

State Statute 1 =
State Statute 2 =

State Statute 3	=
State Statute 4	=
X	=
Y	=
Z	=
A	=
B	=

Dear _____ :

This letter responds to your authorized representative's letter of November 4, 2016, requesting rulings under §§ 2036, 2501, and 2601 of the Internal Revenue Code.

The facts submitted and representations made are as follows. On Date 1, a date prior to September 25, 1985, Grantor created an irrevocable trust (Trust) for the benefit of Daughter and her issue. Trust was funded with shares of stock in Corporation. It is represented that Corporation was an S corporation within the meaning of § 1361(d) and that Trust is a qualified subchapter S Trust (QSST) within the meaning of § 1361(d)(3). It is also represented that there have been no additions to trust since September 25, 1985.

Article 1, Paragraph A, of Trust provides that Trustee shall accumulate income until Daughter reaches the age of X. Upon Daughter attaining the age of X, Trustees are to pay all net income to Daughter semi-annually.

Article 1, Paragraph B, provides that Trustee may apply so much of accumulated income and principal of the trust estate during the minority of daughter as it deems necessary for her comfortable maintenance, medical care and education.

Article, Paragraph C provides that upon Daughter attaining the age of Y, she may request in writing one-fourth of the principal of Trust, and upon attaining the age of Z she may request one-third of the remaining principal of Trust. Upon the death of Daughter the Trustee is directed to distribute the corpus of Trust to the issue of Daughter, as she appoints in her last will. In default of Daughter's appointment the corpus of Trust is to be distributed to her issue *per stirpes*.

Trust is administered under the laws of State 1.

State Statute 1, as in effect during the year at issue, provides that proceeds from the sale of an asset held by a trust will be allocated to trust principal.

State Statute 2 provides that any income taxes due on capital gains is to be paid from the trust principal, notwithstanding that the tax may be denominated a tax upon income by the taxing authority.

State Statute 3 provides a trustee shall take reasonable steps to enforce claims of the trust and to defend claims against the trust.

State Statute 4 provides that a beneficiary is barred from challenging a transaction or asserting a claim against a trustee for breach of trust if:

(i) the trustee provided the beneficiary at least annually with periodic written financial reports concerning the trust;

(ii) the transaction was disclosed in a report to which subparagraph (i) refers or such report provided sufficient information so that the beneficiary knew or should have known of the potential claim or should have inquired into its existence;

(iii) in the 30 months after a report to which subparagraph (ii) refers was sent by the trustee to the beneficiary, the beneficiary did not notify the trustee in writing that the beneficiary challenges the transaction or asserts a claim and provides in writing the basis for that challenge or assertion; and

(iv) all reports were accompanied by a conspicuous written statement describing the effect of this paragraph.

On or about Date 2, Trustee sold Trust's share of stock in Corporation in a transaction that resulted in capital gain to Trust for federal and state tax purposes. Pursuant to State law, the capital gains should have been allocated to Trust principal and all income taxes due on the capital gains were required to be paid from Trust principal. However, Trustee in connection with Trust's Form 1041, U.S. Fiduciary Income Tax Return, erroneously issued Daughter a K-1, Beneficiary's Share of Income, Deductions, Credits, Etc., which treated the capital gain as a taxable distribution to Daughter for both federal and state tax purposes. As a result of receiving the K-1 Daughter reported the entire amount of the capital gain on her individual Federal and state income tax returns which she jointly filed with Spouse. The errors on the Schedules K-1 were in Year 1. Trustee distributed \$A to Daughter in Year 2 as a partial reimbursement for the income taxes erroneously paid by Daughter and Spouse. Daughter did not waive the right of recovery with respect to the erroneous payment of income taxes in Year 1.

Trustee prepared a draft of its first accounting as Trustee on Date 3. Upon receipt of the draft accounting, Daughter became aware that she was due an additional

reimbursement from Trustee for the income taxes paid by Daughter and Spouse in connection with the sale of S Corporation stock.

On or about Date 4, Trustee filed a Petition for Adjudication with Court seeking judicial approval of its first intermediate accounting (Accounting) from Date 5 to Date 6. On Date 7, Daughter, through her counsel, filed an objection (Objection) to the Accounting alleging that it failed to provide for the additional reimbursement to Daughter from Trust for state income taxes in the amount of \$B, together with interest on the unreimbursed taxes at a specified rate, and reimbursement of Daughter's attorney's fees incurred in connection with the Accounting and Objection.

On Date 8, Court entered an order (Order) ruling that the statute of limitations remains open for Daughter to object to any and all matters disclosed in the Accounting; and that the Accounting fails to provide for an additional reimbursement from Trust to Daughter for the unreimbursed taxes, interest and attorney's fees associated with the Accounting and Objection. Trustee intends, in accordance with the Order, to reimburse Daughter for the amount of the unreimbursed taxes, interest, and attorney's fees due for the erroneous payment of income taxes by Daughter and Spouse in Year 1.

You have requested the following rulings:

1. The inadvertent payment by Daughter and Spouse of federal, State 1 and State 2 income taxes in connection with taxable income of Trust does not constitute a constructive addition by Daughter and Spouse to Trust under § 26.2601-1(b)(1)(v)(C).
2. The inadvertent payment by Daughter and Spouse of federal, State 1 and State 2 income taxes in connection with taxable income of Trust, and the subsequent reimbursement to them of the income taxes paid, together with interest and attorney's fees, does not cause any portion of Trust to become subject to chapter 13.
3. The inadvertent payment by Daughter and Spouse of federal, State 1 and State 2 income taxes in connection with the taxable income of Trust, does not constitute a gift to Trust for federal gift tax purposes.
4. The inadvertent payment by Daughter and Spouse of federal, State 1 and State 2 income taxes in connection with taxable income of Trust does not cause any portion of Trust to be includible in Daughter's gross estate for federal estate tax purposes.

Law and Analysis

Section 2601 imposes a tax on every generation-skipping transfer (GST) made after October 22, 1986. Section 2611(a) defines a GST to mean (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Under section 1433(b)(2)(A) of the Tax Reform Act of 1986 and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the tax generally does not apply to any GST transfer made under a trust that was irrevocable on September 25, 1985. However, the tax does apply to a pro rata portion of any GST under an irrevocable trust if additions (actual or constructive) are made to the trust after that date. Under § 26.2601-1(b)(1)(ii)(A), any trust in existence on September 25, 1985, will be considered an irrevocable trust except as provided in §§ 26.2601-1(b)(1)(ii)(B) or (C) (relating to property includible in a grantor's gross estate under §§ 2038 and 2042).

Section 26.2601-1(b)(1)(v)(A) provides, in relevant part, that, except as provided under § 26.2601-1(b)(1)(v)(B), where any portion of a trust remains in the trust after the post September 25, 1985, release, exercise, or lapse of a power of appointment over that portion of the trust, and the release, exercise, or lapse is treated to any extent as a taxable transfer under chapter 11 or chapter 12, the value of the entire portion of the trust subject to the power that was released, exercised, or lapsed is treated as if that portion had been withdrawn and immediately retransferred to the trust at the time of the release, exercise, or lapse.

Under § 26.2601-1(b)(1)(v)(C), where a trust that is not subject to the GST tax by reason of being irrevocable on September 25, 1985, is relieved of any liability properly payable out of the assets of such trust, the person or entity who actually satisfies the liability is considered to have made a constructive addition to the trust in an amount equal to the liability. The constructive addition occurs when the trust is relieved of liability (e.g., when the right of recovery is no longer enforceable).

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

Section 2511 provides that the tax imposed by § 2501 shall apply 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 25.2511-2(b) provides, in part, that as to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete.

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 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.

Based on the facts submitted and representations made, we conclude that there is no constructive addition to Trust under § 26.2601-1(b)(1)(v)(C). Daughter did not waive her right to recovery. Daughter petitioned Court to reimburse her for unreimbursed income taxes together with interest and attorney's fees. Trustee has agreed to reimburse Daughter. Thus, no addition to Trust has occurred as a result of Daughter's inadvertent payment of income tax and her prior reimbursement of income taxes and subsequent reimbursement under Court Order for income taxes, together with interest and attorney's fees. In addition, Daughter's inadvertent payment of income tax and her prior reimbursement of income taxes and subsequent reimbursement under Court Order for income taxes, together with interest and attorney's fees, will not cause Trust to be subject to chapter 13. Thus, Trust retains its exempt status.

Daughter did not make a constructive addition to Trust under § 26.2601-1(b)(1)(v)(C), thus, is not a transferor for gift tax purposes. There has been no change in beneficial interests of the beneficiaries and no transfer of property has occurred as a result of Daughter's inadvertent payment of income tax and her prior reimbursement of income taxes and subsequent reimbursement for income taxes, together with interest and attorney's fees. Consequently, Daughter has not made a gift to Trust for federal gift tax purpose.

Section 2036 includes in a decedent's gross estate property only to the extent that the decedent has made a transfer of the property during his life. In this case, Daughter did not transfer property to Trust. In addition, because the beneficial interests of beneficiaries are the same, before and after of the reimbursement of Daughter for income taxes, interest and attorney's fees, no transfer of property will be deemed to occur as a result of the reimbursement of Daughter for income taxes, interest and attorney's fees. Accordingly, based on the facts presented and the representations made, we conclude that the Daughter's inadvertent payment of income tax and her prior reimbursement of income taxes and subsequent reimbursement for income taxes, together with interest and attorney's fees, will not cause inclusion, under § 2036 of any portion of Trust in the gross estate of Daughter.

Accordingly, we rule as follows:

1. The inadvertent payment by Daughter and Spouse of federal, State 1 and State 2 income taxes in connection with taxable income of Trust does not constitute a constructive addition by Daughter and Spouse to Trust under § 26.2601-1(b)(1)(v)(C).

2. The inadvertent payment by Daughter and Spouse of federal, State 1 and State 2 income taxes in connection with taxable income of Trust and the subsequent reimbursement to them of the income taxes paid, together with interest and attorney's fees, does not cause any portion of Trust to become subject to chapter 13.

3. The inadvertent payment by Daughter and Spouse of federal, State 1 and State 2 income taxes in connection with the taxable income of Trust does not constitute a gift to Trust for federal gift tax purposes where Daughter and Spouse have a right of recovery from Trust, they have exercised their rights, and Trustee, in fact, has previously reimbursed Daughter and Spouse a portion of the income taxes, and will further reimburse Daughter and Spouse the balance of income taxes together with, interest and attorney's fees.

4. The inadvertent payment by Daughter and Spouse of federal, State 1 and State 2 income taxes in connection with taxable income of Trust does not cause any portion of Trust to be includible in Daughter's gross estate.

Except as specifically ruled herein, we express no opinion on the federal tax consequences of the transaction under the cited provisions or under any other provisions of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Lorraine E. Gardner

Lorraine E. Gardner
Senior Counsel, Branch 4
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure

Copy for section 6110 purposes

cc: