[T.D. 8644, 60 FR 66903, Dec. 27, 1995, as amended by T.D. 8912, 65 FR 79738, Dec. 20, 2000; T.D. 9208, 70 FR 37260, June 29, 2005; T.D. 9214, 70 FR 41141, July 18, 2005; T.D. 9348, 72 FR 42294, Aug. 2, 2007; T.D. 9421, 73 FR 44650, July 31, 2008]

§ 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) 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)) 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)) in existence on September 25, 1985, is considered an irrevocable trust.

(B) *Property includible in the gross estate under section 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 (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.* A policy of insurance on an individual's life that is treated as a trust under section 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, 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 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 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 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 of the 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. Thus, the trust is considered an irrevocable trust for purposes of this section.

Example 3. Section 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 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)) 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 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) or section 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). 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) 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).

(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) 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) to reverse the effect of the section 2523(f) election for chapter 13 purposes.

Example 2. Section 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)). 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)) 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. 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 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) 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) 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), 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 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:

$$\frac{\text{Value of addition}}{\text{Total value of trust}} = \frac{\$100{,}000}{\$400{,}000 + \$100{,}000} = .2$$

(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 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 ($600,000×.2). The new allocation fraction is computed as follows:

$$\frac{\text{Total value of additions}}{\text{Total value of trust}} = \frac{\$120{,}000 + \$40{,}000}{\$600{,}000 + \$40{,}000} = \frac{\$160{,}000}{\$640{,}000} = .25$$

(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 ($800,000×.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)) 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 in the case of an election under section 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 × .5) is included in S's gross estate under section 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)). 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 × .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 × .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 (.2 × $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). 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)) 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)) 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. 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 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)) 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.* This paragraph (b)(4) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the generation-skipping transfer tax under paragraph (b)(1), (2), or (3) of this section (hereinafter referred to as an

exempt trust) will not cause the trust to lose its exempt status. 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.

(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) 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) 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) 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) 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) 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) 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) 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) 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). 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.

[T.D. 8644, 60 FR 66903, Dec. 27, 1995; 61 FR 29653, June 12, 1996, as amended at 61 FR 43656, Aug. 26, 1996; T.D. 8912, 65 FR 79738, Dec. 20, 2000; 66 FR 11108, Feb. 22, 2001; 66 FR 12834, Feb. 28, 2001; T.D. 9102, 69 FR 21, Jan. 2, 2004]

§ 26.2611–1 Generation-skipping transfer defined.

A generation-skipping transfer (GST) is an event that is either a direct skip, a taxable distribution, or a taxable termination. See § 26.2612–1 for the definition of these terms. The determination as to whether an event is a GST is made by reference to the most recent transfer subject to the estate or gift tax. See § 26.2652–1(a)(2) for determining whether a transfer is subject to Federal estate or gift tax.

§ 26.2612–1 Definitions.

(a) *Direct skip.* A direct skip is a transfer to a skip person that is subject to Federal estate or gift tax. If property is transferred to a trust, the transfer is a direct skip only if the trust is a skip person. Only one direct skip occurs when a single transfer of property skips two or more generations. See paragraph (d) of this section for the definition of skip person. See § 26.2652–1(b) for the definition of trust. See § 26.2632–1(c)(4) for the time that a direct skip occurs if the transferred property is subject to an estate tax inclusion period.

(b) *Taxable termination*—(1) *In general.* Except as otherwise provided in this paragraph (b), a taxable termination is a termination (occurring for any reason) of an interest in trust unless—

(i) A transfer subject to Federal estate or gift tax occurs with respect to the property held in the trust at the time of the termination;

(ii) Immediately after the termination, a person who is not a skip person has an interest in the trust; or

(iii) At no time after the termination may a distribution, other than a distribution the probability of which occurring is so remote as to be negligible (including a distribution at the termination of the trust) be made from the trust to a skip person. For this purpose, the probability that a distribution will occur is so remote as to be negligible only if it can be ascertained by actuarial standards that there is less than a 5 percent probability that the distribution will occur.

(2) *Partial termination.* If a distribution of a portion of trust property is made to a skip person by reason of a termination occurring on the death of a lineal descendant of the transferor, the termination is a taxable termination with respect to the distributed property.

(3) *Simultaneous terminations.* A simultaneous termination of two or more interests creates only one taxable termination.

(c) *Taxable distribution*—(1) *In general.* A taxable distribution is a distribution of income or principal from a trust to a skip person unless the distribution is a taxable termination or a direct skip. If any portion of GST tax (including penalties and interest thereon) imposed on a distributee is paid from the distributing trust, the payment is an additional taxable distribution to the distributee. For purposes of chapter 13, the additional distribution is treated as having been made on the last day of the calendar year in which the original taxable distribution is made. If Federal estate or gift tax is imposed on any individual with respect to an interest in property held by a trust, the interest in property is treated as having been distributed to the individual to the extent that the value of the interest is subject to Federal estate or gift tax. See § 26.2652–1(a)(6) *Example 5*, regarding the treatment of the lapse of a power of appointment as a transfer to a trust.

(2) *Look-through rule not to apply.* Solely for purposes of determining whether any transfer from a trust to another trust is a taxable distribution, the rules of section 2651(e)(2) do not apply. If the transferring trust and the