

**Internal Revenue Service**

Number: **201807001**

Release Date: 2/16/2018

Index Number: 672.05-00, 672.05-01

Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B01

PLR-115197-17

Date:

November 13, 2017

Trust =

Donor =

Attorney =

Date 1 =

Date 2 =

Year 1 =

Year 2 =

State =

State =  
Statute

Court =

Dear

This letter responds to your authorized representative's letter dated April 18, 2017, and subsequent information requesting a ruling regarding the consequences under § 672(f)(2)(A)(ii) of Trust's reformation.

FACTS:

Attorney drafted Trust agreement to qualify as a grantor trust with respect to Donor under subpart E of part I of subchapter J of the Code. On Date 1, Donor executed Trust agreement and funded Trust. Although Donor is married and has issue now, Donor was not married and had no issue when Trust was executed. Donor, Donor's spouse, and Donor's issue are not and have never been citizens or residents of the United States (within the meaning of § 7701(b)(1)(A) of the Internal Revenue Code (Code)).

Section 2.1(B) of Trust agreement, prior to amendment, provides that during the lifetime of Donor, the Independent Trustees may at any time and from time to time distribute the whole or any part of the income of the Trust to, or expend the same for the benefit of, any one or more of Donor and the issue of Donor, in equal or unequal shares and with or without making any distribution or expenditure to or for the benefit of any other or others, or may accumulate the whole or any part of such income, all as the Independent Trustees may determine.

Section 2.1(C) of Trust agreement, prior to amendment, provides that during the lifetime of Donor, the Independent Trustees may at any time and from time to time distribute the whole or any part of the principal of the Trust to, or expend the same for the benefit of, any one or more of Donor and the issue of Donor, in equal or unequal shares and with or without making any distribution or expenditure to or for the benefit of any other or others, all as the Independent Trustees may determine, without considering other resources available to such beneficiaries, to provide for their respective health, education and comfortable support.

Section 2.1(D) of Trust agreement provides, in part, that upon the death of Donor, the Trustees shall divide the trust estate of the Trust into shares for, and shall set apart one of such shares with respect to each of, the issue then living of Donor, *per stirpes*.

Section 3.7 of Trust agreement provides that in the event any income of the Trust shall be accumulated, such income may (but need not) be separately accounted for in an accumulated income account. At any particular time, the power of the Trustees or the Independent Trustees to dispose of income under the Trust agreement shall for all purposes include the power to dispose of any accumulated income then on hand.

Section 3.8 of Trust agreement provides that an Independent Trustee is a trustee who (i) has no interest, vested or contingent, direct or indirect, in the trust estate of the Trust,

(ii) cannot be benefited by the exercise or nonexercise of any power, authority or discretion given exclusively to or vested exclusively in the Independent Trustee by the provisions of this Agreement or by law, and (iii) can alone possess and exercise such power, authority and discretion without causing income, accumulated income or principal of the trust estate of such Trust to be attributable to any beneficiary of the Trust for income, gift or estate tax purposes.

Section 3.10 of Trust agreement provides, in part, that Trust shall be administered and governed under the laws of State (within the United States).

Section 4.2(P) of Trust agreement provides that the Trustees of Trust shall have and may exercise the power to determine income and principal of such Trust and to allocate receipts and disbursements (including without limitation gains and losses) as between income and principal, all as the Independent Trustees determine to be advisable in the circumstances.

Section 4.4(B)(2)(a) of Trust agreement provides, in general, that in the event that the Trustees exercise any power, authority or discretion given to or vested in them by the provisions of the Trust agreement or by law in the administration and management of the Trust estate, has the effect of making the whole or any part of the income of such Trust taxable to any person who is a beneficiary of such Trust for the purpose of any United States or state income tax law at such time in force and effect prior to the time such person becomes entitled to the distribution of such income or prior to the time it is used or expended for the benefit of such person, then such Trustees or Trustee shall not have the right to exercise or participate in the exercise of such power, authority or discretion and shall be deemed not to have exercised or participated in the exercise of the same.

Section 4.5 of Trust agreement provides that the Independent Trustees are, at any particular time, with the consent or approval of a court of competent jurisdiction, authorized to reform, by a writing made and filed with the records of such Trust and delivered to the other Trustees, any of the provisions of the Trust agreement relating to such Trust to the end and purpose that burdensome tax consequences may, consistent with the purposes of such Trust and this Trust agreement, be eliminated or minimized.

Section 6.2 of Trust agreement provides, in part, that Trust is irrevocable and Donor renounces any rights to revoke, alter or amend the Trust agreement.

Although permitted under Trust's agreement, no distributions have been made from Trust to Donor's issue. Trustees of Trust represent that Trust has consistently filed U.S. tax returns consistent with the treatment of Trust as a grantor trust with respect to Donor. To this end, all U.S.-source fixed and determinable periodic income received by Trust has been subjected to 30% withholding by the payors.

In Year 1, Donor sought the advice of separate counsel who informed Donor that Trust did not qualify as a grantor trust.

LAW:

Section 671 provides, in part, that where it is specified in subpart E, part I, subchapter J (Subpart E) that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual.

Sections 673 through 677 specify the circumstances under which the grantor is treated as the owner of a portion of the trust.

Section 677(a)(1) provides that the grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under § 674, whose income without the approval or consent of any adverse party is, or in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor or the grantor's spouse.

Section 1904 of the Small Business Job Protection Act of 1996 (the Act), Public Law 104-188, 110 Stat. 1755 (August 20, 1996), amended section 672(f) and certain other sections of the Code. The amendments affect the application of §§ 671 through 679 of the Code (the grantor trust rules) to certain trusts created by foreign persons.

Section 672(f)(1) , as amended, provides that subpart E (§§ 671 through 679) applies only to the extent such application results in an amount (if any) being currently taken into account (directly or through one or more entities) under this chapter in computing the income of a citizen or resident of the United States or a domestic corporation.

Section 672(f)(2)(A)(ii), as amended, provides that the general rule does not apply to any portion of a trust if the only amounts distributable from such portion (whether income or corpus) during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor.

Section 672(f)(1) was effective "on the date of enactment" (August 20, 1996). However, section 1904 of the Act provided grandfather rules for certain trusts that were in existence on September 19, 1995, to the extent any transfers to such trusts were made on or before that date.

Trust was executed and partially funded on Date 1, which was after September 19, 1995, and before August 20, 1996. Therefore, Donor was treated as the owner of any portion of the trust over which Donor retained the powers or interests described in

sections 673 through 677 prior to August 20, 1996. However, as a result of the enactment of section 1904 of the Act, Donor was prevented from being the owner of Trust by the operation of § 672(f) as of August 20, 1996, and thereafter because Trust did not qualify for the exception in § 672(f)(2)(A)(ii) because Donor's issue were beneficiaries of Trust during Donor's life.

In Year 2, Donor filed a suit in Court to reform Trust in order to satisfy the terms of Section 672(f)(2)(A)(ii). Both Donor and Attorney, who had drafted Trust agreement, testified to the Court regarding their intent for Trust to qualify as a grantor trust since Date 1 onwards.

As part of the State Court action an attorney was appointed guardian *ad litem* to represent the interests of Donor's issue, who are minors, and the interests of any future issue. Following a trial, Court entered an order (the "Order") on Date 2 modifying, as of Date 1, Section 2.1(B) and 2.1(C) removing "the issue of Donor" as beneficiaries of Trust during the lifetime of Donor. In its Order, Court found clear and convincing evidence that Donor always intended Trust would be a grantor trust deemed owned by Donor. The Court found that Section 1904 of the Act, which applied to certain irrevocable trusts executed prior to the date of its enactment, including Trust, in effect retroactively changed the grantor trust rules relied upon in creating the Trust. Thus, the court concluded that the original Trust agreement was drafted based on what became a mistake of fact and law. The Court determined that reforming Trust to delete the inclusion of Donor's issue as beneficiaries of Trust during Donor's lifetime would correct the mistake of fact and law underlying the creation of Trust and conform the Trust agreement to Donor's intent.

## ANALYSIS AND CONCLUSION

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.

State Statute provides that a court may reform the terms of a trust, even if unambiguous, to conform the terms to the settlor's intention if it is proved by clear and convincing evidence that both the settlor's intent and the terms of the trust were affected by a mistake of fact or law, whether in expression or inducement. Thus, courts in State will reform a trust when it can be shown by clear and convincing evidence that provisions were inserted or omitted because of a mutual or unilateral mistake and that,

as written, the instrument does not truly reflect the settlor's desires and intention at the time of execution and delivery.

In this case, an examination of the relevant State Court trial transcripts and representations of the parties indicate that Donor intended that Trust be a grantor trust with respect to Donor. This intent was not carried out in the Trust agreement as a result of a mistake of fact and law. As discussed above, the judicial action involves bona fide issues and the reformation is consistent with applicable State law that would be applied by the highest court of State. Accordingly, based on the facts presented and the representations made, including the lack of any distributions by Trust to the issue of Donor, we conclude that the reformation of Trust is consistent with applicable State law that would be applied in the highest court of State. Thus, we rule, in these unique circumstances, Trust's reformation will be taken into account as of Date 1 for the purpose of determining whether Trust falls within the § 672(f)(2)(A)(ii) exception to § 672(f)(1).

Except as expressly provided herein, no opinion is expressed or implied concerning tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayers 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 Trust's authorized representatives.

Sincerely,

*Faith P. Colson*

Faith P. Colson  
Senior Counsel, Branch 1  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)

Enclosures (2)  
Copy of this letter  
Copy for § 6110 purposes

cc: