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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 26

TD 9214

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Predeceased Parent Rule

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the predeceased parent rule, which provides an exception to the general rules of section 2651 of the Internal Revenue Code (Code) for determining the generation assignment of a transferee of property for generation-skipping transfer (GST) tax purposes. These regulations also provide rules regarding a transferee assigned to more than one generation. The regulations reflect changes to the law made by the Taxpayer Relief Act of 1997 and generally apply to individuals, trusts, and estates.

DATES: Effective Date: These regulations are effective July 18, 2005.

FOR FURTHER INFORMATION CONTACT: Lian A. Mito at (202) 622-7830 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On September 3, 2004, a notice of proposed rulemaking (REG-145988-03) relating to the predeceased parent rule was published in the **Federal Register** (69 FR 53862).

The public hearing scheduled for December 14, 2004, was cancelled because no requests to speak were received. Written comments responding to the notice of proposed rulemaking were received. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision. The revisions are discussed below.

Summary of Comments

The proposed regulations provided that, for purposes of determining whether the predeceased parent rule applies, an individual transferee's interest in property is established or derived at the time the transferor who transferred the property is subject to either the gift or estate tax on the property. If the transferor will be subject to a transfer tax imposed on the property transferred on more than one occasion, then the relevant time for determining whether the predeceased parent rule applies is the earliest time at which the transferor is subject to the gift or estate tax. In the case of a trust for which an election under section 2056(b)(7) (QTIP election) has been made, the proposed regulations provided that the interest of the remainder beneficiary is considered as established or derived when the QTIP trust was established. However, the proposed regulations also included an exception to this general rule by providing that, to the extent of the QTIP (but not a reverse QTIP) election, the remainder beneficiary's interest is deemed to have been established or derived on the death of the transferor's spouse (the income beneficiary), rather than on the transferor's earlier death.

One commentator indicated that this exception is unnecessary. The commentator believes that the proposed regulations misinterpreted the statute because

a remainder beneficiary's interest in a trust that is subject to a QTIP (but not a reverse QTIP) election should always be deemed to have been established, not at the time of the trust's creation, but rather at the time when the income-beneficiary spouse is first subject to gift or estate tax on the trust property. This position applies the definition of "transferor" in section 2652 in the context of the reference to "established and derived" in section 2651(e), and is based on the conclusion that the tax in this situation is not imposed on the same transferor on more than one occasion. Thus, because the donee or surviving spouse becomes the transferor of a trust that is subject to a QTIP (but not reverse QTIP) election, the remainder beneficiary's interest in such a trust is established upon that spouse's gift of an interest in the trust or that spouse's death, in each case the time at which gift or estate tax on the trust is first imposed on that spouse. Viewed from this perspective, this provision of the proposed regulations is not an exception. The Treasury Department and the IRS agree, and the final regulations adopt the suggested change.

Under the proposed regulations, the predeceased parent rule does not apply to transfers to collateral heirs if, at the time of the transfer, "the transferor (or the transferor's spouse or former spouse) has any living lineal descendant." Thus, under the proposed regulations, if, at the time of the transfer, the transferor has no living lineal descendants but the transferor's spouse or former spouse does, the predeceased parent rule will not apply to any transfer by the transferor to a collateral heir. A number of commentators pointed out that the parenthetical language is inconsistent with the purpose and language of the statute, and will inappropriately narrow the application of the predeceased parent rule with respect to collateral heirs. The Treasury Department

and the IRS agree, and the parenthetical language is removed in the final regulations. Accordingly, the final regulations require that, for the predeceased parent rule to apply to transfers to collateral heirs, only the transferor must have no living lineal descendants at the time of the transfer.

The proposed regulations provided an exception to the general rule that assigns an individual to the youngest of the generations to which that individual may be assigned. Under the exception, an adopted individual will be treated as a member of the generation that is one generation below the adoptive parent for purposes of determining whether a transfer to the adopted individual from the adoptive parent (or the spouse or former spouse of the adoptive parent, or a lineal descendant of a grandparent of the adoptive parent) is subject to the GST tax. The proposed regulations defined an “adopted individual” as an individual who is: (1) a descendant of a parent of the adoptive parent (or the spouse or former spouse of the adoptive parent); and (2) under the age of 18 at the time of the adoption.

Two commentators expressed concern that this objective test (specifically, the age at the time of the adoption) provides a strong inducement to engage in a tax-motivated adoption, particularly in the case of older minors, because of the amount of GST tax that thereby may be avoided. One commentator suggested lowering the limit on the age of the individual at the time of the adoption for purposes of the test. The other commentator recommended adding a third element to the definition of adopted individual, namely, that the individual was not adopted primarily for tax-avoidance purposes.

The Treasury Department and the IRS continue to believe that certain adopted minors should be treated as a member of the generation that is one generation below the adoptive parent, but only if the adoption is not primarily for the purpose of avoiding GST tax. Therefore, under the final regulations, the adopted individual will be treated as a member of the generation that is one generation below the adoptive parent for purposes of determining whether transfers from certain individuals to the adopted individual are subject to GST tax if the following requirements are satisfied: (1) the individual is legally adopted by the adoptive parent; (2) the individual is a descendant of a parent of the adoptive parent (or the adoptive parent's spouse or former spouse); (3) the individual is under the age of 18 at the time of the adoption; and (4) the individual is not adopted primarily for GST tax-avoidance purposes. The determination of whether an adoption is primarily for GST tax-avoidance purposes is to be made based upon all of the facts and circumstances. The Treasury Department and IRS believe that the most significant factor to be considered is whether there is a bona fide parent/child relationship between the adoptive parent and the adopted individual. Other factors that may be considered include (but are not limited to): the age of the adopted individual at the time of the adoption, and the relationship between the adopted individual and the individual's parents immediately before the adoption. Thus, the adoption of an infant will be less likely to be considered primarily for tax-avoidance purposes than the adoption of an individual who is age 17. Objective evidence that the parent was unwilling or unable to act as the individual's parent (e.g., the parent abandons the individual, or is adjudicated incompetent or incapacitated) may indicate that an adoption is not primarily for tax-avoidance purposes.

One commentator suggested clarifying the interaction between section 2651(b)(3), regarding the treatment of legal adoptions, and section 2651(f)(1), regarding individuals assigned to more than one generation. 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. Specifically, an individual who has been adopted will be treated as a blood relative of the adoptive parent under section 2651(b)(3) and generally is treated as a child of the adoptive parent under state law. 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 §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.

The proposed regulations provided that any individual who dies no later than 90 days after a transfer is treated as having predeceased the transferor. One commentator recommended that the final regulations apply this 90-day rule to inter vivos, as well as testamentary, transfers. The 90-day rule is intended to replace a similar 90-day rule in §26.2612-1(a)(2), which is limited to testamentary transfers. Moreover, many state statutes contain similar rules that apply only to testamentary transfers. Accordingly, the final regulations do not adopt this recommendation, and revise the language of this

provision to confirm that it addresses only transfers occurring by reason of the death of the transferor.

Two commentators requested confirmation that the reference to adoption in §26.2651-2(b) applies solely for purposes of the rule in section 2651(f)(1) and has no application to the rule in section 2651(b). Accordingly, the introductory language of §26.2651-2(b) has been revised.

Special Analyses

It has been determined that these proposed regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small entities.

Drafting Information

The principal author of these regulations is Lian A. Mito of the Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 26

Estate taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 26 is amended as follows:

PART 26--GENERATION-SKIPPING TRANSFER TAX REGULATIONS UNDER THE
TAX REFORM ACT OF 1986

Paragraph 1. The authority citation for part 26 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In §26.2600-1, the table is amended by:

1. Removing the entries for §26.2612-1, paragraphs (a)(1) and (a)(2).
2. Adding entries for §§26.2651-1, 26.2651-2, and 26.2651-3.

The additions read as follows:

§26.2600-1 Table of contents.

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§26.2651-1 Generation assignment.

- (a) Special rule for persons with a deceased parent.
 - (1) In general.
 - (2) Special rules.
 - (3) Established or derived.
 - (4) Special rule in the case of additional contributions to a trust.
- (b) Limited application to collateral heirs.
- (c) Examples.

§26.2651-2 Individual assigned to more than one generation.

- (a) In general.
- (b) Exception.
- (c) Special rules.
 - (1) Corresponding generation adjustment.
 - (2) Continued application of generation assignment.
- (d) Example.

§26.2651-3 Effective dates.

- (a) In general.
- (b) Transition rule.

Par. 3. Section 26.2612-1 is amended by:

1. Removing the paragraph designation and heading for (a)(1).
2. Removing paragraph (a)(2).
3. Removing the second sentence of paragraph (f) introductory text.
4. Removing Examples 6 and 7 in paragraph (f).
5. Redesignating Examples 8 through 15 as Examples 6 through 13 in paragraph (f).
6. Revising the first sentence of newly designated Example 7 in paragraph (f).
7. Revising the first sentence of newly designated Example 11 in paragraph (f).

The revisions read as follows:

§26.2612-1 Definitions.

* * * * *

(f) * * *

Example 7. Taxable termination resulting from distribution. The facts are the same as in Example 6, except twenty years after C's death the trustee exercises its discretionary power and distributes the entire principal to GGC. * * *

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Example 11. Exercise of withdrawal right as taxable distribution. The facts are the same as in Example 10, except GC holds a continuing right to withdraw trust principal and after one year GC withdraws \$10,000. * * *

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Par. 4. Sections 26.2651-1, 26.2651-2 and 26.2651-3 are added to read as follows:

§26.2651-1 Generation assignment.

(a) Special rule for persons with a deceased parent--(1) In general. This paragraph (a) applies for purposes of determining whether a transfer to or for the benefit of an individual who is a descendant of a parent of the transferor (or the transferor's spouse or former spouse) is a generation-skipping transfer. If that individual's parent, who is a lineal descendant of the parent of the transferor (or the transferor's spouse or former spouse), is deceased at the time the transfer (from which an interest of such individual is established or derived) is subject to the tax imposed on the transferor by chapter 11 or 12 of the Internal Revenue Code, the individual is treated as if that individual were a member of the generation that is one generation below the lower of--

(i) The transferor's generation; or

(ii) The generation assignment of the individual's youngest living lineal ancestor who is also a descendant of the parent of the transferor (or the transferor's spouse or former spouse).

(2) Special rules--(i) Corresponding generation adjustment. If an individual's generation assignment is adjusted with respect to a transfer in accordance with paragraph (a)(1) of this section, a corresponding adjustment with respect to that transfer is made to the generation assignment of each--

(A) Spouse or former spouse of that individual;

(B) Descendant of that individual; and

(C) Spouse or former spouse of each descendant of that individual.

(ii) Continued application of generation assignment. If a transfer to a trust would be a generation-skipping transfer but for paragraph (a)(1) of this section, any generation assignment determined under this paragraph (a) continues to apply in determining whether any subsequent distribution from (or termination of an interest in) the portion of the trust attributable to that transfer is a generation-skipping transfer.

(iii) Ninety-day rule. For purposes of paragraph (a)(1) of this section, any individual who dies no later than 90 days after a transfer occurring by reason of the death of the transferor is treated as having predeceased the transferor.

(iv) Local law. A living person is not treated as having predeceased the transferor solely by reason of a provision of applicable local law; e.g., an individual who disclaims is not treated as a predeceased parent solely because state law treats a disclaimant as having predeceased the transferor for purposes of determining the disposition of the disclaimed property.

(3) Established or derived. For purposes of section 2651(e) and paragraph (a)(1) of this section, an individual's interest is established or derived at the time the transferor is subject to transfer tax on the property. See §26.2652-1(a) for the definition of a transferor. If the same transferor, on more than one occasion, is subject to transfer tax imposed by either chapter 11 or 12 of the Internal Revenue Code on the property so transferred (whether the same property, reinvestments thereof, income thereon, or any or all of these), then the relevant time for determining whether paragraph (a)(1) of this section applies is the earliest time at which the transferor is subject to the tax imposed by either chapter 11 or 12 of the Internal Revenue Code. For purposes of section 2651(e) and paragraph (a)(1) of this section, the interest of a remainder beneficiary of a

trust for which an election under section 2523(f) or section 2056(b)(7) (QTIP election) has been made will be deemed to have been established or derived, to the extent of the QTIP election, on the date as of which the value of the trust corpus is first subject to tax under section 2519 or section 2044. The preceding sentence does not apply to a trust, however, to the extent that an election under section 2652(a)(3) (reverse QTIP election) has been made for the trust because, to the extent of a reverse QTIP election, the spouse who established the trust will remain the transferor of the trust for generation-skipping transfer tax purposes.

(4) Special rule in the case of additional contributions to a trust. If a transferor referred to in paragraph (a)(1) of this section contributes additional property to a trust that existed before the application of paragraph (a)(1), then the additional property is treated as being held in a separate trust for purposes of chapter 13 of the Internal Revenue Code. The provisions of §26.2654-1(a)(2), regarding treatment as separate trusts, apply as if different transferors had contributed to the separate portions of the single trust. Additional subsequent contributions from that transferor will be added to the new share that is treated as a separate trust.

(b) Limited application to collateral heirs. Paragraph (a) of this section does not apply in the case of a transfer to any individual who is not a lineal descendant of the transferor (or the transferor's spouse or former spouse) if the transferor has any living lineal descendant at the time of the transfer.

(c) Examples. The following examples illustrate the provisions of this section:

Example 1. T establishes an irrevocable trust, Trust, providing that trust income is to be paid to T's grandchild, GC, for 5 years. At the end of the 5-year period or on GC's prior death, Trust is to terminate and the principal is to be distributed to GC if GC

is living or to GC's children if GC has died. The transfer that occurred on the creation of the trust is subject to the tax imposed by chapter 12 of the Internal Revenue Code and, at the time of the transfer, T's child, C, who is a parent of GC, is deceased. GC is treated as a member of the generation that is one generation below T's generation. As a result, GC is not a skip person and Trust is not a skip person. Therefore, the transfer to Trust is not a direct skip. Similarly, distributions to GC during the term of Trust and at the termination of Trust will not be GSTs.

Example 2. On January 1, 2004, T transfers \$100,000 to an irrevocable inter vivos trust that provides T with an annuity payable for four years or until T's prior death. The annuity satisfies the definition of a qualified interest under section 2702(b). When the trust terminates, the corpus is to be paid to T's grandchild, GC. The transfer is subject to the tax imposed by chapter 12 of the Internal Revenue Code and, at the time of the transfer, T's child, C, who is a parent of GC, is living. C dies in 2006. In this case, C was alive at the time the transfer by T was subject to the tax imposed by chapter 12 of the Internal Revenue Code. Therefore, section 2651(e) and paragraph (a)(1) of this section do not apply. When the trust subsequently terminates, the distribution to GC is a taxable termination that is subject to the GST tax to the extent the trust has an inclusion ratio greater than zero. See section 2642(a).

Example 3. T dies testate in 2002, survived by T's spouse, S, their children, C1 and C2, and C1's child, GC. Under the terms of T's will, a trust is established for the benefit of S and of T and S's descendants. Under the terms of the trust, all income is payable to S during S's lifetime and the trustee may distribute trust corpus for S's health, support and maintenance. At S's death, the corpus is to be distributed, outright, to C1 and C2. If either C1 or C2 has predeceased S, the deceased child's share of the corpus is to be distributed to that child's then-living descendants, per stirpes. The executor of T's estate makes the election under section 2056(b)(7) to treat the trust property as qualified terminable interest property (QTIP) but does not make the election under section 2652(a)(3) (reverse QTIP election). In 2003, C1 dies survived by S and GC. In 2004, S dies, and the trust terminates. The full fair market value of the trust is includible in S's gross estate under section 2044 and S becomes the transferor of the trust under section 2652(a)(1)(A). GC's interest is considered established or derived at S's death, and because C1 is deceased at that time, GC is treated as a member of the generation that is one generation below the generation of the transferor, S. As a result, GC is not a skip person and the transfer to GC is not a direct skip.

Example 4. The facts are the same as in Example 3. However, the executor of T's estate makes the election under section 2652(a)(3) (reverse QTIP election) for the entire trust. Therefore, T remains the transferor because, for purposes of chapter 13 of the Internal Revenue Code, the election to be treated as qualified terminable interest property is treated as if it had not been made. In this case, GC's interest is established or derived on T's death in 2002. Because C1 was living at the time of T's death, the predeceased parent rule under section 2651(e) does not apply, even though C1 was deceased at the time the transfer from S to GC was subject to the tax under chapter 11

of the Internal Revenue Code. When the trust terminates, the distribution to GC is a taxable termination that is subject to the GST tax to the extent the trust has an inclusion ratio greater than zero. See section 2642(a).

Example 5. T establishes an irrevocable trust providing that trust income is to be paid to T's grandniece, GN, for 5 years or until GN's prior death. At the end of the 5-year period or on GN's prior death, the trust is to terminate and the principal is to be distributed to GN if living, or if GN has died, to GN's then-living descendants, per stirpes. S is a sibling of T and the parent of N. N is the parent of GN. At the time of the transfer, T has no living lineal descendant, S is living, N is deceased, and the transfer is subject to the gift tax imposed by chapter 12 of the Internal Revenue Code. GN is treated as a member of the generation that is one generation below T's generation because S, GN's youngest living lineal ancestor who is also a descendant of T's parent, is in T's generation. As a result, GN is not a skip person and the transfer to the trust is not a direct skip. In addition, distributions to GN during the term of the trust and at the termination of the trust will not be GSTs.

Example 6. On January 1, 2004, T transfers \$50,000 to a great-grandniece, GGN, who is the great-grandchild of B, a brother of T. At the time of the transfer, T has no living lineal descendants and B's grandchild, GN, who is a parent of GGN and a child of B's living child, N, is deceased. GGN will be treated as a member of the generation that is one generation below the lower of T's generation or the generation assignment of GGN's youngest living lineal ancestor who is also a descendant of the parent of the transferor. In this case, N is GGN's youngest living lineal ancestor who is also a descendant of the parent of T. Because N's generation assignment is lower than T's generation, GGN will be treated as a member of the generation that is one generation below N's generation assignment (i.e., GGN will be treated as a member of her parent's generation). As a result, GGN remains a skip person and the transfer to GGN is a direct skip.

Example 7. T has a child, C. C and C's spouse, S, have a 20-year-old child, GC. C dies and S subsequently marries S2. S2 legally adopts GC. T transfers \$100,000 to GC. Under section 2651(b)(1), GC is assigned to the generation that is two generations below T. However, since GC's parent, C, is deceased at the time of the transfer, GC will be treated as a member of the generation that is one generation below T. As a result, GC is not a skip person and the transfer to GC is not a direct skip.

§26.2651-2 Individual assigned to more than 1 generation.

(a) In general. Except as provided in paragraph (b) or (c) of this section, an individual who would be assigned to more than 1 generation is assigned to the youngest of the generations to which that individual would be assigned.

(b) Exception. Notwithstanding paragraph (a) of this section, an adopted individual (as defined in this paragraph) will be treated as a member of the generation that is one generation below the adoptive parent for purposes of determining whether a transfer to the adopted individual from the adoptive parent (or the spouse or former spouse of the adoptive parent, or a lineal descendant of a grandparent of the adoptive parent) is subject to chapter 13 of the Internal Revenue Code. For purposes of this paragraph (b), an adopted individual is an individual who is--

(1) Legally adopted by the adoptive parent;

(2) A descendant of a parent of the adoptive parent (or the spouse or former spouse of the adoptive parent);

(3) Under the age of 18 at the time of the adoption; and

(4) Not adopted primarily for the purpose of avoiding GST tax. The determination of whether an adoption is primarily for GST tax-avoidance purposes is made based upon all of the facts and circumstances. The 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. Other factors may include (but are not limited to), at the time of the adoption--

(i) The age of the adopted individual (for example, the younger the age of the adopted individual, or the age of the youngest of siblings who are all adopted together, the more likely the adoption will not be considered primarily for GST tax-avoidance purposes); and

(ii) The relationship between the adopted individual and the individual's parents (for example, objective evidence of the absence or incapacity of the parents may indicate that the adoption is not primarily for GST tax-avoidance purposes).

(c) Special rules--(1) Corresponding generation adjustment. If an individual's generation assignment is adjusted with respect to a transfer in accordance with paragraph (b) of this section, a corresponding adjustment with respect to that transfer is made to the generation assignment of each--

- (i) Spouse or former spouse of that individual;
- (ii) Descendant of that individual; and
- (iii) Spouse or former spouse of each descendant of that individual.

(2) Continued application of generation assignment. If a transfer to a trust would be a generation-skipping transfer but for paragraph (b) of this section, any generation assignment determined under paragraph (b) or (c) of this section continues to apply in determining whether any subsequent distribution from (or termination of an interest in) the portion of the trust attributable to that transfer is a generation-skipping transfer.

(d) Example. The following example illustrates the provisions of this section:

Example. T has a child, C. C has a 20-year-old child, GC. T legally adopts GC and transfers \$100,000 to GC. GC's generation assignment is determined by section 2651(b)(1) and GC is assigned to the generation that is two generations below T. In addition, because T has legally adopted GC, GC is generally treated as a child of T under state law. 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 and the transfer to GC is a direct skip.

§26.2651-3 Effective dates.

(a) In general. The rules of §§ 26.2651-1 and 26.2651-2 are applicable for terminations, distributions, and transfers occurring on or after July 18, 2005.

(b) Transition rule. In the case of transfers occurring after December 31, 1997, and before July 18, 2005, taxpayers may rely on any reasonable interpretation of section 2651(e).

For this purpose, these final regulations, as well as the proposed regulations issued on September 3, 2004, (69 FR 53862) are treated as a reasonable interpretation of the statute.

Deputy Commissioner for Services and Enforcement.

Approved:

Acting Deputy Assistant Secretary of the Treasury.