

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:B09-PLR-123671-02

Date:

April 3, 2003

In Re:

Legend

Decedent	=
Date 1	=
Trust	=
Daughter	=
Agreement	=
State Court	=
State	=

Dear :

This is in response to your letter dated March 8, 2002, in which you requested a ruling concerning the generation-skipping transfer tax (GST) and gift tax consequences of the proposed judicial construction of a trust agreement that is exempt from the application of generation-skipping transfer tax imposed under Internal Revenue Code § 2601.

The facts and representations submitted are summarized as follows: Decedent died on Date 1. At the time of his death, Decedent held a limited power of appointment over the corpus of a trust created by his deceased spouse's will. Article 7 of Decedent's will exercised that limited power of appointment by appointing the trust assets to three separate trusts, one for each of Decedent's three daughters and their respective descendants. Trust is the separate trust established for Daughter.

Pursuant to Article 7, paragraph b of Decedent's will, the trustees shall distribute the income of Trust at least quarterly to Daughter, her children or her grandchildren in such amounts and such proportions as the disinterested trustees, in their sole

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discretion, determine. Paragraph c provides for the distribution of Trust principal as the disinterested trustees deem necessary or advisable for the health and maintenance of Daughter, her children or her grandchildren.

Pursuant to Article 7, paragraph d, at the time set for final distribution of Trust, the principal and undistributed earnings of Trust are to be distributed to the then living grandchildren of Daughter as Daughter appoints in her will, and in the absence of such appointment, then equally to the then living grandchildren of Daughter. If there are no then living grandchildren, then to Decedent's deceased wife's descendants by right of representation.

Article 14 of Decedent's will defines the term "descendants" as "lawful blood descendants in the first, second or any other degree of the ancestor designated, and does not include any adopted child of any descendant."

Daughter is currently living and has six living children and nine living grandchildren. Two of Daughter's grandchildren were adopted and lived while a minor as a regular member of the household of the adopting parent. Daughter and other interested parties of Trust represent that there is an ambiguity because it is unclear whether the adopted grandchildren will be considered "grandchildren" and therefore beneficiaries of Trust. Decedent's will defines the term "descendants" to exclude an "adopted child of any descendant," but the term "grandchildren" is not defined and Article 14 appears limited to defining the term "descendants." Daughter, Trust's trustee, and all interested parties of Trust wish to have the ambiguity over the status of adopted grandchildren as beneficiaries clarified. All interested parties have entered into Agreement to document their understanding that the exclusion of an adopted child from the definition of the term "descendant" does not apply to the term "grandchildren" and that Daughter's adopted grandchildren are beneficiaries of Trust.

The trustees of Trust filed a Petition for Construction of Trust Agreement and Approval of Family Agreement with State Court for approval of Agreement. Subsequently, State Court issued an order approving Agreement and stating that Agreement is consistent with the construction of ambiguous trust agreements under State law.

It has been represented that no additions, actual or constructive, have been made to Trust after September 25, 1985.

The trustees of Trust have requested the following rulings:

- (1) that the proposed judicial construction of Trust with a family settlement among the interested parties agreeing to such construction, will not result in any party making a taxable gift or transfer under § 2501.
- (2) that the proposed judicial construction of Trust will not affect the exempt status of Trust for purposes of the generation-skipping transfer tax under § 2601.

## RULING 1 - THE GIFT TAX CONSEQUENCES OF THE BENEFICIARIES' CONSENT TO THE JUDICIAL CONSTRUCTION

Section 2501 imposes a tax for each calendar year on the transfer of property by gift during such calendar year by any individual.

Section 2511(a) provides that, subject to certain limitations, the gift tax applies whether the transfer is in trust or otherwise, direct or indirect, and whether the property transferred is real or personal, tangible or intangible.

Section 2512(a) provides that, if a gift is made in property, the value thereof at the date of the gift will be considered the amount of the gift. Section 2512(b), provides, in part, that where property is transferred for less than adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift.

In Commissioner 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 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 a 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.

In this case, the judicial construction clarifies the terms and beneficiaries of a previous transfer in accordance with Decedent's intent. State Court's construction of Trust is consistent with applicable state law that would be applied by the highest court of the state. Therefore, we conclude that the beneficiaries' consent to the construction would not be a transfer for gift tax purposes and does not constitute a taxable gift pursuant to § 2501.

## RULING 2 - THE EXEMPT STATUS OF TRUST FOR GST PURPOSES

Section 2601 imposes a tax on every generation-skipping transfer, which is defined under § 2611 as a taxable distribution, a taxable termination, or a direct skip.

Section 1433(b)(2)(A) of the Tax Reform Act of 1986 (the Act) and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations provide that the generation-skipping transfer tax shall not apply to any generation-skipping transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added).

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Section 26.2601-1(b)(1)(ii)(A) provides that any trust in existence on September 25, 1985, will be considered an irrevocable trust except as provided in §§ 26.2601-1(b)(ii)(B) or (C), which relate to property includible in a grantor's gross estate under §§ 2038 and 2042. In the present case, Trust is considered to have been irrevocable on September 25, 1985, because neither § 2038 nor § 2042 applies.

Section 26.2601-1(b)(1)(iv) states that, if an addition is made after September 25, 1985, to a trust which was irrevocable on September 25, 1985, a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the GST tax provisions. If an addition is made, the trust is thereafter deemed to consist of two portions, a portion not subject to the GST tax and a portion subject to the GST tax.

Section 26.2601-1(b)(4) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the generation-skipping transfer tax under § 26.2601-1(b)(1), (2), or (3) (hereinafter referred to as an exempt trust) will not cause the trust to lose its exempt status. The rules contained in § 26.2601-1(b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. The rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of § 1001.

Section 26.2601-1(b)(4)(i)(C) provides that a judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause an exempt trust to lose its exempt status provided the judicial action involves a bona fide issue, and the construction is consistent with applicable state law that would be applied by the highest court of the state.

In an action for construction of a will, the court's objective is to ascertain the intention of the testator through the consideration of the instrument as a whole, and, when necessary or appropriate, the circumstances under which the will was executed. *In re Estate of Smith*, 119 Ariz. 293, 295, 580 P.2d 754, 756 (App. 1978). An ambiguity is said to exist in an instrument when the written language is fairly susceptible to two or more constructions. A patent ambiguity is an uncertainty which appears on the face of a will. *Smith*, 119 Ariz. at 296, 580 P.2d at 757.

Based on the information submitted and representations made, we conclude that the terms of Trust present a bona fide issue regarding whether the adopted grandchildren of Daughter are considered "grandchildren" and therefore beneficiaries of Trust. We further conclude that State Court's construction of Trust is consistent with applicable state law that would be applied by the highest court of the state. Accordingly, based on the facts submitted and the representations made, the State Court's order construing Trust will not affect the exempt status of Trust for purposes of the generation-skipping transfer tax and will not result in a transfer of property that will subject Trust or distributions thereunder to the generation-skipping transfer tax imposed under § 2601.

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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 had 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(s) 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 taxpayer.

Sincerely,

Melissa C. Liquerman  
Branch Chief, Branch 9  
Office of Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures

Copy for section 6110 purposes