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Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:4-PLR-109476-99
Date:
May 15, 2000

Re:

LEGEND:

Settlor =
Child A =
Child B =
Child C =
Child D =
Child E =
Trust 1 =

Trust 1A =

Trust 1B =

Trust 1C =

Trust 1D =

Trust 1E =

Trustee =
Will =

Trust 2 =

Agreement =

Attorney =

Dear :

This is in response to the letter of January 31, 2000, and prior correspondence, requesting rulings on the income and gift tax consequences of a reformation of Trust 1.

On March 9, 1988, Settlor created Trust 1, an irrevocable trust. The trust instrument provided that the trust assets were to be divided into five equal shares, one of each of the five shares to be held as a separate trust for each of the Settlor's five children. Accordingly, Trust 1A was established for Child A, Trust 1B was established for Child B, Trust 1C was established for Child C, Trust 1D was established for Child D, and Trust 1E was established for Child E.

Under Paragraph 1.2 of the trust instrument, all of the net income of a separate trust is to be paid to the child of Settlor who is the beneficiary of that trust. If the trustee deems the income to be insufficient, the trustee is to pay to or for the benefit of that child such part or all of the trust principal as the trustee deems necessary for the child's health, support, maintenance, and education.

Under Paragraph 1.1b, each trust will terminate on the death of the respective child for whom it is held. The remaining assets of that trust will be distributed in equal shares to Settlor's then living grandchildren who are (1) that child's children, or (2) the children of another child of Settlor who has predeceased that child (with cumulative limitations).

Under Paragraph 2.8, the terms "child," "children," "grandchild," and "grandchildren," as used in the trust instrument, shall not include descendants by adoption, but shall only include descendants by birth.

Under Paragraph 2.1, subparagraph (k), the trustee has the authority to employ any attorney to assist the trustee in administering the Trust and to pay reasonable compensation by charging the compensation to principal or income.

<u>The Will and Trust 2</u>

Settlor executed her Will and Trust 2 on July 25, 1988. The Will provides that Settlor's estate residue is to pass to Trust 2. The Will further provides that "References to a child, children or issue . . . shall include descendants by adoption as well as by birth."

Under Paragraph 2.3 of Trust 2, at Settlor's death, the estate residue is to be distributed in equal shares to Settlor's children who survive her. If a child does not survive her, but leaves issue who do, those issue will take, by right of representation,

the share that the deceased child would have taken.

Paragraph 9.2, in defining references to the parent-child relationship, provides that the existence of a parent-child relationship shall be determined by California law applicable to wills.

At the time, California law applicable to wills provided (and continues to provide) that, in construing a testamentary transfer by someone who is not the adoptive parent of a person, the person is not considered the child of the adoptive parent unless the person lived while a minor (either before or after the adoption) as a regular member of the household of the adoptive parent. Cal. Probate Code § 21115 (Deering 1999), originally enacted in 1983 as § 6152

The Adoption

Recently, Child A adopted a minor child who, under the current terms of Trust 1A, would not share in the distribution of that trust's principal. In seeking the reformation of Trust 1 to include adopted minors as children and grandchildren, Settlor claims that, when she executed Trust 1, she intended to exclude from the definition of "children" and "grandchildren" under that trust only persons who were adopted as adults.

A declaration by Attorney, who drafted Trust 1 and oversaw its execution, is submitted to corroborate Settlor's intent at the time of execution. Attorney's declaration states that Settlor had become aware of the possibility of manipulative adoptions involving the adoption of an adult to confer upon a non-family member status as a trust beneficiary. She wished to prohibit that, and she asked Attorney to draft language to address that specific concern. Attorney further declares that Settlor never indicated to him any intent to exclude minor adoptees from receiving benefits under Trust 1. In addition, the will's definition of "child," "children," and "issue" and the incorporation of California law in Trust 2 to define the parent-child relationship corroborate Settlor's claimed intent in executing Trust 1.

The Agreement and Court Order

On December 25, 1998, the parties to Trust 1 agreed to the reformation of Trust 1 (the "Agreement"). Under the Agreement, the trustee will advance Trust 1 funds to pay the reasonable and necessary expenses of the trust and the parties relating to the implementation of the Agreement and the resolution of the matter (including attorneys' fees).

On February 17, 1999, the trustee filed a petition in the local court to reform Trust 1. On March 22, 1999, the court held that Trust 1 fails to state the Settlor's original intention and issued an order reforming Trust 1 to provide as follows:

> 2.8 Children and Grandchildren The terms “child,” “grandchild” and “grandchildren” . . . shall include descendants by birth and any adopted person who lived while a minor (either before or after the adoption) as a regular member of the household of the adopting descendant-by-birth.

Requested Rulings:

(1) The reformation of Trust 1 to recognize minor adoptees as “children” and “grandchildren” under Trust 1 will not give rise to income tax or gift tax liability for any party.

(2) The trustee’s use of Trust 1 funds to reimburse any party thereto for the payment of reasonable and necessary attorneys’ fees and related expenses incurred to effect the Agreement for the benefit of the trust will not give rise to any income or gift tax liability for any party.

(3) The trustee’s use of Trust 1 funds to pay or advance reasonable and necessary attorneys’ fees and related expenses to effect the Agreement, for the benefit of the parties thereto, will not give rise to any income or gift tax liability for any party.

THE INCOME TAX

Section 61 of the Internal Revenue Code provides that gross income means all income from whatever source derived, including gains derived from dealings in property and income from the discharge of indebtedness. See §§ 1.61-6 and 1.61-12 of the Income Tax Regulations.

Section 102 provides that gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.

Section 212(2) provides that in the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the year for the management, conservation, or maintenance of property held for the production of income.

Section 1.212-1(i) of the Income Tax Regulations provides, in part, that reasonable amounts paid or incurred by the fiduciary of a trust on account of administration expenses, including expenses of litigation, which are ordinary and necessary in connection with the performance of duties of administration are deduction under section 212, notwithstanding that the trust is not engaged in a trade or business, except to the extent that the expenses are allocated to the production or collection of tax-exempt income.

Section 265(a)(1) provides, in part, that no deduction shall be allowed for any amount otherwise allowable under section 212 that is allocable to interest wholly exempt from the taxes imposed by Subtitle A.

Section 1.265-1(c) provides that expenses that are directly allocable to any class or classes of tax-exempt income shall be allocated to the tax-exempt income. The regulations further provide that if an expense otherwise allowable is indirectly allocable to both nonexempt and exempt income, then a reasonable proportion is allocated to each considering the particular facts and circumstances.

Section 662(a) limits the amount of trust distributions included in the gross income of a beneficiary to the distributable net income of the trust. Under section 643(a), distributable net income is calculated by making certain modifications to taxable income. Section 641(b) provides, in part, that the taxable income of a trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in Part I of Subchapter J.

Section 667(e) provides for the determination of adjusted gross income for trusts, allowing deductions for costs paid or incurred in connection with the administration of a trust, which would not have been incurred if the property were not held in trust.

Section 1001 provides that, unless otherwise provided, the entire amount of gain or loss on the sale or exchange of property shall be recognized. The gain or loss from the sale or other disposition of property is the difference between the adjusted basis of the property and the amount realized. Section 1001(a). The amount realized is the sum of money received plus the fair market value of any property (other than money) received. Section 1001(b).

An exchange of property results in realization of gain or loss under section 1001(a) if the properties exchanged are materially different. Cottage Savings Association v. Commissioner, 499 U.S. 554, 566 (1991). The material difference requirement is met if the properties embody legal entitlements that are different in kind or extent or if they confer different rights and powers. Cottage Savings, 499 U.S. at 565.

We accept that it was Settlor's original intent to exclude only adult adoptees as beneficiaries of the trust. To effectuate the original intent of Settlor, the court has ordered reformation of the trust instrument to correct a drafting error. Because the reformed trust reflects the original intention of Settlor, the beneficiaries' interests before and after reformation do not embody different legal entitlements as a result of the transaction. Thus, there will be no sale or exchange in connection with the Agreement, and no gain or loss will be realized by the parties to the Agreement.

Furthermore, reformation of the trust to recognize minor adoptees as children

and grandchildren will not result in gross income for any minor adoptee beneficiaries. The reformation merely recognizes the rights of the minor adoptees as beneficiaries pursuant to Settlor's original intention and, under section 102, gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.

In addition, no party to the Agreement will realize income from a discharge of indebtedness. Although a taxpayer may realize income from a discharge of indebtedness where settlement of a disputed claim results in the discharge of a determined liability of the taxpayer, there is no disputed claim here. Instead, there is a realization by all the parties that Settlor's original intent was to recognize and treat minor adoptees as children and grandchildren (and beneficiaries) with respect to Trust 1.

Whether legal fees are deductible expenses under section 212, or are capital expenses under section 263, requires an examination of the origin of the claim giving rise to the legal fees. See United States v. Gilmore, 372 U.S. 39, 49 (1963).

Legal expenses relating to the final distribution of trust funds are a function of the management of the trust property and are deductible if they are ordinary and necessary. Trust of Bingham v. Commissioner, 325 U.S. 365, 376 (1945). In Herman A. Moore Trust v. Commissioner, 49 T.C. 430 (1968), acq., 1968-2 C.B. 21, the Service challenged the trustee's deduction of certain attorneys' fees in computing the trust's income. These fees arose from an action brought by the testator's children to accelerate their beneficial interests in the trust. Pursuant to state law, the court ordered that the attorneys' fees for the trustee, the beneficiaries, and the guardian ad litem be paid from trust income. The court decided that (i) the state court decision aided the trustee in its management of the trust property, and (ii) the trust benefitted by the involvement of the beneficiaries and the guardian ad litem in the litigation. Thus, the court held that all of the litigants' attorneys' fees paid from trust income were deductible under section 212(2).[1]

Based on the information submitted, we conclude that the reformation of Trust 1 by court order to recognize and treat minor adoptees as children and grandchildren will not give rise to any income tax for any party. We also conclude that the origin of the claim from which the legal expenses arose was the uncertainty as to the proper beneficiaries of Trust 1. Furthermore, the trust benefitted by the involvement of the actual and potential beneficiaries in the proceedings. Thus, subject to allocations under section 1.265-1(c), we conclude that the attorneys' fees paid for the benefit of Trust 1 or

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[1] In Moore, the Tax Court used the primary purpose test, rather than the origin of the claim test, to determine the deductibility issue. Since the Tax Court's opinion in Moore, it has adopted the origin of the claim test. However, as recently noted by the Tax Court, the application of the origin of the claim test in Moore "would not have materially changed our decision." Stevens v. Commissioner, T.C. Memo. 1999-259.

for the benefit of the trustee are deductible under section 212(2) and do not give rise to income to any party to the Agreement.

THE GIFT TAX

Section 2501 provides that a tax is imposed for each calendar year on the transfer of property by gift during the calendar year.

Section 2511(a) provides that the gift tax applies 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(a) provides that if the gift is made in property, the value thereof at the date of the gift is considered the amount of the gift.

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 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 California law, in interpreting a trust, it is proper for a court to consider the circumstances under which the trust was executed so that the court may be placed in the position of the trustor whose language it is interpreting, in order to determine whether the terms of the trust are clear and definite, or ambiguous in some respect. Wells Fargo Bank v. Marshall, 24 Cal. Rptr.2d 507 (1993). Extrinsic evidence as to the circumstances under which a trust was made is admissible to interpret the trust, although not to give it a meaning to which it is not reasonably susceptible. The court's proper function is to give effect to the intention of the maker of the trust. Ike v. Doolittle, 70 Cal. Rptr. 2d 887 (1998); Estate of Torregano v. Torregano, 5 Cal. Rptr. 137 (1960).

In this case, the court determined that there was sufficient evidence that Settlor intended to include minor adoptees in the terms "child," "grandchild," and "grandchildren." Based on the facts submitted and the representations made, we conclude that the reformation of Trust 1 is consistent with applicable California law as it would be applied by the highest court of California. Thus, the reformation based on a mistake in drafting does not change any of the beneficial interests in Trust 1 and, accordingly, the reformation will not give rise to gift tax liability for any party.

We do not consider the document characterized as the “Agreement” to be a settlement agreement for gift tax purposes because there was no disputed claim among the parties, and neither the basis for the reformation nor the basis for the definitional change in the trust arose by reason of the Agreement. That is, in the Agreement, the parties’ merely acknowledge Settlor’s original intent and state that they will not object to the reformation so long as they do not personally incur any gift tax or income tax liability therefrom or any liability for legal fees and expenses.

Under the terms of the trust, attorney fees and expenditures incurred by the trust to obtain the Agreement and reformation are permissible expenditures. In this regard, the minimal attorney fees incurred for the parties’ legal representation relates to their consent to the court proceeding and facilitated the reformation, thereby benefitting the trust. Accordingly, the trustee’s use of funds to pay or advance reasonable and necessary attorneys’ fees and related expenses to effect the Agreement for the benefit of the trust will not give rise to any gift tax. Likewise, the trustee’s use of funds to pay or reimburse a party for reasonable and necessary attorneys’ fees and related expenses incurred to effect the Agreement does not give rise to any gift tax liability for any party to the Agreement.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under the cited provisions or any other provisions of the Code. This ruling is based on the facts and 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 transaction considered in the ruling takes effect, the ruling will have no force or effect. If the taxpayer is in doubt whether there has been a change in material fact or law, a request for reconsideration of this ruling should be submitted to this office.

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.

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

Sincerely yours,
Assistant Chief Counsel
(Passthroughs and Special Industries)
By Robert Honigman
Acting Assistant to the Branch Chief
Branch 4

Enclosure (1)
Copy for section 6110 purposes