COPY

COMMONWEALTH OF MASSACHUSETTS
SUPREME JUDICIAL COURT
DOCKET NO. SJC-11233

RICHARD MORSE, TRUSTEE OF THE TRUSTS UNDER ARTICLE III OF THE KRAFT IRREVOCABLE FAMILY TRUST

RECEIVED
SUPREME JUDICIAL COURT
MAR 22 2013
FOR THE COMMONWEALTH
SUSAN MELLEN, CLERK

Plaintiff - Appellant,

v.

JONATHAN A. KRAFT, DANIEL A. KRAFT, JOSHUA M. KRAFT, DAVID H. KRAFT, HARRY J. KRAFT, SADIE H. KRAFT, JACOB C. KRAFT, JESSICA R. KRAFT, ALISON F. KRAFT, JOSEPH S. KRAFT, REBECCA H. KRAFT, ANNA R. KRAFT, PATRICIA L. KRAFT, WENDY KRAFT, CAROLYN U. KRAFT, AND DOUGLAS H. SHULMAN, AS THE COMMISSIONER OF INTERNAL REVENUE

Defendants - Appellees.

ON RESERVATION AND REPORT WITHOUT DECISION
BY A SINGLE JUSTICE OF THE SUPREME JUDICIAL COURT
FOR SUFFOLK COUNTY

BRIEF OF THE BOSTON BAR ASSOCIATION, AMICUS CURIAE

Andrew D. Rothstein (BBO# 639653)
Goulston & Storrs, P.C.
400 Atlantic Avenue
Boston, MA 02110-3333
Tel: (617) 482-1776
arothstein@goulstonstorrs.com
Attorney for Amicus Curiae

Dated: March 22, 2013

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases

Statutes

Regulations

Other Authorities

I. INTEREST OF AMICUS CURIAE

The mission of the Boston Bar Association (hereinafter, "Amicus Curiae" or "BBA") traces its origins to meetings convened by John Adams in 1761, thirty-six years before he became President of the United States. The BBA works "to advance the highest standards of excellence for the legal profession, to facilitate access to justice, and to serve the community at large." The vast pool of legal expertise of the BBA's members serves as a resource for the judiciary, as well as the legislative and executive branches of government.

The Boston Bar Association's Trusts and Estates Section is comprised of attorneys who act as advisors as well as fiduciaries in various disciplines pertaining to wills, trusts, estates, taxation of transfers during lifetime and at death, fiduciary income tax and elder law. The Trusts and Estates Section serves as a resource to the bar, providing continuing education and updates on new developments, and actively supports developments in the law that it deems beneficial to the bar, including, where appropriate, proposing or commenting on new legislation and participation in the preparation of amicus briefs on behalf of the BBA.

The duty of trustees is to serve their beneficiaries to their maximum ability consistent with the grantor's intent and what the Court determines to be the common law limit of their authority. The Court's resolution of the fundamental question of trust jurisprudence at issue in this case will assist attorneys who advise trustees or serve as trustees themselves.

II. PROCEDURAL BACKGROUND

Amicus Curiae adopts the Procedural Background set forth in the Brief of Petitioner, Richard Morse.

III. ISSUE PRESENTED

Absent trust language to the contrary, does a discretionary authority given by the grantor of a trust to its trustee to distribute trust property outright to a beneficiary also empower the trustee to make such a distribution in further trust for the benefit of that beneficiary?

IV. STATEMENT OF THE CASE

The BBA adopts the Statement of the Case set forth in the brief of the Plaintiff, Richard Morse.

V. STATEMENT OF FACTS

The BBA adopts the Statement of the Facts set forth in the brief of the Plaintiff, Richard Morse.

VI. SUMMARY OF THE ARGUMENT

The BBA respectfully requests that this Court recognize that trustees have the inherent power to exercise their trust distribution authority by distributing trust property in further trust.[1] By exercising their trust distribution authority by distributing trust property in further trust, trustees may transfer trust assets from a trust with features that, due to external circumstances, no longer effectively carry out the intention of the grantor or no longer serve the best interests of the trust beneficiaries, to another trust with features that would be more appropriate to carry out the intention of the grantor or serve the best interests of the trust beneficiaries in view of existing circumstances.

The power of a trustee to distribute in further trust is consistent with the trust jurisprudence of this Court, the statutory authority that supplements this case law, and the case law of other

[1] The exercise of trust distribution authority by distributing trust property in further trust is sometimes referred to by practitioners and commentators as "trust decanting."

jurisdictions. (5-16). Explicit recognition of the power of a trustee to exercise its distribution authority by distributing trust property in further trust will provide assurance to fiduciaries, especially those who administer long term trusts, that they may use this technique to fulfill the intention of the grantor and address changing circumstances that were never anticipated at the time the trust was established, including changes in tax law. (20-24). Moreover, it is important that this Court explicitly recognize this inherent power because, even though there are today other methods for modifying trusts, a modification pursuant to the distribution authority of a trustee that existed at the time the trust became irrevocable will ensure that the continuing trust will not lose its grandfathered status for purposes of the federal generation-skipping transfer tax. Id. Finally, the Court should recognize the power to distribute trust property in further trust as an existing power of trustees, and should not limit its holding to apply only prospectively. (24-26).

VII. ARGUMENT

A. A TRUSTEE'S DISCRETIONARY AUTHORITY TO DISTRIBUTE TRUST PROPERTY TO TRUST BENEFICIARIES INCLUDES THE AUTHORITY TO DISTRIBUTE SUCH PROPERTY IN FURTHER TRUST.

1. A Trustee's Discretionary Authority to Distribute In Further Trust is a Power of Appointment and Like any Other Power of Appointment may be Exercised in Further Trust.

A power of appointment is a power giving someone the authority to direct the distribution of the trust property among designated permissible appointees. Thompson v. Pew, 214 Mass. 520, 522 (1913). A discretionary power in a trustee to distribute trust property to trust beneficiaries is a power of appointment. The Restatement (Third) of Property (Wills and Other Donative Transfers) (hereinafter the "Third Restatement of Property") defines a power of appointment as "a power that enables the donee of the power to designate recipients of beneficial ownership interests in or powers of appointment over the appointive property." Restatement (Third) of Property (Wills and Other Donative Transfers) § 17 (1999-2003).[2] Comment (g) to the Third Restatement of Property §

[2] The "donee" of the power is "the person on whom the power of appointment was conferred or in whom the power was reserved." Id. at § 17.2.

17.1 concludes that a fiduciary distributive power is a power of appointment. As the Third Restatement of Property observes, the basic distinction between a power of appointment and a trustee's discretionary authority to distribute trust property is that the trustee's authority is limited by fiduciary standards while the donee of the power of appointment is not so limited.[3]

In Loring v. Karri-Davies, 371 Mass. 346 (1976), the Court ruled prospectively that absent the trust settlor's expressed intent to the contrary, a special power of appointment held by a trust beneficiary to direct the distribution of the trust property to one or more of a class of identified appointees carries with it the authority to exercise that power in further trust for the benefit of the permitted appointees. The authority at issue in Karri-Davies is in principle the same as a trustee's discretionary authority to distribute trust property to trust beneficiaries, since both powers permit distribution

[3] The Third Restatement of Property states that fiduciary powers are powers of appointment subject to trust fiduciary rules. Third Restatement of Property § 17.1, cmt. (g). Restatement (Third) of Trusts § 50, comment (a) (2003-2008), makes a similar distinction.

for the benefit of identified beneficiaries.[4] Accordingly, the Court should find that trustees possess this inherent power, no less than do beneficiaries with a power of appointment.

2. Trustees Have An Implied Fiduciary Power to Distribute Property in Further Trust.

The power to distribute property in further trust also resides in the implied powers of a trustee to administer a trust, a conclusion supported by longstanding principles of trust interpretation. Implied fiduciary powers are an essential component of the trustee's ability to administer a trust. As Professor Charles E. Rounds, Jr., has explained:

> [a]scertaining the limits of the trustee's equitable authority (in other words, the limits of the trustee's powers) is more an art than a science. The panoply of powers with respect to a given trust is drawn from long-established customs and practice, the common law, statute, the terms of the trust itself, and by implication from the general purposes of the trust.

---

[4] Courts in jurisdictions outside of Massachusetts recognizing the power of a trustee to make distributions in further trust have, in some instances, done so based on a finding that the trustee's discretionary authority was equivalent to a power of appointment. See, e.g., Phipps v. Palm Beach Trust Co., 142 Fla. 782, 785 (1940). In addition, for federal estate tax purposes, a trustee's power to distribute trust assets has for decades been treated as a power of appointment. See Treas. Reg. § 20-2041-1(b).

Loring and Rounds, A Trustee's Handbook § 3.5.3 (2013 ed.)(citing Restatement (Third) of Trusts § 85(1)(b) (2003-2008) and A. W. Scott, W. F. Fratcher. & M. L. Ascher, Scott and Ascher on Trusts §§ 16.1, 18.1, 19.1.12 (5th ed. 2006)). These powers include implied powers granted by operation of law, "because without them it would be impossible to carry out the trustee's fiduciary responsibilities." Loring & Rounds at § 3.5.3.1 (citing Bogert, Trusts and Trustees § 551). This Court, while not in identical language, has regularly followed that general proposition in its trust jurisprudence.

In McClintock v. Scahill, 403 Mass. 397, 399 (1988) the Court found that a trustee was permitted to disclaim (refuse to accept) property transferred to the trust even though neither statutory law nor the trust instrument contained any specific language authorizing a trustee to do so acting alone. In so finding, the Court observed that "a trustee not only has the express powers contained in the trust instrument but also 'implied' powers necessary to carry out the purpose of the trust." McClintock, 403 Mass. at 399 (citing J.F. Lombard, Probate Law and Practice § 1471(2),(3) (1962 & 1988 Supp.).

In First Agric. Bank v. Coxe, 406 Mass. 879 (1990), the Court held that trustees had the implied power to divide a single trust into multiple trusts where the circumstances warrant. In that case the power was used to avoid future generation-skipping tax, which had been enacted shortly before the widow's death.[5]

It is axiomatic that the language of a trust can only rightly be interpreted so as to carry out the intentions of the grantor, whether specifically expressed in the trust or logically implied from its language and purpose. Where the precise intention of the grantor cannot be ascertained from the trust language alone, this Court has consistently found that trust language must be interpreted in such a way as not to cause adverse consequences that no reasonable grantor could have intended.[6] See, e.g., Mazzola v. Myers, 363 Mass. 625, 638 (1973) ("[W]here possible,

---

[5] The principle of this case has been codified in the Massachusetts Uniform Trust code at G. L. c. 203E, § 417.

[6] From the Complaint and Petitioner's Brief, the instant case evidently involves both tax and non-tax issues, and the Court's jurisprudence suggests that principles of interpretation should be applied the same way to both sets of issues. See Boston Safe Deposit & Trust Co. v. Park, 307 Mass. 255, (1940); McCurdy v. McCallum, 186 Mass. 464, 469 (1904); Fitts v. Powell, 307 Mass. 449 (1940) (applying rules of interpretation in matters not involving taxes).

the powers and duties of fiduciaries should be interpreted to conform in appropriate respects to the requirements of the Federal tax law, when a testator expresses the intention that his estate qualify for some benefit under the Federal tax law.")(citing Old Colony Trust Co. v. Board of Governors of Belleville Gen. Hosp., 355 Mass. 776, 780 (1969) and Worcester County Natl. Bank v. King, 359 Mass. 231 (1971)).

It is apparent that implied powers are necessary in the course of a trust's existence, including the kind of implied power raised in the instant case, because of the unpredictability that circumstances necessitating an implied power may arise. A predictable circumstance can, of course, be anticipated by the grantor and can be planned for, within reason, in drafting the trust. But neither anticipation nor drafting solutions can cover unpredictable circumstances. Implied powers provide trustees with the ability to address unpredicted circumstances and respond in a way that facilitates carrying out the intentions of the grantor and acting in the best interests of the beneficiaries.

3. The Case Law of Other Jurisdictions Supports the Existence of a Trustee's Power to Distribute in Further Trust.

The highest courts in two states have held that an implied power to distribute in further trust lies within a trustee's power to make discretionary distributions. Additionally, the highest court of a third state has suggested that there is such an implied power when considering a case addressing testamentary powers of appointment.

In Wiedenmayer v. Villanueva, 55 N.J. 81 (1969), the New Jersey Supreme Court affirmed the finding of the New Jersey Superior Court Appellate Division that a trustee implicitly had the power to make trust distributions in further trust. Where trustees had absolute discretion to distribute trust property to a beneficiary in the beneficiary's best interest, the New Jersey Superior Court Appellate Division had held, the trustees could condition such a distribution upon the beneficiary establishing a trust to hold the property. Wiedenmayer v. Johnson, 106 N.J. Super 161 (1969), aff'd sub nom., Wiedenmayer v. Villunueva, 55 N.J. 81 (1969).

The court reasoned that if the trustees could distribute the trust property outright to the beneficiary, and had broad discretion to do so, then the trustees could condition the distribution on it being placed in further trust because it was in the beneficiary's best interests.

> "The absolute and uncontrolled discretion" of the trustees to distribute and pay over to the son "any or all of the Trust Property" is limited only by the Trustee's determination that such distribution of the corpus is for the son's "best interests"....If they could make that distribution to the end, as the trust indenture expressly stated, that the trust property would be the son's "absolutely, outright and forever", it seems logical to conclude that the trustees could, to safeguard the son's best interests, condition the distribution upon his setting up a substituted trust.

Id. at 164-165.

The court rested its ruling in part on the principle that "courts may not substitute their opinions as to the [beneficiary's] 'best interests', as opposed to the opinion of the trustees vested by the creator of the trust with the 'absolute and uncontrolled discretion' to make that determination." Id. at 165. The Court also noted that the trustee's decision that the property should be held in further trust did not defeat the purpose of the trust, which was to make distributions in the son's best interests. Id. at 166.

Wiedenmayer's ruling looks directly at the fundamental implicit administration powers of a trustee. Other courts have analogized the trustee's power to make discretionary distributions to a beneficiary's power of appointment. In Phipps v. Palm Beach Trust Co., 142 Fla. 782 (1940), the trust provided that the trust property could be distributed at any time to the issue of the grantor in shares determined by the Individual Trustee. Exercising this authority, the Individual Trustee directed the Institutional Trustee to distribute the trust property to the same Trustees, but as trustees of a new trust which was established for the same beneficiaries but under slightly different trust terms.

The Phipps Court framed the question broadly: "May an individual and a corporate trustee clothed with absolute power to administer a trust estate in the interest of designated beneficiaries create a second trust estate, for the benefit of said beneficiaries at such time and in the manner determined by the individual trustee?" Id. at 785. The Court concluded that "the general rule gleaned from...cases of similar import is that the power vested in a trustee to create an estate in fee included the power to create or appoint any estate less than a general fee unless the donor clearly indicates a contrary intent." Id. at 786. The court equated the Trustee's distribution power to that of a special power of appointment, stating, "The powers vested in a trustee under a deed of trust may be general...or special....We are confronted here with powers of the latter class...." Id. at 785. As discussed above, this is also consistent with the Third Restatement of Property § 17.1, comment g.

The court also relied on the fact that the grantor had great trust and confidence in his chosen trustee: "An examination of the original trust indenture...discloses that the donor reposed unlimited confidence and discretion in the individual trustee and clothed him with absolute power to administer and dispose of the trust estate to anyone of the named beneficiaries to the exclusion of the others." Phipps, 142 Fla. at 786. This trust and confidence in the trustees, coupled with the "unlimited discretion as to the time, amount, manner and condition any sums should be paid to the beneficiaries," led the court to conclude that the trustees had the power to create the second trust. Id. The deference shown in Phipps) to decisions of trustees in whom the grantor has placed trust and confidence has been a consistent hallmark of this Court's decisions for over a century and a half. See, e.g., Hawes Place Congregational Society v. Trustees of Hawes Fund, 59 Mass. 454 (1850).

Finally, the Supreme Court of Iowa concluded that a special power of appointment, granted in a testamentary trust, to create a life estate in real property to one or more appointees could be exercised in further trust. Estate of Spencer, 232 N.W.2d 491 (Iowa 1975). The Court stated that "the basic rules governing our consideration of this will are: (1) the testator's intent is the polestar and must prevail; (2) the intent must be gathered from a consideration of all the language of the will, the scheme of distribution and the facts and circumstances surrounding the making of the will; and (3) technical rules of construction should be resorted to only if the language of the will is clearly ambiguous or conflicting or testator's intent is for any reason uncertain" Id. at 495. The court cited Phipps as support.

While a number of states permit a trustee to make distributions in further trust, either by statute or common law, Amicus Curiae has found no out of state authority contrary to the proposition that a trustee has an implied power to make a distribution in further trust if the trustee has discretion to make trust distributions to a beneficiary.

B. THE POWER OF A TRUSTEE TO DISTRIBUTE PROPERTY IN FURTHER TRUST IS LIMITED BY FIDUCIARY STANDARDS.

In acknowledging a trustee's inherent power to make a discretionary distribution in further trust this Court can take comfort in the fact that the exercise of such a power is subject to fiduciary standards. But Amicus Curiae respectfully requests that this Court articulate the broad outlines of such fiduciary limitations in any decision acknowledging this inherent power for the sake of clarity, since such a power without fiduciary limits could create potential tax issues for trustees and trusts.

In McClintock, the Court found that a trustee was permitted to disclaim property transferred to the trust even though neither statutory law nor the trust instrument contained any specific language authorizing a trustee to do so alone.[7] McClintock v. Scahill, 403 Mass. 397 (1988). In so finding, the court reasoned that its decision "will not affect adversely the beneficiaries of trusts since the trustee's fiduciary status requires any decision to disclaim be made in good faith with the best interests of the trust's beneficiaries in mind." Id. at 400 (citing Young v. Tudor, 323 Mass. 508, 515 (1948) ("Throughout all his transactions in connection with his trust the fiduciary is held to the rule of good faith and due diligence.")); Boston Safe Deposit & Trust Co. v. Lewis, 317 Mass. 137, 140 (1944) ("A trustee must exercise good faith and act solely in the interests of the beneficiaries in administering the trust."). So here, a finding that a trustee's discretionary authority to distribute trust property is equivalent to a power of appointment under Massachusetts common law would not adversely affect beneficiaries of trusts because "[a] trustee must exercise good faith and act solely in the interests of the beneficiaries in administering the trust." Lewis, 317 Mass. at 140.

[7] In so finding, the Court observed that "a trustee not only has the express powers contained in the trust instrument but also 'implied' powers necessary to carry out the purpose of the trust." McClintock, 403 Mass. at 399 (citing J.F. Lombard, Probate Law and Practice § 1471, at 2-3 (1962 & 1988 Supp.)).

This court has recognized that "even very broad discretionary powers are to be exercised in accordance with fiduciary standards and with reasonable regard for usual fiduciary principles." Old Colony Trust Co. v. Silliman, 352 Mass 6, 10 (1967) (citing Boston Safe Deposit & Trust Co. v. Stone, 348 Mass. 345, 351 (1965)). It has also described the nature of those fiduciary limitations:

> Indeed, even with respect to very broad discretionary powers, "a court of equity may control a trustee in the exercise of a fiduciary discretion if it acts beyond the bounds of a reasonable judgment or unreasonably disregards usual fiduciary principles, or the purposes of the trust, or if it fails to observe standards of judgment apparent from the applicable instrument." Such fiduciary powers cannot be used arbitrarily, capriciously, or in bad faith, but must be "exercised after serious and responsible consideration, prudently, and in accordance with fiduciary standards."

Stone, 348 Mass. at 351 (citing Copp v. Worcester County Natl. Bank, 347 Mass. 548, 551 (1964)); see also Price v. Price, 341 Mass. 390, 392-393 (1960); Restatement (Second) of Trusts, § 187 (1959); Scott, Trusts § 187 (2d ed.).

These fiduciary limitations are important; without them, trustees could distribute in further trust in dramatic ways that could be inconsistent with the intent of the grantor. For example, a trust designed to qualify for the estate tax marital deduction must be administered for the sole benefit of the surviving spouse and must pay the surviving spouse net income on a regular basis. If such a trust permitted discretionary distributions of principal to the surviving spouse and the trustee could make such a distribution in further trust without limitation under Massachusetts law, there would be a question whether the trust could qualify for the marital deduction. However, the inherent limits on fiduciary powers would prohibit a trustee from exercising its distribution power in such a way that could disqualify the trust for the marital deduction.

Similarly, an implied power to make a further distribution in trust does not run afoul of the prohibition against a trustee delegating his or her authority. 1 T.H. Balknap, Newhall's Settlement of Estates and Fiduciary Law in Massachusetts § 9:11 (5th ed. 1994)(discussing trustee delegation rules). A distribution to a new trust with a different trustee should not be considered a delegation. The exercise of a distribution power in further trust for the beneficiary replaces an outright distribution to that same beneficiary. Once an outright distribution of property has been made, the trustee's control of that property has ended, by the authorization of the grantor, and the distributing trustee has no further duty remaining respecting that property. In the case of a distribution in further trust, the trustee's fiduciary duties would apply in connection with the prudent selection of the new trustee and terms of the new trust. Having exercised that duty, the distribution of the trust property to the new trust, like the distribution outright, terminates the distributing trustee's control over and duties respecting the distributed property. Thus, the exercise of a distribution power in further trust, whether to the same or different trustees, should not be considered a violation of the common law rules related to delegation of duties.

C. RECOGNITION OF AN INHERENT FIDUCIARY POWER TO DISTRIBUTE TRUST PROPERTY IN FURTHER TRUST IS CONSISTENT WITH SOUND PUBLIC POLICY.

Trustees are often faced with unanticipated circumstances that frustrate their ability to carry out the intent of the trust's grantor or act in the best interests of the trust's beneficiaries. An implied power in the trust to make distributions in further trust can be used to address these unforeseen circumstances, consistent with sound public policy.

A power to distribute trust property in further trust could be used to improve trust administration and permit more convenient and cost effective trustee management. The trustee, for example, could distribute assets to a new trust that contains terms that are more modern or are tailored to address the particular circumstances that may have caused the trust administration to become unworkable or inconsistent with the grantor's intentions and/or the beneficiaries' best interests. Examples might include expressly allowing for certain actions by the trustee in the new trust instrument such as combining and dividing trusts, employing certain investment programs, changing the situs or place of administration of the trust, addressing changes in governing law, and allocating specific functions or decisions to a co-trustee or involving third party experts.

A power to distribute trust property in further trust could be used to permit the trustees to be more responsive to the needs and best interests of the beneficiaries. Examples might include addressing changes in relations, potential creditor claims, disabilities, and divergent interests of the beneficiaries.

A power to distribute trust property in further trust could also be used to correct errors in trusts. This court has acknowledged that mistakes in trusts may be corrected through reformation proceedings as the same seeks to carry out the settlor's intent. See Simches v. Simches, 423 Mass. 683, 688 (1996). A power to distribute trust property in further trust could, at least in some circumstances, present an effective method for trustees to correct drafting errors that are inconsistent with the grantor's intent, where court proceedings are time prohibitive or costly or adverse consequences of the modification proceeding might arise.

A power to distribute trust property in further trust could also be used to facilitate managing changing tax laws. For example, the 1986 federal generation skipping transfer ("GST") tax, which potentially imposes a significant tax burden to trust distributions to a grandchild or more remote descendant of the grantor, was made retroactive to all trusts created on or after September 25, 1985. As is the case with most retroactive federal tax laws, the GST tax was made inapplicable to then-existing irrevocable trusts (and certain others not relevant here), known as "grandfathered" trusts. Grandfathered trust protection is lost if the grandfathered trust is modified in certain ways. However, current Internal Revenue Service regulations provide that the modification of a grandfathered trust will not result in loss of grandfathered status if the modification is effectuated through the exercise of a trustee's power to distribute the trust property from the grandfathered trust to a new trust, provided that power is contained in the terms of the grandfathered trust or exists pursuant to state law in effect at the time that the grandfathered trust was established. Treas. Reg. § 26.2601-1(b)(4)(i)(A).

While modification of a grandfathered trust could be sought through court reformation, either under the Court's general equity jurisdiction or through newly enacted statutory procedures incorporated in the Massachusetts Uniform Trust Code, G. L. c. 203E ("MUTC"), those procedures involve not only the potential of loss of grandfathered trust status, but also may result in deemed gifts for federal gift tax purposes due to the legally required participation of the trust beneficiaries in the modification process under these alternative procedures. MUTC § 411. Such gift could be deemed by the IRS to have occurred, for example, by a beneficiary not objecting to the postponement of the time for termination, even if such postponement was generally in the beneficiary's best interests. Adverse tax consequences could also be deemed to affect the grandfathered trust's settlor if such settlor were to participate in reformation proceedings as authorized under MUTC § 411, in that the participation in the reformation of a trust might be deemed to be a retained power to amend the otherwise irrevocable trust, thus risking estate tax inclusion under Internal Revenue Code §§ 2036 and 2038. This attack would not be available if the trustee has, as the Petitioner asserts, the inherent power as trustee to make distributions in further trust.[8]

[8] For a further discussion of these potential tax issues, see Zeydel & Blattmachr, Tax Effects of Decanting – Obtaining and Preserving the Benefits, 111 J. Tax'n 288 (2009)

D. THE COURT'S RULING SHOULD NOT BE LIMITED TO PROSPECTIVE APPLICATION.

If the Court recognizes that a trustee's discretionary authority to distribute trust property to trust beneficiaries includes the authority to distribute trust property in further trust, it should further announce that such power existed as a matter of common law prior to the date of its decision. Although in some cases, newly-announced rules relating to trusts and estates are made prospective only, no reliance or other equitable reasons require limiting the ruling in this case because neither the Court or the legislature has previously spoken on the issue. Compare Karri-Davies, supra, with Sullivan v. Burkin, 390 Mass. 864 (1984) (in both cases the Court applied a new rule in the area of trust law prospectively because of the bar's reliance on prior decision). Absent some reliance interest on the application of prior settled law, limiting the Court's ruling to prospective application would be a departure from established Court doctrine.

Additionally, Amicus Curiae believes that the bar and the fiduciaries it represents would be best served by as definitive a ruling as to the power of trustees to distribute in further trust as is possible under the posture of this case. Specifically, if the Court were to issue a ruling limited solely to the facts of the Kraft case,[9] or limited only to a specific factual scenario, significant doubt as to the trustees' power in this regard could remain, leading to undesirable uncertainty and potential litigation. On the other hand, a ruling that absent contrary language in a trust instrument, a trustee who has the power to distribute trust property to a beneficiary also has an implied power to distribute trust property in further trust, subject to the trustee's fiduciary obligations to the beneficiaries, will be easily understood and followed by both fiduciaries and the members of the bar who advise them.

VIII. CONLUSION

The existence of an implied power of a trustee to exercise its authority to distribute trust property to a beneficiary by making such distribution in further

[9] For example, in the Kraft case, the trust instrument at issue provides, "Whenever provision is made hereunder for payment of principal or income to a beneficiary, the same may instead be applied for his or her benefit." Jt. Exh. 1 at p. 19. Amicus Curiae believes that the power of a trustee to make distributions in further trust exists regardless of whether a trust instrument contains such language, and a decision relying on such language would not be as helpful to the bar as a broader ruling.

trust for the benefit of the beneficiary is consistent with the trust jurisprudence of this Court, the statutory authority which supplements this case law, and case the law of other jurisdictions.

Explicit recognition of the power of a trustee to distribute trust property in further trust will provide assurance to fiduciaries, especially those who administer long term trusts, that they may use this power to fulfill the intention of the grantor and address changing circumstances that were never anticipated at the time the trust was established, including changes in tax law. Further, recognition of the power of a trustee to distribute trust property in further trust is supported by public policy.

Coupling such explicit recognition with guidance as to the broad outlines of fiduciary limitations applicable to the exercise of such power would confirm that the finding of such a power would not adversely affect beneficiaries of trusts and would guide trustees in understanding the limits of such a power.

Respectfully submitted,

Andrew D. Rothstein (BBO# 639653)
GOULSTON & STORRS, P.C.
400 Atlantic Avenue
Boston, Massachusetts 02110-3333
Tel: (617) 482-1776
arothstein@goulstonstorrs.com

Dated: March 22, 2013

CERTIFICATION PURSUANT TO MASS. R. A. P. 16(k)

I, Andrew D. Rothstein, hereby certify that this brief complies with the rules of this Honorable Court that pertain to the filing of briefs, including but not limited to Mass. R. A. P. 16(a)(6), 16(e), 16(f), 16(h), 18, and 20.

Andrew D. Rothstein

CERTIFICATE OF SERVICE

I, Andrew D. Rothstein, hereby certify that on March 22, 2013 I served the Brief of The Boston Bar Association, Amicus Curiae, by mailing copies thereof via first-class mail, postage prepaid, as follows:

Daniel L. Goldberg, Esq.
Bingham McCutchen LLP
One Federal Street
Boston, MA 02110-1726

Jonathan Bernstein, Esq.
Morgan, Lewis & Bockius LLP
225 Franklin Street
Boston, MA 02110

Mr. Douglas H. Shulman
Commissioner of Internal Revenue
Office of the Commissioner
Room 3000
111 Constitution Avenue, N.W.
Washington, DC 20224-0002

Andrew D. Rothstein

ANDREW D. ROTHSTEIN (BBO# 639653)
GOULSTON & STORRS, P.C.
400 ATLANTIC AVENUE
BOSTON, MA 02110-3333
TEL: (617) 482-1776
AROTHSTEIN@GOULSTONSTORRS.COM

Dated: March 22, 2013

ADDENDUM

LexisNexis®

ANNOTATED LAWS OF MASSACHUSETTS
Copyright © 2013 Matthew Bender & Company, Inc.,
a member of the LexisNexis Group
All rights reserved

*** Current through Acts 464 of the 2012 Legislative Session ***

PART II REAL AND PERSONAL PROPERTY AND DOMESTIC RELATIONS
TITLE II DESCENT AND DISTRIBUTION, WILLS, ESTATES OF DECEASED PERSONS AND ABSENTEES, GUARDIANSHIP, CONSERVATORSHIP AND TRUSTS
Chapter 203E Massachusetts Uniform Trust Code
Article 4 CREATION, VALIDITY, MODIFICATION AND TERMINATION OF TRUST

ALM GL ch. 203E, § 411 (2012)

§ 411. Modification or Termination of Non-Charitable Irrevocable Trust by Consent.

Modification or Termination of Non-Charitable Irrevocable Trust by Consent

(a) If, upon petition, the court finds that the settlor and all beneficiaries consent to the modification or termination of a non-charitable irrevocable trust, the court may approve the modification or termination even if the modification or termination is inconsistent with a material purpose of the trust.

(b) A non-charitable irrevocable trust may be terminated upon consent of all of the beneficiaries if the court concludes that continuance of the trust is not necessary to achieve any material purpose of the trust. A non-charitable irrevocable trust may be modified upon consent of all of the beneficiaries if the court concludes that modification is not inconsistent with a material purpose of the trust.

(c) If not all of the beneficiaries consent to a proposed modification or termination of the trust under subsection (a) or (b), the modification or termination may be approved by the court if the court is satisfied that:

(1) if all of the beneficiaries had consented, the trust could have been modified or terminated under this section; and

(2) the interests of a beneficiary who does not consent will be adequately protected.

HISTORY: 2012, 140, § 56.

NOTES: Editorial Note

Acts 2012, 140, § 56, effective July 8, 2012, enacted this section. Section 66 provides:

Section 66. (a) Except as otherwise provided in this act:

(1) this act shall apply to all trusts created before, on or after the effective date of this act;

(2) this act shall apply to all judicial proceedings concerning trusts commenced on or after the effective date;

(3) an action taken before the effective date of this act shall not be affected by this act.

(b) If a right is acquired, extinguished or barred upon the expiration of a prescribed period that has commenced to run under any other statute before the effective date of this act, that statute shall continue to apply to the right even if it has been superseded.

LexisNexis®

ANNOTATED LAWS OF MASSACHUSETTS
Copyright © 2013 Matthew Bender & Company, Inc.,
a member of the LexisNexis Group
All rights reserved

*** Current through Acts 464 of the 2012 Legislative Session ***

PART II REAL AND PERSONAL PROPERTY AND DOMESTIC RELATIONS
TITLE II DESCENT AND DISTRIBUTION, WILLS, ESTATES OF DECEASED PERSONS AND ABSENTEES, GUARDIANSHIP, CONSERVATORSHIP AND TRUSTS
Chapter 203E Massachusetts Uniform Trust Code
Article 4 CREATION, VALIDITY, MODIFICATION AND TERMINATION OF TRUST

GO TO MASSACHUSETTS CODE ARCHIVE DIRECTORY

ALM GL ch. 203E, § 417 (2012)

§ 417. Combination and Division of Trusts.

Combination and Division of Trusts

After notice to the qualified beneficiaries, a trustee may combine 2 or more trusts into a single trust or divide a trust into 2 or more separate trusts, if the result does not impair the rights of any beneficiary or adversely affect achievement of the purposes of the trusts.

HISTORY: 2012, 140, § 56.

NOTES: Editorial Note

Acts 2012, 140, § 56, effective July 8, 2012, enacted this section. Section 66 provides:

Section 66. (a) Except as otherwise provided in this act:

(1) this act shall apply to all trusts created before, on or after the effective date of this act;

(2) this act shall apply to all judicial proceedings concerning trusts commenced on or after the effective date;

(3) an action taken before the effective date of this act shall not be affected by this act.

(b) If a right is acquired, extinguished or barred upon the expiration of a prescribed period that has commenced to run under any other statute before the effective date of this act, that statute shall continue to apply to the right even if it has been superseded.

UNITED STATES CODE SERVICE
Copyright © 2013 Matthew Bender & Company, Inc.
a member of the LexisNexis Group (TM)
All rights reserved.

*** Current through PL 113-5, approved 3/13/13 ***

TITLE 26. INTERNAL REVENUE CODE
SUBTITLE B. ESTATE AND GIFT TAXES
CHAPTER 11. ESTATE TAX
SUBCHAPTER A. ESTATES OF CITIZENS OR RESIDENTS
PART III. GROSS ESTATE

26 USCS § 2036

§ 2036. Transfers with retained life estate.

(a) General rule. The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death--

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

(b) Voting rights.

(1) In general. For purposes of subsection (a)(1), the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of transferred property.

(2) Controlled corporation. For purposes of paragraph (1), a corporation shall be treated as a controlled corporation if, at any time after the transfer of the property and during the 3-year period ending on the date of the decedent's death, the decedent owned (with the application of section 318 [26 USCS § 318]), or had the right (either alone or in conjunction with any person) to vote, stock possessing at least 20 percent of the total combined voting power of all classes of stock.

(3) Coordination with section 2035. For purposes of applying section 2035 [26 USCS § 2035] with respect to paragraph (1), the relinquishment or cessation of voting rights shall be treated as a transfer of property made by the decedent.

(c) Limitation on application of general rule. This section shall not apply to a transfer made before March 4, 1931; nor to a transfer made after March 3, 1931, and before June 7, 1932, unless the property transferred would have been includible in the decedent's gross estate by reason of the amendatory language of the joint resolution of March 3, 1931 (46 Stat. 1516).

HISTORY:

(Aug. 16, 1954, ch 736, 68A Stat. 382; Oct. 16, 1962, P.L. 87-834, § 18(a)(2)(D), 76 Stat. 1052; Oct. 4, 1976, P.L. 94-455, Title XX, § 2009(a), 90 Stat. 1893; Nov. 6, 1978, P.L. 95-600, Title VII, § 702(i)(1), (2), 92 Stat. 2931; Dec. 22, 1987, P.L. 100-203, Title X, § 10402(a), 101 Stat. 1330-431; Nov. 10, 1988, P.L. 100-647, Title III, § 3031(a)(1), (b)-(e), (g), 102 Stat. 3634-3638; Nov. 5, 1990, P.L. 101-508, Title XI, § 11601(a), 104 Stat. 1388-490.)

HISTORY; ANCILLARY LAWS AND DIRECTIVES

Amendments:

In 1990, P.L. 101-508, Sec. 11601(a), deleted subsec. (c), and redesignated subsec. (d) as subsec. (c), effective for property transferred after 12/17/87.

Prior to deletion, subsec. (c) read as follows:

"(c) Inclusion related to valuation freezes.

"(1) In general. For purposes of subsection (a), if--

"(A) any person holds a substantial interest in an enterprise, and

"(B) such person in effect transfers after December 17, 1987, property having a disproportionately large share of the potential appreciation in such person's interest in the enterprise while retaining an interest in the income of, or rights in, the enterprise,

then the retention of the retained interest shall be considered to be a retention of the enjoyment of the transferred property.

"(2) Special rules for consideration furnished by family members.

"(A) In general. The exception contained in subsection (a) for a bona fide sale shall not apply to a transfer described in paragraph (1) if such transfer is to a member of the transferor's family.

"(B) Treatment of consideration.

"(i) In general. In the case of a transfer described in paragraph (1), if--

"(I) a member of the transferor's family provides consideration in money or money's worth for such member's interest in the enterprise, and

"(II) it is established to the satisfaction of the Secretary that such consideration originally belonged to such member and was never received or acquired (directly or indirectly) by such member from the transferor for less than full and adequate consideration in money or money's worth,

paragraph (1) shall not apply to the applicable fraction of the portion of the enterprise which would (but for this subparagraph) have been included in the gross estate of the transferor by reason of this subsection (determined without regard to any reduction under paragraph (5) for the value of the retained interest).

"(ii) Applicable fraction. For purposes of clause (i), the applicable fraction is a fraction--

"(I) the numerator of which is the amount of the consideration referred to in clause (i), and

"(II) the denominator of which is the value of the portion referred to in clause (i) immediately after the transfer described in paragraph (1).

"(iii) Section 2043 not to apply. The provisions of this subparagraph shall be in lieu of any adjustment under section 2043.

"(3) Definitions. For purposes of this subsection--

"(A) Substantial interest. A person holds a substantial interest in an enterprise if such person owns (directly or indirectly) 10 percent or more of the voting power or income stream, or both, in such enterprise. For purposes of the preceding sentence, an individual shall be treated as owning any interest in an enterprise which is owned (directly or indirectly) by any member of such individual's family.

"(B) Family. The term "family" means, with respect to any individual, such individual's spouse, any lineal descendant of such individual or of such individual's spouse, any parent or grandparent of such individual, and any spouse of any of the foregoing. For purposes of the preceding sentence, a relationship by legal adoption shall be treated as a relationship by blood.

"(C) Treatment of spouse. Except as provided in regulations, an individual and such individual's spouse shall be treated as 1 person.

"(4) Treatment of certain transfers.

"(A) In general. For purposes of this subtitle, if, before the death of the original transferor--

"(i) the original transferor transfers all (or any portion of) the retained interest referred to in paragraph (1), or

"(ii) the original transferee transfers all (or any portion of) the transferred property referred to in paragraph (1) to a person who is not a member of the original transferor's family, the original transferor shall be treated as having made a transfer by gift of property to the original transferee equal to the paragraph (1) inclusion (or proportionate amount thereof). Proper adjustments shall be made in the amount treated as a gift by reason of the preceding sentence to take into account prior transfers to which this subparagraph applied and take into account any right of recovery (whether or not exercised) under section 2207B.

"(B) Coordination with paragraph (1). In any case to which subparagraph (A) applies, nothing in paragraph (1) or section 2035(d)(2) shall require the inclusion of the transferred property (or proportionate amount thereof).

"(C) Special rule where property retransferred. In the case of a transfer described in subparagraph (A)(ii) from the original transferee to the original transferor, the paragraph (1) inclusion (or proportion thereof) shall be reduced by the excess (if any) of--

"(i) the fair market value of the property so transferred, over

"(ii) the amount of the consideration paid by the original transferor in exchange for such property.

"(D) Definitions. For purposes of this paragraph--

"(i) Original transferor. The term "original transferor" means the person making the transfer referred to in paragraph (1).

"(ii) Original transferee. The term "original transferee" means the person to whom the transfer referred to in paragraph (1) is made. Such term includes any member of the original transferor's family to whom the property is subsequently transferred.

"(iii) Paragraph (1) inclusion. The term "paragraph (1) inclusion" means the amount which would have been included in the gross estate of the original transferor under subsection (a) by reason of paragraph (1) (determined without regard to sections 2032 and 2032A) if the original transferor died immediately before the transfer referred to in subparagraph (A). The amount determined under the preceding sentence shall be reduced by the amount (if any) of the taxable gift resulting from the transfer referred to in paragraph (1)(B).

"(iv) Transfers to include terminations, etc. Terminations, lapses, and other changes in any interest in property of the original transferor or original transferee shall be treated as transfers.

"(E) Continuing interest in transferred property may not be retained. A transfer (to which subparagraph (A) would otherwise apply) shall not be taken into account under subparagraph (A) if the original transferor or the original transferee (as the case may be) retains a direct or indirect continuing interest in the property transferred in such transfer.

"(5) Adjustments. Appropriate adjustments shall be made in the amount included in the gross estate by reason of this subsection for the value of the retained interest, extraordinary distributions, and changes in the capital structure of the enterprise after the transfer described in paragraph (1).

"(6) Treatment of certain grantor retained interest trusts.

"(A) In general. For purposes of this subsection, any retention of a qualified trust income interest shall be disregarded and the property with respect to which such interest exists shall be treated as held by the transferor while such income interest continues.

"(B) Qualified trust income interest. For purposes of subparagraph (A) the term "qualified trust income interest" means any right to receive amounts determined solely by reference to the income from property held in trust if--

"(i) such right is for a period not exceeding 10 years,

"(ii) the person holding such right transferred the property to the trust, and

"(iii) such person is not a trustee of such trust.

"(7) Exceptions.

"(A) In general. Paragraph (1) shall not apply to a transaction solely by reason of 1 or more of the following:

"(i) The receipt (or retention) of qualified debt.

"(ii) Except as provided in regulations, the existence of an agreement for the sale or lease of goods or other property to be used in the enterprise or the providing of services and--

"(I) the agreement is an arm's length agreement for fair market value, and

"(II) the agreement does not otherwise involve any change in interests in the enterprise.

"(iii) An option or other agreement to buy or sell property at the fair market value of such property as of the time the option is (or the rights under the agreement are) exercised.

"(B) Limitations.

"(i) Services performed after transfer. In the case of compensation for services performed after the transfer referred to in paragraph (1)(B), clause (ii) of subparagraph (A) shall not apply if such services were performed under an agreement providing for the performance of services over a period greater than 3 years after the date of the transfer. For purposes of the preceding sentence, the term of any agreement includes any period for which the agreement may be extended at the option of the service provider.

"(ii) Amounts must not be contingent on profits, etc. Clause (ii) of subparagraph (A) shall not apply to any amount determined (in whole or in part) by reference to gross receipts, income, profits, or similar items of the enterprise.

"(C) Qualified debt. For purposes of this paragraph, except as provided in subparagraph (D), the term "qualified debt" means any indebtedness if--

"(i) such indebtedness--

"(I) unconditionally requires the payment of a sum certain in money in 1 or more fixed payments on specified dates, and

"(II) has a fixed maturity date not more than 15 years from the date of issue (or, in the case of indebtedness secured by real property, not more than 30 years from the date of issue).

"(ii) the only other amount payable under such indebtedness is interest determined at--

"(I) a fixed rate, or

"(II) a rate which bears a fixed relationship to a specified market interest rate,

"(iii) the interest payment dates are fixed,

"(iv) such indebtedness is not by its terms subordinated to the claims of general creditors,

"(v) except in a case where such indebtedness is in default as to interest or principal, such indebtedness does not grant voting rights to the person to whom the debt is owed or place any limitation on the exercise of voting rights by others, and

"(vi) such indebtedness--

"(I) is not (directly or indirectly) convertible into an interest in the enterprise which would not be qualified debt, and

"(II) does not otherwise grant any right to acquire such an interest.

The requirement of clause (i)(I) that the principal be payable on 1 or more specified dates and the requirement of clause (i)(II) shall not apply to indebtedness payable on demand if such indebtedness is issued in return for cash to be used to meet normal business needs of the enterprise.

"(D) Special rule for startup debt.

"(i) In general. For purposes of this paragraph, the term "qualified debt" includes any qualified startup debt.

"(ii) Qualified startup debt. For purposes of clause (i), the term "qualified startup debt" means any indebtedness if--

"(I) such indebtedness unconditionally requires the payment of a sum certain in money,

"(II) such indebtedness was received in exchange for cash to be used in any enterprise involving the active conduct of a trade or business,

"(III) the person to whom the indebtedness is owed has not at any time (whether before, on, or after the exchange referred to in subclause (II)) transferred any property (including goodwill) which was not cash to the enterprise or transferred customers or other business opportunities to the enterprise,

"(IV) the person to whom the indebtedness is owed has not at any time (whether before, on, or after the exchange referred to in subclause (II)) held any interest in the enterprise (including an interest as an officer, director, or employee) which was not qualified startup debt,

"(V) any person who (but for subparagraph (A)(i)) would have been an original transferee (as defined in paragraph (4)(C)) participates in the active management (as defined in section 2032A(e)(12)) of the enterprise, and

"(VI) such indebtedness meets the requirements of clauses (v) and (vi) of subparagraph (C).

"(8) Regulations. The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection, including such regulations as may be necessary or appropriate to prevent avoidance of the purposes of this subsection through distributions or otherwise."

In 1988, P.L. 100-647, Sec. 3031(a)(1), effective and applicable as provided by Sec. 3031(h) of such Act, which appears as a note to this section.

Prior to amendment, para. (c)(4) read as follows:

"(4) Coordination with section 2035. For purposes of applying section 2035, any transfer of the retained interest referred to in paragraph (1) shall be treated as a transfer of an interest in the transferred property referred to in paragraph (1)."

--P.L. 100-647, Sec. 3031(b), added para. (c)(6) . . . Sec. 3031, (b [sic c]), added paras. (c)(7) and (8) . . . Sec. 3031(d), substituted "Except as provided in regulations, an individual" for "An individual" in subpara. (c)(3)(C), effective and applicable as provided by Sec. 3031(h) of such Act, which appears as a note to this section.

--P.L. 100-647, Sec. 3031(e), substituted "while retaining an interest in the income of, or rights in, the enterprise," for "while retaining a disproportionately large share in the income of, rights in, the enterprise," in subpara. (c)(1)(B), effective and applicable as provided by Sec. 3031(h) of such Act, which appears as a note to this section.

--P.L. 100-647, Sec. 3031(g)(1), amended para. (c)(2) . . . Sec. 3031(g)(2), amended para. (c)(5), effective and applicable as provided by Sec. 3031(h) of such Act, which appears as a note to this section.

Prior to amendment, para. (c)(2) read as follows:

"(2) Special rule for sales to family members. The exception contained in subsection (a) for a bona fide sale shall not apply to a transfer described in paragraph (1) if such transfer is to a member of the transferor's family."

Prior to amendment, para (c)(5) read as follows:

"(5) Coordination with section 2043. In lieu of applying section 2043, appropriate adjustments shall be made for the value of the retained interest."

In 1987, P.L. 100-203, Sec. 10402(a), redesignated subsec. (c) as subsec. (d) and added new subsec. (c), effective for estates of decedents dying after 12/31/87, but only in the case of property transferred after 12/17/87.

In 1978, P.L. 95-600, Sec. 702(i)(1), redesignated subsec. (b) as subsec. (c) and added new subsec. (b) . . . Sec. 702(i)(2), deleted the last sentence in subsec. (a), effective for transfers made after 6/22/76.

Prior to deletion, the last sentence in subsec. (a) read as follows:

"For purposes of paragraph (1), the retention of voting rights in retained stock shall be considered to be a retention of the enjoyment of such stock."

In 1976, P.L. 94-455, Sec. 2009(a), added a sentence to the end of subsec. (a), effective for transfers made after 6/22/76.

In 1962, P.L. 87-834, Sec. 18(a)(2)(D), deleted "(except real property situated outside of the United States)" in subsec. (a), effective for estates of decedents dying after 10/16/62, except as provided in Sec. 18(b) at note following Code Sec. 2031.

Other provisions:

Application of Dec. 22, 1987 amendment. Act Dec. 22, 1987, P.L. 100-203, Title X, Subtitle D, Part I, § 10402(b), 101 Stat. 1330-432, provides: "The amendment made by subsection (a) [amending this section] shall apply with respect to estates of decedents dying after December 31, 1987, but only in the case of property transferred after December 17, 1987.".

Effective date and applicability of Nov. 10, 1988 amendments. Act Nov. 10, 1988, P.L. 100-647, Title III, § 3031(h), 102 Stat. 3639, provides:

"(1) In general. Except as provided in this subsection, any amendment made by this section [enacting 26 USCS § 2207B and amending 26 USCS §§ 2036 and 2501] shall take effect as if included in the provisions of the Revenue Act of 1987 [P.L. 100-203, Title X] to which such amendment relates.

"(2) Subsection (a). The amendments made by subsection (a) [amending 26 USCS §§ 2036 and 2501] shall apply in cases where the transfer referred to in section 2036(c)(1)(B) of the 1986 Code is on or after June 21, 1988.

"(3) Subsection (f). If an amount is included in the gross estate of a decedent under section 2036 of the 1986 Code other than solely by reason of section 2036(c) of the 1986 Code, the amendments made by subsection (f) [enacting 26 USCS § 2207B] shall apply to such amount only with respect to property transferred after the date of the enactment of this Act.

"(4) Correction period. If section 2036(c)(1) of the 1986 Code would (but for this paragraph) apply to any interest arising from a transaction entered into during the period beginning after December 17, 1987, and ending before January 1, 1990, such section shall not apply to such interest if--

"(A) during such period, such actions are taken as are necessary to have such section 2036(c)(1) not apply to such transaction (and any such interest), or

"(B) the original transferor and his spouse on January 1, 1990 (or, if earlier, the date of the original transferor's death), does not hold any interest in the enterprise involved.

"(5) Clarification of effective date. For purposes of section 10402(b) of the Revenue Act of 1987 [§ 10402(b) of P.L. 100-203 (note to this section)], with respect to property transferred on or before December 17, 1987--

"(A) any failure to exercise a right of conversion,

"(B) any failure to pay dividends, and

"(C) failures to exercise other rights specified in regulations,

shall not be treated as a subsequent transfer.".

LexisNexis®

UNITED STATES CODE SERVICE
Copyright © 2013 Matthew Bender & Company, Inc.
a member of the LexisNexis Group (TM)
All rights reserved.

*** Current through PL 113-5, approved 3/13/13 ***

TITLE 26. INTERNAL REVENUE CODE
SUBTITLE B. ESTATE AND GIFT TAXES
CHAPTER 11. ESTATE TAX
SUBCHAPTER A. ESTATES OF CITIZENS OR RESIDENTS
PART III. GROSS ESTATE

26 USCS § 2038

§ 2038. Revocable transfers.

(a) In general. The value of the gross estate shall include the value of all property--
(1) Transfers after June 22, 1936. To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.
(2) Transfers on or before June 22, 1936. To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke, or where the decedent relinquished any such power during the 3-year period ending on the date of the decedent's death. Except in the case of transfers made after June 22, 1936, no interest of the decedent of which he has made a transfer shall be included in the gross estate under paragraph (1) unless it is includible under this paragraph.

(b) Date of existence of power. For purposes of this section, the power to alter, amend, revoke, or terminate shall be considered to exist on the date of the decedent's death even though the exercise of the power is subject to a precedent giving of notice or even though the alteration, amendment, revocation, or termination takes effect only on the expiration of a stated period after the exercise of the power, whether or not on or before the date of the decedent's death notice has been given or the power has been exercised. In such cases proper adjustment shall be made representing the interests which would have been excluded from the power if the decedent had lived, and for such purpose, if the notice has not been given or the power has not been exercised on or before the date of his death, such notice shall be considered to have been given, or the power exercised, on the date of his death.

HISTORY:
(Aug. 16, 1954, ch 736, 68A Stat. 383; Aug. 7, 1959, P.L. 86-141, § 1, 73 Stat. 288; Oct. 16, 1962, P.L. 87-834, § 18(a)(2)(F), 76 Stat. 1052; Oct. 4, 1976, P.L. 94-455, Title XIX, § 1902 (a)(3), Title XX, § 2001(c)(1)(K), 90 Stat. 1804, 1852.)

HISTORY; ANCILLARY LAWS AND DIRECTIVES

Amendments:

In 1976, P.L. 94-455, Sec. 1902(a)(3), deleted subsec. (c), for estates of decedent dying after 10/4/76.
Prior to amendment, subsec. (c) read as follows:
"(c) Effect of disability in certain cases.
"For purposes of this section, in the case of a decedent who was (for a continuous period beginning not less than 3 months before December 31, 1947, and ending with his death) under a mental disability to relinquish a power, the term "power" shall not include a power the relinquishment of which on or after January 1, 1940, and on or before December 31, 1947, would, by reason of section 1000(e) of the Internal Revenue Code of 1939, be deemed not to be a transfer of property for purposes of chapter 4 of the Internal Revenue Code of 1939."
--P.L. 94-455, Sec. 2001(c)(1)(K), substituted "during the 3-year period ending on the date of the decedent's death" for "in contemplation of decedent's death" in para. (a)(1), and substituted "during the 3-year period ending on the date of the decedent's death" for "in contemplation of his death" in para. (a)(2), effective for estates of decedents dying after 12/31/76, but does not apply to transfers made before 1/1/77.

In 1962, P.L. 87-834, Sec. 18(a)(2), deleted "(except real property situated outside of the United States)" in subsec. (a), effective for estates of decedents dying after 10/16/62, except as provided in Sec. 18(b)(2) of this Act, reproduced in note following Code Sec. 2031.

In 1959, P.L. 86-141, added subsec. (c), effective for estates of decedents dying after 8/16/54, and that no interest shall be allowed or paid on any overpayment resulting from the application of the amendment made by the first section of this Act with respect to any payment made before the date of the enactment of this Act [8/7/59].

LexisNexis®

LEXISNEXIS' CODE OF FEDERAL REGULATIONS
Copyright (c) 2013, by Matthew Bender & Company, a member
of the LexisNexis Group. All rights reserved.

*** This section is current through the March 14, 2013 ***
*** issue of the Federal Register ***

TITLE 26 -- INTERNAL REVENUE
CHAPTER I -- INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY
SUBCHAPTER B -- ESTATE AND GIFT TAXES
PART 20 -- ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954
ESTATES OF CITIZENS OR RESIDENTS
GROSS ESTATE

26 CFR 20.2041-1

§ 20.2041-1 Powers of appointment; in general.

(a) Introduction. A decedent's gross estate includes under section 2041 [26 USCS § 2041] the value of property in respect of which the decedent possessed, exercised, or released certain powers of appointment. This section contains rules of general application; § 20.2041-2 contains rules specifically applicable to general powers of appointment created on or before October 21, 1942; and § 20.2041-3 sets forth specific rules applicable to powers of appointment created after October 21, 1942.

(b) Definition of "power of appointment"--(1) In general. The term "power of appointment" includes all powers which are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and regardless of local property law connotations. For example, if a trust instrument provides that the beneficiary may appropriate or consume the principal of the trust, the power to consume or appropriate is a power of appointment. Similarly, a power given to a decedent to affect the beneficial enjoyment of trust property or its income by altering, amending, or revoking the trust instrument or terminating the trust is a power of appointment. If the community property laws of a State confer upon the wife a power of testamentary disposition over property in which she does not have a vested interest she is considered as having a power of appointment. A power in a donee to remove or discharge a trustee and appoint himself may be a power of appointment. For example, if under the terms of a trust instrument, the trustee or his successor has the power to appoint the principal of the trust for the benefit of individuals including himself, and the decedent has the unrestricted power to remove or discharge the trustee at any time and appoint any other person including himself, the decedent is considered as having a power of appointment. However, the decedent is not considered to have a power of appointment if he only had the power to appoint a successor, including himself, under limited conditions which did not exist at the time of his death, without an accompanying unrestricted power of removal. Similarly, a power to amend only the administrative provisions of a trust instrument, which cannot substantially affect the beneficial enjoyment of the trust property or income, is not a power of appointment. The mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment. Further, the right in a beneficiary of a trust to assent to a periodic accounting, thereby relieving the trustee from further accountability, is not a power of appointment if the right of assent does not consist of any power or right to enlarge or shift the beneficial interest of any beneficiary therein.

(2) Relation to other sections. For purposes of §§ 20.2041-1 to 20.2041-3, the term "power of appointment" does not include powers reserved by the decedent to himself within the concept of sections 2036 through 2038 [26 USCS §§ 2036 -- 2038]. (See §§ 20.2036-1 to 20.2038-1.) No provision of section 2041 [26 USCS § 2041] or of §§ 20.2041-1 to 20.2041-3 is to be construed as in any way limiting the application of any other section of the Internal Revenue Code or of these regulations. The power of the owner of a property interest already possessed by him to dispose of his interest, and nothing more, is not a power of appointment, and the interest is includable in his gross estate to the extent it would be includable under section 2033 [26 USCS § 2033] or some other provision of Part III of Subchapter A of Chapter 11. For example, if a trust created by S provides for payment of the income to A for life with power in A to appoint the remainder by will and, in default of such appointment for payment of the income to A's widow, W, for her life and for payment of the remainder to A's estate, the value of A's interest in the remainder is includable in his gross estate under section 2033 [26 USCS § 2033] regardless of its includability under section 2041 [26 USCS § 2041].

(3) Powers over a portion of property. If a power of appointment exists as to part of an entire group of assets or only over a limited interest in property, section 2041 [26 USCS § 2041] applies only to such part or interest. For example, if a trust created by S provides for the payment of income to A for life, then to W for life, with power in A to appoint the remainder by will and in default of appointment for payment of the remainder to B or his estate, and if A dies before W, section 2041 [26 USCS § 2041] applies only to the value of the remainder interest excluding W's life estate. If A dies after W, section 2041 [26 USCS § 2041] would apply to the value of the entire property. If the power were only over one-half the remainder interest, section 2041 [26 USCS § 2041] would apply only to one-half the value of the amounts described above.

(c) Definition of "general power of appointment"--(1) In general. The term "general power of appointment" as defined in section 2041(b)(1) [26 USCS § 2041(b)(1)] means any power of appointment exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate, except (i) joint powers, to the extent provided in §§ 20.2041-2 and 20.2041-3, and (ii) certain powers limited by an ascertainable standard, to the extent provided in subparagraph (2) of this paragraph. A power of appointment exercisable to meet the estate tax, or any other taxes, debts, or charges which are enforceable against the estate, is included within the meaning of a power of appointment exercisable in favor of the decedent's estate, his creditors, or the creditors of his estate. A power of appointment exercisable for the purpose of discharging a legal obligation of the decedent or for his pecuniary benefit is considered a power of appointment exercisable in favor of the decedent or his creditors. However, for purposes of §§ 20.2041-1 to 20.2041-3, a power of appointment not otherwise considered to be a general power of appointment is not treated as a general power of appointment merely by reason of the fact that an appointee may, in fact, be a creditor of the decedent or his estate. A power of appointment is not a general power if by its terms it is either--

(a) Exercisable only in favor of one or more designated persons or classes other than the decedent or his creditors, or the decedent's estate or the creditors of his estate, or

(b) Expressly not exercisable in favor of the decedent or his creditors, or the decedent's estate or the creditors of his estate.

A decedent may have two powers under the same instrument, one of which is a general power of appointment and the other of which is not. For example, a beneficiary may have a power to withdraw trust corpus during his life, and a testamentary power to appoint the corpus among his descendants. The testamentary power is not a general power of appointment.

(2) Powers limited by an ascertainable standard. A power to consume, invade, or appropriate income or corpus, or both, for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent is, by reason of section 2041(b)(1)(A) [26 USCS § 2041(b)(1)(A)], not a general power of appointment. A power is limited by such a standard if the extent of the holder's duty to exercise and not to exercise the power is reasonably measurable in terms of his needs for health, education, or support (or any combination of them). As used in this subparagraph, the words "support" and "maintenance" are synonymous and their meaning is not limited to the bare necessities of life. A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard. Examples of powers which are limited by the requisite standard are powers exercisable for the holder's "support," "support in reasonable comfort," "maintenance in health and reasonable comfort," "support in his accustomed manner of living," "education, including college and professional education," "health," and "medical, dental, hospital and nursing expenses and expenses of invalidism." In determining whether a power is limited by an ascertainable standard, it is immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised.

(3) Certain powers under wills of decedents dying between January 1 and April 2, 1948. Section 210 of the Technical Changes Act of 1953 provides that if a decedent died after December 31, 1947, but before April 3, 1948, certain property interests described therein may, if the decedent's surviving spouse so elects, be accorded special treatment in the determination of the marital deduction to be allowed the decedent's estate under the provisions of section 812(e) of the Internal Revenue Code of 1939. See § 81.47a (h) of Regulations 105 (26 CFR (1939) 81.47a(h)). The section further provides that property affected by the election shall, for the purpose of inclusion in the surviving spouse's gross estate, be considered property with respect to which she has a general power of appointment. Therefore, notwithstanding any other provision of law or of §§ 20.2041-1 to 20.2041-3, if the present decedent (in her capacity as surviving spouse of a prior decedent) has made an election under section 210 of the Technical Changes Act of 1953, the property which was the subject of the election shall be considered as property with respect to which the present decedent has a general power of appointment created after October 21, 1942, exercisable by deed or will, to the extent it was treated as an interest passing to the surviving spouse and not passing to any other person for the purpose of the marital deduction in the prior decedent's estate.

(d) Definition of "exercise". Whether a power of appointment is in fact exercised may depend upon local law. For example, the residuary clause of a will may be considered under local law as an exercise of a testamentary power of appointment in the absence of evidence of a contrary intention drawn from the whole of the testator's will. However, regardless of local law, a power of appointment is considered as exercised for purposes of section 2041 [26 USCS § 2041] even though the exercise is in favor of the taker in default of appointment, and irrespective of whether the appointed interest and the interest in default of appointment are identical or whether the appointee renounces any right to take under the appointment. A power of appointment is also considered as exercised even though the disposition cannot take effect until the occurrence of an event after the exercise takes place, if the exercise is irrevocable and, as of the time of the exercise, the condition was not impossible of occurrence. For example, if property is left in trust to A for life, with a power in B to appoint the remainder by will, and B dies before A, exercising his power by appointing the remainder to C if C survives A, B is considered to have exercised his power if C is living at B's death. On the other hand, a testamentary power of appointment is not considered as exercised if it is exercised subject to the occurrence during the decedent's life of an express or implied condition which did not in fact occur. Thus, if in the preceding example, C dies before B, B's power of appointment would not be considered to have been exercised. Similarly, if a trust provides for income to A for life, remainder as A appoints by will, and A appoints a life estate in the property to B and does not otherwise exercise his power, but B dies before A, A's power is not considered to have been exercised.

(e) Time of creation of power. A power of appointment created by will is, in general, considered as created on the date of the testator's death. However, section 2041(b)(3) [26 USCS § 2041(b)(3)] provides that a power of appointment created by a will executed on or before October 21, 1942, is considered a power created on or before that date if the testator dies before July 1, 1949, without having republished the will, by codicil or otherwise, after October 21, 1942. A power of appointment created by an inter vivos instrument is considered as created on the date the instrument takes effect. Such a power is not considered as created at some future date merely because it is not exercisable on the date the instrument takes effect, or because it is revocable, or because the identity of its holders is not ascertainable until after the date the instrument takes effect. However, if the holder of a power exercises it by creating a second power, the second power is considered as created at the time of the exercise of the first. The application of this paragraph may be illustrated by the following examples:

Example (1). A created a revocable trust before October 22, 1942, providing for payment of income to B for life with remainder as B shall appoint by will. Even though A dies after October 21, 1942, without having exercised his power of revocation, B's power of appointment is considered a power created before October 22, 1942.

Example (2). C created an irrevocable inter vivos trust before October 22, 1942, naming T as trustee and providing for payment of income to D for life with remainder to E. T was given the power to pay corpus to D and the power to appoint a successor trustee. If T resigns after October 21, 1942, and appoints D as successor trustee, D is considered to have a power of appointment created before October 22, 1942.

Example (3). F created an irrevocable inter vivos trust before October 22, 1942, providing for payment of income to G for life with remainder as G shall appoint by will, but in default of appointment income to H for life with remainder as H shall appoint by will. If G died after October 21, 1942, without having exercised his power of appointment, H's power of appointment is considered a power created before October 22, 1942, even though it was only a contingent interest until G's death.

Example (4). If in example (3) above G had exercised his power of appointment by creating a similar power in J, J's power of appointment would be considered a power created after October 21, 1942.

HISTORY: [T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6582, 26 FR 11861, Dec. 12, 1961]

AUTHORITY: Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805.

LEXISNEXIS' CODE OF FEDERAL REGULATIONS
Copyright (c) 2013, by Matthew Bender & Company, a member
of the LexisNexis Group. All rights reserved.

*** This section is current through the March 14, 2013 ***
*** issue of the Federal Register ***

TITLE 26 -- INTERNAL REVENUE
CHAPTER I -- INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY
SUBCHAPTER B -- ESTATE AND GIFT TAXES
PART 26 -- GENERATION-SKIPPING TRANSFER TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1986

26 CFR 26.2601-1

§ 26.2601-1 Effective dates.

(a) Transfers subject to the generation-skipping transfer tax -- (1) In general. Except as otherwise provided in this section, the provisions of chapter 13 of the Internal Revenue Code of 1986 (Code) apply to any generation-skipping transfer (as defined in section 2611 [26 USCS § 2611]) made after October 22, 1986.

(2) Certain transfers treated as if made after October 22, 1986. Solely for purposes of chapter 13, an inter vivos transfer is treated as if it were made on October 23, 1986, if it was --

(i) Subject to chapter 12 (regardless of whether a tax was actually incurred or paid); and

(ii) Made after September 25, 1985, but before October 23, 1986. For purposes of this paragraph, the value of the property transferred shall be the value of the property on the date the property was transferred.

(3) Certain trust events treated as if occurring after October 22, 1986. For purposes of chapter 13, if an inter vivos transfer is made to a trust after September 25, 1985, but before October 23, 1986, any subsequent distribution from the trust or termination of an interest in the trust that occurred before October 23, 1986, is treated as occurring immediately after the deemed transfer on October 23, 1986. If more than one distribution or termination occurs with respect to a trust, the events are treated as if they occurred on October 23, 1986, in the same order as they occurred. See paragraph (b)(1)(iv)(B) of this section for rules determining the portion of distributions and terminations subject to tax under chapter 13. This paragraph (a)(3) does not apply to transfers to trusts not subject to chapter 13 by reason of the transition rules in paragraphs (b) (2) and (3) of this section. The provisions of this paragraph (a)(3) do not apply in determining the value of the property under chapter 13.

(4) Example. The following example illustrates the principle that paragraph (a)(2) of this section is not applicable to transfers under a revocable trust that became irrevocable by reason of the transferor's death after September 25, 1985, but before October 23, 1986:

Example. T created a revocable trust on September 30, 1985, that became irrevocable when T died on October 10, 1986. Although the trust terminated in favor of a grandchild of T, the transfer to the grandchild is not treated as occurring on October 23, 1986, pursuant to paragraph (a)(2) of this section because it is not an inter vivos transfer subject to chapter 12. The transfer is not subject to chapter 13 because it is in the nature of a testamentary transfer that occurred prior to October 23, 1986.

(b) Exceptions -- (1) Irrevocable trusts -- (i) In general. The provisions of chapter 13 do not apply to any generation-skipping transfer under a trust (as defined in section 2652(b) [26 USCS § 2652(b)]) that was irrevocable on September 25, 1985. The rule of the preceding sentence does not apply to a pro rata portion of any generation-skipping transfer under an irrevocable trust if additions are made to the trust after September 25, 1985. See paragraph (b)(1)(iv) of this section for rules for determining the portion of the trust that is subject to the provisions of chapter 13. Further, the rule in the first sentence of this paragraph (b)(1)(i) does not apply to a transfer of property pursuant to the exercise, release, or lapse of a general power of appointment that is treated as a taxable transfer under chapter 11 or chapter 12. The transfer is made by the person holding the power at the time the exercise, release, or lapse of the power becomes effective, and is not considered a transfer under a trust that was irrevocable on September 25, 1985. See paragraph (b)(1)(v)(B) of this section regarding the treatment of the release, exercise, or lapse of a power of appointment that will result in a constructive addition to a trust. See § 26.2652-1(a) for the definition of a transferor.

(ii) Irrevocable trust defined -- (A) In general. Unless otherwise provided in either paragraph (b)(1)(ii) (B) or (C) of this section, any trust (as defined in section 2652(b) [26 USCS § 2652(b)]) in existence on September 25, 1985, is considered an irrevocable trust.

(B) Property includible in the gross estate under section 2038 [26 USCS § 2038]. For purposes of this chapter a trust is not an irrevocable trust to the extent that, on September 25, 1985, the settlor held a power with respect to such trust that would have caused the value of the trust to be included in the settlor's gross estate for Federal estate tax purposes by reason of section 2038 [26 USCS § 2038] (without regard to powers relinquished before September 25, 1985) if the settlor had died on September 25, 1985. A trust is considered subject to a power on September 25, 1985, even though the exercise of the power was subject to the precedent giving of notice, or even though the exercise could take effect only on the expiration of a stated period, whether or not on or before September 25, 1985, notice had been given or the power had been exercised. A trust is not considered subject to a power if the power is, by its terms, exercisable only on the occurrence of an event or contingency not subject to the settlor's control (other than the death of the settlor) and if the event or contingency had not in fact taken place on September 25, 1985.

(C) Property includible in the gross estate under section 2042 [26 USCS § 2042]. A policy of insurance on an individual's life that is treated as a trust under section 2652(b) [26 USCS § 2652(b)] is not considered an irrevocable trust to the extent that, on September 25, 1985, the insured possessed any incident of ownership (as defined in § 20.2042-1(c) of this chapter, and without regard to any incidents of ownership relinquished before September 25, 1985), that would have caused the value of the trust, (i.e., the insurance proceeds) to be included in the insured's gross estate for Federal estate tax purposes by reason of section 2042 [26 USCS § 2042], if the insured had died on September 25, 1985.

(D) Examples. The following examples illustrate the application of this paragraph (b)(1):

Example 1. Section 2038 [26 USCS § 2038] applicable. On September 25, 1985, T, the settlor of a trust that was created before September 25, 1985, held a testamentary power to add new beneficiaries to the trust. T held no other powers over any portion of the trust. The testamentary power held by T would have caused the trust to be included in T's gross estate under section 2038 [26 USCS § 2038] if T had died on September 25, 1985. Therefore, the trust is not an irrevocable trust for purposes of this section.

Example 2. Section 2038 [26 USCS § 2038] not applicable when power held by a person other than settlor. On September 25, 1985, S, the spouse of the settlor of a trust in existence on that date, had an annual right to withdraw a portion of the principal ofthe trust. The trust was otherwise irrevocable on that date. Because the power was not held by the settlor of the trust, it is not a power described in section 2038 [26 USCS § 2038]. Thus, the trust is considered an irrevocable trust for purposes of this section.

Example 3. Section 2038 [26 USCS § 2038] not applicable. In 1984, T created a trust and retained the right to expand the class of remaindermen to include any of T's afterborn grandchildren. As of September 25, 1985, all of T's grandchildren were named remaindermen of the trust. Since the exercise of T's power was dependent on there being afterborn grandchildren who were not members of the class of remaindermen, a contingency that did not exist on September 25, 1985, the trust is not considered subject to the power on September 25, 1985, and is an irrevocable trust for purposes of this section. The result is not changed even if grandchildren are born after September 25, 1985, whether or not T exercises the power to expand the class of remaindermen.

Example 4. Section 2042 [26 USCS § 2042] applicable. On September 25, 1985, T purchased an insurance policy on T's own life and designated child, C, and grandchild, GC, as the beneficiaries. T retained the power to obtain from the insurer a loan against the surrender value of the policy. T's insurance policy is a trust (as defined in section 2652(b) [26 USCS § 2652(b)]) for chapter 13 purposes. The trust is not considered an irrevocable trust because, on September 25, 1985, T possessed an incident of ownership that would have caused the value of the policy to be included in T's gross estate under section 2042 [26 USCS § 2042] if T had died on that date.

Example 5. Trust partially irrevocable. In 1984, T created a trust naming T's grandchildren as the income and remainder beneficiaries. T retained the power to revoke the trust as to one-half of the principal at any time prior to T's death. T retained no other powers over the trust principal. T did not die before September 25, 1985, and did not exercise or release the power before that date. The half of the trust not subject to T's power to revoke is an irrevocable trust for purposes of this section.

(iii) Trust containing qualified terminable interest property -- (A) In general. For purposes of chapter 13, a trust described in paragraph (b)(1)(ii) of this section that holds qualified terminable interest property by reason of an election under section 2056(b)(7) [26 USCS § 2056(b)(7)] or section 2523(f) [26 USCS § 2523(f)] (made either on, before or after September 25, 1985) is treated in the same manner as if the decedent spouse or the donor spouse (as the case may be) had made an election under section 2652(a)(3) [26 USCS § 2652(a)(3)]. Thus, transfers from such trusts are not subject to chapter 13, and the decedent spouse or the donor spouse (as the case may be) is treated as the transferor of such property. The rule of this paragraph (b)(1)(iii) does not apply to that portion of the trust that is subject to chapter 13 by reason of an addition to the trust occurring after September 25, 1985. See § 26.2652-2(a) for rules where an election under section 2652(a)(3) [26 USCS § 2652(a)(3)] is made. See § 26.2652-2(c) for rules where a portion of a trust is subject to an election under section 2652(a)(3) [26 USCS § 2652(a)(3)].

(B) Examples. The following examples illustrate the application of this paragraph (b)(1)(iii):

Example 1. QTIP election made after September 25, 1985. On March 28, 1985, T established a trust. The trust instrument provided that the trustee must distribute all income annually to T's spouse, S, during S's life. Upon S's death, the remainder is to be distributed to GC, the grandchild of T and S. On April 15, 1986, T elected under section 2523(f) [26 USCS § 2523(f)] to treat the property in the trust as qualified terminable interest property. On December 1, 1987, S died and soon thereafter the trust assets were distributed to GC. Because the trust was irrevocable on September 25, 1985, the transfer to GC is not subject to tax under chapter 13. T is treated as the transferor with respect to the transfer of the trust assets to GC in the same manner as if T had made an election under section 2652(a)(3) [26 USCS § 2652(a)(3)] to reverse the effect of the section 2523(f) [26 USCS § 2523(f)] election for chapter 13 purposes.

Example 2. Section 2652(a)(3) [26 USCS § 2652(a)(3)] election deemed to have been made. Assume the same facts as in Example 1, except the trust instrument provides that after S's death all income is to be paid annually to C, the child of T and S. Upon C's death, the remainder is to be distributed to GC. C died on October 1, 1992, and soon thereafter the trust assets are distributed to GC. Because the trust was irrevocable on September 25, 1985, the termination of C's interest is not subject to chapter 13.

(iv) Additions to irrevocable trusts -- (A) In general. If an addition is made after September 25, 1985, to an irrevocable trust which is excluded from chapter 13 by reason of paragraph (b)(1) of this section, a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the provisions of chapter 13. If an addition is made, the trust is thereafter deemed to consist of two portions, a portion not subject to chapter 13 (the non-chapter 13 portion) and a portion subject to chapter 13 (the chapter 13 portion), each with a separate inclusion ratio (as defined in section 2642(a) [26 USCS § 2642(a)]). The non-chapter 13 portion represents the value of the assets of the trust as it existed on September 25, 1985. The applicable fraction (as defined in section 2642(a)(2) [26 USCS § 2642(a)(2)]) for the non-chapter 13 portion is deemed to be 1 and the inclusion ratio for such portion is 0. The chapter 13 portion of the trust represents the value of all additions made to the trust after September 25, 1985. The inclusion ratio for the chapter 13 portion is determined under section 2642 [26 USCS § 2642]. This paragraph (b)(1)(iv)(A) requires separate portions of one trust only for purposes of determining inclusion ratios. For purposes of chapter 13, a constructive addition under paragraph (b)(1)(v) of this section is treated as an addition. See paragraph (b)(4) of this section for exceptions to the additions rule of this paragraph (b)(1)(iv). See § 26.2654-1(a)(2) for rules treating additions to a trust by an individual other than the initial transferor as a separate trust for purposes of chapter 13.

(B) Terminations of interests in and distributions from trusts. Where a termination or distribution described in section 2612 [26 USCS § 2612] occurs with respect to a trust to which an addition has been made, the portion of such termination or distribution allocable to the chapter 13 portion is determined by reference to the allocation fraction, as defined in paragraph (b)(1)(iv)(C) of this section. In the case of a termination described in section 2612(a) [26 USCS § 2612(a)] with respect to a trust, the portion of such termination that is subject to chapter 13 is the product of the allocation fraction and the value of the trust (to the extent of the terminated interest therein). In the case of a distribution described in section 2612(b) [26 USCS § 2612(b)] from a trust, the portion of such distribution that is subject to chapter 13 is the product of the allocation fraction and the value of the property distributed.

(C) Allocation fraction -- (1) In general. The allocation fraction allocates appreciation and accumulated income between the chapter 13 and non-chapter 13 portions of a trust. The numerator of the allocation fraction is the amount of the addition (valued as of the date the addition is made), determined without regard to whether any part of the transfer is subject to tax under chapter 11 or chapter 12, but reduced by the amount of any Federal or state estate or gift tax imposed and subsequently paid by the recipient trust with respect to the addition. The denominator of the allocation fraction is the total value of the entire trust immediately after the addition. For purposes of this paragraph (b)(1)(iv)(C), the total value of the entire trust is the fair market value of the property held in trust (determined under the rules of section 2031 [26 USCS § 2031]), reduced by any amount attributable to or paid by the trust and attributable to the transfer to the trust that is similar to an amount that would be allowable as a deduction under section 2053 [26 USCS § 2053] if the addition had occurred at the death of the transferor, and further reduced by the same amount that the numerator was reduced to reflect Federal or state estate or gift tax incurred by and subsequently paid by the recipient trust with respect to the addition. Where there is more than one addition to principal after September 25, 1985, the portion of the trust subject to chapter 13 after each such addition is determined pursuant to a revised fraction. In each case, the numerator of the revised fraction is the sum of the value of the chapter 13 portion of the trust immediately before the latest addition, and the amount of the latest addition. The denominator of the revised fraction is the total value of the entire trust immediately after the addition. If the transfer to the trust is a generation-skipping transfer, the numerator and denominator are reduced by the amount of the generation-skipping transfer tax, if any, that is imposed by chapter 13 on the transfer and actually recovered from the trust. The allocation fraction is rounded off to five decimal places (.00001).

(2) Examples. The following examples illustrate the application of paragraph (b)(1)(iv) of this section. In each of the examples, assume that the recipient trust does not pay any Federal or state transfer tax by reason of the addition.

Example 1. Post September 25, 1985, addition to trust. (i) On August 16, 1980, T established an irrevocable trust. Under the trust instrument, the trustee is required to distribute the entire income annually to T's child, C, for life, then to T's grandchild, GC, for life. Upon GC's death, the remainder is to be paid to GC's issue. On October 1, 1986, when the total value of the entire trust is $ 400,000, T transfers $ 100,000 to the trust. The allocation fraction is computed as follows:

Value of addition		$ 100,000	
---------------------	=	---------------------	= .2
Total value of trust		$ 400,000 + $ 100,000	

(ii) Thus, immediately after the transfer, 20 percent of the value of future generation-skipping transfers under the trust will be subject to chapter 13.

Example 2. Effect of expenses. Assume the same facts as in Example 1, except immediately prior to the transfer on October 1, 1986, the fair market value of the individual assets in the trust totaled $ 400,000. Also, assume that the trust had accrued and unpaid debts, expenses, and taxes totaling $ 300,000. Assume further that the entire $ 300,000 represented amounts that would be deductible under section 2053 [26 USCS § 2053] if the trust were includible in the transferor's gross estate. The numerator of the allocation fraction is $ 100,000 and the denominator of the allocation fraction is $ 200,000 (($ 400,000-$ 300,000)+$ 100,000). Thus, the allocation fraction is .5 ($ 100,000/$ 200,000) and 50 percent of the value of future generation-skipping transfers will be subject to chapter 13.

Example 3. Multiple additions. (i) Assume the same facts as in Example 1, except on January 30, 1988, when the total value of the entire trust is $ 600,000, T transfers an additional $ 40,000 to the trust. Before the transfer, the value of the portion of the trust that was attributable to the prior addition was $ 120,000 ($ 600,000x.2). The new allocation fraction is computed as follows:

Total value of additions	$ 120,000 + $ 40,000	$ 160,000

------------------------	=	--------------------	=	---------	= .25
Total value of trust		$ 600,000 + $ 40,000		$ 640,000	

(ii) Thus, immediately after the transfer, 25 percent of the value of future generation-skipping transfers under the trust will be subject to chapter 13.

Example 4. Allocation fraction at time of generation-skipping transfer. Assume the same facts as in Example 3, except on March 1, 1989, when the value of the trust is $ 800,000, C dies. A generation-skipping transfer occurs at C's death because of the termination of C's life estate. Therefore, $ 200,000 ($ 800,000x.25) is subject to tax under chapter 13.

(v) Constructive additions -- (A) Powers of Appointment. Except as provided in paragraph (b)(1)(v)(B) of this section, where any portion of a trust remains in the trust after the post-September 25, 1985, release, exercise, or lapse of a power of appointment over that portion of the trust, and the release, exercise, or lapse is treated to any extent as a taxable transfer under chapter 11 or chapter 12, the value of the entire portion of the trust subject to the power that was released, exercised, or lapsed is treated as if that portion had been withdrawn and immediately retransferred to the trust at the time of the release, exercise, or lapse. The creator of the power will be considered the transferor of the addition except to the extent that the release, exercise, or lapse of the power is treated as a taxable transfer under chapter 11 or chapter 12. See § 26.2652-1 for rules for determining the identity of the transferor of property for purposes of chapter 13.

(B) Special rule for certain powers of appointment. The release, exercise, or lapse of a power of appointment (other than a general power of appointment as defined in section 2041(b) [26 USCS § 2041(b)]) is not treated as an addition to a trust if --

(1) Such power of appointment was created in an irrevocable trust that is not subject to chapter 13 under paragraph (b)(1) of this section; and

(2) In the case of an exercise, the power of appointment is not exercised in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period, measured from the date of creation of the trust, extending beyond any life in being at the date of creation of the trust plus a period of 21 years plus, if necessary, a reasonable period of gestation (the perpetuities period). For purposes of this paragraph (b)(1)(v)(B)(2), the exercise of a power of appointment that validly postpones or suspends the vesting, absolute ownership or power of alienation of an interest in property for a term of years that will not exceed 90 years (measured from the date of creation of the trust) will not be considered an exercise that postpones or suspends vesting, absolute ownership or the power of alienation beyond the perpetuities period. If a power is exercised by creating another power, it is deemed to be exercised to whatever extent the second power may be exercised.

(C) Constructive addition if liability is not paid out of trust principal. Where a trust described in paragraph (b)(1) of this section is relieved of any liability properly payable out of the assets of such trust, the person or entity who actually satisfies the liability is considered to have made a constructive addition to the trust in an amount equal to the liability. The constructive addition occurs when the trust is relieved of liability (e.g., when the right of recovery is no longer enforceable). But see § 26.2652-1(a)(3) for rules involving the application of section 2207A [26 USCS § 2207A] in the case of an election under section 2652(a)(3) [26 USCS § 2652(a)(3)].

(D) Examples. The following examples illustrate the application of this paragraph (b)(1)(v):

Example 1. Lapse of a power of appointment. On June 19, 1980, T established an irrevocable trust with a corpus of $ 500,000. The trust instrument provides that the trustee shall distribute the entire income from the trust annually to T's spouse, S, during S's life. At S's death, the remainder is to be distributed to T and S's grandchild, GC. T also gave S a general power of appointment over one-half of the trust assets. On December 21, 1989, when the value of the trust corpus is $ 1,500,000, S died without having exercised the general power of appointment. The value of one-half of the trust corpus, $ 750,000 ($ 1,500,000 x .5) is included in S's gross estate under section 2041(a) [26 USCS § 2041(a)] and is subject to tax under Chapter 11. Because the value of one-half of the trust corpus is subject to tax under Chapter 11 with respect to S's estate, S is treated as the transferor of that property for purposes of Chapter 13 (see section 2652(a)(1)(A) [26 USCS § 2652(a)(1)(A)]). For purposes of the generation-skipping transfer tax, the lapse of S's power of appointment is treated as if $ 750,000 ($ 1,500,000 x .5) had been distributed to S and then transferred back to the trust. Thus, S is considered to have added $ 750,000 ($ 1,500,000 x .5) to the trust at the date of S's death. Because this constructive addition occurred after September 25, 1985, 50 percent of the corpus of the trust became subject to Chapter 13 at S's death.

Example 2. Multiple actual additions. On June 19, 1980, T established an irrevocable trust with a principal of $ 500,000. The trust instrument provides that the trustee shall distribute the entire income from the trust annually to T's spouse, S, during S's life. At S's death, the remainder is to be distributed to GC, the grandchild of T and S. On October 1, 1985, when the trust assets were valued at $ 800,000, T added $ 200,000 to the trust. After the transfer on October 1, 1985, the allocation fraction was .2 ($ 200,000/$ 1,000,000). On December 21, 1989, when the value of the trust principal is $ 1,000,000, T adds $ 1,000,000 to the trust. After this addition, the new allocation fraction is 0.6 ($ 1,200,000/$ 2,000,000). The numerator of the fraction is the value of that portion of trust assets that were subject to chapter 13 immediately prior to the addition (by reason of the first addition), $ 200,000 (.2x $ 1,000,000), plus the value of the second transfer, $ 1,000,000, which equals $ 1,200,000. The denominator of the fraction, $ 2,000,000, is the total value of the trust assets immediately after the second transfer. Thus, 60 percent of the principal of the trust becomes subject to chapter 13.

Example 3. Entire portion of trust subject to lapsed power is treated as an addition. On September 25, 1985, B possessed a general power of appointment over the assets of an irrevocable trust that had been created by T in 1980. Under the terms of the trust, B's power lapsed on July 20, 1987. For Federal gift tax purposes, B is treated as making a gift of ninety-five percent (100%-5%) of the value of the principal (see section 2514 [26 USCS § 2514]). However, because the entire trust was subject to the power of appointment, 100 percent (that portion of the trust subject to the power) of the assets of the trust are treated as a constructive addition. Thus, the entire amount of all generation-skipping transfers occurring pursuant to the trust instrument after July 20, 1987, are subject to chapter 13.

Example 4. Exercise of power of appointment in favor of another trust. On March 1, 1985, T established an irrevocable trust as defined in paragraph (b)(1)(ii) of this section. Under the terms of the trust instrument, the trustee is required to distribute the entire income annually to T's child, C, for life, then to T's grandchild, GC, for life. GC has the power to appoint any or all of the trust assets to Trust 2 which is an irrevocable trust (as defined in paragraph (b)(1)(ii) of this section) that was established on August 1, 1985. The terms of Trust 2's governing instrument provide that the trustee shall pay income to T's great grandchild, GGC, for life. Upon GGC's death, the remainder is to be paid to GGC's issue. GGC was alive on March 1, 1985, when Trust 1 was created. C died on April 1, 1986. On July 1, 1987, GC exercised the power of appointment. The exercise of GC's power does not subject future transfers from Trust 2 to tax under chapter 13 because the exercise of the power in favor of Trust 2 does not suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period, measured from the date of creation of Trust 1, extending beyond the life of GGC (a beneficiary under Trust 2 who was in being at the date of creation of Trust 1) plus a period of 21 years. The result would be the same if Trust 2 had been created after the effective date of chapter 13.

Example 5. Exercise of power of appointment in favor of another trust. Assume the same facts as in Example 4, except that GGC was born on March 28, 1986. The valid exercise of GC's power in favor of Trust 2 causes the principal of Trust 1 to be subject to chapter 13, because GGC was not born until after the creation of Trust 1. Thus, such exercise may suspend the vesting, absolute ownership, or power of alienation of an interest in the trust principal for a period, measured from the date of creation of Trust 1, extending beyond the life of GGC (a beneficiary under Trust 2 who was not a life in being at the date of creation of Trust 1).

Example 6. Extension for the longer of two periods. Prior to the effective date of chapter 13, GP established an irrevocable trust under which the trust income was to be paid to GP's child, C, for life. C was given a testamentary power to appoint the remainder in further trust for the benefit of C's issue. In default of C's exercise of the power, the remainder was to pass to charity. C died on February 3, 1995, survived by a child who was alive when GP established the trust. C exercised the power in a manner that validly extends the trust in favor of C's issue until the latter of May 15, 2064 (80 years from the date the trust was created), or the death of C's child plus 21 years. C's exercise of the power is a constructive addition to the trust because the exercise may extend the trust for a period longer than the permissible periods of either the life of C's child (a life in being at the creation of the trust) plus 21 years or a term not more than 90 years measured from the creation of the trust. On the other hand, if C's exercise of the power could extend the trust based only on the life of C's child plus 21 years or only for a term of 80 years from the creation of the trust (but not the later of the two periods) then the exercise of the power would not have been a constructive addition to the trust.

Example 7. Extension for the longer of two periods. The facts are the same as in Example 6 except local law provides that the effect of C's exercise is to extend the term of the trust until May 15, 2064, whether or not C's child predeceases that date by more than 21 years. C's exercise is not a constructive addition to the trust because C exercised the power in a manner that cannot postpone or suspend vesting, absolute ownership, or power of alienation for a term of years that will exceed 90 years. The result would be the same if the effect of C's exercise is either to extend the term of the trust until 21 years after the death of C's child or to extend the term of the trust until the first to occur of May 15, 2064 or 21 years after the death of C's child.

(vi) Appreciation and income. Except to the extent that the provisions of paragraphs (b)(1)(iv) and (v) of this section allocate subsequent appreciation and accumulated income between the original trust and additions thereto, appreciation in the value of the trust and undistributed income added thereto are not considered an addition to the principal of a trust.

(2) Transition rule for wills or revocable trusts executed before October 22, 1986 -- (i) In general. The provisions of chapter 13 do not apply to any generation-skipping transfer under a will or revocable trust executed before October 22, 1986, provided that --

(A) The document in existence on October 21, 1986, is not amended at any time after October 21, 1986, in any respect which results in the creation of, or an increase in the amount of, a generation-skipping transfer;

(B) In the case of a revocable trust, no addition is made to the revocable trust after October 21, 1986, that results in the creation of, or an increase in the amount of, a generation-skipping transfer; and

(C) The decedent dies before January 1, 1987.

(ii) Revocable trust defined. For purposes of this section, the term revocable trust means any trust (as defined in section 2652(b) [26 USCS § 2652(b)]) except to the extent that, on October 22, 1986, the trust --

(A) Was an irrevocable trust described in paragraph (b)(1) of this section; or

(B) Would have been an irrevocable trust described in paragraph (b)(1) of this section had it not been created or become irrevocable after September 25, 1985, and before October 22, 1986.

(iii) Will or revocable trust containing qualified terminable interest property. The rules contained in paragraph (b)(1)(iii) of this section apply to any will or revocable trust within the scope of the transition rule of this paragraph (b)(2).

(iv) Amendments to will or revocable trust. For purposes of this paragraph (b)(2), an amendment to a will or a revocable trust in existence on October 21, 1986, is not considered to result in the creation of, or an increase in the amount of, a generation-skipping transfer where the amendment is --

(A) Basically administrative or clarifying in nature and only incidentally increases the amount transferred; or

(B) Designed to ensure that an existing bequest or transfer qualifies for the applicable marital or charitable deduction for estate, gift, or generation-skipping transfer tax purposes and only incidentally increases the amount transferred to a skip person or to a generation-skipping trust.

(v) Creation of, or increase in the amount of, a GST. In determining whether a particular amendment to a will or revocable trust creates, or increases the amount of, a generation-skipping transfer for purposes of this paragraph (b)(2), the effect of the instrument(s) in existence on October 21, 1986, is measured against the effect of the instrument(s) in existence on the date of death of the decedent or on the date of any prior generation-skipping transfer. If the effect of an amendment cannot be immediately determined, it is deemed to create, or increase the amount of, a generation-skipping transfer until a determination can be made.

(vi) Additions to revocable trusts. Any addition made after October 21, 1986, but before the death of the settlor, to a revocable trust subjects all subsequent generation-skipping transfers under the trust to the provisions of chapter 13. Any addition made to a revocable trust after the death of the settlor (if the settlor dies before January 1, 1987) is treated as an addition to an irrevocable trust. See paragraph (b)(1)(v) of this section for rules involving constructive additions to trusts. See paragraph (b)(1)(v)(B) of this section for rules providing that certain transfers to trusts are not treated as additions for purposes of this section.

(vii) Examples. The following examples illustrate the application of paragraph (b)(2)(iv) of this section:

(A) Facts applicable to Examples 1 through 5. In each of Examples 1 through 5 assume that T executed a will prior to October 22, 1986, and that T dies on December 31, 1986.

Example 1. Administrative change. On November 1, 1986, T executes a codicil to T's will removing one of the co-executors named in the will. Although the codicil may have the effect of lowering administrative costs and thus increasing the amount transferred, it is considered administrative in nature and thus does not cause generation-skipping transfers under the will to be subject to chapter 13.

Example 2. Effect of amendment not immediately determinable. On November 1, 1986, T executes a codicil to T's will revoking a bequest of $ 100,000 to C, a non-skip person (as defined under section 2613(b) [26 USCS § 2613(b)]) and causing that amount to be added to a residuary trust held for a skip person. The amendment is deemed to increase the amount of a generation-skipping transfer and prevents any transfers under the will from qualifying under paragraph (b)(2)(i) of this section. If, however, C dies before T and under local law the property would have been added to the residue in any event because the bequest would have lapsed, the codicil is not considered an amendment that increases the amount of a generation-skipping transfer.

Example 3. Refund of tax paid because of amendment. T's will provided that an amount equal to the maximum allowable marital deduction would pass to T's spouse with the residue of the estate passing to a trust established for the benefit of skip persons. On October 23, 1986, the will is amended to provide that the marital share passing to T's spouse shall be the lesser of the maximum allowable marital deduction or the minimum amount that will result in no estate tax liability for T's estate. The amendment may increase the amount of a generation-skipping transfer. Therefore, any generation-skipping transfers under the will are subject to tax under chapter 13. If it becomes apparent that the amendment does not increase the amount of a generation-skipping transfer, a claim for refund may be filed with respect to any generation-skipping transfer tax that was paid within the period set forth in section 6511 [26 USCS § 6511]. For example, it would become apparent that the amendment did not result in an increase in the residue if it is subsequently determined that the maximum marital deduction and the minimum amount that will result in no estate tax liability are equal in amount.

Example 4. An amendment that increases a generation-skipping transfer causes complete loss of exempt status. T's will provided for the creation of two trusts for the benefit of skip persons. On November 1, 1986, T executed a codicil to the will specifically increasing the amount of a generation-skipping transfer under the will. All transfers made pursuant to the will or either of the trusts created thereunder are precluded from qualifying under the transition rule of paragraph (b)(2)(i) of this section and are subject to tax under chapter 13.

Example 5. Corrective action effective. Assume that T in Example 4 later executes a second codicil deleting the increase to the generation-skipping transfer. Because the provision increasing a generation-skipping transfer does not become effective, it is not considered an amendment to a will in existence on October 22, 1986.

(B) Facts applicable to Examples 6 through 8. T created a trust on September 30, 1985, in which T retained the power to revoke the transfer at any time prior to T's death. The trust provided that, upon the death of T, the income was to be paid to T's spouse, W, for life and then to A, B, and C, the children of T's sibling, S, in equal shares for life, with one-third of the principal to be distributed per stirpes to each child's surviving issue upon the death of the child. The trustee has the power to make discretionary distributions of trust principal to T's sibling, S.

Example 6. Amendment that affects only a person who is not a skip person. A became disabled, and T modified the trust on December 1, 1986, to increase A's share of the income. Since the amendment does not result in the creation of, or increase in the amount of, a generation-skipping transfer, transfers pursuant to the trust are not subject to chapter 13.

Example 7. Amendment that adds a skip person. Assume that T amends the trust to add T's grandchild, D, as an income beneficiary. The trust will be subject to the provisions of chapter 13 because the amendment creates a generation-skipping transfer.

Example 8. Refund of tax paid during interim period when effect of amendment is not determinable. Assume that T amends the trust to provide that the issue of S are to take a one-fourth share of the principal per stirpes upon S's death. Because the distribution to be made upon S's death may involve skip persons, the amendment is considered an amendment that creates or increases the amount of a generation-skipping transfer until a determination can be made. Accordingly, any distributions from (or terminations of interests in) such trust are subject to chapter 13 until it is determined that no skip person has been added to the trust. At that time, a claim for refund may be filed within the period set forth in section 6511 [26 USCS § 6511] with respect to any generation-skipping transfer tax that was paid.

(3) Transition rule in the case of mental incompetency -- (i) In general. If an individual was under a mental disability to change the disposition of his or her property continuously from October 22, 1986, until the date of his or her death, the provisions of chapter 13 do not apply to any generation-skipping transfer --

(A) Under a trust (as defined in section 2652(b) [26 USCS § 2652(b)]) to the extent such trust consists of property, or the proceeds of property, the value of which was included in the gross estate of the individual (other than property transferred by or on behalf of the individual during the individual's life after October 22, 1986); or

(B) Which is a direct skip (other than a direct skip from a trust) that occurs by reason of the death of the individual.

(ii) Mental disability defined. For purposes of this paragraph (b)(2),the term mental disability means mental incompetence to execute an instrument governing the disposition of the individual's property, whether or not there was an adjudication of incompetence and regardless of whether there has been an appointment of a guardian, fiduciary, or other person charged with either the care of the individual or the care of the individual's property.

(iii)(A) Decedent who has not been adjudged mentally incompetent. If there has not been a court adjudication that the decedent was mentally incompetent on or before October 22, 1986, the executor must file, with Form 706, either --

(1) A certification from a qualified physician stating that the decedent was --

(i) mentally incompetent at all times on and after October 22, 1986; and

(ii) did not regain competence to modify or revoke the terms of the trust or will prior to his or her death; or

(2) Sufficient other evidence demonstrating that the decedent was mentally incompetent at all times on and after October 22, 1986, as well as a statement explaining why no certification is available from a physician; and

(3) Any judgement or decree relating to the decedent's incompetency that was made after October 22, 1986.

(B) Such items in paragraphs (b)(3)(iii) (A)(1), (2), and (3) of this section will be considered relevant, but not determinative, in establishing the decedent's state of competency.

(iv) Decedent who has been adjudged mentally incompetent. If the decedent has been adjudged mentally incompetent on or before October 22, 1986, a copy of the judgment or decree, and any modification thereof, must be filed with the Form 706.

(v) Rule applies even if another person has power to change trust terms. In the case of a transfer from a trust, this paragraph (b)(3) applies even though a person charged with the care of the decedent or the decedent's property has the power to revoke or modify the terms of the trust, provided that the power is not exercised after October 22, 1986, in a manner that creates, or increases the amount of, a generation-skipping transfer. See paragraph (b)(2)(iv) of this section for rules concerning amendments that create or increase the amount of a generation-skipping transfer.

(vi) Example. The following example illustrates the application of paragraph (b)(3)(v) of this section:

Example. T was mentally incompetent on October 22, 1986, and remained so until death in 1993. Prior to becoming incompetent, T created a revocable generation-skipping trust that was includible in T's gross estate. Prior to October 22, 1986, the appropriate court issued an order under which P, who was thereby charged with the care of T's property, had the power to modify or revoke the revocable trust. Although P exercised the power after October 22, 1986, and while T was incompetent, the power was not exercised in a manner that created, or increased the amount of, a generation-skipping transfer. Thus, the existence and exercise of P's power did not cause the trust to lose its exempt status under paragraph (b)(3) of this section. The result would be the same if the court order was issued after October 22, 1986.

(4) Retention of trust's exempt status in the case of modifications, etc. -- (i) In general. In general, unless specifically provided otherwise, the rules contained in this paragraph are applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. Thus (unless specifically noted), the rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of gain for purposes of section 1001 [26 USCS § 1001]. The rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of section 1001 [26 USCS § 1001].

(A) Discretionary powers. The distribution of trust principal from an exempt trust to a new trust or retention of trust principal in a continuing trust will not cause the new or continuing trust to be subject to the provisions of chapter 13, if --

(1) Either --

(i) The terms of the governing instrument of the exempt trust authorize distributions to the new trust or the retention of trust principal in a continuing trust, without the consent or approval of any beneficiary or court; or

(ii) at the time the exempt trust became irrevocable, state law authorized distributions to the new trust or retention of principal in the continuing trust, without the consent or approval of any beneficiary or court; and

(2) The terms of the governing instrument of the new or continuing trust do not extend the time for vesting of any beneficial interest in the trust in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period, measured from the date the original trust became irrevocable, extending beyond any life in being at the date the original trust became irrevocable plus a period of 21 years, plus if necessary, a reasonable period of gestation. For purposes of this paragraph (b)(4)(i)(A), the exercise of a trustee's distributive power that validly postpones or suspends the vesting, absolute ownership, or power of alienation of an interest in property for a term of years that will not exceed 90 years (measured from the date the original trust became irrevocable) will not be considered an exercise that postpones or suspends vesting, absolute ownership, or the power of alienation beyond the perpetuities period. If a distributive power is exercised by creating another power, it is deemed to be exercised to whatever extent the second power may be exercised.

(B) Settlement. A court-approved settlement of a bona fide issue regarding the administration of the trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to the provisions of chapter 13, if --

(1) The settlement is the product of arm's length negotiations; and

(2) The settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. A settlement that results in a compromise between the positions of the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes.

(C) Judicial construction. A judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause an exempt trust to be subject to the provisions of chapter 13, if --

(1) The judicial action involves a bona fide issue; and

(2) The construction is consistent with applicable state law that would be applied by the highest court of the state.

(D) Other changes. (1) A modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A), (B), or (C) of this section) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651 [26 USCS § 2651]) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

(2) For purposes of this section, a modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is measured against the effect of the instrument in existence immediately before the modification. If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651 [26 USCS § 2651]) than the person or persons who held the beneficial interest prior to the modification. A modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust. In addition, administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount

(or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of § 1.643(b)-1 of this chapter.

(E) Examples. The following examples illustrate the application of this paragraph (b)(4). In each example, assume that the trust established in 1980 was irrevocable for purposes of paragraph (b)(1)(ii) of this section and that there have been no additions to any trust after September 25, 1985. The examples are as follows:

Example 1. Trustee's power to distribute principal authorized under trust instrument. In 1980, Grantor established an irrevocable trust (Trust) for the benefit of Grantor's child, A, A's spouse, and A's issue. At the time Trust was established, A had two children, B and C. A corporate fiduciary was designated as trustee. Under the terms of Trust, the trustee has the discretion to distribute all or part of the trust income to one or more of the group consisting of A, A's spouse or A's issue. The trustee is also authorized to distribute all or part of the trust principal to one or more trusts for the benefit of A, A's spouse, or A's issue under terms specified by the trustee in the trustee's discretion. Any trust established under Trust, however, must terminate 21 years after the death of the last child of A to die who was alive at the time Trust was executed. Trust will terminate on the death of A, at which time the remaining principal will be distributed to A's issue, per stirpes. In 2002, the trustee distributes part of Trust's principal to a new trust for the benefit of B and C and their issue. The new trust will terminate 21 years after the death of the survivor of B and C, at which time the trust principal will be distributed to the issue of B and C, per stirpes. The terms of the governing instrument of Trust authorize the trustee to make the distribution to a new trust without the consent or approval of any beneficiary or court. In addition, the terms of the governing instrument of the new trust do not extend the time for vesting of any beneficial interest in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period, measured from the date of creation of Trust, extending beyond any life in being at the date of creation of Trust plus a period of 21 years, plus if necessary, a reasonable period of gestation. Therefore, neither Trust nor the new trust will be subject to the provisions of chapter 13 of the Internal Revenue Code.

Example 2. Trustee's power to distribute principal pursuant to state statute. In 1980, Grantor established an irrevocable trust (Trust) for the benefit of Grantor's child, A, A's spouse, and A's issue. At the time Trust was established, A had two children, B and C. A corporate fiduciary was designated as trustee. Under the terms of Trust, the trustee has the discretion to distribute all or part of the trust income or principal to one or more of the group consisting of A, A's spouse or A's issue. Trust will terminate on the death of A, at which time, the trust principal will be distributed to A's issue, per stirpes. Under a state statute enacted after 1980 that is applicable to Trust, a trustee who has the absolute discretion under the terms of a testamentary instrument or irrevocable inter vivos trust agreement to invade the principal of a trust for the benefit of the income beneficiaries of the trust, may exercise the discretion by appointing so much or all of the principal of the trust in favor of a trustee of a trust under an instrument other than that under which the power to invade is created, or under the same instrument. The trustee may take the action either with consent of all the persons interested in the trust but without prior court approval, or with court approval, upon notice to all of the parties. The exercise of the discretion, however, must not reduce any fixed income interest of any income beneficiary of the trust and must be in favor of the beneficiaries of the trust. Under state law prior to the enactment of the state statute, the trustee did not have the authority to make distributions in trust. In 2002, the trustee distributes one-half of Trust's principal to a new trust that provides for the payment of trust income to A for life and further provides that, at A's death, one-half of the trust remainder will pass to B or B's issue and one-half of the trust will pass to C or C 's issue. Because the state statute was enacted after Trust was created and requires the consent of all of the parties, the transaction constitutes a modification of Trust. However, the modification does not shift any beneficial interest in Trust to a beneficiary or beneficiaries who occupy a lower generation than the person or persons who held the beneficial interest prior to the modification. In addition, the modification does not extend the time for vesting of any beneficial interest in Trust beyond the period provided for in the original trust. The new trust will terminate at the same date provided under Trust. Therefore, neither Trust nor the new trust will be subject to the provisions of chapter 13 of the Internal Revenue Code.

Example 3. Construction of an ambiguous term in the instrument. In 1980, Grantor established an irrevocable trust for the benefit of Grantor's children, A and B, and their issue. The trust is to terminate on the death of the last to die of A and B, at which time the principal is to be distributed to their issue. However, the provision governing the termination of the trust is ambiguous regarding whether the trust principal is to be distributed per stirpes, only to the children of A and B, or per capita among the children, grandchildren, and more remote issue of A and B. In 2002, the trustee files a construction suit with the appropriate local court to resolve the ambiguity. The court issues an order construing the instrument to provide for per capita distributions to the children, grandchildren, and more remote issue of A and B living at the time the trust terminates. The court's construction resolves a bona fide issue regarding the proper interpretation of the instrument and is consistent with applicable state law as it would be interpreted by the highest court of the state. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

Example 4. Change in trust situs. In 1980, Grantor, who was domiciled in State X, executed an irrevocable trust for the benefit of Grantor's issue, naming a State X bank as trustee. Under the terms of the trust, the trust is to terminate, in all events, no later than 21 years after the death of the last to die of certain designated individuals living at the time the trust was executed. The provisions of the trust do not specify that any particular state law is to govern the administration and construction of the trust. In State X, the common law rule against perpetuities applies to trusts. In 2002, a State Y bank is named as sole trustee. The effect of changing trustees is that the situs of the trust changes to State Y, and the laws of State Y govern the administration and construction of the trust. State Y law contains no rule against perpetuities. In this case, however, in view of the terms of the trust instrument, the trust will terminate at the same time before and after the change in situs. Accordingly, the change in situs does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651 [26 USCS § 2651]) than the person or persons who held the beneficial interest prior to the transfer. Furthermore, the change in situs does not extend the time for vesting of any beneficial interest in the trust beyond that provided for in the original trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code. If, in this example, as a result of the change in situs, State Y law governed such that the time for vesting was extended beyond the period prescribed under the terms of the original trust instrument, the trust would not retain exempt status.

Example 5. Division of a trust. In 1980, Grantor established an irrevocable trust for the benefit of his two children, A and B, and their issue. Under the terms of the trust, the trustee has the discretion to distribute income and principal to A, B, and their issue in such amounts as the trustee deems appropriate. On the death of the last to die of A and B, the trust principal is to be distributed to the living issue of A and B, per stirpes. In 2002, the appropriate local court approved the division of the trust into two equal trusts, one for the benefit of A and A's issue and one for the benefit of B and B's issue. The trust for A and A's issue provides that the trustee has the discretion to distribute trust income and principal to A and A's issue in such amounts as the trustee deems appropriate. On A's death, the trust principal is to be distributed equally to A's issue, per stirpes. If A dies with no living descendants, the principal will be added to the trust for B and B's issue. The trust for B and B's issue is identical (except for the beneficiaries), and terminates at B's death at which time the trust principal is to be distributed equally to B's issue, per stirpes. If B dies with no living descendants, principal will be added to the trust for A and A's issue. The division of the trust into two trusts does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651 [26 USCS § 2651]) than the person or persons who held the beneficial interest prior to the division. In addition, the division does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the two partitioned trusts resulting from the division will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

Example 6. Merger of two trusts. In 1980, Grantor established an irrevocable trust for Grantor's child and the child's issue. In 1983, Grantor's spouse also established a separate irrevocable trust for the benefit of the same child and issue. The terms of the spouse's trust and Grantor's trust are identical. In 2002, the appropriate local court approved the merger of the two trusts into one trust to save administrative costs and enhance the management of the investments. The merger of the two trusts does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651 [26 USCS § 2651]) than the person or persons who held the beneficial interest prior to the merger. In addition, the merger does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the trust that resulted from the merger will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

Example 7. Modification that does not shift an interest to a lower generation. In 1980, Grantor established an irrevocable trust for the benefit of Grantor's grandchildren, A, B, and C. The trust provides that income is to be paid to A, B, and C, in equal shares for life. The trust further provides that, upon the death of the first grandchild to die, one-third of the principal is to be distributed to that grandchild's issue, per stirpes. Upon the death of the second grandchild to die, one-half of the remaining trust principal is to be distributed to that grandchild's issue, per stirpes, and upon the death of the last grandchild to die, the remaining principal is to be distributed to that grandchild's issue, per stirpes. In 2002, A became disabled. Subsequently, the trustee, with the consent of B and C, petitioned the appropriate local court and the court approved a modification of the trust that increased A's share of trust income. The modification does not shift a beneficial interest to a lower generation beneficiary because the modification does not increase the amount of a GST transfer under the original trust or create the possibility that new GST transfers not contemplated in the original trust may be made. In this case, the modification will increase the amount payable to A who is a member of the same generation as B and C. In addition, the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the trust as modified will not be subject to the provisions of chapter 13 of the Internal Revenue Code. However, the modification increasing A's share of trust income is a transfer by B and C to A for Federal gift tax purposes.

Example 8. Conversion of income interest into unitrust interest. In 1980, Grantor established an irrevocable trust under the terms of which trust income is payable to A for life and, upon A's death, the remainder is to pass to A's issue, per stirpes. In 2002, the appropriate local court approves a modification to the trust that converts A's income interest into the right to receive the greater of the entire income of the trust or a fixed percentage of the trust assets valued annually (unitrust interest) to be paid each year to A for life. The modification does not result in a shift in beneficial interest to a beneficiary who occupies a lower generation (as defined in section 2651 [26 USCS § 2651]) than the person or persons who held the beneficial interest prior to the modification. In this case, the modification can only operate to increase the amount distributable to A and decrease the amount distributable to A's issue. In addition, the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

Example 9. Allocation of capital gain to income. In 1980, Grantor established an irrevocable trust under the terms of which trust income is payable to Grantor's child, A, for life, and upon A's death, the remainder is to pass to A's issue, per stirpes. Under applicable state law, unless the governing instrument provides otherwise, capital gain is allocated to principal. In 2002, the trust is modified to allow the trustee to allocate capital gain to the income. The modification does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651 [26 USCS § 2651]) than the person or persons who held the beneficial interest prior to the modification. In this case, the modification can only have the effect of increasing the amount distributable to A, and decreasing the amount distributable to A's issue. In addition, the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

Example 10. Administrative change to terms of a trust. In 1980, Grantor executed an irrevocable trust for the benefit of Grantor's issue, naming a bank and five other individuals as trustees. In 2002, the appropriate local court approves a modification of the trust that decreases the number of trustees which results in lower administrative costs. The modification pertains to the administration of the trust and does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651 [26 USCS § 2651]) than the person or persons who held the beneficial interest prior to the modification. In addition, the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

Example 11. Conversion of income interest to unitrust interest under state statute. In 1980, Grantor, a resident of State X, established an irrevocable trust for the benefit of Grantor's child, A, and A's issue. The trust provides that trust income is payable to A for life and upon A's death the remainder is to pass to A's issue, per stirpes. In 2002, State X amends its income and principal statute to define income as a unitrust amount of 4% of the fair market value of the trust assets valued annually. For a trust established prior to 2002, the statute provides that the new definition of income will apply only if all the beneficiaries who have an interest in the trust consent to the change within two years after the effective date of the statute. The statute provides specific procedures to establish the consent of the beneficiaries. A and A's issue consent to the change in the definition of income within the time period, and in accordance with the procedures, prescribed by the state statute. The administration of the trust, in accordance with the state statute defining income to be a 4% unitrust amount, will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code. Further, under these facts, no trust beneficiary will be treated as having made a gift for federal gift tax purposes, and neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes. Similarly, the conclusions in this example would be the same if the beneficiaries' consent was not required, or, if the change in administration of the trust occurred because the situs of the trust was changed to State X from a state whose statute does not define income as a unitrust amount or if the situs was changed to such a state from State X.

Example 12. Equitable adjustments under state statute. The facts are the same as in Example 11, except that in 2002, State X amends its income and principal statute to permit the trustee to make adjustments between income and principal when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that shall or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding allocation of receipts between income and principal is unable to administer the trust impartially. The provision permitting the trustees to make these adjustments is effective in 2002 for trusts created at any time. The trustee invests and manages the trust assets under the state's prudent investor standard, and pursuant to authorization in the state statute, the trustee allocates receipts between the income and principal accounts in a manner to ensure the impartial administration of the trust. The administration of the trust in accordance with the state statute will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code. Further, under these facts, no trust beneficiary will be treated as having made a gift for federal gift tax purposes, and neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes. Similarly, the conclusions in this example would be the same if the change in administration of the trust occurred because the situs of the trust was changed to State X from a state whose statute does not authorize the trustee to make adjustments between income and principal or if the situs was changed to such a state from State X.

(ii) Effective dates. The rules in this paragraph (b)(4) are generally applicable on and after December 20, 2000. However, the rule in the last sentence of paragraph (b)(4)(i)(D)(2) of this section and Example 11 and Example 12 in paragraph (b)(4)(i)(E) of this section regarding the administration of a trust and the determination of income in conformance with applicable state law applies to trusts for taxable years ending after January 2, 2004.

(5) Exceptions to additions rule -- (i) In general. Any addition to a trust made pursuant to an instrument or arrangement covered by the transition rules in paragraph (b) (1), (2) or (3) of this section is not treated as an addition for purposes of this section. Moreover, any property transferred inter vivos to a trust is not treated as an addition if the same property would have been added to the trust pursuant to an instrument covered by the transition rules in paragraph (b) (2) or (3) of this section.

(ii) Examples. The following examples illustrate the application of paragraph (b)(4)(i) of this section:

Example 1. Addition pursuant to terms of exempt instrument. On December 31, 1980, T created an irrevocable trust having a principal of $ 100,000. Under the terms of the trust, the principal was to be held for the benefit of T's grandchild, GC. Pursuant to the terms of T's will, a document entitled to relief under the transition rule of paragraph (b)(2) of this section, the residue of the estate was paid to the trust. Because the addition to the trust was paid pursuant to the terms of an instrument (T's will) that is not subject to the provisions of chapter 13 because of paragraph (b)(2) of this section, the payment to the trust is not considered an addition to the principal of the trust. Thus, distributions to or for the benefit of GC, are not subject to the provisions of chapter 13.

Example 2. Property transferred inter vivos that would have been transferred to the same trust by the transferor's will. T is the grantor of a trust that was irrevocable on September 25, 1985. T's will, which was executed before October 22, 1986, and not amended thereafter, provides that, upon T's death, the entire estate will pour over into T's trust. On October 1, 1985, T transfers $ 100,000 to the trust. While T's will otherwise qualifies for relief under the transition rule in paragraph (b)(2) of this section, the transition rule is not applicable unless T dies prior to January 1, 1987. Thus, if T dies after December 31, 1986, the transfer is treated as an addition to the trust for purposes of any distribution made from the trust after the transfer to the trust on October 1, 1985. If T dies before January 1, 1987, the entire trust (as well as any distributions from or terminations of interests in the trust prior to T's death) is exempt, under paragraph (b)(2) of this section, from chapter 13 because the $ 100,000 would have been added to the trust under a will that would have qualified under paragraph (b)(2) of this section. In either case, for any generation-skipping transfers made after the transfer to the trust on October 1, 1985, but before T's death, the $ 100,000 is treated as an addition to the trust and a proportionate amount of the trust is subject to chapter 13.

Example 3. Pour over to a revocable trust. T and S are the settlors of separate revocable trusts with equal values. Both trusts were established for the benefit of skip persons (as defined in section 2613 [26 USCS § 2613]). S dies on December 1, 1985, and under the provisions of S's trust, the principal pours over into T's trust. If T dies before January 1, 1987, the entire trust is excluded under paragraph (b)(2) of this section from the operation of chapter 13. If T dies after December 31, 1986, the entire trust is subject to the generation-skipping transfer tax provisions because T's trust is not a trust described in paragraph (b)(1) or (2) of this section. In the latter case, the fact that S died before January 1, 1987, is irrelevant because the principal of S's trust was added to a trust that never qualified under the transition rules of paragraph (b)(1) or (2) of this section.

Example 4. Pour over to exempt trust. Assume the same facts as in Example 3, except upon the death of S on December 1, 1985, S's trust continues as an irrevocable trust and that the principal of T's trust is to be paid over upon T's death to S's trust. Again, if T dies before January 1, 1987, S's entire trust falls within the provisions of paragraph (b)(2) of this section. However, if T dies after December 31, 1986, the pour-over is considered an addition to the trust. Therefore, S's trust is not a trust excluded under paragraph (b)(2) of this section because an addition is made to the trust.

Example 5. Lapse of a general power of appointment. S, the spouse of the settlor of an irrevocable trust that was created in 1980, had, on September 25, 1985, a general power of appointment over the trust assets. The trust provides that should S fail to exercise the power of appointment the property is to remain in the trust. On October 21, 1986, S executed a will under which S failed to exercise the power of appointment. If S dies before January 1, 1987, without having exercised the power in a manner which results in the creation of, or increase in the amount of, a generation-skipping transfer (or amended the will in a manner that results in the creation of, or increase in the amount of, a generation-skipping transfer), transfers pursuant to the trust or the will are not subject to chapter 13 because the trust is an irrevocable trust and the will qualifies under paragraph (b)(2) of this section.

Example 6. Lapse of general power of appointment held by intestate decedent. Assume the same facts as in Example 5, except on October 22, 1986, S did not have a will and that S dies after that date. Upon S's death, or upon the prior exercise or release of the power, the value of the entire trust is treated as having been distributed to S, and S is treated as having made an addition to the trust in the amount of the entire principal. Any distribution or termination pursuant to the trust occurring after S's death is subject to chapter 13. It is immaterial whether S's death occurs before January 1, 1987, since paragraph (b)(2) of this section is only applicable where a will or revocable trust was executed before October 22, 1986.

(c) Additional effective dates. Except as otherwise provided, the regulations under §§ 26.2611-1, 26.2612-1, 26.2613-1, 26.2632-1, 26.2641-1, 26.2642-1, 26.2642-2, 26.2642-3, 26.2642-4, 26.2642-5, 26.2652-1, 26.2652-2, 26.2653-1, 26.2654-1, 26.2663-1, and 26.2663-2 are effective with respect to generation-skipping transfers as defined in § 26.2611-1 made on or after December 27, 1995. However, taxpayers may, at their option, rely on these regulations in the case of generation-skipping transfers made, and trusts that became irrevocable, after December 23, 1992, and before December 27, 1995. The last four sentences in paragraph (b)(1)(i) of this section are applicable on and after November 18, 1999.

HISTORY: [T.D. 8187, 53 FR 8442, Mar. 15, 1988; 53 FR 13464, Apr. 25, 1988; 53 FR 18839, May 25, 1988; T.D. 8644, 60 FR 66898, 66904, Dec. 27, 1995, as corrected at 61 FR 29653, June 12, 1996 and 61 FR 43656, Aug. 26, 1996; T.D. 8912, 65 FR 79735, 79738, Dec. 20, 2000, as corrected at 66 FR 11108, Feb. 22, 2001, and at 66 FR 12834, Feb. 28, 2001; T.D. 9102, 69 FR 12, 21, Jan. 2, 2004]

AUTHORITY: AUTHORITY NOTE APPLICABLE TO ENTIRE PART:
26 U.S.C. 7805 and 26 U.S.C. 2663.
Section 26.2632-1 also issued under 26 U.S.C. 2632 and 2663.
Section 26.2642-4 also issued under 26 U.S.C. 2632 and 2663.
Section 26.2662-1 also issued under 26 U.S.C. 2662.
Section 26.2663-2 also issued under 26 U.S.C. 2632 and 2663.
Section 26.6060-1 also issued under 26 U.S.C. 6060(a).
Section 26.6109-1 also issued under 26 U.S.C. 6109(a).
Section 26.6109-2 also issued under 26 U.S.C. 6109(a).
Section 26.6695-1 also issued under 26 U.S.C. 6695(b).

NOTES: [EFFECTIVE DATE NOTE: 69 FR 12, 21, Jan. 2, 2004, amended this section, effective Jan. 2, 2004.]