

Internal Revenue Service

Department of the Treasury

Number: **200232027**

Release Date: 8/9/2002

Index Number: 2652.01-02; 2652.03-00
9100.22-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:BO9:PLR-161796-01

Date:

May 7, 2002

In Re:

Decedent =

Spouse =

Children =

Grandchildren =

Attorney =

Date 1 =

Date 2 =

Date 3 =

Trust 1 =

Trust 2 =

Court =

State =

Dear _____ :

This is in response to your representative's letter, dated October 31, 2001, and subsequent correspondence, requesting an extension of time in which to sever a trust into exempt and nonexempt trusts for purposes of the Generation-Skipping Transfer ("GST") Tax and to make a "reverse" qualified terminable interest property ("QTIP") election with respect to the exempt trust.

The facts and representations submitted are summarized as follows. During her life, Decedent created Trust 1, a revocable trust to which she transferred the bulk of her assets, and Trust 2. Decedent died testate on Date 1, survived by Spouse, Children, and Grandchildren. Trust 1 became irrevocable at her death. Under her will, Decedent bequeathed her tangible personal property to Spouse, and the residue of her estate to Trust 2. Under the terms of Trust 2, as of the date of Decedent's death, an interest in residential real property was distributed to Spouse, and the remainder of the assets of Trust 2 was distributed outright in equal shares to Decedent's Children.

Article V.A.1 of the agreement governing Trust 1 provides that the net income of Trust 1 shall be paid to or for Spouse, quarter annually or at more frequent intervals. Article V.B. provides that on the death of Spouse, the balance of the trust estate shall be divided into equal shares for Children.

Article V.B.2 of the agreement governing Trust 1 provides that the shares allocated to each of the Children shall be further divided into two shares, one that is exempt for GST tax purposes (the "exempt trusts") and one that is nonexempt for GST tax purposes (the "non-exempt trusts"), each of which is to be held, administered, and distributed as a separate trust. Article V.B.2 further provides that each Child's exempt trust shall include assets equal in value to the amount of any of Decedent's GST tax exemption that has been allocated to that Child's exempt share by the person having the authority to make that allocation on behalf of Decedent.

Article V.B.3.a. of the agreement governing Trust 1 provides that the trustee shall pay to or for each Child the entire net income of that Child's trusts. If the trustee deems the income to be insufficient, the trustee shall also invade the principal of the trusts as the trustee, in the trustee's discretion, deems necessary for the Child's proper support, maintenance, health and education. Articles V.B.3.b. and V.B.4.a. provide that upon the death of a Child, if no other Child of Decedent remains living, the deceased Child's trusts shall terminate and the balance of the trusts shall be distributed free of trust to the then living issue of such Child, by right of representation or, if none, to the then living issue of Decedent, by right of representation. Articles V.B.3.b. and V.B.4.b. provide that if, upon the death of a Child, any other Child of Decedent remains living, the remaining balance in the deceased Child's trusts shall be retained in trust for the benefit of that Child's issue (the grandchildren). If the deceased Child has no living issue, the remaining balance in that Child's trust shall be distributed to Decedent's then living issue, by right of representation. If a part of that balance would otherwise be distributed to a person for whose benefit a trust is then being administered under Article 3, that part shall instead be added to that trust and administered according to its terms.

Article VII.F of the agreement governing Trust 1 provides that in any case in which the trustee is required, pursuant to the provisions of Trust 1, to divide any trust property into parts or shares for the purpose of distributions, or otherwise, the trustee is authorized to make the division and distribution in kind, including undivided interests in any property, or partly in kind and partly in cash. In making distributions in kind or partly in kind, the trustee may take into consideration the basis for income tax purposes of the property to be distributed to any beneficiary and the potential income tax burden to be borne by a beneficiary as a result of distribution in kind.

On Date 2, Decedent's estate timely filed a Form 706, Estate (and Generation-Skipping Transfer) Tax Return, prepared by Attorney. On Schedule M of the Form 706, Attorney made an election under section 2056(b)(7) of the Internal Revenue Code to treat the entire value of Trust 1 as QTIP property, and claimed a deduction in this amount. Attorney did not make a reverse QTIP election under section 2652(a)(3) to treat Decedent as the transferor of any portion of Trust 1 for GST tax purposes, and did not make an effective allocation of Decedent's GST tax exemption to any portion of Trust 1.

Attorney represents in an affidavit that she neither advised Spouse, as personal representative of Decedent's estate, that Trust 1 could or should be divided into GST tax exempt and nonexempt trusts nor that a reverse QTIP election under section 2652(a)(3) could or should be made for any portion of Trust 1.

Spouse, as trustee of Trust 1, filed a petition with State Court requesting "Reformation to Divide [Trust 1] to Reduce Taxes," as of Decedent's death, into two trusts, one that is exempt from imposition of the GST tax, and a second trust consisting of the balance that is nonexempt. The petition stated that the language of Trust 1's governing instrument shows Decedent's intention to plan her estate to take advantage of the GST tax exemption provided by the Code and that, in order to fully and effectively use her entire GST tax exemption; (1) Trust 1 should be divided into GST-exempt and nonexempt shares to be held as separate trusts; and (2) a reverse QTIP election should be made for Decedent's estate with respect to the GST-exempt share. The petition proposed that the "GST Exempt Trust" would consist of that portion of the assets of Trust 1 equal in value to \$1,000,000, that the "GST Non-Exempt Trust" would consist of the remainder of the assets of Trust 1, and that the personal representative of Decedent's estate then would apply all of her \$1,000,000 GST tax exemption to the GST Exempt Trust. Each trust would be governed in accordance with the provisions governing Trust 1.

On Date 3, State Court issued an order pursuant to State law, effective as of the date of Decedent's death, granting the petition to reform Trust 1 by directing the trustee to divide Trust 1 into two separate trusts. Pursuant to that order, the GST Exempt Trust is to consist of assets equal in value to the amount of Decedent's unused federal GST tax exemption at the date of death, and the GST Non-Exempt Trust is to consist of the balance of the assets of Trust 1. The funding of these two trusts may be made on a nonpro rata basis, provided funding is based on the fair market value of the assets on

the date of funding. The order stated that the reformation and division of Trust 1 was directed in order "to protect the rights of beneficiaries and accomplish the purposes of [Decedent]."

It is represented that no additional contributions have been made to Trust 1 since Decedent contributed her assets to Trust 1 prior to her death. It is further represented that all of Decedent's children survived her, that the required distributions from Trust 2 to Spouse and Children were made effective as of Decedent's date of death, and that no other potential generation-skipping trusts existed at or after Decedent's death.

Decedent's estate requests an extension of time under § 301.9100 of the Procedure and Administration Regulations in which: (1) to sever Trust 1, pursuant to § 26.2652-2(b)(1) of the GST tax regulations, into GST tax exempt and nonexempt trusts; and (2) to make a section 2652(a)(3) reverse QTIP election with respect to the exempt trust.

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

Section 2044(a) provides that the value of the gross estate shall include the value of any property to which this section applies in which the decedent had a qualifying income interest for life.

Section 2044(b) provides, in relevant part, that section 2044 applies to any property if a deduction was allowed with respect to the transfer of such property to the decedent under section 2056 by reason of subsection (b)(7) thereof.

Section 2044(c) provides that for purposes of chapter 11 and chapter 13, property includible in the gross estate of the decedent under section 2044(a) shall be treated as property passing from the decedent.

Section 2056(a) provides that, for purposes of the tax imposed by section 2001, the value of the taxable estate is determined, except as limited by section 2056(b), by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

Section 2056(b)(1) provides, in pertinent part, that where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail, no deduction shall be allowed with respect to such interest.

Section 2056(b)(7)(A) provides that, in the case of qualified terminable interest property, such property shall be treated as passing to the surviving spouse for purposes

of section 2056(a), and no part of such property shall be treated as passing to any person other than the surviving spouse for purposes of section 2056(b)(1)(A).

Section 2056(b)(7)(B)(i) provides that the term “qualified terminable interest property” means property: (I) which passes from the decedent; (II) in which the surviving spouse has a qualifying income interest for life, and; (III) to which an election under section 2056(b)(7)(B)(v) applies.

Section 2056(b)(7)(B)(ii) provides that the surviving spouse has a qualifying income interest for life if: (I) the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, or has a usufruct interest for life in the property, and; (II) no person has a power to appoint any part of the property to any person other than the surviving spouse.

Section 2056(b)(7)(B)(v) provides that an election under section 2056(b)(7)(B) with respect to any property shall be made by the executor on the return of tax imposed by section 2001 (a “QTIP election”). Such an election, once made, shall be irrevocable.

Section 2601 provides that a tax is imposed on every generation-skipping transfer.

Section 2611(a) provides that the term “generation-skipping transfer” means: (1) a taxable distribution; (2) a taxable termination; and (3) a direct skip.

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

Section 2632(a)(1) provides that any allocation by an individual of his GST tax exemption under section 2631(a) may be made at any time on or before the date prescribed for filing the estate tax return for such individual’s estate (determined with regard to extensions), regardless of whether such a return is required to be filed.

Section 2632(c)(1) (redesignated as section 2632(e)(1) by the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. No. 107-16)) provides that any portion of an individual’s GST tax exemption which has not been allocated within the time prescribed by subsection (a) shall be deemed to be allocated as follows – (A) first, to property which is the subject of a direct skip occurring at such individual’s death, and (B) second, to trusts with respect to which such individual is the transferor and from which a taxable distribution or a taxable termination might occur at or after such individual’s death.

Section 26.2632-1(d)(2) of the Generation-Skipping Transfer Tax Regulations provides that no automatic allocation of GST tax exemption is made to a trust that will

have a new transferor with respect to the entire trust prior to the occurrence of any generation-skipping transfer with respect to the trust.

Section 2652(a)(1) provides that, for purposes of chapter 13, 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.

Section 2652(a)(3) provides, in pertinent part, that in the case of any trust with respect to which a deduction is allowed to the decedent under section 2056(b)(7), the estate of the decedent may elect to treat all of the property in such trust for purposes of chapter 13 as if the election to be treated as qualified terminable interest property had not been made (a “reverse QTIP election”). The consequence of a reverse QTIP election is that the decedent remains, for GST tax purposes, the transferor of the QTIP trust for which the election is made. As a result, the decedent's GST tax exemption may be allocated to the QTIP trust.

Section 26.2652-2(b) provides that a reverse QTIP election is made on the return on which the QTIP election is made.

Section 26.2654-1(b)(1) 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 – (i) the trust is severed pursuant to a direction in the governing instrument providing that the trust is to be divided upon the death of the transferor; or (ii) 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 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 non pro 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 section 26.2654-1(a)(ii) if it were paid to an individual.

Section 301.9100-1(c) of the Procedure and Administration Regulations provides that the Commissioner may grant a reasonable extension of time under the rules set forth in §§ 301.9100-2 and 301.9100-3 to make a regulatory election, or a statutory

election (but no more than 6 months except in the case of a taxpayer who is abroad), under all subtitles of the Code except subtitles E, G, H, and I.

Section 301.9100-2 provides an automatic extension of time for making certain elections.

Section 301-9100-3(a) provides that, in general, requests for extensions of time for regulatory elections which do not meet the requirements of § 301.9100-2 must be made under the rules of § 301.9001-3. Requests for relief subject to this section will be granted when the taxpayer provides the evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the Government.

Section 301-9100-3(b)(1)(v) provides that a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make, the election.

State law provides that, on petition by a trustee, personal representative, beneficiary, or a party in interest, after notice to affected parties as the court may direct, and for good cause shown, a court may: (i) divide a trust into 2 or more separate trusts; or (ii) consolidate 2 or more trusts into a single trust.

State law further provides that a court may divide a trust or consolidate trusts on terms and conditions as the court considers appropriate, and if the court is satisfied that a division of a trust or consolidation of trusts will not defeat or materially impair (1) the accomplishment of trust purposes or (2) the interests of the beneficiaries.

In this case, because a QTIP election was made on Decedent's Form 706 with respect to Trust 1, the assets of Trust 1 will be included Spouse's gross estate under section 2044 at his death unless there is a disposition under section 2519. Spouse is considered the transferor of such property for GST tax purposes, thereby initially precluding the allocation of Decedent's unused GST tax exemption to any portion of Trust 1. If Decedent's estate is allowed to make a reverse QTIP election under section 2652(a)(3) and § 26.2652-2(b) with respect to any portion of the assets of Trust 1, however, Decedent will be treated as the transferor of such assets for GST tax purposes.

Based on the facts and representations submitted, the requirements of §§ 26.2654-1 and 301.9100-3 have been satisfied. The severance of Trust 1 into a GST exempt trust and a GST nonexempt trust will be recognized for GST tax purposes. Accordingly, an extension of time is granted to Date 3 for the severance. An extension of time also is granted until 60 days from the date of this letter for making a reverse QTIP election under section 2652(a)(3) with respect to the GST exempt trust. The election should be made on a supplemental Form 706 filed with the appropriate Service

Center. A copy of this letter should be attached to the supplemental Form 706, and a copy is enclosed for that purpose.

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. We note, however, that an extension of time in which to make a reverse QTIP election under section 2652(a)(3) does not extend the time in which to allocate any of Decedent's GST tax exemption remaining unused at her death. In this case, no allocation of GST tax exemption was made on Decedent's estate tax return. Accordingly, in view of the reverse QTIP election, Decedent's unused GST tax exemption is allocated in accordance with the rules of section 2632(e) and § 26.2632-1(d)(2).

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.

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

In accordance with the Power of Attorney on file with this office, copies of this letter are being sent to the taxpayer's authorized representatives.

Sincerely,
Paul F. Kugler
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure (1)
Copy for Section 6110 purposes