

Title 26: Internal Revenue

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

§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 qualified 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 separate trust resulting from the severance, each such 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 a resulting trust is funded on a non-pro rata basis, each 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. See paragraph (j), *Example 6* of this section.

(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)(i) 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 either paragraph (d)(7)(ii) or (iii) of this section must be satisfied.

(ii) The trust is severed initially into only two resulting 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.

(iii) The trust is severed initially into more than two resulting trusts. One or more of the resulting trusts in the aggregate 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 used to determine the inclusion ratio of the original trust immediately before the severance. The trust or trusts receiving such fractional share shall have an inclusion ratio of zero, and each of the other resulting trust or trusts shall have an inclusion ratio of one. (If, however, two or more of the resulting trusts each receives the fractional share of the total 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 and which will have an inclusion ratio of one.) The resulting trust or trusts with an inclusion ratio of one must receive in the aggregate 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 second sentence of this paragraph. See paragraph (j), *Example 9*, 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) *Treatment of trusts resulting from a severance that is not a qualified severance.* Trusts resulting from a severance (other than a severance recognized for GST tax purposes under §26.2654-1) that does not meet the requirements of a qualified severance under paragraph (b) of this section will be treated, after the date of severance, as separate trusts for purposes of the GST tax, provided that the trusts resulting from such severance are recognized as separate trusts under applicable state law. The post-severance treatment of the resulting trusts as separate trusts for GST tax purposes generally permits the allocation of GST tax exemption, the making of various elections permitted for GST tax purposes, and the occurrence of a taxable distribution or termination with regard to a particular resulting trust, with no GST tax impact on any other trust resulting from that severance. Each trust resulting from a severance described in this paragraph (h), however, will have the same inclusion ratio immediately after the severance as that of the original trust immediately before the severance. (See §26.2654-1 for the inclusion ratio of each trust resulting from a severance described in that section.) Further, any trust resulting from a nonqualified severance may be severed subsequently, pursuant to a qualified severance described in this §26.2642-6.

(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), not to 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 2009, 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. Furthermore, because the severance results in no non-skip person having an interest in Trust 2, Trust 2 constitutes a skip person under section 2613 and, therefore, the severance results in a taxable termination subject to GST tax.

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. Funding of severed trusts on a non-pro rata basis. (i) T's will establishes an irrevocable trust (Trust) for the benefit of T's descendants. As a result of the allocation of GST tax exemption, the applicable fraction with respect to Trust is .60 and Trust's inclusion ratio is .40 [1-.60]. Pursuant to authority granted under applicable state law, on August 1, 2008, the trustee executes a document severing Trust into two trusts, Trust 1 and Trust 2, each of which is identical to Trust. The instrument of severance provides that the severance is intended to qualify as a qualified severance within the meaning of section 2642(a)(3) and designates August 3, 2008, as the date of severance (within the meaning of paragraph (d)(3) of this section). The instrument further provides that Trust 1 and Trust 2 are to be funded on a non-pro rata basis with Trust 1 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 and Trust 2 funded with assets having a fair market value equal to 60% of the value of Trust's assets on that date. The fair market value of the assets used to fund each trust is to be determined in compliance with the requirements of paragraph (d) (4) of this section.

(ii) On August 3, 2008, the fair market value of the Trust assets totals \$4,000,000, consisting of 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. Trustee proposes to divide the Company stock equally between Trust 1 and Trust 2, and thus transfer 26% of the Company stock to Trust 1 and 26% of the stock to Trust 2. In addition, the appropriate amount of cash and marketable securities will be distributed to each trust. In accordance with paragraph (d)(4) of this section, for funding purposes, the interest in the Company stock distributed to each trust is valued as a pro rata portion of the value of the 52% interest in Company held by Trust before severance, without taking into account, for example, any valuation discount that might otherwise apply in valuing the noncontrolling interest distributed to each resulting trust.

(iii) Accordingly, for funding purposes, each 26% interest in Company stock distributed to Trust 1 and Trust 2 is valued at \$1,500,000 (.5 × \$3,000,000). Therefore, Trust 1, which is to be funded with \$1,600,000 (.40 × \$4,000,000), receives \$100,000 in cash and marketable securities valued as of August 3, 2008, in addition to the Company stock, and Trust 2, which is to be funded with \$2,400,000 (.60 × \$4,000,000), receives \$900,000 in cash and marketable securities in addition to the Company stock. Therefore, the severance is a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied.

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 precede 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. Regulatory qualified severance. (i) In 2004, T establishes an inter vivos irrevocable trust (Trust) providing that trust income is to be paid annually in equal shares to T's children, A and B, for 10 years. Trust provides that the trustee has discretion to make additional distributions of principal to A and B during the 10-year term without adjustments to their shares of income or the trust remainder. If either (or both) dies prior to the expiration of the 10-year term, the deceased child's share of trust income is to be paid to the child's then living descendants, per stirpes, for the balance of the trust term. At the expiration of the 10-year term, the corpus is to be distributed equally to A and B; if A and B (or either or them) 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 GST tax exemption to Trust such that Trust's applicable fraction is .25 and its inclusion ratio is .75.

(ii) In 2006, pursuant to applicable state law, the trustee severs the trust into three trusts: Trust 1, Trust 2, and Trust 3. The instrument severing Trust provides that Trust 1 is to receive 50% of Trust's assets, Trust 2 is to receive 25% of Trust's assets, and Trust 3 is to receive 25% of Trust's assets. All three resulting trusts are identical to Trust, except that each has different beneficiaries: A and A's issue are designated as the beneficiaries of Trust 1, and B and B's issue are designated as the beneficiaries of Trust 2 and Trust 3. 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 1. Because both Trust 2 and Trust 3 have each received the fractional share of Trust's assets equal to Trust's applicable fraction of .25, trustee designates that Trust 2 will have an inclusion ratio of one and that Trust 3 will have an inclusion ratio of zero.

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.)

Example 12. Other severance that does not meet the requirements of a qualified severance. (i) In 2004, T establishes an irrevocable inter vivos trust (Trust) providing that Trust income is to be paid to T's children, A and B, in equal shares for their joint lives. Upon the death of the first to die of A and B, all Trust income will be paid to the survivor of A and B. At the death of the survivor, the corpus is to be distributed in equal shares to T's grandchildren, W and X (with any then-deceased grandchild's share being paid in accordance with that grandchild's testamentary general power of appointment). W is A's child and X is B's child. T elects under section 2632(c)(5) not to have the automatic allocation rules contained in section 2632(c) apply with respect to T's transfers to Trust, but T allocates GST tax exemption to Trust resulting in Trust having an inclusion ratio of .30.

(ii) In 2009, the trustee of Trust, as permitted by applicable state law, divides Trust into two separate trusts, Trust 1 and Trust 2. Trust 1 provides that trust income is to be paid to A for life and, on A's death, the remainder is to be distributed to W (or pursuant to W's testamentary general power of appointment). Trust 2 provides that trust income is to be paid to B for life and, on B's death, the remainder is to be distributed to X (or pursuant to X's testamentary general power of appointment). Because Trust 1 and Trust 2 do not provide A and B with the contingent survivor income interests that were provided to A and B under the terms of Trust, Trust 1 and Trust 2 do not provide for the same succession of interests in the aggregate as provided by Trust. Therefore, the severance does not satisfy the requirements of this section and is not a qualified severance. Provided that Trust 1 and Trust 2 are recognized as separate trusts under applicable state law, Trust 1 and Trust 2 will be recognized as separate trusts for GST tax purposes pursuant to paragraph (h) of this section, prospectively from the date of the severance. However, Trust 1 and Trust 2 each have an inclusion ratio of .30 immediately after the severance, the same as the inclusion ratio of Trust prior to severance.

Example 13. Qualified severance following a non-qualified severance. Assume the same facts as in *Example 12*, except that, as of November 4, 2010, the trustee of Trust 1 severs Trust 1 into two trusts, Trust 3 and Trust 4, in accordance with applicable local law. The instrument severing Trust 1 provides that both resulting trusts have provisions identical to Trust 1. The terms of the instrument severing Trust 1 further provide that Trust 3 is to be funded on a pro rata basis with assets having a fair market value as of the date of severance equal to 70% of the value of Trust 1's assets on that date, and Trust 4 is to be funded with assets having a fair market value as of the date of severance equal to 30% of the value of Trust 1's assets on that date. The severance constitutes a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied. Trust 3 will have an inclusion ratio of zero and Trust 4 will have an inclusion ratio of one.

(k) *Effective/applicability date—(1) In general.* Except as otherwise provided in this paragraph (k), this section applies to severances occurring on or after August 2, 2007. Paragraph (d)(7)(iii), paragraph (h), and *Examples 9, 12 and 13* of paragraph (j) of this section apply to severances occurring on or after September 2, 2008.

(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.

[T.D. 9348, 72 FR 42294, Aug. 2, 2007, as amended by T.D. 9421, 73 FR 44650, July 31, 2008]