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Department of the Treasury

P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:4- PLR-103755-99
Date: June 17, 1999

Re:

Legend:

Decedent	=
Date 1	=
Date 2	=
Revocable Trust	=
Daughter 1	=
Daughter 2	=
Trustees	=
d	=
e	=
f	=
g	=
h	=
i	=
j	=
k	=

We received your letter dated February 10, 1999, requesting a ruling concerning the application of § 2632 of the Internal Revenue Code to certain trusts established under the terms of an irrevocable trust agreement. This letter responds to that request.

Facts

Decedent died on Date 1, survived by her daughters (Daughter 1 and Daughter 2) and several grandchildren. Upon her death, Revocable Trust, created by Decedent during her life, became irrevocable.

Under Article V, Section 5.4(01), upon the death of Decedent, all remaining assets of the trust will be divided into two equal shares, Share A and Share B. Share A is to be held for the benefit of Daughter 1 and her issue. Share B is to be held for the benefit of Daughter 2 and her issue.

Article V, Section 5.4(02) provides that if Daughter 1 survives Decedent, assets with a value equal to f will be distributed outright to her from Share A, and the balance of Share A is to be divided into Trust A and Trust B, as follows:

(a) Such assets shall be allocated between Trust A and Trust B as follows:

(1) All property with an inclusion ratio, as defined in § 2642(a)(1), of 0% will be allocated to Trust A.

(2) All property with an inclusion ratio of 100% will be allocated to Trust B.

(3) That property which has an inclusion ratio of neither 100% nor 0% will be divided into two fractional shares, one to have an inclusion ratio of 100% which shall be allocated to Trust B, and the other to have an inclusion ratio of 0% which shall be allocated to Trust A.

The trustees are to expend for the benefit of Daughter 1 and her issue such portion of trust income and principal as they deem advisable for the education, comfort, maintenance, and general welfare of the beneficiaries.

Article V, Section 5.4(02) provides Daughter 1 with a testamentary general power of appointment over the portion of Trust B that would be subject to the Federal estate tax at less than the highest estate tax rate. The balance of Trust B and all of Trust A is to be distributed to such of Daughter 1's issue as she appoints in her will.

Additionally, under Article V, Section 5.4(02), if Daughter 1 is living on the last day of any calendar year, she may withdraw, by instrument in writing signed by her and delivered to the Trustees (other than Daughter 1) within 30 days prior to the last day of the calendar year as to which the right is exercised, an amount equal to the lesser of (1) $20,000 and (2) 5% of the then market value of the net principal of Trust B (not reduced by any income taxes chargeable to principal). Once the assets of Trust B are exhausted, Daughter 1 will have the same withdrawal power over the assets comprising Trust A.

Article V, Section 5.4(03) provides for the creation of one separate trust (Share B) for the benefit of Daughter 2. The trustees are directed to pay to, or expend for the benefit of, Daughter 2 or her issue, such part or all of the income and principal as the trustees deem necessary for the education,

comfort, maintenance, and general welfare of Daughter 2 or her issue.

Pursuant to Article V, Section 5.4(03) of the trust agreement, upon Daughter 2's death, the lesser of (1) $200,000 and (2) one-fourth of the total value of such trust assets as of the time of Daughter 2's death is to be distributed to Daughter 2's husband if he survives her. The balance of the assets will be distributed to the issue of Daughter 2 who survive her, by right of representation.

It is represented that after payment of estate taxes and other expenses, the value of the assets available for distribution to Shares A and B was d. Therefore, e was distributed to Share A and e was distributed to Share B. After the outright distribution of f to Daughter 1, i was available for distribution to Trusts A and B.

Decedent's personal representatives timely filed the Federal estate tax return on Date 2. A Schedule R was not filed with the original Federal estate tax return, but was later submitted to the examining agent during the estate tax audit. Accordingly, no allocation of GST exemption was made at the time the return was filed. However, a copy of the trust instrument was attached to the return.

It is represented that no direct skip bequests are provided for in the trust agreement and that none of Decedent's generation-skipping transfer (GST) exemption had been allocated by Decedent prior to her death (or treated as allocated with respect to a direct skip).

You have requested rulings regarding the allocation of Decedent's available GST exemption to Share A, Trust A, and Trust B, and the inclusion ratios with respect to Trust A and Trust B.

Law and Analysis

Section 2601 imposes a tax on every generation-skipping transfer. A generation-skipping transfer (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) provides that the term "skip person" means a natural person assigned to a generation that is 2 or more generations below the generation assignment of the transferor, or a trust if all interests in the trust are held by skip persons.

Under § 2602, the amount of GST tax is determined by multiplying the taxable amount by the applicable rate. Under § 2641, the applicable rate is the maximum federal estate tax rate multiplied by the inclusion ratio with respect to the transfer. Under § 2642, the inclusion ratio with respect to any transfer is one minus the applicable fraction with respect to the property. The applicable fraction is defined as a fraction, the numerator of which is the GST exemption allocated to the trust, and the denominator of which is the value of the trust at the time of the allocation.

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 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.

Under § 2632(b), if any individual makes a direct skip during his lifetime, any unused portion of the individual's GST exemption shall be allocated to the property transferred to the extent necessary to make the inclusion ratio for the property zero. If the amount of the direct skip exceeds the unused portion, the entire unused portion shall be allocated to the property transferred. The unused portion of an individual's GST exemption is that portion of the exemption that has not previously been allocated by the individual (or treated as allocated with respect to a direct skip).

Section 2632(c)(1) provides that any portion of an individual's GST exemption that has not been allocated within the time prescribed by § 2632(a) shall be deemed to be allocated as follows–

> (A) first, to property that is the subject of a direct skip occurring at the individual's death, and
>
> (B) second, to trusts with respect to which the individual is the transferor and from which a taxable distribution or a taxable termination might occur at or after the individual's death.

Section 2632(c)(2)(A) provides that the allocation under § 2632(c)(1) shall be made among the properties described in subparagraph (A) thereof and the trusts described in subparagraph (B) thereof, as the case may be, in proportion to the respective amounts (at the time of allocation) of the nonexempt portions of such properties or trusts.

Section 26.2632-1(d)(1) provides that, except as otherwise provided in this paragraph (d), an allocation of a decedent's unused GST exemption by the executor of the decedent's estate is made on the appropriate United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706 or Form 706NA) filed on or before the date prescribed for filing the return by § 6075(a) (including any extensions actually granted (the due date)). An allocation of GST exemption with respect to property included in the gross estate of a decedent is effective as of the date of death. An allocation of GST exemption to a trust (whether or not funded at the time the Form 706 or Form 706NA is filed) is effective if the notice of allocation clearly identifies the trust and the amount of the decedent's GST exemption allocated to the trust. An executor may allocate the decedent's GST exemption by use of a formula.

Section 26.2632-1(d)(2) provides that a decedent's unused GST exemption is automatically allocated on the due date for filing Form 706 or Form 706NA to the extent not otherwise allocated by the decedent's executor on or before that date. The automatic allocation occurs whether or not a return is actually required to be filed. Unused GST exemption is allocated pro rata (subject to the rules of § 26.2642-2(b)), on the basis of the value of the property as finally determined for purposes of chapter 11 (chapter 11 value), first to direct skips treated as occurring at the transferor's death. The balance, if any, of unused GST exemption is allocated pro rata (subject to the rules of § 26.2642-2(b)) on the basis of the chapter 11 value of the nonexempt portion of the trust property (or in the case of trusts that are not included in the gross estate, on the basis of the date of death value of the trust) to trusts with respect to which a taxable termination may occur or from which a taxable distribution may be made. The automatic allocation of GST exemption is irrevocable, and an allocation made by the executor after the automatic allocation is made is ineffective. No automatic allocation of GST exemption is made to a trust that will have a new transferor with respect to the entire trust prior to the occurrence of any GST with respect to the trust.

The first issue is whether the language of the trust agreement, which was attached to the federal estate tax return, provided sufficient information to constitute a notice of allocation of the Decedent's remaining GST exemption. A decedent's GST exemption may be allocated to direct skips on Line

6 of either Part 2 or Part 3 of Schedule R of Form 706. Otherwise, the exemption is allocated on Part 1 of Schedule R of Form 706. The instructions for Schedule R (Form 706) state that in order to avoid the application of the deemed allocation rules, Form 706 and Schedule R should be filed to allocate the GST exemption to trusts that may later have taxable terminations or distributions under § 2612, even if the form is not required to be filed to report estate or GST tax.

The instructions for Part 1, Line 9 of Schedule R (Form 706) applicable for the return filed by the executor of the decedent's estate state:

> Line 9 is used to allocate the remaining unused GST exemption (from line 8) and to help compute the trust's inclusion ratio. Line 9 is also a Notice of Allocation for allocating the GST exemption to trusts as to which the decedent is the transferor and from which a generation-skipping transfer could occur after the decedent's death. If line 9 is not completed, the deemed allocation at death rules will apply to allocate the decedent's remaining unused GST exemption, first to property that is the subject of a direct skip occurring at the decedent's death, and then to trusts as to which the decedent is the transferor. If you wish to avoid the application of the deemed allocation rules, you should enter on line 9 every trust to which you wish to allocate any part of the decedent's GST exemption. Unless you enter a trust on line 9, the unused GST exemption will be allocated to it under the deemed allocation rules.

In this case, the executors did not comply with the instructions on Form 706. A Schedule R was not filed with the Form 706. However, literal compliance with the procedural instructions to make an election is not always required. See Hewlett-Packard Company v. Commissioner, 67 T.C. 736 (1977), acq. in result, 1979-1 C.B. 1. Thus, an allocation that does not strictly comply with the instructions on Form 706, or the applicable regulations, will be deemed valid if the information on the return is sufficient to indicate that the executor intended to make an allocation of GST exemption.

In this case, the personal representatives attached a copy of the trust document to the federal estate tax return that was filed. Although the trust agreement identified the trusts to be created (Share A and Share B), the trust agreement was silent regarding allocation of GST exemption between Share A and Share B. Therefore, the automatic allocation rules of § 2632 apply with respect to the allocation of Decedent's GST exemption between Share A and Share B.

Pursuant to Article V, Section 5.4(01) of the trust agreement, the Trustees were directed to divide the remaining trust assets into two trusts (Share A and Share B) of equal value. In addition, Article V, Section 5.4(02) provides that if Daughter 1 survives Decedent, assets with a value equal to f will be distributed outright to her from the assets so allocated for her benefit. Under § 26.2654-1(a)(1)(ii), this outright pecuniary bequest of f payable immediately to Daughter 1 from Share A constitutes a separate trust for GST purposes. Accordingly, under the automatic allocation rules of § 2632, Decedent's $1,000,000 GST exemption is allocated pro rata between Share A (valued at i) and Share B (valued at e). Therefore, a greater portion of the GST exemption is allocated to Share B than to Share A. Decedent's $1,000,000 GST exemption will be allocated h to Share A (i/j x $1,000,000) and k to Share B (e/j x $1,000,000).

While the trust agreement is silent regarding the allocation of GST exemption between Share A and Share B (thereby triggering the automatic allocation rules of § 2632), the agreement expresses the intent of the grantor and fiduciary to divide Share A into two trusts, one having an inclusion ratio of zero (Trust A) and the other having an inclusion ratio of one (Trust B). The trust agreement attached to the federal estate tax return contains sufficient information to constitute substantial compliance with the requirements for making an allocation with respect to Trust A and Trust B. The GST exemption is allocated between Trust A and Trust B so that Trust A has an inclusion ratio of zero and Trust B has an inclusion ratio of one. Trust A is to be funded with that fraction of the date of distribution value of Share A, the numerator of which is h and the denominator of which is i. Trust B is funded with the balance. The inclusion ratio with respect to Trust A will be zero, and the inclusion ratio with respect to Trust B will be one.

Except as specifically ruled herein, we express no opinion as to the consequences of this transaction under the cited provisions of the Code or under any other provisions of the Code.

This 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,

Assistant Chief Counsel
(Passthroughs and Special Industries)

By_____

George Masnik
Chief, Branch 4

Enclosure
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