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Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

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PLR-110178-06

Date: JANUARY 09, 2007

Re:

Legend

Taxpayer	-
Spouse	-
Child A	-
Child B	-
Child C	-
Grandchild C	-
Trust 1	-

Trust 1A	-
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Trust 1B	-
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Trust 1C	-
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Trust 2	-
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Year 2	-
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Year 3	-
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State X	-
State Y	-
Y Dollars	-
Z Dollars	-

Dear _____ :

This letter is in response to a letter dated February 6, 2006 from your authorized representative requesting rulings under § 2632 of the Internal Revenue Code concerning the allocation of generation-skipping transfer (GST) tax exemption under § 2631(a).

The facts and representations submitted are summarized as follows:

Taxpayer and Spouse are residents of State X. Taxpayer and Spouse have three adult children, Child A, Child B and Child C, also residents of State X. Trust 1 (described below) was established by Taxpayer and is governed by the law of State Y. Trust 2 (described below) was also established by Taxpayer and is governed by the law of State X.

In Year 2, after December 31, 2000, Taxpayer established Trust 1, an irrevocable trust for the benefit of his children and their issue. Under the terms of Trust 1, the trust corpus was divided equally between three separate subtrusts; Trusts 1A, 1B, and 1C. The primary beneficiaries of Trusts 1A, 1B and 1C are Child A, Child B and Child C, respectively, and each child's descendants. It is represented that Trusts 1A, 1B and 1C are GST Trusts as defined in § 2632(c)(3)(B) and that the Taxpayer's and Spouse's transfers to Trusts 1A, 1B and 1C constitute indirect skips.

In Year 3, also after December 31, 2000, Taxpayer established Trust 2, an irrevocable trust for the primary benefit of Grandchild C, Taxpayer's grandchild. It is represented that Trust 2 is a "skip person" within the meaning of § 2613(a)(2) and that the Taxpayer's and Spouse's transfers to Trust 2 constitute direct skips.

In Year 3, Taxpayer transferred cash in the amount of Y Dollars to Trust 1 that, pursuant to the terms of the trust instrument, was divided equally between Trusts 1A, 1B, and 1C. In addition, in Year 3 Taxpayer transferred cash in the amount of Z Dollars to Trust 2. Spouse also transferred cash in the amount of Z Dollars to Trust 2.

Also, during Year 3, Taxpayer and Spouse made additional transfers both directly to individuals and to other GST trusts established for the benefit of their children and grandchildren.

Taxpayer and Spouse both timely filed separate Forms 709, United States Gift (and Generation-Skipping Transfer) Tax Return for Year 3. Both Taxpayer and Spouse consented to treat the gifts made by each as made one-half by Taxpayer and one-half by Spouse, as provided under § 2513.

As pertinent to this ruling request, the returns were prepared as follows.

Transfers to Trusts 1A, 1B and 1C

With respect to Taxpayer's transfers to Trusts 1A, 1B and 1C as reported on Taxpayer's return, one-half of the value of the gift attributable to Taxpayer under § 2513, is correctly reported as Items 1, 2 and 3 on Schedule A, Part 3 (Indirect Skips). The box on the schedule signifying an election out of the automatic allocation rules under § 2632(c) with respect to indirect skips was not checked with respect to these transfers. No amount is entered on Line 5 on Schedule C, Part 2, GST Exemption Reconciliation, but an entry is made referring to "Statement 5" attached to the return. Statement 5 entitled "Notice of Allocation," lists the transfers to Trusts 1A, 1B and 1C, the amount of such transfers, and provides that the amount of GST exemption being allocated to each gift is zero, but nonetheless states that the inclusion ratio after allocation is zero. The statement then provides that, with respect to the transfers to Trust 1A, 1B and 1C respectively, Taxpayer is allocating the smallest amount necessary to produce an inclusion ratio of zero and that this allocation is a formula allocation.

Regarding the transfers to Trust 1A, 1B and 1C as reported on Spouse's return, one-half of the value of the gift attributable to Spouse under § 2513 is correctly reported as Items 1, 2 and 3 on Schedule A, Part 3 (Indirect Skips). The box on the schedule signifying an election out of the automatic allocation rules under § 2632(c) with respect to indirect skips was not checked with respect to these transfers. No amount is entered on Line 5 on Schedule C, Part 2, GST Exemption Reconciliation, but an entry is made referring to "Statement 12" attached to the return. Statement 12 entitled "Notice of Allocation" lists the transfers to Trusts 1A, 1B and 1C, and the amount of such transfers and provides that the amount of GST exemption being allocated to each gift is zero, but nonetheless states that the inclusion ratio after allocation is zero. The statement then provides that, with respect to the transfers to Trust 1A, 1B and 1C respectively, Spouse is allocating the smallest amount necessary to produce an inclusion ratio of zero and that this allocation is a formula allocation.

Transfers to Trust 2

With respect to the transfers to Trust 2 as reported on Taxpayer's return, consistent with the election under § 2513, Taxpayer reported one-half the value of his Z Dollar gift to the trust. However, Taxpayer's gift to Trust 2 was incorrectly reported as Item 12 on Schedule A, Part 3 (Indirect Skips), rather than on Schedule A, Part 2 (Direct Skips)

subject to both gift tax and GST Tax. Further, Taxpayer failed to report one-half the value of Spouse's Z Dollar gift to the Trust 2, attributable to Taxpayer under § 2513.

Regarding the allocation of GST exemption with respect to this transfer, there is no indication on Taxpayer's return that Taxpayer elected out of the automatic allocation rules under § 2632(b) with respect to this transfer. However, on Schedule C, Part 2, GST Exemption Reconciliation, a zero is entered for lines 4, 5 and 6, indicating no exemption is being allocated, automatically or otherwise on the return.

With respect to Spouse's return, the full amount of Spouse's transfer to Trust 2, Z Dollars (rather than one-half reflecting the § 2513 election), was reported on the correct schedule as Item 1 on Schedule A, Part 2, as a direct skip. In addition, consistent with the election under § 2513, Spouse also reported one-half the value of Husband's gift to Trust 2. However, this transfer was incorrectly reported as Item 12 on Schedule A, Part 3 (Indirect Skips), rather than as a direct skip on Schedule A, Part 2. On Schedule C, Part 2, line 4, and on Part 3, Spouse allocated Z Dollars of GST exemption.

Finally, with respect to the transfers to other GST trusts described in the return, the Taxpayer and Spouse attached to their respective returns a statement pursuant to which each elected out of the automatic allocation rules under § 2632(c)(5)(A)(i)(II). However, the transfers to Trusts 1A, 1B and 1C and to Trust 2 were not listed in these statements.

Taxpayer and Spouse request the following rulings:

1. Taxpayer's gift tax return for Year 3 substantially complied with the requirements for an effective and timely allocation of Taxpayer's GST exemption to Taxpayer's transfers in Year 3 to Trust 1, and the resulting distributions to Trusts 1A, 1B, and 1C, resulting in an inclusion ratio of zero for Trusts 1A, 1B, and 1C.
2. Taxpayer's GST exemption was automatically allocated to all transfers in Year 3 to Trust 2 (taking into account §§ 2513 and 2652(a)(2)) to the extent those transfers are not nontaxable gifts resulting in an inclusion ratio of zero for Trust 2.
3. Spouse's gift tax return for Year 3 substantially complied with the requirements for an effective and timely allocation of Spouse's GST exemption to Spouse's transfers in Year 3 to Trust 1, and the resulting distributions to Trusts 1A, 1B, and 1C, resulting in an inclusion ratio of zero for Trusts 1A, 1B, and 1C.
4. Spouse's GST exemption was automatically allocated to all transfers in Year 3 to Trust 2 (taking into account §§ 2513 and 2652(a)(2)) to the extent those transfers are not nontaxable gifts resulting in an inclusion ratio of zero for Trust 2.

Section 2513(a) provides generally that, for gift tax purposes, if the parties consent, a gift made by one spouse to any person other than his or her spouse shall, for gift tax purposes, be considered as made one-half by the donor spouse and one-half by his or her spouse.

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

Section 2602 provides that the amount of the tax is the taxable amount multiplied by the “applicable rate.” Section 2641(a) defines applicable rate as the product of the maximum Federal estate tax rate and the inclusion ratio with respect to the transfer.

Under § 2642(a)(1), in general, the inclusion ratio with respect to any property transferred in a generation-skipping transfer is the excess (if any) of 1 over the applicable fraction determined for the trust from which such transfer is made, or in the case of a direct skip, the applicable fraction determined for such transfer. Section 2642(a)(2) provides that the applicable fraction is a fraction (A) the numerator of which is the amount of the GST exemption allocated to the trust under § 2631(a), and (B) the denominator of which is (i) the value of the property transferred to the trust, reduced by (ii) 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.

Section 2631(a), as in effect for transfers made in Year 3, 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)) which 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 may be made at any time on or before the date prescribed for filing the estate tax return for such individual’s estate. Under § 26.2632-1(b)(4)(i) of the Generation-skipping Transfer Tax Regulations, generally an allocation of GST exemption to property transferred during the transferor’s lifetime is made on Form 709. The allocation must clearly identify the trust to which the allocation is being made and the amount of GST exemption allocated to it. The allocation should also state the inclusion ratio of the trust after the allocation. The regulation further provides that an allocation of GST exemption may be made by a formula; for example, the allocation may be expressed in terms of the amount necessary to produce an inclusion ratio of zero.

Under § 2632(b)(1), if an individual makes a direct skip transfer during his or her

lifetime, any unused portion of such individual's GST exemption is automatically allocated to the property transferred to the extent necessary to make the inclusion ratio zero. Section 2632(b)(3) provides that an individual may elect out of this automatic allocation rule with respect to direct skips. Section 26.2632-1(b)(1) provides that if a direct skip occurs during the transferor's lifetime, the transferor's GST exemption not previously allocated is automatically allocated to the transferred property. The transferor may prevent the automatic allocation of GST exemption by describing on a timely-filed United States Gift (and Generation-Skipping Transfer) Tax Return (Form 709) the transfer and the extent to which the automatic allocation is not to apply.

Section 2632(c)(1) provides that if any individual makes an "indirect skip" during such individual's lifetime, any unused portion of such individual's GST exemption is treated as allocated to the property transferred to the extent necessary to make the inclusion ratio for such property zero. If the amount of the indirect skip exceeds such unused portion, the entire unused portion shall be allocated to the property transferred.

Under § 2632(c)(3)(A), the term "indirect skip" means any transfer of property (other than a direct skip) subject to the tax imposed by chapter 12 made to a GST trust, as defined in § 2632(c)(3)(B). Under § 2632(c)(3)(B), a GST trust is a trust that could have GST potential with respect to the transferor unless the trust satisfies any of the exceptions listed in § 2632(c)(3)(B)(i)-(vi).

Section 2632(c)(5)(A)(i) provides that an individual may elect to have the automatic allocation rules of § 2632(c)(1) not apply to an indirect skip, or any or all transfers made by such individual to a particular trust. Section 2632(c)(5)(B)(ii) provides that the election may be made on a timely filed gift tax return for the calendar year for which the election is to become effective.

Section 26.2632-1(b)(2)(i) provides that in the case of an indirect skip made after December 31, 2000, to which § 2642(f) (relating to transfers subject to the estate tax inclusion period or ETIP) does not apply, the transferor's unused GST exemption is automatically allocated to the property transferred (but not in excess of the fair market value of the property on the date of the transfer). This automatic allocation is effective whether or not a Form 709 is filed reporting the transfer, and is effective as of the date of the transfer to which it relates. An automatic allocation is irrevocable after the due date of the Form 709 for the calendar year in which the transfer is made.

Section 26.2632-1(b)(2)(ii) provides that, except as otherwise provided, the transferor may prevent the automatic allocation of GST exemption with regard to an indirect skip by making an election as provided in § 26.2632-1(b)(2)(iii). The transferor may also prevent the automatic allocation of a GST exemption with regard to an indirect skip by making an affirmative allocation of GST exemption on a Form 709 filed at any time on or before the due date for timely filing of an amount that is less than (but not equal to) the value of the property transferred as reported on that return.

Section 26.2632-1(b)(2)(iii)(A) provides that a transferor may prevent the automatic allocation of GST exemption (elect out) with respect to any transfer or transfers constituting an indirect skip made to a trust or to one or more separate shares that are treated as separate trusts under § 26.2654-1(a)(1). In the case of a transfer treated under § 2513 as made one-half by the transferor and one-half by the transferor's spouse, each spouse shall be treated as a separate transferor who must satisfy separately the requirements of § 26.2632-1(b)(2)(iii)(B) to elect out with respect to the transfer. Under § 26.2632-1(b)(2)(iii)(B), to elect out, the transferor must attach a statement to a Form 709 that identifies the trust and specifically provides that the transferor is electing out of the automatic allocation of GST exemption with respect to the described transfer or transfers. Section 26.2632-1(b)(2)(iii)(D) provides that an election out does not affect the automatic allocation of GST exemption to any transfer not covered by the election out statement.

Section 26.2632-1(b)(4)(iii), Example 6 considers a situation in which T transfers \$100,000 to an irrevocable GST trust described in § 2632(c)(3)(B). On a timely filed gift tax return, T allocates \$ 40,000 of GST exemption to the trust. The example concludes that by filing a timely Form 709 on which a partial allocation is made of \$40,000, T effectively elected out of the automatic allocation rules for the remaining value of the transfer for which T did not allocate GST exemption.

Section 2642(g)(2) captioned "Substantial Compliance" provides that an allocation of GST exemption under § 2632 that demonstrates an intent to have the lowest possible inclusion ratio with respect to a transfer to a trust shall be deemed to be an allocation of so much of the transferor's unused GST exemption as produces the lowest possible inclusion ratio. In determining whether there has been substantial compliance, all relevant circumstances shall be taken into account, including evidence of intent contained in the trust instrument.

Section 2652(a) and § 26.2652-1(a)(4) provide that, if, under § 2513, one-half of a gift is treated as made by an individual and one-half is treated as made by the spouse of the individual, then for purposes of the GST tax, each spouse is treated as the transferor of one-half of the entire value of the property transferred by the donor spouse, regardless of the interest the electing spouse is actually deemed to have transferred under § 2513.

In the present case, regarding Taxpayer's transfers to Trust 1A, 1B and 1C, the Notice of Allocation attached to Taxpayer's return listed the portion of the transfer reported by Taxpayer as a result of the § 2513 election, and specifically states that Taxpayer is making a formula allocation pursuant to which the amount being allocated is the smallest amount necessary to produce an inclusion ratio of zero with respect to the trusts, and that the inclusion ratio after allocation is zero. Similarly, the Notice of Allocation attached to Spouse's return listed the portion of the transfer reported by Spouse, and specifically states that Spouse is making a formula allocation pursuant to

which the amount being allocated is the smallest amount necessary to produce an inclusion ratio of zero with respect to the trusts, and that the inclusion ratio after allocation is zero.

Under these circumstances, with respect to Taxpayer's and Spouse's returns, the Notice of Allocation is sufficient to constitute substantial compliance under § 2642(g). Although the Notice of Allocation and Schedule C, Part 2, indicate that zero exemption is being allocated, these entries are viewed as an erroneous determination that zero exemption was allocated under the formula.

Therefore, we conclude that Taxpayer is deemed to have made a timely allocation of Taxpayer's GST exemption with respect to Taxpayer's transfers in Year 3 to Trusts 1A, 1B, and 1C, sufficient to produce a zero inclusion ratio. Likewise, Spouse is deemed to have made a timely allocation of Spouse's GST exemption with respect to Spouse's transfers in Year 3 to Trusts 1A, 1B, and 1C, sufficient to produce a zero inclusion ratio. As a result, Trusts 1A, 1B, and 1C, will have an inclusion ratio of zero, assuming the transfers to the trusts are properly valued.

With respect to the transfers to Trust 2, Trust 2 constitutes a skip person with respect to Taxpayer and Spouse and their respective transfers to Trust 2 constitute direct skips. As discussed above, there is no indication on Taxpayer's Year 3 Form 709 that Taxpayer elected out of the § 2632(b) automatic allocation rule with respect to one-half of Taxpayer's transfer to Trust 2, or with respect to one-half of Spouse's transfer to Trust 2 that should have been reported on Taxpayer's return under § 2513. Accordingly, we conclude that Taxpayer's GST exemption was automatically allocated to Taxpayer's transfer in Year 3 to Trust 3 (taking into account §§ 2513 and 2652(a)(2)) to the extent the transfer is not a nontaxable gift under § 2642(c).

With respect to Spouse's return, as discussed above, Spouse allocated Z Dollars of GST exemption, an amount that would have produced a zero inclusion ratio if Spouse had properly reported the transfer taking into account the split gift treatment under § 2513 with respect to her transfer and Taxpayer's transfer. Accordingly, we conclude that Spouse is deemed to have made a timely allocation of Spouse's GST exemption with respect to Spouse's transfers in Year 3 to Trust 2 (taking into account §§ 2513 and 2652(a)(2)) sufficient to produce a zero inclusion ratio, to the extent the transfer is not a nontaxable gift under § 2642(c).

As a result, Trust 2 will have an inclusion ratio of zero with respect to these transfers, assuming Spouse allocated sufficient GST exemption with respect to the transfers.

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.

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

George Masnik
Chief, Branch 4
Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures

Copy for section 6110 purposes
Copy of this letter