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PLR 201442046 - Section 2036 - Transfers With Retained Life Estate

Internal Revenue Service
Department of the Treasury
Washington, DC 20224

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Person To Contact:
-, ID No. -
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Date:
June 18, 2014

Re:

LEGEND

Grantor =
Company =
State =
Child 1 =
Child 2 =
Child 3 =
Child 4 =
Year 1 =
Attorney 1 =
Date 1 =
Children's Trust =
Date 2 =
Year 2 =
Accountant =
Year 3 = Financial Planner =
Attorney 2 =
Court =
Date 3 =
Date 4 =
Year 4 =
Statute 1 =
Statute 2 =
Citation 1 =
Citation 2 =

Dear [redacted data]:

This letter responds to your submission dated December 20, 2013, and subsequent correspondence regarding the effect of a state court reformation of a trust for federal gift and estate tax purposes.

FACTS

The facts submitted and representations made are as follows:

Grantor is a businessman and a co-owner of Company in State. Grantor is married and has four adult children, Child 1, Child 2, Child 3, and Child 4 (collectively, Children). In Year 1, Grantor and his wife met with Attorney 1 to discuss short-and long-term estate planning, including the use of grantor retained annuity trusts (GRATs). Attorney 1 was retained to prepare estate planning documents, including powers of attorney, medical powers, and living wills. Further discussions ensued about creating two GRATs, one for a four-year term (GRAT 1) and another for a fifteen-year term (GRAT 2). In contemporaneous correspondence, Attorney 1 informed Grantor that a GRAT "may be an effective means for you to retain all or most of the income from a high-yielding and rapidly appreciating property . . . to transfer that property to a child or other person with minimal gift tax cost while saving estate taxes." Grantor agreed to the plan and on Date 1, Grantor established GRAT 1 and GRAT 2. On the same date, Grantor made gifts of Company stock to GRAT 1 and GRAT 2.

Pursuant to the terms of GRAT 1, Grantor was to retain the right to receive an annuity for four years, after which the remaining trust assets, if any, would pass to the Children's Trust, a trust for the benefit of Grantor's Children. The terms of GRAT 2 are similar to GRAT 1, but with a fifteen-year term. The remainder beneficiary of GRAT 2 is also Children's Trust.

Children's Trust, dated Date 2, was drafted as a revocable trust, permitting Grantor to revoke the trust at any time, as well as amend or modify the Children's Trust at any time. The terms of Children's Trust provide that with respect to any assets received by the trustee, such assets shall be set apart in a separate and equal share, or "Sub Trust" (Separate Trust), for each of Grantor's Children. If any child is not then living, such child's share is to be held in further trust for such child's own children, or if none, to be paid equally among the then-surviving children of Grantor, or if none, equally among all of Grantor's grandchildren. During the term of each Separate Trust, the trustee is directed to distribute "so much of the income and so much of the principal as they may deem appropriate and advisable in their sole and absolute discretion for the health, welfare, education, and support" of the child who is the beneficiary of such Separate Trust. Any income not expended in any year is to be added to principal. Mandatory distributions of principal are to be made to each beneficiary at ages 28, 31, and 34. If a child dies prior to the termination of his or her Separate Trust, that child's share is to be held in trust for his or her own children, or if none, distributed to specified relatives pursuant to the provisions in Children's Trust. The initial trustee of Children's Trust is Grantor. By its terms, Children's Trust conforms consistently to the terms of a revocable instrument (e.g., creating powers under § 2036 or 2038). In Year 2, Accountant was retained by Grantor to prepare the Form 709 (United States Gift (and Generation-Skipping Transfer) Tax Return) reporting the Date 1 transfers to GRAT 1 and GRAT 2. After reviewing the trust documents, Accountant contacted Grantor to express concerns about the language in the Children's Trust. Specifically, Accountant noted, and was alarmed by the fact, that the language making Children's Trust revocable by Grantor appeared to defeat Grantor's intent in creating GRAT 1 and GRAT 2 by causing the remainder interests in the GRATs to be included in the estate of Grantor for federal estate tax purposes and causing any distributions from Children's Trust to Grantor's children to be taxable gifts for federal gift tax purposes. Accountant contacted Attorney 1 to express his concerns, but Attorney 1 insisted that his drafting of Children's Trust was proper and noted that Accountant, not being an attorney, did not understand the State law governing the trust. Accountant memorialized his conversation with Attorney 1 in a contemporaneous file memorandum and prepared Grantor's gift tax return for Year 1 showing completed gifts to GRAT 1 and GRAT 2.

Several years later in Year 3, Company retained Financial Planner to work with Company shareholders on financial and estate planning issues. Financial Planner reviewed Grantor's estate planning documents and also concluded that the Children's Trust contained incorrect provisions. Financial Planner retained Attorney 2 to review Children's Trust who confirmed that for Grantor's transfers to GRAT 1 and GRAT 2 to be complete as intended, Grantor should not have the power to revoke the Children's Trust. Financial Planner informed Grantor that Children's Trust was flawed. Grantor contacted Attorney 1, who continued to maintain that the drafting of Children's Trust was proper and that the transfers to the GRATs were, in fact, completed gifts and out of Grantor's estate.

Grantor subsequently retained Attorney 2 to reform Children's Trust under State law. On Date 3, a petition was filed in State Court requesting reformation of Children's Trust to correct mistakes under scrivener's error. State Court approved the petition on Date 4, providing an Order that the correction of these scrivener's errors made by the reformation are to be effective ab initio, as if they were included in the original Children's Trust as executed on Date 2. Specifically, Article FOURTEENTH is restated as follows:

FOURTEENTH: This Trust and any trusts created hereunder shall be irrevocable and not subject to modification by the Grantor. The Grantor intends any transfers the Trustees hereunder to be completed transfers for federal gift and estate tax purposes. The Grantor intends to retain no power or interest, direct or indirect, that will cause inclusion in the Grantor's federal gross estate of any property transferred to the Trustees hereunder under any provision of the Internal Revenue Code, including but not limited to §§ 2036, 2037 and 2038. Every provision of this Trust shall be construed to effectuate the intentions set forth in this Article and any provision of this Trust that is inconsistent with any of these intentions shall be void.

The Order of the Court is conditioned upon the issuance by the Internal Revenue Service (Service) of a private letter ruling stating that the Service will respect the Court's retroactive reformation of the Children's Trust for federal estate and gift tax purposes. Such ruling must be received within 9 months of Date 4 or the Court's order will become void.

It is represented that Grantor intended to make completed gifts of Company stock when transferred to GRAT 1 and GRAT 2 on Date 1. Grantor did not intend to retain any powers over the Children's Trust that would cause the gifts on Date 1 to be incomplete or that would cause the assets of Children's Trust to be included in his estate (unless he did not survive the GRAT term). Attorney 1 attests in a sworn affidavit that "due to a scrivener's error," the Children's Trust was drafted as a revocable trust which would only be appropriate to include the assets in the Grantor's gross estate for federal tax purposes. Further, Attorney 1 avers that "[t]hese provisions were contrary to [Grantor's] intent."

You request the following rulings:

1. As a result of the reformation of Children's Trust to correct scrivener's errors, the Grantor's transfers of the remainder interests in GRAT 1 and GRAT 2 will be completed gifts, and upon the completion of the respective GRAT terms, the distribution of the remainder interests to the Children's Trust will not cause the Grantor to make an additional gift. As a result of the reformation of Children's Trust to correct scrivener's errors, the assets of the Children's Trust will not be included in the gross estate of Grantor when he dies. The reformation of Children's Trust to correct scrivener's errors will not cause any current or future beneficiary of the Trust to make a gift to any other current or future beneficiary of the Trust.

LAW AND ANALYSIS

Section 2033 of the Internal Revenue Code provides that the value of the gross estate includes the value of all property to the extent of a decedent's interest in the property at the time of his death.

Section 2036(a) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Section 2038(a)(1) provides that the value of the gross estate shall include the value of all property, to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.

Section 2501 imposes a tax on the transfer of property by gift by an individual.

Section 2511 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 a gift is made in property, the value of the property at the date of the gift is considered the amount of the gift. Where property is transferred for less than an adequate and full consideration in money or money's worth, the gift is the amount by which the value of the property transferred exceeded the value of the consideration.

It is well settled under State law that the mistake of a scrivener in preparing a deed or other writing may be established by parol evidence, and the instrument reformed accordingly. Citation 1. However, the evidence required to reform a written instrument must be clear, precise, convincing, and of the most satisfactory character. Citation 2.

In Year 4, State adopted Uniform Trust Code § 415, which allows the reformation of the terms of a trust to correct mistakes. The statute provides:

The court may reform a trust instrument, even if unambiguous, to conform to the settlor's probable intention if it is proved by clear and convincing evidence that the settlor's intent as expressed in the trust instrument was affected by a mistake of fact or law, whether in expression or inducement. The court may provide that the modification have retroactive effect.

Statute 1. State also enacted Statute 2 which provides:

The court may modify a trust instrument in a manner that is not contrary to the settlor's probable intention in order to achieve the settlor's tax objectives. The court may provide that the modification have retroactive effect.

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.

In this case, affidavits made by the Grantor, Attorney 1, Accountant, Financial Planner, and Attorney 2, together with contemporaneous correspondence, memoranda, and emails provide clear and convincing evidence that the provision in Children's Trust of Grantor's power to revoke Children's Trust does not conform to the Grantor's intention. The correspondence from Attorney 1 indicates that the transfers to GRAT 1 and GRAT 2 were intended to be completed gifts. In reforming Children's Trust, State Court found that there was clear and convincing evidence of scrivener's errors, the reformation of Children's Trust was necessary and appropriate to achieve Grantor's tax objectives, and the reformation was not contrary to Grantor's intentions.

Therefore, we conclude that State Court's Order on Date 4, reforming Children's Trust based on scrivener's errors is consistent with applicable State law, as applied by the highest court of State. Accordingly, we conclude that as a result of the reformation of Children's Trust to correct scrivener's errors: (1) the transfers of the remainder interests in GRAT 1 and GRAT 2 are completed gifts, and upon the completion of the respective GRAT terms, the distribution of the remainder interests to Children's Trust will not cause the Grantor to make an additional gift; (2) the assets of Children's Trust will not be included in the gross estate of Grantor when he dies (provided Grantor survives the annuity period of the respective GRATs); and (3) the Court's reformation of Children's Trust will not cause any current or future beneficiary of the trust to make a gift to any other current or future beneficiary of the trust. Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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 your authorized representative.

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,

Leslie H. Finlow
Senior Technician Reviewer, Branch 4

Office of Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2)

cc:

Contact us at <http://www.bna.com/contact/index.html> or call 1-800-372-1033

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