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Third Party Communication: N/A

Person To Contact:

Telephone Number:

Refer Reply To:
CC:PSI:BR04
PLR-101500-12

In Re:

Date:
July 10, 2012

Legend:

Decedent	=
Son	=
Wife	=
Trust 1	=
Trust 2	=
Date 1	=
Deceased Spouse	=
Date 2	=
Date 3	=
x	=
Date 4	=
Date 5	=
Court	=
Trust 3	=
Date 6	=
Attorney	=
State	=
Child 1	=
Date 7	=
Citation 1	=
Citation 2	=
Citation 3	=

Dear :

This letter responds to your representative's request for a ruling regarding whether a state court reformation of a trust will be recognized for gift, estate, and generation-skipping transfer (GST) tax purposes.

The facts and representations are as follows. On Date 1, Deceased Spouse and Decedent established a revocable trust, Trust 1. Deceased Spouse and Decedent were the primary beneficiaries of Trust 1 during their lives. On Date 2, Trust 1 was amended and restated. Pursuant to this restatement (Restatement), upon the death of the first spouse to die, Trust 1 is to be divided into two separate trusts, a Credit Shelter Trust and a revocable trust, Trust 2. Deceased Spouse died on Date 3. Trust 1 was divided into the two trusts.

Pursuant to the Restatement, Trust 2 provides that upon the death of the last spouse to die, the trust estate will be held in trust and administered and distributed pursuant to the same terms and conditions of the Credit Shelter Trust. The Credit Shelter Trust provides that upon the death of the last spouse to die, x percent of the trust estate will pass outright to Son.

On Date 4, prior to Decedent's death, Decedent and Son met with Decedent's attorney (Attorney) to amend Trust 2. Attorney prepared the amendment (First Amendment) and Decedent signed the amendment. The First Amendment provides that pursuant to the terms of Trust 2, upon the death of Decedent, x percent of Trust 2 will pass outright "to [Son], if surviving, but he shall have the right to disclaim all or any part of his share of said assets." If Son disclaims all or any part of his share of the trust estate, the disclaimed property will pass to an irrevocable trust, Trust 3. The beneficiaries of Trust 3 include Son and his surviving lineal descendants. Trust 3 provides that the trustee, Son, may pay to or use for the benefit of the beneficiaries so much of the net income and/or principal as the trustee, in the trustee's discretion, deems necessary for the health, education, maintenance, and support in reasonable comfort of the beneficiaries. Unused income will be added to principal. The primary purpose of Trust 3 is to provide for the health, education, maintenance, and support in reasonable comfort of Son. The secondary purpose of Trust 3 is to provide for Son's lineal descendants. Upon Son's death, Trust 3 will terminate and the trust estate will be distributed to Son's lineal descendants.

Decedent died on Date 5, survived by Son, Son's wife (Wife) and Son's child (Child 1). Son did not file a qualified disclaimer within the nine-month period allowed under § 2518. Son did not disclaim his interest in Trust 2 or Trust 3. On Date 6, more than one year following Decedent's death, Son, in his capacity as trustee of Trust 1 and Trust 3, petitioned Court to reform the provisions of Trust 2, *nunc pro tunc,* as of the Decedent's date of death. The reformed instrument removes the provision that x

percent of Trust 2 would pass outright to Son and the disclaimer provisions. The reformed instrument provides that upon the death of the last spouse to die, x percent of Trust 2 will be distributed to and administered as a separate trust, Trust 3. The terms of Trust 3 were not modified. On Date 7, Court issued an order (Order) reforming Trust 2 as requested, *nunc pro tunc,* as of the date of death of Decedent. The Court Order cites State Statute as authority for reforming a trust following the death of the grantor. State Statute provides that "[n]othing in this section shall prohibit modification or termination of any trust pursuant to its terms or limit general equitable power of a court to modify a trust in whole or in part." The Court Order is contingent upon a favorable letter ruling from the Internal Revenue Service (Service). To date, Trust 3 has not been funded. Trust 2 is governed by State law.

The evidence submitted to the Court by Son included an affidavit by Attorney, to which is attached a portion of a letter from Son's attorney. A summary of the relevant statements Attorney made in the affidavit is as follows:

1. On Date 4, Attorney met with Decedent and Son to discuss Decedent's desires with respect to her estate plan. During that meeting, in Decedent's presence, Son provided Attorney with a copy of a letter from Son's attorney containing a suggested amendment to Decedent's revocable trust. Decedent indicated to Attorney that Decedent wanted to amend Trust 2 so that, upon her death, certain assets passing to Son would be retained in an irrevocable trust in which Son would have a beneficial interest, outside of Son's estate for GST tax purposes and other federal transfer tax purposes, as suggested in the letter. Attorney suggested that this could be achieved through a disclaimer by Son. Son and Decedent agreed to proceed with the disclaimer, if it would allow the assets to be retained in a GST exempt trust for Son.

2. Attorney prepared an amendment to Trust 2 designed to allow Son to make a qualified disclaimer, which would result in a distribution of trust assets in Trust 2 to Trust 3. First Amendment was executed on Date 5.

3. After Decedent's death, Attorney became aware that the requirements of a qualified disclaimer cannot be satisfied by a person who is not the spouse of the grantor if the disclaimed property passes to a trust for the benefit of the person making the disclaimer.

4. Attorney believes the reformation is necessary in order to bring about Decedent's intent with regard to the disposition of her estate.

A summary of the relevant portions of the letter from Son's attorney, which was attached to the affidavit, is as follows. Son's attorney recommended that Son speak to Decedent's attorney about the possibility of modifying Trust 2 to direct that instead of receiving x percent of Trust 2 outright, these assets be held in trust for Son for his lifetime. Decedent's GST exemption and unified credit could be applied to the trust

assets so that at Son's death, he would not have to allocate his GST exemption to the trust assets.

It is represented that in connection with this ruling request, Son's representative contacted Attorney to request copies of any documents or notes from Attorney's files with regard to Decedent's intent. It is represented that no such documents or notes are available. Further, Son admits that there are no express references to GST planning in Decedent's estate planning documents. Son did provide an e-mail from Attorney to Son in which Attorney states, in part, that:

> It is an amendment whereby your mother authorizes you to disclaim your interest into a trust for the benefit of your and your lineal descendants in which you are the sole trustee but which the assets of the trust would not be included in your taxable estate upon your death and then upon your death the remaining assets would go into trust for your son [Child 1] if he [sic] under 45 years of age or outright to him if he's over 45.

You have requested a ruling that the State Court Order reforming Trust 2, *nunc pro tunc*, as of the date of death of Decedent, will be recognized for gift, estate, and GST tax purposes.

LAW AND ANALYSIS

In the ruling request, you have taken the position that the First Amendment created an ambiguity or a scrivener's error due to a mistake of law or fact and, accordingly, the reformation should be recognized retroactively for federal tax purposes.

As a general rule, a state court reformation of a trust instrument has retroactive effect as between the parties to the instrument, but not as to third parties who previously acquired rights under the instrument. Generally, retroactive changes to the legal effects of a transaction through judicial nullification of a transfer or judicial reformation of a document do not have retroactive effect for federal tax purposes. *Van Den Wymelenberg v. United States*, 397 F.2d 443 (7th Cir. 1968), *aff'g* 272 F. Supp. 571 (E.D. Wis. 1967); *M.T. Straight Trust v. Comm'r*, 245 F.2d 327 (8th Cir. 1957), *aff'g* 24 T.C. 69 (1955); *Sinopoulo v. Jones*, 154 F.2d 648 (10th Cir. 1946); *American Nurseryman Publishing Co. v. Comm'r,* 75 T.C. 271 (1980), *aff'd without published opinion*, 673 F.2d 133 (7th Cir. 1981); *Estate of Hill v. Comm'r*, 64 T.C. 867 (1975), *aff'd without published opinion*, 568 F.2d 1365 (5th Cir. 1978).

In *Van Den Wymelenberg*, the taxpayer executed a trust agreement that was intended to achieve a gift tax exemption under § 2503(c). However, the agreement did not empower the trustee to invade corpus to meet the needs of the beneficiaries or allow the beneficiaries to dispose of their interests by will. The gifts did not qualify under the annual gift exclusion of § 2503. The taxpayer changed the trust agreement to correct

the error but did not obtain a court order to make the correction retroactive for state law purposes. The Service refused to apply the correction retroactively. The Seventh Circuit opined that even if the amendment properly expressed the original intent and the error was due to inadvertence, tax consequences should be determined by the terms of the initial agreement. The court's concern was that a different conclusion would provide an opportunity for "collusive" state court actions having the sole purpose of reducing federal tax liabilities. Further, the court stated that federal tax liabilities would remain unsettled for years after their enactment if state courts and private persons were empowered to retroactively affect the tax consequences of completed transactions and completed tax years.

Similarly, in *M.T. Straight Trust*, the taxpayer thought he created three separate trusts, and the trustees accordingly filed separate returns for each of the trusts for the years 1946-1948. After the Service asserted that only one trust had been created, the state court amended the trust instrument retroactively to create three trusts out of one. The court concluded that retroactive reformation did not affect the previous tax years.

In *Comm'r v. Estate of Bosch*, 387 U.S. 456 (1967), the Supreme 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 law, a unilateral mistake by the settlor of a trust may be sufficient grounds to reform a trust. *Citation 1.* The party advocating reformation must establish the mistake by clear and convincing evidence. *See e.g., Citation 2*. The State Supreme Court may reform a document whether there is a mistake of fact or a mistake of law. *See e.g., Citation 3.*

In this case, the highest court and the appellate courts in State have not considered the issue in this case. However, the Service will give "proper regard" to the State Court Order in this case to determine whether to recognize the retroactive reformation of Trust 2. We have reviewed the documentation submitted to the Court, including the trust instrument and amendments to the trust, the State Court Order, and the documentation provided with this letter ruling submission. On its face, the First Amendment does not contain any ambiguity. Moreover, the petition submitted to the State Court and the Service as part of this ruling request does not assert that the relevant provision is ambiguous. Instead, the petition asserts that Attorney made a drafting error or mistake and that the reformation proceeding was commenced to carry

out the intent of Decedent. The State Court Order refers only to State Statute for its authority to modify Trust 1 and does not conclude that Trust 2 contained any ambiguities. We conclude that this documentation does not support a conclusion that there is an ambiguity in Trust 2 and does not provide clear and convincing evidence that Decedent intended for Son's share in Trust 2 to be distributed to Trust 3, as reformed by the State Court.

In this case, on the Decedent's date of death, the provisions of Trust 2, as amended by the First Amendment, provided that x percent of the trust was to pass outright to Son, subject to Son's "right to disclaim all or any part of his share of said assets" in favor of Trust 3. Son did not disclaim any portion of his interest in Trust 2 or in Trust 3. This provision is determinative for federal tax purposes.

Based upon the facts submitted (including the affidavit and attached letter) and the representations made, we conclude that the reformation of Trust 2 is not consistent with applicable State law, as applied by the highest court of State. Accordingly, we conclude that the reformation of Trust 2 will not be recognized retroactively for gift, estate, or GST tax purposes. The State Court Order reforming trust is contingent upon receipt of a favorable ruling from the Service. You have represented that if a favorable ruling cannot be obtained, Son will not disclaim any portion of the x percent of Trust 2 and, instead, Trust 2 will distribute this amount outright to Son pursuant to provisions in the Restatement.

In accordance with the Power of Attorney on file with this office, we have sent a copy of this letter to your authorized representatives.

Except as expressly provide herein, we neither express nor imply any opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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 the ruling, it is subject to verification on examination.

Sincerely,

Lorraine E. Gardner

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Lorraine E. Gardner
Senior Counsel, Branch 4
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures:
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