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Department of the Treasury

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CC:DOM:P&SI:4 - PLR-108495-98

Date: December 4, 1998

Re:

Legend:

We received your authorized representative's letter, dated March 19, 1998, requesting a ruling concerning the application of § 2632 of the Internal Revenue Code. This letter responds to that request.

On Date 1, Taxpayer established Trust. Pursuant to Article II, Paragraph 2.1, of the Trust agreement, the Trust is irrevocable.

Under Article III, paragraph 3.1, the trustee, during Taxpayer's lifetime, may distribute net income and trust corpus to Spouse for her health, education, support and maintenance. The trustee also has discretion to distribute net income and trust corpus to Taxpayer's descendants.

Article III, Paragraph 3.3, of the Trust agreement provides that the Taxpayer may indicate in writing that a contribution to the Trust is subject to a right of withdrawal. If the Taxpayer so indicates, the Spouse has the right to withdraw during each calendar year the lesser of the contribution to the trust or \$5,000. However, where the value of trust corpus, immediately

following any contribution, is greater than \$5,000, then the lesser of 5% of the Trust corpus or the amount of the contribution can be withdrawn. In addition, Taxpayer's children and grandchildren may withdraw the lesser of \$5,000 or an amount determined by subtracting from the amount of the contribution, the amount, if any, which Spouse is entitled to withdraw, and dividing the result by the number of Taxpayer's then living children and grandchildren.

Article III, Paragraph 3.4, states that upon Taxpayer's death, all of the net income from the trust assets is to be distributed to Spouse, if she survives him. The trustee may also distribute corpus to Spouse if, after first looking to all other available assets, in the trustee's discretion, distributions are necessary to maintain the standard of living that Spouse enjoyed during the marriage. At Spouse's death, the remaining trust assets are to be distributed as Spouse may appoint, pursuant to the exercise of a special power to appoint corpus in favor of Taxpayer's descendants, spouses of such descendants, and qualified charitable organizations.

Article III, Paragraph 3.5, provides that if Spouse fails to exercise her power of appointment, then the balance of the trust assets are to be divided into two equal portions, one for each of Taxpayer's two children who are then living, and also one for either child who has died and left surviving issue. The portion for the issue of a deceased child is to be divided among the deceased child's then living issue, by right of representation, and is to be held in "Separate Trusts." Each portion for a living child is to be held in a separate trust, each to be designated the "Taxpayer Children's Trusts," the provisions of which are contained in Article III, Paragraphs 3.6 through 3.10, of the Trust agreement.

Under Article III, Paragraph 3.6, the trustee of the "Taxpayer Children's Trusts" may distribute to Taxpayer's child, child's spouse, or child's descendants income and/or corpus as the trustee considers desirable, taking into consideration the potential distributee's needs, best interests, and welfare, including the desirability of augmenting his or her individual estate, his or her ability to conserve, manage, and employ property and money usefully and prudently, and all other factors which trustee considers pertinent.

Article III, Paragraph 3.9, provides that upon the death of Taxpayer's child, the "Taxpayer Children's Trust" established for the benefit of that child is to terminate. The remaining trust assets are to be distributed pursuant to the child's exercise of a special power of appointment.

Under Article III, Paragraph 3.10, to the extent the special power of appointment is not exercised by the child, the trustee is to distribute the remaining trust assets: (a) to each child of the beneficiary who is then living and to any child of the beneficiary who has died and left issue then living, if any; otherwise, (b) to Taxpayer's issue then living, by right of representation. Any amount, which would pass to a child of the Taxpayer under this provision, is to be allocated to the "Taxpayer Children's Trust" for that child. Any other portion for a grandchild or other issue of a deceased child is to be held and administered pursuant to the "Separate Trust" terms found in Article III, Paragraphs 3.11 through 3.14, of the Trust agreement.

On Date 2, Taxpayer transferred three life insurance policies to the Trust. The total value of these policies, on the date of the gift, was x. Taxpayer's spouse and children were each entitled to withdrawal an amount equal to y (5% of the value of the trust corpus).

Form 709 was timely filed on behalf of Taxpayer, reporting the transfers of the three life insurance policies to the Trust on Schedule A, Part 2. (Schedule C, Part 1, was also completed reporting the transfer.) Part 3, line 4, of Schedule C was also completed and indicated that Taxpayer allocated z to the transfer. No Notice of Allocation of Generation-Skipping Transfer Tax exemption was attached to the return.

Taxpayer requests a ruling that he substantially complied with the requirements for making a timely allocation of his GST tax exemption, in the amount of z, to the transfers to the Trust on his 1987 gift tax return.

Section 2601 imposes a tax on every generation-skipping transfer (GST). A generation-skipping transfer is defined under § 2611(a) as (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Section 2612(c)(1) provides that the term "direct skip" means a transfer subject to a tax imposed by chapter 11 or 12 of an interest in property to a skip person.

Section 2613(a) provides that the term "skip person" means a natural person assigned to a generation that is two or more generations below the generation assignment of the transferor, or a trust if all interests in the trust are held by skip persons.

Section 26.2612-1(d) of the Generation-Skipping Transfer Tax Regulations provides, in part, that a skip person is a trust if (i) all interests in the trust are held by skip persons; or (ii) no person holds an interest in the trust and no distributions,

other than a distribution the probability of which occurring is so remote as to be negligible (including distributions at the termination of the trust), may be made after the transfer to a person other than a skip person.

Under § 2602, the amount of the GST tax is determined by multiplying the amount of the GST transfer by the "applicable rate." Under § 2641, the applicable rate with respect to any generation-skipping transfer is the product of the maximum federal estate tax rate and the "inclusion ratio" with respect to the transfer. Section 2642(a) defines the inclusion ratio, in the case of a transfer from a trust, as the excess of 1 over the applicable fraction with respect to trust. The applicable fraction, with respect to a trust, is a fraction, the numerator of which is the amount of GST exemption allocated to the trust, and the denominator of which is the value of the property transferred to the trust (reduced as provided in the section.)

Section 2631(a) provides that, for purposes of determining the inclusion ratio, every individual shall be allowed a GST exemption of \$1,000,000 that may be allocated by the individual (or his executor) to any property with respect to which the individual is the transferor.

Section 2631(b) provides that any allocation under § 2631(a) once made, is irrevocable.

Section 2632(a) provides that any allocation by an individual of his or her GST exemption under § 2631(a) may be made at any time on or before the date prescribed for filing the estate tax return for the individual's estate (determined with regard to extensions), regardless of whether such a return is required to be filed.

Section 26.2632-1(b)(2)(i) provides that an allocation of GST exemption to property transferred during the transferor's lifetime, other than in a direct skip, is made on Form 709. The allocation must clearly identify the trust to which the allocation is made, the amount of GST exemption allocated to it, and if the allocation is late or an inclusion ratio greater than zero is claimed, the value of the trust assets at the effective date of the allocation. The allocation should also state the inclusion ratio of the trust after the allocation. Generally, an allocation of GST exemption may be expressed by a formula; e.g., the allocation may be expressed in terms of the amount necessary to produce an inclusion ratio of zero. An allocation is void if the allocation is made with respect to a trust that has no GST potential with respect to the transferor making the allocation, at the time of the allocation. For this purpose, a trust has GST potential even if the possibility of a GST is so remote as to be negligible.

Section 26.2632-1(b)(2)(ii)(A)(1)(i) provides that generally an allocation of GST exemption is effective as of the date of any transfer as to which the Form 709 on which it is made is a timely filed return (a timely allocation). With respect to a timely allocation, an allocation of GST exemption becomes irrevocable after the due date of the return. An allocation to a trust made on Form 709 filed after the due date for reporting a transfer to a trust (a late allocation) is effective on the date the Form 709 is filed and is deemed to precede in point of time any taxable event occurring on such date.

Under § 26.2632-1(b)(ii)(2), a late allocation to a trust may be made on a Form 709 that is timely filed with respect to another transfer. A late allocation is irrevocable when made.

Section 2652(a)(1) provides that, except as provided in § 2653(a), the term "transferor" means:

(A) in the case of any property subject to the tax imposed by chapter 11, the decedent, and

(B) in the case of any property subject to the tax imposed by chapter 12, the donor.

An individual shall be treated as transferring any property with respect to which such individual is the transferor.

The issue is whether Taxpayer made a timely allocation of his GST tax exemption to the transfers to the Trust on his 1987 gift tax return. In the present case, the transfers to the Trust were not direct skips because all of the beneficiaries of the Trust were not skip persons. An allocation of GST exemption to property transferred during the transferor's lifetime, other than in a direct skip, is made on Form 709. The allocation must clearly identify the trust to which the allocation is made and the amount of GST exemption allocated to it. The allocation should also state the inclusion ratio of the trust after the allocation.

The instructions for Form 709 applicable for the returns filed by the taxpayer during the period, states:

You may wish to allocate your exemption to transfers made in trust that are not direct skips. For example, if you transferred property to a trust that has your children as its present beneficiaries and your grandchildren as future beneficiaries, the transfer was not a direct skip because the present interests in the trust are held by non-skip persons. However, future terminations and distributions made from this trust would be subject to GST tax. You may

elect to reduce the trust's inclusion ratio by allocating part or all of your exemption to the transfer. Because this transfer would be entered on Schedule A, Part I of Form 709, it will not be shown on Schedule C. To allocate your exemption to such transfers, attach a statement to the Form 709 and entitle it "Notice of Allocation."

The notice should contain the following for each trust:

1. The trust's EIN, if known;
2. The item number(s) from column A, Schedule A, Part 1, of the gifts to that trust;
3. The values shown in column E, Schedule A, Part 1, for gifts (adjusted to account for split gifts, if any, reported on Schedule A, Part 3, line 2);
4. The annual exclusion claimed against each gift;
5. The net value of each gift after the reduction for the annual exclusion, if applicable; and
6. The amount of your GST exemption allocated to each gift.

In this case, it appears that Taxpayer did not literally comply with the instructions on Form 709. Taxpayer reported the 1987 gifts to the Trust on Schedule A, Part 2 (Gifts Subject to Both Gift and GST Tax) and completed portions of Schedule C. However, Taxpayer did not attach to the 1987 return a Notice of Allocation of GST exemption. However, literal compliance with the procedural instructions to make an election is not always required. Elections may be held to be effective where the taxpayer complied with the essential requirements of a regulation even though the taxpayer failed to comply with certain procedural directions therein. See Hewlett-Packard Company v. Commissioner, 67 T.C. 736, 748 (1977), acq. in result, 1979-1 C.B. 1. The allocation will be deemed valid if there are enough facts and circumstances to indicate that the Taxpayer intended to allocate part of his exemption to the Trust.

We believe that there is sufficient information provided on Taxpayer's 1987 gift tax return to conclude that Taxpayer intended to allocate part of his exemption to the Trust established under the Trust Agreement. Taxpayer reported the 1987 transfer on Schedule C of the Form 709. On Schedule C, Part 3 (GST Exemption Reconciliation), line 4 (Exemption Claimed on This Return) Taxpayer entered z, for the 1987 transfer. On Schedule C, Part 4, line 1 (GST Exemption Allocated), Taxpayer entered the same amount. In addition, Taxpayer attached a statement to his 1987 return which provided the trust

identification number and the value of the property transferred to the trust. We note that Taxpayer did not complete the GST portions of the form correctly, in view of the fact that the transfer was not a direct skip. However, based on the information provided on the return, we conclude that Taxpayer substantially complied with the requirements for making an allocation of GST exemption for the transfer reported on the 1987 gift tax return. Taxpayer is, therefore, deemed to have allocated the exemption as described above for the 1987 transfer to the Trust.

Except as ruled above, we express or imply no opinion concerning the federal tax consequences of this transaction under the cited provisions of the Code or any other provision of the Code.

We are expressing no opinion regarding whether the transfers qualified for the annual exclusion under § 2503(b), or regarding the inclusion ratio with respect to the Trust.

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

Sincerely yours,

George Masnik
Chief, Branch 4
Office of the Assistant Chief
Counsel
(Passthroughs and Special
Industries)

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Enclosure

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