

PENNIES FROM HEAVEN (OR GRANDMA):
UNDERSTANDING THE GENERATION SKIPPING TRANSFER TAX
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I. **What is the Generation Skipping Transfer (“GST”) Tax?**

- A. This tax is imposed, in addition to any gift or estate tax otherwise incurred, on “generation-skipping transfers”. IRC §2601.
- B. There are three basic types of generation-skipping transfers, the Direct Skip (a transfer directly to a skip person), a Taxable Distribution (a distribution from a trust to a skip person), and a Taxable Termination (the termination of the interests of all non-skip persons in a trust). IRC §2611.
- C. The “skip” in generation-skipping transfer does not mean that a generation of beneficiaries is skipped. Instead, it relates to an objective of Congress that wealth be subject to transfer tax at each generation. The GST Tax applies when a transfer is made directly to someone in two or more generations younger than the transferor, or if it is transferred to a trust that will not be includible in the estate when it passes from one generation to the next. Transfers that benefit a transferor’s child can incur GST Tax if they are not subject to transfer tax at the time they move from the child to the grandchild or lower generation, or where the child and more remote descendants are simultaneously beneficiaries.

II. **Who is the Transferor for GST Purposes?**

- A. General. In the case of a transfer of property subject to the estate tax, the transferor for GST purposes is the decedent. In the case of a transfer of property subject to gift tax, the transferor for GST purposes is the donor. IRC §2652(a)(1).

- B. Gift Splitting. If a married couple makes a gift under IRC §2513 to treat a gift as made one-half by each spouse for gift tax purposes, the gift will also be treated as “split” for GST tax purposes and each spouse will be treated as the transferor of one half of the property. IRC §2652(a)(2).
- C. Reverse QTIP Election. In the case of a QTIP Trust, established during life or at death, the donor spouse (or such spouse’s executor) may make an election (the “reverse QTIP election) to have the donor spouse continue to be treated as the transferor for GST purposes even though the trust will be subject to estate tax at the beneficiary spouse’s death and thus normally the beneficiary spouse would become the transferor. Under this rule, for GST purposes, the trust is treated as though no QTIP election were made. IRC §2652(a)(3).

III. Who is a Skip Person?

- A. The definitions of the three types of generation-skipping transfers all depend upon the definitions of “skip person” and “non-skip person”, which are found in IRC §2613.
 - 1. A “skip person” is a natural person assigned to a generation which is two or more generations below the generation assignment of the transferor, OR a trust, if all interests in such trust are held by skip persons, or there is no person holding an interest in such trust and at no time after such transfer may a distribution be made from such trust to a non-skip person. IRC §2613(a).
 - 2. A “non-skip person” is any person who is not a skip person. IRC §2613(b).
- B. Generation Assignments (IRC §2651)
 - 1. Lineal Descendants. An individual who is a lineal descendant of a grandparent of the transferor shall be assigned to that generation which results from comparing the number of generations between the grandparent and such individual with the number of generations between the grandparent and the transferor. Similarly, a lineal descendant of the grandparent of a spouse or former spouse of the transferor (other than such spouse) shall be assigned to that generation which results from comparing the

number of generations between such grandparent and such individual with the number of generations between such grandparent and such spouse. IRC §2651(b).

- a. Relationships of the half-blood are treated the same as relationships of the whole blood. IRC §2651(b)(3)(B).
- b. Relationships by legal adoption are treated the same as relationships by blood. IRC §2651(b)(3)(A).
- c. A person who has ever been married to the transferor is assigned to the same generation as the transferor, and any person who has ever been married to a lineal descendant of the transferor is assigned to the same generation as the descendant. IRS §2651(c).

2. Persons other than Lineal Descendants. If a person is not assigned to a generation by the rules for descendants of a grandparent of the transferor or the transferor's spouse or former spouse, then the generation assignment is made on the basis of age. In making these calculations, the IRS has determined that a generation is limited to persons born within 25 years of each other and assigns the transferor to the middle of that statistical generation. As a result:

- a. An individual born not more than 12.5 years after the transferor's date of birth is assigned to the transferor's generation.
- b. An individual born more than 12.5 years but not more than 37.5 years after the transferor's date of birth is assigned to the first generation younger than the transferor (e.g. the "child" generation).
- c. Each 25-year segment then creates a new generation in the same fashion.
- d. Thus, a non-family member more than 37.5 years younger than the transferor will generally be a skip-person. IRC §2651(d).

- e. Practice Note. Be sure to obtain the birthdates of all non-family legatees or donees to determine their generation assignments. It is not uncommon for cash gifts to caregivers, employees and friends to include individuals more than 37.5 years younger than an elderly decedent, and those gifts will be subject to the GST tax.
3. Predeceased Parent Exception. IRC §2651(e) provides that in certain cases where an individual predeceases the transferor, the child of such deceased individual is moved up to the pre-deceased parent's generation.
- a. For transfers occurring on or before December 31, 1997, this rule applied only if the deceased person was both an ancestor of the recipient and a descendant of the transferor (or the transferor's spouse or former spouse). In addition, it only applied for purposes of determining whether a direct skip occurred and did not apply to any other type of generation skipping transfer.
 - b. For transfers occurring after December 31, 1997, the predeceased parent rule applies to all direct skips, taxable terminations, and taxable distributions, as long as:
 - i. The transferee is a descendant of a parent of the transferor, the transferor's spouse, or the transferor's former spouse; and
 - ii. The deceased person who is a lineal descendant of the parent of the transferor or spouse must be dead at the time the transfer is subject to estate or gift tax imposed upon the transferor; and
 - iii. For persons other than lineal descendants of the transferor, the transferor's spouse or the transferor's former spouse, the rule does not apply unless the transferor had no living descendants at the time of the transfer.
 - c. If the governing instrument or local law provides that a beneficiary is deemed to have predeceased the transferor if the beneficiary does not survive the transferor by a period not to exceed 90 days, the beneficiary will be deemed to have

predeceased the transferor for these purposes as well. However, this does not apply to a person who is treated as having predeceased the transferor solely because of the state law treatment of a disclaimer. Treas. Reg. §26.2612-1(a)(2).

4. Multiple Generation Assignments. If the general rules would result in a person being assigned to more than one generation, the individual is assigned to the lowest such generation. IRC §2651(f).
5. Move Down Rule. In the case of trusts, one a generation skipping transfer has occurred, the transferor is moved down to the generation immediately above the highest generation person who has an interest in such trust immediately after such transfer. IRC §2653(a).

C. Examples: (Refer to Appendix A for the Family Tree of the Donor Family for these examples).

1. Chuck makes a transfer to Emily who is the child of his niece, Diane. Emily is a descendant of Chuck's grandfather, Allen. There are two generations between Chuck and Allen (Allen to Bob, Bob to Chuck) and there are four generations between Emily and Allen (Allen to Bob, Bob to Carol, Carol to Diane, Diane to Emily). Therefore, Emily is two generations below Chuck and is a skip person.
2. Chuck makes a transfer to Debbie, who is the child of his cousin, Cindy. Debbie is a lineal descendant of Chuck's grandfather, Allen. There are two generations between Chuck and Allen (Allen to Bob, Bob to Chuck) and there are three generations between Debbie and Allen (Allen to Betty, Betty to Cindy, Cindy to Debbie). Therefore Debbie is one generation below Chuck and is a non-skip person.
3. Chuck makes a transfer to a trust that pays the income to his son David for life and at David's death, the principal will be distributed to David's descendants, or if David has no descendants, to Chuck's daughter, Diane. Because David is a non-skip person to Chuck and has an interest in the trust, the trust is a non-skip person.
4. Chuck makes a transfer to a trust that provides that the net income will be accumulated for ten years and at that time, all income and

principal will be distributed to his then living grandchildren, per capita. Because there is no current beneficiary who is a non-skip person, and no distributions may be made to a non-skip person in the future, the trust is a skip person.

5. Chuck was born in 1930. At his death in 2015, he made gifts to three people. Hannah, his housekeeper, was born in 1970, Wendy his spouse, was born in 1975. And Don, his nephew, was born in 1980. Under the generation assignment rules, Hannah, age 45 and not related to Chuck, is 40 years younger than Chuck and is therefore a skip person. Wendy, age 40, is Chuck's wife and so is automatically assigned to the same generation as Chuck and is therefore a non-skip person. Don, age 35, is only one generation removed from Chuck and is therefore a non-skip person.
6. Carol's daughter, Diane, predeceased her. At Carol's death, she makes a gift to Diane's child (Carol's grandchild), Emily. Although Emily is a descendant two generations younger than Carol, the predeceased parent exception applies and provides that Diane is ignored in computing Emily's generation assignment. Therefore, Emily is treated as one generation younger than Carol and a non-skip person for purposes of this transfer.
7. Chuck's niece, Diane, died in 2015. Chuck dies in 2019 leaving children, grandchildren and great-grandchildren surviving him. At Chuck's death, he makes a gift to Diane's child, Emily. As we saw above, Emily is a skip person as to Chuck. The predeceased parent does not apply to this transfer even though Diane is a lineal descendant of a parent of Chuck (both Chuck and Diane are descendants of Bob). This is because Chuck has lineal descendants who survive him.

IV. Which Transfers are Subject to the GST Tax?

A. Effective Dates

1. General Rule. The GST Tax applies to all generation-skipping transfers made after October 22, 1986. Treas. Reg. §26.2601-1(a)(1).
2. Exceptions:

- a. Pre-1986 Lifetime Transfers. An inter-vivos transfer subject to the gift tax and made between September 25, 1985 and October 23, 1986 is treated as made on October 23, 1986. Treas. Reg. §26.2601-1(a)(2). Thus, you may come across trusts with funding dates in this range to which GST exemption was allocated or to which the move down rules applies due to the payment of GST Tax on such a transfer.
- b. Pre-1985 Irrevocable Trusts. The GST Tax does not apply to a trust that was irrevocable on September 25, 1985. If additions were made to that trust after September 25, 1985, a pro rata portion of such trust is exempt from tax. If the trust would be includible in the transferor's gross estate under §2038 or §2042, it is not treated as irrevocable. Treas. Reg. §26.2601-19(b).
- c. Pre-Existing Wills and Trusts. There are exceptions, which are unlikely to be encountered this long after the enactment, for estate plans that were in place at the time the tax became effective and were not modified thereafter, and for Wills and Trusts created before that date by individuals who lacked capacity to modify them after that date.
- d. Pre-1990 Grandchild's Exclusion. The Tax Reform Act of 1986 provided for a "grandchild's exclusion" which excepted from the GST Tax direct skip transfers outright or in trust for the benefit of the transferor's grandchildren, up to a total of \$2,000,000 per grandchild. This only applied to transfers prior to January 1, 1990. These so called "Gallo Trusts" cannot be created now, but many remain in existence.

B. Direct Skip Defined

1. A transfer of an interest in property to a person or trust that is a "skip person" is a direct skip if the transfer is subject to gift or estate tax. IRC §2612(c).
2. Only one GST Tax is imposed per transfer, even if more than one generation is skipped.

3. Examples:

- a. Betty makes a lifetime gift to Ethan, her great-grandson, of \$20,000. This is a direct skip. In addition, it is a single direct skip, even though Ethan is three generations younger than Betty, and both Cindy (Betty's child) and Debbie (Betty's grandchild) are "skipped" in this transfer.
- b. David establishes a trust for the best interests and welfare of Tracy, Tom and Fred, his grandniece and grandnephews. Once these individuals all attain age 25, the remaining principal is to be distributed to them in equal shares. Fred is a grandson of David's sister, Danielle, so Fred is a skip person as to David. Tracy and Tom are grandchildren of David's half-sister Rachel, and therefore are skip persons as to David. Therefore, since no non-skip person has an interest in the trust, it is a skip person and the transfer is a direct skip. Note that if one of the beneficiaries' parents who was related to David had died before the gift to the trust, the transfer would not be a direct skip because of the predeceased parent exception. In this case, the rule would apply because David has no descendants of his own.
- c. Chuck sets up a trust to pay the income to his granddaughter, Ellen, for life, and at Ellen's death, the principal is to be paid to charity. Since the charitable organization is a non-skip person, the trust is not a skip person and the transfer is not a direct skip.

C. Taxable Termination Defined.

1. Under IRC §2612(a), a taxable termination is the termination (by death, lapse of time, release of power or otherwise) of an interest in property held in trust unless immediately after the termination:
 - a. A non-skip person has an interest in the property, or
 - b. A no time after such termination may a distribution be made to a skip person.
2. However, no taxable termination occurs if the transfer is subject to Federal estate or gift tax at the time the interest is terminated.

Instead a new transferor will exist. Depending on what happens to the property, you could have no generation-skipping transfer, a direct skip, or a possible future taxable distribution or taxable termination. Treas. Regs. §26.2612-1(b)(1).

3. A partial termination may in certain circumstances be treated as a taxable termination. If by reason of the death of a lineal descendant of the transferor there is a termination of an interest held in trust, and a specific portion of the trust's assets are distributed to one or more skip persons (or trusts for the exclusive benefit of such persons) such termination shall constitute a taxable termination as to such portion. IRC §2612(a)(2).
4. Examples:
 - a. In 2010, Chuck made a lifetime taxable gift to a trust for his daughter, Danielle. At Danielle's death, the property is to be distributed in equal shares to her children, Edward and Ellen. The distribution at Danielle's death to Edward and Ellen, who are skip persons as to Chuck, is a taxable termination.
 - b. Assume the same facts as in (a), except that Danielle has a testamentary general power of appointment over all assets in the trust at her death. In this case, Danielle's power of appointment will cause the trust assets to be subject to the estate tax at her death. As a result, there is no taxable termination. Danielle is treated as the new transferor. Because Edward and Ellen are Danielle's children, and therefore, not skip-persons as to her, there is no generation-skipping transfer.
 - c. Assume the same facts as in (a), except that only one-half of the trust assets are to be distributed to Edward and Ellen. The remaining half stay in trust for the benefit of Danielle's brother, David. In this case, at Danielle's death there is a partial termination. Because she is a descendant of the transferor, the distribution to Edward and Ellen is treated as a taxable termination of their portion of the trust.

D. Taxable Distribution Defined

1. A “taxable distribution” is any distribution from a trust to a skip person that is not a taxable termination or a direct skip. §2612(b).
2. Example: Wilma established a trust at her death in 2013 for the benefit of her daughter, Rachel, and Rachel’s descendants, whenever born. In 2018, the trust makes three distributions. The first is a distribution of income to Rachel. The second is a distribution of principal to Rachel’s son, Steve, for his support, pursuant to the terms of the trust. The third is a distribution for the benefit of Rachel’s grandson, Tom, pursuant to Rachel’s exercise of her lifetime general power of appointment. The distribution to Rachel is not a taxable distribution because she is a non-skip person as to Wilma. The distribution to Steve is not a taxable termination but a direct skip. The distribution to Tom is a partial termination of the trust due to the exercise of Rachel’s power of appointment, which is a transfer subject to gift tax. After the exercise of the power of appointment, there is a transfer from Rachel to Tom. Since Tom is Rachel’s grandson, that transfer is a direct skip.

V. What is the GST Exemption and how is it Allocated?

A. GST Exemption Defined

1. IRC §2631 grants each individual taxpayer an exemption from the GST Tax that can be applied by the taxpayer during his or her life or by his or her executor at death to any property of which such taxpayer is the transferor.
2. Since 2011, the GST exemption has been equal to the exclusion amount under IRC §2010(c). See IRC §2631(c). That amount is currently \$10,000,000 adjusted for inflation after 2016. The amount for 2019 is \$11,400,000.

B. Time and Manner of Allocation

1. GST exemption is allocated on or before the date prescribed for the transferor’s federal estate tax return (including extension), regardless of whether a federal estate tax return is required to be filed. §2632(a).
2. The exemption may be allocated on a federal gift tax return (for lifetime transfers (Treas. Reg. §26.2632-1(b)(4)) or on the transferor’s

federal estate tax return (Treas. Reg. §2631-1(d)(1)) for transfers occurring at death. Any such allocation is generally irrevocable. IRC §2631(b).

3. A transferor may allocate GST exemption to a trust which is not a skip person but from which a generation-skipping transfer may occur in the future, on a “Notice of Allocation” attached to the appropriate transfer tax return. The notice of allocation must clearly identify the trust, the amount of GST exemption being allocated, the value of the assets, and whether the allocation is late or timely. Treas. Reg. §26.2632-1(b)(2).
4. Example: Cindy establishes a trust during her lifetime for the benefit of her descendants, whenever born. Since her child, Debbie, is a beneficiary, the trust is not a skip person and no generation-skipping transfer occurs when Cindy transfers Blackacre, valued at \$500,000, to the trust. However, because a taxable termination or taxable distribution may occur in the future, Cindy may allocate GST exemption to the trust by attaching a Notice of Allocation to the federal gift tax return reporting the transfer to the trust.
5. Allocations of GST Exemption at the Transferor’s Death
 - a. To determine what GST exemption is available to allocate at a decedent’s death, step one is to compute how much GST exemption the decedent has left.
 - i. Review allocations made on previously filed gift tax returns, including notices of allocation.
 - ii. Determine whether any allocations were made automatically pursuant to the automatic allocation rules for lifetime transfers made by the decedent.
 - iii. Determine whether any allocation needs to be made on the decedent’s final gift tax return for the year of death.
 - iv. Determine whether any late allocations are required for transfers made during the decedent’s lifetime.
 - b. GST exemption can be allocated to gifts made before death but not yet reported on the decedent’s final gift tax return. The final 709 is due on April 15 of the calendar year following the transfer, or the due date of the federal estate

tax return for the transferor, whichever is earlier. This amount is also reported on line 3 of Schedule R of the estate tax return.

- c. GST exemption is allocated to direct skips occurring at death on Schedule R, part 2 (for direct skips bearing the tax) or part 3 (for direct skips that do not bear the tax) and reported on lines 4 and 5 of Schedule R.
- d. GST exemption is allocated to direct skips from a trust at death on Schedule R-1 and reported on Schedule R. The executor completes Schedule R-1 and files one copy with the estate tax return and sends two copies to the Trustee of the trust in question by the due date for the 706. The trust from which the direct skip is made must pay the tax, and file one copy of Schedule R-1 with the IRS by the due date for the transferor's 706.
- e. GST exemption is allocated to Trusts on Line 9 of Schedule R of the 706.

C. Automatic Allocations

- 1. Under IRC §2632(b)(1), a transferor who has unused GST exemption is deemed to automatically allocate GST exemption to all lifetime direct skip transfers. There is an election to opt out of this treatment under IRC §2632(b)(3).
- 2. Under IRC §2632(c), a transferor who has unused GST exemption is also deemed to automatically allocate GST exemption to certain transfers that constitute "indirect skips" (that is to say not direct skips) made to trusts that are defined as "GST Trusts", generally trusts where it is more likely than not that a future distribution could result in a direct skip, a taxable termination, or a taxable distribution.
 - a. The trust must not be a skip person.
 - b. The trust must have a possibility of a future generation skipping transfer.
 - c. Exceptions:

- i. A non-skip person beneficiary has a right to withdraw 25% or more of the trust corpus prior to reaching age 46, prior to a date or dates specified that must occur prior to such beneficiary's reaching age 46, or prior to an event the occurrence of which may be reasonably expected to occur before such non-skip beneficiary reaches age 46, or
 - ii. The trust provides that at least 25% of the property must be distributed to one or more non-skip persons upon the death of a person who is 10 years or more older than such beneficiaries; or
 - iii. If one or more individuals die before the dates specified in i or ii above, at least 25% of the property must be distributed to the estate of a non-skip beneficiary or is subject to a general power of appointment held by a non-skip beneficiary; or
 - iv. The trust would be includible in the estate of a non-skip person if such person died immediately after the date of the transfer; or
 - v. The trust is a Charitable Remainder Unitrust, a Charitable Remainder Annuity Trust, or a Charitable Lead Annuity Trust
 - vi. The trust is a party to a charitable gift annuity and a non-skip person would receive the annuity payments as they came due.
 - d. Elections. If a taxpayer has available GST Exemption, the automatic allocation rules will allocate it automatically to transfers to a GST Trust as defined above without the filing of any gift tax or other return. If this is not what a taxpayer wishes, however, the taxpayer on a gift tax return may elect to have a trust treated as not a GST Trust for purposes of the automatic allocation rules. Similarly, a taxpayer may elect to treat any other trust as a GST Trust for purposes of the automatic allocation rules, either for a particular transfer or for all future transfers made until another election is made. IRC §2632(c).
- 3. If all GST exemption is not allocated by the time the federal estate tax return is due (with extensions), the exemption will automatically be allocated first to direct skips occurring at the transferor's death, and then to trusts of which the decedent is the transferor from which a taxable distribution or taxable termination or direct skip could occur later. Such allocations are made on a pro rata basis. §2632(c)(1)(B) and (c)(2).

D. Late allocations

1. A late allocation is any allocation not made on a timely basis. Such an allocation can be made on a Form 709 before the decedent's death or on a Form 706 at the transferor's death. Treas. Reg. §26.2631-1(d).
2. The primary difference is that for purposes of a late allocation, assets are valued as of the date of the allocation, rather than the date of the transfer. Treas. Reg. §26.2632-1(d)(i).
3. For assets other than life insurance policies, a transferor can elect to value the property to which a late allocation is made on the first day of the month in which the late allocation is made. Treas. Reg. §6.2642-2(a)(2).

E. Allocations Subject to an Estate Tax Inclusion Period.

1. Under IRC §2642(f), if a generation-skipping transfer is subject to an "estate tax inclusion period" (ETIP), no allocation of GST exemption is effective until the end of the ETIP.
2. An ETIP occurs where a donor makes a lifetime transfer of property and the property would still be includible in the donor's estate for estate tax purposes immediately after the transfer (other than by reason of IRC §2035).
3. If a transfer is made subject to an ETIP, no allocation of GST exemption is EFFECTIVE. The transferor can make an allocation prior to the end of the ETIP. However, this is difficult because the value for purposes of the allocation is the value of the property at the end of the ETIP (see IRC §2642(f)(2)), which will be hard to predict. Thus, typically, GST exemption typically is allocated one the ETIP ends.
4. In estate administration, the issue is to determine whether there has been any allocation previously made to a transfer subject to an ETIP, and whether any additional allocation needs to be made.

5. Example: Chuck creates a Grantor Retained Annuity Trust that will pay him a 10% annuity each year for five years. At the end of five years, the property will be paid to his grandson, Edward. The property will be includible in Chuck's estate under IRC §2036 if he dies during the five year term of the GRAT. Consequently, the transfer is subject to an ETIP until the end of the five year period. Any allocation of GST exemption will not be effective until that period passes, and will have to be based on the value of trust property at the time of the allocation.

F. Formula Allocations

1. Valuation of a GST transfer is critical in allocation exemption. If the asset is difficult to value, there is a risk of allocation too little exemption if the Service successfully challenges the value of the transfer after the allocation of GST exemption.
2. For example, if closely-held stock contributed to a trust is valued at \$100 per share for gift tax purposes and for allocating GST exemption is revalued by the IRS on audit to \$125 per share, the GST exemption allocated is now only 80% of the value of the transferred property and the trust will have an inclusion ratio of 2/10 or 20%.
3. To avoid this result, tax preparers turn to the formula allocation. This concept is to draft a verbal description of the amount of GST exemption to be allocated related to the fair market value of the property rather than solely to place a numerical value on the amount allocated. In that case, the adjustment of the fair market value adjusts the amount of GST exemption allocated as long as the transferor has any left.
4. Example of formula allocation language: The executor allocates to the transfer of 1000 shares of Widget Corporation to the XYZ GST Trust such portion of the decedent's GST exemption as will result in the lowest possible inclusion ratio of the XYZ GST Trust. Based on the attached valuation of Widget Corporation by Acme Appraisals, Inc., the executor believes this amount to be \$500,000.
5. Formula allocations on gift tax returns may force the executor to make formula allocations on the estate tax return due to the ambiguity of the amount of GST exemption available to be allocated.

VI. What is an Inclusion Ratio?

- A. The first step in calculating GST Tax owed is to compute the Applicable Fraction and the Inclusion Ratio for the transfer.
 1. The Applicable Fraction has a numerator equal to the amount of GST exemption allocated to the transfer (if a direct skip) or to the trust (for other GST's) and a denominator equal to the value of the property transferred or involved in the skip or held in the trust. The denominator is reduced by the value of federal and state death taxes actually paid, and by any available charitable deductions. IRC §2642(a)(2).
 2. The Inclusion Ratio is equal to 1 minus the applicable fraction.
 3. If the GST exemption allocated to a transfer is equal to the value of the transferred asset, the applicable fraction is 1, and the inclusion ratio is zero. If no GST exemption is allocated, the applicable fraction is zero, and the inclusion ratio is 1.
- B. Generally the goal in allocating GST exemption is to have transfers and trusts have an inclusion ratio of zero (be entirely exempt from the tax) or an inclusion ratio of 1 (be entirely subject to the tax).

VII. How Do You Sever a Trust for GST Purposes?

- A. ,In the event the inclusion ratio is a number between zero and 1, so that the trust is partially subject to the GST tax, most practitioners prefer to sever the trust under state law or the terms of the trust agreement into two shares, one funded with assets valued at the amount of the available GST exemption to which exemption will be allocated and which will have an inclusion ratio of 1, and the other with the rest of the assets to which no exemption will be allocated, and which will have an inclusion ratio of zero.
- B. A single trust with separate shares or multiple transferors may be divided into separate trusts at any time. Treas. Reg. §26.2654-1(a)(3). *See, e.g.*, PLR 200039004.

C. Treas. Reg. 26.2654-1(b) permits severance of a trust that is included in the estate of the transferor under limited circumstances.

1. The governing instrument directs severance; or
2. The governing instrument does not require severance but the trust is severed pursuant to a discretionary power to sever the trust under applicable local law or the governing instrument, AND
 - a. The terms of the new trusts (in the aggregate) provide for the same beneficiaries and succession of interest as the original trust;
 - b. The severance occurs prior to the date prescribed for filing the transferor's federal estate tax return (or, if the governing instrument or local law authorizes severance of the trust, it is sufficient to describe on the form 706 that separate trusts will be created and the method by which the severance and funding will occur); and
 - c. The trusts are severed on a fractional basis, or a pecuniary amount severance is required under the trust agreement or local law.

D. Qualified Severances (sometimes called a "downstream split").

1. Under IRC §2642(a)(3), a trust severance other than one described above is recognized for GST purposes only if it meets the requirements for a "qualified severance".
2. A qualified severance is a severance of a trust into two or more shares by any means available under the governing instrument or applicable local law (including but not limited to a statute or a court order) as long as the severance is effective under local law, the single trust is divided on a fractional basis (which can be a formula fraction) and funding is accomplished within a reasonable time (not to exceed 90 days) after the date of the severance. Treas. Reg. §26.2642-6(d).

VIII. Examples.

1. If Chuck makes a transfer of \$1,000,000 to a trust for his granddaughter, Ellen, and allocates \$1,000,000 in GST exemption

to the transfer, the trust will have an applicable fraction of 1 and an inclusion ratio of zero (the trust would be fully “Exempt” from the GST Tax).

2. If instead Chuck allocated no GST exemption to the transfer, the trust would have an applicable fraction of zero and an inclusion ratio of 1 (the trust will be Non-Exempt or completely subject to the GST tax).
3. Finally , if Chuck only had \$700,000 in GST exemption to allocate, he could allocate it all to the transfer, in which case the trust would have an applicable fraction of 7/10 or 70% and an inclusion ratio of 3/10 or 30%. The alternative would be to split the trust into two, one valued at \$700,000 to which the GST exemption would be allocated to create an applicable fraction of 1 and an inclusion ratio of zero (wholly Exempt), and one valued at \$300,000 to which no GST exemption would be allocated, with an applicable fraction of zero and an inclusion ratio of 1 (wholly subject to the GST Tax or Non-Exempt).

IX. How Is the GST Tax Calculated?

- A. The tax is imposed at the highest marginal estate and gift tax rate then in effect (currently 40%). It is a flat rate. IRC §2641.
- B. Valuation.
 1. General Rule. The general rule is that property is valued for GST tax purposes at its fair market value on the date of the generation-skipping transfer. IRC §2624(a).
 2. Alternate Valuation and Special Use Valuation Apply to Certain Direct Skips. In the case of a direct skip of property included in the transferor’s gross estate for federal estate tax purposes, the value is its value for purposes of the estate tax, including the application of alternate valuation under IRC §2032 and special use valuation under IRC §2032A.
 3. Alternate Valuation Applies to Certain Taxable Terminations. In the case of taxable terminations occurring at and due to the death of an

individual, an election may be made to value such property in accordance with §2032 (alternate valuation).

4. Reduction for Consideration. The value of property subject to any generation-skipping transfer is reduced by the amount of any consideration provided by the transferee.

C. Exemptions and Exclusion

1. Transfer which (if made inter vivos) would qualify for the gift tax exclusion under IRC §2503(e) for direct payment of tuition and health care are excluded from the generation skipping tax. IRC §2611(b)(1).
2. A lifetime direct skip is effectively exempt from the GST tax as to any portion that qualifies for the IRC §2503(b) gift tax annual exclusion because it is assigned a zero inclusion ratio. IRC §2642(c)(1).
 - a. For gifts in trust, the gift must be vested in a single beneficiary. This requires that the trust be for the exclusive benefit of a single beneficiary during life, and that the trust property be includible in the beneficiary's gross estate if the beneficiary dies before the trust terminates. IRC §2642(c)(2), Treas. Reg. §26.2642-1(c)(3).
 - b. Practice Note: This means that transfers to the typical Crummey trust for multiple beneficiaries (used often with Irrevocable Life Insurance Trusts for example) will not qualify for the GST annual exclusion even if they do qualify for the gift tax annual exclusion. Only transfers to a trust for a single beneficiary can qualify for the GST annual exclusion.

D. Taxable Amount

1. As provided in IRC §2622, the taxable amount in the case of a taxable termination is the value of all property subject to the taxable termination, reduced by expenses similar to those deductible under IRC §2053.
2. The taxable amount in the case of a taxable distribution is the value of the property received by the transferee, reduced by costs incurred for determination, collection or refund of GST tax related to such distribution. §IRC 2621.

3. The taxable amount in the case of a direct skip is the property received by the transferee. IRC §2623.

E. Computation of GST Tax

1. Value the property as of the effective date of the generation-skipping transfer.
2. Compute the taxable amount (e.g. reduce for annual exclusions, consideration, if any, and any deductible expenses).
3. Compute the inclusion ratio.
4. Multiply the inclusion ratio by the applicable rate (currently 40%) to find the tax rate.
5. Multiply the taxable amount by the tax rate.

- F. The tax is not deductible for estate tax purposes. For income tax purposes, there is an income tax deduction under IRC §691(c) for generation-skipping transfer tax imposed on a taxable distribution or a direct skip

X. **What are the GST Tax Reporting, Filing and Payment Requirements?**

A. Reporting Generation Skipping Transfers

1. Lifetime Gifts

- a. List direct skips subject to both gift tax and GST tax on Schedule A, part 2 of the transferor's form 709 (gift tax return).
- b. List indirect skips (e.g. transfers to GST Trusts as described above) on Schedule A on part 3 of the transferor's form 709.
- c. Such gifts are further listed on Schedule D of form 709
 - i. List the transfer on part 1
 - ii. Allocate GST exemption on part 2
 - iii. Compute tax on part 3

- d. The return is due at the same time as the transferor's income tax return (April 15 of the following calendar year unless extended)

2. Taxable Distributions

- a. Taxable Distributions are reported on form 706-GS(D) (Generation-Skipping Transfer Tax Return for Distributions) **and** on Form 706-GD(D-1) (Notification of Distribution from a Generation-Skipping Trust).
- b. A separate 706-GS(D) and 706-GS(D-1) is filed for each recipient
- c. Form 706-GS(D) is filed by the distribute (beneficiary) with the IRS on or after January 1 but before April 15 of the calendar year following the distribution.
- d. Form 706-GS(D-1) is filed by the Trustee with the IRS and sent to the distribute (copy B) by April 15 of the calendar year following the distribution.

3. Taxable Terminations

- a. Taxable Terminations are reported on Form 706-GS(T).
- b. The form is filed by the trustee of a trust that has a taxable termination.
- c. It is due by April 15 of the calendar year following the taxable termination.

4. Direct Skips at Death

- a. Direct Skips at death are reported on Schedule R of the transferor's form 706 (estate tax return).
- b. Report Direct Skips that bear the GST tax on part 2 of Schedule R, and ones that do not bear the GST tax on part 3.
- c. Form 706 is due nine months after the decedent's date of death unless extended.

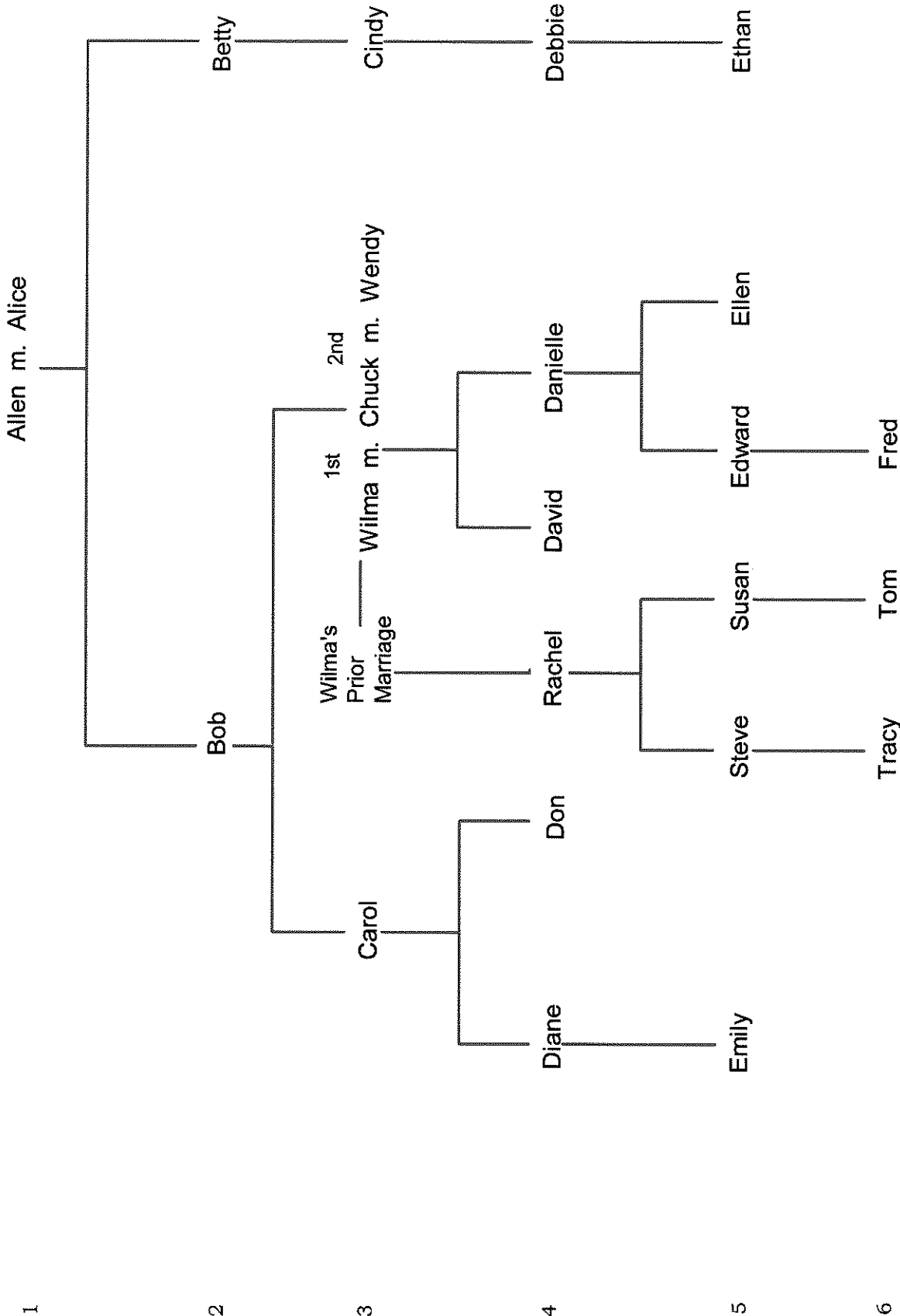
B. Payment of GST Tax (IRC §2603)

1. Unless the governing instrument directs otherwise, the GST tax is to be paid out of the property subject to the tax.
2. Taxable Distributions
 - a. Liability for GST tax imposed on taxable distributions is imposed on the recipient/transferee.
 - b. Consequently, in this case, the tax is “tax-inclusive”, as the beneficiary receives the gross amount and the tax is calculated on the whole amount, including dollars used to pay tax. The result is generally a higher tax than would be imposed on a tax-exclusive direct skip of the same amount.
 - c. Example. Rachel establishes a \$10,000,000 trust for the benefit of her son, Steve, and her granddaughter, Tracy, and allocates no GST exemption to the trust. The trustee of the trust makes a \$1,000,000 distribution to Tracy. Out of that distribution, Tracy must pay \$400,000 in GST tax leaving her with \$600,000. If instead, Rachel made a tax-exclusive direct skip to Tracy of \$600,000, Tracy would get to keep the whole \$600,000. Rachel would pay GST Tax of \$240,000 on the transfer to get the same amount to Tracy.
3. Taxable Terminations and Direct Skip Transfer from a Trust
 - a. Liability for GST tax imposed on taxable termination and direct skips from trusts is also imposed on the transferee.
 - b. These transfers are also tax-inclusive.
4. Direct Skips.
 - a. Liability for GST Tax on direct skips (other than a direct skip transfer from a trust) is imposed on the transferor.
 - b. If the direct skip transfer bears the tax, the transfer is “tax-exclusive.” It is a tax on what the beneficiary receives, and does not include tax on the dollars used to pay the tax. This reduces the

effective rate to transfer a sum to the recipient when compared to taxable terminations and taxable distributions.

- c. Practice Note. Review tax-payment clauses in the governing instrument to determine whether the direct skip bears the tax or whether the burden is elsewhere (e.g. on the residue) and whether there is a blanket waiver of a right to have transferred property bear a share of the tax. Either of these could shift the GST tax burden away from the direct skip which will increase the effective tax rate.

FAMILY TREE OF THE DONOR FAMILY



Notes:
 Only Chuck's spouses are shown, to illustrate stepchild/half-sibling rules.
 Except for spouses and stepchildren, persons descended from Allen have the same initial as all other members of their generation.