Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:4-PLR-114524-00
Date:
JANUARY 5, 2001

Re:

Legend

Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

Trustor =
Child 1 =
Child 2 =
Grandchild 1 =
Grandchild 2 =
Grandchild 3 =
Grandchild 4 =

Dear :

This is in response to your letter of July 25, 2000, requesting a ruling on the generation-skipping transfer (GST) tax consequences of a proposed reformation of Trusts 1-4.

On May 20, 1992, Trustor created trusts for the benefit of her children and grandchildren under a single trust agreement. Child 1 and Child 2 are the trustees of each trust.

Paragraph A of Article II of the trust instrument states that the Trustor has two children, Child 1 and Child 2. Paragraph A also states that Child 1 has three children, Grandchild 1, Grandchild 2, and Grandchild 3 and that Child 2 has one child, Grandchild 4.

Paragraph A of Article II directs the trustee to divide the initial trust estate into a separate trust estate for each beneficiary in the following manner: (i) one-fourth for Child 1; (ii) one-fourth for Child 2; (iii) one-eighth for Grandchild 1; (iv) one-eighth for Grandchild 2; (v) one-eighth for Grandchild 3; and (vi) one-eighth for Grandchild 4. Each trust is to bear the name of the beneficiary for whom it is set apart and is to be administered as a separate trust. Pursuant to this provision, the trustee established Trust 1 for the benefit of Grandchild 1, Trust 2 for the benefit of Grandchild 2, Trust 3 for the benefit of Grandchild 3, and Trust 4 for the benefit of Grandchild 4. Two separate trusts were also established for the benefit of Child 1 and Child 2, respectively.

Paragraph A of Article III provides that, during the term of each trust, the trustees may distribute such portions of the net income and principal as may be necessary or desirable, in the discretion of the trustee, to provide for the health, education, maintenance, and support of the beneficiary.

Paragraph B of Article III provides that each grandchild's trust (Trust 1-4) will remain in existence until the later of the death of Trustor or the 40th birthday of the grandchild for whom the trust was established. Upon termination, the assets of the trust will be distributed to the grandchild.

Paragraph C of Article III provides that each beneficiary shall have the power to direct the trustee to pay to the beneficiary from the trust bearing the name of the beneficiary, for each calendar year, the lesser of (i) with respect to Trustor or other donor, the annual exclusion amount provided in § 2503 (b) of the Internal Revenue Code, or (ii) with respect to Trustor or other donor, an amount equal to the fair market value (determined at the time of the transfer) of any property transferred or deemed transferred to the trust during the year in which the power is exercised. The trustees shall give the beneficiary prompt notice of all transfers to his or her trust within 10 days of the transfer. The power may be exercised for any calendar year only by the beneficiary giving written notice of the exercise to the trustees within 40 days after the date of the transfer to the trust.

Paragraph F of Article III states as follows:

> F. General Power of Appointment. Anything in this Article III to the contrary notwithstanding, upon the death of any beneficiary hereunder (other than [Child 1] and [Child 2]) *who has then surviving issue*, the trustee shall distribute the remaining Trust Estate of the trust held for that particular beneficiary in such proportions and in such manner, outright, in trust, or otherwise, to or for the benefit of any one or more persons or entities as may be appointed by specific reference thereto in the Will of such beneficiary. . . . [Emphasis added.]

Under Paragraph F of Article IX, the trust instrument is to be governed by the laws of Texas.

It has been represented that from May 20, 1992, through June 5, 1999, Trustor made annual transfers to each of the trusts. The amounts transferred to each of the trusts did not exceed $5,000 per year.

It has also been represented that, when Trustor's intentions were being reduced to writing, the inclusion of the language "who has then surviving issue" in Paragraph F of Article III was erroneous and contrary to Trustor's intent. Trustor intended that the trusts for the benefit of each of the grandchildren (Trusts 1-4) should provide each grandchild with an unconditional general power of appointment that is exercisable at death, in all events.

On February 15, 2000, Trustor petitioned the local court to reform Paragraph A of Article II, as it applies to Trusts 1-4. At the hearing, the attorney who drafted the instrument testified, under oath, that she inadvertently included the words "who has then surviving issue," thereby limiting the circumstances under which the power of appointment could be exercised and contradicting the heading of the paragraph referring to a general power of appointment. Placing a condition on the exercise of the power of appointment thwarted Trustor's intent to exclude the transfers to each trust from application of the GST tax. Trustor testified under oath that she intended to give each grandchild an unlimited general power of appointment so that the transfers to each grandchild's trust would be excluded from the application of the GST tax.

The local court issued an order declaring that the language in Paragraph F of Article III regarding the beneficiary's power to appoint did not reflect Trustor's true intentions due to a scrivener's error. The local court further held that, based on the entirety of the provisions of the trust agreement and the testimony and other evidence before the court, the language of Paragraph F of Article III of the Trust was to be construed, ab initio, as an unconditional general power of appointment with respect to each of Grandchild 1-4, exercisable whether or not each has issue living at the time of death. Paragraph F of Article III was reformed to delete the requirement that the power holder die with surviving issue in order to exercise the power.

Trustor has requested a ruling that to the extent that the value of any cumulative annual transfer from Trustor to each of Trusts 1-4 does not exceed the annual federal gift tax exclusion amount for the beneficiary, the inclusion ratio for purposes of computing the generation-skipping transfer tax on the transfer will be zero.

Section 2041(a)(1) provides that the value of the gross estate shall include the value of all property to the extent of any property with respect to which a general power of appointment created on or before October 21, 1942, is exercised by the decedent--

(A) by will, or (B) 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.

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

Section 2501(a) provides for the imposition of a tax on the transfer of property by gift. Section 2511(a) provides that the gift tax applies to a transfer by gift 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 2503(b)(1) provides that, in the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year, the first $ 10,000 of the value of the gifts (adjusted for inflation as provided in § 2503(b)(2)) is not included in the total amount of gifts during the year. This annual exclusion is only available for gifts of present interests in property. In general, a gift of property in trust is a gift of a present interest in property where the trust beneficiary has a legally unrestricted present right to demand that the trustee distribute the property to the beneficiary free and clear. See Crummey v. Commissioner, 379 F.2d 82 (9th Cir. 1968); Rev. Rul. 85-24, 1985-1 C.B. 329; Rev. Rul. 73-405, 1973-2 C.B. 321.

Section 2601 imposes a tax on every generation-skipping transfer. A generation-skipping transfer is defined under section 2611(a) as a taxable distribution, a taxable termination, and a direct skip.

Under § 2612(c), a direct skip is a transfer subject to the estate or gift tax of an interest in property to a skip person. A "skip person" is a natural person assigned to a generation that is two or more generations below the generation assignment of the transferor. A "skip person" may also be a trust, if all the interests in the trust are held by skip persons. Section 2613(a).

Under § 2602, the amount of GST tax imposed on a GST transfer is determined by multiplying the taxable amount by the "applicable rate." Section 2623 provides that, in the case of a direct skip, the taxable amount shall be the value of the property received by the transferee.

Under § 2641(a)(1), the "applicable rate" of the generation-skipping transfer tax is the product of the maximum federal estate tax rate and the inclusion ratio with respect to the generation-skipping transfer. Under § 2642(a)(2), the inclusion ratio with respect to any property transferred in a generation-skipping transfer is, in the case of a direct skip, the excess (if any) of 1 over the applicable fraction determined for the direct skip. Under § 2642(a)(2), in the case of a direct skip, the applicable fraction is a fraction, the numerator of which is the amount of the GST tax exemption allocated

(under § 2631) to the property transferred in the direct skip and the denominator of which is the value of the property involved in the direct skip reduced by the sum of any Federal estate or state death tax actually recovered from the transfer of the property and any charitable deduction allowed under § 2055 or § 2522 with respect to the property.

Section 2642(c)(1) provides that, in the case of a direct skip that is a nontaxable gift, the inclusion ratio is zero. A "nontaxable gift" is defined in § 2642(c)(3) as a transfer of property to the extent the property is not treated as a taxable gift by reason of § 2503(b) (taking into account the application of § 2513), or § 2503(e).

However, § 2642(c)(2) states that § 2642(c)(1) does not apply to any transfer to a trust for the benefit of any individual unless (A) during the life of the individual, no portion of the corpus or income of the trust may be distributed to (or for the benefit of) any person other than the individual, and (B) if the individual dies before the trust is terminated, the assets of the trust will be includible in the gross estate of the individual.

Under Texas law, if by mistake, an instrument as 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). See also, Bogert & Bogert, The Law of Trusts and Trustees, section 991 (revised 2d ed. 1983).

In this case, Trusts 1-4 are skip persons because all of the interests in each of these trusts are held by a natural person who is two or more generations below the generation assignment of Trustor, the transferor. Section 2613(a). Consequently, transfers from Trustor to the trusts are excludible from the generation-skipping transfer tax under § 2642(c)(1) only if the trusts satisfy the requirements of § 2642(c)(2) and the transfers are nontaxable gifts under § 2642(c)(3).

Upon consideration of the facts and applicable case law, we conclude that the reformation based on scrivener's error is consistent with applicable state law. Therefore, under Paragraph A of Article III of Trust, the trustees may distribute net income and principal only to the beneficiary for his or her health, education maintenance and support. Furthermore, under Paragraph F of Article III, as reformed by the local court, each grandchild has a testamentary general power of appointment over the assets of their trust. Therefore, the value of the assets of the trust will be includible the grandchild's gross estate under § 2041, if he or she should die before their trust terminates. Each grandchild's trust, as reformed, meets the requirements of § 2642(c)(2).

Accordingly, based on the facts submitted and the representations made, we conclude that each of Trustor's transfers to Trusts 1-4, respectively, to the extent each transfer qualifies for the annual exclusion under § 2503(b) will be a direct skip that is a nontaxable gift under § 2642(c)(3). Thus, the inclusion ratio for purposes of computing the GST tax on each transfer, to the extent the transfer qualifies for the annual exclusion, will be zero.

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.

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 rulings, it is subject to verification on examination.

Sincerely yours,
Associate Chief Counsel
(Passthroughs and Special Industries)
By: George Masnik
Chief, Branch 4

Enclosure (1)
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