

## Internal Revenue Service

## Department of the Treasury

Number: **200315016**

Release Date: 4/11/2003

Index Number: 2652.01-02; 2652.03-00  
9100.22-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

**CC:PSI:9-PLR-148858-02**

Date:

**January 3, 2003**

Re:

### LEGEND:

Decedent =

Spouse =

Trust =

State =

Children =

Grandchild =

Trustee =

Accountant =

Law Firm =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

x =

y =

z =

State Statute =

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Dear Madam:

This letter responds to your representative's letter, dated August 14, 2002, and subsequent correspondence, requesting an extension of time under § 301.9100-3 of the Procedure and Administration Regulations to sever a trust into an exempt and nonexempt trust for purposes of Generation-Skipping Transfer (GST) tax and to make a "reverse" qualified terminable interest property (QTIP) election under § 2652(a)(3) of the Internal Revenue Code with respect to the exempt trust.

The facts and representations submitted are summarized as follows. On Date 1, Decedent and Spouse created Trust, a revocable trust, to which they transferred the bulk of their assets. Trust was amended and restated in its entirety on Date 2 and was amended in part on Date 3. On Date 4, Decedent died, a resident of State, whereupon Trust became irrevocable. Decedent was survived by Spouse, Children, and Grandchild.

Article 3, Section II of Trust provides that after the death of the predeceased spouse, the trustee shall divide the trust estate into three trusts: the Survivor's Trust to consist of the one-half community property interest of the surviving spouse, the Marital Deduction Trust to consist of the smallest amount necessary to reduce to zero the federal estate tax payable as a result of the death of the predeceased spouse, and the Bypass Trust to consist of the balance of the trust estate.

Article 3, Section II, Paragraph B of Trust provides, in part, that each of the trustors intends to take advantage of the unlimited marital deduction available under the Internal Revenue Code as amended, but only to the extent the estate of the predeceased spouse is not otherwise sheltered from tax by available credits, exclusions, and other deductions.

With regard to the Marital Deduction Trust, Article 3, Section IV, Paragraph A of Trust provides that the net income of the Marital Deduction Trust shall be paid to or for the surviving spouse quarter-annually or at more frequent intervals and provides that trust principal may be paid to or for the surviving spouse as the trustee deems necessary for the proper health, maintenance, and support of the surviving spouse. It further provides the surviving spouse the noncumulative right to receive an amount of principal in each calendar year not to exceed the greater of five thousand dollars or five percent of the value of the principal of the Marital Deduction Trust as determined at the end of the calendar year.

Article 3, Section VII of Trust provides, in part, that on the death of the surviving spouse, the balance of the Marital Deduction Trust shall be divided into as many equal shares as there are children of trustors then living and children of trustors then deceased leaving issue then living.

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Article 3, Section VII, Paragraph 2 of Trust provides, in part, that for each share of the Marital Deduction Trust allocated to a living child, the trustee shall pay to or for the beneficiary at quarter-annual or more frequent intervals until the beneficiary attains age sixty, the greater of the entire net income of the beneficiary's share or \$x. In addition, the trustee may distribute to the beneficiary in any given year the amount of principal the trustee deems necessary for the beneficiary's health, support, maintenance, and education. The trustee is to distribute y percent of the principal of the beneficiary's share when the beneficiary attains fifty-five years of age, and the balance of the beneficiary's share at sixty years of age.

Article 3, Section VII, Paragraph 3 of Trust provides that if a beneficiary dies before becoming entitled to receive distribution of his or her entire share of the Marital Deduction Trust, the undistributed balance of that beneficiary's trust is to be distributed to his or her issue, free of trust, by right of representation, or in default thereof this share is to be distributed to the trustors' then living issue by right of representation, free of trust; provided, however, that if a part of the balance would otherwise be distributed to a person for whose benefit a trust is then being administered under the terms of the trust agreement, then the share is to be added to the share already held by the trustee.

Trustee hired Accountant, a qualified tax professional, to prepare Decedent's federal estate tax return (Form 706). Accountant timely filed the Form 706 on behalf of Decedent's estate on Date 5. On the Form 706, an election was made to treat the property of the Marital Deduction Trust as qualified terminal interest property under § 2056(b)(7). Schedule R of Form 706 reported that none of Decedent's allowable GST exemption had been allocated to the decedent's lifetime transfers and the maximum allowable GST exemption was still available for allocation. Schedule R of Form 706 allocated \$z of the available exemption to the Bypass Trust, but did not identify the Marital Deduction Trust as a trust to which a portion of the GST exemption was allocated. It has been represented that Trustee relied on Accountant to prepare the return, and Accountant failed to make, or advise Trustee to make, the reverse QTIP election.

Subsequently, Trustee hired Law Firm. After reviewing the Form 706, Law Firm discovered Accountant's failure to make the reverse QTIP election. Law Firm filed a court petition to divide the Marital Deduction Trust into the GST Exempt Marital Deduction Trust ("GST Exempt Trust"), consisting of assets of the Marital Deduction Trust that are equal in value to the amount of the Decedent's unused GST tax exemption, and the GST Nonexempt Marital Deduction Trust ("GST Nonexempt Trust"), consisting of the balance of the assets of the Marital Deduction Trust. It is represented that, upon severance, the GST Exempt Trust and the GST Nonexempt Trust will be governed in accordance with the provisions governing the Marital Deduction Trust. It is further represented that if the funding of the GST Exempt Trust and the GST Nonexempt Trust is done on a non pro rata basis, funding will be based on either the fair market value of the assets on the date of funding or in a manner that fairly reflects

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the net appreciation or depreciation in the value of the assets measured from the valuation date to the date of funding.

You request a ruling granting an extension of time under § 301.9100-3 to sever the Marital Deduction Trust into the GST Exempt Trust and the GST Nonexempt Trust, pursuant to § 26.2654-1(b)(1) of the Generation Skipping Transfer Tax Regulations, and to make a “reverse” qualified terminable interest property election under § 2652(a)(3) of the Internal Revenue Code with respect to the exempt trust.

Section 2001(a) of the Internal Revenue Code imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

Section 2056(a) provides that, for purposes of the tax imposed by § 2001, the value of the taxable estate is to be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property that passes or has passed from the decedent to the surviving spouse.

Section 2056(b)(1) provides, in pertinent part, that no deduction shall be allowed under § 2056(a) where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail.

Section 2056(b)(7)(A) provides that, in the case of qualified terminable interest property, the entire property shall be treated as passing to the surviving spouse for purposes of § 2056(a), and no part of such property shall be treated as passing to any person other than the surviving spouse for purposes of § 2056(b)(1)(A).

Section 2056(b)(7)(B)(i) defines the term “qualified terminable interest property” as property: (I) which passes from the decedent; (II) in which the surviving spouse has a qualifying income interest for life; and (III) to which an election under § 2056(b)(7) applies.

Section 2056(b)(7)(B)(ii) provides that the surviving spouse has a qualifying income interest for life if: (I) the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, or has a usufruct interest for life in the property; and (II) no person has a power to appoint any part of the property to any person other than the surviving spouse.

Section 2056(b)(7)(B)(v) provides that an election under § 2056(b)(7) with respect to any property shall be made by the executor on the return of tax imposed by § 2001, and that such an election, once made, shall be irrevocable.

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Section 2044(a) provides that the value of the gross estate shall include the value of any property to which § 2044 applies in which the decedent had a qualifying income interest for life.

Section 2044(b) provides, in relevant part, that § 2044 applies to any property if a deduction was allowed with respect to the transfer of such property to the decedent under section 2056 by reason of subsection (b)(7) thereof.

Section 2044(c) provides that for purposes of chapter 11 and chapter 13, property includible in the gross estate of the decedent under § 2044(a) shall be treated as property passing from the decedent.

Section 2601 imposes a tax on every generation-skipping transfer. Section 2611(a) provides that the term "generation-skipping transfer" means: (1) a taxable distribution; (2) a taxable termination; and (3) a direct skip.

Section 2602 provides that the amount of the GST tax is determined by multiplying the taxable amount by the applicable rate.

Section 2641(a) defines the term "applicable rate" with respect to any GST as the product of the maximum federal estate tax rate and the inclusion ratio with respect to the transfer.

Section 2642(a)(1) provides that, generally, the inclusion ratio with respect to any property transferred in a GST is the excess of 1 over the "applicable fraction." With respect to a GST that is not a direct skip, § 2642(a)(2) provides that, in general, the applicable fraction is a fraction the numerator of which is the amount of the GST exemption under § 2631 allocated to the trust and the denominator of which is the value of the property transferred to the trust.

Section 2631(a) provides that, for purposes of determining the inclusion ratio, every individual shall be allowed a GST exemption of \$1,000,000 (adjusted for inflation under § 2631(c)) that may be allocated by such individual (or his executor) to any property with respect to which such individual is the transferor. Section 2631(b) provides that any allocation under § 2631(a), once made, shall be irrevocable.

Section 2632(a)(1) 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 such individual's estate (determined with regard to extensions), regardless of whether such a return is required to be filed.

Section 2632(e)(1) provides that, in general, any portion of an individual's GST exemption that has not been allocated within the time prescribed by § 2632(a) shall be

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

Section 26.2632-1(d)(2) provides that a decedent's unused GST exemption is automatically allocated on the due date for filing the Form 706, or Form 706NA, to the extent not otherwise allocated by the decedent's executor on or before that date. 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 to trusts with respect to which a taxable termination may occur or from which a taxable distribution may be made. 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.

Section 2652(a)(1) provides that for purposes of chapter 13, the term "transferor" means: (A) in the case of any property subject to the tax imposed by chapter 11, the decedent; and (B) in the case of any property subject to the tax imposed by chapter 12, the donor. An individual shall be treated as transferring any property with respect to which such individual is the transferor.

Section 2652(a)(3) provides, in pertinent part, that in the case of any trust with respect to which a deduction is allowed to the decedent under § 2056 by reason of subsection (b)(7) thereof, the estate of the decedent may elect to treat all of the property in such trust for purposes of this chapter as if the election to be treated as qualified terminable interest property had not been made. This election is referred to as a "reverse" QTIP election, and, as provided in § 26.2652-2(b), is made on the return on which the QTIP election was made.

Section 26.2652-2(a) provides, in part, that a reverse QTIP election is not effective unless it is made with respect to all of the property in the trust to which the QTIP election applies.

Section 2642(a)(3)(A) provides that if a trust is severed in a qualified severance, the trusts resulting from the severance shall be treated as separate trusts thereafter for GST purposes.

Section 2642(a)(3)(B)(i) defines "qualified severance" as the division of a single trust and the creation (by any means available under the governing instrument or under local

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law) of two or more trusts if: (I) the single trust was divided on a fractional basis; and (II) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust.

Section 2642(a)(3)(B)(ii) provides that if a trust has an inclusion ratio of greater than zero and less than 1, a severance is a qualified severance only if the single trust is divided into two trusts, one of which receives a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance. In this case, the trust receiving the fractional share shall have an inclusion ratio of zero and the other trust shall have an inclusion ratio of 1.

Section 2642(a)(3)(B)(ii) provides that the term “qualified severance” includes any other severance permitted under regulations prescribed by the Secretary. Section 2642(a)(3)(C) provides that a severance provided for in § 2642(a)(3) may be made at any time.

Section 26.2654-1(b)(1)(ii) provides that the severance of a trust that is included in the transferor’s gross estate into two or more trusts is recognized for purposes of chapter 13 if the governing instrument does not require or otherwise direct severance but the trust is severed pursuant to discretionary authority granted either under the governing instrument or under local law; and

- (A) The terms of the new trusts provide in the aggregate for the same succession of interests and beneficiaries as are provided in the original trust; and
- (B) The severance occurs prior to the date prescribed for filing the federal estate tax return (including extensions actually granted) for the estate of the transferor; and
- (C) Either (1) the new trusts are severed on a fractional basis or (2) if the severance is required (by the terms of the governing instrument) to be made on the basis of a pecuniary amount, the pecuniary payment is satisfied in a manner that would meet the requirements of § 26.2654-1(a)(1)(ii) if it were paid to an individual. If severed on a fractional basis, the separate trusts need not be funded with a pro rata portion of each asset held by the undivided trust. The trusts may be funded on a non pro rata basis provided funding is based on either the fair market value of the assets on the date of funding or in a manner that fairly reflects the net appreciation or depreciation in the value of the assets measured from the valuation date to the date of funding.

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Section 26.2654-1(b)(2) provides that if a court order severing the trust has not been issued at the time the federal estate tax return is filed, the executor must indicate on a statement attached to the return that a proceeding has been commenced to sever the trust and describe the manner in which the trust is proposed to be severed. A copy of the petition or other instrument used to commence the proceeding must also be attached to the return. If the governing instrument of a trust or local law authorizes the severance of the trust, a severance pursuant to that authorization is treated as meeting the requirements of § 26.2654-1(b)(1)(ii)(B) if the executor indicates on the federal estate tax return that separate trusts will be created (or funded) and clearly sets forth the manner in which the trust is to be severed and the separate trusts funded.

Under § 301.9100-1(c), the Commissioner may grant a reasonable extension of time under the rules set forth in §§ 301.9100-2 and 301.9100-3 to make a regulatory election, or a statutory election (but no more than 6 months except in the case of a taxpayer who is abroad), under all subtitles of the Code except subtitles E, G, H, and I.

Section 301.9100-2 provides an automatic extension of time for making certain elections.

Section 301.9100-3(a) provides, in pertinent part, that requests for extensions of time for regulatory elections that do not meet the requirements of § 301.9100-2 must be made under the rules of § 301.9100-3. Requests for relief subject to § 301.9100-3 will be granted when the taxpayer provides the evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the Government.

Section 301.9100-3(b)(1) provides, in part, except as provided in § 301.9100-3(b)(3)(i) through (iii), a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make, the election.

Section 301.9100-3(c)(1) provides, in pertinent part, that the Commissioner will grant a reasonable extension of time to make a regulatory election only when the interests of the Government will not be prejudiced by the granting of relief.

State Statute provides, in relevant part, that “[o]n petition by a trustee or beneficiary, the court, for good cause shown, may divide a trust into two or more separate trusts, if the court determines that dividing the trust will not defeat or substantially impair the accomplishment of the trust purposes or the interests of the beneficiaries.”

As a result of the QTIP election made on the Decedent's Form 706, the property of the Marital Deduction Trust is includible in Spouse's gross estate pursuant to § 2044. Spouse, accordingly, is considered the transferor of the property for GST tax purposes



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and Decedent's remaining GST exemption may not be allocated to the assets of the Marital Deduction Trust. However, Decedent will be treated as the transferor of the GST Exempt Trust's assets for GST tax purposes if the Marital Deduction Trust is severed in accordance with Treas. Reg. § 26.2654-1(b)(1) and a reverse QTIP election under § 2652(a)(3) is made for the exempt portion. Thereupon, the automatic allocation rules of § 2632(e) will apply Decedent's remaining GST tax exemption to the GST Exempt Trust.

Based on the facts submitted and the representations made, we conclude that the requirements of § 301.9100-3 have been satisfied. Accordingly, an extension of time of 60 days from the date of this letter is granted for severing the Marital Deduction Trust, pursuant to § 26.2654-1(b)(1), into the GST Exempt Trust and the GST Nonexempt Trust and to file a supplemental Form 706 making the "reverse" QTIP election with respect to the GST Exempt Trust.

The Form 706 should be filed with the Internal Revenue Service Center, Cincinnati, Ohio 45999. A copy of this letter should be attached to the form. A copy is enclosed for this purpose.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer 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.

Sincerely,

Heather C. Maloy

Heather C. Maloy  
Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures

Copy for section 6110 purposes  
Copy of this letter