

GST Tax Update: Income & Transfer Tax Roundtable

**American Bar Association
Joint Fall CLE Meeting
Real Property Probate & Trust Section**

September 16, 2005

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I. Final Regulations (T.D. 9208): Elections “Out” of and “Into” Automatic Allocations to GST Trusts under Section 2632(c)(5)(A)

The Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”)¹ introduced new Section 2632(c)² providing for automatic allocation of an individual’s available GST exemption to lifetime “indirect skips” to a “GST trust,”³ to the extent necessary to produce an inclusion ratio of 0 for such trust. Section 2632(c)(4) provides an automatic allocation rule for property subject to an estate tax inclusion period (“ETIP”) similar to the voluntary allocation rule under Section 2642(f).⁴ Section 2632(c) applies to transfers subject to federal gift tax or estate tax made after December 31, 2000, and to ETIPs ending after December 31, 2000.

On August 2, 2004, the IRS published proposed regulations (Reg-153841-02, IRB 2004-31) regarding the:

(i) Election under Section 2632(c)(5)(A)(i) to prevent the automatic allocation of GST exemption to one or more indirect skip transfers to a GST trust; and

(ii) Election under Section 2632(c)(5)(A)(ii) to treat a trust as a GST trust with respect to one or more transfers to the trust.

On June 29, 2005, the IRS published final regulations (T.D. 9208) clarifying the effect and revocability of these elections, which may promote the popularity of these elections.

¹ P.L. 107-16 (June 7, 2001). EGTRRA also included new Section 2642(b)(1) and (2), which clarify that the value as finally determined for gift and estate tax purposes will determine the inclusion ratio relating to timely and automatic allocations of GST exemption.

² Unless otherwise noted, references to “Sections” herein refer to the Internal Revenue Code of 1986, as amended.

³ An “indirect skip” is any transfer of property (other than a direct skip) subject to the federal gift tax made to a GST trust. Section 2632(c)(3)(A). In general, a “GST trust” is a trust that could have a GST with respect to the transferor, subject to certain exceptions described in the statute. Section 2632(c)(3)(B).

⁴ An indirect skip of ETIP property will be deemed to occur only at the close of the ETIP. The fair market value of the transfer will be the fair market value of the trust property at the close of the ETIP. Section 2632(c)(4).

Practitioners may have difficulty determining whether transfers to a particular trust are subject to automatic allocation, due to the potentially confusing statutory exceptions to the definition of “GST trust” and the possibility that the character of a trust as a GST trust might not remain constant from year to year. These elections would facilitate consistent treatment of a trust for GST tax purposes and, arguably, allow practitioners to ignore the definition of GST trust altogether when evaluating whether to make elections regarding automatic allocations under Section 2632(c). After all, the advisor should know whether a given trust is intended for allocations of the transferor’s GST exemption. Instead of parsing the statutory definition of “GST trust” each time a transfer to the trust occurs, the advisor can simply elect “in” or “out” with respect to all transfers to the trust as is consistent with the intention regarding its GST exempt status.⁵ Once the election is made, no further action would be necessary to prevent unintended allocations of, or failures to allocate, GST exemption until circumstances change to require reexamination of the use of such exemption.

A. Automatic Allocations to Indirect Skips after December 31, 2000.

An automatic allocation to an indirect skip under Section 2632(c) is effective as of the date of the subject transfer and irrevocable after the due date of the Form 709 for the calendar year in which the transfer is made, regardless of whether a Federal Form 709 gift tax return is filed reporting the transfer. Treas. Reg. §26.2632-1(b)(2)(i). In the case of an indirect skip subject to an ETIP, that transfer is deemed to occur at the close of the ETIP. *Id.*

B. Election out: to prevent automatic allocation of GST exemption to indirect skips.

1. Expanded options for election out: The proposed regulations only contemplated elections out of the automatic allocation rules with respect to (i) a current transfer, or (ii) all transfers (current year and all future transfers) to a trust.

The final regulations provide greater flexibility by clarifying that a transferor may elect out with respect to:

- Any one or more transfers in prior years subject to ETIP(s) to a specified trust;
- Any one or more (up to all) transfers in a current year or in the future to a specified trust;
- All future transfers to all trusts, regardless of whether any such trust exists at the time of the election; or
- Any combination of the above.

Treas. Reg. §26.2632-1(b)(2)(iii).

2. Effect of election out: The election out remains in effect unless and until terminated,

⁵ At the time when a taxpayer chooses to elect “in,” she also should consider allocating to the trust by formula the amount of GST exemption necessary to produce an inclusion ratio of 0 to remedy any past failures to properly allocate GST exemption to transfers to the trust.

and an election out for future transfers to a trust eliminates the need to file Form 709s solely to elect out of automatic allocations. Treas. Reg. §26.2632-1(b)(2)(iii)(D). These final regulations provide the *general rule* that an election out will not apply to any transfer in a prior year to a trust, even if the transfer is subject to an ETIP closing in the future (subject to the exception described below for certain qualifying electors for transfers subject to such ETIPs). *Id.* The election out does not prevent affirmative allocations of GST exemption to the trust. *Id.*

3. Exception for ETIPs: Transfers in Prior Years. The preamble to the final regulations notes that an election out for “future transfers” generally will not suffice to prevent automatic allocation to a trust at the future expiration of an ETIP where the original transfer occurred in a prior year. However, the final regulations provide an exception and describe the specific method to elect out for a transfer in a prior year that subject to an ETIP, to prevent automatic allocation upon the future close of that ETIP. Treas. Reg. §26.2632-1(b)(2)(iii)(A)(1). Thus, practitioners should perform a comprehensive review of their files to identify existing trusts with ongoing ETIPs that may benefit from this protective election. Otherwise, the general rule applies: an election out will not apply to any transfer in a prior year to a trust. Treas. Reg. §26.2632-1(b)(2)(iii)(D).

4. Partial allocations: The final regulations clarify that a timely affirmative allocation of GST exemption in an amount less than the value of the transferred property constitutes an election out of the automatic allocation rules. Treas. Reg. §26.2632-1(b)(2)(ii). *See also* Treas. Reg. §26.2632-1(b)(4)(iii), Example 6. This provision eliminates the need for a separate election out coupled with the affirmative partial allocation to prevent allocation equal to the entire value of the transfer.

5. Method of Election Out: The election out must be made on a statement (“election out statement”) attached to a Form 709 filed on or before the due date for a timely filed Form 709 for the year when (i) for a transfer subject to an ETIP, the ETIP closes, or (ii) for all other transfers, the first transfer to be covered by the election out occurred. Treas. Reg. §26.2632-1(b)(2)(iii)(C).

Thus, the final regulations confirm that the transferor may elect out for a trust subject to an ETIP at any time before the due date of the Form 709 for the year when the ETIP period expires (for example, on the Form 709 reporting the original transfer) instead of being required to wait until such expiration, addressing commentators’ concerns that the proposed regulations were unclear in this respect. *Id.*; Treas. Reg. §26.2632-1(c), including Example 5.

The final regulations also eliminate the requirement of specific references to Code or Treasury Regulation Sections for an effective election from the proposed regulations. Instead, the final regulations require that the election out statement “specifically must provide” the election out of automatic allocation and the transfers must be “specifically described or otherwise identified.” Treas. Reg. §26.2632-1(b)(2)(iii)(B).

Treasury Regulation Section 26.2632-1(b)(4)(iv) provides examples of language that satisfies the requirements for various types of effective elections out of automatic

allocations

6. Termination of Election Out: A transferor can terminate a prior election out, “to the extent that election out applied to future transfers or to a transfer subject to [an ETIP].” Treas. Reg. §26.2632-1(b)(2)(iii)(E).⁶ The regulations do not require a blanket termination, and the termination can be limited in scope by describing “the extent to which the prior election out is being terminated” or “any current-year transfers to which the election out is not to apply.” *Id.*

The termination must be made on a statement (“termination statement”) attached to a Form 709 filed on or before the due date for a timely filed Form 709 for the year when the first transfer to which the election out is not to apply. The termination statement must “specifically provide” that the prior election out is being terminated.

The termination of an election out cannot revoke the election for any transfer in a prior year (except those subject to an ETIP if the termination occurs on or before the deadline for a timely filed Form 709 for the year the ETIP closes). *Id.* A termination does not prevent the transferor from making another subsequent election out in the same or a future year. *Id.*

7. Scope of election. The final regulations clarify that this election out only affects allocation to lifetime transfers, and does not affect the automatic allocations applying after the transferor’s death under Section 2632(e). Treas. Reg. §26.2632-1(b)(2)(ii).

C. GST Trust Election: to treat a trust as a GST trust

1. Expanded options for GST trust election: The proposed regulations only contemplated a blanket election “into” treatment as a GST trust with respect to all transfers in the current and future years to a trust.

The final regulations provide greater flexibility by clarifying that transferors may elect to treat any trust as a GST trust with respect to:

- Any one or more (up to all) transfers in a current year by the electing transferor;
- Any selected future transfers by the electing transferor;
- All future transfers by the electing transferor; or
- Any combination of the above.

2. Effect of GST trust election: The GST trust election remains in effect unless and until the election is terminated or the transferor elects out of automatic allocation with

⁶ The regulation does not provide for a “termination” of an election out applying to a transfer in the current year, presumably because a subsequent timely filed Form 709 for such year clearly modifying the earlier timely-filed Form 709 to eliminate the election should suffice to prevent its operation. *See* Treas. Reg. §26.2632-1(b)(4)(ii)(A)(1).

respect to the trust. Treas. Reg. §26.2632-1(b)(3)(iii). Note that the termination of the GST trust election will not preclude automatic allocations to the trust if it otherwise constitutes a GST trust when a subsequent transfer to the trust occurs.

3. Method of GST Trust Election: The GST trust election must be made on a statement (“GST trust election statement”) attached to a Form 709 filed on or before the due date for a timely filed Form 709 for the year when the first transfer to be covered by the election occurred.

The final regulations also eliminate the requirement of specific references to Code or Treasury Regulation Sections for an effective election from the proposed regulations. Instead, the final regulations require that the GST trust election statement “specifically provide” that the transferor elects to treat the trust as a GST trust and “specifically describe or otherwise identify” the transfers subject to the election. Unlike the provisions governing the election out, the regulations do not provide examples of language satisfying these criteria.

4. Termination of GST Trust Election: A transferor can terminate a prior GST trust election, “to the extent that election applied to future transfers or to a transfer subject to [an ETIP].” Treas. Reg. §26.2632-1(b)(2)(iv).⁷

The regulations assume a blanket termination for all transfers: the termination statement must “provide that the prior GST trust election is terminated” and, if the trust otherwise does not constitute a GST trust, the automatic allocation rules will not apply to the specified transfer in the current year, if any, “or to any future transfer made by the transferor to the trust” unless another GST trust election is made for the trust. *Id.*

The termination must be made on a statement (“termination statement”) attached to a Form 709 filed on or before the due date for a timely filed Form 709 for (i) the year when the electing transferor’s first transfer to which the GST trust election is not to apply or (ii) the first calendar year in which the GST trust election is not to apply even if there is no transfer in that year. *Id.* The termination statement must identify the trust, describe the current-year transfer, if any, and provide that the prior GST election out is being terminated. *Id.*

Presumably, the termination of a GST trust election does not revoke that election for any transfer in a prior year (except those subject to an ETIP if the termination occurs on or before the deadline for a timely filed Form 709 for the year the ETIP closes), although the final regulations are silent on this matter.

The final regulations indicate that the termination of a GST trust election does not prevent the transferor from making another subsequent GST trust election with respect to

⁷ The regulation does not provide for a “termination” of a GST trust election applying to a transfer in the current year, presumably because a subsequent timely filed Form 709 for such year clearly modifying the earlier timely-filed Form 709 to eliminate the election should suffice to prevent its operation. See Treas. Reg. §26.2632-1(b)(4)(ii)(A)(1).

that trust by providing that the automatic allocation rules will not apply “unless and until another [GST trust] election under this paragraph (b)(3) is made.” *Id.*

D. Effective Date.

Treasury Regulation Section 26.2632-1(c)(1) and Example 5 of Treasury Regulation Section 26.2632-1(c)(5), regarding allocations to indirect skips subject to an ETIP, apply to elections made on or after June 29, 2005. The other changes to Treasury Regulation Section 26.2632-1 resulting from these new final regulations apply to elections made on or after July 13, 2004.

II. **Final Regulations (T.D. 9214): Predeceased Parent Rule under Section 2651(e) and Multiple Generation Rule under Section 2651(f).**

The Taxpayer Relief Act of 1997⁸ added Section 2651(e), which expands the predeceased parent exception from GST tax (formerly contained in repealed Section 2612(c)(2)) to include all generation-skipping transfers and to apply to certain collateral heirs. Section 2651(e) applies to terminations, distributions and transfers after December 31, 1997.

On October 18, 2004, the IRS published proposed regulations (Reg-145988-03, IRB 2004-42) regarding the predeceased parent exception under Section 2651(e) and the rules governing assignments to more than one generation under Section 2651(f).

On July 18, 2005, the IRS published final regulations (T.D. 9214) discussed below.

A. Generation Assignment.

Treasury Regulation Section 26.2651-1(a) describes the general requirements for the predeceased parent exception adjusting the generation assignment of an individual for GST tax purposes in certain cases where the individual’s parent predeceases the relevant transfer.⁹ However, a living person will not be treated as being predeceased merely due to a provision of applicable local law. Treas. Reg. §26.2651-1(a)(iv).

1. Collateral Heirs: The predeceased parent exception will not apply to an individual who is not a lineal descendant of the transferor (or the transferor’s spouse or former spouse) if the transferor has any lineal descendants at the time of the transfer. Treas. Reg. §26.2651-1(b).

Thus, responding to commentators, the final regulations modify the proposed regulations,

⁸ P.L. 105-34 (August 5, 1997).

⁹ If an individual is a descendant of a parent of the transferor (or the transferor’s spouse or former spouse) and the individual’s parent is (i) also a lineal descendant of a parent of the transferor (or the transferor’s spouse or former spouse) and (ii) deceased at the time when the transfer (from which the individual derived or established an interest) is first subject to federal gift or estate tax, then the individual is treated as if s/he is a member of the generation one generation below the lower of the transferor’s generation or the generation assignment of the individual’s youngest living lineal ancestor. Treas. Reg. §26.2651-1(a). Corresponding adjustments are made to assignments for the individual’s descendants and spouses or former spouses of the individual or his/her descendants. *Id.*

which did not apply this exception to collateral heirs if “the transferor (or the transferor’s spouse or former spouse) has any living lineal descendant” (*emphasis added*) at the time of transfer.

2. Time of Determination: Section 2651(e) narrowed the application of this predeceased parent exception by requiring that the parent be deceased at the “earliest time” when the transferor is subject to federal gift or estate tax on the transfer creating the transferee’s interest.¹⁰ In contrast, the pre-1998 exception under former Section 2612 applied the exception wherever the parent was deceased at the time of the direct skip, regardless of whether the parent was deceased at a *prior* time when the transferor was subject to gift or estate tax on the transfer.

The final regulations under Section 2651(e) reflect that the relevant time for determination of eligibility for this exception is the first time when the “transferor” is subject to gift or estate taxes on the transfer. Treas. Reg. §26.2652-1(a)(3). Thus, the final regulations eliminate the phrase under the proposed regulations, “transferor who transferred the property that makes up the interest,” which did not reflect the change in “transferor” that can occur if another individual is subject to gift or estate tax after the original transfer.

Commentators noted that the proposed regulations specifying that a remainder beneficiary’s interest in a QTIP trust (not subject to a reverse QTIP election) is established upon the death of the surviving spouse incorrectly characterized this result as an exception to the general rules, rather than the logical conclusion resulting from application of the rules. The final regulations have eliminated those confusing references. See *Preamble*, Treas. Reg. §26.2651-1(a)(3), Examples 3 and 4 under Treas. Reg. §26.2651-1(c).

¹⁰ However, note that Section 2632(d) may provide relief to taxpayers in circumstances where the exception under Section 2651(e) is not available to prevent a taxable GST. Transferors typically do not allocate GST exemption to trusts likely to benefit non-skip persons. However, a non-skip person/beneficiary could unexpectedly predecease the transferor, thereby causing a taxable termination or increasing the likelihood of future GSTs from the trust. No means existed under pre-EGTRRA law to make a late allocation of GST exemption effective as if the allocation had been made on a timely filed gift tax return reporting the transfer. EGTRRA introduced Section 2632(d) to allow such late allocations where certain non-skip beneficiaries predecease the transferor.

Section 2632(d) provides that if a child, niece, nephew, or child of a first cousin of the transferor, the transferor's spouse or former spouse has an interest or a future interest in a trust and predeceases the transferor, then the transferor may allocate his unused GST exemption to any previous transfer or transfers to the trust on a chronological basis. If the transferor makes the retroactive allocation under Section 2632(d) on a timely filed gift tax return for the calendar year in which the non-skip person’s death occurred, then the allocation will be treated as if made on a timely filed gift tax return for each such transfer. Section 2632(d) applies to deaths of non-skip persons occurring after December 31, 2000.

The amount of the transferor's unused GST exemption available to be allocated will be determined immediately before such death. Thus, the allocation will be made using the original value of each prior transfer, but the transferor’s available GST exemption as of those prior dates is not relevant. The transferor cannot take full advantage of this new retroactive allocation under Section 2632(d) if he has insufficient exemption remaining immediately before the non-skip person’s death.

3. Ninety-Day Rule: The final regulations flatly treat any individual who dies within ninety days after a transfer occurring due to the transferor's death as having predeceased the transferor, thereby simplifying this rule. Treas. Reg. §26.2651-1(a)(2)(iii). In contrast, former Treasury Regulation Section 26.2612-1(a)(2) required that the governing instrument or applicable local law *also* provide this presumption to be eligible for the ninety-rule for GST tax purposes.

Commentators suggested that this ninety-day rule apply to lifetime gifts. However, the preamble to the final regulations explains that drafters deliberately chose to restrict this rule to testamentary transfers because former Treasury Regulation Section 26.2612-1(a)(2) and analogous state statutes are limited to testamentary transfers. Accordingly, the final regulations confirm that this rule will not apply to *inter vivos* gifts. Treas. Reg. §26.2651-1(a)(2)(iii).

B. Multiple Generation Assignment: Effect of Adoptions.

1. General rule: Section 2651(f) generally provides that an individual who would be assigned to more than one generation is assigned to the youngest of those generations (the "multiple generation rule"). The final regulations provide rules relating to the effect of legal adoptions on the application of this multiple generation rule. Treas. Reg. §26.2651-2.

2. Legal Adoptions: Section 2651(b)(3) provides that "a relationship by legal adoption shall be treated as a relationship by blood."

Section 2651(b)(3) does not specify the effect of adoption on the individual's generation assignment with respect to the birth family. For example, the plain terms of the statute could indicate that the adoption eliminates the blood relationship with the birth family for purposes of generation assignment. Thus, the statute does not address cases where an individual was already assigned to a generation with respect to the transferor prior to the adoption, and whether the adoption replaces the initial generation assignment or adds another generation assignment subject to the multiple generation assignment rule of Section 2651(f).¹¹ This silence also renders unclear the effect of a transfer to the adopted individual from an ancestor in the individual's birth family.

The proposed regulations seemed to presume a general rule that the adoption does not affect the original generation assignment based on blood relationship when they detailed an "exception" to the multiple generation rule for certain adoption of minor relatives. *See* Prop. Treas. Reg. §26.2651-2(b). However, the proposed regulations did not expressly articulate this general rule to which they provided the "exception."

The final regulations still do not expressly address the effect of adoption on the individual's generation assignment with respect to the birth family. However, the preamble to the final regulations recites:

¹¹ For example, a transferor who adopts Grandchild would convert Grandchild from a skip person to a non-skip person if the adoption entirely replaces the original assignment.

In order to provide that clarification, the Treasury Department and the IRS confirm that, for purposes of chapter 13, a legal adoption may create an additional generation assignment, but the adoption does not constitute a substitute for the blood relationship In spite of the adoption, however, the adopted individual also continues to be a blood relative of the individual's birth parents. Thus, the generation assignment of the adopted individual with regard to a transfer from an ancestor of the birth parent, for example, will continue to be measured under Section 2651(b), but, subject to the exception in [Treasury Regulation] §26.2651-2(b), the relationship between them may be subject to the special rule in section 2651(f)(1), which provides that an individual who would be assigned to more than one generation is assigned to the youngest of those generations. *Emphasis added.*

In addition, Treasury Regulation Section 26.2651-2(d) adds a new example where T adopts grandchild GC who is twenty years old. The example explains that GC is assigned to the generation two generations below T under the general assignment rules and is also treated as T's child due to the adoption. "Under these circumstances, GC is an individual who is assigned to more than one generation and the exception in §26.2651-2(b) does not apply. Thus, the special rule under section 2651(f)(1) applies and GC is assigned to the generation that is two generations below T. GC remains a skip person with respect to T."

Overall, the combination of the preamble, this new example and the creation of an "exception" (discussed below) appear to confirm a default rule that legal adoption does not supplant the original generation assignment resulting from a blood relationship -- despite the lack of express provisions in the final regulations directly describing this rule.

The preamble acknowledges that the multiple generation assignment rule should not apply where tax avoidance does not motivate the adoption of a minor relative. Accordingly, the final regulations describe an exception that assigns an "adopted individual" to the generation immediately below the adoptive parent for purposes of determining whether transfers from certain members of the adoptive family are subject to GST tax. Treas. Reg. §26.2651-2(b). An "adopted individual" is a descendant of a parent of the adoptive parent (or the adoptive parent's spouse or former spouse) who is under age 18 at the time of the adoption, if the individual was not adopted primarily for the purpose of avoiding GST tax, as determined upon reviewing all facts and circumstances. *Id.* The regulation cites several relevant factors, but "[t]he most significant factor is whether there is a bona fide parent/child relationship between the adoptive parent and the adopted individual, in which the adoptive parent has fully assumed all significant responsibilities for the care and raising of the adopted child." Treas. Reg. §26.2651-2(b)(4) (emphasis added).

Note the specific limitation of this exception to descendants of a parent of the adoptive parent (or the adoptive parent's spouse or former spouse). Thus, for example, Transferor's adoption of nieces or nephews may qualify for this exception, but adoption of Transferor's cousin's children would not qualify. There does not seem to be a logical

reason for imposing this limitation, instead of providing the exception uniformly to all blood relationships where an adoption might subject the transferor to the multiple generation assignment rule.

3. Adoption of unrelated persons: The multiple generation rule does not apply where the transferor adopts a person who is unrelated to the transferor prior to the adoption because there is no generation assignment based on a family relationship prior to the adoption. Thus, 80-year-old Transferor could adopt unrelated 20-year-old individual, who apparently is assigned to the first generation below Transferor for GST tax purposes.

C. Effective date. These final Treasury Regulations Sections 26.2651-1 and 26.2651-2 apply to terminations, distributions and transfers occurring on or after July 18, 2005. Treas. Reg. §26.2651-3. Taxpayers may rely on any “reasonable interpretation” of Section 2651(e) with respect to any transfers after December 31, 1997, and before July 18, 2005. *Id.*

III. Cases & Rulings

A. Robertson v. U.S., Civil Action No. 3-03-CV-2113-BD (U.S. District Court of Texas, Northern District).¹²

This case involved four charitable lead annuity trusts (CLATs) that provided the trustee with the discretionary power to choose the charities that would receive the annuity payments. The parties disputed whether the final distribution to charity was a taxable termination or whether the subsequent distribution to skip persons was a taxable distribution.

The taxpayer argued that no taxable termination was possible under these CLATs because no charity had an “interest” in the trust property and the definition of a taxable termination requires a “termination (by death, lapse of time, release of power or otherwise) of an interest in property held in trust.” §§2612(a)(1), 2652(c)(1)(B). The Government has chosen not to pursue this argument further.

Apparently, the taxpayer disputed the nature of the GST in this case because both the GST tax rate and the value of the trust property declined between the last charitable distribution in 2001 and the distribution to skip persons in 2002. However, it seems odd that the character of the GST would determine the timing of the GST for tax purposes if the CLAT instruments provided that the skip persons succeeded to their interests in the CLATs immediately upon the cessation of the charitable lead term, which would not depend on the timing of the actual distribution in satisfaction of their interests.

B. PLR 200429004: qualified severance

EGTRRA introduced new Section 2642(a)(3), which describes “qualified severances” that will be recognized for GST purposes and allows certain severances of trusts with inclusion

¹² This author was unable to obtain copies of the pleadings in this action in sufficient time to prepare these materials. This discussion results from a review of the synopses of this case included in *Practical Drafting*, U.S. Trust Company (April 2005; July, 2005).

ratios between 0 and 1 into separate trusts with inclusion ratios of 0 and 1.¹³ On September 27, 2004, the IRS published proposed regulations regarding qualified severances (Reg-145987-03, IRB 2004-39).

Section 2642(a)(3) does not require that the terms of the trusts resulting from the severance be identical, as long as the trusts collectively preserve the beneficial interests under the original single trust. However, most rulings to date applying Section 2642(a)(3) involve qualified severances resulting in separate trusts with terms identical to the original trust, often because required under the applicable state law or governing instrument or because the ruling is requested solely to remedy failures to make effective reverse QTIP elections under Section 2652(a)(3). See PLRs 200519008, 200508001, 200502036, 200451029, 200451021, 200352011, 200351010, 200340015, 200223016, 200213014. Thus, most rulings involving qualified severances have not addressed how trusts may differ from the original trust without changing the succession of beneficial interests under the original single trust for purposes of Section 2642(a)(3).

However, PLR 200429004 provides some guidance in this respect. Grantor initially created separate trusts for the benefit of Grantor's grandchildren prior to September 25, 1986 (the "Grandchildren's Trusts").¹⁴ The trust instrument governing the Grandchildren's Trusts provided that the primary trust beneficiary would receive a distribution of one-third of the trust corpus upon the later of reaching age twenty-five or the fifth anniversary of the death of the Grantor's daughter. "Multiple persons" subsequently transferred property to the trusts prior to September 25, 1986. Grantor's daughter died after September 25, 1986, and all of her property was bequeathed equally to the Grandchildren's Trusts.

The trustees proposed to sever each of the Grandchildren's Trusts into a (i) GST Non-Exempt Trust holding the fraction of the trust attributable to the post-September 25, 1986, additions to the trust and a (ii) GST Exempt Trust consisting of the fraction of the trust attributable to the pre-September 25, 1986, additions to the trust. The ruling notes that "[t]he severed trusts will have terms identical to the respective Grandchildren's Trust." PLR 200429004 (*emphasis added*). However, the trustees further proposed that all distributions following the severance (including the extraordinary distribution of one-third of the trust assets to the primary beneficiary) be made from the severed trusts on a non-pro rata basis, such that distributions may be made selectively first from the GST Non-Exempt Trusts rather than the GST Exempt Trusts.

¹³ The trusts resulting from a "qualified severance" will be treated as separate trusts thereafter for GST purposes. A "qualified severance" is the division of a single trust (pursuant to the governing instrument or local law) on a fractional basis into two or more trusts which, in the aggregate, provide for the same succession of beneficial interests as are provided in the original trust. Section 2642(a)(3) permits the issuance of regulations describing severances in addition to those described in the statute that will be treated as "qualified severances." Section 2642(a)(3) applies to severances occurring after December 31, 2000.

¹⁴ Generally, a trust that was irrevocable on September 25, 1985, is not subject to GST tax to the extent the transfer is not made from trust principal allocable to any addition to the trust after September 25, 1985 ("exempt trust"). Treas. Reg. §26.2601-1(a). Treasury Regulations Section 26.2601-1(b)(4) describes rules for determining whether a modification, judicial construction, settlement agreement, or trustee action with respect to an exempt trust will cause it to lose its exempt status. Thus, a severance of an exempt trust must satisfy those rules to avoid becoming subject to GST tax.

Thus, despite the characterization of the severed trusts as subject to terms identical to the original trusts, this provision now permitting non pro-rata distributions to exhaust the GST Non-Exempt Trust first effectively would seem to change the terms governing the trusts. Grantor's daughter is treated as the transferor of the GST Non-Exempt Trusts¹⁵ and distributions from those trusts to Grantor's grandchildren will not be GSTs. Consequently, the ability to make distributions non pro-rata first from the GST Non-Exempt Trusts delays taxable GSTs overall and preserves the GST Exempt Trust for future generations. Nevertheless, the IRS concluded that the severance would constitute a qualified severance under Section 2642(a)(3) and would not constitute a modification causing the GST Exempt Trusts to become subject to GST tax as provided in Treasury Regulation Section 26.2601-1(b)(4)(i)(D).

C. PLR 200530020: State Statute Limiting Trustee Powers Affecting Trustee/Beneficiary

In PLR 200530020, Spouse was a permissible income beneficiary and co-trustee of a trust that was irrevocable on September 25, 1985, and not subject to GST tax. The trustees could distribute income to beneficiaries "as the trustees in their sole and absolute discretion deem advisable from time to time" In 1995, an applicable state statute was enacted that prevents a trustee from performing any of the following actions for the benefit of a beneficiary who is also a trustee: (i) make discretionary distributions of income or principal except to provide for the "health, education, maintenance or support of the trustee as described under sections 2041 and 2514 of the Internal Revenue Code," (ii) allocate receipts or expenses between income and principal unless the trustee has no power to enlarge or shift beneficiary interests except as an incidental consequence of fiduciary duties, and (iii) make distributions of income or principal to satisfy any legal or support obligations of the trustee/beneficiary.

The IRS acknowledged that Spouse held a general power of appointment over trust income prior to the enactment of the state statute. Citing Revenue Procedure 94-44, which addressed the enactment of a similar Florida statute, the IRS concluded:

- The enactment of the statute will not be treated as causing a lapse of Spouse's general power of appointment for purposes of Section 2514(e);
- Due to the limitations imposed by the new statute, Spouse will not have a general power of appointment over trust income by virtue of her fiduciary power to distribute income; and
- The enactment of the statute does not constitute a modification that shifts a beneficial interest in the trust, and will not cause the trust to lose its exempt status.

Bernstein Investment Research & Management does not provide tax, legal, or accounting advice. In considering this material, you should discuss your individual circumstances with professionals in those areas before making any decisions.

¹⁵ Treas. Reg. §26.2654-1(a)(2).