

7. A simplified employee pension of an employer that satisfies the requirements of § 408(k);

8. A plan described in § 501(c)(18);

9. A simple retirement account described in § 408(p);

10. A deemed IRA described in § 408(q);

11. A Roth IRA described in § 408A;

12. A § 415(m) plan that is also a “governmental plan” within the meaning of § 414(d);

13. A § 457(f) plan that has as its sponsor either (i) a charitable organization described in § 818(a)(4), or (ii) a governmental organization described in § 818(a)(4), whose employees are described in § 403(b)(1)(A)(ii); and

14. Any other trust, plan, account, contract, or annuity that the Internal Revenue Service has determined in a letter ruling to be within the scope of § 1.817-5(f)(3)(iii).

EFFECT ON OTHER REVENUE RULING(S)

Rev. Rul. 94-62 is *supplemented*.

DRAFTING INFORMATION

The principal author of this revenue ruling is Melissa S. Luxner of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling, contact Melissa S. Luxner at (202) 622-3970 (not a toll-free call).

Section 2642.—Inclusion Ratio

26 CFR 26.2642-6: *Qualified severance.*

T.D. 9348

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1, 26, and 602

Qualified Severance of a Trust for Generation-Skipping Transfer (GST) Tax Purposes

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations providing guidance regarding the qualified severance of a trust for generation-skipping transfer (GST) tax purposes under section 2642(a)(3) of the Internal Revenue Code (Code), which was added to the Code by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). The regulations will affect trusts that are subject to the GST tax.

DATES: *Effective Date:* The regulations are effective August 2, 2007.

Applicability Date: For dates of applicability, see §26.2642-6(k)(1) and §26.2642-6(k)(2).

FOR FURTHER INFORMATION CONTACT: Mayer R. Samuels, (202) 622-3090 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been previously reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1902.

The collection of information in these final regulations is in §26.2642-6(e). This information is requested by the IRS to identify whether a trust is exempt from the GST tax. This information is required to determine whether the amount of tax has been calculated correctly. The respondents are trustees of trusts that are being severed.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

The estimated average annual burden per respondent / recordkeeper is .5 hours per respondent. Comments concerning the accuracy of this burden estimate should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224 and the **Office of Management**

and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Section 2642(a)(3) was added to the Internal Revenue Code by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Public Law 107-16 (115 Stat. 38 (2001)). Under section 2642(a)(3), if a trust is divided into two or more trusts in a “qualified severance,” the resulting trusts will be recognized as separate trusts for GST tax purposes. In many cases, a qualified severance of a trust will facilitate the most efficient and effective use of the transferor’s GST tax exemption. The GST tax exemption is each person’s lifetime exemption that may be allocated to a generation-skipping transfer. If the transfer is made in trust, allocation of the donor’s GST tax exemption reduces the trust’s inclusion ratio, which in turn determines the amount of GST tax imposed on any generation-skipping transfer made with regard to the trust.

On August 24, 2004, the IRS published in the **Federal Register** a notice of proposed rulemaking (REG-145987-03, 2004-2 C.B. 519 [69 FR 51967]), providing rules under section 2642(a)(3) regarding the qualified severance of a trust for GST tax purposes. The IRS received written and oral comments responding to the notice of proposed rulemaking. No public hearing was requested or held. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision, and the corresponding proposed regulations are removed. The comments and revisions to the proposed regulations are discussed below. In addition, additional proposed regulations (REG-128843-05) are being issued contemporaneously with these final regulations in order to respond to certain comments that the Treasury Department and the IRS believe merit further consideration in proposed regulations.

Summary of Comments

The proposed regulations take the position that the severance rules contained in §26.2654-1(b) of the regulations were superseded by the enactment of section 2642(a)(3), and therefore that §26.2654-1(b) is no longer effective. However, many commentators noted that sections 2654(b) and 2642(a)(3) address different situations, and they suggested that section 2642(a)(3) was intended to supplement, rather than to replace, section 2654(b), and to thereby provide more flexibility in severing trusts for GST tax purposes. The commentators noted that section 2642(a)(3) qualified severances are effective prospectively from the date of severance and thus, that section only addresses severances that typically would occur after an irrevocable trust (whether *inter vivos* or testamentary) has been in existence for a period of time. In contrast, §26.2654-1(b) addresses only severances of testamentary trusts and revocable *inter vivos* trusts included in the transferor's gross estate, and a severance satisfying §26.2654-1(b) is effective retroactively to the date of death. Section 26.2654-1(b) provides for the recognition of severances of separate shares of such trusts, and of discretionary severances that, although not provided for in the governing instrument, are necessary to fully utilize available tax benefits (for example, the reverse qualified terminable interest property election under section 2652(a)(3)). To fulfill the purpose of these severances (generally, efficient utilization and allocation of the decedent's GST exemption), the severance must be effective retroactive to the date of death. Thus, section 2642(a)(3) and §26.2654-1(b) address different circumstances.

In response to these comments, the final regulations do not supersede §26.2654-1(b). Rather, §26.2654-1(b) is retained, but, as explained hereafter, is proposed to be amended as described in a notice of proposed rulemaking issued contemporaneously with these final regulations. Subject to those proposed changes, §26.2654-1(b) will continue to provide rules for mandatory and discretionary severances of trusts includible in the transferor's gross estate, effective retroactively to the transferor's date of death. The final regulations under §26.2642-6 generally

provide rules for the qualified severance of a trust (whether or not includible in the transferor's gross estate) if the severance will be effective only prospectively from the date of severance.

One commentator requested that the regulations provide that separate trusts, created as the result of a mandated division of a single trust that is effective under state law, be recognized prospectively as separate trusts for certain GST tax purposes, even if the severance does not satisfy the requirements of a qualified severance. This comment will be addressed in the proposed regulations under section 2642, issued contemporaneously with these final regulations.

One commentator requested that the regulations provide additional flexibility in severing a trust that has an inclusion ratio between zero and one. Specifically, the commentator requested that the final regulations permit the qualified severance of a trust into one or more separate resulting trusts, as long as one or more of the resulting trusts, in the aggregate, would receive a fractional share of the total value of the original trust's assets that equals the applicable fraction of the original trust. In such a qualified severance, the resulting trust or trusts receiving this fractional share would each have an inclusion ratio of zero, and each of the other resulting trusts would have an inclusion ratio of one. This comment will be addressed in the proposed regulations under section 2642, issued contemporaneously with these final regulations.

In response to comments, the final regulations continue to require that, in notifying the IRS of the severance of a trust, the words "Qualified Severance" should appear at the top of Form 706-GS(T), "*Generation-Skipping Transfer Tax Return For Terminations*," but the use of red ink for that purpose is not required.

One commentator questioned the requirement in the proposed regulations that any non-*pro rata* funding of trusts resulting from a qualified severance must be based on the value of the trust assets as of the date of funding. The commentator pointed out that, in many cases, the funding of trusts resulting from a qualified severance will take place over a period of time, rather than on one specific date. Accordingly, under the final regulations, the non-*pro rata* funding of trusts result-

ing from a qualified severance must be achieved by applying the appropriate fraction or percentage to the total value of the trust assets as of the "date of severance." The term "date of severance" is defined as the date selected for determining the value of the trust assets (whether selected on a discretionary basis or by a court order), provided that funding is commenced immediately and occurs within a reasonable time before or after the selected date of severance. For this purpose, a reasonable time may differ depending upon the type of asset involved, but in no event may be more than 90 days.

Several commentators requested that the regulations address the severance of a trust that was irrevocable on September 25, 1985, but with respect to which an addition was made to the trust after September 25, 1985. For purposes of determining the inclusion ratio with respect to such a trust, §26.2601-1(b)(1)(iv)(A) provides that the trust is deemed to consist of two portions, one portion not subject to GST tax (the non-chapter 13 portion) with an inclusion ratio of zero, and one portion subject to GST tax (the chapter 13 portion) with an inclusion ratio determined under section 2642. In response to these comments, the final regulations provide guidance regarding a qualified severance of the chapter 13 portion of these trusts.

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. The Treasury Department and the IRS believe that the qualified severance rules were not intended to be optional; that is, able to be employed or avoided depending upon the tax consequences of a particular 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 provisions of Chapter 13 of the Code may be properly applied with regard to the trusts.

One commentator noted that §1.1001-1(h)(1) of the proposed regulations provides favorable income tax treatment only with respect to a qualified severance. The commentator re-

questioned that the regulations also address the income tax treatment of all other trust modifications and severances. The commentator noted that the failure to address, for example, the income tax consequences of severances that are not qualified severances for GST tax purposes implies that such severances are taxable events for income tax purposes. In response to these comments, the category of severances to which §1.1001-1(h)(1) will apply has been broadened. No inference should be drawn with respect to the income tax consequences under section 1001 of any severance that is not described in §1.1001-1(h)(1).

Commentators noted that some qualified severances may result in a taxable termination or taxable distribution, for example, if after the severance, one of the resulting trusts is a skip person. The final regulations clarify that, if the qualified severance itself results in a GST taxable event, the taxable event is treated as occurring immediately after the severance. As a result, if the resulting trust that is a skip person is also the trust that has a zero inclusion ratio after the severance, then no GST tax will result from the taxable event that is deemed to occur after the severance. An example was added illustrating this rule.

Finally, in response to comments, an example has been added addressing the qualified severance rules in the case of a trust where the beneficiary is granted a contingent testamentary general power of appointment that is dependent upon the trust's inclusion ratio.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the collection of information imposed by this regulation is not significant as reflected in the estimated burden of information collection for, which is 0.5 hours per respondent, and

that few trustees are likely to be small entities. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these final regulations is Mayer R. Samuels, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. Other personnel from the IRS and the Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 26 and 602 are amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. In §1.1001-1, paragraph (h) is added to read as follows:

§1.1001-1 Computation of gain or loss.

* * * * *

(h) *Severances of trusts*—(1) *In general*. The severance of a trust (including without limitation a severance that meets the requirements of §26.2642-6 or of §26.2654-1(b) of this chapter) is not an exchange of property for other property differing materially either in kind or in extent if—

(i) An applicable state statute or the governing instrument authorizes or directs the trustee to sever the trust; and

(ii) Any non-*pro rata* funding of the separate trusts resulting from the severance (including non-*pro rata* funding as described in §26.2642-6(d)(4) or §26.2654-1(b)(1)(ii)(C) of this chapter), whether mandatory or in the discretion of the trustee, is authorized by an applicable state statute or the governing instrument.

(2) *Effective/applicability date*. This paragraph (h) applies to severances occurring on or after August 2, 2007. Taxpayers may apply this paragraph (h) to severances occurring on or after August 24, 2004, and before August 2, 2007.

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

Par. 3. The authority citation for part 26 is amended by adding an entry in numerical order to read, in part, as follows:

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

Section 26.2642-6 also issued under 26 U.S.C. 2642. * * *

Par. 4. In §26.2600-1, the table of contents is amended by adding entries for §§26.2642-6 and 26.2654-1 to read as follows:

§26.2600-1 Table of contents.

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§26.2642-6 Qualified severance.

- (a) In general.
- (b) Qualified severance defined.
- (c) Effective date of qualified severance.
- (d) Requirements for a qualified severance.
- (e) Reporting a qualified severance.
- (f) Time for making a qualified severance.

(g) Trusts that were irrevocable on September 25, 1985.

- (1) In general.
- (2) Trusts in receipt of a post-September 25, 1985, addition.
- (h) [Reserved]
- (i) [Reserved]
- (j) Examples.
- (k) Effective date.
- (1) In general.
- (2) Transition rule.

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§26.2654-1 Certain trusts treated as separate trusts.

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- (c) Cross reference.

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Par. 5. Section 26.2642-6 is added to read as follows:

§26.2642-6 Qualified severance.

(a) *In general.* If a trust is divided in a qualified severance into two or more trusts, the separate trusts resulting from the severance will be treated as separate trusts for generation-skipping transfer (GST) tax purposes and the inclusion ratio of each new resulting trust may differ from the inclusion ratio of the original trust. Because the post-severance resulting trusts are treated as separate trusts for GST tax purposes, certain actions with respect to one resulting trust will generally have no GST tax impact with respect to the other resulting trust(s). For example, GST exemption allocated to one resulting trust will not impact on the inclusion ratio of the other resulting trust(s); a GST tax election made with respect to one resulting trust will not apply to the other resulting trust(s); the occurrence of a taxable distribution or termination with regard to a particular resulting trust will not have any GST tax impact on any other trust resulting from that severance. In general, the rules in this section are applicable only for purposes of the GST tax and are not applicable in determining, for example, whether the resulting trusts may file separate income tax returns or whether the severance may result in a gift subject to gift tax, may cause any trust to be included in the gross estate of a beneficiary, or may result in a realization of gain for purposes of section 1001. See §1.1001-1(h) of this chapter for rules relating to whether a qualified severance will constitute an exchange of property for other property differing materially either in kind or in extent.

(b) *Qualified severance defined.* A qualified severance is a division of a trust (other than a division described in §26.2654-1(b)) into two or more separate trusts that meets each of the requirements in paragraph (d) of this section.

(c) *Effective date of qualified severance.* A qualified severance is applicable as of the date of the severance, as defined in §26.2642-6(d)(3), and the resulting trusts are treated as separate trusts for GST tax purposes as of that date.

(d) *Requirements for a qualified severance.* For purposes of this section, a quali-

fied severance must satisfy each of the following requirements:

(1) The single trust is severed pursuant to the terms of the governing instrument, or pursuant to applicable local law.

(2) The severance is effective under local law.

(3) The date of severance is either the date selected by the trustee as of which the trust assets are to be valued in order to determine the funding of the resulting trusts, or the court-imposed date of funding in the case of an order of the local court with jurisdiction over the trust ordering the trustee to fund the resulting trusts on or as of a specific date. For a date to satisfy the definition in the preceding sentence, however, the funding must be commenced immediately upon, and funding must occur within a reasonable time (but in no event more than 90 days) after, the selected valuation date.

(4) The single trust (original trust) is 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 one hundred percent, respectively. For this purpose, the fraction or percentage may be determined by means of a formula (for example, that fraction of the trust the numerator of which is equal to the transferor's unused GST tax exemption, and the denominator of which is the fair market value of the original trust's assets on the date of severance). The severance of a trust based on a pecuniary amount does not satisfy this requirement. For example, the severance of a trust is not a qualified severance if the trust is divided into two trusts, with one trust to be funded with \$1,500,000 and the other trust to be funded with the balance of the original trust's assets. With respect to the particular assets to be distributed to each resulting trust, each resulting trust may be funded with the appropriate fraction or percentage (*pro rata* portion) of each asset held by the original trust. Alternatively, the assets may be divided among the resulting trusts on a non-*pro rata* basis, based on the fair market value of the assets on the date of severance. However, if funded on a non-*pro rata* basis, each resulting trust must be funded by applying the appropriate fraction or percentage to the total fair market value of the trust assets as of the date of severance.

(5) 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 the separate resulting trusts and the interests of the beneficiaries with respect to the separate trusts, when the separate trusts are viewed collectively, are the same as the beneficiaries and their respective beneficial interests with respect to the original trust before severance. With respect to trusts from which discretionary distributions may be made to any one or more beneficiaries on a non-*pro rata* basis, this requirement is satisfied if—

(i) The terms of each of the resulting trusts are the same as the terms of the original trust (even though each permissible distributee 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. For example, in the case of the severance of a discretionary trust established for the benefit of A, B, and C and their descendants with the remainder to be divided equally among those three families, this requirement is satisfied if the trust is divided into three separate trusts of equal value with one trust established for the benefit of A and A's descendants, one trust for the benefit of B and B's descendants, and one trust for the benefit of C and C's descendants;

(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.

(6) In the case of a qualified severance of a trust with an inclusion ratio as defined in §26.2642-1 of either one or zero, each trust resulting from the severance will have an inclusion ratio equal to the inclusion ratio of the original trust.

(7) In the case of a qualified severance occurring after GST tax exemption has been allocated to the trust (whether by an affirmative allocation, a deemed allocation, or an automatic allocation pursuant

to the rules contained in section 2632), if the trust has an inclusion ratio as defined in §26.2642-1 that is greater than zero and less than one, then the trust must be severed initially 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 that is equal to the applicable fraction, as defined in §26.2642-1(b) and (c), used to determine the inclusion ratio of the original trust immediately before the severance. The other resulting trust must receive that fractional share of the total value of the original trust as of the date of severance that is equal to the excess of one over the fractional share described in the preceding sentence. The trust receiving the fractional share equal to the applicable fraction shall have an inclusion ratio of zero, and the other trust shall have an inclusion ratio of one. If the applicable fraction with respect to the original trust is .50, then, with respect to the two equal trusts resulting from the severance, the Trustee may designate which of the resulting trusts will have an inclusion ratio of zero and which will have an inclusion ratio of one. Each separate trust resulting from the severance then may be further divided in accordance with the rules of this section. See paragraph (j), *Example 7* of this section.

(e) *Reporting a qualified severance*—(1) *In general.* A qualified severance is reported by filing Form 706-GS(T), “*Generation-Skipping Transfer Tax Return For Terminations*,” (or such other form as may be provided from time to time by the Internal Revenue Service (IRS) for the purpose of reporting a qualified severance). Unless otherwise provided in the applicable form or instructions, the IRS requests that the filer write “*Qualified Severance*” at the top of the form and attach a Notice of Qualified Severance (Notice). The return and attached Notice should be filed by April 15th of the year immediately following the year during which the severance occurred or by the last day of the period covered by an extension of time, if an extension of time is granted, to file such form.

(2) *Information concerning the original trust.* The Notice should provide, 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.

(3) *Information concerning each new trust.* The Notice should provide, with respect to each of the resulting trusts created by the severance—

(i) The name and tax identification number of the trust;

(ii) The date of severance (within the meaning of paragraph (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.

(f) *Time for making a qualified severance.* (1) A qualified severance of a trust may occur at any time prior to the termination of the trust. Thus, provided that the separate resulting trusts continue in existence after the severance, a qualified severance may occur either before or after—

(i) GST tax exemption has been allocated to the trust;

(ii) A taxable event has occurred with respect to the trust; or

(iii) An addition has been made to the trust.

(2) Because a qualified severance is effective as of the date of severance, a qualified severance has no effect on a taxable termination as defined in section 2612(a) or a taxable distribution as defined in section 2612(b) that occurred prior to the date of severance. A qualified severance shall be deemed to occur before a taxable termination or a taxable distribution that occurs by reason of the qualified severance. See paragraph (j) *Example 8* of this section.

(g) *Trusts that were irrevocable on September 25, 1985*—(1) *In general.* See §26.2601-1(b)(4) for rules regarding severances and other actions with respect to trusts that were irrevocable on September 25, 1985.

(2) *Trusts in receipt of a post-September 25, 1985, addition.* A trust described in §26.2601-1(b)(1)(iv)(A) that is deemed for GST tax purposes to consist of one separate share not subject to GST tax (the non-chapter 13 portion) with an inclusion ratio of zero, and one separate share subject

to GST tax (the chapter 13 portion) with an inclusion ratio determined under section 2642, may be severed into two trusts in accordance with §26.2654-1(a)(3). One resulting trust will hold the non-chapter 13 portion of the original trust (the non-chapter 13 trust) and will not be subject to GST tax, and the other resulting trust will hold the chapter 13 portion of the original trust (the chapter 13 trust) and will have the same inclusion ratio as the chapter 13 portion immediately prior to the severance. The chapter 13 trust may be further divided in a qualified severance in accordance with the rules of this section. The non-chapter 13 trust may be further divided in accordance with the rules of §26.2601-1(b)(4).

(h) [Reserved].

(i) [Reserved].

(j) *Examples.* The rules of this section are illustrated by the following examples:

Example 1. Succession of interests. T dies in 2006. T’s will establishes a testamentary trust (Trust) providing that income is to be paid to T’s sister, S, for her life. On S’s death, one-half of the corpus is to be paid to T’s child, C (or to C’s estate if C fails to survive S), and one-half of the corpus is to be paid to T’s grandchild, GC (or to GC’s estate if GC fails to survive S). On the Form 706, “*United States Estate (and Generation-Skipping Transfer) Tax Return*,” filed for T’s estate, T’s executor allocates all of T’s available GST tax exemption to other transfers and trusts, such that Trust’s inclusion ratio is 1. Subsequent to filing the Form 706 in 2007 and in accordance with applicable state law, the trustee divides Trust into two separate trusts, Trust 1 and Trust 2, with each trust receiving 50 percent of the value of the assets of the original trust as of the date of severance. Trust 1 provides that trust income is to be paid to S for life with remainder to C or C’s estate, and Trust 2 provides that trust income is to be paid to S for life with remainder to GC or GC’s estate. Because Trust 1 and Trust 2 provide for the same succession of interests in the aggregate as provided in the original trust, the severance constitutes a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied.

Example 2. Succession of interests in discretionary trust. In 2006, T establishes Trust, an irrevocable trust providing that income may be paid from time to time in such amounts as the trustee deems advisable to any one or more members of the group consisting of T’s children (A and B) and their respective descendants. In addition, the trustee may distribute corpus to any trust beneficiary in such amounts as the trustee deems advisable. On the death of the last to die of A and B, the trust is to terminate and the corpus is to be distributed in two equal shares, one share to the then-living descendants of each child, per stirpes. T elects, under section 2632(c)(5), to not have the automatic allocation rules contained in section 2632(c) apply with respect to T’s transfers to Trust, and T does not otherwise allocate GST tax exemption with respect to Trust. As a result, Trust has an inclusion ratio of one. In 2008,

the trustee of Trust, pursuant to applicable state law, divides Trust into two equal but separate trusts, Trust 1 and Trust 2, each of which has terms identical to the terms of Trust except for the identity of the beneficiaries. Trust 1 and Trust 2 each has an inclusion ratio of one. Trust 1 provides that income is to be paid in such amounts as the trustee deems advisable to A and A's descendants. In addition, the trustee may distribute corpus to any trust beneficiary in such amounts as the trustee deems advisable. On the death of A, Trust 1 is to terminate and the corpus is to be distributed to the then-living descendants of A, per stirpes, but, if A dies with no living descendants, the principal will be added to Trust 2. Trust 2 contains identical provisions, except that B and B's descendants are the trust beneficiaries and, if B dies with no living descendants, the principal will be added to Trust 1. Trust 1 and Trust 2 in the aggregate provide for the same beneficiaries and the same succession of interests as provided in Trust, and the severance does not shift any beneficial interest to a beneficiary who occupies a lower generation than the person or persons who held the beneficial interest in Trust. Accordingly, the severance constitutes a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied.

Example 3. Severance based on actuarial value of beneficial interests. In 2004, T establishes Trust, an irrevocable trust providing that income is to be paid to T's child C during C's lifetime. Upon C's death, Trust is to terminate and the assets of Trust are to be paid to GC, C's child, if living, or, if GC is not then living, to GC's estate. T properly elects, under section 2632(c)(5), to not have the automatic allocation rules contained in section 2632(c) apply with respect to T's transfers to Trust, and T does not otherwise allocate GST tax exemption with respect to Trust. Thus, Trust has an inclusion ratio of one. In 2008, the trustee of Trust, pursuant to applicable state law, divides Trust into two separate trusts, Trust 1 for the benefit of C (and on C's death to C's estate), and Trust 2 for the benefit of GC (and on GC's death to GC's estate). The document severing Trust directs that Trust 1 is to be funded with an amount equal to the actuarial value of C's interest in Trust prior to the severance, determined under section 7520 of the Internal Revenue Code. Similarly, Trust 2 is to be funded with an amount equal to the actuarial value of GC's interest in Trust prior to the severance, determined under section 7520. Trust 1 and Trust 2 do not provide for the same succession of interests as provided under the terms of the original trust. Therefore, the severance is not a qualified severance.

Example 4. Severance of a trust with a 50% inclusion ratio. On September 1, 2006, T transfers \$100,000 to a trust for the benefit of T's grandchild, GC. On a timely filed Form 709, "United States Gift (and Generation-Skipping Transfer) Tax Return," reporting the transfer, T allocates all of T's remaining GST tax exemption (\$50,000) to the trust. As a result of the allocation, the applicable fraction with respect to the trust is .50 [\$50,000 (the amount of GST tax exemption allocated to the trust) divided by \$100,000 (the value of the property transferred to the trust)]. The inclusion ratio with respect to the trust is .50 [1 - .50]. In 2007, pursuant to authority granted under applicable state law, the trustee severs the trust into two trusts, Trust 1 and Trust 2, each of which is identical to the original trust and each of which receives

a 50 percent fractional share of the total value of the original trust, valued as of the date of severance. Because the applicable fraction with respect to the original trust is .50 and the trust is severed into two equal trusts, the trustee may designate which resulting trust has an inclusion ratio of one, and which resulting trust has an inclusion ratio of zero. Accordingly, in the Notice of Qualified Severance reporting the severance, the trustee designates Trust 1 as having an inclusion ratio of zero, and Trust 2 as having an inclusion ratio of one. The severance constitutes a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied.

Example 5. Funding of severed trusts on a non-pro rata basis. T's will establishes a testamentary trust (Trust) for the benefit of T's descendants, to be funded with T's stock in Corporation A and Corporation B, both publicly traded stocks. T dies on May 1, 2004, at which time the Corporation A stock included in T's gross estate has a fair market value of \$100,000 and the stock of Corporation B included in T's gross estate has a fair market value of \$200,000. On a timely filed Form 706, T's executor allocates all of T's remaining GST tax exemption (\$270,000) to Trust. As a result of the allocation, the applicable fraction with respect to Trust is .90 [\$270,000 (the amount of GST tax exemption allocated to the trust) divided by \$300,000 (the value of the property transferred to the trust)]. The inclusion ratio with respect to Trust is .10 [1 - .90]. On August 1, 2008, in accordance with applicable local law, the trustee executes a document severing Trust into two trusts, Trust 1 and Trust 2, each of which is identical to Trust. The instrument designates August 3, 2008, as the date of severance (within the meaning of paragraph (d)(3) of this section). The terms of the instrument severing Trust provide that Trust 1 is to be funded on a non-pro rata basis with assets having a fair market value on the date of severance equal to 90% of the value of Trust's assets on that date, and Trust 2 is to be funded with assets having a fair market value on the date of severance equal to 10% of the value of Trust's assets on that date. On August 3, 2008, the value of the Trust assets totals \$500,000, consisting of Corporation A stock worth \$450,000 and Corporation B stock worth \$50,000. On August 4, 2008, the trustee takes all action necessary to transfer all of the Corporation A stock to Trust 1 and to transfer all of the Corporation B stock to Trust 2. On August 6, 2008, the stock transfers are completed and the stock is received by the appropriate resulting trust. Accordingly, Trust 1 is funded with assets having a value equal to 90% of the value of Trust as of the date of severance, August 3, 2008, and Trust 2 is funded with assets having a value equal to 10% of the value of Trust as of the date of severance. Therefore, the severance constitutes a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied. Trust 1 will have an inclusion ratio of zero and Trust 2 will have an inclusion ratio of one.

Example 6. [Reserved].

Example 7. Statutory qualified severance. T dies on October 1, 2004. T's will establishes a testamentary trust (Trust) to be funded with \$1,000,000. Trust income is to be paid to T's child, S, for S's life. The trustee may also distribute trust corpus from time to time, in equal or unequal shares, for the benefit of any one or more members of the group consisting of S and T's three grandchildren (GC1, GC2, and GC3).

On S's death, Trust is to terminate and the assets are to be divided equally among GC1, GC2, and GC3 (or their respective then-living descendants, per stirpes). On a timely filed Form 706, T's executor allocates all of T's remaining GST tax exemption (\$300,000) to Trust. As a result of the allocation, the applicable fraction with respect to the trust is .30 [\$300,000 (the amount of GST tax exemption allocated to the trust) divided by \$1,000,000 (the value of the property transferred to the trust)]. The inclusion ratio with respect to the trust is .70 [1 - .30]. On June 1, 2007, the trustee determines that it is in the best interest of the beneficiaries to sever Trust to provide a separate trust for each of T's three grandchildren and their respective families. The trustee severs Trust into two trusts, Trust 1 and Trust 2, each with terms and beneficiaries identical to Trust and thus each providing that trust income is to be paid to S for life, trust principal may be distributed for the benefit of any or all members of the group consisting of S and T's grandchildren, and, on S's death, the trust is to terminate and the assets are to be divided equally among GC1, GC2, and GC3 (or their respective then-living descendants, per stirpes). The instrument severing Trust provides that Trust 1 is to receive 30% of Trust's assets and Trust 2 is to receive 70% of Trust's assets. Further, each such trust is to be funded with a *pro rata* portion of each asset held in Trust. The trustee then severs Trust 1 into three equal trusts, Trust GC1, Trust GC2, and Trust GC3. Each trust is named for a grandchild of T and provides that trust income is to be paid to S for life, trust principal may be distributed for the benefit of S and T's grandchild for whom the trust is named, and, on S's death, the trust is to terminate and the trust proceeds distributed to the respective grandchild for whom the trust is named. If that grandchild has predeceased the termination date, the trust proceeds are to be distributed to that grandchild's then-living descendants, per stirpes, or, if none, then equally to the other two trusts resulting from the severance of Trust 1. Each such resulting trust is to be funded with a *pro rata* portion of each Trust 1 asset. The trustee also severs Trust 2 in a similar manner, into Trust GC1(2), Trust GC2(2), and Trust GC3(2). The severance of Trust into Trust 1 and Trust 2, the severance of Trust 1 into Trust GC1, Trust GC2, Trust GC3, and the severance of Trust 2 into Trust GC1(2), Trust GC2(2) and Trust GC3(2), constitute qualified severances, provided that all other requirements of section 2642(a)(3) and this section are satisfied with respect to each severance. Trust GC1, Trust GC2, Trust GC3 will each have an inclusion ratio of zero and Trust GC1(2), Trust GC2(2), and Trust GC3(2) will each have an inclusion ratio of one.

Example 8. Qualified severance deemed to preclude a taxable termination. In 2004, T establishes an *inter vivos* irrevocable trust (Trust) for a term of 10 years providing that Trust income is to be paid annually in equal shares to T's child C and T's grandchild GC (the child of another then-living child of T). If either C or GC dies prior to the expiration of the 10-year term, the deceased beneficiary's share of Trust's income is to be paid to that beneficiary's then-living descendants, per stirpes, for the balance of the trust term. At the expiration of the 10-year trust term, the corpus is to be distributed equally to C and GC; if either C or GC is not then living, then such decedent's share is to be distributed instead to such decedent's then-living descendants, per stirpes. T allocates T's

GST tax exemption to Trust such that Trust's applicable fraction is .50 and Trust's inclusion ratio is .50 [1-.50]. In 2006, pursuant to applicable state law, the trustee severs the trust into two equal trusts, Trust 1 and Trust 2. The instrument severing Trust provides that Trust 1 is to receive 50% of the Trust assets, and Trust 2 is to receive 50% of Trust's assets. Both resulting trusts are identical to Trust, except that each has different beneficiaries: C and C's descendants are designated as the beneficiaries of Trust 1, and GC and GC's descendants are designated as the beneficiaries of Trust 2. The severance constitutes a qualified severance, provided all other requirements of section 2642(a)(3) and this section are satisfied. Because the applicable fraction with respect to Trust is .50 and Trust was severed into two equal trusts, the trustee may designate which resulting trust has an inclusion ratio of one, and which has an inclusion ratio of zero. Accordingly, in the Notice of Qualified Severance reporting the severance, the trustee designates Trust 1 as having an inclusion ratio of one, and Trust 2 as having an inclusion ratio of zero. Because Trust 2 is a skip person under section 2613, the severance of Trust resulting in the distribution of 50% of Trust's corpus to Trust 2 would constitute a taxable termination or distribution (as described in section 2612(a)) of that 50% of Trust for GST tax purposes, but for the rule that a qualified severance is deemed to precede a taxable termination that is caused by the qualified severance. Thus, no GST tax will be due with regard to the creation and funding of Trust 2 because the inclusion ratio of Trust 2 is zero.

Example 9. [Reserved].

Example 10. Beneficiary's interest dependent on inclusion ratio. On August 8, 2006, T transfers \$1,000,000 to Trust and timely allocates \$400,000 of T's remaining GST tax exemption to Trust. As a result of the allocation, the applicable fraction with respect to Trust is .40 [\$400,000 divided by \$1,000,000] and Trust's inclusion ratio is .60 [1 - .40]. Trust provides that all income of Trust will be paid annually to C, T's child, for life. On C's death, the corpus is to pass in accordance with C's exercise of a testamentary limited power to appoint the corpus of Trust to C's lineal descendants. However, Trust provides that if, at the time of C's death, Trust's inclusion ratio is greater than zero, then C may also appoint that fraction of the trust corpus equal to the inclusion ratio to the creditors of C's estate. On May 3, 2008, pursuant to authority granted under applicable state law, the trustee severs Trust into two trusts. Trust 1 is funded with 40% of Trust's assets, and Trust 2 is funded with 60% of Trust's assets in accordance with the requirements of this section. Both Trust 1 and Trust 2 provide that all income of Trust will be paid annually to C during C's life. On C's death, Trust 1 corpus is to pass in accordance with C's exercise of a testamentary limited power to appoint the corpus to C's lineal descendants. Trust 2 is to pass in accordance with C's exercise of a testamentary power to appoint the corpus of Trust to C's lineal descendants and to the creditors of C's estate. The severance constitutes a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied. No additional contribution or allocation of GST tax exemption is made to either Trust 1 or Trust 2 prior to C's death. Accordingly, the inclusion ratio with respect to Trust 1 is zero. The inclusion ratio

with respect to Trust 2 is one until C's death, at which time C will become the transferor of Trust 2 for GST tax purposes. (Some or all of C's GST tax exemption may be allocated to Trust 2 upon C's death.)

Example 11. Date of severance. Trust is an irrevocable trust that has both skip person and non-skip person beneficiaries. Trust holds two parcels of real estate, Property A and Property B, stock in Company X, a publicly traded company, and cash. On June 16, 2008, the local court with jurisdiction over Trust issues an order, pursuant to the trustee's petition authorized under state law, severing Trust into two resulting trusts of equal value, Trust 1 and Trust 2. The court order directs that Property A will be distributed to Trust 1 and Property B will be distributed to Trust 2, and that an appropriate amount of stock and cash will be distributed to each trust such that the total value of property distributed to each trust as of the date of severance will be equal. The court order does not mandate a particular date of funding. Trustee receives notice of the court order on June 24, and selects July 16, 2008, as the date of severance. On June 26, 2008, Trustee commences the process of transferring title to Property A and Property B to the appropriate resulting trust(s), which process is completed on July 8, 2008. Also on June 26, the Trustee hires a professional appraiser to value Property A and Property B as of the date of severance and receives the appraisal report on Friday, October 3, 2008. On Monday, October 6, 2008, Trustee commences the process of transferring to Trust 1 and Trust 2 the appropriate amount of Company X stock valued as of July 16, 2008, and that transfer (as well as the transfer of Trust's cash) is completed by October 9, 2008. Under the facts presented, the funding of Trust 1 and Trust 2 occurred within 90 days of the date of severance selected by the trustee, and within a reasonable time after the date of severance taking into account the nature of the assets involved and the need to obtain an appraisal. Accordingly, the date of severance for purposes of this section is July 16, 2008, the resulting trusts are to be funded based on the value of the original trust assets as of that date, and the severance is a qualified severance assuming that all other requirements of section 2642(a)(3) and this section are met. (However, if Trust had contained only 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.)

(k) *Effective date*—(1) *In general.* This section applies to severances occurring on or after August 2, 2007.

(2) *Transition rule.* In the case of a qualified severance occurring after December 31, 2000, and 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. For this purpose, the proposed regulations (69 FR 51967) are treated as a reasonable interpretation of the statute. For purposes of the reporting provisions

of §26.2642-6(e), notice to the IRS should be mailed by the due date of the gift tax return (including extensions granted) for gifts made during the year in which the severance occurred. If no gift tax return is filed, notice to the IRS should be mailed by April 15th of the year immediately following the year during which the severance occurred. 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.

Par. 6. Section 26.2654-1 is amended by adding paragraphs (b)(4) *Example 3* and (c) to read as follows:

§26.2654-1 *Certain trusts treated as separate trusts.*

* * * * *

(b) * * * * *

(4) *Examples.* * * * *

Example 3. Formula severance. T's will establishes a testamentary marital trust (Trust) that meets the requirements of qualified terminable interest property (QTIP) if an election under section 2056(b)(7) is made. Trust provides that all trust income is to be paid to T's spouse for life. On the spouse's death, the trust corpus is to be held in further trust for the benefit of T's then-living descendants. On T's date of death in January of 2004, T's unused GST tax exemption is \$1,200,000, and T's will includes \$200,000 of bequests to T's grandchildren. Prior to the due date for filing the Form 706, "*United States Estate (and Generation-Skipping Transfer) Tax Return*," for T's estate, T's executor, pursuant to applicable state law, divides Trust into two separate trusts, Trust 1 and Trust 2. Trust 1 is to be funded with that fraction of the Trust assets, the numerator of which is \$1,000,000, and the denominator of which is the value of the Trust assets as finally determined for federal estate tax purposes. Trust 2 is to be funded with that fraction of the Trust assets, the numerator of which is the excess of the Trust assets over \$1,000,000, and the denominator of which is the value of the Trust assets as finally determined for federal estate tax purposes. On the Form 706 filed for the estate, T's executor makes a QTIP election under section 2056(b)(7) with respect to Trust 1 and Trust 2 and a "reverse" QTIP election under section 2652(a)(3) with respect to Trust 1. Further, T's executor allocates \$200,000 of T's available GST tax exemption to the bequests to T's grandchildren, and the balance of T's exemption (\$1,000,000) to Trust 1. If the requirements of paragraph (b) of this section are otherwise satisfied, Trust 1 and Trust 2 are recognized as separate trusts for GST tax purposes. Accordingly, the "reverse" QTIP election and allocation of GST tax exemption with respect to Trust 1 are recognized and effective for generation-skipping transfer tax purposes.

(c) *Cross reference.* For rules applicable to the qualified severance of trusts

(whether or not includible in the transferor's gross estate), see §26.2642-6.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 7. The authority citation for part 602 continues to read as follows:
Authority: 26 U.S.C. 7805.

Par. 8. In §602.101, paragraph (b) is amended by adding entries in numerical order to the table to read as follows:

§602.101 OMB Control numbers.
* * * * *
(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.1001-1 * * * * *	1545-1902
26.2642-6 * * * * *	1545-1902
26.2654-1 * * * * *	1545-1902

Linda E. Stiff,
Acting Deputy Commissioner for Services and Enforcement.

Approved July 24, 2007.

Eric Solomon,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on August 1, 2007, 8:45 a.m., and published in the issue of the Federal Register for August 2, 2007, 72 F.R. 42291)

fuel, other importers of record, and certain sureties.

DATES: *Effective Date:* These regulations are effective July 27, 2007.

Applicability Dates: For dates of applicability, see §§48.4081-1(f) and 48.4081-3(j).

FOR FURTHER INFORMATION CONTACT: Celia Gabrysh at (202) 622-3130 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1897. The collection of information in these final regulations is in §48.4081-3(c)(2)(iii) and (iv). This collection of information allows certain importers of record and sureties to avoid liability for the tax on the entry of taxable fuel into the United States.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

The estimated annual burden per respondent and/or recordkeeper varies from 15 minutes to 2.25 hours, depending on in-

dividual circumstances, with an estimated average of 1.25 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224, and the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document amends the Manufacturers and Retailers Excise Tax Regulations (26 CFR part 48) to provide rules relating to the tax that section 4081 of the Internal Revenue Code (Code) imposes on the entry of taxable fuel into the United States. On July 30, 2004, a temporary regulation (T.D. 9145, 2004-2 C.B. 464 [69 FR 45587]) relating to this topic was published in the **Federal Register**. A notice of proposed rulemaking (REG-120616-03, 2004-2 C.B. 474 [69 FR 45631]) cross-referencing the temporary regulations was published in the **Federal Register** on the same day. Written

Section 4081.—Imposition of Tax

26 CFR 48.4081-1: Taxable fuel; definitions.

T.D. 9346

**DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 48 and 602**

Entry of Taxable Fuel

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations relating to the tax on the entry of taxable fuel into the United States. The final regulations affect enterers of taxable