

Internal Revenue Service

Department of the Treasury

Index Number: 2654.00-03, 2642.01-00
9999.98-00

Washington, DC 20224

Number: **199939024**
Release Date: 10/1/1999

Person to Contact:

Telephone Number:

Refer Reply To:

CC:DOM:P&SI:4-PLR-119768-98

Date:

July 1, 1999

In Re:
Legend

Decedent =

Trust =

Daughter =

Individual =

Corporation =

X =

Y =

Z =

This is in response to your letter of May 24, 1999, and prior correspondence, in which you requested rulings concerning the generation-skipping transfer (GST) tax consequences of a division of a trust.

Decedent executed her will in 1983 and amended it in 1986, 1989, and 1991. Article FIFTH of the will provides that, if Daughter survives Decedent, the residue of Decedent's estate is to be paid to Trust. Article FIFTH further provides that, during Daughter's lifetime, the trustees shall pay and/or accumulate the net income received by the trust in each year to or for the benefit of Daughter, her descendants, and Daughter's spouse. Upon Daughter's death, the trustee is to pay the principal of the trust as Daughter shall appoint by exercise of a non-general power of appointment. If Daughter fails to validly appoint the principal, the trustee shall hold the principal for the benefit of Daughter's children (grandchildren of Decedent). Daughter and Individual were the initial trustees of Trust.

Paragraph C(2) of Article THIRTEENTH authorizes the executors, at any time before the transfer of property to any trust created under the will, to divide the property into as many equal or unequal shares or trusts as they, in their discretion, determine, and to allocate Decedent's GST exemption to each such separate share so that the inclusion ratio under § 2642(a) of the Internal Revenue Code of each trust is either zero or one. Each separate trust shall be treated as a separate trust for all purposes, with all of the same terms as those that would have applied in the absence of the division, except for the purposes of computing the commissions of Trustees.

Paragraph D of Article THIRTEENTH states as follows:

1. Discretionary Distributions of Income or Principal. I authorize and request my Executors and/or Trustees, in their discretion, to take the following principles into account when exercising any discretion to pay or apply income or principal of any trust to or for the benefit of any beneficiary who is a permissible recipient of income and/or principal of more than one trust under any one or more of this Will and/or any other instrument or instruments (collectively, 'such trusts'):

(a) Any payment or application to or for the use or benefit of a non-skip person (as defined in Section 2613(b) of the Code) should be made out of such trusts sequentially (to the exhaustion of each such trust respectively) in descending order of the inclusion ratios (as defined in Section 2642(a) of the Code) of such trusts.

(b) Any payment or application to or for the use or benefit of a skip person (as defined in Section 2613(a) of the Code) should be made out of such trusts sequentially (to the exhaustion of each such trust respectively) in ascending order of the inclusion ratios of such trusts, provided, however, that if the exclusion contained in Section 2611(b) of the Code, relating to educational or medical expenses, is applicable, such payment or application should be made as provided in paragraph (a) of this subsection applied as if such beneficiary were a non-skip person.

Decedent died on February 14, 1991, and was survived by Daughter. The value of Decedent's taxable estate was X and the residue of the estate that passed to the Trust totaled Y. Daughter and another individual were appointed the trustees of Trust. The executor timely filed Decedent's Federal estate tax return (Form 706).

On the Decedent's Form 706, the executor of Decedent's estate indicated that Trust was to be divided into two trusts, Decedent's Testamentary Exempt Trust and Decedent's Testamentary Non-Exempt Trust. On Schedule R of the Form 706, the executor allocated Decedent's \$1,000,000 GST exemption under § 2631(a) to the

Decedent's Testamentary Exempt Trust. The trustees, however, failed to divide the Trust into two trusts. On February 17, 1995, the trustees made five equal distributions of Z to Daughter's two children and three grandchildren (all skip-persons).

Subsequently, the individual who was the co-trustee with Daughter resigned, and Corporation was appointed the successor co-trustee. Corporation determined that the Trust was never severed into two separate trusts as indicated on the Decedent's Federal estate tax return. On November 18, 1996, the Trust was severed into the Decedent's Testamentary Exempt Trust and Decedent's Testamentary Non-Exempt Trust. The trusts were funded in a manner such that the February 17, 1995 distributions were treated as having been made from the Decedent's Testamentary Exempt Trust.

Trustees have requested the following rulings:

1. The funding of the two separate trusts on November 18, 1996, was consistent with the division of the trust under the terms of the governing instrument and § 26.2654-1(b)(1)(ii)(C)(1).

2. Decedent's Testamentary Exempt Trust has an inclusion ratio of zero under § 2642 and Decedent's Testamentary Non-Exempt Trust has an inclusion ratio of one under § 2642.

Law and Analysis

Section 2642(a)(1) provides that, except as otherwise provided in § 2642, the inclusion ratio with respect to any property transferred in a generation-skipping transfer shall be the excess (if any) of 1 over--(A) the applicable fraction determined for the trust from which the transfer is made, or (B) in the case of a direct skip, the applicable fraction determined for the skip.

Section 2642(a)(2) provides that for the purposes of § 2642(a)(1), the applicable fraction is a fraction--(A) the numerator of which is the amount of GST exemption allocated to the trust (or in the case of a direct skip, allocated to the property transferred in the skip) and (B) the denominator of which is--

(i) the value of the property transferred to the trust (or involved in the direct skip) reduced by

(ii) the sum of--

(l) any Federal estate or State death tax actually recovered from the trust attributable to the property, and

(II) any charitable deduction allowed under § 2055 or § 2522 with respect to such property.

Section 2654(b)(2) provides that substantially separate and independent shares of different beneficiaries in a trust shall be treated as separate trusts.

Section 26.2654-1(b)(1)(ii) of the Generation-skipping Transfer Tax Regulations provides that the severance of a trust that is included in the transferor's gross estate (or created under the transferor's will) into two or more trusts is recognized for purposes of chapter 13 if the governing instrument does not require or otherwise direct severance but the trust is severed pursuant to discretionary authority granted either under the governing instrument or under local law; and

(A) The terms of each of the new trusts provide in the aggregate for the same succession of interests and beneficiaries as are provided in the original trust;

(B) The severance occurs (or a reformation proceeding, if required, is commenced) prior to the date prescribed for filing the Federal estate tax return (including extensions actually granted) for the estate of the transferor; and

(C) Either--

(1) The new trusts are severed on a fractional basis. If severed on a fractional basis, the separate trusts need not be funded with a pro rata portion of each asset held by the undivided trust. The trusts may be funded on a nonpro rata basis provided funding is based on either the fair market value of the assets on the date of funding or in a manner that fairly reflects the net appreciation or depreciation in the value of the assets measured from the valuation date to the date of funding; or

(2) If the severance is required (by the terms of the governing instrument) to be made on the basis of a pecuniary amount, the pecuniary payment is satisfied in a manner that would meet the requirements of § 26.2654-1(a)(1)(ii) if it were paid to an individual.

Section 26.2654-1(b)(2) provides that, if the governing instrument of a trust or local law authorizes the severance of the trust, a severance pursuant to that authorization is treated as meeting the requirements of § 26.2654-1(b)(1)(ii)(B) if the executor indicates on the Federal estate tax return that separate trusts will be created (or funded) and clearly sets forth the manner in which the trust is to be severed and the separate trusts funded.

In this case, the trust instrument authorized the trustees to divide the trust into a trust with a zero inclusion ratio and a trust with an inclusion ratio of one. The executor

timely filed Decedent's Federal estate tax return, Form 706. On Schedule R of the return, the executor indicated that the Trust was to be divided into two trusts, Decedent's Testamentary Exempt Trust and Decedent's Testamentary Non-Exempt Trust. In addition, the executor also allocated the Decedent's \$1,000,000 GST exemption under § 2631(a) to the Decedent's Testamentary Exempt Trust.

On November 18, 1996, after Corporation was appointed co-trustee, Trust was severed into two trusts. The two trusts were funded in a manner such that the February 17, 1995 distributions were treated as having been made from the Decedent's Testamentary Exempt Trust. In view of the terms of Paragraph D of Article THIRTEENTH of Trust, the funding of the trusts in this manner was consistent with the terms of the Trust.

Therefore, based on the facts submitted and the representations made, we conclude as follows:

1. The funding of the two separate trusts on November 18, 1996, was consistent with the division of the trust under the terms of the governing instrument and § 26.2654-1(b)(1)(ii)(C)(1).

2. Decedent's Testamentary Exempt Trust has an inclusion ratio of zero under § 2642 and Decedent's Testamentary Non-Exempt Trust has an inclusion ratio of one under § 2642.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(j)(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.

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 yours,

Assistant Chief Counsel
(Passthroughs and Special
Industries)

By _____
George Masnik
Chief, Branch 4

Enclosure (1)
Copy for § 6110 purposes