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THE GENERATION-SKIPPING TRANSFER TAX:

A USER'S MANUAL

**THE SAN ANTONIO
ESTATE PLANNERS COUNCIL**

DOCKET CALL IN PROBATE COURT

ESTATE PLANNING, PROBATE AND GUARDIANSHIP SEMINAR

February 15-16, 2007

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BIOGRAPHICAL INFORMATION

GARY V. POST is a partner in The Blum Firm, P.C., a Fort Worth law firm. The firm, comprised of ten attorneys, specializes in the areas of estate planning and probate, asset protection, and business and tax planning. Five of the ten attorneys are also Certified Public Accountants, six are Board Certified by the Texas Board of Legal Specialization in Estate Planning and Probate Law, and one is Board Certified in Tax Law.

Mr. Post received his J.D. in 1983 from Southern Methodist University School of Law and his B.B.A. (magna cum laude; Beta Alpha Psi) in 1980 from Texas A&M University. He is Board Certified in Estate Planning and Probate Law by the Texas Board of Legal Specialization, and is a frequent speaker and author on estate planning and tax topics. Mr. Post volunteers with many civic organizations and is currently serving on the Board of Directors for the Tarrant County Probate Bar Association.

THE GENERATION-SKIPPING TRANSFER TAX: A USER'S MANUAL

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I. INTRODUCTION

The Generation-Skipping Transfer Tax ("GSTT") is a Transfer Tax imposed on conveyances that skip a generation. A complete, practical understanding of the GSTT and all of its parts is a must for the tax practitioner to enable him or her to provide creative, successful planning for the client and, perhaps more importantly, to prepare the practitioner to carry out planning and compliance functions while avoiding the traps and costly mistakes that await the unprepared.

II. TRANSFER TAXES

The Federal Transfer Tax System includes three separate Transfer Taxes.

A. Gift Tax. The Gift Tax is a tax imposed on completed transfers during lifetime ("gifts"). The tax is computed with reference to the fair market value of the transferred property as of the date of the gift. Only "taxable gifts" are included in the gift tax base for purposes of computing the gift tax. Certain gifts are not considered "taxable gifts" and are therefore excluded from the gift tax base.

1. Gift Tax Annual Exclusion Amount. The Gift Tax Annual Exclusion represents the amount any donor can give to any person in any year without being deemed to have made a "taxable gift." The Gift Tax Annual Exclusion is currently $12,000, but is subject to future adjustment for inflation. Only transfers that provide the donee with a "present interest" in the gifted property qualify for the Exclusion.

Outright gifts automatically qualify for the Gift Tax Annual Exclusion. Gifts for minors made to Uniform Gifts to Minors Act or Uniform Transfers to Minors Act accounts also qualify.

Generally, gifts made in trust will qualify for the Exclusion if the recipient trust qualifies as a "2503(c) Trust" or if the trust dictates that the trustee must provide the beneficiary with notice of the contribution and a right to withdraw it (at least to the extent of the Exclusion amount) for a reasonable period of time (a "*Crummey* withdraw right").

A donor's "taxable gift" for a year to a donee is the amount by which the entire gift for that year exceeds the Gift Tax Annual Exclusion amount (if applicable).

Example: Mom gives each of Son and Daughter $5,000 in 2006 and makes no other gift to either child during the year. Mom has not made a taxable gift to either Son or Daughter because her gift to each ($5,000) is within her Annual Exclusion amount for each of them for 2006 ($12,000).

Example: Mom gives Son $15,000 in 2006 and makes no other gift to Son during the year. Mom has made a taxable gift to Son of $3,000, or $15,000 less the Annual Exclusion amount ($12,000).

Note: The IRS has taken the position that an outright gift of a limited partnership interest will only qualify for the gift tax annual exclusion if (1) the donee has the immediate use, possession and enjoyment of the gifted limited partnership interest, (2) the donee has the ability to sell or assign the limited partnership interest at any time, and (3) the general partner is held to fiduciary standards equivalent to those imposed on a trustee with discretionary distribution authority. Tech. Adv. Mems. 9131006 (April 30, 1991); 199944003 (July 2, 1999). The IRS position has met with some approval by the Tax Court and the Seventh Circuit. *Hackl v. Commr,* 118 TC 279 (2002), aff'd, 335 F3d 664 (7th Cir. 2003). The IRS has ruled that a donee's ability to sell a limited partnership interest subject to a right of first refusal qualifies as sufficient present enjoyment of the partnership interest to qualify the gift for gift tax annual exclusion treatment. Priv Ltr Rul. 9415007 (Jan. 12, 1994).

2. Tuition and Medical Care Exclusions. A donor can pay any person's tuition without having to (i) pay gift tax, (ii) use any exemptions or exclusions, or (iii) report the payments on a Gift Tax return, provided payment is made directly to a qualified educational institution. Room and board, books, meals, etc. do not qualify for the tuition exclusion, nor do payments to the ballet or piano teacher.

A donor can also pay for any person's medical care without having to (i) pay gift tax, (ii) use any exemptions or exclusions, or (iii) report the payments on a gift tax return, provided payment is made directly to the medical care provider. Expenses relating to prevention, diagnosis, treatment, cure, and alleviation are covered, as are certain necessary transportation and lodging expenses. Health insurance is also covered. Expenses relating to cosmetic surgery and expenses reimbursed by medical insurance do not qualify for the medical care exclusion.

3. Gift Tax Exemption. The Gift Tax exemption represents the amount of taxable gifts any donor can make over the course of his lifetime without having to pay Gift Tax. Gifts qualifying for the Annual Exclusion or the medical or tuition exclusions do not count towards a donor's Gift Tax exemption amount.

The Gift Tax exemption amount is $1,000,000. A donor will owe gift tax only if he makes more than $1,000,000 in total taxable gifts during life.

Example: Mom gives Son $15,000 in 2006 and makes no other gift to Son during the year. Mom has made a taxable gift to Son of $3,000, or $15,000 less the annual exclusion amount ($12,000). Mom must report her $3,000 taxable gift to Son and the corresponding use of $3,000 of her Gift Tax exemption amount on her 2006 Form 709, which will be due April 15, 2007, absent an extension. (Mom will actually report the entire $15,000 gift and indicate that $12,000 of the gift is offset by the Annual Exclusion amount.) Had she given Son only $12,000, she would not have been required to report the $12,000 gift on a Form 709.

4. Gift Tax Base and Gift Tax Calculation. The gift tax in any year is the excess of (certain adjustments may be required if any GSTT has or will be imposed on Direct Skips in the current or prior years or if the computation relates to gifts made after 2010. The applicability of those adjustments is beyond the scope of this presentation):

a. the tax calculated on the sum of all taxable gifts made during the reported year plus the value of all taxable gifts made in prior years (including taxable gifts made prior to 1977), over

b. the tax calculated on the sum of all taxable gifts made in prior years (including taxable gifts made prior to 1977).

5. Gift Tax Rates. The Gift Tax is imposed on cumulative lifetime taxable transfers at graduated rates, which range from a rate of 18% (applicable to the first $10,000 in taxable value) to a current top rate of 45% (applicable for taxable value in excess of $2,000,000).

Under current law, the highest marginal Gift Tax rate will be 45% for 2007 - 2009, 35% in 2010, and return to 55% in 2011.

6. Gift Tax Return and Gift Tax Payment Due Dates. Taxable gifts in any year must be reported on a Form 709 filed by the donor by April 15th of the following year, unless an extension is granted. An automatic extension for filing the Form 709 (but not paying any Gift Tax due) can be obtained by filing an extension for filing the donor's income tax return or by filing a Form 8892, Payment of Gift/GST Tax and/or Application for Extension of Time to File Form 709.

The donor is responsible for any Gift Tax, which is due on April 15th of the year following the year in which the donor made the taxable gift that caused the Gift Tax to be due. If the donor does not pay the tax due, the donee can be liable for payment.

If a donor dies before filing a Form 709 that is due, the executor of his estate is responsible for filing the Form 709 and paying any Gift Tax owing. The due date for the Form 709 and payment of Gift Tax in that event will be the same due date (including extensions) applicable with respect to the donor's Estate Tax return if that date is sooner than the date the Gift Tax return would otherwise be due.

B. Estate Tax. The Estate Tax is imposed on all transfers following the death of an individual, including transfers through wills, life insurance policies, IRA's and retirement plans. The tax is computed with reference to the fair market value of the property as of the date of death.

1. Estate Tax Base. The Estate Tax base includes the previously described transfers occurring at death less appropriate deductions (the "taxable estate") plus cumulative taxable gifts made by the decedent after 1976 that are not included in the decedent's gross estate ("adjusted taxable gifts").

Example: In 2005, Decedent gave $511,000 to Son and contributed $500,000 to Trust A, which provides Son with the remainder interest and the Decedent an income interest for life. Decedent died in January, 2006, at which point the trust assets were valued at $1,000,000 and Decedent owned $500,000 in real and personal property. Decedent will have a gross estate of $1,500,000 comprised of $500,000 in assets owned directly by the Decedent and $1,000,000 (the date of death value of trust assets) includible under IRC 2036 due to the Decedent's retained interest in Trust A. The Decedent's $1,500,000 gross estate will be added to his $500,000 in adjusted taxable gifts ($511,000 given to Son less the annual exclusion amount, but not including the contribution to Trust A since the trust assets are included in the Decedent's gross estate under IRC 2036) to result in his having a $2,000,000 Estate Tax base.

2. Estate Tax Rates. The Estate Tax is imposed on the taxable estate at graduated rates, which range from a rate of 18% (applicable to the first $10,000 in taxable value) to a current top rate of 45% (applicable for taxable value in excess of $2,000,000).

3. Estate Tax Exemption. Each individual is given an Estate Tax exemption, which represents the amount of total taxable transfers an individual may make during life (as taxable gifts) and/or at death without incurring Estate Taxes. The Estate Tax exemption for 2006 through 2008 is $2,000,000, and will top out at $3,500,000 in 2009. The estate tax is repealed for 2010, but is scheduled to return with a $1,000,000 Estate Tax exemption in 2011.

Example: In 2005, Decedent gave $511,000 to Son and contributed $500,000 to Trust A, which provides Son with the remainder interest and the Decedent an income interest for life. Decedent died in January, 2006, at which point the trust assets were valued at $1,000,000 and Decedent owned $500,000 in real and personal property. Decedent will have a gross estate of $1,500,000, comprised of $500,000 in assets owned directly by the Decedent and $1,000,000 (the date of death value of trust assets) includible under IRC 2036 due to the Decedent's retained interest in Trust A. The Decedent's $1,500,000 gross estate will be added to his $500,000 in adjusted taxable gifts ($511,000 given to Son less the annual exclusion amount, but not including the contribution to Trust A since the trust assets are included in the Decedent's gross estate under IRC 2036) to result in his having a $2,000,000 Estate Tax base. The Decedent's $2,000,000 gross estate causes the Decedent's estate to owe $780,800 in Estate Tax, which is offset by a $780,800 unified credit produced from the Decedent's $2,000,000 Estate Tax exemption.

Any allocation of a donor's Gift Tax exemption against taxable gifts made during life effectively uses up the Estate Tax exemption available at the donor's death due to the cumulative taxation of all taxable transfers made by an individual either during life or at death.

Example: In 2005, Dad gave $511,000 to Son, resulting in a taxable gift of $500,000 (or $511,000 less the annual exclusion amount of $11,000). Correspondingly, $500,000 of Dad's Gift Tax exemption is used. Dad dies in 2006 owning real and personal property valued at $1,500,000, resulting in a gross estate of $1,500,000. Dad's adjusted taxable gifts of $500,000 are added to his gross estate of $1,500,000 to produce an estate tax base of $2,000,000. As a result, an estate tax of $780,800 is incurred but offset by the $780,800 unified credit corresponding to the $2,000,000 estate tax exemption. Had Dad owned $2,000,000 in real and personal property at death, his estate would have owed $1,010,800 in estate taxes, which after the $780,800 unified credit offset, would result in Dad's estate owing $230,000 in Estate Taxes.

4. Estate Tax Return and Estate Tax Payment Due Dates. A decedent's taxable estate, adjusted taxable gifts, and any Estate Tax owing are reported on a Form 706, which is due 9 months after the date of death, unless an extension is granted. An automatic six-month extension of time to file a Form 706 can be sought by filing a Form 4768, "Application for Extension of Time to File a Return and/or Pay U. S. Estate (and Generation-Skipping Transfer) Taxes," with the IRS on or before the due date for the Estate Tax return. Estates filing Form 706-A, 706-D, or 706-NA will still need to file a Form 4768 to request a discretionary extension for filing, and estates filing a Form 706-QDT should follow the instructions for that form. Extensions requesting additional time to pay may be granted within the IRS' discretion in limited circumstances.

C. Generation-Skipping Transfer Tax. Section 2601 imposes a tax on every "generation-skipping transfer."

1. Generation-Skipping Transfer Defined. Pursuant to Section 2611, there are three types of generation-skipping transfers:

a. Direct Skip. A (1) transfer (2) that is subject to a gift or estate tax (3) of an interest in property to a "skip person" [see 2. below].

Examples:

(1) An $11,000 cash gift from a grandparent to a grandchild.

(2) A $50,000 gift of interests in a family limited partnership from a grandparent to a trust for her grandchildren.

b. Taxable Termination. The termination of an interest in property held in trust, unless (1) immediately thereafter, a "non-skip" person has a interest in the trust property or (2) at no time may a distribution be made from the trust to a skip person.

Example: Parent transfers property to a trust for the benefit of a child. The trust lasts for the child's lifetime and at the child's death the property is retained in the trust for the child's children (a "Skip Trust"). The child's death triggers a Taxable Termination.

c. **Taxable Distribution**. Any distribution from a trust to a skip person that is not a Taxable Termination or a Direct Skip.

Example: Parent establishes a trust for children and grandchildren. A distribution is made from the trust to a grandchild.

2. **Skip Person**. A transfer to a "skip person," whether made directly or in trust, is subject to GSTT. A skip person includes:

a. a transferor's grandchild or more remote descendant or any other family member in the grandchild or more remote descendant's generation;

b. a nonfamily member who is more than 37.5 years younger than the transferor;

c. a trust for which all beneficiaries are skip persons (or skip persons and charities, if the trust is a charitable remainder trust); and

d. a trust without any current beneficiaries and which will never distribute property to anyone other than skip persons.

3. **Non-Skip Person**. A "non-skip person" is a person or trust who is not otherwise defined as a skip person (e.g., a transferor's child, niece/nephew, a charity).

4. **Predeceased Ancestor Exception**. Under certain circumstances an individual who is a descendant of a (i) transferor, (ii) transferor's spouse or (iii) transferor's ex-spouse may "move up" one or more generations with respect to gifts received from the transferor that are otherwise subject to GSTT if the descendant has an ancestor who is (1) also a descendant of an individual described in (i), (ii) or (iii) and (2) deceased at the time the transfer becomes subject to Gift or Estate taxes, as applicable.

Example: Mom gives $50,000 to Grandchild at a time when Child (Grandchild's parent and Mom's child) is deceased. Normally, Mom's gift would be considered a Direct Skip, but because Child is deceased at the time the gift is made, Grandchild is deemed to have "moved up" to Child's generational level for GSTT purposes under the predeceased ancestor rule. Consequently, Mom is deemed to have made a gift to a non-skip person.

The predeceased ancestor exception also applies with respect to transfers to descendants of a parent of the transferor or the transferor's spouse or ex-spouse, if the transferor has no living descendants at the time a transfer is subject to Gift or Estate taxes.

Example: Jeff has never married and has no descendants. His brother's only child died leaving one child, Susan. If Jeff makes a gift to Susan, she will be considered to occupy the generation of her deceased parent (a descendant of Jeff's parents) so that Jeff will be deemed to make a gift to a non-skip person.

The predeceased ancestor rule will treat any descendant of a transferor who dies within 90 days of a transfer subject to Gift/Estate tax as having predeceased the transfer, provided the governing instrument or local law provides for the same presumption. A deemed "death" of a disclaiming beneficiary will not qualify the transfer for the predeceased ancestor exception.

Example: Mom bequeaths $50,000 to her child, Susan. Mom's will provides that Susan must survive Mom by 90 days in order to receive the bequest, otherwise the $50,000 is to pass to Susan's only child, Betty. If Susan dies within 90 days of Mom's death, Betty will "move up" a generation, and Mom's bequest to her will not be considered a Direct Skip subject to GSTT.

The predeceased ancestor exception does not normally apply with respect to Taxable Distributions or Taxable Terminations unless the transferor established the trust in a transfer subject to Gift or Estate tax for a descendant of another descendant who is deceased.

Example: Mom creates a trust providing for discretionary distributions to Child 1 and Grandchild, a child of Child 2, who is deceased at the time the trust is created. Distributions to Grandchild will not be Taxable Distributions because Child 2 was deceased at the time the trust was established. Also, no Taxable Termination will occur at Child 1's death for the same reason.

5. Individual Assigned to More Than 1 Generation Exception. Generally, an individual who can be assigned to more than one generation is assigned to the youngest of the generations. Under Section 26.2651-2(b), an exception is be made to include an adopted individual in the generation one generation below the adoptive parent, as long as the adopted individual is (i) legally adopted by the adoptive parent (ii) before reaching the age of 18, (iii) is a descendant of the parent of the adoptive parent (or spouse or former spouse of the adoptive parent), and (iv) is not adopted primarily for the purpose of avoiding GST tax. A review of the facts and circumstances will be used in determining whether the adoption was primarily for the purpose of avoiding GST tax.

Note: The Treasury Department and IRS will consider whether there is a bona fide parent/child relationship between the adopted individual and adoptive parent. Additionally, factors such as the age of the child at adoption, the willingness and/or ability of the birth parent(s)

to act as the adoptive individual's parent, etc. will also be considered. Treasury Decision 9214, 70 FR 41140-41144, July 18, 2005.

Example: Grandparent has a daughter, who has a 20 year old son. Grandparent legally adopts grandson, and transfers $100,000 to grandson. Under Section 2651(b)(1), grandson is two generations below grandparent, but under state law, grandson is generally treated as a child of the grandparent. In this situation grandson remains two generations below grandparent, and is considered a skip person with respect to the transfer. If, however, the grandson was 10 years old at the time of adoption, and the adoption occurred as a result of daughter being declared legally incompetent, then the exception would apply, and the grandson would be assigned to the generation one generation below his grandparent, making him a non-skip person with respect to the transfer.

6. **Transferor**. The "transferor," for purposes of the GSTT, is:

a. in the case of property subject to the gift tax – the donor;

b. in the case of property subject to the estate tax – the decedent.

Note: When a spouse dies and passes property to a QTIP Trust, that spouse is not the "transferor" because the property is not subject to the estate or gift tax. Thus, as discussed later, none of that spouse's GST exemption may be allocated to the QTIP property. Further, the surviving spouse is the "transferor" with respect to the property held in the QTIP Trust at time of that spouse's death because such property is subject to the estate tax in his or her estate.

7. **Computation of the GSTT** (Section 2602)

GSTT = Taxable Amount x Applicable Rate

a. **Taxable Amount**.

(1) Direct Skip – value of property received by the transferee (Section 2623)

(2) Taxable Termination – value of property with respect to which the Taxable Termination has occurred, with a deduction for certain expenses (Section 2622)

(3) Taxable Distributions – value of property received by transferee, with a deduction for certain expenses (Section 2621)

b. **Applicable Rate** (Section 2641)

Maximum Federal Estate Tax Rate x Inclusion Ratio

c. **Inclusion Ratio** (Section 2642)

1 – Applicable Fraction

d. **Applicable Fraction** (Section 2642)

Amount of GST exemption allocated to trust (or, for a Direct Skip, to the property transferred) ÷ value of property transferred (with certain offsets for death taxes and charitable deductions)

e. Example: In 2006, a grandparent transfers $40,000 to a trust for 3 grandchildren, at a time when he has no GST exemption remaining. This is a Direct Skip subject to the GSTT. The Applicable Fraction is -0- (0 ÷ $40,000). The Inclusion Ratio is 1 (1-0). The Applicable Rate is 46% (46% x 1). The Taxable Amount is $40,000. The GSTT = $18,400 ($40,000 x 46%), due to be paid by the grandparent on or before April 15, 2007.

f. Example: Parent previously established a trust to last for the lifetime of her child in 1990 and allocated no GST exemption to the trust. At the child's death, in 2006, the only remaining beneficiaries of the trust were Parent's grandchildren and the trust assets were worth $500,000. The death of the child triggered a Taxable Termination, subject to the GSTT. The Applicable Fraction is -0- (0 ÷ $500,000). The Inclusion Ratio is 1 (1 - 0). The Applicable Rate is 46% (46% x 1). The Taxable Amount is $500,000. The GSTT = $230,000 ($500,000 x 46%), due to be paid by the trust on or before April 15, 2007.

8. **GST Exemption**. When the current version of the GSTT was introduced in 1986, the GST exemption was set at $1,000,000, while the then-unified Estate and Gift Tax exemption was at $600,000. This lack of unity among the three Transfer Tax exemptions created an inherent problem for allocating GST exemption upon the death of a first spouse to die. Under the standard plan, the Will would allocate $600,000 to the Bypass Trust to make full use of the decedent's Estate Tax exemption, and the balance of the estate would pass to a QTIP Trust to qualify for the Marital Deduction and defer taxes until the death of the surviving spouse.

As mentioned above, this would cause the decedent to be the transferor only with respect to the $600,000 Bypass Trust amount leaving $400,000 of the $1,000,000 GST exemption unused. The Executor is allowed to correct this problem by making a Reverse QTIP election. The Executor of the first spouse to die may choose to make the QTIP election with respect to a qualifying trust in order to obtain the Estate Tax marital deduction and defer any Estate Taxes but opt to treat the trust as if the QTIP election had not been made for GSTT purposes. As a result, the deceased spouse will be considered the transferor of the QTIP property for GSTT purposes,

rather than the surviving spouse being considered the transferor, which would normally be the result of the QTIP being taxed in the surviving spouse's estate. Consequently, the deceased spouse can allocate his/her GST exemption to the QTIP. Partial Reverse QTIP elections are not allowed, but a QTIP trust can be divided into two separate trusts so that one trust can be subject to a Reverse QTIP election and the other not.

A Reverse QTIP election is only advisable if the deceased spouse's GST exemption would otherwise not be fully allocated since the mandatory income payout requirement will cause otherwise GSTT exempt property to be distributed to the surviving spouse, a non-skip person.

9. Limited Annual Exclusion for Generation-Skipping Transfers. There is no formal Annual Exclusion under the GSTT system. However, certain gifts that qualify for the Gift Tax Annual Exclusion receive an automatic GSTT exclusion and therefore are deemed to have an Inclusion Ratio of 0 without requiring any allocation of GST exemption:

a. Annual Exclusion gifts made free of trust to skip persons; and

b. Annual Exclusion gifts to a trust for which a skip person is the sole beneficiary during his/her lifetime, provided the trust assets will be includible in the beneficiary's gross estate for Estate Tax purposes if he/she dies prior to the trust's termination. (Section 2642(c)).

Example: Grandmother gives Grandchild $11,000 in cash. The gift qualifies for the Gift Tax Annual Exclusion and GSTT exclusion.

Example: Grandmother gives $5,000 in cash to a trust for Grandchild for which Grandchild is the only beneficiary during his/her lifetime. The terms of the trust provide Grandchild with the ability to withdraw any contributions made to the trust for a reasonable period after being notified by a trustee of any contribution. The trust also provides Grandchild with a testamentary general power of appointment exercisable with respect to any assets remaining in the trust at his/her death. Grandmother's gift to Grandchild's trust qualifies for the Gift Tax Annual exclusion and GSTT exclusion.

Example: Grandmother gives $5,000 in cash to a pot trust for which her three grandchildren are all beneficiaries. The terms of the trust provide each grandchild with the ability to withdraw an equal portion of any contributions made to the trust for a reasonable period after being notified by a trustee of any contribution. Grandmother's gift to the Grandchildren's trust qualifies for the Gift Tax Annual exclusion but not GSTT exclusion.

III. SEPARATE TAX SYSTEMS

The practitioner must always remember that the three Transfer Taxes are each a separate Tax with its own rules and operating procedures. This is complicated by the fact that reporting for the GSTT (including allocations of GST exemption) is combined with Gift Tax and Estate Tax reporting on the Forms 709 and 706. As an illustration of the dangers of failing to always distinguish between the three taxes, consider that the GST exemption may not always equal the Estate Tax Exemption remaining at death.

Example: Dad contributes $5,000 each year to each of the trusts he established for his three children. Dad makes these same gifts during the course of 10 years. His children are each given the right to withdraw the contributed amount for 30 days after they receive notice from the trustee of the contribution. These withdrawal rights qualify each of Dad's contributions for the Gift Tax Annual Exclusion. Each child's withdrawal right will lapse at the end of the 30 day period but will not result in the child's having made a transfer for Gift or Estate Tax purposes because of the 5/5 exception. Dad elects to allocate GST exemption to each child's trust in the amount of his contribution because the assets of each child's trust will pass at the child's death to dynastic trusts for the deceased child's descendants. Dad makes no taxable gifts or other GSTT allocations during his lifetime. Consequently, if Dad dies in 2006, he will have $2,000,000 in Estate Tax exemption but only $1,850,000 in GST exemption (calculated by multiplying 10 years times $15,000 GST exemption allocated each year to Annual Exclusion Gifts made to his children's trusts).

Example: Dad gives $22,000 each year to each of his three children, causing him to make a total of $30,000 in taxable gifts each year ($22,000 less $12,000, or a $10,000 taxable gift for each child). Dad makes these gifts during the course of 10 years. Dad makes no other taxable gifts or GSTT allocations during his lifetime. Consequently, if Dad dies in 2006, he will have $1,700,000 in Estate Tax exemption (calculated by $2,000,000 less $300,000 in Gift Tax exemption used on the $30,000 in taxable gifts he made each year over the course of 10 years to his children) but will have $2,000,000 of GST exemption.

Example: Dad gives $11,000 to Child A in January of 2005. He subsequently gives $50,000 to a trust he established for Child A in December of 2005 and uses up $50,000 of his Gift Tax exemption as a result. He does not make a corresponding allocation of GST exemption to the contribution on the timely filed Gift Tax return he files reporting the taxable gift he made to Child A's trust. Dad decides in June of 2006 to make a late allocation of his GST exemption to Child A's trust at a time when trust assets have increased in value to $100,000 for transfer tax purposes. His allocation of GST exemption to Child A's trust in June of 2006 must be made based upon date of allocation values. Consequently, he uses $100,000 of his $2,000,000 GST exemption in order to cause Child A's trust to have an Inclusion Ratio of 0. Dad has not made nor will he make any other taxable gifts or allocations of his GST exemption prior to his death in December of 2006. Thus, at Dad's death, he will have $1,950,000 of Estate Tax exemption remaining ($2,000,000 less $50,000

Gift Tax exemption allocated to the $50,000 transfer in trust) but only $1,900,000 of GST Exemption remaining ($2,000,000 less $100,000 used for the late allocation in June of 2006).

IV. ALLOCATION OF GST EXEMPTION

As mentioned above, as of January 1, 2004, the GST exemption is the same as the Estate Tax exemption (thus, $1,500,000 for 2004 and 2005, $2,000,000 for 2006-2008, etc.). The individual may allocate his or her exemption to the transfer of any property (lifetime or at death) with respect to which he is the "transferor." An individual's GST exemption may be allocated at any time on or before the due date (including extensions actually granted) for filing the estate tax return for his or her estate. An allocation, once made, is irrevocable.

Once the GST exemption has been allocated to transferred property, the property (and all income and appreciation with respect to the property after the effective date of the allocation) is exempted from the GSTT. For example, if a parent forms a trust and transfers property to that trust with a Gift Tax value of $30,000 and effectively allocates $30,000 of his GST exemption to that transfer, then the trust (and all of the income and appreciation of the trust assets that accrues thereafter) will be exempt from the GSTT. Thus, when the child dies and his interest passes to his children (a Taxable Termination), the fact that the trust is exempted from the GSTT will cause there to be no tax due at the time of that otherwise taxable generation-skipping transfer.

A. Allocation on a 709. A donor may allocate GST exemption to a lifetime transfer of property by accomplishing that allocation on a timely filed Form 709 reporting that transfer. A 709 will be filed on a timely basis if it is filed on or before its due date (including extensions actually granted). If the allocation is on a timely filed return, then the allocation is effective as of the date of the transfer of the property. Thus, an allocation of GST exemption equal to the dollar value of the property as reported on the timely filed 709 (*i.e.*, the value on the date it was transferred) will cause the transfer to be fully exempted from the GSTT.

Subject to the deemed allocation rules (discussed below), the rules change if the allocation of GST exemption with respect to a specific transfer is a late allocation (*i.e.*, an allocation made after the due date, including granted extensions, for filing the Gift Tax return with respect to the transfer). See Sections 2642(b)(3), 26.2632-1(b)(2)(ii) and (iii), and 26.2642-2(a)(2) for rules with respect to late allocations. In this case, the late allocation can still be accomplished by filing a Form 709, but the effective date for a late allocation is the date that a 709 is filed and, most importantly, the dollar amount of the GST exemption that must be allocated to the property in order to fully exempt it from the GSTT is the fair market value of the property on that date. To address the difficulty in determining the fair market value of an asset on the date a 709 is filed, Regulation Section 26.2642-2(a)(2) provides that for determining the fair market value of the property, the taxpayer may elect to treat the allocation as having been made on the first day of the month in which the 709 is filed.

Practitioner Suggestion. The rules for a timely allocation of GST exemption on a Form 709 are obviously ones that the return preparer must be aware of, though there are ample incentives for

the Gift Tax return to be filed on a timely basis. Still, the consequences of a late filing can be quite substantial when the cost is lost GST exemption. For example, assume property is transferred to a trust on February 15, 2000, with a gift tax value of $25,000. Further, assume that a timely filed Gift Tax return reporting that gift and allocating $25,000 of GST exemption to fully exempt it from the tax is not filed. Then, assume that mistake is found and the late allocation of GST exemption is made on a Gift Tax return filed on April 15, 2006. Further, assume that the value of that $25,000 asset at that date is $60,000. In this case, $60,000 of GST exemption will be used to fully exempt the asset from the GSTT, when the same result could have been achieved on a timely filed gift tax return through the use of only $25,000 of GST exemption.

The late allocation can actually be a tool to reverse that outcome and cause the transfer to be fully exempted from the tax through the use of a lesser amount of GST exemption than the value of the gift at the date it was made. For example, assume that stock was transferred to a trust on January 15, 2004, and at that time the stock had a value of $200,000. The Gift Tax return reporting that stock gift is extended until October 15, 2005. At that time, the stock in the company has dropped substantially so that the gifted stock is now worth $60,000. At this time, assuming that by election out or otherwise the deemed allocation rules do not apply, the taxpayer can choose to not make an allocation of the GST exemption to the trust on the timely filed Gift Tax return (on which it would take a $200,000 allocation of GST exemption to fully exempt the gift from the tax) and, instead, make a late allocation of the GST exemption upon a gift tax return filed October 16, 2005. On that return, an allocation of GST exemption equal in amount to the then current fair market value of the stock ($60,000) would be sufficient to fully exempt that stock (and all appreciation and income from the stock) from the GSTT.

B. Deemed Allocation – Direct Skip. Section 2632(b) has long provided for an automatic allocation of GST exemption to a Direct Skip transfer made by an individual during lifetime. The way this works is that if an individual makes a Direct Skip transfer during a year and fails to allocate any (or an insufficient amount) of GST exemption to that gift on a timely filed Gift Tax return for that year, then there will be an automatic allocation of a sufficient amount of the individual's unused GST exemption to the extent necessary to fully exempt the property from the GSTT. Just like an actual allocation of GST exemption on the Gift Tax return, the automatic allocation is effective as of the date of the transfer and thus allocates an amount of exemption up to the fair market value as of the date of the transfer and no more. The automatic allocation occurs, and becomes irrevocable, once the due date (including extensions actually granted) for the Gift Tax return passes.

The individual may elect to not have the automatic allocation of GST exemption apply to a Direct Skip transfer. This election is made on a timely filed gift tax return by describing the transfer and stating the extent to which the automatic allocation is not to apply. The election out of Section 2632(b) is irrevocable after the due date (including extensions granted) of the Gift Tax return.

Example: Grandparent gifts $11,000 to a trust for grandchild on July 15, 2004. This was the only gift by grandparent to grandchild for that year. A Gift Tax return reporting other gifts is filed

for grandparent on the due date of April 15, 2005, but that return does not report the gift to the grandchild and no GST exemption is allocated to the gift. [Note: This gift qualified for the Annual Gift Tax Exclusion, so it did not have to be reported for gift tax purposes. However, it was not eligible for the automatic allocation of GST exemption so a GST tax was due on April 15, 2005.] Grandparent has her full GST exemption remaining. Pursuant to the deemed allocation rules of Section 2632(b), $11,000 of grandparent's GST exemption is automatically allocated to the July 15, 2004, Direct Skip gift to grandchild (wholly exempting that gift and the recipient trust from the GSTT). As of April 16, 2005, the automatic allocation of GST exemption is irrevocable.

C. Deemed Allocation – Other Transfers. By their nature, Direct Skip transfers trigger an immediate GSTT due on or before the due date for filing a Gift Tax return for the year in which the transfer is made. It is for this reason that the Congress felt comfortable at the early stages of the GSTT in providing a "safety net" for those individuals who fail to properly allocate GST exemption on a timely filed return and thus do not fully exempt the transfer from the tax. This safety net operates by allocating GST exemption for those individuals through the deemed allocation rules of Section 2632(b). If, for some reason, the individual did not want that allocation (*i.e.*, wanted to pay the GSTT), then he or she could elect out of the allocation on a timely filed Gift Tax return. The Congress did not initially see a need to provide such a safety net with respect to other transfers (*i.e.*, those that did not trigger an immediate GSTT, but could trigger such tax in the future). However, by the year 2001, the perception (and reality) was that there existed a substantial number of cases in which transfers that should have received an allocation of GST exemption had received either an insufficient allocation or none at all. Thus, the 2001 Tax Act introduced Section 2632(c) to provide for a deemed allocation of GST exemption to certain lifetime transfer to trusts.

Section 2632(c) provides that there will be an automatic allocation of an individual's GST exemption to the following transfers made by the individual during his or her lifetime: a transfer of property (other than a Direct Skip), subject to the Gift Tax, to a trust that could have a generation-skipping transfer with respect to the transferor, unless the trust qualifies under one of the six exceptions provided in Section 2632(c)(3)(B). The purpose of the six exceptions is to prohibit the automatic allocation of GST exemption to trust arrangements that, though they could trigger a GSTT, are structured so that they are not expected to incur such a tax. For example, exceptions are provided for:

1. a trust that requires that more than 25% of the trust principal will be distributed to a non-skip person before that person reaches the age of 46 – Section 2632(c)(3)(B)(i);

2. a trust that requires that more than 25% of the principal be distributed to a non-skip person if that person is living on the date of death of another individual who is more than 10 years older than such person (*e.g.*, trust property is to pass outright to a child of the donor if such child is living upon the death of the donor/parent) – Section 2632(c)(3)(B)(ii);

3. a trust that is structured so that any portion of the principal would be included in the gross estate of a non-skip person (other than the transferor) if that person died immediately after the transfer (*e.g.*, a non-exempt trust that is structured to last for the lifetime of a child of the donor/parent, with that child granted a general power of appointment exercisable under his Will that causes the trust estate to be taxable in his or her estate) – Section 2632(c)(3)(B)(iv).

Section 2632(c)(5) provides for three elections.

1. An election to have Section 2632(c) not apply to an otherwise subject transfer. To be effective, this election must be made on a timely filed Gift Tax return for the calendar year in which the transfer was made.

2. An election to have Section 2632(c) not apply to any or all transfers made to a specific trust. This election will be timely if made on a timely filed Gift Tax return for the calendar year for which the election is to become effective.

3. An election to subject any or all transfers made to a specific trust to the automatic allocation rule of 2632(c). This election is made on a timely filed Gift Tax return for the calendar year for which the election is to become effective.

Section 26.2632-1(b)(iii) allows the transferor, in addition to being able to elect out of a prior transfer subject to Section 2642(f), and current and future year transfers to a specified trust or trusts, the option to elect out of the automatic allocation on all future transfers made by the transferor to all trusts, whether or not such trusts are in existence at the time of the election, or any combination of elections. This election is made on a timely filed Gift Tax return for the calendar year in which the first transfer to be covered by the elect out is made.

Note: The deemed allocation rules under Section 2632(c) apply to transfers subject to the Gift or Estate Tax made after December 31, 2000, and to estate tax inclusion periods ending after December 31, 2000. Thus, the Section 2632(c) "safety net" does not apply to gift transfers made prior to January 1, 2001.

Example: Parent gifts $12,000 to a trust for child in August, 2006, with the trust to last for the child's lifetime and then pass to her children. The gift qualifies for the Annual Gift Tax Exclusion and does not have to be reported for Gift Tax purposes. However, the preparer's duties do not stop there. There is an intentional Taxable Termination that will trigger a GSTT at the death of the child, so it is intended that the gift be allocated GST exemption to fully exempt it from that tax. Prior to the deemed allocation rules of Section 2632(c), a common mistake was to neither report the gift on the 709 nor allocate to the trust $12,000 of GST exemption (most likely because reporting was not required for Gift Tax purposes or a mistaken belief that Annual Exclusion gifts were also

exempted from the GSTT). As a result, the trust would be subject to the imposition of the GSTT upon the death of the child. Under the rules of Section 2632(c), if no 709 is filed, there will be an automatic allocation of $12,000 to the trust, thus protecting it from the GSTT exposure.

Example: Same facts as the preceding example, except that the gift is $15,000. In this case, the Annual Exclusion shelters only $12,000 from the Gift Tax and there is a $3,000 taxable gift. Another mistake is a tendency at this point to allocate only $3,000 of GST exemption to the gift. This fails to recognize that the $12,000 Annual Exclusion is a Gift Tax function and does not apply in the GSTT context. An allocation of only $3,000 of GST exemption in this case causes approximately one-fifth of the trust to be exempt, with the remaining four-fifths subject to the tax (an undesirable outcome). The proper action is to allocate enough GST exemption to cover the total value of the gift to the trust ($15,000 in this case). Again, the deemed allocation rules would correct this error and avoid the GSTT exposure for the trust by providing an automatic allocation of the remaining $12,000 of GST exemption needed to fully exempt the trust.

D. Retroactive Allocations. The 2001 Tax Act also added Section 2632(d) to allow a late allocation of GST exemption for a specific type trust arrangement that, though it is not intended to result in a generation-skipping transfer, can operate to skip a generation in the event there is an unnatural order of deaths (*i.e.*, a child predeceases a parent).

Specifically, Section 2632(d) provides that (1) if, a non-skip person has an interest in a trust, is a lineal descendant of a grandparent of the transferor (or of a grandparent of the transferor's spouse or former spouse), is a member of a generation below the transferor and predeceases the transferor, (2) then, the transferor may allocate his or her unused GST exemption to previous transfers he or she has made to the trust.

If the allocation is made on a Gift Tax return filed on or before the due date for gifts made within the calendar year in which the non-skip person dies, then:

1. the amount of the exemption that will need to be allocated to fully exempt each gift to the trust from the GSTT will be the value of the gift as of the date it was transferred to the trust (*i.e.*, the allocation is treated as if made on a timely filed 709 with respect to the gift);

2. the allocation is effective immediately before the death of the non-skip person, so that the trust is fully exempted from the GSTT at the time of the death; and

3. the unused portion of the transferor's GST exemption is determined at the point immediately before such death.

Example: Parent transfers $100,000 cash in trust for child in 2005 when the child is age 32. Child is to receive distributions of income and principal, subject to the Trustee's discretion, until the

child reaches the age of 60, at which time the trust is to terminate and the property is to be distributed outright to the child. In the event the child should die prior to reaching age 60, then the trust property is to be retained in trust for the benefit of his children. The trust arrangement is not designed to, or expected to, cause the trust property to pass to the transferor's grandchildren; however, due to the death of the child prior to age 60, at the time of his death a Taxable Termination occurs as the trust property passes to his children. The parent allocated no GST exemption to the trust, but, assuming the parent survives the child and has sufficient unused GST exemption, the parent can avoid having the trust suffer a GSTT by making a Section 2632(d) retroactive allocation of GST exemption to the trust. If the allocation is made on a Gift Tax return filed on or before the due date for gifts made in the year in which the child dies, the amount of GST exemption necessary to fully exempt the trust from the tax will be an amount equal to $100,000, the value of the gift to the trust as of the date such gift was made (avoiding the normal "late allocation" rules that would require an amount of GST exemption equal to the value of the property on the date that the return is filed).

E. Relief From Late Elections / Substantial Compliance. The 2001 Tax Act also included relief provisions for taxpayers with respect to late allocations of GST exemption and substantial compliance scenarios. Section 2642(g).

1. Late Elections. Section 2642(g)(1) directs the Secretary to identify circumstances and procedures through which extensions of time will be granted to allow a taxpayer to make a late allocation of GST exemption, elect out of an automatic allocation of GST exemption to a Direct Skip transfer, and elect in or out of the Section 2632(c) automatic allocations with respect to transfers to trusts (that are not Direct Skips). This discretion is to be exercised after considering all relevant circumstances, including evidence of intent contained in the trust agreement.

This Section is applicable to relief requests pending on, or filed after, December 31, 2000, and is explicitly made applicable to transfers made before that date (transfers that are not eligible for relief under the Section 2632(c) automatic allocation or Section 2632(d) retroactive allocation rules).

In the event that an extension of time to allocate GST exemption is granted, then the amount of GST exemption needed to fully exempt the transfer from the tax will be the value as of the date of the transfer (as if the allocation was accomplished on a timely filed 709).

See 3. and 4. below for the IRS response to this Section's directive.

2. Substantial Compliance. Section 2642(g)(2) addresses the case in which there was an allocation of GST exemption that was ineffective to fully exempt the transfer from the GSTT. Under that Section, if there was

substantial compliance with the rules for allocating GST exemption, then there is a deemed allocation of the transferor's unused GST exemption to the extent necessary to fully exempt (or exempt to the greatest extent possible) such transfer from the tax. Again, all relevant circumstances are to be considered in determining whether "substantial compliance" is present, including evidence of intent contained in the trust agreement.

The relief available under Section 2642(g)(2) applies to transfers subject to the estate or gift tax made after December 31, 2000. For pre-December 31, 2000, transfers where the IRS has granted relief from ineffective allocations of GST exemption on "substantial compliance" grounds, see PLR 200017013 and PLR 199919027.

3. **Notice 2001-50.** The IRS issued Notice 2001-50, 2001-2 CB 189, 8/02/2001 in response to its direction in Section 2642(g)(1) to provide guidance with respect to relief from late allocations of GST exemption. That Notice establishes that:

   a. A taxpayer is to follow the provisions of Section 301.9100-3 of the Procedure and Administration Regulations in seeking an extension of time to make an allocation of GST exemption (a late allocation), an election under Section 2632(b)(3) [automatic allocation to Direct Skip], or an election under Section 2632(c) [automatic allocation to other transfers to trust].

   b. Generally, relief will be granted under that Section 301.9100-3 if the taxpayer can show that he or she acted reasonably and in good faith and that such relief would not prejudice the interests of the government.

   c. The taxpayer's request should follow the procedures for requesting a private letter ruling under Section 301.9100 (contained in Section 5.02 of Rev. Proc. 2001-1, or its successor), 2001-1 I.R.B. 1, 28.

   d. The Notice is effective as to requests pending on, or filed after, December 31, 2000.

4. **Revenue Procedure 2004-46 – Simplified Procedure for Certain Late Allocations.** Effective August 2, 2004, the IRS introduced a simplified procedure taxpayers can use to make a late allocation of GST exemption under certain situations. In these cases, the late allocation is accomplished by simply filing a 709 for the year of the transfer (regardless of whether one has previously been filed). This allows the taxpayer to avoid the letter ruling

process and related user fees that accompany the procedures for a late allocation provided in Notice 2001-50.

A taxpayer may use this procedure to make a late allocation of GST exemption to a transfer to a trust only if the following requirements are satisfied:

a. the transfer was a gift to a trust from which a generation-skipping transfer may be made;

b. the transfer was made on or before December 31, 2000;

c. no Taxable Distributions have been made from the trust and no Taxable Terminations have occurred;

d. the transfer qualified for the Annual Gift Tax Exclusion and the total gifts made by the taxpayer to that donee for that year (including the transfer to the trust in question) was less than or equal to the applicable Annual Exclusion for that year;

e. no GST exemption was allocated to the transfer; and

f. at the time the late allocation is made, the taxpayer has unused GST exemption available to allocate to the transfer.