Income & Transfer Tax Planning Group Roundtable:

Generation Skipping Transfer Tax Update

by
Julie K. Kwon
McDermott, Will & Emery
227 West Monroe Street, Suite 4400
Chicago, Illinois 60606

ABA Real Property, Trust & Estate Law
19th Annual Spring Symposia
May 2, 2008
Washington, D.C.

Generation Skipping Transfer Tax Update: Recent Developments

by
Julie K. Kwon
McDermott, Will & Emery
227 West Monroe Street, Suite 4400
Chicago, Illinois 60606

ABA Real Property, Trust & Estate Law
19th Annual Spring Symposia
May 2, 2008
Washington, D.C.

I. QUALIFIED SEVERANCES[1]

The 2001 Economic Growth and Tax Relief Reconciliation Act ("EGTRRA")[2] enacted several provisions to facilitate proper generation-skipping transfer ("GST") tax planning and allocations of GST exemption.

Before the enactment of Section 2642(a)(3)[3] allowing qualified severances under EGTRRA, the regulations recognized for GST tax purposes only the severances of trusts treated as separate under Section 2654(b) (trusts with more than one transferor and trusts that establish substantially separate and independent shares of different beneficiaries)[4] and certain severances of trusts included in the transferors' gross estates. Moreover, Regulation 26.2654-1(a) states that a separate share of a trust will not be recognized for GST tax purposes unless the share exists from, and at all times after, the creation of the trust. Regulation 26.2654–1(a)(5), Example 8, last sentence, states that trusts that are separate under state law will be treated as a single trust if they are not separate from creation. Thus, the uncertainty of whether separate trusts would be recognized as separate under the GST tax rules complicated the planning to achieve inclusion ratios of zero or one. In addition, even if the severance of a single trust with an inclusion ratio between zero and one was recognized, it resulted in separate trusts with the same inclusion ratio

---

[1] Significant portions of these materials regarding qualified severances previously have appeared in the same or substantially similar form in the following articles: Carol A. Harrington, Julie K. Kwon, Carlyn S. McCaffrey, Lloyd Leva Plaine & Pam H. Schneider, "Breaking Up May Get Even Easier To Do – Proposed GST Tax Severance Regulations," Journal of Taxation, Vol. 107, No. 6 at 331 (December, 2007); and Carol A. Harrington, Julie K. Kwon, Carlyn S. McCaffrey, Lloyd Leva Plaine & Pam H. Schneider, "Breaking Up Is No Longer Hard To Do – Final GST Tax Qualified Severance Regulations," Journal of Taxation, Vol. 107, No. 5 at 271 (November, 2007).

[2] P.L. 107-16, 107th Cong., 1st Sess. (June 7, 2001). EGTRRA also included new Section 2642(b)(1) and (2), which clarify that the value as finally determined for gift and estate tax purposes will determine the inclusion ratio relating to timely and automatic allocations of GST exemption.

[3] All references herein to the "Code" refer to the Internal Revenue of Code of 1986, as amended. Unless otherwise specified, all references to "Sections" herein refer to Sections of the Code. All references to "Regulations" refer to Treasury Regulations.

[4] The phrase "substantially separate and independent shares" generally has the same meaning as provided in Regulation 1.663(c)-3.

as the original single trust.[5]

The refusal to recognize the severance of a single trust into one or more new trusts under state law for GST tax purposes has four important consequences. First, unless a severance is respected for GST tax purposes, a purported allocation of

GST exemption to one but not the other new trust will be treated as if made to the single original trust and the new trusts will have the same inclusion ratio. Second and similarly, an addition to one new trust will be treated as a *pro rata* addition to both trusts. Third, unless a severance is respected for GST tax purposes, a reverse QTIP election made with respect to one of the severed trusts will be treated as if made for all of the trusts. Fourth, unless a severance is respected for GST tax purposes, a taxable termination with respect to one new trust will not be recognized until a taxable termination with respect to the other new trust also occurs.

EGTRRA introduced Section 2642(a)(3), which describes "qualified severances" that will result in trusts that will be treated as separate trusts thereafter for GST purposes.[6] Section 2642(a)(3) describes a qualified severance as the division of a single trust on a fractional basis pursuant to the governing instrument or local law into two or more trusts. The resulting trusts must preserve, in the aggregate, the same succession of beneficial interests as are provided in the original trust.[7] Moreover, if the original trust has an inclusion ratio between zero and one, this qualified severance must result in two trusts, one of which must be funded with a fractional share of the total value of all assets equal to the single trust's applicable fraction[8] immediately before the severance.[9] This new trust will have an inclusion ratio of zero. The other trust will receive the balance of the original trust's assets and will have an inclusion ratio of one. Section 2642(a)(3) also defines a qualified severance as "any other severance permitted under regulations prescribed by the Secretary."

This provision gives the Treasury the ability to define a qualified severance with other criteria. Section 2642(a)(3) applies to severances occurring after December 31, 2000. Section 2642(a)(3) also states that the trusts resulting from a qualified severance will be treated as

[5] Transfers from a trust with an inclusion ratio of 0 are not subject to GST tax, whereas transfers from a trust with an inclusion ratio of one are fully subject to GST tax.

[6] Section 2642(a)(3) permits the issuance of regulations describing severances in addition to those described in the statute that will be treated as "qualified severances."

[7] Section 2642(a)(3)(B)(i). It should be noted that, in the unlikely case that no change in the law occurs, Section 2642(a)(3) authorizing "qualified severances" and other GST tax changes made by EGTRRA will sunset on January 1, 2011, *i.e.*, Section 2642(a)(3) will disappear. Title IX of EGTRRA "Compliance with Congressional Budget Act" provides in Section 901(a), "Sunset of Provisions of Act," that "[a]ll provisions of, and amendments made by, this Act shall not apply . . . to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010." If such sunset occurs, the pre-Act law springs back into place and will apply to estates, gifts, and GSTs after December 31, 2010.

[8] The "applicable fraction" is the ratio of the amount of GST exemption allocated over the value of the trust when the allocation was effective. *See* Section 2642(a)(2). The inclusion ratio is 1 minus the applicable fraction. The applicable fraction is rounded to the third decimal place, and so the inclusion ratio is also. Reg. 26.2642-1(a).

[9] Section 2642(a)(3)(B)(ii).

separate trusts "thereafter" for GST tax purposes, indicating that the qualified severance becomes effective at the time when it occurs.[10]

On August 2, 2007, the Internal Revenue Service issued final regulations addressing severances of trusts for generation-skipping transfer tax ("GST tax") and income tax purposes.[11] In these final regulations, the IRS has made important changes to the Proposed Regulations that were issued in 2004 (the "2004 Proposed Regulations"). On the same day, the IRS also issued new Proposed Regulations regarding severances to address additional changes meriting further consideration.[12]

New Regulation 26.2642-6 addresses qualified severances and applies to severances occurring after August 1, 2007. This regulation confirms that the trusts resulting from a qualified severance will be treated, after the severance, as separate for GST tax purposes. This means that after the qualified severance, (1) GST exemption can be allocated to one trust without affecting the inclusion ratio of the other, and (2) whether a taxable termination occurs with respect to one trust will be determined independently of the terms and beneficiaries of the other.

The regulation cautions that the rules governing qualified severances are applicable only for GST tax purposes. Although Regulation 1.1001-1(h)(1), discussed below, was amended to address whether a severance may result in recognition of capital gain or loss for income tax purposes, advisers should consider the potential gift and estate tax consequences of the severance.

A. **Requirements of Qualified Severance.**

Regulation 26.2642-6(d) itemizes the requirements for a qualified severance. However, this regulation creates an exception for divisions of certain trusts included in the gross estate (an "included trust") described in Regulation 26.2654-1(b). The division of an included trust is not a qualified severance even if the division satisfies the seven requirements otherwise defining a qualified severance. This exception seems appropriate because the severance of an included trust under the Section 2654 regulations is effective as of the date of the transferor's death while a qualified severance is effective only prospectively.

No specific exception was provided or necessary for divisions recognized under Regulation 26.2654-1(a)(3). This regulation recognizes the separate trusts created upon division of a single trust that consisted of separate shares (as defined for income tax purposes in Regulation 1.663(c)–3) from creation, or created upon division of a single trust that was treated

[10] In contrast, Regulation 26.2654-1(b)(1) recognize some severances of trusts included in a transferor's taxable gross estate as "retroactive" to the date of death, even if the severance is not complete at the time of death or the due date of the federal estate tax return.

[11] T.D. 9348

[12] Notice of Proposed Rulemaking REG-128843-05, 72 Fed. Regulation 48249 (August 2, 2007, as corrected on August 22, 2007).

as separate trusts due to different transferors. No exception was necessary because these divisions are recognized for GST tax purposes whether or not they are qualified severances.[13]

1. Requirements 1 and 2: Effectiveness of Severance.

Regulation 26.2642-6(d)(1)-(2) describe requirements that ensure the effectiveness of the severance. The severance must be made pursuant to the governing instrument or applicable local law and be effective under local law. Section 2642(a)(3) states that "any means available under" local law or the trust instrument will be effective. Accordingly, even in the absence of the specific power to sever in the trust instrument or state statute, a severance by judicial order or other means available under local law should suffice for purposes of Section 2642(a)(3).

2. Requirement 3: Effective Date of Severance.

Regulation 26.2642-6(d)(3) provides that a qualified severance is not retroactive and the resulting trusts will be recognized as separate only from the effective date of the severance. The date of severance is either the date selected by the trustee as of which the trust assets are to be valued to fund the resulting trusts, or the court-imposed date of funding where the local court with jurisdiction over the trust has ordered the trustee to fund the resulting trusts on or as of a specific date. However, the regulation does not require notice to the Internal Revenue Service or otherwise detail how the trustee will evidence the selection of the valuation date.

An effective date of the severance will only qualify under the regulation if funding must commence "immediately." Example 5 treats a severance as qualified when the trustee began funding the day after the effective date of the severance, but it is unclear whether funding that begins later than the day after the effective date satisfies the immediacy requirement.[14]

Funding also must occur within a "reasonable time" (but in no event more than 90 days) after, that selected valuation date. This provision acknowledges the practical impossibility of valuing all of the trust assets, making allocation decisions and completing the actions necessary to transfer assets to fund a non-*pro rata* division on the same day. The Preamble to the regulations suggests that the nature of the trust assets determines the reasonable period of time for completion of funding, i.e., the severance of a hedge fund interest is expected to take longer than severance of a marketable securities portfolio.

It is not clear how this effective date requirement can be satisfied if a trustee severs a trust without a court order and funds the new trusts by distributing to each a fraction of each asset of the original trust ("*pro rata* funding," addressed further below). Such *pro rata* funding does not require valuation of trust assets and so there will never be a date as of which the assets are to be valued to determine funding. Moreover, the date of the actual transfer of the assets is not particularly important because it does not affect the value of the assets received. However, to

[13] If a single trust treated as separate shares or separate trusts by this regulation is not actually divided under local law, future distributions and contributions will be treated as occurring *pro rata* from the separate shares even though recognized as separate trusts for GST tax purposes.

[14] Reg. 26.2642-6(j), Ex. 5.

ensure satisfaction of this effective date requirement, the trustee should consider designating a particular date as the effective date of severance. The regulations do not require additional information; however, this designation should state that each new trust is to receive a specified fraction of each asset and that the assets will be valued as of such date. In any event, the government might not recognize such new trusts as separate until completion of the actual transfer of all assets to the new trusts.

3. Requirement 4: Severance on Fractional Basis.

Regulation 26.2642-6(d)(4) requires that the original trust must be severed on a fractional basis, such that each new trust (resulting trust) is funded with a fraction or percentage of the original trust, and the sum of those fractions or percentages is one or 100 percent, respectively. The severance of a trust based on a pecuniary amount will not constitute a qualified severance.

The regulations expressly authorize the use of a formula to determine this fraction or percentage. For example, the severance could be based on a fraction, with a numerator equal to the transferor's unused GST tax exemption on the date of severance (or any other pecuniary amount) and a denominator equal to the fair market value of the trust's assets on the date of severance. One new trust would receive this fraction of the original trust's assets and the other new trust would receive the balance. Once the fraction or percentage is established, the trustee may fund the new trusts by allocating each of the original trust's assets between the new trusts based on each trust's appropriate fraction or percentage. The regulations refer to this method as "*pro rata* funding."

Alternatively, the trust assets may be divided on a non-*pro rata* basis so that each trust receives trust assets with an aggregate value, as of the effective date of severance, equal to the total value of the original trust's assets on such date multiplied by that trust's appropriate fraction. As discussed above, it is unnecessary to value trust assets for *pro rata* severances because each new trust will receive a fraction of each asset of the original trust. Consequently, the rule that permits valuation to occur on the effective date of severance while the actual transfer of assets takes place later should only affect only non-*pro rata* severances.

This non-*pro rata* funding rule seems designed to prevent deliberate over-funding of the trust with a zero inclusion ratio. The rule should preclude the trustee from using hindsight to select appreciated assets to fund the zero inclusion ratio trust by selecting a valuation date that has already passed or by delaying funding to allow the trustee to identify appreciated assets. Even without this rule, fiduciary duties requiring the trustee to treat the beneficiaries fairly and the potential gift tax consequences if beneficiaries do not object to using hindsight in funding should preclude the trustee from taking such actions to over-fund one trust.

Example 5 illustrates a non-*pro rata* funding that meets the funding requirement.[15] In this example, the initial trust has an inclusion ratio of .90. On August 1, 2008, the trustee executes a document severing the Trust into two new trusts, Trust 1 and Trust 2, and designates August 3, 2008, as the effective date of the severance. The document provides for a non-*pro*

[15] Reg. 26.2642-6(j), Ex. 5.

rata division, with Trust 1 to have an inclusion ratio of one and be funded with assets equal to 90% of the effective date value of the Trust and Trust 2 to have an inclusion ratio of zero and be funded with assets equal to 10% of the effective date value of the Trust. The Trust consists solely of publicly traded stocks in two corporations, A and B. On August 3, such A stock is worth $450,000 and such B stock is worth $50,000. On August 4, the trustee takes all necessary actions to transfer the A stock to Trust 1 and B stock to Trust 2 and those transfers are completed by August 6. The example concludes that if all other requirements for a qualified severance are met, Trust 1 will have an inclusion ratio of zero and Trust 2 an inclusion ratio of one.

Example 11 illustrates the operation of this funding provision where property must be appraised.[16] This example approves the completion of funding of trusts owning real estate on October 9, 2008, within 90 days from July 16, 2008, the date of severance selected by the trustee. However, Example 11 warns in a parenthetical that if the only trust assets had been marketable securities and cash, "then in order to satisfy the reasonable time requirement, the stock transfer would have to have been commenced, and generally completed, immediately after the date of severance, and the cash distribution would have to have been made at the same time." Thus, the 90-day period is not a safe measure of the "reasonable time" for funding trusts in all cases; instead, this period may differ significantly from "immediately after the date of the severance" to 90 days, depending on the nature of the asset.

Severance of a trust based on a pecuniary amount will not constitute a qualified severance. As a result, a trust divided on a pecuniary basis will continue to be treated for GST tax purposes as a single trust, even if the trust's terms direct the division. However, the economic effect of a pecuniary severance can easily be accomplished within the fractional severance rules by specifying that the fraction to be applied will include a pecuniary amount in the numerator and the fair market value of the trust assets on the effective date of the severance in the denominator.

Separate Regulation 26.2654-1(b)(1)(ii)(C)(2) authorizes a pecuniary severance of an included trust that will be recognized for GST tax purposes. The 2004 Proposed Regulations had provided for the repeal of Regulation 26.2654-1(b) for all severances occurring after December 31, 2000, as 2004 Proposed Regulation 26.2642-6(a) which recognized separate trusts "only if" they resulted from a qualified severance.[17] However, nothing in Section 2642(a)(3) or its legislative history suggests that it should be the sole means of creating separate trusts for GST tax purposes. The final regulations now omit the provisions repealing Regulation 26.2654-1(b), which will continue to recognize the fractional or pecuniary severance of an included trust. Consequently, taxpayers may continue to use a pecuniary formula to allocate property to included trusts at death.

4. __Requirement 5: "Same Succession of Interests."__

[16] Reg. 26.2642-6(j), Ex. 11.

[17] 2004 Prop. Reg. 26.2654-1(b).

Regulation 26.2642-6(d)(5) requires that the terms of the resulting trusts must provide, in the aggregate, for the "same succession of interests" of beneficiaries as are provided in the original trust. This requirement is satisfied if the beneficiaries of, and their respective beneficial interests in, the original trust remain the same after the severance in the resulting separate trusts when those resulting trusts are viewed collectively.

Thus, the terms of the trusts resulting from a qualified severance are not required to be *identical*, as long as the trusts collectively preserve the beneficial interests under the original single trust. However, most trust instruments and state statutes, to the extent they address trust severances at all, typically require that resulting trusts remain governed by terms "identical" to those terms governing the original, single trust. Thus, a judicial reformation may be required to sever a trust on terms that differ from the original trust if the applicable local law and trust instrument lack express authorization for divisions resulting in trusts with terms differing from the original terms. To provide maximum flexibility in future planning, drafters should consider including express authorization in the trust instrument for divisions resulting in trusts with different terms, if the resulting trusts preserve the aggregate beneficial interests under the original trust. An example of such language is included as Appendix A.

Most private letter rulings to date applying Section 2642(a)(3), prior to the issuance of the recent final regulations, involve qualified severances resulting in separate trusts with terms identical to the original trust, in most cases because the taxpayers severed pursuant to a state statute or governing instrument authorizing severances on identical terms.[18] Thus, most rulings involving qualified severances prior to the issuance of the final regulations regarding qualified severances have not addressed how trusts may differ from the original trust without changing the succession of beneficial interests under the original single trust for purposes of Section 2642(a)(3). However, the Examples under new Regulation 26.2642-6(j) now provide additional guidance in this respect.

The "succession of interests" language in Section 2642(a)(3) is drawn from Regulation 26.2654-1(b)(1)(ii)(A), as the latter similarly requires preservation of the same succession of beneficial interests after severance of a trust included in the transferor's estate or created under the transferor's will.[19] Example 1 under the new qualified severance regulation also parallels

[18] *See* PLRs 200713002, 200713001, 200519008, 200508001, 200502036, 200451021, 200441022, 200429004, 200408014, 200403072, 200451029, 200451021, 200352011, 200351010, 200340015, 200223016, 200213014. In numerous instances, a trust for which the qualified terminable interest property ("QTIP") election under Section 2056(b)(7) was made is severed on identical terms because the severance is required solely to facilitate an effective reverse QTIP election under Section 2652(a)(3). *See* 200540007, 200519008, 200508001, 200451029, 200443025, 200441022.

[19] Example 1 of Regulation 26.2642-6(j) addressing qualified severances parallels the following Example 1 of Regulation 26.2654-1(b)(1), in each case illustrating a trust severance that preserves the succession of beneficial interests in the original trust:

> Example 1. Severance of single trust. T's will establishes a testamentary trust providing that income is to be paid to T's spouse for life. At the spouse's death, one-half of the corpus is to be paid to T's child, C, or C's estate (if C fails to survive the spouse) and one-half of the corpus is to be paid to T's grandchild, GC, or GC's estate (if GC fails to survive the spouse). If the requirements of paragraph [Regulation 26.2654-1](b) of this Section are otherwise satisfied, T's executor may divide the testamentary trust equally into two

(continued…)

Example 1 under Regulation 26.2654-1(b)(1), and describes a trust with an inclusion ratio of one providing for distribution of income to T's sister S for life.[20] The remainder of the trust will be divided at S's death between transferor's child C (or C's estate if C is deceased) and grandchild GC (or GC's estate if GC is deceased). This example confirms that a severance creating two equal separate trusts, both of which distribute trust income to S for life, with distribution of Trust 1 to C (or C's estate) at S's death and distribution of Trust 2 to GC (or GC's estate) at S's death, would satisfy the succession of interests requirement.

Example 3 of the final regulations illustrates a trust severance based on the actuarial value of the respective beneficiaries' interests that does not meet the "same succession of interests" test.[21] Example 3 describes a trust with an inclusion ratio of one that provides for distribution of all trust income to T's child C for life with distribution of the remainder to T's grandchild GC (or GC's estate if GC is deceased). The trust is severed to create two trusts, Trust 1 for C's benefit funded with an amount equal to the actuarial value of C's interest in the original trust and Trust 2 for GC's benefit funded with an amount equal to the actuarial value of GC's interest in the original trust. Example 3 concludes that the division is not a qualified severance because the resulting trusts do not provide the same succession of interests.

As the final regulations do not acknowledge the separate trusts resulting from non-qualified severances, the taxable termination that otherwise would occur upon distribution to the separate trust for GC under Example 3 apparently would not occur until C's death. If Treasury adopts Proposed Regulation 26.2642-6(h), which recognizes separate trusts resulting from non-qualified severances for GST tax purposes, the transferor may be required to allocate GST exemption to the entire original trust to protect the GST occurring upon severance. Although the final regulations specify that a qualified severance is deemed to occur before a taxable termination or a taxable distribution that occurs due to the qualified severance, that rule does not address non-qualified severances.

a. "Same Succession of Interests" - Trust Terms That Depend on Trust's Inclusion Ratio.

The regulations provide an example applying the succession of interests requirement to a trust with terms that depend on the trust's inclusion ratio. Example 10 of the final regulations describes a trust with an inclusion ratio of .60.[22] The trust requires the distribution of all trust income to T's child C for life and gives C a testamentary power of appointment limited to C's lineal descendants. However, C also has a testamentary general power of appointment over the fraction of the trust equal to the trust's inclusion ratio. The trust is divided into two separate

---

separate trusts, one trust providing an income interest to spouse for life with remainder to C, and the other trust with an income interest to spouse for life with remainder to GC. Furthermore, if the requirements of paragraph [Regulation 26.2654-1](b) of this Section are satisfied, the executor or trustee may further divide the trust for the benefit of GC. GST exemption may be allocated to any of the divided trusts.

[20] Reg. 26.2642-6(j), Ex. 1.

[21] Reg. 26.2642-6(j), Ex. 3.

[22] Reg. 26.2642-6(j), Ex. 10.

trusts, one consisting of 40% (Trust 1) and one consisting of 60% (Trust 2) of the original trust's assets. C has a limited testamentary power of appointment over Trust 1 and a general testamentary power of appointment over Trust 2. The example concludes that the division of a trust into two trusts with the same terms as the original trust will satisfy the succession of interests requirement, even though the class of permissible appointees will differ between the two trusts. This conclusion is not surprising because C has a general power of appointment over the same .60 portion of the original trust's assets both before and after the division, and, in all other respects, the provisions of the two new trusts are exactly the same.

An example describing the effect of a severance that changes the scope of a beneficiary's general power of appointment over trust property would be more helpful. For example, some trust instruments give trustees a broad power to divide trusts into two or more separate trusts with identical terms but also provide that the primary beneficiary of any trust held under the instrument that has an inclusion ratio of one has a testamentary general power of appointment over the trust property. Suppose a trust held under such an instrument had an inclusion ratio of .60, and the trustee divided it into two separate trusts, one consisting of 60% of the trust's assets (Trust 1) and the other consisting of 40% of the trust's assets. (Trust 2). As a consequence of the division, the beneficiary would acquire a testamentary general power of appointment over 60% of the trust's assets. It is not clear from Example 10 that this type of division would satisfy the succession of interests requirement.

If this division resulting in a new general power of appointment satisfies the same succession of interest requirement, other provisions that become effective upon a severance resulting in trusts with inclusion ratios of one or zero may also be permitted. For example, a trust instrument could provide for mandatory or more liberal discretionary distributions to non-skip persons from any trust with an inclusion ratio of one. In contrast, the trust instrument might dictate narrower standards for distributions from any trust with an inclusion ratio of zero, to preserve the assets for skip persons. However, it remains unclear whether such changes resulting from a discretionary severance will meet the same succession of interests test. Consequently, the safer approach would be to state differences in the trust terms as recommendations or guidelines with respect to distributions from trusts with inclusions ratios of one or zero. The trustee then could administer the trusts with inclusion ratios of zero or one differently from each other, despite the terms being identical to those that governed the original trust. Such severances should not be viewed as changing the provisions of the original trust instrument**.**

The cautious draftsperson likely would prohibit a trust beneficiary from participating in a severance that would change whether or not the beneficiary has a general power of appointment over trust property. If a beneficiary would acquire a new general power of appointment by a severance, a failure to sever could be treated as the release of a general power of appointment. Conversely, a severance that causes the conversion of a general power of appointment into a limited power of appointment could cause the property subject to the power to be included in the power holder's estate, as if the partial release had never occurred.[23] A general trust provision

[23] *See* Rev. Rul. 86-39, 1986-1 C. B. 301, and Rev. Rul. 79-421, 1979-2 C. B. 347, in which the IRS found complete releases of presently exercisable general powers of appointment from indirect acts.

that prohibits a trustee from participating in a trustee decision that would either increase or decrease his or her interests in or powers over trust property should be sufficient to protect against these risks.

b. <u>"Same Succession of Interests" - Discretionary Trusts.</u>

Instead of tailoring trust terms to vary with the inclusion ratio, trust instruments contemplating a qualified severance could include flexible terms giving the trustee sufficiently broad discretion to administer and make distributions from the trusts as appropriate, considering their inclusion ratios. Such broad discretion would facilitate severance of the original trust into resulting trusts that continue to be governed by terms identical to the original trust. In fact, Regulation 26.2642-6(d)(5) now describes certain severances of discretionary trusts permitting distributions to any one or more beneficiaries on a non-*pro rata* basis that will maintain the "same succession of beneficial interest" if all of the following requirements are satisfied:

(i) The terms of each resulting trust are the same as the terms of the original trust, though each permissible beneficiary of the original trust is not a beneficiary of all of the resulting trusts;

(ii) Each beneficiary's interest in the resulting trusts (collectively) equals the beneficiary's interest in the original trust, determined by the terms of the trust instrument or, if none, "on a per-capita basis;"

(iii) The severance does not shift a beneficial interest in the trust to any beneficiary in a lower generation (as determined under Section 2651) than the person or persons who held the beneficial interest in the original trust; and

(iv) The severance does not extend the time for the vesting of any beneficial interest in the trust beyond the period provided for in (or applicable to) the original trust.

The regulation provides an example of a severance of a wholly discretionary trust that maintains the "same succession of beneficial interests." A discretionary trust for the benefit of A, B, and C and their descendants with the remainder to be divided equally among those three families is severed into three separate trusts of equal value: one for the benefit A and A's descendants, one for the benefit of B and B's descendants, and one trust for the benefit of C and C's descendants. This example for severances of discretionary trusts parallels Example 5 under Regulation 26.2601-1(b)(4)(E) addressing permissible modifications of trusts grandfathered from application of the GST tax that will not subject the trusts to such tax.

This provision authorizing certain severances of discretionary trusts facilitates divisions of trusts along family lines, which are often important means of resolving family disputes. However, several aspects of this rule require additional clarification. Under the example, the meaning of "per capita" for purposes of this rule is unclear. If A, B and C described in the example are the transferor's children, then a per capita division treats each family line equally and likely reflects the intention of most transferors or interested parties. However, if A is the transferor's child while B and C represent the transferor's grandchildren born to a deceased child who was A's sibling, then the example results in the allocation to A's trust of only one-half the amount of property allocated to the trusts held for members in A's sibling's family. The division of property "per capita" may significantly differ among separate family lines based on the chance order of deaths of family members and the number of children each individual chooses to have. In contrast, experience suggests that transferors and parties negotiating resolutions to disputes regarding the division of trust property typically prefer a "per stirpes" division of property that preserves the shares of property allocated to each family line, beginning with a per capita division at the children's generation. If such per stirpes division was actually contemplated in this provision, then a technical correction might revise the reference to clarify that a per stirpes measure of the beneficiaries' interests after the severance is appropriate.

The example concludes that severances of discretionary trusts meeting certain criteria satisfy the succession of interests requirement. This conclusion is logical because the trustee in the example has the broadest possible discretion to distribute among multiple beneficiaries on a non-*pro rata* basis. This discretion probably precludes any beneficiary from asserting an interest in a particular or identifiable portion of the trust that could be affected by a severance. For the same reason, this example may indicate that the requirement is met even if beneficiaries of one trust do not have a cross-remainder interest in the other trusts, either as discretionary beneficiaries if their trusts are exhausted or as contingent remainder beneficiaries if one family line terminates. This example does not appear to require that each of A, B and C and their respective descendants maintain interests in all of the trusts resulting from the severance to the extent that any single trust is exhausted. This conclusion seems to be confirmed by the statement that "each permissible beneficiary of the original trust is not a beneficiary of all of the resulting trusts."[24] In contrast, Examples 2 and 7 of the final regulations illustrating qualified severances recite facts showing that the beneficiaries retain their interests in the remainders of both trusts resulting from the severance in the event a single trust is exhausted. However, without specific discussion, the final regulations remain unclear as to whether the preservation of the original beneficiaries' interests in all of the post-severance trusts is required for a qualified severance.

In addition, the final regulations do not provide extensive guidance regarding the standards for the exercise of discretion that would meet the definition of a discretionary trust for purposes of this exception. Example 2 addressing this exception merely states that the trustee may distribute "as the trustee deems advisable." Hopefully, this absolute discretion without qualification is not the only type that satisfies this exception and other discretionary standards considered similarly non-ascertainable for transfer tax purposes (i.e., "best interests and welfare," "comfort" or "happiness") will suffice.

5. <u>Requirement 6: Original Inclusion Ratio of One or Zero</u>

Regulation 26.2642-6(d)(6) provides that each trust resulting from a qualified severance of a trust with an inclusion ratio of either one or zero must have the same inclusion ratio as the original trust. This requirement is puzzling to the extent that it suggests that a severance of a trust with an inclusion ratio of either one or zero can change the inclusion ratio. Section 2642(a)(3) does not indicate that such severances can affect the original inclusion ratio to

[24] Reg. 26.2642-6(d)(5)(i)

produce resulting trusts with inclusion ratios different from the original trust.

6. Requirement 7: Original Inclusion Ratio Between One and Zero

Regulation 26.2642-6(d)(7) incorporates the requirement under Section 2642(a)(3)(B)(ii) that when an undivided trust has an inclusion ratio between zero and one, a severance is a qualified severance only if it divides the trust into two trusts. One resulting trust must receive that fractional share of the total value of the original trust as of the date of severance equal to the applicable fraction and will have an inclusion ratio of zero. The other resulting trust must receive the remaining fractional share of the original trust and will have an inclusion ratio of one. If the applicable fraction of the original trust is .50, the trustee may designate which of the resulting equal trusts will have an inclusion ratio of zero and which will have an inclusion ratio of one.[25] The regulation confirms that each resulting trust may be further divided in additional qualified severances to create further separate trusts.[26]

Example 7 of the final regulations illustrates successive qualified severances.[27] As noted above, Section 2642(a)(3)(B)(ii) provides that a qualified severance initially must divide a trust into only two new trusts. Thus, a severance into more than two trusts would not qualify even if each of the new trusts had an inclusion ratio of either zero or one. Instead, each trust resulting from the first qualified severance may be further divided by qualified severance to create more than two trusts from the original single trust. Example 7 confirms that successive severances of a single trust with an inclusion ratio between zero and one is effective to create more than two resulting trusts with inclusion ratios of zero or one. In Example 7, a trust is established under T's will upon his death in October, 2004, and funded with $1 million. S is a non-skip person who must receive all trust income during S's life. The trustee may distribute trust principal non-*pro rata* among a class consisting of T's three grandchildren, G1, G2 and G3 and S. On S's death, the trust will terminate and the trust property will be divided equally among the three grandchildren "(or their respective then-living descendants, per stirpes)." T's executor allocates $300,000 of T's GST exemption to the trust, which then has an inclusion ratio of .70. In June, 2007, the trustee severs the trust into two trusts, Trust 1 and Trust 2, with terms and beneficiaries identical to the original trust. Trust 1 receives 30% of the assets of the original trust and Trust 2 receives 70% of those assets, in each case funded with a portion of each asset held in the original trust.

The trustee next severs each of Trust 1 and Trust 2 into three equal separate trusts, each to be funded *pro rata* and named for a separate grandchild. Each separate trust provides that S must receive all trust income during S's life and the trustee may distribute trust principal to S and to the respective grandchild for whom the trust is named. On S's death, the trust will terminate and the trust property will be distributed to that grandchild, or if deceased, per stirpes to that grandchild's then living descendants. Both severances are qualified severances, assuming all

[25] Example 4 illustrates the severance of a trust with an initial inclusion ratio of .50 into equal separate trusts, requiring the trustee to designate which trust has the inclusion ratio of zero and of one. Reg. 26.2642-6(j), Ex. 4.

[26] Reg. 26.2642-6(d)(7).

[27] Reg. 26.2642-6(j), Ex. 7.

other requirements are satisfied. Each trust resulting from the severance of Trust 1 has an inclusion ratio of zero, and each trust resulting from the severance of Trust 2 has an inclusion ratio of one. The specification that the trustee funded the separate trusts resulting from both qualified severances on a *pro rata* basis confirms that a *pro rata* division of assets is always an acceptable method of funding the resulting trusts.

B. Qualified Severances of "Grandfathered" Exempt Trusts.

Section 2642(a)(3) addresses the recognition of the creation of separate trusts resulting from a qualified severance for GST tax purposes. However, the GST tax rules, including those authorizing qualified severances under Section 2642(a)(3), do not apply at all to a trust that is exempt from the GST tax due to its effective date provisions ("grandfathered trusts").[28] Instead, Regulation 26.2601-1(b)(4) describes rules for determining whether a modification, judicial construction, settlement agreement, or trustee action with respect to an exempt trust will cause it to lose its exempt status. Thus, a severance of an exempt trust must satisfy those rules to avoid becoming subject to GST tax.

However, where contributions are added to a grandfathered trust after September 25, 1985, Regulation 26.2601-1(b)(1)(iv)(A) deems the trust to consist of one separate share attributable to contributions before such date that is not subject to GST tax (the "non-chapter 13 portion") and another separate share attributable to contributions after such date that is subject to GST tax (the "chapter 13 portion"). This regulation, however, does not describe any method for dividing such a trust into separate trusts recognized for GST tax purposes. Instead, it provides that after the contribution, a *pro rata* portion of all distributions from and terminations of interest in the trust will be subject to the GST tax.

When a donor other than the original transferor contributes property after September 25, 1985, to a grandfathered trust, the donor becomes the transferor of the chapter 13 portion. The portions of the trust attributable to the original transferor and the portion attributable to the donor have been treated as separate trusts for GST tax purposes under Section 2654(b)(1). Thus, related Regulations treat portions of a trust attributable to different transferors as separate trusts and recognize the severance of such a single trust to separate those portions into separate trusts.[29] These rules, however, do not apply to a trust that has only one transferor. Similarly, the other limited rules recognizing severances of substantially separate and independent shares or included trusts did not apply to such trusts with only one transferor. As a result, prior to the enactment of Section 2642(a)(3) authorizing qualified severances, no authority recognized the severance of a trust with one transferor who made contributions before and after the effective date of the GST tax to segregate the chapter 13 and non-chapter 13 portions.

---

[28] Grandfathered trusts include trusts irrevocable on September 25, 1985; wills and revocable trusts in existence on October 22, 1986, if the decedent died before January 1, 1987; and transfers from a person unable to change the disposition of his or her property on October 22, 1986, because of a mental disability if he or she does not regain competence before death. *See* Section 1433(b) of the Tax Reform Act of 1986 for the effective date provisions of the GST tax.

[29] *See* Reg. 26.2654-1(a).

The final regulations now allow qualified severances to divide grandfathered trusts with post-September 25, 1985, contributions.[30] These trusts may be severed into two trusts to segregate the non-chapter 13 portion from the chapter 13 portion. The regulations also confirm that the trust holding the chapter 13 portion may be further divided by an additional qualified severance, and that the non-chapter 13 portion may be further divided in accordance with Regulation 26.2601-1(b)(4). Such severances must comply with Regulation 26.2654-1(b)(1)(ii)(c), which permits fractional severances, and in some cases, severances based on pecuniary amounts.

C. <u>Reporting - Qualified Severances.</u>

Contrary to the 2004 Proposed Regulations, the final regulations do not require that a qualified severance be reported to be effective for GST purposes. The Preamble explains the rationale for this change:

> The Proposed Regulations include a mandatory reporting requirement, without which a severance would not constitute a qualified severance. One commentator noted that, in some situations, it may be advantageous to sever a trust but to avoid qualification under section 2642(a)(3) as a qualified severance. . . . Therefore, under the final regulations, the reporting provisions do not constitute a requirement for qualified severance status, but each severance should be reported to ensure that the [GST tax provisions] of the Code may be properly applied with regard to the trusts.

Although not required, reporting the qualified severance in cases where the inclusion ratios of the resulting trusts differ from the original trust may be useful to avoid future confusion when reporting subsequent GST events. A qualified severance of a trust with an inclusion ratio of .50 into equal separate trusts, which requires the trustee to designate which trust has the inclusion ratio of zero and of one[31] also requires reporting as a practical matter. However, reporting those severances occurring after the issuance of the final regulations may not provide a meaningful advantage to the taxpayer when the resulting trusts will maintain the inclusion ratio of the original trust. Regardless of whether the severance is reported to the IRS, the trustee should document the severance of the trust as it will be relevant in the ongoing administration of the trust and to memorialize the relevant facts establishing qualification under Section 2642(a)(3) at a later time, if necessary.

When the trustee decides to report a qualified severance to the government, Regulation 26.2642-6(e) describes how to do so. A qualified severance is reported by filing Form 706-GS(T), "Generation-Skipping Transfer Tax Return for Terminations" (or such other form as the IRS may provide for the purpose of reporting qualified severances) by April 15th of the year immediately following the year during which the severance occurred or by the last day of the

---

[30] *See* Reg. 26.2642-6(g), 26.2654-1(a)(3).

[31] *See* Reg. 26.2642-6(d)(7).

period covered by an extension of time, if an extension of time is granted, to file such return.[32] The IRS requests that filers write the words "Qualified Severance" at the top of the return and attach a Notice of Qualified Severance including the basic information regarding the original and resulting trusts and their respective inclusion ratios described in the regulation.[33] The regulations provide that the Notice of Qualified Severance should provide information concerning the original trust and each new trust.

Specifically, the Notice of Qualified Severance should provide the following information with respect to the original trust that was severed: (i) the name of the transferor; (ii) the name and date of creation of the original trust; (iii) the tax identification number of the original trust; and (iv) the inclusion ratio before the severance.[34] Further, the Notice of Qualified Severance should provide the following information with respect to each trust resulting from the severance: (i) the name and tax identification number of the trust; (ii) the date of severance (within the meaning of Regulation 26.2642-6(c) of this section); (iii) the fraction of the total assets of the original trust received by the resulting trust; (iv) other details explaining the basis for the funding of the resulting trust (a fraction of the total fair market value of the assets on the date of severance, or a fraction of each asset); and (v) the inclusion ratio.[35]

Curiously, the transition rules for the final regulations retain the notice requirement for severances occurring before August 2, 2007. Taxpayers may rely on "any reasonable interpretation of Section 2642(a)(3) as long as reasonable notice concerning the qualified severance and identification of the trusts involved has been given to the IRS."[36] The 2004 Proposed Regulations are treated as a reasonable interpretation of the statute for this purpose. For severances occurring between December 31, 2000, and January 1, 2007, "notification should be mailed to the IRS as soon as reasonably practicable after August 2, 2007, if sufficient notice has not already been given." [37] For severances occurring after December 31, 2006, and before August 2, 2007, the notice should be mailed by the due date for the gift tax return (including extensions granted) for gifts made during the year in which the severance occurred or, if no gift occurred, by April 15th of the year after the year in which the severance occurred.[38]

D. <u>Time for Making a Qualified Severance.</u>

A qualified severance cannot have retroactive effect because Section 2642(a)(3)(A) states that trusts resulting from a qualified severance will be treated as separate trusts "thereafter" for

[32] Reg. 26.2642-6(e). The regulations do not describe any procedure for obtaining an extension of time to file a Notice of Qualified Severance. Because this filing is not required, this omission is not particularly troublesome.

[33] *Id*. The former requirement under the 2004 Proposed Regulations to label the return with "Qualified Severance" in red ink has been eliminated. *See* 2004 Prop. Regulation 26.2642-6(b)(6).

[34] Reg. 26.2642-6(e)(2).

[35] Reg. 26.2642-6(e)(3).

[36] Reg. 26.2642-6(k)(2).

[37] *Id*.

[38] *Id*.

GST tax purposes. Consequently, Regulation 26.2642-6(f) specifies that a qualified severance of a trust may occur at any time before the trust terminates and will be effective thereafter.[39]

As discussed above, the 2004 Proposed Regulations repealed Regulation 26.2654-1(b) governing severances of included trusts that are recognized for GST tax purposes retroactively, as of the date of the grantor's death. The final regulations do not eliminate Regulation 26.2654-1(b). Instead, the Preamble acknowledges that Regulation 26.2654-1(b) will be retained to provide guidance regarding mandatory and discretionary severances of included trusts, effective retroactively to the transferor's date of death. The Preamble clarifies that Regulation 26.2642-6 will govern any qualified severance of a trust (whether or not included in the transferor's gross estate) that will be effective from the date of severance.

Accordingly, a qualified severance cannot prevent or otherwise affect taxable transfers that occur prior to the date of the severance. However, the final regulations helpfully provide that "[a] qualified severance shall be deemed to occur before a taxable termination or a taxable distribution that occurs by reason of the qualified severance." Example 8 illustrates the operation of this rule and describes the qualified severance of a single trust with an inclusion ratio of .50 held for T's child C and T's grandchild GC into two equal separate trusts.[40] The trust pays all trust income in equal shares to C and GC for ten years, and if either dies before the end of the term, the deceased beneficiary's share of income will be paid to the beneficiary's descendants per stirpes until the end of the term. At the end of the term, the trust balance is to be distributed equally to C and GC with a deceased beneficiary's share to be distributed per stirpes to that beneficiary's then living descendants. The resulting trusts have terms identical to the original trust, except that Trust 1 is held for C and C's descendants, and Trust 2 is held for GC and GC's descendants. The trustee designates Trust 2 as the trust with the inclusion ratio of zero.[41] The example concludes that a taxable termination occurs as a result of the qualified severance because Trust 2 is a skip person. Nevertheless, the taxable event is protected from GST tax because Trust 2 acquired an inclusion ratio of zero as a result of the qualified severance and the severance is deemed to occur before any taxable event caused by the severance.[42]

---

[39] Reg. 26.2642-6(f).

[40] Reg. 26.2642-6(j), Ex. 8.

[41] Example 8 appears to omit certain facts. *See* Reg. 26.2642-6(j), Ex. 8. As written, Example 8 describes a trust that provides substantially separate and independent shares for C and GC from creation. Section 2654(b)(2) provides that different beneficiaries' substantially separate and independent shares of a trust are treated as separate trusts for GST tax purposes. *See also* Reg. 26.2654-1(a)(1). Thus, the GST tax regulations would treat the separate shares as separate trusts for GST tax purposes without regard to any actual division into separate trusts. Moreover, the original transfer to the trust would have been a taxable direct skip with respect to GC's share. For this example to be correct as described, one must assume that the trust does not require any adjustment for discretionary distributions of principal to C and GC to their shares of income or the trust remainder. This assumption would prevent the shares being treated as separate shares for income tax purposes under Regulation 1.663(c)-3 and, therefore, separate shares for GST tax purposes.

[42] Example 8 appears to include a technical misstatement but the error has no impact on the example's ultimate conclusion. *See* Reg. 26.2642-6(j), Ex. 8. Example 8 states that the severance of the original trust that resulted in the distribution of 50% of the trust property to Trust 2 would have been a taxable termination or distribution "but for the rule that a qualified severance is deemed to precede the taxable termination that is caused by the qualified

(continued…)

E. Income Tax Consequences of Qualified Severances.

Practitioners also should consider whether a qualified severance may have other gift, estate or income tax consequences that are not described in the GST tax rules under Sections 2642 and 2654. New Regulation 1.1001-1(h), issued together with the final qualified severance GST tax regulations, describes criteria for qualified severances that will not constitute a taxable event causing recognition of gain or loss for income tax purposes.

1. Qualified Severances - Recognition of Capital Gain or Loss.

Section 1001 governs the determination of the amount and recognition of capital gain or loss for income tax purposes upon the sale or other disposition of property. Effective as of August 2, 2007, Regulation 1.1001-1 is amended to add a helpful new subparagraph (h) describing a safe harbor for income tax purposes for certain severances of trusts, including without limitation qualified severances under Regulation 26.2642-6 or severances described in Regulation 26.2654-1(b). This new provision addresses the concern that the severance of a trust may be deemed to create a taxable exchange resulting in the recognition of capital gain by one or more of the trust beneficiaries.

The IRS addressed taxable gains resulting from the severance of a trust in PLR 9731041. PLR 9731041 describes the proposed partition of a single trust grandfathered from application of the GST tax into two separate trusts to be governed by the terms of the original trust. One resulting trust would own all of the closely held company stock and the other owning all of the remaining trust assets. Certain beneficiaries entitled to annual fixed payments from the single trust also proposed to renounce their interests in the trust holding company stock as the other resulting trust was determined to be actuarially sufficient to provide for their annual payments entirely. Due to the trustee's power to make non-*pro rata* distributions under the trust instrument and local law, the IRS concluded that the partition was not a taxable event for income tax purposes. However, the IRS relied primarily upon *Cottage Savings Ass'n. v. Comm'r.*,[43] in its analysis of whether the partition resulted in recognition of gain or loss under Section 1001.

In *Cottage Savings*, the Court held that a realization event under Section 1001(a) occurs upon an exchange of properties that are "materially different."[44] The Court further stated that properties are "materially different" for purposes of Section 1001(a) to the extent their respective possessors enjoy legal entitlements that are different in kind or extent.[45] Under this standard, the Court concluded that a taxpayer's exchange of interests in groups of mortgage loans considered "substantially identical" by the regulating agency nevertheless resulted in a taxable exchange because the mortgage loans made to different obligors and secured by different homes embodied distinct legal entitlements. In PLR 9731041, the IRS applied the *Cottage Savings* analysis and

severance." Technically, a taxable termination in fact occurred, but because Trust 2 has a zero inclusion ratio, the tax rate is zero so that no GST tax was imposed on the taxable termination.

[43] 499 U.S. 554 (1991).

[44] *Id*. at 560-61.

[45] *Id*. at 564-65.

concluded that the partition of the single trust would not change the beneficiaries' interests. Thus, the IRS concluded that "[I]t is inconsistent with the Supreme Court's opinion in Cottage Savings to find that the interests of the beneficiaries of the two successor trusts will not differ materially from their interests in the existing trust."

The IRS subsequently has ruled favorably for taxpayers that severances of trusts will not result in a taxable exchange under Section 1001 after applying the *Cottage Savings* test.[46] However, the IRS also has declined to rule on at least one request for a ruling on this issue, based on "the factual nature of the problem or in the interest of sound tax administration" without offering further explanation.[47] Given the IRS's reliance on *Cottage Savings*, taxpayers must analyze whether beneficiaries may obtain interests in the trust after a severance that are "materially different" from their original interests to avoid unexpected recognition of taxable gain under Section 1001. In particular, a severance that results in separate trusts governed by terms that are not identical to the original trust may warrant close scrutiny to ensure that resulting beneficial interests are not "materially different" under the *Cottage Savings* test -- even though the severance may retain the "same succession of interests" for GST tax purposes.[48]

Regulation 1.1001-1(h) incorporates the language of the *Cottage Savings* test and provides that any severance of a trust will not constitute an exchange of property for other property differing materially either in kind or in extent if--

a. An applicable state statute or the governing instrument authorizes or directs the trustee to sever the trust; and

b. If the separate trusts created by the severance are funded on a non-*pro rata* basis (as provided in Regulation 26.2642-6(b)(3)), the non-*pro rata* funding is authorized by an applicable state statute or the governing instrument.

Regulation 1.1001-1(h)(1) is narrower in scope than the definition of a "qualified severance" under Code Section 2642(a)(3), which includes a severance that occurs pursuant to "any means available under" local law (not only by state statute).[49] Accordingly, even in the absence of the specific power to sever in the trust instrument or state statute, a severance by judicial order or other means available under local law should suffice for purposes of the qualified severance statute. However, Regulation 1.1001-1(h)(1) requires authorization by "state statute" if the trust instrument does not expressly direct or authorize the severance. This express

[46] PLR 200010037 (trustee had discretionary power to divide trust and IRS concluded trustee's division of trust was not an exchange and no gain realization). Similarly, in PLRs 200116016 and 200210056 trustee's power in trust instrument to divide trusts and the subsequent division of trust was not an exchange and no gain realization. In PLR 200128035, the IRS determined the beneficiaries interests in proposed trusts resulting from a division of a trust were not materially different from their interests in the original trust, and, therefore, no gain realization.

[47] PLR 9831023.

[48] For a detailed discussion of *Cottage Savings* and its application to planning with trusts for GST tax purposes, *see* Lloyd Leva Plaine, "How Cottage Savings and Recognition of Gain Relate to Trusts," 38th Annual Heckerling Institute on Estate Planning, Chapter 4 (2004).

[49] Section 2642(a)(3).

limitation to statutory authority potentially excludes severances that do not fit squarely within any statute but are effective under broader "state law." For example, a court with proper equitable jurisdiction generally has the power to divide a trust by reformation. The basis for distinguishing among alternative means that are equally effective under state law for severance of a trust in the regulation is unclear, especially given the statutory direction to recognize any severance effective under local law.

The Preamble notes that "[n]o inference is to be drawn with respect to the income tax consequences under section 1001 of any severance that is not described in Section 1.1001-1(h)(1)." Where a severance is not described in the new safe harbor, the severance must be reviewed for the two elements of a taxable event for income tax purposes under Regulation 1.1001-1: whether an exchange of property has occurred, and if so, whether the exchange was "for other property differing materially either in kind or in extent." No exchange should result from a severance pursuant to the trustee's authority, because the trustee's ongoing power generally prevented the beneficiaries from acquiring a fixed and identifiable interest in the trust that would be altered by the severance. The trustee's exercise of a severance power should be treated the same as any other exercise of a trustee's discretion, such as the discretion to make distributions. For example, a severance of a trust providing for wholly discretionary spray distributions of income and principal to beneficiaries does not create interests differing from the beneficiaries' interests in the original trust because those were always subject to change through the exercise of the trustee's discretion. Thus, the beneficiaries do not receive any new interest different from the original interest to which they were entitled and the severance should not incur gain or loss for income tax purposes. However, a severance that results from any means other than pursuant to the trustee's authority must be reviewed for an exchange of property differing materially in kind or in extent.

2. <u>Qualified Severances - Distribution of Distributable Net Income.</u>

New Regulation 1.1001-1(h)(1) addresses only the issue of whether gain or loss is recognized when a qualified severance occurs. Another issue that arises when trusts are divided is how the division carries out distributable net income ("DNI") when the new trusts are funded, which must be analyzed under subchapter J of the Code governing taxation of trust income.[50]

For example, assume that Trust A has an inclusion ratio of .6, that the trustee of Trust A divides Trust A into two separate trusts, Trust A1 and A2, in a qualified severance, and that Trust A1 will have an inclusion ratio of zero and be funded with 40% of the value of the trust on the effective date of the severance while Trust A2 will have an inclusion ratio of one and be funded with 60% of value on the effective date.

While the mechanics of subchapter J are beyond the scope of this article, the issue is whether DNI will be carried out to Trust A1 and A2 in the ratio of 40% and 60% respectively, or whether under Section 643(e), the DNI will be pro rated between the trusts based on the value of what was actually distributed, for this purpose using the lesser of fair market value or basis in

[50] *See* Section 641 *et. seq.*

computing value for property distributed other than cash.[51] While this issue is not entirely free from doubt, the qualified severance should result in separate shares as of the effective date of the severance because at that moment, the new trusts are entitled to a definite fraction of the whole trust and are thereafter independent of each other. Distributions from one share will not affect the other share.[52] Although the separate shares did not arise before June 30, with respect to the actual income earned to the point, each new trust is entitled to 40% and 60% respectively of all income and appreciation, and again, the trustee's decision to fund with one asset or another does not change the amount of property, including income, to which each trust is entitled. For that reason, DNI should be pro rated 40% and 60% respectively regardless of the basis of property received, which basis would carry over in the hands of the recipient trusts.

F. Qualified Severances - Proposed Regulations.

Simultaneous with the issuance of the final regulations regarding qualified severances, the Treasury Department issued Proposed Regulations addressing issues that it considered as requiring further consideration. Notice of Proposed Rulemaking REG-128843-05. The new Proposed Regulations recognize for GST tax purposes all severances recognized under local law and certain mandatory severances, a position that many practitioners have long championed. However, these regulations depart from state law by denying valuation discounts in funding post-severance trusts and the separate shares created in certain trusts.

The final qualified severance Regulations discussed above describe the requirements of a qualified severance. However, the "multiple trust rule" under existing Regulations continues to deny recognition of separate trusts resulting from a non-qualified severance that is effective under state law.[53] Consequently, the multiple trust rule creates an incentive for a taxpayer with more than one child to create a multigenerational single trust for all of his or her children and more remote issue rather than separate trusts for each child's family branch. If separate trusts are created, each child's death is likely to be a taxable termination as to the trust for his or her family line. In contrast, if a single trust is created, even if the trust is divided later into separate trusts for each child's family, a taxable termination will not occur with respect to any of the trusts until the death of the last child to die.

Section 2642(a)(3) defines a qualified severance as "any other severance permitted under regulations prescribed by the Secretary." This provision gives the Treasury the ability to expand the definition of a qualified severance beyond the terms set forth in the Code.

1. Valuation of Assets for Purposes of Non-*Pro rata* Funding.

---

[51] *See* Section 643(e)(2).

[52] *See* Section 633(c); Reg. Section 1.663(c)-3.

[53] The government's failure to recognize trusts that are separate under state law as separate for GST tax purposes is nowhere authorized in the GST tax statutory provisions and is, in fact, directly contrary to clear legislative history stating that Section 2654 does not affect the treatment of trusts that are separate under state law. See H.R. Rep. No. 795, 100th Cong., 2d Sess. (1988), p. 354.

Recently issued final Regulation 26.2642-6(d)(4) addresses the requirement that a qualified severance must be made on a fractional basis. The regulation requires that a non-*pro rata* funding must be "based on the fair market value of the assets on the date of the severance." However, Proposed Regulation 26.2642-6(d)(4) adds the new requirement that:

> [E]ach asset received by a resulting trust must be valued, solely for funding purposes, by multiplying the fair market value of the asset held in the original trust as of the date of severance by the fraction or percentage of that asset received by that resulting trust. Thus, the assets must be valued without taking into account any discount or premium arising from the severance, for example, any valuation discounts that might arise because the resulting trust receives less than the entire interest held by the original trust.

This Proposed Regulation denies any valuation discount attributable to the division of that asset. This denial of discounts otherwise required in proper valuation of trust assets is troubling as it lacks any basis in Section 2642(a)(3) or its legislative history. In fact, this Proposed Regulation contravenes the express statutory requirements of Section 2642(a)(3) for funding the trusts resulting from a qualified severance. Section 2642(a)(3)(B)(ii) states that "a severance [of a trust with an inclusion ratio between one and zero] is a qualified severance <u>only</u> if the single trust is divided into two trusts, one of which receives a <u>fractional share of the total value of all trust assets equal to the applicable fraction</u> of the single trust immediately before the severance." (Emphasis added.) As discussed further below, this requirement may not be satisfied in some circumstances if trusts are funded pursuant to the Proposed Regulation .

The "total value" of trust assets in the statutory formula, as is the norm for transfer tax purposes, should be fair market value. Fair market value has the generally accepted meaning throughout the Code as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of the relevant facts.[54] Such valuation of property requires consideration of appropriate discounts for lack of marketability, minority interest, illiquidity or other relevant factors, as courts presiding over decades of case law have acknowledged when addressing the determination of fair market value.[55] In adopting a special rule for funding trusts resulting from qualified severances, this Proposed Regulation departs from the traditional definition of value solely for this purpose. This method of valuation, being contrary to judicial precedent and applicable state law, will require funding that is contrary to Section 2642(a)(3) to the extent it denies legitimate discounts required for valuation of trust assets. Moreover, funding pursuant to this Proposed Regulation may shift beneficial interests between the resulting trusts from the allocation that would result from funding based on values determined under state law. This shift in beneficial interests in the trust property could violate the trustee's duty of impartiality under applicable state law to fund the resulting trusts based on the trust assets' fair market values.

[54] Regulations 1.170 A-1(c)(2), 20.2031-1(b) and 25.2512-1.

[55] *Estate of Andrews v Commissioner*, 79 T.C. 938(1979); *Estate of Bright v United States*, 81-2 U.S.T.C. 13,436 (5th Circuit 1981); *Propstra v. U.S.*, 680 F. 2nd 1248 (1982).

Example 6 of Proposed Regulation 26.2642-6(j) illustrates the effect of this proposed new rule ignoring valuation discounts. Example 6 describes the severance of a trust with an inclusion ratio of .40 into two separate trusts as of August 3, 2008, intended to be a qualified severance funded on a non-*pro rata* basis. Trust 1 will have an inclusion ratio of one and be funded with assets having a fair market value on the date of severance equal to 40% of the value of Trust's assets on that date. Trust 2 will have an inclusion ratio of zero and be funded with assets having a fair market value equal to 60% of the value of Trust's assets on that date. On August 3, 2008, the fair market value of the Trust assets totals $4,000,000. These assets include 52% of the outstanding common stock in Company, a closely-held corporation, valued at $3,000,000 and $1,000,000 in cash and marketable securities. The example does not specify the value of 100% of the Company stock, and so any control premium that may have applied to value the 52% interest at $3,000,000 remains unknown.

Trustee proposes to divide the Company stock equally between Trust 1 and Trust 2, to fund each with 26% of the Company stock. Example 6 explains that, for funding purposes, the Company stock distributed to each trust is valued as a *pro rata* portion of the value of the controlling 52% interest in Company held in the original Trust. No discount that otherwise would apply in valuing the non-controlling 26% interest transferred to each resulting trust will be considered in funding. Accordingly, each 26% interest in Company stock distributed to Trust 1 and Trust 2 is valued for funding purposes at $1,500,000 (.5 x $3,000,000). Therefore, Trust 1 which is to be funded with $1,600,000 total (.40 x $4,000,000), also receives $100,000 in cash and marketable securities valued as of August 3, 2008. Trust 2, which is to be funded with $2,400,000 total (.60 x $4,000,000) receives the balance of $900,000 in cash and marketable securities. The example concludes that if all other requirements are satisfied, then the severance based on this non-*pro rata* funding allocation is a qualified severance.

However, Example 6 reveals how allocations pursuant to Proposed Regulation 26.2642-6(d)(4) may violate the statutory requirements for qualified severance. Section 2642(a)(3) requires that one trust resulting from the qualified severance must receive "a fractional share of the total value of all trust assets <u>equal to the applicable fraction of the single trust immediately before the severance</u>." (Emphasis added.) According to Section 2642(a)(3), Trust 2 in Example 6 must be funded with assets with a total value equal to the applicable fraction of .60 or $2,400,000 (.60 applicable fraction x $4,000,000 value of the single trust immediately before the severance). However, if any discount properly applies in valuing a 26% interest in the Company, then ignoring the discount in funding the trusts will violate the statute. For example, assume that a court would find that a 26% interest in Company stock would be valued at a 30% discount from the value of one half of a 52% interest. (In fact, the difference in value probably would be even greater than 30% if the 52% interest were valued with a control premium.) Trust 2 ultimately receives assets with an actual total fair market value of only $1,950,000 ($1,500,000 undiscounted value of 26% interest x .7 (to reflect 30% discount) + $900,000 cash). Thus, Proposed Regulation 26.2642-6(d)(4) requires Trust 2 to be funded with assets having a total fair market value of $1,950,000 insufficient to fully fund Trust 2 with the $2,400,000 amount required under Section 2642(a)(3). This example demonstrates why the Proposed Regulation may be invalid as contrary to the plain terms of the statute, as well as the trustee's potential liability for breach of fiduciary duties to beneficiaries for inadequately funding Trust 2.

In fact, this Example 6 demonstrates that, as applied, the Proposed Regulation also accommodates a greater potential shift in value to Trust 2 than should be allowed. This result is illustrated if the trustee of Trust 2 buys the 26% interest in Company from Trust 1 at fair market value, which we have assumed is $1,050,000, for $900,000 in cash and a note for the balance of $150,000. Trust 2 now has a 52% interest valued at $3,000,000, with a debt of $150,000, for a net value of $2,850,000, rather than the $2,400,000 it should have had after the division. After the sale, Trust 1 has the $100,000 cash it received originally, the $900,000 paid for the 26% Company interest, and a note receivable for $150,000, for a net asset value of $1,150,000, rather than the $1,600,000 it should have received.

Overall, application of this Proposed Regulation may produce inconsistent results or be subject to manipulation, and could radically skew the actual values of resulting trusts from their proper allocations under state law. Instead, the Proposed Regulations could be revised to require that the "total value of all trust assets" will be determined by using traditional fair market values, but by valuing all trust assets *after* any proposed division of assets to be used in funding. This revision should maintain consistency between the Proposed Regulation and the statutory language of Section 2642(a)(3), while addressing the IRS's concerns. Applying this alternative rule in Example 6, the 52% interest in Company would not be valued at $3,000,000 for funding purposes if the funding plan is to pass one-half to each trust as two separate blocks of 26% each. Assuming a valid 30% discount in valuing each 26% block, the total value of the trust assets would be treated as $3,100,000 ((2 x .7 x $1,500,000) + $1,000,000 cash and marketable securities), rather than $4,000,000 as described in the original Example. Trust 1 would be entitled to $1,240,000 (.40 x $3,100,000) and Trust 2 would be entitled to $1,860,000 (.60 x $3,100,000). Trust 1 then would consist of the 26% interest in Company, valued at $1,050,000, plus $190,000 in cash and marketable securities. Trust 2 would consist of its 26% interest in Company plus $810,000 in cash and marketable securities.

This alternative funding method will result in allocation of a minority interest at fair market value to a trust with an inclusion ratio of zero. If the company is liquidated afterwards, all premiums and discounts are ignored in distributing proceeds to the trusts. However, the this result is consistent with existing law and Section 2642(a)(3), and allows no greater abuse than the Proposed Regulation allows as described above.

2. <u>Qualified Severances Resulting in Multiple Trusts.</u>

Section 2642(a)(3) states that a trust with an inclusion ratio between zero and one must be severed into two trusts. However, severance into more than two trusts may be necessary for optimal allocations of GST exemption or other GST tax planning. As discussed above, a new final regulation confirms that an initial severance to create two separate trusts with inclusion ratios of zero and one could be followed by a subsequent severance to create additional separate trusts with inclusion ratios of zero or one. Prior to the issuance of these Proposed Regulations, no guidance confirmed whether this cumbersome series of severances could be consolidated to provide that the initial qualified severance may create more than two resulting trusts. However, Section 2642(a)(3)(B)(iii) gives the Treasury the ability to broaden the definition of a qualified severance by providing that "[t]he term 'qualified severance' includes any other severance permitted under regulations prescribed by the Secretary."

Based on this authority, Proposed Regulation 26.2642-6(d)(7)(ii) provides that the severance of a trust with an inclusion ratio between zero and one may be a qualified severance if it creates more than two resulting trusts so long as one or more resulting trusts in the aggregate receive that fractional share of the value of the original trust as of the date of severance equal to the applicable fraction of the original trust. The trust or trusts receiving such share will have an inclusion ratio of zero, and each of the other resulting trust or trusts will have an inclusion ratio of one. If two or more of the resulting trusts receives a fractional share of the value of the original trust equal to the applicable fraction, the trustee may designate which of those resulting trusts will have an inclusion ratio of zero or of one.

Example 9 under Proposed Regulation 26.2642-6(j) illustrates the operation of this new rule allowing a qualified severance into more than two trusts, labeled a "Regulatory Qualified Severance."

3. Recognition of Non-Qualified Severances.

Proposed Regulation 26.2642-6(h) provides that separate trusts resulting from a non-qualified severance (other than a severance described in Regulation 26.2654-1) that are treated as separate under applicable state law will be respected as separate from the date of the severance for all GST tax purposes. However, the inclusion ratio of the resulting trusts will remain the same as the inclusion ratio of the original trust immediately before the severance. Thus, the non-qualified severance of a trust with an inclusion ratio between zero and one will not produce separate trusts with the most efficient inclusion ratios of zero and one. However, recognition of the separate resulting trusts means that allocations of GST exemption, GST tax elections, additions of property and generation-skipping transfers with respect to one such trust will not impact any other such trust for GST tax purposes. Such recognition of non-qualified severances would increase the alternatives for taxpayers to improve the configuration of trusts creating adverse GST tax consequences. If Treasury ultimately adopts this Proposed Regulation 26.2642-6(h), compliance with the requirements for a "qualified severance" will be unnecessary in cases where a change in the inclusion ratio from the original trust is unnecessary.

Proposed Regulation 26.2642-6(j) includes new examples 12 and 13 to illustrate the new recognition of non-qualified severances. Example 12 describes the division of a single trust into trusts that are separate under applicable state law, but is not a qualified severance due to the failure to fund those trusts in accordance with Regulation 26.2642-6(d)(3). Example 13 describes the division of a single trust into trusts that are separate under applicable state law, but is not a qualified severance due to the failure to preserve contingent survivor income interests existing under the original trust. Because the contingent survivor income interests were not preserved, the "same succession of interests" requirement of a qualified severance was not met. Both examples conclude that the non-qualified severance results in trusts that are recognized as separate for GST tax purposes because they are separate under applicable state law, though the inclusion ratio of those trusts remains the same as the inclusion ratio of the original trust.

Example 13 specifies that the transferor elected to prevent automatic allocations of GST exemption to the original trust and did not otherwise affirmatively allocate GST exemption to the trust. Thus, the conclusion at the end of Example 13 that each severed trust has the same inclusion ratio of the original trust is not particularly significant. Treasury has not yet issued any guidance concerning changes to a trust that may cause the loss of GST exemption that has previously been allocated to a trust. The IRS, however, has issued a number of private letter rulings in which it has stated that "[a]t a minimum, a change that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status of such a trust."[56] Presumably, the severance described in Example 13 would have satisfied the standards described in Regulation 26.2601-1(b)(4), the regulations that establish safe harbors for amendments to grandfathered trusts (i.e., those trusts that were irrevocable on September 24, 1985). To be more specific, it seems to fit within Regulation 26.2601-1(b)(4)(A), which describes a trustee power to distribute to a new trust that is permitted under state law as in effect when the trust became irrevocable. If, however, the distribution had been made pursuant to a state law that became effective after the trust became irrevocable, the GST exemption might have been lost.

4. **Recognition of Separate Shares and Separate Trusts.**

The Preamble to the Proposed Regulations explains that Regulation 26.2642-6(h) was added to recognize trusts resulting from a non-qualified severance for GST tax purposes if those resulting trusts are separate trusts under applicable state law.[57] The Preamble then notes briefly without explanation that the Regulation 26.2654-1(a)(1)(i) and (a)(5), Example 8, are also amended. The lack of independent explanation for these amendments in Proposed Regulation 26.2654-1(a) suggests that the changes were intended to coordinate with Proposed Regulation 26.2642-6(h) to recognize separate trusts for GST tax purposes. Proposed Regulation 26.2642-6(h) expressly excludes from its application the trusts resulting from a severance under Regulation 26.2654-1, perhaps because drafters concluded that the new rule was unnecessary for separate trusts recognized under Regulation 26.2654-1. Unfortunately, the coordination between the Regulations under Sections 2642 and 2654 is imperfect and potentially confusing.

The Proposed Regulations under Section 2654 address both "actual severances" that result in "separate trusts" and severances that merely create "separate shares" of a single trust. Proposed Regulation 26.2654-1(a)(1)(i) continues to recognize separate shares in a single trust that existed from the creation of the trust as separate shares for GST tax purposes. Proposed Regulation 26.2654-1(a)(1)(i) recites that "except as provided in paragraph (a)(1)(iii) of this section [addressing mandatory severances into separate shares], a portion of a trust is not a separate share unless such share exists from and at all times after the creation of the trust." This Proposed Regulation ends by stating: "See section 26.2642-6 and paragraph (b) of this section regarding the treatment, for purposes of chapter 13, of separate trusts resulting from the *actual severance* of a single trust." (Emphasis added.) Thus, separate shares under Regulation 26.2654-1(a)(1)(i) are distinguished from an "actual severance" into separate trusts that will be recognized under Regulations Section 26.2642-6 (including a non-qualified severance if Proposed Regulation 2642-6(h) is adopted).

This distinction between separate shares of a single trust and actual severances into separate trusts would be understandable if the changes to Regulation 26.2654-1(a) only

[56] *See*, for example, PLR 200740328, PLR 200615001, and 200536018..

[57] *See* discussion of Proposed Regulation 26.2642-6(h) above

addressed separate shares. Proposed Regulation 26.2654-1(a)(1)(iii), however, addresses severances into separate trusts as well as the creation of separate shares within a single trust. It provides that the separate trusts or shares resulting from certain mandatory severances upon the occurrence of an event not within any person's discretion will be recognized as separate for GST tax purposes. To be recognized as separate for GST tax purposes, such shares or trusts must be recognized as separate under applicable local law and, apparently, must satisfy the funding rules under Regulation 26.2654-1(b)(ii)(C) which require either a fractional severance or certain types of pecuniary severances. As is the case with non-qualified severances under Proposed Regulation 26.2642-6(h), the resulting trusts or shares will have the same inclusion ratio as the original trust. Accordingly, the mandatory severance of any such trust with an inclusion ratio between zero and one still must meet the requirements of a qualified severance to result in separate trusts with inclusion ratios of zero or one.

The Proposed Regulations state that such separate shares or trusts resulting from a mandatory severance will not be treated as separate trusts for purposes of filing income tax returns or calculating any other taxes. Proposed Regulation 26.2654-1(a)(1)(iii). However, this statement appears incorrect to the extent it applies to shares or trusts that are recognized as separate trusts under local law. Presumably, this statement should apply only to separate shares created within a single trusts.

It is unclear why the changes to the Regulations under Section 2654 must address at all those severances that result in separate trusts when Proposed Regulation 26.2642-6(h) would have addressed all such severances perfectly adequately. Any severance of a single trust into separate trusts that is recognized under Proposed Regulation 26.2654-1(a)(1)(iii) also would have been recognized under Proposed Regulation 26.2642-6(h), but for the express exclusion of severances under Regulation 26.2654-1. Proposed Regulation 26.2642-6(h) also does not contain the funding requirements described in the Section 2654 regulations, which seem unnecessary limitations on the recognition of separate trusts or shares. The restriction of Proposed Regulation 26.2654-1(a)(1)(iii) to divisions of trusts into separate shares would clarify its effect and improve its coordination with Proposed Regulation 26.2642-6(h).

The Proposed Regulations also amend Example 8 to illustrate the recognition of separate shares that do not exist from the creation of the trust but result from the mandatory severance of a single trust. Example 8 describes the creation of an irrevocable trust with the discretionary power in the trustee to distribute income or principal among T's children and grandchildren. The trust provides that when T's youngest child reaches age 21, the trust will be divided into separate shares, one share for each child of T. Thereafter, the income from the child's share will be paid to that child for life with the remainder to that child's children at the child's death. Currently, Example 8 denies recognition of the separate shares resulting from the division when the youngest child reaches age 21 because they do not exist at all times from the creation of the trust. However, the proposed amendment recognizes those shares as separate for GST tax purposes.[58] The example further clarifies that T may allocate GST exemption to any one or more of the

[58] Although Example 8 does not expressly recite that the separate shares or trusts are recognized as separate under applicable state law, this fact is assumed as it is a requirement for recognition as separate for GST tax purposes.

separate shares, instead of requiring an allocation that applies to the entire trust and all three separate shares after the severance. The example confirms that same conclusions would apply if the trust instrument required division of the original trust into separate trusts, rather than separate shares of a single trust.

II. SECTION 9100 RELIEF – GIFTS OF DISCOUNTED ASSETS

The IRS recently may have changed informally the factors that it considers in evaluating requests for relief under Section 2642(g)(1), which could undermine the effectiveness of this remedy. The IRS apparently is concerned that a taxpayer who made a gift of property valued at a discount may wait for the statute of limitations to expire on the gift tax return reporting the gift before applying for relief under Regulation 301.9100-3 to allocate GST exemption. PLR 200746006 denying such relief without explanation may reflect an informal policy to deny such relief where the fair market value of the original contribution to the trust was determined with a discount and the statute of limitations has expired for gift tax purposes. Commentators urged the IRS, if adopting a new policy, to articulate its new criteria in formal guidance available for public review and comment before it begins to apply those criteria. *See* July 16, 2007, Letter to Donald Korb, Chief Counsel, IRS, from Daniel H. Markstein, III, on behalf of the American College of Trust & Estate Counsel.[59] In fact, the Treasury Department's 2007-2008 Priority Guidance Plan thereafter added an item: "Guidance under section 2642(g) regarding extensions of time to make allocations of the generation-skipping transfer tax exemption."

Until EGTRRA, the failure to allocate on a timely filed gift tax return generally was irrevocable and taxpayers could not remedy unintentional failures to allocate GST exemption to treat a later allocation as if timely made. Relief for certain tax elections is available pursuant to Regulations 301.9100-1 through 301.9100-3 ("Section 9100 relief"). Section 9100 relief allows the government to grant an extension of time to make certain elections late as if they were made timely. However, the IRS maintained that allocations of GST exemption were statutory elections and thus ineligible for the discretionary extension of time to make regulatory elections under Regulation 301.9100-3. *See* PLRs 9840011, 9835025, 9827032, 9813013, 9226014. Regulation 301.9100-2 provides an automatic 6-month extension for regulatory or statutory elections whose due dates are the due date of the return (including extensions) if the return was timely filed by the due date (including extensions). However, in many cases when an error concerning the allocation of GST exemption has occurred, no gift tax returns have been filed or the errors are not discovered within 6 months of the due date of the return.

Assuming that no automatic allocation had occurred (which was limited to direct skips before EGTRRA), the only other option available for a transferor who failed to allocate timely was to make a late allocation of GST exemption. Because the trust may have appreciated from the date the gift was first made until the failure to allocate GST exemption was discovered, making a late allocation would not put the transferor in the same position had a timely allocation been made.

[59] The principal drafters of those comments were Carol A. Harrington, Lloyd Leva Plaine, Carlyn S. McCaffrey, and Pam H. Schneider, all or whom are fellows of the College, and Julie K. Kwon.

EGTRRA added Section 2642(g)(1), which provided for the first time that Section 9100 relief is available under Regulation 301.9100-3 for the failure to make a timely allocation of GST exemption. Section 2642(g)(1) directs the Secretary by regulation to prescribe circumstances and procedures under which extensions of time will be granted to make an allocation of GST exemption for lifetime gifts or gifts at death. The provision also allows an extension to be granted to elect out of the automatic allocation rules. In determining whether to grant relief, the IRS is to consider all relevant circumstances including evidence of intent to attain in the trust instrument and such other factors as the Secretary deems relevant. Section 2642(g)(1)(B). When relief is granted, the original gift or estate tax value of the transfer to the trust is used in determining the allocation of GST exemption instead of the value of the trust at the time a late allocation would be made. The effective date provides that the section applies to requests pending on, or filed after, December 31, 2000.

This legislative history of Section 2642(g)(1) indicates Congress's intent that the IRS should disregard the expiration of any statute of limitations in considering requests for Section 9100 relief under that statute. The Joint Committee on Taxation's discussion of Section 2642(g)(1) explains:[60]

> [Under EGTRRA], the Treasury Secretary is authorized <u>and directed</u> to grant extensions of time to make the election to allocate generation-skipping transfer tax exemption and to grant exceptions to the time requirement, <u>without regard to whether any period of limitations has expired</u>. If such relief is granted, then the gift tax or estate tax value of the transfer to trust would be used for determining generation-skipping transfer tax exemption allocation.

As a result, Section 2642(g)(1) does not restrict the availability of relief based on the type of assets transferred or on whether the period of limitations for assessment of gift tax has expired with respect to the original transfer. Instead, Section 2642(g)(1) and its legislative history reflect Congress's clear intent to provide liberal relief to taxpayers and their tax advisors who inadvertently failed to allocate GST exemption despite their good faith efforts to comply with the GST tax rules. Thus, the IRS should not deny such requests for Section 9100 relief that otherwise qualify for relief.

IRS Notice 2001-50[61] provides that the procedures for seeking an extension of time under the new section will be those that generally apply under Regulation 301.9100-3:

> [R]elief will be granted if the taxpayer establishes to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice the interests of the government. Taxpayers requesting relief should follow the procedures for requesting a private letter ruling

[60] Joint Committee on Taxation's General Explanation of Tax Legislation Enacted in the 107th Congress, at p. 81 (emphasis added).

[61] 2001-34 IRB 189, issued on August 1, 2001.

> under § 301.9100 contained in Section 5.02 of Rev. Proc. 2001-1 (or its successor), 2001-1 I.R.B. 1, 13.

Regulation 301.9100-3 requires that the taxpayer show that the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice the interests of the government. Under the regulations for Section 9100 relief, the taxpayer is deemed not to have acted reasonably or in good faith if the taxpayer was fully informed of the required election and chose not to make the election. Also, the taxpayer is considered not to have acted reasonably and in good faith if the taxpayer uses hindsight in requesting relief, which is the case if specific facts have changed since the original election would have been made that make an election later to be more advantageous. Finally, prejudice to the government arises if granting relief results in a lower tax liability in the aggregate for all taxable years affected by the election compared to the liability had the election been timely made. Prejudice to the government also will arise if the statute of limitations is closed before the taxpayer's receipt of a ruling granting the relief requested.

Thus, taxpayers seeking Section 9100 relief to obtain the extension of time to allocate GST exemption must independently satisfy the criteria of Regulation 301.9100-3. These regulations are designed to preclude exactly the abuse that the IRS fears and, consequently, satisfying these requirements should suffice to obtain relief under Section 2642(g)(1). Under Regulation 301.9100-3(b)(1) the taxpayer will not be considered to have acted reasonably and in good faith if the taxpayer "uses hindsight" in requesting relief.[62] Similarly, the IRS should not use hindsight to deny relief because the taxpayer would have achieved a beneficial result if the taxpayer had properly implemented her intention to allocate GST exemption. Hindsight is particularly inappropriate when the only "abuse" is that the IRS failed to audit the return despite adequate disclosure sufficient to trigger the running of the statute of limitations. The IRS's failure to challenge the valuation of the gift in time to assess gift tax should not prejudice taxpayers who otherwise have complied fully with the tax laws and are entitled to seek relief pursuant to Section 2642(g)(1).

Regulation 301.9100-3(c)(1) notes that the interests of the government will ordinarily be prejudiced when the tax year in which the regulatory election should have been made, or any tax year affected by the election had it been made timely, are closed by the statute of limitations before the taxpayer's receipt of a ruling granting Section 9100 relief.[63] However, the statute of limitations for GST tax purposes almost never will have expired before the taxpayer seeks Section 9100 relief under Section 2642(g)(1), because a GST subject to GST tax typically will not occur for many years after the initial transfer. The expiration of the separate statute of limitations for assessment of gift tax should not be relevant when the taxpayer seeks Section 9100 relief to allocate GST exemption for GST tax purposes because the IRS has not been prejudiced with regard to the election by the expiration of the statute. Further, the legislative

[62] The regulations make clear that when specific facts have changed since the original due date of the election that make a later election advantageous to a taxpayer, the IRS will not ordinarily grant relief absent strong proof that the decision to seek Section 9100 relief did not involve hindsight.

[63] *See* Reg. § 301.9100-3(c)(1)(ii).

history of section 2642(g)(1) specifically states that extensions of time to allocate GST exemption are to be granted "without regard to whether any period of limitations has expired."[64]

Overall, the existing requirements to obtain Section 9100 relief forestall the abuse that the IRS seeks to prevent. The IRS need not, and should not, counter Congress's intent by imposing additional criteria to the existing requirements of Regulation 301.9100-3 designed to prevent abuse by taxpayers.

The allocation of GST exemption does not affect the independent requirements of adequate disclosure to begin the running of the statute of limitations for assessment of gift tax, or the likelihood or success of an audit regarding valuation for gift tax purposes. Thus, the denial of relief for gifts for which the statute of limitations has closed will affect taxpayers who otherwise provided the IRS with an initial opportunity to audit the return by providing full disclosure. However, statutes of limitation ensure that matters become final for both the taxpayer and the IRS at some time, to promote expeditious pursuit of claims against each other. By their nature, statutes of limitation inevitably create injustices by barring a taxpayer's rightful claim to a refund or the government's rightful assessment of a tax; otherwise, limitation periods would have no effect and, therefore, serve no purpose. To promote the public policy of efficient and final determination of the parties' respective rights, the IRS should not consider factors other than those properly described in Regulation 301.9100-3 for Section 9100 relief for GST tax purposes.

III. <u>General Powers of Appointment.</u>

In *Estate of Gerson v. Comm'r*, 507 F.3d 435 (6th Cir. 2007), the federal Sixth Circuit Court of Appeals recently affirmed the Tax Court[65] to uphold the validity of Regulation 26.2601-1(b)(1)(i) which subjects to GST tax a transfer of property by "the exercise, release, or lapse of a general power of appointment that is treated as a taxable transfer under chapter 11 or chapter 12."

The effective date provisions of the GST tax state that a trust is not subject to GST tax if it was "irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income treatable to corpus)." However, these provisions do not define "irrevocable" or "added to the trust" for purposes of determining their applicability, or whether the lapse, release or exercise of a general power of appointment ("GPOA") under an irrevocable trust instrument should subject the trust to GST tax.

Prior to 2006, only three courts had addressed the issue of whether property of a grandfathered trust included in a taxpayer's taxable estate for estate tax purposes due to a GPOA becomes subject to GST tax. *See E. Norman Peterson Marital Trust v. Comm'r*, 78 F.3d 795 (2d Cir. 1996), *aff'g* 102 T.C. 790 (1994); *Simpson v. U.S.*, 183 F.3rd 812 (8th Cir. 1999), *non-acq.*

---

[64] *See* the Conference Report to H.R. 1836, H. Rept. 107-84 (May 26, 2001) ("Conference Report") at p. 202.

[65] *Gerson v. Comm'r.*, 127 T.C. No. 11 (2006).

2000-9 IRB 711 (2000); *Bachler v. United States*, 281 F.3d 1078 (9th Cir. 2002), *rev'g and rem'g*, 126 F. Supp. 2d 1279 (N.D. Ca. 2000).

In *Peterson*, the appellate court concluded that property remaining in the trust after the lapse of a GPOA was a constructive addition that became subject to GST tax, because a GPOA is "essentially identical to outright ownership of the property." 78 F.3d at 800. The appellate court's analysis echoed the lower Tax Court's conclusion that "[a] person who holds a general power of appointment over trust property maintains control over the ultimate disposition of that property and is, in practical effect, in a position similar to the actual owner of the property. [Citation omitted.] This is the rationale underlying the inclusion of such property in the gross estate of the holder of the power for purposes of the Federal estate tax." 102 T.C. at 801.

However, in *Simpson and Bachler*, the courts held that a grandfathered trust passing pursuant to the exercise of a taxable GPOA to skip persons did not become subject to GST tax. The courts adhered to the literal terms of the effective date statute, which requires only that the trust was irrevocable on the effective date and that the transfer occurred under the trust. Based on the plain language of the statute, they determined that any transfer pursuant to a power of appointment is a transfer "under" the trust. Accordingly, they denied that the existence or even the exercise of a taxable GPOA subjects a grandfathered trust to GST tax.

In reaction to *Simpson*, the IRS amended Regulation 26.2601-1(b)(1)(i) to specify that property transferred pursuant to a taxable GPOA is treated as a transfer by the power holder which subjects the property to GST tax. As amended, Regulation 26.2601-1(b)(1)(i) provides that the effective date provisions of the statute do not apply to exempt a transfer of property "pursuant to the exercise, release, or lapse of a GPOA that is treated as a taxable transfer under chapter 11 or chapter 12." Instead, "[t]he transfer is made by the person holding the power at the time the exercise, release, or lapse of the power becomes effective, and is not considered a transfer under a trust that was irrevocable on September 25, 1985."

In addition, Regulation 26.2601-1(b)(1)(v) provides:

> (A) *Powers of Appointment*. [E]xcept as provided in paragraph (b)(1)(v)(B) of this Section, where any portion of a trust remains in the trust after the post-September 25, 1985, release, exercise, or lapse of a power of appointment over that portion of the trust, and the release, exercise, or lapse is treated to any extent as a taxable transfer under chapter 11 or chapter 12, the value of the entire portion of the trust subject to the power that was released, exercised, or lapsed is treated as if that portion had been withdrawn and immediately retransferred to the trust at the time of the release, exercise, or lapse. The creator of the power will be considered the transferor of the addition except to the extent that the release, exercise, or lapse of the power is treated as a taxable transfer under chapter 11 or chapter 12.

In *Simpson* and *Bachler*, the Eighth and Ninth Circuits based their holdings in favor of taxpayer on their conclusion that the plain meaning of the effective date provisions of the GST tax was clear and not ambiguous. Under *Nat'l Cable & Telecomm. Association v. Brand X Internet Servs*., 545 U.S. 967 (2005):

> A court's prior judicial construction of a statute trumps an agency construction otherwise entitled to Chevron deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion.

Accordingly, the Eighth and Ninth Circuits would not be required to give deference to Regulation 26.2601-1(b)(1)(i) in future challenges, if they adhere to their characterization of the effective date provisions as unambiguous.

In *Gerson v. Comm'r*, 127 T.C. No. 11 (2006), the Tax Court upheld the validity of Regulation 26.2601-1(b)(1)(i) which subjects to GST tax a transfer of property by "the exercise, release, or lapse of a GPOA that is treated as a taxable transfer under chapter 11 or chapter 12." In *Gerson*, the decedent exercised her testamentary GPOA over a marital trust that was not subject to GST tax prior to her death because it had become irrevocable prior to the effective date of the GST tax. Consequently, the marital trust property passed at her death to a trust for the benefit of her grandchildren or more remote descendants pursuant to her exercise of her testamentary GPOA. The court held that the regulation is valid as a reasonable interpretation of the effective date provisions of the GST tax. As a result, the court concluded that the marital trust property became subject to GST tax at the decedent's death.

The court determined that the purpose of the effective date provisions was "to protect taxpayers who, on the basis of pre-existing rules, made estate planning arrangements from which they could not reasonably escape and which would otherwise generate GST tax liability." *Id.* at 28. As in *Peterson*, the court equated GPOAs with outright ownership and focused on the power holder's ability to determine the ultimate recipients of the trust property. Consequently, the court declined to exempt "a volitional generation-skipping transfer arising from the exercise of a GPOA as opposed to a specific transfer by the settlor to identified persons." *Id.* at 26. In support of its analysis, the court noted that a GPOA holder must include the subject property in her taxable estate and is treated as the new "transferor" for GST tax purposes (if the trust is subject to GST tax). The court concluded that this regulation maintains consistency by treating the GPOA holder as the owner of property for all transfer tax purposes. Thus, in *Gerson*, the Tax Court continued to adopt the same rationale that it had articulated previously in *Peterson* as the basis for subjecting such property to GST tax.

In addition, the Tax Court assumed in *Peterson* and *Gerson* that the Regulations consistently reflect a single unifying principle: that inclusion of property in the taxable gross estate due to "ownership" must subject the property to GST tax. On appeal of *Gerson*, the Sixth Circuit largely adopted the same rationale as did the Tax Court in affirming the Tax Court's decision. Applying the *Chevron*[66] level of deference to review Regulation 26.2601-1(b)(1)(i),

[66] In *Chevron U.S.A., Inc. v. Natural Res. Def. Council*, Inc., 467 U.S. 837 (1984), the Supreme Court articulated the following two-step analysis applicable to judicial review of an agency's construction of a statute:

> When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.

(continued…)

the Sixth Circuit disagreed with the taxpayer that the effective date provisions of the GST tax have a plain meaning and concluded that they are ambiguous. The court further concluded that the regulation reasonably construed the statutory ambiguity based on their analysis equating a GPOA with ownership. The court reasoned that "the appointment power holder becomes the owner of the trust assets for tax purposes" under Sections 2041 and 2514 which subject certain transfers or lapses subject to GPOAs to estate and gift tax, respectively. The court also explained in conclusion:

> As the Peterson court recognized, 'For tax purposes, a [GPOA] has for many, many years been viewed as essentially identical to outright ownership of the property.' [Citation omitted.] Thus, the regulation conforms the grandfather clause to other elements of the tax scheme. [Citations to Sections 2041 and 2514 omitted.] In addition, the other exceptions to the GST tax surrounding the irrevocable trust provision all represent inescapable contingencies that justify grandfathering, while the [Taxpayer's] proposed interpretation protects disproportionately broad reliance on prior tax laws.

The logic of *Peterson* and *Gerson* equating GPOAs with outright ownership for GST tax purposes is not consistently reflected in the regulations, which include several examples to the contrary. For example, the GST rules expressly provide that a QTIP trust that was irrevocable on the effective date will not become subject to GST tax on the surviving spouse's death, despite inclusion in such spouse's gross estate under IRC Section 2044. Reg. 26.2601-1(b)(1)(iii). In addition, a grandfathered trust that is includible in a settlor's gross estate under IRC Sec. 2036, but not IRC Sec. 2038, does not become subject to GST tax due to such inclusion. Reg. 26.2601-1(b)(1)(ii)(B). Also, a trust subject to inclusion in the settlor's taxable estate under IRC Section 2038 on the effective date is subject to GST tax; however, a grandfathered trust that first becomes subject to inclusion under IRC Section 2038 after the effective date does not become subject to GST tax. *Id.* Thus, inclusion for estate tax purposes is not treated as the basis for subjecting a grandfathered trust to GST tax.

The Tax Court's treatment of "ownership" as the consistent basis for GST taxation explains its focus on the irrevocability of the "transfer" rather than irrevocability of the "trust" in applying the statute that exempts "any generation-skipping transfer under a trust which was irrevocable on September 25, 1985 . . . ." However, Regulation 26.2601-1(b)(1)(v)(B) provides that the release, exercise or lapse of a non-general, or special, power of appointment ("SPOA") is not treated as a constructive addition if the SPOA was created under an irrevocable trust that is not otherwise subject to GST tax and the exercise does not postpone the vesting of interests beyond the traditional rule against perpetuities. The Tax Court's analysis fails to recognize that the difference in control between a testamentary GPOA and the broadest possible SPOA

> If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.

Id., at 842-843 (footnote references and citations omitted).

(excluding only the holder, the holder's estate or creditors of either) is meaningless, other than allowing the holder to appoint to creditors. The latter hardly locks taxpayers into "estate planning arrangements from which they could not reasonably escape" or "a specific transfer by the settlor to identified persons." Thus, the effective date rules do not subject property to GST tax based on the extent of control over the trust. *See also Reg.* §26.2601-1(b)(1)(ii)(C) (denying treatment as "irrevocable" for purposes of GST tax if the insured possesses any incident of ownership, which include the power to change beneficiaries but also encompasses powers which cannot affect beneficial interests).

Overall, the Tax Court's assumption that a unifying policy underlies the effective date Regulations is not clearly reflected in those rules. Given such lack of a coherent rationale, the *Simpson* and *Bachler* courts offer a reasonable alternative analysis based on a straightforward reading of the effective date statute. Based on the statute's literal terms, each found that a transfer pursuant to the exercise of a GPOA granted under a trust that was irrevocable on the effective date was not subject to GST tax.

> Trust A, having been created by Mr. Simpson's will in 1966, was of course irrevocable on September 25, 1985. Was the transfer made by Mrs. Simpson a transfer "under" the trust? We do not see how an affirmative answer can be avoided. The power of appointment that made the transfer possible was created by the trust. Language has to mean something, and the argument that this particular transfer was not "under" trust A is simply untenable.

Simpson, supra at 814.

None of *Peterson, Simpson, Bachler* or *Gerson* limited or otherwise affected the validity of the exception to the constructive addition rules for SPOAs under Regulation 26.2601-1(b)(1)(v)(B). In fact, a concurring opinion in *Gerson* noted that "the principal architects of the transitional rule understood it to apply to the exercise of a <u>limited</u> power of appointment under an otherwise grandfathered trust, provided that the exercise of the limited power did not unduly extend the time for the vesting of any beneficial interest in the trust." *Id.* at 43 (emphasis in original).

The IRS also has provided guidance regarding the special rule under Regulation 26.2601-1(b)(1)(v)(B) for transfers subject to SPOAs resulting from a partial release of a GPOA. *See* PLRs 9125018 and 9229018. In these rulings, the IRS applied Regulation 26.2601-1(b)(1)(v)(B) and concluded that property subject to an SPOA resulting from a partial release of a GPOA does not become subject to GST tax, despite inclusion in the taxable gross estate under Section 2041.

In PLR 9125018, the taxpayer partially released her GPOA over a marital trust for her benefit that became irrevocable before the effective date, so that she could no longer exercise the power in favor of herself, her estate or her creditors. Her release reduced the GPOA to an SPOA but the trust remained includable in her taxable estate under IRC Sec. 2041. The taxpayer proposed to exercise her testamentary SPOA in 1991, after the effective date of the GST tax. The IRS considered the specific issue of whether inclusion in the taxable estate subjects the property to GST tax:

> The question is whether the characterization of the power as a general power of appointment for purposes of [Section 2041] should control for purposes of [Regulation 26.2601-1(b)(1)(v).] If so, the proposed exercise of the power will constitute an "addition" under section 26.2601-1(b)(1)(v)(A). If not, section 26.2601-1(b)(1)(v)(B) will control, and the exercise of the power will not constitute an addition to the trust. We conclude that the power is a SPOA for purposes of the GST tax provisions. Therefore, [Regulation 26.2601-1(b)(1)(v)(B)] controls, and the proposed exercise of the power will not constitute an addition to the trust.

The IRS reasoned that the trust was analogous to an irrevocable trust created before the effective date with a retained lifetime income interest, which would not be considered revocable on the effective date based on inclusion under IRC Section 2036. However, the ruling does not address the fact that the testamentary SPOA would cause inclusion under IRC Section 2038, which would preclude the trust from qualifying as "irrevocable" under the effective date regulations. Thus, the ruling's conclusion is correct only if the treatment of the testamentary power of appointment as special, rather than general, for GST tax purposes is the determinative factor.

In PLR 9229018, the IRS again considered similar facts and concluded that the proposed exercise of a testamentary SPOA resulting from the partial release of a GPOA would not subject the trust to GST tax, relying on the plain terms of Regulation 26.2601-1(b)(1)(v)(B). The IRS noted that if the trust was irrevocable on the effective date and the exercise did not postpone vesting beyond the original perpetuities period, then the exercise would not subject to the GST tax if the power is characterized as an SPOA rather than a GPOA. The IRS recognized that the trust would have been includable in the taxpayer's taxable estate on the effective date under Sections 2036 and 2038 if he had been the settlor, correcting the misstatement in PLR 9125018. Nonetheless, the IRS concluded that the trust did not become subject to GST tax because taxpayer held an SPOA and Regulation 26.2601-1(b)(1)(v)(B) controls despite estate taxation under Section 2041.

In both PLR 9229018 and PLR 9125018, the partial release that reduced the GPOA to an SPOA occurred before the effective date of the GST tax. However, neither ruling cites that fact as relevant and this fact does not affect the analysis in both rulings. While these PLRs are not authority and cannot be cited as precedent, a return position reasonably based on a private letter ruling issued after October 31, 1976, generally may satisfy the reasonable basis standard for tax reporting. Regulation 1.6662-3(b)(3). These PLRs reinforce the position that inclusion of a grandfathered trust in a GPOA holder's taxable estate should not necessarily subject the trust to GST tax.

Planners may consider advising clients who hold such GPOAs to release them to the extent necessary to create a non-taxable SPOA as described in PLRs 9229018 and 9125018, to seek the application of Regulation 26.2601-1(b)(1)(v)(B). In addition, planners may consider whether the exercise of any such GPOA should benefit one or more non-skip persons by providing them with genuine and meaningful interests in the property.[67] (In contrast, the taxpayer in each of *Peterson*, *Bachler, Simpson* and *Gerson* exercised the GPOA in favor of skip persons which created immediately taxable direct skip GSTs if the transfer is subject to GST tax.) Planners have suggested that a small distribution could be made from a trust created pursuant to such exercise, to be reported on a timely filed return declaring the exempt character of the trust property due to the effective date of the GST tax and achieve finality under the rules governing finality of inclusion ratios. However, those GST tax rules may provide no such benefit in this circumstance, as only trusts subject to GST tax have inclusion ratios – those rules do not apply at all to a trust to which the GST tax does not apply.

[67] However, planners must consider the anti-abuse rule of Section 2652(c)(2) which provides that "an interest which is used primarily to postpone or avoid any tax imposed by this chapter shall be disregarded." Neither the statute nor the related regulation provide any guidance regarding the amount that may be sufficient to deflect the anti-abuse rule. In fact, Section 2652(c)(2) bases its criterion purely on the intention motivating inclusion of the interest and does not indicate that the magnitude of the interest is relevant. Interestingly, the related regulation further elaborates: "An interest is considered as used primarily to postpone or avoid the GST tax if a significant purpose for the creation of the interest is to postpone or avoid the tax." (Italics added.) Thus, the regulation appears to provide more leniency than does the statute in determining that an interest should be ignored for GST tax purposes.

<u>APPENDIX A</u>

THIS SAMPLE PROVISION IS INCLUDED FOR DISCUSSION PURPOSES ONLY AND IS NOT INTENDED OR APPROPRIATE FOR INSERTION IN ANY DOCUMENT WITHOUT INDEPENDENT REVIEW AND REVISION, OR WITHOUT THE INDEPENDENT DECISION AS TO WHETHER THE SAMPLE IS APPROPRIATE FOR THE CLIENT'S PARTICULAR SITUATION, WHETHER THE SAMPLE IS EFFECTIVE TO ACCOMPLISH WHATEVER PURPOSE FOR WHICH THE SAMPLE IS USED AND WHETHER THE SAMPLE SATISFIES THE TECHNICAL REQUIREMENTS OF THE LAW. THE SAMPLE LANGUAGE MAY CONTAIN ERRORS OR MAY OMIT ESSENTIAL RELATED LANGUAGE. SEE TEXT OF ACCOMPANYING OUTLINE REGARDING ISSUES RAISED IN USING SUCH LANGUAGE. THE AUTHOR DOES NOT ACCEPT ANY LIABILITY FOR THE USE OF THIS SAMPLE.

(_) To hold property otherwise directed to be added to or consolidated with the trust property of any trust held hereunder as a separate trust having terms identical to the terms of the existing trust; to sever any trust on a fractional basis into two or more separate trusts for any reason; to segregate by allocation to a separate account or trust a specific amount out of, a portion of, or specific assets included in, the trust property of any trust held hereunder to reflect a partial disclaimer or for any tax or other reason in a manner consistent with any applicable rules or regulations. Income earned on a segregated amount, portion or specific assets after the segregation is effective shall pass to the recipient of such amount, portion or specific assets. In administering the trust property of any separate account or trust and in making applicable tax elections, the trustee shall consider the differences in federal tax attributes and all other factors the trustee believes pertinent and may make disproportionate distributions out of the separate trusts created. A separate trust created by severance or segregation shall be treated as a separate trust for all purposes from and after the date designated by the trustee as the effective date of the severance or segregation and shall be held on terms and conditions that are equivalent to the terms of the trust from which it was severed or segregated so that the aggregate interests of each beneficiary in the several trusts are equivalent to the beneficiary's interests in the trust before severance or segregation; provided, however, that any terms of the trust before severance or segregation, the change of which could adversely affect qualification of the trust for any federal tax deduction, exclusion, election, exemption or other special federal tax status, must remain identical in each of the separate trusts created.

Date: April 1, 2008