

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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LEGEND:

Donor:

Spouse:

Trust:

Co-Trustee:

Children:

Charity:

year 1:

year 2:

date 1:

date 2:

a:

b:

c:

d:

Dear :

This letter is in response to a letter of August 18, 1999, submitted on behalf of Donor and Spouse (Taxpayers). Taxpayers seek a ruling that they substantially complied with the requirements for making a timely allocation of their generation-skipping transfer (GST) exemptions to Trust on their year 1 and year 2 Form 709s, U.S. Gift Tax Returns.

On date 1, Donor created Trust. Donor, Spouse and Co-Trustee were the initial trustees of Trust. Trust provides for the appointment of trustees (Independent Trustees) other than the Donor or Spouse and issue of Donor. Co-Trustee is an Independent Trustee. Pursuant to the terms of the trust agreement, during the Taxpayers' lifetimes, a single trust was established for the benefit of Spouse and Donor's issue living at any time during the term of the trust. Donor has two children.

Subdivision A of Article 1 of the trust agreement directs that until the death of the survivor of the Donor and Spouse, the Independent Trustees are empowered to pay a part or all of the net income and principal of Trust to or for the benefit of any one or more or all of Spouse and issue of Donor living at any time during the term of Trust in such proportions as the Independent Trustees shall deem advisable in their absolute discretion. Any net income not so paid is to be accumulated and added to the principal of Trust.

Subdivision B(1) of Article 1 provides that upon the death of the survivor of the Donor and Spouse, or, in the absolute discretion of the Independent Trustees, at any time prior to the death of the survivor of the Donor and Spouse, the principal of Trust shall be divided and set aside into equal shares, one share for each of the Children who shall be living at that time and one share in equal subshares per stirpes for the issue who shall be living at that time of each of the Children who shall not be living at that time, and such shares and subshares shall be disposed of in accordance with the provisions of Subdivision C of Article 1.

Subdivision C of Article 1 provides that a share or subshare of the principal of Trust created hereunder shall be held by the trustees in a separate trust for the benefit of one of the Children or more remote issue of Donor (each of whom is hereinafter referred to in this Subdivision C as the Beneficiary).

Subdivision C(1) of Article 1 provides that the net income shall be paid to or applied for the benefit of the Beneficiary, so long as the Beneficiary shall live, annually or more often in the discretion of the trustees, provided that the Independent Trustees, may, in their absolute discretion, (i) pay or apply any part or all of such net income to any one or more or all of the Beneficiary's issue, and in such proportions, as such Independent Trustees shall deem advisable, or (ii) accumulate and add to principal the whole or any part of such net income, any such accumulated income thereafter to be disposed of as a part of such principal.

Subdivision C(2) of Article 1 provides that the Independent Trustees are

authorized, at any time and from time to time, to pay any one or more or all of the Beneficiary and the Beneficiary's issue such part or all of the principal of the trust, and in such proportions, as the Independent Trustees shall deem advisable in their absolute discretion for any reason whatsoever, including the termination of the trust, without any duty to take into account the other resources or income of the Beneficiary or the Beneficiary's issue.

Subdivision C(3) of Article 1 provides that, upon the death of the Beneficiary, the Beneficiary has the power to appoint the remaining principal by will admitted to probate, provided, however, that in no event shall the Beneficiary appoint any of the property subject to this power of appointment in favor of himself or his estate or his creditors or the creditors of his estate. This power of appointment shall be exercisable only by a specific reference thereto in the Beneficiary's will and shall not be deemed to have been exercised by any general residuary article contained therein.

Subdivision C(4) of Article 1 provides that, to the extent the Beneficiary does not exercise the foregoing power of appointment, the remaining principal at the Beneficiary's death shall be divided and set aside into equal shares per stirpes for the Beneficiary's issue living at that time. If there are no living issue, the principal shall be divided and set aside into equal shares per stirpes for the issue who are living at that time of the Beneficiary's nearest ancestor who is one of the Children or more remote issue of Donor and who has issue living at that time. If there are no such living issue, the principal shall be divided and set aside into equal shares per stirpes for the Donor's issue who shall be living at that time, and each such share shall be added to the principal of the trust created for the benefit of the child or more remote issue of the Donor for whom such share shall have been so set aside under the provisions of this Subdivision C and disposed of as a part thereof.

Subdivision C(5) of Article 1 provides that any trust created under this Subdivision C will terminate, if it has not sooner terminated, twenty-one years after the death of the survivor of the Donor's parents' issue and the Spouse's parents' issue who were living on the date of this agreement, and upon the termination, the principal of the trust, at the time remaining, will be distributed to the Beneficiary.

Subdivision D of Article 1 provides that, if trusts created hereunder terminate and the principal of the trust is not effectively disposed pursuant to the foregoing provisions, the principal of that trust will be distributed to Charity.

By an instrument dated date 2, Spouse renounced any interest she may have had in the income or principal of Trust.

During year 1, Donor transferred cash and securities with an aggregate value of \$a to Trust. Spouse elected to split the gift made by Donor in year 1. These gifts were reported by Taxpayers on timely filed gift tax returns. On their year 1 gift tax returns, Taxpayers each allocated \$b of their respective GST exemptions to the gifts made to

Trust by Donor in year 1, one-half of which was treated as being made by Spouse.

During year 2, Donor transferred cash and securities with an aggregate value of \$c to Trust. Spouse elected to split the gift made by Donor in year 2. These gifts were reported by Taxpayers on timely filed gift tax returns. On their year 2 gift tax returns, Taxpayers each allocated \$d of their respective GST exemptions to the gifts made to Trust by Donor in year 2, one-half of which was treated as being made by Spouse. In addition, Donor attached a statement to his year 1 and year 2 return which provided Trust's name and the total value of the non-cash property Taxpayers transferred to Trust. Spouse also wrote a letter to Taxpayers' accountant indicating their intent to use a portion of their GST exemptions on the year 1 gift.

With respect to the year 1 and year 2 transfers, Taxpayers request a ruling that they substantially complied with the requirements for making a timely allocation of their GST tax exemptions to Trust, in the amount of \$a transferred to Trust respectively on their year 1 gift tax returns, and in the amount of \$c transferred to Trust respectively on their year 2 gift tax returns.

Section 2601 imposes a tax on every GST. A GST 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)(1) 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 2613(a)(2) provides, in part, that a trust is a skip person 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 § 2652(c)(1), a person has an interest in property held in trust, if (at the time the determination is made) such person has a right to receive income or corpus from the trust, or is a permissible current recipient of income or corpus and is not described in § 2055(a).

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.

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 Taxpayers made timely allocations of their GST tax exemptions to the transfers to Trust on their year 1 and year 2 gift tax returns. In the present case, the transfers to Trust were not direct skips. 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 Taxpayers during the period state:

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 Taxpayers did not literally comply with the instructions on Form 709. Taxpayers reported the year 1 and year 2 gifts to Trust on Schedule A, Part 2 (Gifts Subject to Both Gift and GST Tax) and completed portions of Schedule C. In addition, Taxpayers did not attach to the year 1 or year 2 returns a Notice of Allocation of GST exemption. However, 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 allocations will be deemed valid if there are enough facts and circumstances to indicate that the Taxpayers intended to allocate part of their GST exemption to Trust.

Based on the information submitted and the representations made, we conclude that there is sufficient information provided on Taxpayers' year 1 and year 2 gift tax returns to conclude that Taxpayers intended to allocate part of their exemptions to Trust. On the year 1 and year 2 gift tax returns, Taxpayers reported the transfers on Schedule C. For the year 1 gifts, Taxpayers each entered a total of \$b on Schedule C, Part 2 (GST Exemption Reconciliation), line 4 (Exemption Claimed on This Return). On Schedule C, Part 3, column C (GST Exemption Allocated) of their respective gift tax returns, Taxpayers each entered a total of \$b. For the year 2 gifts, Taxpayers each entered a total of \$d on Schedule C, Part 2 (GST Exemption Reconciliation), line 4 (Exemption Claimed on This Return). On Schedule C, Part 3, column C (GST Exemption Allocated) of their respective gift tax returns, Taxpayers each entered a total of \$d. We note that Taxpayers did not complete the GST portions of the form correctly, in view of the fact that the transfers were not direct skips. However, based on the information provided on the return, we conclude that Taxpayers substantially complied with the requirements for making an allocation of their GST exemptions for the transfers reported on their year 1 and year 2 gift tax returns. Taxpayers are, therefore, deemed to have allocated their exemptions as described above for the year 1 and year 2 transfers to Trust.

Except as ruled above, we express or imply no opinion concerning the federal tax consequences of this transaction under the cited provisions or any other provision of the Code. We are expressing no opinion regarding the value of the transfers to Trust, whether the transfers qualified for the annual exclusion under § 2503(b), or regarding the inclusion ratio with respect to Trust.

This letter 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,
James C. Gibbons
Assistant to the Chief, Branch 7
Office of the Assistant Chief Counsel
Passthroughs and Special Industries