

Internal Revenue Service

Department of the Treasury

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March 5, 1999

Re:

Legend

Taxpayer A =

Taxpayer B =

Trust A =

Trust B =

Trust C =

Trust D =

Date 1 =

Date 2 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Year 6 =

Year 7 =

Year 8 =

\$x =

\$y =

Court =

We received a letter dated October 16, 1998, from your authorized representative requesting rulings under the Internal Revenue Code regarding the proposed reformation of certain grantor retained income trusts.

You represent the facts to be as follows: Taxpayer A and Taxpayer B are husband and wife (together "Taxpayers"). On Date 1, Taxpayer A created Trust A and Taxpayer B created Trust B. Trust A and Trust B are grantor retained income trusts ("GRITs") with identical terms. Under the terms of each trust, income from the GRIT is to be distributed to the respective Taxpayer quarter-annually for 10 years. If a Taxpayer predeceases the 10-year term, income is payable to the surviving spouse for the balance of the term. On Date 1, Taxpayer A also created an irrevocable trust, Trust C. On Date 2, the end of the 10-year term of Taxpayers' GRITs, the assets in each GRIT are to be distributed to Trust C.

Under the terms of Trust C, the Trustees have the discretion during the Taxpayers' lifetimes to distribute as much of the income to Taxpayers' children as the Trustees deem advisable for any reason. Upon the death of both Taxpayers, Trust C is to be divided into four separate shares, one for each child of Taxpayers. During a child's life, the Trustees are required to distribute all income from a child's share to each child and the Trustees have the discretion to distribute principal to a child for health expenses. Upon the death of a child, that child's share is to be divided into one equal share for each then living child of the deceased child (Taxpayers' grandchildren). The Trustees are required to distribute all income to the grandchild for the rest of his or her life. The Trustees also have discretion to distribute principal for maintenance, education, health, and support. Upon the death of a grandchild, the share to be divided into as many equal shares as there are descendants of the deceased grandchild

(Taxpayers' great grandchildren). Each descendant has the right to withdraw all of his or her share subject to certain age restrictions. Taxpayers currently have five grandchildren.

Taxpayers each timely filed a Year 1 gift tax return. The returns reported Taxpayer A's gift to Trust A of \$x and Taxpayer B's gift to Trust B of \$y. Taxpayers also reported gifts to Trust C. Taxpayer A allocated his unused generation-skipping transfer ("GST") tax exemption to Trust A and Taxpayer B allocated her unused GST tax exemption to Trust B. Taxpayers did not allocate any GST exemption to the gifts to Trust C. These returns were filed prior to December 27, 1995.

Taxpayers made yearly gifts after Year 1 in cash or securities to Trust C. The only timely filed gift tax returns reporting the transfers to Trust C were in Year 1 and in Year 7. In Year 8, Taxpayers filed amended returns as follows: For Year 1, the amended returns reported the original gifts to the Trust A, Trust B and Trust C, but no allocation of GST was made with respect to either Trust A or Trust B. For Year 2, Year 3, Year 4, Year 5, Year 6, and Year 7 late gift tax returns for the gifts to Trust C were filed and allocations of GST tax exemption was made with respect to the transfers to Trust C. The amended returns did not comply with all procedural filing requirements for making an allocation of GST exemption.

Taxpayers propose to petition Court to reform Trust A and Trust B to change the remainder beneficiary from Trust C to Trust D. Trust D contains dispositive provisions similar to Trust C, except that each child has a testamentary general power to appoint the balance of his or her trust to his or her estate or the creditors of his or her estate. If the power is not exercised, the balance of the child's trust is to be distributed according to terms that are the same as the distribution provisions in Trust C.

You have requested the following rulings:

1. Taxpayers' allocations of GST tax exemption on their Year 1 Federal gift tax returns were void.
2. Taxpayers' allocations of GST tax exemption on their amended Year 1 through Year 7 Federal gift tax returns are effective for GST tax purposes.
3. The proposed judicial reformation of Trust A and Trust B will be respected on a prospective basis for transfer tax purposes such that each child's separate trust share of Trust D will be included in the child's gross estate and the child will be the transferor of the trust for GST purposes.

Rulings 1 and 2

Section 2601 provides that a tax is imposed on every generation-skipping transfer. Section 2611 defines the term “generation-skipping transfer” to mean a taxable termination, a taxable distribution, or a direct skip.

Under § 2631(a), with regard to the generation-skipping transfer tax, each individual is allowed an exemption of \$1,000,000 (adjusted for inflation as provided in § 2631(c)) that may be allocated by such individual (or by his or her executor) to any property with respect to which such individual is the transferor. Section 2631(b) provides that any allocation under § 2631(a), once made, shall be irrevocable. In general, under § 2632(a) an allocation of an individual's GST exemption may be made at any time before the date prescribed for filing the estate tax return for such individual's estate.

Under § 2602 the amount of tax imposed under § 2601 is determined by multiplying the taxable amount by the “applicable rate.” Under § 2641(a), the term “applicable rate” is the product of the maximum Federal estate tax rate and the “inclusion ratio with respect to the transfer.”

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

Section 2642(a)(2) provides that the applicable fraction is a fraction (A) the numerator of which is the amount of the GST exemption allocated to the trust (or in the case of a direct skip, allocated to the property transferred in such 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 (I) any Federal estate tax or State death tax actually recovered from the trust attributable to such property and (II) any charitable deduction allowed under §§ 2055 or 2522 with respect to such property.

Section 2642(b)(1) provides the general rule that if the allocation of GST exemption is made on a timely filed gift tax return reporting the transfer, then for purposes of determining the applicable fraction under § 2642(a)(2), the value of the property (the denominator of the fraction) is the value of the property for purposes of Chapter 12. Under § 2642(b)(3), an allocation not made on a timely gift tax return is effective on and after the date it is made, and the value of the property, for purposes of determining the applicable fraction, is the value on the effective date of the allocation.

Section 2642(f)(1) provides special rules for certain inter vivos transfers. For purposes of the inclusion ratio, if (A) an individual makes an inter vivos transfer of property, and (B) the value of the property would be includible in the gross estate of the individual under chapter 11 if the individual died immediately after making the transfer

(other than by reason of section 2035), any allocation of GST exemption to the property may not be made before the close of the “estate tax inclusion period” (ETIP). The value of the property for purposes of determining the denominator of the applicable fraction is determined under § 2642(f)(2). Section 2642(f)(2) provides that, in the case of any property to which paragraph (f)(1) applies, the value of the property shall be (A) if such property is includible in the gross estate of the transferor (other than by reason of section 2035), its value for purposes of chapter 11, or (B) if subparagraph (A) does not apply, its value as of the close of the estate tax inclusion period (or, if any allocation of GST exemption to such property is not made on a timely filed gift tax return for the calendar year in which such period ends, its value as of the time such allocation is filed with the secretary).

Under section 2642(f)(3), the term “estate tax inclusion period” means any period after the transfer described in § 2642(f)(1) during which the value of the property involved in the transfer would be includible in the gross estate of the transferor if the transferor died. Such period in no event extends beyond the earlier of the date on which there is a generation-skipping transfer with respect to such property, or the date of the death of the transferor.

Section 26.2632-1(c)(1) of the Generation-Skipping Transfer Tax Regulations provides that an allocation of GST tax exemption to property subject to an ETIP that is made prior to termination of the ETIP cannot be revoked, but becomes effective no earlier than the date of any termination of the ETIP. Where an allocation has not been made prior to the termination of the ETIP, an allocation is effective at the termination of the ETIP during the transferor’s lifetime if made by the due date for filing a Form 709 that would apply to a taxable gift occurring at the time the ETIP terminated. Pursuant to § 26.2601-1(c), the regulation is effective for a generation skipping transfer, as defined in § 26.2611-1, made on or after December 27, 1995.

Section 26.2611-1 defines a “generation-skipping transfer” as an event that is either a direct skip, a taxable distribution, or a taxable termination. The determination as to whether an event is a GST is made by reference to the most recent transfer subject to the estate or gift tax.

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 a Form 709. The allocation must clearly identify the trust to which the allocation is being made, the amount of GST exemption allocated to it, and if the allocation is late or if 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.

Section 26.2632-1(b)(2)(ii) provides that 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). If it is unclear whether an allocation of GST exemption on a Form 709 is a late or a timely allocation to a trust, the allocation is effective in the following order: (i) to any transfer to the trust disclosed on the return as to which the return is a timely return; (ii) as a late allocation; and (iii) to any transfer to the trust not disclosed on the return as to which the return would be a timely filed return. 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.

Literal compliance with procedural instructions is not always required to make a valid election. Elections may be held to be effective where the taxpayer complies 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.

In the instant case, Trust A and Trust B were both subject to an estate tax inclusion period since each respective trust would have been included in the respective grantor's gross estate under § 2036, if the grantor died after the transfer. Accordingly, the rules of § 2642(f) apply with respect to allocations of GST exemption. Taxpayers' allocations of their GST tax exemptions to Trust A and Trust B on the returns filed for Year 1 were made prior to December 27, 1995, the publication date of § 26.2632-1(c)(1), which provides that an allocation made during an ETIP, although not effective until the close of the ETIP, may not be revoked. Because Taxpayers allocated their GST tax exemptions to property subject to an ETIP prior to promulgation of § 26.2631-1(c)(1), we conclude that the allocations were void. The allocations made in Year 8 with respect to transfers to Trust C, on Taxpayers' amended federal gift tax returns for Years 1 through 7, substantially complied with the essential requirements. Accordingly, the allocations of GST tax exemption made on these returns with respect to the transfers to Trust C were effective (as late allocations) for GST tax purposes, when the allocations were made.

Ruling No. 3

Retroactive changes to the legal effects of a transaction through judicial nullification of a transfer or judicial reformation of a document are not accorded retroactive effect for Federal tax purposes if the Federal tax consequences have attached to the transaction. M.T. Straight Trust v. Commissioner, 245 F.2d 327 (8th Cir. 1957); Sinopoulo v. Jones, 154 F.2d 648 (10th Cir. 1946); American Nurseryman Publishing Co. v. Commissioner, 75 T.C. 271, 276-277 (1980) aff'd without published opinion, 673 F.2d 1333 (7th Cir. 1982); Rev. Rul. 93-79, 1993-2 C.B. 269; Rev. Rul. 73-142, 1973-1 C.B. 405.

In the instant case, Trust A and Trust B will be judicially reformed on a prospective basis to provide that on the termination of each trust, the trust corpus will pass to Trust D. Each of Taxpayers' children will possess a testamentary general power to appoint the corpus of each trust established for their benefit under the terms of Trust D.

Based on the facts presented, Taxpayer's representations, and the applicable state law, we conclude that the proposed judicial reformations of Trust A and Trust B will be respected on a prospective basis for federal estate, gift, and generation-skipping transfer tax purposes. Accordingly, the corpus of the trust established for each child under the terms of Trust D will be included in the child's gross estate for federal estate tax purposes. The trust corpus will be subject to GST tax on the child's death only to the extent the corpus passes either pursuant to the exercise of the general power, or in default of exercise, to a skip person with respect to the deceased child.

However, as a result of the reformation, each remainder beneficiary of Trust C, the Taxpayers' grandchildren, will relinquish his or her remainder interest in the corpus of Trust A and Trust B that would otherwise have passed to Trust C. Accordingly, these beneficiaries are treated as making a gift for federal gift tax purposes of the value of his or her interest in Trust A and Trust B corpus that is being relinquished.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under the cited provisions or any other provisions of the Code.

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

In accordance with a power of attorney on file with this office, a copy of this ruling is being sent to your authorized representative.

Sincerely,

Assistant Chief Counsel
(Passthroughs and Special
Industries)

By _____
George Masnik
Chief, Branch 4

Enclosure
Copy for § 6110 purposes