

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:B04 - PLR - 138516-02

Date:

DECEMBER 17, 2002

Re:

Legend

Trustor =
Trust =

Trustee =
Policy =

\$m =
A =
X =
Y =
Z =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Year 1 =
Court =
State =
Statute =

Dear :

This is in response to your June 26, 2002 letter in which you request rulings on the application of federal estate tax to the proposed reformation of Trust.

The facts and representations submitted are summarized as follows: On Date 1,

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Trustor created Trust, an irrevocable life insurance trust, for the benefit of Trustor's children.

Article I, Paragraph A of Trust provides that during Trustor's life, the trustee shall hold and administer all funds remaining after the exercise or lapse of all demand powers and may, but is not required to, use some or all of the Trust's net income and principal to acquire and pay premiums of policies of life insurance on the life of Trustor. The trustee of Trust acquired Policy, dated Date 2, with a face value of \$m. Trustor is the insured under Policy.

Article I, Paragraph B provides that following the death of Trustor, the trustee shall divide the principal of Trust into as many equal shares as there are children of Trustor then living and children of Trustor then deceased leaving issue then living. Trustee shall allocate one such equal share to each living child of Trustor, and once such equal share to each group composed of the living issue of a deceased child of Trustor to be further allocated into subshares among such living issue. Each share allocated to a child of Trustor shall be distributed to such child free of trust. Each share or subshare allocated to the issue of a deceased child of Trustor shall be treated as a separate trust and each such trust shall be distributed, or retained in trust, as set forth under the terms of Trust.

Article I, Paragraph C provides that immediately following any transfer to Trust ("contribution"), any beneficiary, or the guardian or other fiduciary of such beneficiary's estate, may demand in writing ("demand power"), to receive, free to trust, an amount equal to such beneficiary's proportionate share of such contribution to Trust. The proportionate share of any contribution which each beneficiary may demand shall be determined by dividing the total amount of the contribution by the total number of beneficiaries entitled to make such demand. However, in no event shall the withdrawal by any beneficiary exceed the lesser of: (i) the maximum pecuniary amount which may be withdrawn by such beneficiary without resulting in any federal gift tax liability by reason of such withdrawal, after taking into account in determining the imposition of any such gift taxes, any credits, exemptions or exclusion relating thereto, or (ii) ten thousand dollars. Upon receipt of such notice, the trustee shall immediately transfer such pecuniary amount to the beneficiary or his guardian ("distribution"). In all events, any such distribution shall be made by December 31st of the year in which the contribution to Trust was previously made. In no event can Trustor make the demand for a beneficiary, regardless of Trustor's relationship to him or her.

Article I, Paragraph D provides that the demand power is noncumulative and lapses on the earlier of (a) the last day of the calendar year in which the contribution was made, or (b) sixty calendar days following the date of the contribution. No demand or transfer may be made in a subsequent year on account of any beneficiary's failure to demand a distribution in a prior year.

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Article I, Paragraph F provides that the trustee may satisfy any beneficiary's demand for a distribution by distributing cash, other assets or fractional interests in other assets, as the trustee deems appropriate. Without limiting the trustee's power to select assets to satisfy a demand, Trustor prefers that cash or tangible assets normally be distributed before life insurance policies and other intangible assets, unless the trustee decides that another selection is warranted.

Article II, Paragraph A provides that X shall act as original trustee of Trust. If X is unavailable to act as trustee, then Y shall act as trustee.

Article II, Paragraph B provides that if neither X nor Y are available to act as trustee or is or are removed, then Trustor may name a successor individual trustee or corporate trustee; provided, however, that under no circumstances may any related or subordinate party, as such term is defined in section 672 of the Internal Revenue Code, be named as successor individual trustee or corporate trustee.

Article III, Paragraph L provides that the trustee is expressly prohibited from exercising any power vested in him as trustee primarily for the benefit of the Trustor rather than for the benefit of the beneficiaries. Furthermore, the Trustor shall not have (1) the power to purchase, exchange or otherwise deal with or dispose of the principal or the income of the trust estate for less than adequate and full consideration in money or money's worth, (2) the power to borrow the principal or income of the trust estate, directly or indirectly, without adequate interest or without adequate security or (3) the power to vote any securities transferred by the Trustor to the Trust.

Article III, Paragraph M 1. provides that the trustee is authorized to continue to hold as part of Trust all insurance policies on the life of the Trustor which shall be acquired by or transferred to the trustee as part of the trust estate. The trustee shall hold all powers conferred on the owner of any policy in Trust and shall designate Trust as beneficiary of all such policies.

Article III, Paragraph M 3. provides that the trustee as owner of each policy made payable to Trust reserves all rights, options, and privileges conferred on the owner by the terms of the policy, including, but not limited to, the right to hypothecate the policy and to borrow funds from the insurer; provided, however, that all such borrowed funds are used for the benefit of the Trust and no portion thereof insures directly to the benefit of the trustee. Trustee shall not, however, have the right to designate any natural person or entity other than this Trust as beneficiary of any such policy.

Article IV, Paragraph G provides that any trustee named or acting as trustee, may refuse to so act or may resign or may be discharged from acting as a trustee by giving, personally or by mail, written notice of his resignation or refusal, to the then beneficiaries and the guardians of any minor beneficiaries. Such notice shall specify the date when such resignation shall take effect, which date (unless the person

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receiving such resignation shall otherwise consent) shall be at least thirty days after the service or mailing thereof. If the Trustor does not name a successor trustee within thirty days after the resignation, refusal or discharge of such trustee, the then beneficiaries and guardians of any minor beneficiaries may, by majority act in a duly acknowledged written instrument, designate a successor trustee, any corporate trustee with combined capital and surplus of at least \$100,000,000.

In Year 1, X resigned as trustee. At that time, Y was unavailable to serve as trustee. Trustor exercised her power under Paragraph B of Article II and appointed Z as trustee. On Date 3, Z resigned as trustee and Trustor attempted to appoint her son, A, as trustee. However, due to the restrictions in Article II, Paragraph B, Trustor's appointment of A was not effective. Z remained trustee and submitted a new resignation on Date 4. Trustor then appointed Trustee as trustee, who continues to serve as the current trustee.

As noted above, Article II, Paragraph B provides that Trustor may name a successor trustee if X or Y are unable to serve or are removed. The paragraph provides that the successor trustee cannot be a "related or subordinate party" within the meaning of section 672. However, the provision does not clearly specify the person with respect to whom the successor cannot be related or subordinate. No provision of Trust expressly prohibits Trustor from appointing herself as trustee in the event X and Y are unable or unwilling to serve as trustee.

It is represented that Trustor intended to include a provision that would expressly prohibit her from appointing herself or any party related or subordinate to herself, as trustee in the event of a vacancy in the office of trustee. However, due to a scrivener's error, that express prohibition was omitted from Trust. In order to correct this scrivener's error, it is represented that Trustee will file with the Court, pursuant to State Statute, a Petition for Reformation of Trust. The proposed petition requests the Court to issue an order reforming Article II, Paragraph B to include the following terms (identified in bold) as of Date 1, the effective date of Trust:

"Notwithstanding any other provision hereof, if neither X, nor Y, are available to act as trustee hereunder or is or are removed as herein provided, then Trustor may name a succession individual Trustee or Corporate Trustee hereunder; provided, however, that under no circumstances may **the Trustor or any party related or subordinate to the Trustor**, as such term is defined in section 672 of the Internal Revenue Code of 1986, as amended (or any succeeding provision thereto of the same or similar import), be named as successor individual Trustee or Corporate Trustee hereunder. . ."

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You have requested the following rulings:

1. Trustor will not possess any incidents of ownership with respect to the insurance policy held in Trust, as reformed, under section 2042(2).
2. Section 2035 will not apply to cause the inclusion of the Trust assets in Trustor's gross estate for federal estate tax purposes.

LAW AND ANALYSIS

Section 2001 imposes a tax on the taxable estate of every decedent who is a citizen or resident of the United States.

Section 2033 provides that the value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of the decedent's death.

Section 2035(a) provides that if the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, within three years of the decedent's death, and the value of the property (or an interest therein) would have been included in the gross estate under section 2036, 2037, 2038, or 2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death, the value of the gross estate shall include the value of any property (or interest therein) which would have been included in the gross estate.

Section 2036 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 the 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 right to 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 from the property.

Section 20.2036-1(b)(3) of the Estate Tax Regulations provides, as an example, that if the decedent reserved the unrestricted power to remove or discharge a trustee at any time and appoint himself as trustee, the decedent is considered as having the powers of the trustee.

Section 2042(2) provides that the value of the gross estate includes the value of all property to the extent of the amount receivable by all other beneficiaries as insurance under policies on the life of the decedent with respect to which the decedent

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possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person.

Regarding the application of section 2042(2), section 20.2042-1(c)(2) provides that the term "incidents of ownership" is not limited in its meaning to ownership of a policy in the technical legal sense. Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy.

Section 20.2042-1(c)(4) provides that a decedent is considered to have an "incident of ownership" in an insurance policy on his life held in trust if, under the terms of the policy, the decedent, (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust.

Rev. Rul. 77-182, 1977-1 C.B. 273, considers a situation where the decedent-grantor held the power, for life, to appoint a successor corporate trustee if the original trustee resigned or was removed by judicial process. Under the terms of the irrevocable trust, the corporate trustee had the power to make discretionary distributions of income among the grantor's children. The revenue ruling concludes that the decedent's power to appoint a successor corporate trustee in the event of resignation or removal of the original trustee did not amount to a power to remove the original trustee that, in effect would have endowed the decedent with the trustee's discretionary control over trust income. Accordingly, the value of the trust assets at the death of the decedent is not includible in the decedent's gross estate under section 2036.

Rev. Rul. 95-58, 1995-2 C.B. 191, modifies Rev. Rul. 77-182 and holds that even if the decedent had possessed the power to remove the trustee and appoint an individual or corporate successor trustee that was not related or subordinate to the decedent (within the meaning of section 672(c)), the decedent would not have retained the trustee's discretionary control over trust income, for purposes of section 2036.

In Commissioner v. Estate of Bosch, 387 U.S. 456 (1967), the Supreme Court held that where the issue involved is the determination of property interests for federal estate tax purposes, and the determination is based on state law, the highest court of the state is the best authority on its own law. The Service, however, is not bound by a lower court decision. If there is a decision by a lower 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.

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In Ike v. Doolittle, 61 Cal. App. 4th 51, 82 (1998), the Court stated, "In [State], the common law equitable power of a trial court to modify or reform a trust extends to situations where, as here, the trust instrument contains some expression of the trustor's intention, but a drafting error renders that expression ambiguous."

The facts presented in the instant case indicate that Trustor intended that the trust corpus would not be subject to inclusion in her gross estate. The omission of the words "the Trustor or any party related or subordinate to the Trustor", which precludes Trustor from appointing herself as the trustee of Trust, was the result of a scrivener's error and contrary to the intent of Trustor.

We believe that the proposed reformation would resolve the ambiguity regarding Trustor's authority to name herself as Trustee, and that such reformation is consistent with State law. Therefore, the reformation will not be considered a release or transfer of any retained interest or power that would subject the Trust assets to inclusion in Trustor's gross estate under section 2035. Furthermore, Trustor does not possess any incidents of ownership over the insurance policy held in Trust, as reformed, under section 2042.

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.

Except as expressly provided herein, we express or imply no opinion on the Federal tax consequences of any aspect of any transaction or item discussed or referenced in this letter under any other provisions of the Code.

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 the office, we are sending a copy of this letter to your authorized representative.

Sincerely,

Lorraine E. Gardner
Senior Counsel
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures

Copy for section 6110 purposes
Copy of this letter