished such power within the three-year period ending on the date of the decedent's death.

Section 2041(a)(2) provides that the value of the gross estate includes the value of all property to the extent of any property with respect to which the decedent has at the time of his death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under §§ 2035 to 2038, inclusive. For purposes of § 2041(a)(2), the power of appointment shall be considered to exist on the date of the decedent's death even though the exercise of the power is subject to a precedent giving of notice or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the date of the decedent's death notice has been given or the power has been exercised.

Section 2041(b)(1) provides that for purposes of § 2041(a), the term "general power of appointment" means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate.

Section 2041(b)(2) provides that the lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power.

Under § 2042(2), the value of the gross estate includes the value of all property to the extent of the amount receivable by all other beneficiaries as insurance under policies on the life of the decedent with respect to which the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person.

Section 20.2042-1(c)(2) provides that the term “incidents of ownership” is not limited in its meaning to ownership of the policy in the technical legal sense. Generally, the term has reference to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or

cancel the policy, to assign the policy, to revoke the assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy.

Section 20.2042-1(c)(4) provides that a decedent is considered to have an "incident of ownership" in an insurance policy on his life held in trust if, under the terms of the policy, the decedent (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust.

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. George Gleason Bogert & George Taylor Bogert, The Law of Trusts and Trustees § 991 (rev. 2d ed. 1983).

Under State X law, a court of equity has jurisdiction to reform and correct a deed executed through a mutual mistake of fact to conform to the actual agreement of the parties to the deed when such mistake results from the mistake of the scrivener in the preparation of the deed. Citation 1. “To justify the reformation of an instrument for mistake, it is necessary: First, that the mistake should be one of fact, not of law; second, that the mistake should be proved by clear and convincing evidence; third, that the mistake should be mutual and common to both parties of the instrument.” Citation 1. Though parol evidence is admissible to establish mutual mistake of fact of the parties to a plain and unambiguous deed or other written instrument, the proof required to justify a court of equity to reform and correct such instrument to conform to the true intention of the parties must be strong, clear, unequivocal, preponderating and convincing. Citation 1. See also, Citation 2; Citation 3; Citation 4.

In this case, the documentation submitted by Grantor strongly indicates that Grantor intended to relinquish all control over the assets held in Trust A and that the provisions in Trust A, Sections 5(C)(2) and 5(D) that pass the Trust A assets to

Grantor's revocable trust upon the death of the survivor of Grantor and Spouse were the result of scrivener error since such provisions serve to put the assets back under Grantor's control. In reforming Trust A, the court also found that Grantor intended to relinquish all control over the assets of Trust A and that the error by the scrivener resulted in Trust A not reflecting the intentions of Grantor at the time Trust A was executed.

Consequently, we conclude that the court order on Date 2 that reformed Trust A based on scrivener's error is consistent with applicable State X law that would be applied by the highest court of that state.

Grantor has not retained any interest in the property in Trust A for purposes of § 2033. The reformation of Trust A, consistent with the terms of the court order, will not be considered a release, transfer or relinquishment of any retained interest or power that would subject the Trust A assets to inclusion in Grantor's gross estate for purposes of § 2035. Grantor has not retained, for his life, the right, either alone or in conjunction with any person, to designate who will possess or enjoy the property or income from the reformed trust within the meaning of § 2036. Grantor has not retained any power, either alone or in conjunction with another person, to alter, amend, revoke, or terminate the reformed trust within the meaning of § 2038. Further, Grantor does not possess a general power of appointment, as defined under § 2041, with respect to Trust A. Trust A, not Grantor, is the owner of the life insurance policies for purposes of § 2042. Additionally, Grantor has represented that he possesses no incidents of ownership in the policies under § 2042. Accordingly, if Trust A is reformed pursuant to the terms of the court order, we conclude that the value of the property in Trust A, as reformed, will not be includible in Grantor's gross estate under §§ 2033, 2035, 2036, 2038, 2041, or 2042.

Issues 2 & 3

Section 2501(a) imposes a gift tax for each calendar year on the transfer of property by gift during the year by an individual.

Section 2511 provides that the gift tax 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 an adequate and full consideration in money or money's worth, the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift.

For gift tax purposes, § 2514(b) provides that the exercise or release of a general power of appointment created after October 21, 1942, shall be deemed a transfer of property by the individual possessing such power.

For gift tax purposes, § 2514(c) provides that the term "general power of appointment" means a power which is exercisable in favor of the individual possessing the power, his estate, his creditors, or the creditors of his estate. Section 2514(e) provides that the lapse of a power of appointment created after October 21, 1942, during the life of the person possessing the power is considered a release of the power.

Under the terms of Trust A, as executed on Date 1, Grantor did not have a power to appoint any assets of Trust A in favor of himself, his estate, or the creditors of either. The reformation of Trust A, as described, will not constitute the exercise or release of a general power of appointment by Grantor, within the meaning of § 2514(b). Further, the reformation of Trust A, as described, will not be treated as a deemed transfer of an interest in Trust A by Grantor for gift tax purposes under § 2501.

A copy of this letter should be attached to any gift, estate, or generation-skipping transfer tax returns that you may file relating to these matters.

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 the 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. Except as specifically ruled above, no opinion is expressed as to the federal tax consequences of the facts described above under the cited provisions or any other provisions of the Code or regulations.

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

Sincerely yours,

Lorraine E. Gardner
Senior Counsel, Branch 4
(Office of Passthroughs and Special Industries)

Enclosure
Copy for section 6110 purposes

cc: