**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

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Legend

Taxpayers:

Trust 1 =

Trust 2 =

Partnership =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Year 6 = 1998

Date A =

$x =

$y =

$z =

Dear :

We received your letter, dated December 6, 1999, requesting rulings regarding the allocations of generation-skipping transfer tax exemptions to certain inter vivos trusts created by Taxpayers. This letter responds to that request.

Facts

You represent the facts to be as follows:

In Year 1, Taxpayers, husband and wife, created an irrevocable trust, Trust 1, for the benefit of their two living children and for any children subsequently born to or legally adopted by them.

Under Article 4 of the trust instrument, the beneficiaries are given the right to withdraw from the principal of the trust at the time of its creation and at the time of any subsequent contribution. The amount which may be withdrawn by any beneficiary in any calendar year is limited by (1) the amount of the contribution divided by the number of trust beneficiaries and (2) the annual exclusion amount under § 2503(b) of the Internal Revenue Code. The total amount which may be withdrawn under Article 4 is cumulative, provided that on December 31 of each year, the total amount which may be withdrawn by each beneficiary is to be reduced by the greater of $5,000 or 5 percent of the trust principal on that date.

The trust instrument provides, at Article 5, that the trustee, in the trustee's sole and absolute discretion, may accumulate and retain income, in whole or in part, or may distribute to the Taxpayers' children and the children's issue such amounts of income or corpus, or both, as in the sole and absolute discretion of the trustee are in the best interest of such distributees. However, no distribution of income or corpus may be made to or for the benefit of the Taxpayers or to a beneficiary in discharge of the Taxpayers' legal obligation of support.

Article 5 further provides that following the 35th birthday of Taxpayers' youngest child, the trustee is to divide the trust into equal shares: one share for each living child and one share for each deceased child survived by issue. Each share is to be held as a separate trust.

During the term of a separate trust created for a living child of the Taxpayers, the trustee, in the trustee's sole and absolute discretion, may accumulate and retain income in whole or in part, or may distribute to the child for whom the trust was created and that child's issue such amounts of income or corpus, or both, as in the sole and absolute discretion of the trustee are in the best interest of such distributees.

Upon the death of a child, the trustee is to distribute the child's share in such proportions and in such manner, outright or in trust, to or for the benefit of any one or more of Taxpayers' issue as the child appoints by will. In default of a child's exercise of this testamentary limited power of appointment, the child's share is to be distributed to the child's living issue or, if none, to Taxpayers' living issue or, if none, to Taxpayers' heirs.

In the case of a separate trust created for the descendants of a deceased child of Taxpayers, such trust shall terminate and its assets shall be distributed outright to the deceased child's issue.

Article 7 of the trust instrument provides that Trust 1 and all trusts created thereunder shall terminate no later than 21 years after the death of Taxpayers and Taxpayers' descendants who are living at the time of the creation of Trust 1.

In Year 1, Taxpayers transferred shares of stock to Trust 1 and timely reported the gift on their respective Forms 709, Schedules A and C, which were prepared by Taxpayers' accountants. Taxpayers listed the gifts on Part 2 of Schedule A as direct skips, rather than on Part 1 of Schedule A as gifts subject only to gift tax. Taxpayers allocated an amount of their GST exemption equal to the reported value of the transferred property on Line 4, Part 2 of Schedule C, rather than attaching a notice of allocation as instructed on Line 5, Part 2 of Schedule C.

In Year 2, Taxpayers created a limited partnership (Partnership) and transferred shares of stock to the Partnership. In return, each Taxpayer received a 1-percent general partnership interest and a 49-percent limited partnership interest in the Partnership. Also in Year 2, Taxpayers made a gift of their 98-percent limited partnership interest in the Partnership to Trust 1 and timely reported the gift on their respective Forms 709, which were prepared by Taxpayers' accountants. Taxpayers listed the gifts on Part 2 of Schedule A as direct skips, rather than on Part 1 of Schedule A as gifts subject only to gift tax. Taxpayers allocated an amount of their GST exemption equal to the reported value of the transferred property on Line 4, Part 2 of Schedule C, rather than attaching a notice of allocation as instructed on Line 5, Part 2 of Schedule C.

In Year 3, Taxpayers created another irrevocable trust, Trust 2, for the benefit of their living children and for any children subsequently born to or legally adopted by them.

Under Article 4 of the trust instrument, the beneficiaries are given the right to withdraw from the principal of the trust at the time of its creation and at the time of any subsequent contribution. The amount which may be withdrawn by any beneficiary in any calendar year is limited by (1) the amount of the contribution divided by the number of trust beneficiaries and (2) the annual exclusion amount under § 2503(b) of the Code. The withdrawal right is noncumulative and lapses if not exercised within the 45-day period following notice to the beneficiaries by the trustee of the contribution to the trust.

Article 5 of the trust instrument provides that during the term of the trust, the trustee may distribute to or for the Taxpayers' children and the children's issue only such amounts of income and/or corpus which are necessary to provide for such distributee's health, education, support and maintenance in order to maintain them in

accordance with their accustomed manner of living. No distribution of income or corpus may be made to or for the benefit of the Taxpayers, and no distribution may be made in a manner that discharges a legal obligation (including a legal obligation of support) of any person other than the beneficiary to whom the distribution is made.

Article 5 further provides that following the second anniversary of the death of the second Taxpayer to die, the trustee is to divide the trust into equal shares: one share for each living child of Taxpayers and one share for each deceased child who is survived by issue. Each share is to be held as a separate trust.

During the term of a separate trust created for a living child of the Taxpayers, the trustee may distribute to or for the child and such child's issue only such amounts of income and/or corpus which are necessary to provide for such distributee's health, education, support and maintenance in order to maintain them in accordance with their accustomed manner of living. No distributions can be made in a manner that discharges a legal obligation (including a legal obligation of support) of any person other than the beneficiary to whom the distribution is made.

When a child reaches age 30, one-third of such child's share is to be transferred to him or her. When a child reaches age 35, one-half of such child's share as it then exists is to be transferred to him or her, and when a child reaches age 40, the balance of such child's share is to be transferred to him or her. If a child dies prior to receiving all of his or her share, the assets of his or her trust are to be distributed by the trustee in such manner, outright or in trust or otherwise, to or for the benefit of anyone, including such child's estate, his or her creditors or the creditors of his or her estate, as such child appoints by will. In default of a child's exercise of this testamentary general power of appointment, the child's trust assets are to be distributed to the child's living issue or, if none, to Taxpayers' living issue or, if none, to Taxpayers' heirs.

In the case of a separate trust created for the descendants of a deceased child of Taxpayers, such trust shall terminate and its assets shall be distributed in such manner, outright or in trust or otherwise, to or for the benefit of anyone, including such child's estate, his or her creditors or the creditors of his or her estate, as such child shall have appointed by will. In default of a child's exercise of this testamentary general power of appointment, the deceased child's trust shall be distributed to such child's living issue or, if none, to Taxpayers' living issue or, if none, to Taxpayers' heirs.

Article 7 of the trust instrument provides that all trusts created pursuant to the trust instrument shall terminate no later than 21 years after the death of the Taxpayers and the Taxpayers' descendants who are living at the time of the creation of Trust 2.

In Year 3, Taxpayers transferred cash to Trust 2 and timely reported the gift on their respective Forms 709, which were prepared by Taxpayers' accountants. Taxpayers listed the gifts on Part 2 of Schedule A as direct skips, rather than on Part 1 of Schedule A as gifts subject only to gift tax. Taxpayers allocated an amount of their

GST exemption equal to the reported value of the transferred property on Line 4, Part 2 of Schedule C, rather than attaching a notice of allocation as instructed on Line 5, Part 2 of Schedule C.

In Year 4, Taxpayers transferred shares of stock to the Partnership. The transfer constituted a gift to Trust 1, which owned a 98-percent limited partnership interest in the Partnership. Taxpayers timely reported the gift to Trust 1 on their respective Forms 709, which were prepared by Taxpayers' accountants. Taxpayers listed the gifts on Part 2 of Schedule A as direct skips, rather than on Part 1 of Schedule A as gifts subject only to gift tax. Taxpayers allocated an amount of their GST exemption equal to the reported value of the transferred property on Line 4, Part 2 of Schedule C, rather than attaching a notice of allocation as instructed on Line 5 , Part 2 of Schedule C.

In Year 5, Taxpayers transferred additional shares of stock to the Partnership, and the transfer constituted a gift to Trust 1. Taxpayers timely reported the gift on their respective Forms 709, which were prepared by Taxpayers' accountants. Taxpayers reported the value of the gift as the value of the property transferred, minus $20,000, for which they claimed the annual exclusion under § 2503(b). Taxpayers listed the gifts on Part 2 of Schedule A as direct skips, rather than on Part 1 of Schedule A as gifts subject only to gift tax. Taxpayers allocated an amount of their GST exemption equal to the reported value of the property transferred, minus $20,000, on Line 4, Part 2 of Schedule C, rather than attaching a notice of allocation as instructed on Line 5, Part 2 of Schedule C.

In Year 6, Taxpayers transferred additional shares of stock to the Partnership, and the transfer constituted a gift to Trust 1. Taxpayers timely reported the gift on their respective Forms 709, which were prepared by Taxpayers' accountants. Taxpayers listed the gifts on Part 1 of Schedule A as gifts subject only to gift tax. Taxpayers allocated an amount of their GST exemption equal to the reported value of the transferred property by attaching a notice of allocation as instructed on Line 5, Part 2 of Schedule C. In addition, on their timely filed gift tax returns for Year 6, Taxpayers made late allocations of their GST exemptions to Trust 1 in the amount of $x in order to rectify the error of reducing the amount of the allocations by $20,000 on their gift tax returns for Year 5.

You request the following rulings:

1. Taxpayers substantially complied with the requirements for making timely allocations of their generation-skipping transfer tax exemptions to the transfers made to Trust 1 as reported on their gift tax returns for Year 1, Year 2, Year 4, and Year 5.

2. Taxpayers substantially complied with the requirements for making timely allocations of their generation-skipping transfer tax exemptions to the transfer made to Trust 2 as reported on their gift tax returns for Year 3.

3. Taxpayers each made a late allocation of their generation-skipping transfer tax exemptions (effective as of the Date A filing date for their Year 6 gift tax returns, which included such notices of late allocation) in the amount of the transfers made to Trust 1 in Year 5 for which generation-skipping transfer tax exemptions had not been timely allocated by the Taxpayers, and therefore have effectively made the inclusion ratio for Trust 1 equal zero.

Law and Analysis

Section 2601 imposes a tax on every generation-skipping transfer (GST). A GST is defined under § 2611(a) as (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Section 2612(a) defines “taxable termination” as the termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in a trust unless (A) immediately after such termination, a non-skip person has an interest in such property, or (B) at no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person.

Section 2612(b) defines “taxable distribution” as any distribution from a trust to a skip person (other than a taxable termination or a direct skip).

Section 2612(c)(1) provides that the term "direct skip" means a transfer subject to a tax imposed by chapter 11 (the estate tax) or chapter 12 (the gift tax) 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.

Section 2652(a)(1) provides that, in general, the term transferor means the decedent in the case of any property subject to the estate tax, or the donor in the case of any property subject to the gift tax. Section 2652(a)(1) further provides that an individual shall be treated as transferring any property with respect to which such individual is the transferor.

Section 2613(a)(2) provides that the term “skip person” means a trust 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 (including distributions at the termination of the trust) may be made from the trust 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).

In the present case, the transfers by Taxpayers to Trust 1 and Trust 2 during the years at issue were not direct skips as defined in § 2612(c)(1) because non-skip persons, i.e., the Taxpayers' children are current beneficiaries of the trusts. However, Taxpayers' grandchildren are also current beneficiaries of the trusts. Therefore, any distributions from the trusts to them would be subject to the GST tax as taxable distributions. Moreover, with respect to Trust 1, upon the death of a child of the Taxpayers, that child's separate share might pass, either pursuant to the child's exercise of a testamentary limited power of appointment, or, in default of the exercise, pursuant to the Trust 1 terms, to persons who would be skip persons with reference to the Taxpayers. Also with respect to Trust 1, if there are issue surviving a deceased child of the Taxpayers at the time Trust 1 is to be divided into separate shares, the deceased child's surviving issue, who are skip persons with reference to the Taxpayers, will take their parent's share. These transfers to skip persons would be taxable terminations.

Under § 2602, the amount of the GST tax is determined by multiplying the "taxable amount" by the "applicable rate." The taxable amount in the case of a taxable distribution is determined under § 2621; the taxable amount in the case of a taxable termination is determined under § 2622; and the taxable amount in the case of a direct skip is determined under § 2623.

Under § 2641(a), the applicable rate with respect to any GST is the product of the "maximum federal estate tax rate" and the "inclusion ratio" with respect to the transfer.

Section 2641(b) defines the term maximum federal estate tax rate as the maximum rate imposed by § 2001 on the estates of decedents dying at the time of the taxable distribution, taxable termination, or direct skip, as the case may be.

Section 2642(a) defines the inclusion ratio, with respect to any property transferred in a GST, as the excess of 1 over the applicable fraction with respect to the trust from which the transfer is made. 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 (as reduced by certain values not relevant to this case).

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.

Rulings 1 and 2

In the present case, as discussed above, Taxpayers' transfers to Trust 1 and Trust 2 were not direct skips as defined in § 2612(c)(1).

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 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. 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.

Section 26.2632-1(b)(2)(ii)(A)(1) 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.

Generally, the instructions for Form 709 applicable for the returns filed by 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 and greatgrandchildren as future beneficiaries, the transfer was not a direct skip because 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. Since 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 the 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, Taxpayers did not literally comply with the instructions on Form 709. For Year 1, Year 2, Year 4, and Year 5, Taxpayers reported gifts to Trust 1 on Part 2 of Schedule A as direct skips, subject to both the GST tax and the gift tax, rather than on Part 1 of Schedule A as gifts subject only to gift tax. For each transfer, the Taxpayers allocated an amount of their generation-skipping transfer tax exemption equal to the reported value of the transferred property (except for the Year 5 transfer in which they reduced the amount allocated by $20,000) so that Trust 1 would have an inclusion ratio for generation-skipping transfer tax purposes equal to zero. Taxpayers, however, made all allocations on Line 4, Part 2 of Schedule C and did not attach notices of allocation as instructed on Line 5, Part 2 of Schedule C. For Year 3, Taxpayers reported a gift to Trust 2 in the same manner that they reported the gifts to Trust 1.

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 a taxpayer intended to allocate the taxpayer's exemption to the trust.

We believe that there is sufficient information provided on Taxpayers' gift tax returns to conclude that Taxpayers intended to allocate their GST exemptions and, therefore, conclude as follows:

1. The Taxpayers substantially complied with the requirements for making timely allocations of their generation-skipping transfer tax exemptions to the transfers made to Trust 1 as reported on their gift tax returns for Year 1, Year 2, Year 4, and Year 5.

2. The Taxpayers substantially complied with the requirements for making timely allocations of their generation-skipping transfer tax exemption to the transfer made to Trust 2 as reported on their gift tax returns for Year 3.

Ruling 3

Section 2642(d) provides special rules with respect to the inclusion ratio where more than one transfer is made to a trust. Generally, if a transfer of property is made to a trust in existence before such transfer, the applicable fraction for such trust is recomputed as of the time of such transfer. Under § 2642(d)(2), the recomputed applicable fraction is a fraction:

(A) the numerator of which is the sum of–
(i) the amount of the GST exemption allocated to property involved in such transfer, plus
(ii) the nontax portion of such trust immediately before such transfer, and

(B) the denominator of which is the sum of–
(i) the value of the property involved in such transfer reduced by 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, and
(ii) the value of all of the property in the trust (immediately before such transfer).

Section 2642(d)(3) defines the term nontax portion as the product of (A) the value of all the property in the trust, and (B) the applicable fraction in effect for such trust.

Section 2642(d)(4) provides that if any allocation of the GST exemption to property transferred to a trust is not made on a timely filed gift tax return and there was a previous allocation with respect to property transferred to such trust, the applicable fraction for such trust shall be recomputed as of the time of such allocation under rules similar to the rules of § 2642(d)(2).

Section 26.2642-2(a)(2) provides that if a transferor makes a late allocation of GST exemption to a trust, for purposes of determining the denominator of the applicable fraction, the value of the property transferred to the trust is the fair market value of the trust assets determined on the effective date of the allocation of GST exemption. In most cases, if a transferor makes a late allocation of GST exemption to a trust, the transferor may, solely for purposes of determining the fair market value of the trust assets, elect to treat the allocation as having been made on the first day of the month during which the late allocation is made (valuation date). An allocation subject to such election is not effective until it is actually filed with the Internal Revenue Service. The election is made by stating on the Form 709 on which the allocation is made–(i) that the election is being made; (ii) the applicable valuation date; and (iii) the fair market value of the trust assets on the valuation date.

Section 26.2632-1(b)(2)(ii)(A)(1) provides that an allocation to a trust made on a Form 709 filed after the due date for reporting the transfer to the 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.

In the present case, Taxpayers made late allocations of their GST exemptions to Trust 1 on their timely filed Forms 709 for Year 6. The allocations were made by means of a formula allocation on a notice of allocation attached to the returns. Taxpayers elected to treat the late allocations as having been made as of the first day of the month in which they filed the returns for purposes of valuing the Trust 1 assets in order to determine the inclusion ratio. It is represented that the value of the Trust 1 assets on the valuation date was $x, and the nontax amount was $y. Under the formula, Taxpayers made late allocations to Trust 1 in the total amount of $z.

Based on the facts submitted and representations made, we conclude that:

3. Taxpayers each made a late allocation of their generation-skipping transfer tax exemptions (effective as of the Date A filing date for their Year 6 gift tax returns) in the amount which effectively makes the inclusion ratio for Trust 1 equal zero.

Except as ruled above, we express or imply no opinion concerning the federal tax consequences of these transactions under the cited provisions of the Code or any other provision of the Code or regulations. In addition, we are expressing no opinion regarding the value of the transfers to Trust 1 or Trust 2, or whether any of the transfers qualified for the annual exclusion under § 2503(b).

The rulings contained in this letter are based upon information and representations submitted by Taxpayers 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 Taxpayers who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely yours,
Assistant Chief Counsel
(Passthroughs and Special Industries)
By Katherine A. Mellody
Senior Technician Reviewer
Branch 4

Enclosure
Copy for section 6110 purposes