The Blum Firm, P.C. *420 Throckmorton, Suite 650, Fort Worth, Texas 76102*
Attorneys at Law *(817) 334-0066 — fax (817) 334-0078*

PREPARING THE 709 AND ALLOCATING THE GST EXEMPTION

TEXAS SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

2006 ADVANCED ESTATE PLANNING CONFERENCE

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GARY V. POST

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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. Four of the ten attorneys are also Certified Public Accountants, five 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 and the Board of Directors for the Tarrant County Unit of the American Cancer Society.

THE GIFT TAX RETURN: NEW CHALLENGES, TRAPS AND OPPORTUNITIES

GARY V. POST

I. INTRODUCTION.

On the surface, the reporting of gifts on a Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, can appear to be a straight-forward exercise, and the make-up of the Form itself does nothing to deny that illusion. There are, in fact, clerical aspects to the preparation of a gift tax return, but, due to the complicated nature of the planning that underlies many gifts (generation-skipping transfer tax planning and use of the GST exemption, gifting with respect to a Qualified Personal Residence Trust, separate property funding of a life insurance trust, gifts invoking valuation discounts such as interests in family limited partnerships, etc.) and the unusual concepts that have crept into the gift tax arena (Crummey power withdrawal rights, "5 or 5" limitations on withdrawal rights, gift-splitting, etc.), the Form 709 preparer needs to be well-versed on a number of requisite concepts in order to accurately complete a Form 709.

This can be a challenge because the person who is charged with preparing the Form 709 may not be the person who did the underlying planning. For example, it is not uncommon for the client's lawyer to perform the planning function, draft the instruments, and prepare the documents necessary to carry out the gifts; but, the client then looks to his or her CPA to prepare the Form 709. In this case, the CPA has the responsibility of preparing the Form 709 in such a manner so as to cause the client's estate planning objectives that have been "set up" through the prior steps to be accomplished. Further, with a good working knowledge of all aspects of the Form 709, the CPA has the opportunity to create additional tax savings for the client.

II. REPORTING THE GIFT

A. Direct Skips - Other Gifts. Gifts are reported on Schedule A of Form 709, including the donee's name, the description of the gift, the donor's adjusted income tax basis in the gift, the date of the gift and the value of the gift as of the date it was transferred.

1. Gifts subject only to the gift tax are reported on Part 1.

2. Gifts that are Direct Skips (for generation-skipping transfer tax purposes) and are subject to both the gift tax and the generation-skipping transfer tax are reported on Part 2.

3. Gifts that are Indirect Skips to trusts that are currently subject to the gift tax and may later be subject to the generation-skipping transfer tax (*i.e.*, upon the

occurrence of a Taxable Termination or Taxable Distribution) are reported on Part 3.

Practitioner Suggestion. Schedule A, Part 3 of the 709 was added in 2003, to address the tendency practitioners had of reporting any gifts that would receive an allocation of GST exemption on Part 2 of Schedule A. As a consequence, some gifts and the GST exemption were being incorrectly reported on various parts of Schedule C. The only gifts that are to be reported on Part 2 of Schedule A are gifts that are classified as Direct Skips for generation-skipping transfer tax purposes (as discussed below) and are subject to the generation-skipping transfer tax as of the date they are made. Likewise, the only gifts that are to be reported on Part 3 of Schedule A are gifts that are (1) classified as Indirect Skips for generation-skipping transfer tax purposes (as discussed below), (2) subject to the gift tax as of the date they are made, and (3) may be subject to the generation-skipping transfer tax at a future date.

B. Generation-Skipping Transfers. A working knowledge of the character of transfers for generation-skipping transfer tax purposes is necessary in order to be able to properly report (allocate GST exemption, etc.) those transfers on the 709.

Internal Revenue Code ("Code")[1] 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: direct skip, taxable termination and taxable distribution.

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 3. below]. Section 2612(c).

Examples: (1) A $12,000 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 an interest in the trust property or (2) at no time may a distribution be made from the trust to a skip person. Section 2612(a).

[1] Unless otherwise noted, all references in this outline to "Section" are referring to the respective Internal Revenue Code Section.

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. Section 2612(b).

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

2. Transferor. The "transferor," for purposes of the generation-skipping transfer tax, 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.

   Practitioner Suggestion: 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.

3. Skip Person. A transfer to a "skip person," whether made directly or in trust, is subject to generation-skipping transfer tax. 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.

   Sections 2613(a) and 2651.

4. 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). Section 2613(b).

5. 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 generation-skipping transfer tax 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. Section 2651(e).

   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 generation-skipping transfer tax 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 ninety (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 ninety (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 ninety (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 generation-skipping transfer tax.

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.

6. Individual Assigned to More Than One (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.

Practitioner Suggestion: 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.

C. Limited Annual Exclusion for Generation-Skipping Transfers. There is no formal Annual Exclusion under the generation-skipping transfer tax system. However, certain gifts that qualify for the Annual Gift Tax Exclusion (as defined in Article III) receive an automatic generation-skipping transfer tax exclusion and therefore are

deemed to have an Inclusion Ratio of zero (0) without requiring any allocation of GST exemption:

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

2. 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 includable 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 $12,000 in cash. The gift qualifies for the Annual Gift Tax Exclusion and generation-skipping transfer tax 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 Annual Gift Tax Exclusion and generation-skipping transfer tax exclusion (requirements a. and b. noted above for automatic exclusion are satisfied).

   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 Annual Gift Tax Exclusion but not generation-skipping transfer tax exclusion (requirements for automatic allocation not satisfied).

D. Where To (Not To) Report. Direct Skip transfers that are subject to a generation-skipping transfer tax are to be reported on Part 2 of Schedule A. The process of allocating GST exemption, determining the Inclusion Ratio, and computing the generation-skipping transfer tax with respect to such gifts is handled by completing Parts 1, 2 (line 4), and 3 of Schedule C.

Indirect Skip transfers to trust that are (1) currently subject to gift tax, and (2) may be subject to the generation-skipping transfer tax in the future (*i.e.*, upon the occurrence of a Taxable Termination or Taxable Distribution), receive an allocation of GST Exemption on the Form 709. Such gifts are reported on Part 3 of Schedule A and only on Part 2 (line 5) of Schedule C.

Example: Parents make a gift in trust for the benefit of their child, and the trust provisions call for the child's interest to terminate upon his or her death, with the trust property to then pass to the grandchildren. In this case, there is a planned generation-skipping transfer (a Taxable Termination) and a dollar-for-dollar amount of the transferor's GST exemption will be allocated to the gift on the Form 709. That gift is reported on Part 3 of Schedule A and the allocation of GST exemption is entered on line 5 of Schedule C, Part 2.

If a late allocation is being made, as discussed further in Section IV.A below, the amount of such allocation is reported on Schedule C, Part 2, Line 6. Additionally, a Notice of Allocation must be attached to the Form 709. There is no prescribed form for preparing the Notice of Allocation, but the information to be included is contained in the Form 709 instructions. The basic function of the Notice is to identify the transfer, the amount of GST exemption allocated, and the Inclusion Ratio of the recipient trust after the allocation.

See Article IV. below for more information on allocating GST exemption.

E. Community / Separate Property Distinction. It is important to identify the character of the property that has been transferred in the case of gifts made by a husband and wife. A gift of community property is treated as a one-half transfer by each spouse, with each spouse's one-half interest in the property being reported on his or her individual Form 709. The transfer of one spouse's separate property is reported in whole on that spouse's Form 709 and (unless there is gift-splitting as discussed below) no part of such gift is reported on the other spouse's return.

Planning Tip. To keep your planning options open, keep in mind that the character of marital property may be changed by spouses under Texas law. Community property may be converted to the separate property of one spouse in a marital property agreement or, alternatively, spouses may now take the step of converting one spouse's separate property to community property.

Example: Husband and Wife want to transfer a community property life insurance policy on Husband's life to an Insurance Trust (hereinafter in this example referred to as the "Trust") to remove the proceeds from their taxable estates, but they want Wife to have access to the insurance proceeds for financial security if she survives Husband. As that arrangement would cause policy proceeds to be taxed in Wife's estate under Section 2036 due to her retained interest, they do not implement the Trust plan.

However, there is a way to accomplish their tax and non-tax objectives using the Trust, as follows: the spouses execute a marital property agreement partitioning the life insurance policy into Husband's separate property (future cash to be gifted to this Trust to pay premiums will be partitioned to his separate property pursuant to the same type agreement). Thus, Husband is the sole transferor of the policy (and cash)

to the Trust and Wife can be a beneficiary of the Trust without adverse estate tax consequences.

Practitioner Suggestion. The planning illustrated in the preceding Example allows the Husband and Wife to accomplish tax and non-tax objectives that previously had been blocked; but, the actions taken have not left them in the best position from a gift tax perspective (for one, they have cut the number of donors to the Trust to one and, thus, cut the available annual exclusion in half). A knowledgeable 709 preparer can address this problem and improve the gift tax consequences to the clients. See Section V.B.3 below for the use of the Split-Gift Election.

F. Gifts to Spouses. As a general rule, a gift tax return does not have to be filed to report gifts between spouses regardless of whether those gifts were of present or future interests. However, you are required to report gifts under the following circumstances:

1. Gifts to Non-United States Citizen Spouses. A martial deduction is not allowed with respect to a non-citizen spouse. Section 2523(i)(1). Rather, an increase is made to the annual exclusion gifts under Section 2503(b), which for non-citizen spouses is the first $100,000 of gifts (other than gifts of future interests) - as adjusted for inflation - as long as such gifts in excess of the initial annual exclusion amount (*i.e.,* $12,000, as adjusted for inflation) would otherwise qualify for the gift tax marital deduction under Section 2523(a). See Section 2523(i)(2) and Treas. Reg. 25.2503-2(f)(2). As of calendar year 2006, the annual exclusion gift amount for non-citizen spouses has been adjusted to $120,000. Rev. Proc. 2005-70. Any gift that does not qualify for exclusion, or is in excess of the exclusion amount, must be reported on Schedule A, Part 1.

   Example: Husband transfers stock worth $120,000 (for federal gift tax purposes) to non-citizen Wife on June 15, 2006. As this is a gift of a present interest in property that would otherwise qualify for a marital deduction, and as the gift does not exceed the exclusion amount provided for in Section 2523(i)(2), this gift is excluded from the total amount of gifts made by Husband during calendar year 2006 for gift tax purposes.

2. Gifts Made to a QTIP Trust. A gift must be reported, on a timely filed gift tax return, if the gift is for the benefit of the spouse and made to a QTIP Trust. Section 2523(f). Once the gift to the QTIP Trust has been reported on the gift tax return, an election to treat it as a marital deduction, and thus a tax-free gift, is accomplished by deducting the entire value of the gift on Schedule A, Part 4, line 4. Once made, this election is irrevocable. Section 2523(f)(4)(B).

III. ANNUAL GIFT TAX EXCLUSION

IRS Code Section 2503(b) provides that the first $10,000 of gifts made to a donee during a calendar year are to be excluded in determining the total amount of gifts made to that donee by the donor during the year (the "Annual Gift Tax Exclusion"). Pursuant to the 1997 Act, the Annual Gift Tax Exclusion has been indexed for inflation and will increase in $1,000 increments. As of calendar year 2006, there have been two adjustments per this rule, so the Annual Exclusion is currently $12,000. Gifts for educational and medical expenses may exceed $12,000 per year, subject to restrictions, as discussed in Section III.D below.

The Annual Gift Tax Exclusion only applies to gifts that are transfers of a present interest in property, and does not apply to any future interest transfers. Outright gifts to individuals qualify for the present interest requirement. Gifts associated with a Qualified Personal Residence Trust do <u>not</u> qualify for the Annual Gift Tax Exclusion because those are gifts of a future interest in property held in trust (*i.e.*, a remainder interest in the residence once the donor's interest for a period of years terminates).

A. <u>Crummey Power Withdrawal Rights</u>. As stated above, a gift in trust for an individual is a future interest gift that does not generally qualify for the Annual Gift Tax Exclusion. Yet, since the issuance of the landmark case of <u>*Crummey v. Commissioner*</u>, 397 F.2d 82 (9th Cir. 1968), gifts made in trust qualify for the Annual Gift Tax Exclusion when: (1) a gift is transferred to a trust for the benefit of a donee; (2) the donee is given a right for a period of time to withdraw that gift from the trust and own the property outright; and (3) once the time period has elapsed, if the donee has not withdrawn the property from the trust then it remains in trust pursuant to the terms of the trust agreement. The ability of the donee to withdraw the property, albeit for a short period of time, makes the gift a present interest eligible for the Annual Gift Tax Exclusion.

Thus, it is clear, under current law, that qualified gifts (*i.e.,* gifts meeting the tests noted above) to trusts that are associated with a Crummey power withdrawal right can qualify for the Annual Gift Tax Exclusion. This is normally accomplished through the execution of gift notice letters from the trustor to the trustee notifying him or her of the gift and a letter from the trustee to the beneficiary giving notification of the gift and the right to withdraw for the designated period of time.

<u>Practitioner Suggestion</u>: Gift notice letters must be prepared carefully each time a qualified gift is made. In 2005, the IRS conducted an audit in which it challenged annual exclusion gifts totaling over $600,000, which were made by the donor over a ten-year period. The IRS based its challenge on the donor's failure to give <u>actual notice</u> to trust beneficiaries of their withdrawal rights. AALU Washington Report, September 2, 2005, Bulletin No. 05-88. The IRS's challenge highlights the importance of preparing adequate Crummey gift notice letters <u>every time</u> a gift is made to an irrevocable trust, obtaining the beneficiaries' signatures on the letters, and retaining the letters in a file, where they can be easily accessed in the event of an IRS challenge.

One issue in controversy between the Internal Revenue Service and the Tax Court with respect to Crummey powers focuses on identifying the trust beneficiaries that are eligible to have a qualified Crummey withdrawal right. Obviously, for each beneficiary that holds such a withdrawal power there is an additional $12,000 ($24,000 for a married couple) of tax-free gifts that can be conveyed to the trust each year. The Service has repeatedly taken the position that would: (1) limit Annual Exclusions to the actual beneficiaries of a trust, (2) deny Crummey withdrawal rights for contingent remaindermen, and (3) impose a "substance over form" analysis (that would nullify withdrawal rights if there was an agreement in advance by the donee not to exercise those rights).

The Service has not had any success in convincing the Courts to accept its position on these points. The Tax Court has found contingent beneficiaries to be qualified for the annual exclusion, and the Court would not impute an agreement to not exercise the withdrawal rights (which would nullify the rights, thus the Annual Exclusion) where there was no actual evidence of such an agreement.

However, the IRS has enjoyed success on another front with respect to the Annual Gift Tax Exclusion as it applies to gifts of interests in closely-held entities. The Tax Court and the 7th Circuit have both held in *Hackl* that a donee of closely held membership shares in a limited liability company did not receive a present interest where the LLC had never earned any profit, never made any distributions, and had an operating agreement with substantial transfer restrictions. *Hackl v. Commissioner*, 118 T.C. 279 (2002), *aff'd*, 335 F.3d 664 (7th Cir. 2003). Many commentators believe this case was wrongly decided because the donors transferred their entire interest in the shares. Correct or not, this case stands for the proposition that the donor be able to show that the donee received a "right to a present economic benefit." The taxpayer litigated this case without the benefit of expert testimony that might have shown this benefit.

B. "5 or 5" Powers. Technically, a Crummey power withdrawal right is a general power of appointment held by the trust beneficiary that lapses upon the termination of the withdrawal period. Pursuant to Section 2514(e), the lapse of a power of appointment during the life of the individual is treated as a transfer of the property by the individual possessing such power; but, that result is not reached to the extent that the lapse of the power of appointment during any calendar year does not exceed the greater of $5,000 or 5% of the aggregate value of the assets out of which the exercise of the power could be satisfied.

The effect of this statute on a lapsed Crummey power is as follows: upon the lapse of the Crummey power withdrawal right, the donee is deemed to transfer property to the trust equal to the value of the property that could have been withdrawn, less the greater of the $5,000 or 5% amount. That lapse/deemed transfer can subject the donee to a gift tax and cause inclusion of the trust assets in his or her estate for estate tax purposes.

In cases where there is a sensitivity to this situation, one option is to limit the donee's withdrawal right to the greater of the $5,000 or 5% amount, thus eliminating the deemed transfer to the trust and the potentially adverse gift and estate tax consequences. This is often times seen in the case of a transfer of property to a trust for generation-skipping transfer tax purposes.

Example: A parent transfers property in trust for the benefit of a child for life, and then, upon the child's death, the property passes to the grandchildren. In this case, the parent allocates GST exemption to the trust so that it is fully exempted from the generation-skipping transfer tax and thus can pass free of that tax to the grandchildren upon the child's death. Likewise, as the child only holds a life estate in the trust, the property should not be taxable in the child's estate upon death and thus pass free of any transfer taxes to the grandchildren. However, if the child's Crummey power withdrawal right is applicable to property in excess of the $5,000 or 5% amount, then the lapse of that withdrawal right could be treated as a transfer to the trust by the child which could arguably require a portion of the trust to be taxable in the child's estate upon the child's death under Code Section 2036.

In this example, the parent's objective (and the result promised by the professionals) has been thwarted by the lapse of the Crummey power withdrawal right. This outcome would be avoided if the withdrawal power was limited to the "5 or 5" amount.

Practitioner Suggestion. In preparing the Form 709 for gifts of property to trusts, the preparer should always check the trust agreement for the provisions addressing the withdrawal right powers of the trust beneficiaries. If there is a $5,000 or 5% limitation on the withdrawal rights, the preparer should review the transfers and assure that all consequences of that limitation are accurately reported on the return.

1. Take care to properly calculate the withdrawal right amount, which will be the greater of $5,000 or 5% of the trust principal out of which the withdrawal could be made. The 5% portion of that equation can be tricky. For example, in many cases a single trust agreement is executed for the benefit of all of the children of the donor, and each child's share is held, under the trust agreement, in a separate trust for the benefit of that child. In that case, take note to recognize the fact that the 5% amount is determined by multiplying 5% times the value of the principal in the child's separate trust. A common mistake is to view the multiple trusts held under the single trust agreement as a whole and calculate the 5% amount based upon the value of all of the assets held under the single trust agreement umbrella.

   Example: Mr. Smith makes a gift of $100,000 of marketable securities to the Smith Children's Trust. Pursuant to the trust agreement, a separate trust is established for each of the four children. On January 1st of the year following the year that the trust was created, Mr. Smith makes another gift of $100,000 of marketable securities to the trust. On that date, the total value of the assets

(including the current gift) held under the Smith Children's Trust is \$220,000, but the value of the assets held in each child's separate trust is \$55,000 (\$220,000 ÷ 4). In this case, each child's withdrawal right is subject to a \$5,000 or 5% limitation. As each child's share is held in a separate trust which holds \$55,000, the 5% amount is only \$2,750 (5% x \$55,000 – not 5% x \$220,000 = \$11,000) and each child's withdrawal right is limited to \$5,000.

Alternatively, if the Smith Children's Trust Agreement provided for the property to be held in a single trust for the four Smith children, then the 5% amount would be computed with reference to the total value of the trust assets on the whole. Thus, under the previous example, the 5% limitation imposed on each child would be \$11,000 (5% x \$220,000).

2. Note, under Section 2514(e), that the \$5,000 or 5% exclusion is a single exclusion applied to the individual donee on a calendar year basis. There is not a separate \$5,000 or 5% limitation available for each trust to which gifts are made for the benefit of the donee during a year. Nor is the exclusion applied on a gift-by-gift basis. Thus, if more than one gift is made to a trust for the benefit of the donee during the year and the donee has a "5 or 5" withdrawal right with respect to each such gift, care must be taken to assure that the \$5,000 or 5% limitation exemption is properly applied to each gift.

Example: Parent transfers a life insurance policy to a trust for Child on January 1, and on that date the policy has a gift tax value of \$60,000. Child has a Crummey power withdrawal right subject to the "5 or 5" limitation. The withdrawal right is thus \$5,000 (the 5% limit is \$3,000).

On August 1 of that year, Parent gifts \$10,000 cash to the same trust to cover pending insurance premiums. The 5% limitation is calculated as follows:

Value of trust assets - 8/1:	
Insurance policy	\$64,000
Cash	10,000
	\$74,000
	x 5 %
	\$ 3,700

Child's withdrawal right with respect to the 8/1 gift is:

"5 or 5" Limit (\$5,000 > \$3,700)	\$ 5,000
Less: prior lapsed withdrawal right for year	(5,000)
	\$ - 0 -

Alternatively, consider: The January 1 value of the policy had been $95,000, so the withdrawal right with respect to that gift would still be $5,000 (the 5% limit is $4,750). The August 1 value of the insurance policy was $102,000. The 5% limitation for the August 1 gift is:

Value of trust assets - 8/1:	
Insurance policy	$102,000
Cash	10,000
	$112,000
	x 5 %
	$ 5,600

Child's withdrawal right with respect to the 8/1 gift is:

"5 or 5" Limit ($5,600 > $5,000)	$ 5,600
Less: prior lapsed withdrawal right for year	(5,000)
	$ 600

3. Where Crummey power withdrawal rights are limited to a $5,000 or 5% amount, that limited withdrawal right amount is the amount eligible for the Annual Gift Tax Exclusion. It is important for the 709 preparer to assure that the withdrawal right amount for each donee is accurately computed and the total of those amounts is inserted on line 2 of Schedule A, Part 4.

   One mistake that can occur in this case is for the preparer to disregard the "5 or 5" limit and to simply multiply the number of donees by the $12,000 Annual Gift Tax Exclusion amount and report that amount on line 2. In cases where a donee's withdrawal rights are limited to an amount less than $12,000, this would result in an overstatement of the Annual Gift Tax Exclusion and thus an under-allocation of Unified Credit on the Form 709.

   Note: This problem can also arise where the total amount of gifts to the beneficiary during the year exceed $12,000, and the beneficiary has a full withdrawal right (no "5 or 5" limit) with respect to all eligible gifts, but the present interest gifts are worth less than $12,000 and the rest of the gifts are future interest gifts (i.e. an interest in a Qualified Personal Residence Trust). In this case, a blanket allocation of $12,000 of Annual Gift Tax Exclusion to each donee would overstate the amount of the gifts eligible for the Exclusion and also result in a failure to allocate a sufficient amount of Unified Credit on the Form 709.

C. Hanging Powers. Often, gifts are made in excess of the $5,000 or 5% limitation imposed by Section 2514(e). A way to fully exempt anticipated gifts in excess of the "5 or 5" withdrawal limitation is to provide for "hanging powers" of withdrawal. Hanging powers allow the gift to gradually lapse, using annual exemptions of the "5 or 5" power. If the donee lives until the last of the power has lapsed, then none of the gift will be includable in that donee's estate.

Example: Parent transfers stock to a trust for Child on Year 1, and on that date the stock has a gift tax value of $10,000. Child has a Crummey power withdrawal right subject to the "5 or 5" limitation, but with hanging powers. The withdrawal right for Year 1 is thus $5,000 (the 5% limit is $500). This leaves a balance subject to withdrawal after the lapse of $5,000 ($10,000 gift - $5,000 lapse).

In Year 2, Parent makes a second gift of $10,000 to the trust, subject to a withdrawal right of $5,000 (the 5% limit is now $1,000). This leaves a balance subject to withdrawal after the lapse of $10,000 ($10,000 gift + $5,000 hanging power from Year 1 - $5,000 lapse).

In Year 3, Parent makes no gift to the trust, yet is able to utilize a lapse of $5,000 towards the hanging powers carried over from Years 1 and 2, leaving a balance subject to withdrawal after the lapse of $5,000 ($10,000 hanging powers from Years 1 and 2 - $5,000 lapse for Year 3).

In Year 4, when Parent does not make a gift, the final $5,000 of hanging powers from Years 1 and 2 shall lapse, and now none of the gifts made to the trust in Years 1 and 2 shall be subject to inclusion in the Child's estate.

Drafting Note. Use care when drafting hanging powers. In TAM 8901004, the language of the trust being reviewed stated in part that:

> if the person holding the power will be deemed to have made a taxable gift for federal gift tax purposes, then such power of withdrawal will not lapse, but will continue to exist with respect to the amount that would have been a taxable gift and will terminate as soon as such termination will not result in a taxable gift.

It was held that this provision was found to be a condition subsequent and not valid, as it tended to discourage enforcement of federal gift tax provisions. Thus, it is better to provide a hanging power which references an amount that is fixed or determinable, without reference to the lapse of a particular gift.

D. Educational / Medical Expenses – Expanded Exclusion. Section 2503(e) extends the benefits of the Annual Gift Tax Exclusion to gifts made on behalf of an individual to cover qualified educational and medical expenses. Under that Section, payments made directly to an educational organization to cover the tuition of an individual are not reportable on the Form 709 as gifts. This exclusion does not apply to gifts made to individuals for the purpose of the individual paying tuition and does not apply to education-related expenses such as books, rent, cars, etc.

Example: In PLR 200602002, the IRS ruled that prepayments of tuition for 6 grandchildren, for grades 1 through 12 each, under an agreement that acknowledged (1) that any increase in tuition will be paid by the donor or the parents of the respective grandchild, (2) that the payments are non-refundable (i.e., forfeited for any

years in which a grandchild does not attend), and (3) that extended no special privileges to the grandchildren, were excluded from gift and generation-skipping transfer tax.

Likewise, payments made directly to a medical care provider in return for the provision of medical care for an individual do not have to be reported on the Form 709. "Medical care" includes expenses for prevention, treatment, and medical insurance, but does not apply to amounts for medical care that are reimbursed by the individual's insurance policy.

There is no limit on the amount of qualified educational and medical payments that can be made in any year that qualify for this gift tax exclusion.

IV. ALLOCATION OF GST EXEMPTION

A. GST Exemption. Beginning in the year 2004, the GST exemption was adjusted to be the same as the estate tax exemption amount (thus, $2,000,000 for 2006-2008, and $3,500,000 in 2009, 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." (Section 2652 identifies the "transferor" as the decedent, in the case of a property subject to the estate tax, and the donor, in the case of a transfer subject to the gift tax.) 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 generation-skipping transfer tax. 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 generation-skipping transfer tax. Thus, when the child dies and his interest passes to his children (a Taxable Termination), the fact that the trust is exempted from the generation-skipping transfer tax will cause there to be no tax due at the time of that otherwise taxable generation-skipping transfer.

B. 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 generation-skipping transfer tax.

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 generation-skipping transfer tax 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 generation-skipping transfer tax, 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 generation-skipping transfer tax.

C. 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 generation-skipping transfer tax. 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 generation-skipping transfer tax). As of April 16, 2005, the automatic allocation of GST exemption is irrevocable.

D. Deemed Allocation – Other Transfers. By their nature, Direct Skip transfers trigger an immediate generation-skipping transfer tax 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 Congress felt comfortable at the early stages of the generation-skipping transfer tax in providing a "safety net" for those individuals who fail to properly allocate GST exemption to a Direct Skip 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 generation-skipping transfer tax), then he or she could elect out of the allocation on a timely filed gift tax return. 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 generation-skipping transfer tax, 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 generation-skipping transfer tax, 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); and

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. Section 2632(c)(5)(A)(i)(I). 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. Section 2632(c)(5)(B)(i).

2. An election to have Section 2632(c) not apply to any or all transfers made to a specific trust. Section 2632(c)(5)(A)(i)(II). 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. Section 2632(c)(5)(B)(ii).

3. An election to subject any or all transfers made to a specific trust to the automatic allocation rule of 2632(c). Section 2632(c)(5)(A)(ii). This election is made on a timely filed gift tax return for the calendar year for which the election is to become effective. Section 2632(c)(5)(B)(ii).

Section 26.2632-1(b)(2)(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 that child's 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 generation-skipping transfer tax 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 generation-skipping transfer tax). As a result, the trust would be subject to the imposition of the generation-skipping transfer tax 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 generation-skipping transfer tax 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 generation-skipping transfer tax 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 generation-skipping transfer tax exposure for the trust by providing an automatic allocation of the remaining $12,000 of GST exemption needed to fully exempt the trust.

E. 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 generation-skipping transfer tax 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 generation-skipping transfer tax 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 generation-skipping transfer tax 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).

F. 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 generation-skipping transfer tax. 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, 2001-34 I.R.B. 189, 8/20/2001 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 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. [See Rev. Proc. 2004-46, 2004-31 I.R.B. 142 (8/2/04) for the procedural requirements of filing such 709.] 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.

V. SPLIT-GIFT ELECTION

A. Procedures.

1. Each spouse is responsible for filing his or her own Form 709 reporting the gifts that he or she made during the year (50% of each community property gift and 100% of separate property gifts). Additionally, there are special provisions for those spouses who elect to split their gifts for a tax year. Section 2513. Generally, where a spouse has made a gift of separate property and husband and wife agree to split gifts:

a. Each spouse completes an individual Form 709 reporting the gifts he or she made on Schedule A. These gifts are listed in the upper portion of Part 1, Part 2 or Part 3, as applicable.

b. If an individual is reporting a gift made by his or her spouse, which the individual is electing to split, then the gift is reported on the lower portion of Part 1, Part 2 or Part 3 of Schedule A, as applicable.

c. In Column G of Schedule A, one-half of the donor's gift is deducted from the total value of the gift reflected in Column F, and the net gift is then listed in Column H. The total of Column H (Part 1, Part 2 and Part 3) is then entered on Part 4, line 1 of Schedule A.

d. Lines 12 through 18 of Form 709, Page one, Part 1 (General Information) must be completed, including the signature of the spouse agreeing to the gift-splitting election.

2. A husband and wife must satisfy the following criteria, pursuant to Section 2513(a)(1), in order to be eligible to elect to split gifts for a given year:

a. they must have been married at the time of the gift;
b. if they divorced after the gift, neither spouse could have remarried during the year;
c. if one spouse died after the gift, the survivor could not have remarried during the year;
d. neither spouse was a nonresident alien at the time of the gift; and

e. neither gave the other spouse a general power of appointment over the transferred property.

3. As discussed below, there are incidences in which gift-splitting can be used to generate important transfer tax benefits for the client. However, it is important to note that a gift-splitting election made by a husband and wife for a calendar year applies to all of the gifts made by either spouse during that year while they were married. Thus, even though the election might make sense with respect to one or more transfers made by either spouse during the year, the decision to make that election must be made after assessing the overall impact (see Section V.D below).

B. Gift-Splitting Opportunities. Gift-splitting can be used to achieve important transfer tax benefits that may not have been considered at the planning stage and, thus, left to the return preparer to identify the benefits and to claim them through the skilled use of the gift-splitting election. Some examples of situations in which this election can be useful include:

1. One spouse makes a gift of separate property to a donee and the other spouse does not make a gift to that donee during the year. Without any action, the Annual Exclusion available for that separate property gift to the donee would be $12,000 for the year. However, if the spouses elect to gift-split, one-half of the gift is reported on each spouse's Form 709 and the Annual Gift Tax Exclusion is effectively expanded to $24,000 for the year.

2. Husband and Wife partition their residence into two separate property halves and each transfers his or her half to a Qualified Personal Residence Trust, which includes a gift of the remainder interests to their children. In this case, assuming that the parents have different ages, the value of each parent's remainder interest gift computed under the tables will be different. As a result, without any action, each spouse will use a different amount of his or her Unified Credit and the remaining balances of the respective Credits will be out of line. In some cases, this is not a desirable result.

More specifically, consider the case wherein the spouses have also formed a life insurance trust that is receiving annual gifts to cover the life insurance premiums. Further, assume that those premium gifts are in excess of the Annual Gift Tax Exclusion for the year so that the spouses are each using up an equal amount of Unified Credit on each year's Form 709. In this case, where one spouse's remaining Unified Credit balance is less than the other's, then it is possible that such spouse will reach a point at which his or her Unified Credit is exhausted and the gifts to the insurance trust will trigger a gift tax payment. The point at which this gift tax payment would be reached could be delayed by equalizing the spouses' Unified Credit balances so that they each reached that point at the same time. The Unified Credit balances

would remain equal if a gift-splitting election was made for the year the gift to the Qualified Personal Residence Trust was reported.

3. Husband and Wife form a life insurance trust to exclude the proceeds from the taxable estates, but, to allow the non-insured spouse to enjoy the benefits of the proceeds should he or she survive the insured, the trust has been funded out of the separate property of the insured spouse so that the non-insured spouse's beneficial interest in the trust will not trigger an estate tax inclusion problem. (See Example under Section II.E above.) As a result, the gift to the insurance trust will be reported in total on the insured spouse's Form 709. If the spouses elect to gift-split, a dual benefit can be accomplished by:

    a. expanding the Annual Gift Tax Exclusion for the gifts to the insurance trust from $12,000 to $24,000 per child per year; and

    b. by allowing the spouses' Unified Credits to be reduced on an equal basis as the annual gifts are made.

    Thus, if such an election were made, the insured spouse would complete the upper portion of Part 1, Part 2 or Part 3 of Schedule A, as applicable to the type of trust being funded, and the non-insured spouse would complete the lower portion of the same Part on his or her 709.

C. <u>Filing Procedures</u>. Under normal circumstances a husband and wife should mail their Forms 709 in separate envelopes. However, where the couple has elected to split gifts the returns should be filed together in the same envelope.

Previously there were two exceptions under which a consenting spouse was able to file a Form 709-A (United States Short Form Gift Tax Return). The Service has made that form obsolete, so now both the donor spouse and the non-donor spouse, who has elected to gift-split, must prepare and file a 709.

D. <u>Look Before You Leap</u>. As mentioned above, the gift-splitting election must apply to all gifts made by the spouses during the year while they are married and, though the benefits on a gift-by-gift basis can be quantified, the overall impact on both spouses must be assessed before the election is implemented. One of the key factors to consider is that the consenting spouse will be treated as transferring half of each gift for all purposes, including <u>use of that spouse's Annual Gift Tax Exclusion, Unified Credit, and GST exemption</u>.

<u>Example</u>: Assume a <u>second marriage situation</u>, where one spouse has separate property and desires to make a transfer of that property to her two grandchildren (from a prior marriage) for estate tax planning reasons. Further assume that she wants to make the maximum dollar amount of gifts each year that can qualify for the Annual Gift Tax Exclusion. To accomplish that objective, the decision is made to

give $48,000 to a trust for her grandchildren and have the husband elect to gift-split to expand the Annual Gift Tax Exclusion to $24,000 for each grandchild. The husband has no problems in agreeing to this because he does not plan to make any gifts to those grandchildren for the year and thus the use of his Annual Exclusion with respect to each donee is inconsequential.

However, as the gifts are Direct Skips each gift must be allocated a dollar-for-dollar amount of GST exemption or will be subject to an immediate generation-skipping transfer tax due on or before April 15 of the following year. The donor is willing to use an amount of her GST exemption necessary to fully cover those gifts. However, as the gift-splitting election is to be made, the husband is treated as the transferor of one-half of the gifts for generation-skipping transfer tax purposes. See Regulation Section 26.2652-1(a)(4) and (5), Example 2. This changes things, because now the consenting spouse must agree to the use of his GST exemption with respect to gift transfers that he did not make. In some cases, particularly in cases such as in this Example where the gift is being made to grandchildren from a prior marriage, the consenting spouse may not agree to this gift-splitting election due to the GST exemption consequences.

Thus, while it may be palatable to the consenting spouse to use his or her otherwise unused Annual Gift Tax Exclusion for transfers to donees, it is quite a different story for that spouse to agree to a gift-splitting election when such will require the use of his or her Unified Credit and/or GST exemption. Thus, it is imperative that the return preparer fully explain all consequences of the gift-splitting election to both spouses. In some cases, like the one illustrated in the preceding example, it may be necessary to limit the amount of the gift to that which will qualify for the Annual Gift Tax Exclusion for the donor spouse.

Planning Tip: In the immediately preceding Example, with the husband not willing to use his GST exemption for the gifts, the first alternative considered was to limit each grandchild's gift to $12,000 per year and thus allow them to qualify for the Annual Gift Tax Exclusion without any gift-splitting election. However, this did not satisfy the client's objectives of maximizing the gifts within the Annual Exclusion limitations (*i.e.*, expanding that Exclusion to $24,000 per year). A solution was found, as follows: the trust agreement would be drafted so that the gifts to the trust would automatically qualify for GST exemption by providing that each grandchild was the sole beneficiary of his or her trust and, should the grandchild die before the trust terminates, the trust proceeds would be includable in his or her taxable estate. Section 2642(c). Thus, the gifts avoided the generation-skipping transfer tax without allocating GST exemption so the husband was agreeable to the gift-splitting election and the full $24,000/grandchild could be removed from the wife's estate each year.

VI. VALUATION DISCLOSURE REQUIREMENTS - STATUTE OF LIMITATIONS

A key provision of the Taxpayer Relief Act of 1997 curtailed the IRS's ability to revalue adjusted taxable gifts reported on the Form 706, but in so doing raised the bar for a taxpayer's ability to start the statute of limitations running. For gifts made after December 31, 1996, the 1997 Act substantially revised the rules relating to the statute of limitations for gifts reported on gift tax returns, both for (1) assessment and collection of gift tax for the year the gift is made, and (2) the IRS's ability to adjust the value of the gift for purposes of later gift tax or estate tax returns.

A. Gifts Fixed by Statute for All Purposes. In general, if the statute of limitations (usually three years after the return was filed – see Section 6501) has run for assessing the gift tax on a gift disclosed on a 709, the value of the gift cannot be adjusted for later gift tax returns or estate tax returns. Sections 2001(f)(1) and 2504(c). In addition, it is no longer required under Section 2504(c) that a tax actually be paid in order for the statute of limitations to begin to run. This provides a certainty that the taxpayer did not formerly have. The trade off for this certainty is that the statute of limitations will not run on a gift tax return unless the gift is adequately disclosed on the return itself. The former law allowed a six-year statute to run even on undisclosed gifts, unless the failure to disclose was fraudulent.

B. What Constitutes Disclosure? Disclosure Rules for Gifts. It is important to understand what constitutes "disclosure," because there is no statute of limitations on a gift without adequate disclosure of the gift on a 709. *If a gift is made and the value is required to be shown on the gift tax return (without regard to the Annual Exclusion), and it is not adequately disclosed on the return, no statute of limitations will apply.* Code Section 6501(c)(9). This rule mirrors the disclosure rule previously applied only to gifts valued under Code Sections 2701 and 2702. (See Treas. Reg. Section 301.6501(c)-1(e).) While under the previous law a taxpayer could be assured that either the three or six year statute of limitations would run on any gifts for a year in which a return was filed (absent fraud), this assurance is no longer available. The statute remains open unless the disclosure requirements have been met.

C. What Are These Disclosure Requirements? To be adequately disclosed, the gift must be reported on a gift tax return "in a manner adequate to apprise the IRS of the nature of the gift and the basis for the value so reported." Reg Sec. 301.6501(c)-1(f)(2). Reg. Section 301.6501(c)-1(f) tells us that adequate disclosure exists only if the return provides a complete and accurate description of the transaction, including:

   1. A description of the transferred property and the consideration, if any, received by transferor;

   2. The identity of the transferee and the relationship between the transferor and the transferee;

   3. For a gift in trust, the trust's taxpayer id number and either a copy of the trust instrument or a "brief description" of the terms of the trust;

4. Either (1) an appraisal that contains certain prescribed elements (the "Appraisal Safe Harbor"), or (2) a description of the method used to determine fair market value (the "Description Safe Harbor") [see D. below];

5. The identification of "any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer."

These are vast improvements over the proposed Regulations, which basically required the transferor to list all facts that would result in an audit issue, or to actually set forth the IRS's audit position.

D. Safe Harbors.

1. Appraisal Safe Harbor [Sec. 301.6501(c)-1(f)(3)]. The gift tax return preparer should note that to take advantage of the Appraisal Safe Harbor the appraisal must be prepared by an appraiser who is an independent third party, and not the transferor, transferee, member of either's family, or an individual on the regular payroll of either of them or a member of either one's family. The appraiser must also be someone who holds himself or herself out to the public as an appraiser or who regularly performs appraisals, and who is qualified by background, experience, education, and professional memberships (if any) to appraise the type of property involved. Also, those qualities of the appraiser should be included in the appraiser's report. The Regulations, in Sec. 301.6501(c)-1(f)(3)(ii) (A) through (H), outline the information that must be included in an appraisal for the appraisal to qualify.

2. Description Safe Harbor. The Regulations in Section 301.6501(c)-1(f)(2)(iv) give guidance on what valuation information must be disclosed to satisfy the Description Safe Harbor, including:

   a. The financial data used in valuing the transferred property;

   b. Any restrictions on the transferred property that were considered;

   c. A description of any discounts claimed, such as discounts for blockage, minority or fractional interests, and lack of marketability;

   d. For a gift of an interest in an entity that is actively traded on an established exchange, such as the NYSE, a description of the exchange on which the entity is traded, the CUSIP number of the stock and the mean between the highest and lowest selling points on the valuation date;

e. For a gift of an interest in an entity such as a corporation or partnership that is not actively traded, a description of any discounts claimed in valuing any assets owned by the entity (as well as any discounts claimed in valuing the transferred interest itself);

f. For a transfer of an interest in an entity properly valued with reference to the value of the assets held by the entity, a statement regarding the undiscounted fair market value of 100 percent of the entity, the pro rata portion of the entity subject to the transfer, and the fair market value of the transferred property as reported on the return;

g. For a transfer of an interest in a non-actively-traded entity that itself directly or indirectly owns an interest in another non-actively-traded entity, a detailed description of the method used to determine the fair market value of that owned interest, including all the foregoing information, if the information is "relevant and material" in determining the value of the interest.

E. Starting the Statute's Run. Does the taxpayer have an incentive to file the gift tax return on January 1 after the year of the gift to start the statute running? No, as a return filed early is deemed filed as of the last day a gift tax return is due to be filed as prescribed by law, and thus, the statute would not begin until such date. IRC Section 6501(b)(1).

F. What to do if No Gift Tax Return was Filed for the Year in Which a Gift was Made or a Gift was not Adequately Disclosed. In Rev. Proc. 2000-34, 2000-34 I.R.B. 186 the IRS provided guidance as to how taxpayers can comply with the disclosure requirements set forth in Code Section 6501(c)(9) and Treas. Reg. Section 301.6501(c)-1(f) if the taxpayer previously filed a 709 in the year in which a gift was made, but did not adequately disclose the gift because either the gift was omitted from the 709 or the taxpayer failed to submit the information required under Treas. Reg. Section 301.6501(c)-1(f)(2). The period of limitations on assessments under Code Section 6501(a) will commence when the taxpayer files an amended 709 which complies with the disclosure requirements. The statute of limitations will expire three years from the date on which the 709 is filed. The taxpayer must file the amended 709 with the IRS Service Center where the original 709 was filed. The taxpayer should include the following language at the top of the 709 – "Amended Form 709 for gift(s) made in [insert year] – In accordance with Rev. Proc. 2000-34, 2000-34 I.R.B. 186."

G. IRS Guidance.

1. Chief Counsel Advice 200221010. On April 7, 1997 the taxpayer gifted a 19% interest in ABC, LLC to a generation skipping trust and a 1% interest in ABC, LLC to a family trust. The taxpayer and his wife split the gifts in accordance with Code Section 2513. The taxpayer filed a 709 on October 9,

1998 with the following description of the gift "Class B units in ABC, LLC. Units acquired on 4/6/97 for $200,000 cash." The taxpayer also reported that the adjusted basis and fair market value of the gifted Class B units was $200,000. The IRS alleged that the fair market value of the gifts was $14 million and proposed to issue a notice of deficiency to that effect. The IRS raised the question of whether it may rely on the exception for gifts not adequately shown on a 709 as a defense to the taxpayer's argument that the three year statute of limitations had expired.

The taxpayer filed the gift tax return prior to December 3, 1999, the effective date of the adequate disclosure rules of Treas. Reg. Section 301.6501(c)-1(f), so the these requirements were not yet effective. However, since there were no reported gift tax cases addressing what constitutes adequate disclosure, the Chief Counsel's Office used the requirements of Treas. Reg. Section 301.6501(c)-1(f) as an illustration as to what constitutes adequate disclosure. The Chief Counsel's Office found that the taxpayer did not adequately disclose the gift because the taxpayer did not identify the number of units gifted, the percentage ownership that these units represented and the nature of the Class B interests. The Chief Counsel's Office also found that the six year statute of limitations contained in Code Section 6501(e)(2) applied because the actual fair market value of the Class B units was in excess of 25% of the total gifts stated on the 709.

2. Chief Counsel Advice 200205027. The taxpayer's husband was a sophisticated businessman well-known in his industry. He owned 100% of the stock of an S corporation and made gifts of 48% of the stock to his children. The taxpayer's husband provided fraudulent information to the tax return preparer concerning the valuation of the stock for purposes of preparing the 709. The taxpayer and the taxpayer's husband filed separate 709s reporting the gift and the taxpayer indicated her consent to split the gift on her husband's 709 and, similarly, the husband indicated consent to split the gift on her 709.

The three year statute of limitations has expired on the gifts; however, the IRS plans to assert that the statute of limitations remains open on the husband's 709 under Code Section 6501(c)(1) because of the fraud. However, the IRS requested the advice of the Chief Counsel's Office as to whether it could assert that the statute of limitations remained open on the taxpayer's gift tax return based on the husband's fraud.

The Chief Counsel's Office found that the husband's fraud could not be used to keep the statute of limitations open against the wife. It differentiated income tax cases in which the statute of limitations remains open against both spouses when only one spouse commits fraud. In the income tax context two taxpayers are reporting one tax liability where in the gift tax case, each spouse has a separate unified credit amount and, therefore, their

gift tax liabilities may not be equal for a given year. Since the wife was unaware of the husband's fraud, the statute of limitations could not be extended against her.

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Gary V. Post
The Blum Firm, P.C.
420 Throckmorton, Suite 650
Fort Worth, Texas 76102
(817) 334-0066

THE GIFT TAX RETURN: NEW CHALLENGES,
TRAPS AND OPPORTUNITIES

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EXHIBIT A – 2005 FORM 709