title XVI overpayment by regular monthly installments.

(2) We will not apply cross-program recovery against your title II benefits while we are recovering a title II overpayment by adjusting your title II benefits under § 404.502 of this chapter.

(3) We will not apply cross-program recovery against your title VIII benefits while we are recovering a title VIII overpayment by adjusting your title VIII benefits under §§ 408.922 through 408.923 of this chapter.

§ 416.573 How much will we withhold from your title II and title VIII benefits to recover a title XVI overpayment?

(a) If past-due benefits are payable to you, we will withhold the lesser of the entire overpayment balance or the entire amount of past-due benefits.

(b)(1) We will collect the overpayment from current monthly benefits due in a month by withholding the lesser of the amount of the entire overpayment balance or 10 percent of the monthly title II benefits and monthly title VIII benefits payable to you in the month.

(2) If we are already recovering a title II, title VIII or title XVI overpayment from your monthly title II benefit, we will figure your monthly withholding from title XVI (as described in § 416.571) without including your title II income in your total countable income.

(3) Paragraph (b)(1) of this section does not apply if:

(i) You request and we approve a different rate of withholding, or

(ii) You or your spouse willfully misrepresented or concealed material information in connection with the overpayment.

(c) In determining whether to grant your request that we withhold less than the amount described in paragraph (b)(1) of this section, we will use the criteria applied under § 416.571 to similar requests about withholding from title XVI benefits.

(d) If you or your spouse willfully misrepresented or concealed material information in connection with the overpayment, we will collect the overpayment by withholding the lesser of the overpayment balance or the entire amount of title II benefits and title VIII benefits payable to you. We will not collect at a lesser rate. (*See* § 416.571 for what we mean by concealment of material information.)

§ 416.574 Will you receive notice of our intention to apply cross-program recovery?

Before we collect an overpayment from you using cross-program recovery, we will send you a written notice that tells you the following information:

(a) We have determined that you owe a specific overpayment balance that can be collected by cross-program recovery;

(b) We will withhold a specific amount from the title II or title VIII benefits (see § 416.573);

(c) You may ask us to review this determination that you still owe this overpayment balance;

(d) You may request that we withhold a different amount from your current monthly benefits (the notice will not include this information if § 416.573(d) applies); and

(e) You may ask us to waive collection of this overpayment balance.

§ 416.575 When will we begin cross-program recovery from your current monthly benefits?

(a) We will begin collecting the overpayment balance by cross-program recovery from your current monthly title II and title VIII benefits no sooner than 30 calendar days after the date of the notice described in § 416.574. If within that 30-day period you pay us the full overpayment balance stated in the notice, we will not begin cross-program recovery.

(b) If within that 30-day period you ask us to review our determination that you still owe us this overpayment balance, we will not begin cross-program recovery from your current monthly benefits before we review the matter and notify you of our decision in writing.

(c) If within that 30-day period you ask us to withhold a different amount from your current monthly benefits than the amount stated in the notice, we will not begin cross-program recovery until we determine the amount we will withhold. This paragraph does not apply when § 416.573(d) applies.

(d) If within that 30-day period you ask us to waive recovery of the overpayment balance, we will not begin cross-program recovery from your current monthly benefits before we review the matter and notify you of our decision in writing. *See* §§ 416.550 through 416.556.

[FR Doc. 04–19321 Filed 8–23–04; 8:45 am]

BILLING CODE 4191–02–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 26

[REG–145987–03]

RIN 1545–BC50

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

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

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

DATES: Written or electronic comments and requests for a public hearing must be received by November 22, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–145987–03), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG–145987–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the IRS Internet site at *http://www.irs.gov/regs* or via the Federal eRulemaking Portal at *http://www.regulations.gov* (IRS–REG–145987–03).

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

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP; Washington, DC

20224. Comments on the collection of information should be received by October 25, 2004. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in this proposed regulation is in § 26.2642–6(b). This collection of information is required by the IRS to identify whether a trust is exempt from the GST. This information will be used to determine whether the amount of tax has been calculated correctly. The collection of information is required in order to have a qualified severance. The respondents are trustees of trusts that are being severed.

Estimated total annual reporting burden: 12,500 hours.

Estimated average annual burden hours per respondent: 30 minutes.

Estimated number of respondents: 25,000.

Estimated annual frequency of responses: on occasion.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget. Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Section 2642(a)(3) was added to the Internal Revenue Code by EGTRRA, Public Law 107–16 (115 Stat. 38 (2001)). Under section 2642(a)(3), if a trust is divided into two or more trusts in a qualified severance, the resulting trusts will be recognized as separate trusts for GST tax purposes. In many cases, a qualified severance of a trust will facilitate the most efficient and effective use of the transferor's GST tax exemption. The GST tax exemption is the lifetime exemption applicable in determining the inclusion ratio with respect to the trust, which in turn determines the amount of GST tax imposed on any generation-skipping transfer made from the trust.

Section 2642(a)(3) expands the options for trustees wishing to sever trusts by providing more time to make the severance, providing that severances may occur for more trusts, and providing a uniform system for severance. Section 2642(a)(3) was intended to supercede and replace § 26.2654–1(b) of the Generation-Skipping Transfer Tax Regulations, which authorizes the recognition of severed trusts for GST tax purposes in limited situations involving testamentary trusts or inter vivos trusts that are included in the transferor's gross estate for estate tax purposes. That regulation does not apply to irrevocable inter vivos trusts that are not includible in the decedent's gross estate. Further, under that regulation, a severance is recognized only if commenced within a prescribed time period, and only if specifically authorized under the terms of the governing instrument or local law.

Section 2642(a)(3)(B)(i) provides a general rule that a qualified severance is defined as the division of a single trust and the creation of two or more trusts if: (1) The single trust is divided on a fractional basis; and (2) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust. Under section 2642(a)(3)(B)(ii), if a trust has an inclusion ratio that is greater than zero and less than one, the trust must be severed in a specified manner that produces one trust that is wholly exempt from GST tax, and one trust that is wholly subject to GST tax. Each of the two new trusts created may be further divided into two or more trusts under section 2642(a)(3)(B)(i). Under section 2642(a)(3)(C), a trustee may elect to sever a trust in a qualified severance at any time, and the manner in which the qualified severance is to be reported is to be specified by regulation. Section 2642(a)(3) is applicable for severances of trusts occurring after December 31, 2000.

Explanation of Provisions

I. Division on a Fractional Basis

Under section 2642(a)(3), in order to constitute a qualified severance, the single trust must be divided on a fractional basis. Under the proposed regulations, each new trust must receive assets with a value equal to a fraction or percentage of the total value of the trust assets. Thus, for example, the severance of a single trust on the basis that one trust is to be funded with 30% of the trust assets and that the other trust is to be funded with the remaining 70% of the trust assets would satisfy this requirement. Similarly, a severance stated in terms of a fraction of the trust assets such that one trust is to receive, for example, that fraction of the trust assets the numerator of which is $1,500,000 and the denominator of which is the fair market value of the trust assets on a specified date and the second trust is to receive the remaining fraction, would also satisfy this requirement. However, the severance of a trust based on a pecuniary amount (for example, severance of a single trust on the basis that one trust is to be funded with $1,500,000, and the other trust is to be funded with the balance of the trust corpus) would not satisfy this requirement.

The proposed regulations provide that each separate trust need not be funded with a pro rata portion of each asset held by the original trust. Rather, the separate trusts may be funded on a non pro rata basis (that is, where each resulting trust does not receive a pro-rata portion of each asset) provided that funding is based on the total fair market value of the assets on the date of funding. This avoids the necessity of dividing each and every asset on a fractional basis to fund the severed trusts.

II. New Trusts Must Provide for the Same Succession of Interests

Under section 2642(a)(3)(B)(i)(II), the new trusts created as a result of the qualified severance must provide in the aggregate for the same succession of interests of beneficiaries as provided in the original trust. Under the regulations, the beneficiaries of each separate trust resulting from the severance need not be identical to those of the original trust. In the case of trusts that grant the trustee the discretionary power to make non pro rata distributions to beneficiaries, the separate trusts will be considered to have the same succession of interests of beneficiaries if the terms of the separate trusts are the same as the terms of the original trust, the severance does not shift a beneficial interest in the trust to any beneficiary in a lower generation (as determined under section 2651) than the person or persons who held the beneficial interest in the original trust, and the severance does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. This rule for discretionary trusts is intended to facilitate the severance of trusts along family lines.

In this regard, the Treasury Department and the IRS recognize that in many cases involving discretionary trusts, when the members of two or more families are beneficiaries, the parties may desire to divide the trust along family lines so that one trust is established exclusively for the benefit of one family and one trust is established exclusively for the benefit of another family. If the inclusion ratio of the trust is between zero and one, section 2642(a)(3)(B)(ii) would ordinarily, as a practical matter, preclude the division of the trust along family lines because the section requires that the severance result in one trust with an inclusion ratio of zero and one trust with an inclusion ratio of one. However, under the proposed regulations, a similar result may be accomplished through a series of severances; that is, first a division of the trust based on the inclusion ratio, and then a division of each resulting trust along family lines.

Finally, § 26.2601–1(b)(4) of the regulations contains rules for determining when certain actions with respect to a non-chapter 13 trust (a trust that was irrevocable on or before September 25, 1985) will not cause the trust to lose its exempt status. In particular, under § 26.2601–1(b)(4)(i)(D)(1), a modification (including a severance) of a non-chapter 13 trust will not cause the trust to be subject to the provisions of chapter 13 if the modification does not (1) shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the modification or (2) extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

Under the proposed regulations, the rules in § 26.2601–1(b)(4) will continue to apply to severances (and other actions) with respect to trusts created on or before September 25, 1985. However, the post-2000 severance of a trust created after September 25, 1985, will be governed by section 2642(a)(3) and the applicable regulations.

III. Reporting Requirements

The proposed regulations provide that a qualified severance is to be reported by filing a Form 706–GS(T), ''Generation-Skipping Transfer Tax Return for Terminations,'' or such other form that may be published by the IRS in the future that is specifically designated to be utilized to report qualified severances. When Form 706–GS(T) is utilized, the filer should write ''Qualified Severance'' in red at the top of the return and attach a Notice of Qualified Severance to the return that clearly identifies the trust that is being severed and the new trusts created as a result of the severance. The notice must also provide the inclusion ratio of the trust that was severed and the inclusion ratios of the new trusts resulting from the severance. The return and attached notice must be filed even if the severance does not result in a taxable termination. A transition rule applies in the case of severances occurring before the date of publication of the final regulations.

IV. Income Tax Consequences of Severance Under the Proposed Regulations

The proposed regulations provide that a qualified severance will not constitute an exchange of property for other property differing materially either in kind or in extent, for purposes of section 1001, provided that: (1) An applicable state statute or the governing instrument authorizes the trustee to sever the trust; and (2) if the separate trusts created by the severance are funded on a non pro rata basis, as discussed in Section I above, an applicable state statute or the governing instrument authorizes the trustee to fund the separate trusts on a non pro rata basis. If section 1001 does not apply in accordance with this standard, then under section 1015, the basis of the trust assets will be the same after the severance as the basis of those assets before the severance, and under section 1223, the holding periods of the assets distributed to the new trusts will include the holding period of the assets in the original trust.

V. Proposed Effective Date

Section 2642(a)(3) supercedes the regulatory rules contained in § 26.2654–1(b). Accordingly, under the proposed regulations, the applicability of § 26.2654–1(b) is limited to severances occurring on or before December 31, 2000. The regulations under section 2642(a)(3), as proposed, apply to severances occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations. In the case of severances occurring after December 31, 2000, and before publication of final regulations, taxpayers may rely on any reasonable interpretation of section 2642(a)(3) as long as reasonable notice concerning the severance and identification of the trusts involved has been given to the IRS.

The regulations under section 1001, as proposed, apply to severances occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations. However, taxpayers may apply the proposed regulations under section 1001 to severances occurring after August 24, 2004, and before publication of final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the collection of information imposed by this regulation is not significant as reflected in the estimated burden of information collection for, which is 0.5 hours per respondent, and that few trustees are likely to be small entities. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the substance of the proposed regulations, as well as on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is Mayer R.

Samuels, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. If you have any questions concerning these proposed regulations, please contact Mayer R. Samuels at (202) 622–3090. Other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 26

Estate taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 26 are proposed to be amended as follows:

PART 1—INCOME TAXES

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

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

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

§ 1.1001–1 Computation of gain or loss.

* * * * *

(h) *Qualified severances of trusts*—(1) *In general.* A severance of a trust that meets the requirements of § 26.2642–6 is not an exchange of property for other property differing materially either in kind or in extent if—

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

(ii) If the separate trusts created by the severance are funded on a non pro rata basis as provided in § 26.2642–6(b)(3), an applicable state statute or the governing instrument authorizes the trustee to fund the separate trusts on a non pro rata basis.

(2) *Effective date.* This paragraph (h) applies to severances occurring on or after the date these regulations are published as final regulations in the **Federal Register**. Taxpayers may apply this paragraph (h) to severances occurring on or after August 24, 2004, and before the date these regulations are published as final regulations in the **Federal Register**.

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

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

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

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

Par. 4. In § 26.2600–1, the table is amended as follows.

1. An entry for § 26.2642–6 is added.

2. The entry for § 26.2654–1(b) introductory text is revised.

3. An entry for § 26.2654–1(c) is added.

The revision and additions read as follows:

§ 26.2600–1 Table of contents.

* * * * *

§ 26.2642–6 Qualified Severance

* * * * *

§ 26.2654–1 Certain Trusts Treated as Separate Trusts

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

§ 26.2642–6 Qualified severance.

(a) *In general.* If a trust is severed into two or more trusts, the separate trusts resulting from the severance will be treated as separate trusts for generation-skipping transfer tax purposes only if the severance is a qualified severance. In general, the rules in this section are applicable only for purposes of the generation-skipping transfer tax and are not applicable in determining, for example, whether the severance may result in a gift subject to gift tax, cause the trust to be included in the gross estate of a beneficiary, or result in a realization of gain for purposes of section 1001. *See* § 1.1001–1(h) for rules relating to whether a qualified severance will constitute an exchange of property for other property differing materially either in kind or in extent.

(b) *Requirements for a qualified severance.* For purposes of this section, a qualified severance is a division of a single trust into two or more trusts that meets each of the following requirements:

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

(2) The severance is effective under local law.

(3) The single trust is severed on a fractional basis, such that each new trust is funded with a fraction or percentage of the entire trust. For this purpose, the fraction or percentage may be determined by means of a formula (for example, that fraction of the trust the numerator of which is equal to transferor's unused GST tax exemption, and the denominator of which is the fair market value of the trust assets on the date of severance). The severance of a trust based on a pecuniary amount does not satisfy this requirement. For example, the severance of a trust would not be a qualified severance if the trust was divided into two trusts, with one trust to be funded with $1,500,000 and the other trust to be funded with the balance of the original trust assets. For purposes of this paragraph, the separate trusts resulting from the severance may be funded with the appropriate fraction, percentage, or pro rata portion of each asset held by the undivided trust, or on a non pro rata basis. However, if funded on a non pro rata basis, each resulting trust must be funded by applying the appropriate fraction or percentage to the total fair market value of the trust assets as of the date of funding.

(4) The terms of the new trusts must provide, in the aggregate, for the same succession of interests of beneficiaries as are provided in the original trust. This requirement will be satisfied if the beneficiaries of the separate trusts and the interests of the beneficiaries with respect to the separate trusts, when the separate trusts are viewed collectively, are identical to the beneficiaries and their respective beneficial interests with respect to the original trust before severance. With respect to trusts from which discretionary distributions may be made to any one or more beneficiaries on a non pro rata basis, this requirement will be satisfied if the terms of each of the separate trusts are the same as the terms of the original trust (even though each permissible distributee of the original trust might be a beneficiary of only one of the separate trusts), the severance does not shift a beneficial interest in the trust to any beneficiary in a lower generation (as determined under section 2651) than the person or persons who held the beneficial interest in the original trust, and the severance does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

(5) In the case of a severance after GST tax exemption has been allocated to the trust as a result of an allocation, deemed allocation, or automatic

allocation pursuant to the rules contained in section 2632, if the trust has an inclusion ratio as defined in § 26.2642–1 that is greater than zero and less than one, then the trust may be severed initially only into two trusts. One separate trust must receive that fractional share of the total value of all trust assets as of the date of funding equal to the applicable fraction, as defined in § 26.2642–1(b) and (c), with respect to the single trust immediately before the severance. The other separate trust must receive the balance of the trust assets. The trust receiving the fractional share equal to the applicable fraction shall have an inclusion ratio of zero, and the other trust shall have an inclusion ratio of one. If the applicable fraction with respect to the original trust is .50, then with respect to the two equal trusts resulting from the severance, the Trustee may designate which of the resulting trusts will have an inclusion ratio of zero and which will have an inclusion ratio of one. Each separate trust resulting from the severance may be further divided in accordance with the rules of this section.

(6) The severance is reported by filing Form 706–GS(T), ''Generation-Skipping Transfer Tax Return for Terminations,'' or such other form that may be published by the IRS that is specifically designated to be utilized to report qualified severances. When Form 706–GS(T) is utilized, the filer should write ''Qualified Severance'' in red at the top of the return and attach a Notice of Qualified Severance to the return. The Notice must contain: a statement identifying the trust that is severed, the name of the transferor of the trust, the date of creation, the tax identification number, and the inclusion ratio with respect to the trust before severance; and a statement identifying each of the new trusts created as a result of the severance, the name and tax identification number of each new trust, the fraction of trust assets received by each new trust, other details explaining the basis for funding each new trust (a fraction of the total fair market value of the assets on the date of funding or a fraction of each asset), and the inclusion ratio of each new trust. The return and attached Notice must be filed by April 15th of the year immediately following the year during which the severance occurred or the last day of the period covered by an extension of time, if an extension of time is granted.

(c) *Time for making a qualified severance.* A trust may be severed in a qualified severance at any time prior to the termination of the trust. Thus, provided that the separate trusts resulting from the severance continue in existence after the severance, a trust may be severed in a qualified severance either before or after: GST tax exemption has been allocated to the trust; a taxable event has occurred with respect to the trust; or an addition has been made to the trust. A qualified severance is effective at the time the trust is divided into two or more separate trusts. Thus, a qualified severance has no effect on a taxable termination as defined in section 2612(a) or a taxable distribution as defined in section 2612(b) that occurred prior to the effective date of the qualified severance.

(d) *Irrevocable trusts.* See § 26.2601–1(b)(4) for rules regarding severances and other actions with respect to trusts that were irrevocable on September 25, 1985.

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

Example 1. Formula severance. T's will establishes a testamentary marital trust (Trust) that qualifies as qualified terminable interest property (QTIP) under section 2056(b)(7). Trust provides that all trust income is to be paid to T's spouse for life. On the spouse's death, the trust corpus is to be held in further trust for the benefit of T's then-living descendants. On T's date of death in January of 2004, T's unused GST tax exemption is $1,200,000, $200,000 of which T's executor will allocate to bequests to T's grandchildren. Prior to the due date for filing the Form 706, ''United States Estate (and Generation-Skipping Transfer) Tax Return,'' for T's estate, and thus, prior to the allocation of any GST tax exemption with respect to Trust, T's executor, pursuant to applicable state law, divides Trust into two separate trusts, Trust 1 and Trust 2. Trust 1 is to be funded with that fraction of the Trust assets, the numerator of which is $1,000,000, and the denominator of which is the value of the Trust assets as finally determined for federal estate tax purposes. Trust 2 is to be funded with the balance of the Trust assets. On the Form 706 filed for the estate, T's executor makes a QTIP election under section 2056(b)(7) with respect to Trust 1 and Trust 2 and a *reverse* QTIP election under section 2652(a)(3) with respect to Trust 1. Further, T's executor allocates T's available GST tax exemption to Trust 1. If the requirements of section 2642(a)(3) are otherwise satisfied, the severance constitutes a qualified severance. Accordingly, Trust 1 and Trust 2 are treated as separate trusts, and the GST tax elections and GST tax exemption allocation are recognized and effective for generation-skipping transfer tax purposes.

Example 2. Severance of single trust with one income beneficiary. T's will establishes a testamentary trust providing that income is to be paid to T's sister, S, for her life. On S's death, one-half of the corpus is to be paid to T's child, C, or to C's estate if C fails to survive S and one-half of the corpus is to be paid to T's grandchild, GC, or to GC's estate if GC fails to survive S. Prior to the due date for filing the Form 706, T's executor, pursuant to applicable state law, divides the testamentary trust into two separate trusts, Trust 1 and Trust 2, with each trust receiving 50 percent of the current value of the assets of the original trust. Trust 1 provides that trust income is to be paid to S for life with remainder to C or C's estate, and Trust 2 provides that trust income is to be paid to S for life with remainder to GC or GC's estate. Because Trust 1 and Trust 2 provide for the same succession of interests in the aggregate as provided in the original trust, the severance will constitute a qualified severance if the requirements of section 2642(a)(3) are otherwise satisfied. On the Form 706, T's executor may allocate T's available GST tax exemption to Trust 2.

Example 3. Severance of discretionary trust. T's will establishes a testamentary trust (Trust) providing that income is to be paid from time to time in such amounts as the trustee deems advisable to T's children, A and B, and to their respective descendants. In addition, the trustee may distribute corpus to any trust beneficiary in such amounts as the trustee deems advisable. On the death of the last to die of A and B, the trust is to terminate and the corpus is to be distributed in two equal shares, one share to the descendants of each child, per stirpes. Prior to the due date for filing the Form 706, T's executor, pursuant to applicable state law, divides Trust into two separate trusts, Trust 1 and Trust 2. Trust 1 provides that income is to be paid in such amounts as the trustee deems advisable to A and A's descendants. In addition, the trustee may distribute corpus to any trust beneficiary in such amounts as the trustee deems advisable. On the death of A, Trust 1 is to terminate and the corpus is to be distributed to the descendants of A, per stirpes, but if A dies with no living descendants, the principal will be added to Trust 2. Trust 2 contains identical provisions, except that B and B's descendants are the trust beneficiaries and, if B dies with no living descendants, the principal will be added to Trust 1. Because Trust 1 and Trust 2 provide for the same beneficiaries and the same succession of interests in the aggregate as provided in Trust, and because the severance does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation than the person or persons who held the beneficial interest in Trust, the severance constitutes a qualified severance if the requirements of section 2642(a)(3) are otherwise satisfied.

Example 4. Severance of single trust with two income beneficiaries. T's will establishes a testamentary trust (Trust) providing that Trust income is to be paid to T's children, A and B, for their joint lives. Upon the death of the first to die of A and B, the income will be paid to the survivor. At the death of the survivor of A and B, the corpus is to be distributed equally to T's grandchildren, W and X (with any then-deceased grandchild's share being paid to that grandchild's estate). W is A's child and X is B's child. Prior to the due date for filing Form 706, T's executor divides the testamentary trust equally into two separate trusts, Trust 1 and Trust 2. Trust 1 provides that trust income is to be paid to A for life and, on A's death, the remainder is to pass to W. Trust 2 provides that trust income is to be paid to B for life and the remainder on B's death to X. Because Trust 1 and Trust 2 do not provide A and B with contingent survivor income interests as provided under the terms of the original trust, Trust 1 and Trust 2 do not provide for the same succession of interests in the aggregate as provided in Trust. Therefore, the division is not a qualified severance, and Trust 1 and Trust 2 are treated as one trust. If, however, in this example, Trust 1 instead provides that trust income is to be paid to A for life and then to B (if B survives A), with remainder to W, and if Trust 2 instead provides that trust income is to be paid to B for life and then to A (if A survives B), with remainder to X, then Trust 1 and Trust 2 would provide for the same succession of interests in the aggregate as provided in Trust, and the severance would constitute a qualified severance.

Example 5. Severance of a trust with a 50% inclusion ratio. On September 1, 2004, T transfers $100,000 to a trust for the benefit of T's grandchild, GC. On a timely filed Form 709, ''United States Gift (and Generation-Skipping Transfer) Tax Return,'' reporting the transfer, T allocates all of T's remaining GST tax exemption ($50,000) to the trust. As a result of the allocation, the applicable fraction with respect to the trust is .50 [$50,000 (the amount of GST tax exemption allocated to the trust) divided by $100,000 (the value of the property transferred to the trust)]. The inclusion ratio with respect to the trust is .50[1–.50]. In 2006, pursuant to authority granted under applicable state law, the trustee severs the trust into two trusts, Trust 1 and Trust 2, each of which receives a 50 percent fractional share of the total value of all trust assets at that time. Because the applicable fraction with respect to the original trust is .50 and the trust was severed into two equal trusts, the trustee may designate which trust has an inclusion ratio of one, and which trust has an inclusion ratio of zero. Accordingly, in the Notice of Qualified Severance reporting the severance, the trustee designates Trust 1 as having an inclusion ratio of zero, and Trust 2 as having an inclusion ratio of one.

Example 6. Funding of severed trusts on a non pro rata basis. T's will establishes a testamentary trust (Trust) for the benefit of T's descendants, to be funded with T's stock in Corporation A and Corporation B. T dies on May 1, 2004, at which time the Corporation A stock included in T's gross estate has a fair market value of $100,000 and the stock of Corporation B included in T's gross estate has a fair market value of $200,000. On a timely filed Form 706, T's executor allocates all of T's remaining GST tax exemption ($270,000) to Trust. As a result of the allocation, the applicable fraction with respect to Trust is .90 [$270,000 (the amount of GST tax exemption allocated to the trust) divided by $300,000 (the value of the property transferred to the trust)]. The inclusion ratio with respect to Trust is .10 [1–.90]. On August 1, 2008, when the value of the Trust assets totals $500,000, consisting of Corporation A stock worth $450,000 and Corporation B stock worth $50,000, the trustee severs Trust into two identical trusts, Trust 1 and Trust 2. The terms of the instrument severing Trust provides that Trust 1 is to be funded on a non pro rata basis with assets having a fair market value on the date of funding equal to 90% of the value of the Trust assets on that date, and Trust 2 is to be funded with assets having a fair market value on the date of funding equal to 10% of the value of the Trust assets on that date. Also on August 1, 2008, the trustee funds Trust 1 with all of the Corporation A stock and funds Trust 2 with all of the Corporation B stock. Accordingly, Trust 1 is funded with assets having a value equal to 90% of the value of Trust as of the date of funding, August 1, 2008, and Trust 2 is funded with assets having a value equal to 10% of the value of Trust as of the date of funding. Therefore, if the requirements of section 2642(a)(3) are otherwise satisfied, the severance constitutes a qualified severance. Trust 1 will have an inclusion ratio of zero and Trust 2 will have an inclusion ratio of one.

Example 7. Severance of a trust along family lines. T dies on October 1, 2004. T's will establishes a testamentary trust (Trust) to be funded with $1,000,000. Trust income is to be paid to T's child, S, for S's life. On S's death, Trust is to terminate and the assets are to be divided equally among T's three grandchildren, GC1, GC2, and GC3 (or their respective descendants, per stirpes). On a timely filed Form 706, T's executor allocates all of T's remaining GST tax exemption ($300,000) to Trust. As a result of the allocation, the applicable fraction with respect to the trust is .30 [$300,000 (the amount of GST tax exemption allocated to the trust) divided by $1,000,000 (the value of the property transferred to the trust)]. The inclusion ratio with respect to the trust is .70 [1–.30]. On June 1, 2007, the trustee determines that it is in the best interest of the beneficiaries to sever Trust to provide a separate trust for each of T's three grandchildren and their respective families. The trustee severs Trust into two identical trusts, Trust 1 and Trust 2, each trust providing that trust income is to be paid to S, for life, and on S's death, the trust is to terminate and the assets are to be divided equally among GC1, GC2, and GC3 (or their respective descendants, per stirpes). The terms of the instrument severing Trust provide that Trust 1 is to receive 30% of the Trust assets and Trust 2 is to receive 70% of the Trust assets. Further, each trust is to be funded with a pro rata portion of each asset held in Trust. The trustee then severs Trust 1 into three equal trusts, Trust GC1, Trust GC2, and Trust GC3. Each trust is named for a grandchild of T and provides that trust income is to be paid to S for life, and on S's death, the trust is to terminate and the trust proceeds distributed to the respective grandchild for whom the trust is named. If that grandchild has predeceased the termination date, the trust proceeds are to be distributed to that grandchild's then-living descendants, per stirpes, or, if none, to the other grandchildren (or their respective then-living descendants, per stirpes). Each trust is to be funded with a pro rata portion of each Trust 1 asset. The trustee also severs Trust 2 in a similar manner, into Trust GC1(2), Trust GC2(2), and Trust GC3(2). If the requirements of section 2642(a)(3) are otherwise satisfied, the severance of Trust into Trust 1 and Trust 2, the severance of Trust 1 into Trust GC1, Trust GC2, Trust GC3, and the severance of Trust 2 into Trust GC1(2), Trust GC2(2) and Trust GC3(2), constitute qualified severances. Trust GC1, Trust GC2, Trust GC3 will each have an inclusion ratio of zero and Trust GC1(2), Trust GC2(2) , and Trust GC3(2) will each have an inclusion ratio of one.

(f) *Effective date.* (1) This section applies to severances occurring on or after the date that this document is published in the **Federal Register** as final regulations.

(2) *Transition rule.* In the case of severances occurring after December 31, 2000, and before the date that this document is published in the **Federal Register** as a final regulation, taxpayers may rely on any reasonable interpretation of section 2642(a)(3) as long as reasonable notice concerning the severance and identification of the trusts involved has been given to the IRS. For this purpose, these proposed regulations are treated as a reasonable interpretation of the statute. For purposes of the notification requirement contained in § 26.2642–6(b)(6), notification will be deemed timely if mailed by April 15th of the year immediately following the year during which the severance occurred or the last day of the period covered by an extension of time, if an extension of time is granted. For severances occurring between December 31, 2000, and January 1, 2004, notification will be deemed timely if mailed by November 22, 2004.

Par. 6. Section 26.2654–1 is amended as follows:

1. The paragraph heading for (b) and the introductory text of paragraph (b)(1) are revised.

2. Paragraph (c) is added.

The revision and addition reads as follows:

§ 26.2654–1 Certain trusts treated as separate trusts.

* * * * *

(b) *Division of a trust included in the gross estate occurring on or before December 31, 2000*—(1) *In general.* If a trust that is included in the transferor's gross estate (or created under the transferor's will) is severed on or before December 31, 2000, into two or more trusts, the severance is recognized for purposes of chapter 13 if—

* * * * *

(c) *Qualified severance occurring after December 31, 2000.* For rules applicable to the severance of a trust for GST tax purposes occurring after December 31, 2000, *see* § 26.2642–6.

Deborah M. Nolan,

Acting Deputy Commissioner for Services and Enforcement.

[FR Doc. 04–19352 Filed 8–23–04; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF THE TREASURY

31 CFR Part 103

RIN 1506–AA67

Financial Crimes Enforcement Network; Amendment to the Bank Secrecy Act Regulations—Imposition of Special Measure Against Infobank as a Financial Institution of Primary Money Laundering Concern

AGENCY: Financial Crimes Enforcement Network (FinCEN), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: FinCEN is issuing this notice of proposed rulemaking to impose a special measure against Infobank as a financial institution of primary money laundering concern, pursuant to the authority contained in 31 U.S.C. 5318A of the Bank Secrecy Act.

DATES: Written comments on the notice of proposed rulemaking must be submitted on or before September 23, 2004.

ADDRESSES: You may submit comments, identified by RIN 1506–AA67, by any of the following methods:

• *Federal e-rulemaking portal: http://www.regulations.gov.* Follow the instructions for submitting comments.

• *E-mail: regcomments@fincen.treas.gov.* Include RIN 1506–AA67 in the subject line of the message.

• *Mail:* FinCEN, P.O. Box 39, Vienna, VA 22183. Include RIN 1506–AA67 in the body of the text.

Instructions: It is preferable for comments to be submitted by electronic mail because paper mail in the Washington, DC, area may be delayed. Please submit comments by one method only. All submissions received must include the agency name and the Regulatory Information Number (RIN) for this rulemaking. All comments received will be posted without change to *http://www.fincen.gov,* including any personal information provided. Comments may be inspected at FinCEN between 10 a.m. and 4 p.m., in the FinCEN reading room in Washington, DC. Persons wishing to inspect the comments submitted must request an appointment by telephoning (202) 354–6400 (not a toll-free number).

FOR FURTHER INFORMATION CONTACT: Office of Regulatory Programs, FinCEN, (202) 354–6400; and Office of Chief Counsel, FinCEN, at (703) 905–3590 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

I. Background

A. Statutory Provisions

On October 26, 2001, the President signed into law the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT Act) Act of 2001 (the USA Patriot Act), Pub. L. 107–56. Title III of the USA Patriot Act amends the anti-money laundering provisions of the Bank Secrecy Act (BSA), codified at 12 U.S.C. 1829b, 12 U.S.C. 1951–1959, and 31 U.S.C. 5311–5314, 5316–5332, to promote the prevention, detection, and prosecution of international money laundering and the financing of terrorism. Regulations implementing the BSA appear at 31 CFR part 103. The authority of the Secretary of the Treasury (Secretary) to administer the BSA and its implementing regulations has been delegated to the Director of FinCEN.

Section 311 of the USA Patriot Act (section 311) added section 5318A to the BSA, granting the Secretary the authority, upon finding that reasonable grounds exist for concluding that a foreign jurisdiction, institution, class of transactions, or type of account is of ''primary money laundering concern,'' to require domestic financial institutions and financial agencies to take certain ''special measures'' against the primary money laundering concern. Section 311 identifies factors for the Secretary to consider and agencies to consult before the Secretary may conclude that a jurisdiction, institution, or transaction is of primary money laundering concern. The statute also provides similar procedures, *i.e.*, factors and consultation requirements, for selecting the imposition of specific special measures against the primary money laundering concern.

Taken as a whole, section 311 provides the Secretary with a range of options that can be adapted to target specific money laundering and terrorist financing concerns most effectively. These options give the Secretary the authority to bring additional and useful pressure on those jurisdictions and institutions that pose money laundering threats. Through the imposition of various special measures, the Secretary can gain more information about the concerned jurisdictions, institutions, transactions, and accounts; can more effectively monitor the respective jurisdictions, institutions, transactions, and accounts; and/or can protect U.S. financial institutions from involvement with jurisdictions, institutions, transactions, or accounts that pose a money laundering concern. Before making a finding that reasonable grounds exist for concluding that a foreign financial institution is of primary money laundering concern, the Secretary is required to consult with both the Secretary of State and the Attorney General.

In addition to these consultations, the Secretary, when finding that a foreign financial institution is of primary money laundering concern, is required by statute to consider ''such information as the Secretary determines to be relevant, including the following potentially relevant factors'':

• The extent to which such financial institution is used to facilitate or promote money laundering in or through the jurisdiction;

• The extent to which such financial institution is used for legitimate business purposes in the jurisdiction; and

• The extent to which the finding that the institution is of primary money laundering concern is sufficient to ensure, with respect to transactions involving the institution operating in the jurisdiction, that the purposes of the BSA continue to be fulfilled, and to guard against international money laundering and other financial crimes.

If the Secretary determines that a foreign financial institution is of primary money laundering concern, the Secretary must determine the appropriate special measure(s) to address the specific money laundering risks. Section 311 provides a range of special measures that can be imposed, individually, jointly, in any combination, and in any sequence.[1] The Secretary's imposition of special measures follows procedures similar to those for designations, but carries with it additional consultations to be made and factors to consider. The statute requires the Secretary to consult with appropriate Federal agencies and other

[1] Available special measures include requiring: (1) Recordkeeping and reporting of certain financial transactions; (2) collection of information relating to beneficial ownership; (3) collection of information relating to certain payable-through accounts; (4) collection of information relating to certain correspondent accounts; and (5) prohibition or conditions on the opening or maintaining of correspondent or payable-through accounts. 31 U.S.C. 5318A(b)(1)–(5). For a complete discussion of the range of possible countermeasures, *see* 68 FR 18917 (April 17, 2003) (proposing to impose special measures against Nauru).