Guam Society of CPAs

Estate, Gift, and Generation Skipping Transfer Taxes [Part I]

August 22, 2023

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Internal Revenue Code

§ 2801 Imposition of tax.

(a) In general.

If, during any calendar year, any United States citizen or resident receives any covered gift or bequest, there is hereby imposed a tax equal to the product of—

(1)

the highest rate of tax specified in the table contained in section 2001(c) as in effect on the date of such receipt , and

(2)

the value of such covered gift or bequest.

(b) Tax to be paid by recipient.

The tax imposed by subsection (a) on any covered gift or bequest shall be paid by the person receiving such gift or bequest.

(c) Exception for certain gifts.

Subsection (a) shall apply only to the extent that the value of covered gifts and bequests received by any person during the calendar year exceeds the dollar amount in effect under section 2503(b) for such calendar year.

(d) Tax reduced by foreign gift or estate tax.

The tax imposed by subsection (a) on any covered gift or bequest shall be reduced by the amount of any gift or estate tax paid to a foreign country with respect to such covered gift or bequest.

(e) Covered Gift or Bequest

(1) In general.

For purposes of this chapter, the term "covered gift or bequest" means—

(A) any property acquired by gift directly or indirectly from an individual who, at the time of such acquisition, is a covered expatriate, and

(B) any property acquired directly or indirectly by reason of the death of an individual who, immediately before such death, was a covered expatriate.

(2) Exceptions for transfers otherwise subject to estate or gift tax.

Such term shall not include—

(A) any property shown on a timely filed return of tax imposed by chapter 12 which is a taxable gift by the covered expatriate, and

(B) any property included in the gross estate of the covered expatriate for purposes of chapter 11 and shown on a timely filed return of tax imposed by chapter 11 of the estate of the covered expatriate.

(3) Exceptions for transfers to spouse or charity.

Such term shall not include any property with respect to which a deduction would be allowed under section 2055 , 2056 , 2522 , or 2523 , whichever is appropriate, if the decedent or donor were a United States person.

(4) Transfers in trust.

(A) Domestic trusts. In the case of a covered gift or bequest made to a domestic trust—

(i) subsection (a) shall apply in the same manner as if such trust were a United States citizen, and

(ii) the tax imposed by subsection (a) on such gift or bequest shall be paid by such trust.

(B) Foreign trusts.

(i) In general. In the case of a covered gift or bequest made to a foreign trust, subsection (a) shall apply to any distribution attributable to such gift or bequest from such trust (whether from income or corpus) to a United States citizen or resident in the same manner as if such distribution were a covered gift or bequest.

(ii) Deduction for tax paid by recipient. There shall be allowed as a deduction under section 164 the amount of tax imposed by this section which is paid or accrued by a United States citizen or resident by reason of a distribution from a foreign trust, but only to the extent such tax is imposed on the portion of such distribution which is included in the gross income of such citizen or resident.

(iii) Election to be treated as domestic trust. Solely for purposes of this section , a foreign trust may elect to be treated as a domestic trust. Such an election may be revoked with the consent of the Secretary.

(f) Covered expatriate.

For purposes of this section , the term "covered expatriate" has the meaning given to such term by section 877A(g)(1) .

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¶ R-8100 Introduction—Transfer Tax on Gifts and Bequests from Expatriates

A special transfer tax is imposed on any "covered gift or bequest" from a "covered expatriate" to a U.S. citizen or resident under Code Sec. 2801 .[1] The tax is payable by the recipient of the covered gift or bequest. The rate of tax is the greater of the highest estate tax rate or the highest gift tax rate in effect on the date the transferee receives the covered gift or bequest. A per-donee, per-year exclusion, in an amount equal to the gift tax annual exclusion in effect for the year of the transfer, is allowed. The tax does not apply to property that (i) is reported by the covered expatriate as a taxable gift for gift tax purposes, (ii) is included in the covered expatriate's gross estate for estate tax purposes, or (iii) would qualify for the estate tax or gift tax marital or charitable deduction, if the donor or decedent were a U.S. citizen.

For the transfer tax on covered gifts and bequests, see ¶ R-8101 .

For the definition of "covered expatriate," see ¶ R-8102 .

For exceptions to the Code Sec. 2801 tax, see ¶ R-8103 et seq.

For an annual, per-donee exclusion equal to the gift tax annual exclusion amount, see ¶ R-8107 .

For reduction of the Code Sec. 2801 tax for foreign gift or estate taxes paid on a covered gift or bequest, see ¶ R-8108 .

For the treatment of covered gifts and bequests to domestic trusts, see ¶ R-8109 .

For the treatment of covered gifts and bequests to foreign trusts, see ¶ R-8110 .

For rules regarding electing foreign trusts, see ¶ R-8111 et seq.

For who is liable for the Code Sec. 2801 transfer tax, see ¶ R-8115 et seq.

For computing the Code Sec. 2801 tax, see ¶ R-8118 .

For valuing the covered bequests, and dealing with disputes regarding the valuation, see ¶ R-8119 et seq.

For determining the date of receipt of the covered gift or bequest, see ¶ R-8121 .

For what form to use to report covered gifts and bequests, see ¶ R-8122 .

For determining the basis of covered gifts and bequests, see ¶ R-8123 .

For filing returns for covered gifts and bequests, see ¶ S-2314 et seq.

For penalties concerning the Code Sec. 2801 tax, see ¶ V-2253 .

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1 Code Sec. 2801 .

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¶R-8101. Transfer tax on covered gifts and bequests from expatriates.

A special transfer tax (the " Code Sec. 2801 tax") is imposed on any "covered gift or bequest" (see ¶ R-8102) received by a a U.S. citizen or resident (see below). [2]

Under proposed regs, the Code Sec. 2801 tax also would also apply to distributions from foreign trusts that are attributable to covered gifts or bequests (see ¶ R-8110). [2.1]

A U.S. citizen would be an individual who is a citizen or resident of the U.S., under the estate and gift tax rules, at the time when the covered gift or bequest is received. For purposes of the Code Sec. 2801 tax, a U.S. citizen or resident also would include domestic trusts (see below) and foreign trusts that have elected to be treated as domestic trusts (referred to as electing foreign trusts, see ¶ R-8111). [3]

A domestic trust would include a trust defined in Code Sec. 7701(a)(30)(E) (see ¶ C-5602.1) and an electing foreign trust (see ¶ R-8111). [4]

Further, a U.S. recipient would be a U.S. citizen or resident that receives a covered gift or bequest, directly or indirectly, during the year. A U.S. recipient would include:

. . . a U.S. citizen or resident that receives a distribution from a foreign trust that is not an electing foreign trust if the distributions are attributable to one or more covered gifts or bequests received by the foreign trust, and

. . . a U.S. citizen or resident shareholder, partner, member or others who hold an interest in a domestic entity that receives a covered gift or bequest. [5]

The amount of the Code Sec. 2801 tax is determined by multiplying the value of the covered gift or bequest [6] by the highest estate tax rate listed in the Code Sec. 2001(c) rate table (see Tables & Rates ¶ TBL-1008) in effect on the date the transferee receives the covered gift or bequest.[7]

> **RIA observation:** For purposes of determining the value of a covered bequest, Code Sec. 2801 does not provide for any elections comparable to the Code Sec. 2032 alternate valuation date election (see ¶ R-5001) or the Code Sec. 2032A special use valuation election for farm or other closely held business real property (see ¶ R-5201).

For gifts made in 2010, [8] the rule at footnote 7 included a reference to the separate gift tax table under Code Sec. 2502(a) that was in effect for taxable gifts made in 2010.[9]

> **RIA observation:** The Economic Growth and Tax Relief Reconciliation Act of 2001 (PL 107-16, 6/7/2001, EGTRRA) created a separate rate table for gifts made in 2010 because the estate tax was originally scheduled to be repealed in 2010 (with the gift tax scheduled to remain in tact). The 2010 Tax Relief Act (PL 111-312, 12/17/2010) retroactively reinstated the estate tax and reunified the gift tax rate schedule with the estate tax rate schedule in one table under Code Sec. 2001(c) . Thus, the earlier reference in Code Sec. 2801(a)(1) (footnote 7) to the separate gift tax rate table under Code Sec. 2502(a) (a table which no longer existed) became unnecessary. The 2014 Tax Increase Prevention Act (Sec. 206(b)DivA, PL 113-295, 12/19/2014) made this technical correction by deleting the reference.

For covered gifts and bequests received before June 17, 2008, from transferors (or from the estates of transferors) whose expatriation date was before June 17, 2008, [10] the Code Sec. 2801 tax on covered gifts and bequests did not apply.

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2 Code Sec. 2801(a) .

2.1 Prop Reg § 28.2801-1(a) .

3 Prop Reg § 28.2801-2(b) .

4 Prop Reg § 28.2801-2(c) .

5 Prop Reg § 28.2801-2(e) .

6 Code Sec. 2801(a)(2) .

7 Code Sec. 2801(a)(1) .

8 Sec. 206(d)DivA , PL 113-295 , 12/19/2014 .

9 Code Sec. 2801(a)(1) before amend by Sec. 206(b)DivA , PL 113-295 , 12/19/2014 .

10 Sec. 301(g)(2) , PL 110-245 , 6/17/2008 .

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¶R-8102. Definition of "covered gift or bequest" for purposes of the tax on transfers from expatriates.

For purposes of the Code Sec. 2801 tax on covered gifts and bequests from expatriates (see ¶ R-8101), the term "covered gift or bequest" means: [11]

. . . any property acquired by gift directly or "indirectly" (see below) from an individual who, at the time of the acquisition, is a "covered expatriate" (see ¶ R-8106), [12] and

. . . any property acquired directly or "indirectly" by reason of the death of an individual who, immediately before his death, was a covered expatriate. [13]

Under proposed regs, a covered gift would include:

. . . any property acquired by gift directly or "indirectly" from an individual who is a covered expatriate at the time the property is received by a U.S. citizen or resident, regardless of the property's location and of whether the property was acquired by the covered expatriate before or after expatriation, and

. . . distributions made, other than by reason of the death of a covered expatriate, from a foreign trust that is not an electing foreign trust (see ¶ R-8111), to the extent the distributions are attributable to covered gifts or covered bequests made to the foreign trust. [14]

Similarly, a covered bequest would include property that is acquired directly or "indirectly" by reason of the death of a covered expatriate, regardless of the location of the property or whether the property was acquired by the covered expatriate before or after the individual expatriated. A covered bequest would also include distributions from a foreign trust (see ¶ R-8110), to the extent that the distributions are attributable to covered gifts or bequests made to the foreign trust.[15]

For purposes of the Code Sec. 2801 tax, property that has been acquired "indirectly" would include property that has been:

(a) acquired by a transfer that is a covered gift or bequest to a corporation or other entity other than a trust or estate, to the extent of the respective ownership interest of the recipient U.S. citizen or resident in the corporation or other entity;

(b) acquired by or on behalf of a U.S. citizen or resident, either from a covered expatriate or from a foreign trust that received a covered gift or bequest, through one or more other foreign trusts, other entities, or a person not subject to the Code Sec. 2801 tax;

(c) paid by a covered expatriate, or distributed from a foreign trust that received a covered gift or bequest, in satisfaction of a debt or liability of a U.S. citizen or resident, regardless of the payee of that payment or distribution;

(d) acquired by or on behalf of a U.S. citizen or resident pursuant to a non-covered expatriate's power of appointment (see below) granted by a covered expatriate over property not in trust, unless the property was subject to Code Sec. 2801 tax when the power was granted, or the covered expatriate had only a non-general power of appointment over that property; and

(e) acquired by or on behalf of a U.S. citizen or resident in other transfers not made directly by the covered expatriate to the U.S. citizen or resident.[16]

For purposes of item (e), above, a power of appointment would refer to both a general (see ¶ R-3006) and non-general (see ¶ R-3007) power of appointment.[17]

RIA illustration: X (a U.S. citizen or resident) owes $100,000 to Y. Z (a covered expatriate who is not X's spouse) discharges X's indebtedness by paying $100,000 directly to Y. If Z were a U.S. citizen or resident, the payment would be treated as an indirect gift of $100,000 from Z to X, and thus would be subject to gift tax. The transfer would be treated as an indirect covered gift of $100,000 from Z to X for purposes of the Code Sec. 2801 tax (under item (c), above).

A covered gift would have the same meaning as a gift for gift tax purposes, without taking into account the following exceptions for gift tax purposes:

(1) transfers of intangible property under Code Sec. 2501(a)(2) , see ¶ Q-4003 ;

(2) transfers to political organizations under Code Sec. 2501(a)(4) , see ¶ Q-3201 ;

(3) transfers of stock in foreign corporations under Code Sec. 2501(a)(5) , see ¶ Q-4003.5 ;

(4) the annual gift tax exclusion under Code Sec. 2503(b) , see ¶ Q-5002 ;

(5) the exception for medical and educational payments under Code Sec. 2503(e) , see ¶ Q-5252 and ¶ Q-5255 ; and

(6) the waiver of pension rights under Code Sec. 2503(f) , see ¶ Q-5281 .[18]

A covered bequest would include property that would have been includible in the covered expatriate's gross estate had the covered expatriate been a U.S. citizen at the time of death (under the federal estate tax rules). A covered bequest would include property that has been acquired by reason of a covered expatriate's death:

(i) by bequest, devise, trust provision, beneficiary designation or other contractual arrangement, or by operation of law;

(ii) by transfer by the covered expatriate during life, either before or after expatriation, which would have been includible in the covered expatriate's gross estate under Code Sec. 2036 (covered expatriate's retained life estate or power to enjoy, see ¶ R-2400 et seq.), Code Sec. 2037 (postponement of full enjoyment or possession, see ¶ R-2500 et seq.), Code Sec. 2038 (covered expatriate's power to revoke or change disposition, see ¶ R-2600 et seq.), if the covered expatriate had been a U.S. citizen at the time of death;

(iii) by receipt for the benefit of a covered expatriate from the covered expatriate's spouse, or predeceased spouse, for which a valid QTIP election was made on the spouse's, or predeceased spouse's, gift tax return on Form 709, or estate tax return on Form 706-NA, which would have been included in the covered expatriate's gross estate as a qualifying income interest for life under Code Sec. 2044 (see ¶ R-2900.1), if the covered expatriate was a U.S. citizen at the time of death; or

(iv) by otherwise passing from the covered expatriate as:

. . . property held by the covered expatriate and another person as joint tenants with right of survivorship or as tenants by the entirety, but only to the extent the property would have been included in the covered expatriate's gross estate as a joint interest under Code Sec. 2040 (see ¶ R-2700 et seq.) if the covered expatriate had been a U.S. citizen at the time of death;

. . . an annuity or other payment that would have been includible in the covered expatriate's gross estate if the covered expatriate had been a U.S. citizen at the time of death;

. . . property subject to a general power of appointment held by the covered expatriate at death; or

. . . life insurance proceeds payable upon the covered expatriate's death that would have been includible in the covered expatriate's gross estate under Code Sec. 2042 (see ¶ R-4002) if the covered expatriate had been a U.S. citizen at the time of death.[19]

For exceptions, from the definition of "covered gift or bequest," for—

. . . transfers that are otherwise subject to gift or estate tax, see ¶ R-8103 ,

. . . transfers that would qualify for a marital or charitable deduction, if the donor or decedent were a U.S. citizen, see ¶ R-8104 , and

. . . transfers that are pursuant to a qualified disclaimer, see ¶ R-8105 .

For covered gifts and bequests received before June 17, 2008, from transferors (or from the estates of transferors) whose expatriation date was before June 17, 2008, [20] the Code Sec. 2801 tax on covered gifts and bequests did not apply.

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11 Code Sec. 2801(e)(1) .

12 Code Sec. 2801(e)(1)(A) .

13 Code Sec. 2801(e)(1)(B) .

14 Prop Reg § 28.2801-2(g) .

15 Prop Reg § 28.2801-2(f) .

16 Prop Reg § 28.2801-2(i) .

17 Prop Reg § 28.2801-2(j) .

18 Prop Reg § 28.2801-3(a) .

19 Prop Reg § 28.2801-3(b) .

20 Sec. 301(g)(2) , PL 110-245 , 6/17/2008 .

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¶R-8103. Reported transfers otherwise subject to gift or estate tax—exception from definition of "covered gift or bequest" for purposes of the tax on transfers from expatriates.

For purposes of the Code Sec. 2801 tax on covered gifts and bequests from expatriates (see ¶ R-8101), the term "covered gift or bequest" does not include: [21]

(1) for a covered gift, any property shown on a timely filed gift tax return which is a taxable gift by the covered expatriate, [22] and

(2) for a covered bequest, any property included in the gross estate of the covered expatriate for estate tax purposes, and shown on a timely filed estate tax return of the covered expatriate's estate. [23]

Under proposed regs, the exception to the definition of a covered gift (see text at footnote 22) would only apply if the donor of the gift paid the gift tax due, if applicable, as reported on the timely filed gift tax return (see item 1, above). Further, a transfer excluded from the definition of a taxable gift, such as a transfer of a present interest not more than the annual exclusion amount under Code Sec. 2503(b) (see ¶ Q-5002), would not be excluded from the definition of a covered gift even if the gift was reported on the donor's gift tax return.[24]

The exception to the definition of a covered bequest (see text at footnote 23) would only apply for property that is includible in the covered expatriate's gross estate for which the estate paid the estate tax due, if applicable, as reported on the timely filed estate tax return (see item 2, above).

Further, any estate tax imposed on distributions from or on the remainder of a qualified domestic trust (QDOT) would be deemed to be reported on a timely filed estate tax return, if the estate tax due was timely paid. [25]

> **Illustration:** For example, if the covered expatriate's gross estate is not large enough to require the filing of a Form 706-NA (estate tax return for a nonresident, noncitizen of the U.S.), and no Form 706-NA is timely filed, the property passing from that covered expatriate would not be excluded from the definition of a covered bequest.[26]

Further, the exclusion would not apply to the property that is not listed on the form, whether or not subject to U.S. estate tax (that is, property that does not have situs in the U.S. that passes to U.S. citizens or residents). [27]

For covered gifts and bequests received before June 17, 2008, from transferors (or from the estates of transferors) whose expatriation date was before June 17, 2008, [28] the Code Sec. 2801 tax on covered gifts and bequests did not apply.

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21 Code Sec. 2801(e)(2) .

22 Code Sec. 2801(e)(2)(A) .

23 Code Sec. 2801(e)(2)(B) .

24 Prop Reg § 28.2801-3(c)(1) .

25 Prop Reg § 28.2801-3(c)(1) .

26 Prop Reg § 28.2801-3(c)(1) .

27 Prop Reg § 28.2801-3(c)(1) .

28 Sec. 301(g)(2) , PL 110-245 , 6/17/2008 .

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¶R-8104. Transfers to spouse or charity—exception from definition of "covered gift or bequest" for purposes of the tax on transfers from expatriates.

For purposes of the Code Sec. 2801 tax on covered gifts and bequests from expatriates (see ¶ R-8101), the term "covered gift or bequest" does not include any property for which a deduction would be allowed under any of the following, if the decedent or donor were a U.S. person:

. . . Code Sec. 2055 (the estate tax charitable deduction, see ¶ R-5701 et seq.),

. . . Code Sec. 2056 (the estate tax marital deduction, see ¶ R-6001 et seq.),

. . . Code Sec. 2522 (the gift tax charitable deduction, see ¶ Q-6001 et seq.), or

. . . Code Sec. 2523 (the gift tax marital deduction, see ¶ Q-6101 et seq.). [29]

Under proposed regs, a transfer from a covered expatriate to the covered expatriate's spouse would not be a covered gift or bequest to the extent a marital deduction (for gift tax purposes under Code Sec. 2523 (see ¶ Q-6301) or for estate tax purposes under Code Sec. 2056 (see ¶ R-6392)) would have been allowed if the covered expatriate had been a U.S. citizen or resident at the time of the transfer. Similarly, a gift or bequest to a trust (or to a separate share of the trust) that qualifies for the marital deduction would not be a covered gift or bequest. However, a marital deduction would not be allowed for qualified terminable interest property (QTIP, see ¶ R-6391) or for property in a qualified domestic trust (QDOT, see ¶ R-6203) unless a valid QTIP and/or QDOT election is made. [30]

A covered bequest also would not include the assets in a QDOT that had been funded for the benefit of a covered expatriate by the covered expatriate's predeceased spouse, but only if a valid election was made on the predeceased spouse's estate tax return to treat the trust as a QDOT.[31]

A gift to a donee, or a bequest to a beneficiary, would not be a covered gift or bequest to the extent that a charitable deduction (for gift tax purposes under Code Sec. 2522 (see ¶ Q-6010) or, for estate tax purposes under Code Sec. 2055 (see ¶ R-5720)) would have been allowed if the covered expatriate had been a U.S. citizen or resident at the time of the transfer.[32]

> **Illustration:** In Year 1, CE, a covered expatriate domiciled in Country F, a foreign country with which the U.S. does not have a gift tax treaty, gives $300,000 cash to his wife, W, a U.S. resident and citizen of Country F. The $100,000 exemption for a noncitizen spouse, as indexed for inflation in Year 1, is excluded from the definition of a covered gift because only that amount of the transfer would have qualified for the gift tax marital deduction if CE had been a U.S. citizen at the time of the gift. The remaining amount ($300,000 less the $100,000 exemption for a noncitizen spouse as indexed for inflation), however, is a covered gift from CE to W. [33]

For covered gifts and bequests received before June 17, 2008, from transferors (or from the estates of transferors) whose expatriation date was before June 17, 2008, [34] the Code Sec. 2801 tax on covered gifts and bequests did not apply.

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29 Code Sec. 2801(e)(3) .

30 Prop Reg § 28.2801-3(c)(4) .

31 Prop Reg § 28.2801-3(c)(4) .

32 Prop Reg § 28.2801-3(c)(3) .

33 Prop Reg § 28.2801-3(f) , Ex 1 .

34 Sec. 301(g)(2) , PL 110-245 , 6/17/2008 .

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800 Introduction

800.1 If an older generation individual (e.g., a grandparent) transfers property to, or for the benefit of, an individual who is more than one generation younger (e.g., a grandchild), the transfer will theoretically escape one layer of transfer tax that would have applied if the property was transferred first to an individual in the generation immediately succeeding that of the transferor (e.g., a parent) and then to the ultimate transferee. To ensure that transfer tax is paid when generations are *skipped*, Congress enacted the generation-skipping transfer (GST) tax.

800.2 The GST tax is broad-based and applies to most transfers from grandparents to grandchildren or others (including nonfamily members) below their children's generation. The transferor's statutory exemption amount is the most effective means of sheltering these transfers from the GST tax. The lifetime exemption amount is $12.92 million for 2023 ($12.06 million for 2022).

800.3 This topic focuses on how to maximize the transferor's GST tax exemption, as well as the annual GST tax exclusion, and thereby minimize the effect of the GST tax. This topic also provides specific planning strategies to avoid or reduce the GST tax. The advantages and other considerations of generation-skipping transfer tax planning are summarized at Appendix 8B.

800.4 Before a planner can offer GST tax planning tips, it is important to understand the terminology used in the statute and regulations. Section 801 defines several GST tax terms and provides several examples. Section 802 provides an overview of the GST tax. Practice Aid PA-24 contains a checklist for generation-skipping transfers.

801 Understanding Key Generation-skipping Transfer (GST) Definitions

801.1 The following generation-skipping transfer terms are discussed in this section: *generation-skipping transfer*, *transferor*, *GST tax exemption*, *applicable fraction*, *inclusion ratio*, *valuation*, *skip person*, *interest in a trust*, *nonskip person*, and *generation assignment*. See the Glossary at PA-97 for definitions of applicable terms.

Generation-skipping Transfer

801.2 A *generation-skipping transfer* (GST) is a transfer by a U.S. citizen or resident to, or for the benefit of, an individual who is more than one generation below that of the transferor (e.g., from a grandparent to a grandchild). The GST tax applies to the following types of transfers: direct skips, taxable distributions, and taxable terminations. The GST tax does not apply if the transferor is not a U.S. citizen or resident at the time of the transfer (Ltr. Rul. 201311004).

801.3 Direct Skip. A *direct skip* occurs when property subject to either the estate tax or gift tax is transferred to a skip person. There are three types of direct skips—*inter vivos* (lifetime) direct skips, direct skips at death, and direct skips at death from a trust. See section 802 for a discussion and examples of direct skips. See paragraph 801.37 for a definition of skip person and paragraph 801.38 for a discussion of trusts as skip persons.

801.4 Taxable Distribution. A *taxable distribution* is any distribution (other than a taxable termination or a direct skip) from a trust to a skip person. See section 802 for a discussion and examples of taxable distributions.

801.5 Taxable Termination. Generally, a *taxable termination* is the termination (for the benefit of a skip person) of an interest in property held in trust. Certain partial terminations are also treated as taxable terminations. See section 802 for a discussion and examples of taxable terminations.

801.6 Note: It is important to understand the distinction between these types of transfers because the person liable for the GST tax depends on the type of transfer. Generally the beneficiary is liable for the GST tax on a taxable distribution and the trust is liable for the GST tax on a taxable termination.

Transferor

801.7 The transferor's identity is important in a GST because the generation assignment is determined with reference to the transferor (IRC Sec. 2651). Also, only the transferor or the transferor's executor (in the case of an estate) may allocate the GST tax exemption to the transferred property (IRC Sec. 2631).

801.8 The transferor is the donor for any transferred property subject to the gift tax and is the decedent for any transferred property subject to the estate tax [IRC Sec. 2652(a)]. A transfer is subject to the gift tax if it is a completed gift for federal gift tax purposes, regardless of whether the gift tax is actually imposed under IRC Sec. 2501(a) [Reg. 26.2652-1(a)]. See section 304 for additional discussion about the completed gift requirements for gift tax.

801.9 QTIP Property. Transfers that qualify for the marital deduction cause the transferred property to be subject to gift or estate tax on subsequent transfers by the beneficiary spouse. This means the beneficiary spouse becomes the transferor when property that originally qualified for the marital deduction is subject to estate or gift tax. However, a special election is available for qualified terminable interest property (QTIP) that allows the creator of the QTIP property to treat the property as if no QTIP election had been made for GST purposes [IRC Sec. 2652(a)(3)]. This election is referred to as the *reverse QTIP election* and is discussed further in section 807.

801.10 Note: The portability election (to transfer a decedent's unused exclusion to a surviving spouse) does *not* apply to the GST tax exemption. Therefore, any unused GST tax exemption that is not affirmatively or automatically allocated at death is lost. (See the discussion on using portability to maximize a married couple's exclusion amounts in section 1102).

801.11 Gift-splitting Elected. When a married couple elects gift-splitting under IRC Sec. 2513, each spouse is treated as the transferor of half the gift [IRC Sec. 2652(a)(2)]. Therefore, each spouse may allocate the GST tax exemption to their respective part of the gift for GST tax purposes (Ltr. Rul. 200147021). See section 807 for additional discussion of gift-splitting.

801.12 Property Passing by Disclaimer. If a person disclaims an interest in property using a qualified disclaimer, the transferor (for GST purposes) is the original transferor of the property [IRC

Sec. 2654(c)]. Because the disclaimant is treated as predeceasing the transferor (in the case of a transfer at death), the property subject to a qualified disclaimer is considered to have passed directly from the original transferor (the decedent) to the person receiving the property as a result of the disclaimer. See the discussion of qualified disclaimers beginning at paragraph 305.2.

801.13 General Power of Appointment Changes Identity of Transferor. If an individual transfers property to a trust over which one or more individuals have a general power of appointment, the transferor (for GST tax purposes) changes from the original donor to the other individuals holding the general power of appointment. As defined in IRC Secs. 2041 and 2514, a *general power of appointment* is a power to appoint property either to oneself, one's estate, one's creditors, or the creditors of one's estate. If the person holds the power at death, the value of the property subject to the power is included in the power holder's taxable estate and the GST tax consequences to the power holder will be determined at that time.

801.14 Generally, an individual that holds a general power of appointment over trust assets makes a gift if they allow the power to lapse, releases it, or exercises it prior to death. (However, see the exception for withdrawal rights limited to *five and five* discussed in paragraph 802.22.) Once the triggering event (e.g., exercise or lapse) occurs, the power holder becomes the transferor and the GST tax consequences to the power holder must be determined.

801.15 Caution: Granting an individual a general power of appointment over trust assets does not exempt the original donor or transferor from GST tax liability. The GST tax consequences of the original transfer must be determined. The general power of appointment changes the identity of the transferor, and a second determination of the GST tax consequences must be made.

801.16 Planning Tip: The general power of appointment is an important GST tax planning tool. For example, assume the trust provides for income distributions to the transferor's child for life, with the remainder to the grandchildren. No exemption is allocated to the trust. The transfer (at the death of the child) to the grandchildren is a generation-skipping transfer. However, if the trust granted the child (a nonskip person) a general power to appoint all or a defined portion of the trust at the child's death by will, it will be included in the child's estate, and the child will become the transferor. A transfer to the child's children will not be a taxable GST (Ltr. Rul. 202206008).For this reason, many trust documents are written so that the beneficiary has a general power of appointment if the trust will be subject to a taxable termination. The lapse, release, or exercise of the general power of appointment is a taxable event for gift or estate tax purposes [Reg. 26.2601-1(b)(1)(v)(D) , Example 1].

GST Tax Exemption

801.17 GST planning primarily revolves around carefully using the transferor's statutory lifetime GST tax exemption amount. The exemption is allocated to property or trusts and not to transferors.

Each individual may plan for transfers up to the exemption amount (during lifetime or at death) without subjecting the transfers to the GST tax. The exemption generally is allocated based on the property's value on the date of the gift for lifetime transfers or on the date of death for testamentary transfers.

801.18 An individual's lifetime GST tax exemption of $12.92 million for 2023 ($12.06 million for 2022) is adjusted annually for inflation.

801.19 Caution: Any unused basic exclusion amount of a deceased spouse (the *deceased spousal unused exclusion amount*) is available for use by the surviving spouse for lifetime gifts or transfers at death if certain elections are made. However, the portability of the unused basic exclusion amount does not apply for GST tax purposes. See section 1102 for additional discussion of the portability election.

801.20 Statutory provisions determine how a transferor's GST tax exemption is allocated if the transferor fails to do so. The GST tax exemption is allocated first to lifetime direct skips, unless the transferor elects otherwise. See section 804 for coverage of the automatic exemption allocation rules. For transfers after 2000, if a taxpayer demonstrates an intent to have the lowest possible inclusion ratio for a trust or a transfer, the transferor's unused GST tax exemption will be allocated to the extent it produces the lowest possible inclusion ratio. (See paragraph 801.24 for a discussion of inclusion ratio.) In determining whether there has been substantial compliance, all relevant circumstances will be considered, including evidence of intent contained in the trust or transfer instruments and other factors as the IRS deems appropriate [IRC Sec. 2642(g)(2)].

801.21 Observation: The IRS ruled that filing Form 709 and attaching a copy of the GST trust's governing document was sufficient to allocate GST tax exemption to the trust (Ltr. Rul. 201936001).

801.22 Worksheet for Allocation of the GST Tax Exemption. See Practice Aid PA-88 for a worksheet to use to allocate the available GST tax exemption.

Applicable Fraction

801.23 The GST tax is calculated by multiplying the taxable amount by the *applicable rate*. The *applicable rate* is the maximum estate tax rate (currently 40%) multiplied by the *inclusion ratio* (see paragraph 801.24). The inclusion ratio equals one minus the *applicable fraction*. Generally, the numerator of the applicable fraction is the amount of the GST tax exemption allocated to the trust or transferred property. The denominator of the applicable fraction is the gift or estate tax value of the property transferred, reduced by the sum of (a) any federal estate tax or state death tax recoverable from the trust, and (b) the charitable deduction allowed for the property, if any [IRC Sec. 2642(a)(2)]. In the case of a timely allocation, the value of the property transferred is the value as finally determined for gift tax purposes (lifetime transfers) or estate tax purposes (transfers at death) [IRC Sec. 2642(b)(1)(A); Reg. 26.2642-2(a)(1)]. See the discussion beginning at paragraph 801.25 for an example of how to calculate the applicable fraction and inclusion ratio.

Inclusion Ratio

801.24 The inclusion ratio is used to determine the portion of the transferor's GST tax exemption allocated to a given transfer. It is multiplied by the maximum estate tax rate to determine the effective GST tax rate applied to the taxable amount (generally, the FMV of the property transferred). The allocation of the GST tax exemption for a particular transfer reduces the effective GST tax rate on a prorata basis via the inclusion ratio [IRC Sec. 2642(a)].

801.25 The statute defines the inclusion ratio as 1 minus the *applicable fraction* [IRC Sec. 2642(a)(1)]. In computing the inclusion ratio, the applicable fraction must be rounded to the nearest one-thousandth (.001) before subtracting it from 1 [Reg. 26.2642-1(a)]. See discussion at paragraph 801.23 for a definition of applicable fraction.

Example 801-1: Determining the inclusion ratio.

Harold established a trust in the current year and transferred $8 million in property to it. Harold had previously allocated $5 million of his exemption to other transfers, so he allocates the remaining $7.92 million ($12.92 million − $5 million) exemption amount to this trust. The applicable fraction is $7.92 million ÷ $8 million, or .990. The inclusion ratio is .010 (1 − .990). Any taxable distribution from the trust will be taxed at 1% of the GST tax rate, or 0.4% (40% × 1%).

801.26 The applicable fraction and the inclusion ratio are required to be recomputed when additional property is transferred to an existing trust [IRC Sec. 2642(d)(1)]. See section 803 for additional discussion of recomputing the inclusion ratio.

Valuation

801.27 Valuation is a key concept in determining the denominator of the applicable fraction. The regulations address the valuation concept for lifetime transfers and for transfers at death.

801.28 Planning Tip: Trusts holding assets such as a closely held corporation will require an appraisal of the entity.

801.29 Lifetime Transfers. When determining the denominator of the applicable fraction, the value of property transferred during life is its fair market value (as finally determined for gift tax purposes) on the effective date of the GST tax exemption allocation [IRC Sec. 2642(b)(1)(A)]. This effective date is the date of the transfer (the date of the gift) if a timely exemption allocation is made [i.e., if the allocation is made on a timely filed gift tax return (including extensions) (Reg. 26.2632-1)].

801.30 If the exemption allocation is made on a gift tax return that is not timely filed (e.g., a *late allocation*), the value of the property is the value on the date the gift tax return is filed [IRC Sec. 2642(b)(3)]. Fortunately, the regulations provide some relief to the practical impossibility (for certain assets) of both knowing the value of the property transferred and preparing the notice of allocation (which must be attached to the gift tax return) on the same day the gift tax return is filed.

801.31 A transferor that makes a late allocation of the GST tax exemption to a trust may elect to value the transferred property as of the first day of the month in which the allocation occurs [Reg. 26.2642-2(a)(2)]. This election is not available for gifts of life insurance if the insured has died. See section 805 for a discussion of late allocation of the exemption.

801.32 Retroactive Allocation for Out-of-sequence Death. A retroactive allocation of the transferor's unused GST tax exemption is available if a nonskip person (see discussion beginning at paragraph 801.44) has an interest in a trust and dies before the transferor. This provision allows the transferor to retroactively allocate the GST tax exemption when there is an unnatural order of death (i.e., the son or daughter predeceases the parent) which could otherwise result in a taxable termination. The exemption is allocated to the trust based on the fair market value of the property at the date the property was transferred to the trust. This retroactive allocation provision applies to deaths of nonskip persons occurring after December 31, 2000. See section 806 for additional discussion of the retroactive allocation of the GST tax exemption.

801.33 Transfers at Death. Generally, when determining the denominator of the applicable fraction, the value of property transferred at death is its value, as finally determined, for estate tax purposes [IRC Sec. 2642(b)(2)(A)]. Therefore, property is valued at the date of death or alternate valuation date.

801.34 However, if property other than cash is used to satisfy a pecuniary (fixed-dollar) bequest, the denominator of the applicable fraction is the pecuniary amount only if the payment (a) must be made at the date-of-distribution values or (b) must be made with property that fairly reflects the net appreciation and depreciation that occurs from the date of death in all assets available to satisfy the payment [Reg. 26.2642-2(b)(2)(i)]. Otherwise, the date-of-distribution values for the property used to satisfy the pecuniary bequest will be used to determine the denominator of the applicable fraction [Reg. 26.2642-2(b)(2)(ii)]. These rules prohibit the executor from using the most highly appreciated assets to fund a pecuniary gift to which the GST tax exemption will be allocated.

Example 801-2: Allocating the GST tax exemption to a pecuniary bequest funded with assets other than cash.

Under the provisions of Ethyl's will, $200,000 is to be paid to her grandchild. The executor of Ethyl's estate funds the pecuniary bequest with assets that have a date-of-death value of $200,000 and a date-of-distribution value of $250,000. The executor allocates $200,000 of the GST tax exemption to the transfer.

If the assets used to fund the transfer are fairly representative of the appreciation and depreciation of all of the estate's assets from which the distribution could have been made, then the applicable fraction is 1.0 ($200,000 ÷ $200,000) and the inclusion ratio is 0.0 (1.0 – 1.0).

However, if the assets used to fund the transfer are *not* representative of the appreciation and depreciation of all of the estate's assets from which the distribution could have been made, the date-of-distribution value must be used for the denominator, resulting in an applicable fraction of .800 ($200,000 ÷ $250,000) and an inclusion ratio of .200 (1.0 – .80). In this situation, if the executor desires an inclusion ratio of 0.0, an allocation of $250,000 of the GST tax exemption must be made to the transfer.

801.35 If the exemption is to be allocated to a residual trust after a pecuniary payment, the denominator of the applicable fraction is generally the date of death value reduced, if the pecuniary payment carries appropriate interest, by the pecuniary amount. *Appropriate interest* means either interest required under state law on the distribution or 80% of the Section 7520 rate at the decedent's death. If the pecuniary share does not carry appropriate interest, the denominator is the date of death value reduced by the present value of the pecuniary payment [Reg. 26.2642-2(b)(3)]. In other words, the pecuniary amount is discounted to present value using applicable interest rates, and this reduced pecuniary amount is then subtracted from the estate tax value of the residue.

801.36 Note: Pecuniary bequests and various funding formulas are discussed in sections 1110 and 1504.

Skip Person

801.37 A *skip person* is a natural person assigned to a generation that is two or more generations below the transferor [IRC Sec. 2613(a)(1)]. Therefore, grandchildren of the transferor are skip persons. Only one direct skip occurs when a single transfer of property skips two or more generations. See the discussion beginning at paragraph 801.46 for generation assignments and paragraph 801.53 for the special rule for a predeceased parent.

801.38 Trusts as Skip Person. A trust will be a skip person if all interests in the trust are held by skip persons [IRC Sec. 2613(a)(2)]. For this purpose, a person has an interest in a trust if the person (a) has a present right to receive trust principal or income; (b) is a permissible current recipient of trust principal or income and is not described in IRC Sec. 2055(a) (e.g., religious, charitable, scientific, literary, or educational organization); or (c) is described in IRC Sec. 2055(a) and the trust is a charitable remainder annuity trust or unitrust or a pooled income fund [Reg. 26.2612-1(e)].

Example 801-3: All interests in trust held by skip persons.

Joe sets up a trust to make annual distributions to his grandchild, Bart, for life. When the trust terminates, the assets are to be distributed to Bart's descendants. The trust is a skip person because all interests in the trust are held by skip persons.

801.39 Observation: If a trust is a skip person, the GST occurs when the trust is established. Therefore, there will not be taxable distributions when distributions are made to trust beneficiaries nor will there be a taxable termination when the trust terminates. See section 802 for additional discussion of taxable distributions and taxable terminations.

801.40 A trust will also be a skip person if (a) no person holds an "interest in the trust," and (b) at no time after the transfer may a distribution (including distributions on termination) be made to a nonskip person [IRC Sec. 2613(a)(2)]. Someone has an interest in a trust if that person has a present right to receive trust principal or income [Reg. 26.2612-1(e)]. A remoteness test is used to determine whether a trust distribution could be made to a nonskip person [Reg. 26.2612-1(d)(2)(ii)]. Under this test, there must be a less than 5% probability, determined actuarially, that a distribution would be made to a nonskip person.

Example 801-4: No person holds an interest in a trust.

Jim sets up a trust to accumulate income to be distributed to his grandchild, Bobby, at age 21, or to Bobby's estate if Bobby dies before age 21. The trust is a skip person because no person has an interest in the trust (i.e., no one has a present right to receive trust principal or income) and no distribution may be made to a nonskip person.

Example 801-5: Application of the 5% test for a distribution to a nonskip person.

Bill sets up a trust that accumulates income. Income and principal are to be distributed to his twin 18-year-old grandchildren, Charles and Carl, when they attain age 30 or to the survivor if either grandchild dies before then. If neither grandchild survives to age 30, the principal and accumulated income is to be distributed to any of Bill's six currently living nieces and nephews who survive Charles and Carl.

Bill's nieces and nephews are one generation below Bill and therefore are nonskip persons for GST tax purposes. However, the actuarial probability that both 18-year-old grandchildren will not survive to reach age 30 is less than 5%. Therefore, the trust is a skip person because the probability of a distribution from the trust to a nonskip person is less than 5%.

801.41 Probability Test. The less than 5% actuarial probability test, also referred to as the *remoteness test*, appears in the GST tax regulations in two places other than the one previously mentioned. The remoteness test is used in the definition of a *taxable termination* [Reg. 26.2612-1(b)(1)(iii)] and in the definition of the *estate tax inclusion period* (ETIP) [Reg. 26.2632-1(c)(2)(ii)(A)]. See paragraph 802.13 for additional discussion of a taxable termination and paragraph 808.3 for a discussion on the estate tax inclusion period.

801.42 Although this test is used when defining three separate GST terms, there is no guidance on how the probability is calculated. The primary factors for determining the probability are the number, age, and relationship of the beneficiaries. However, each trust must be analyzed for other contingencies that may cause a distribution or reversion as defined under the respective regulation. If a trust includes a peculiar contingency provision (i.e., a distribution or reversion contingency based on events or factors other than the death and/or relationship of the beneficiaries), the burden is on the taxpayer to prove that the sum of the distribution or reversion probabilities associated with the peculiar contingency plus that of all other contingencies is less than 5%.

Interest in a Trust

801.43 As mentioned in paragraph 801.40, a trust can be a skip person if no person holds an interest in the trust. Someone has an interest in a trust if that person has a present right to receive trust principal or income [Reg. 26.2612-1(e)].

Example 801-6: Interest in a trust.

Bob establishes an irrevocable trust in which the income is payable to his daughter Nicole, for her life. On the death of Nicole, the trust principal is to be paid to Bob's grandchild (Nicole's son), Matthew. Because Nicole has a present right to receive income, she has an interest in the trust. Because Matthew cannot currently receive distributions from the trust, he does not have an interest in the trust for purposes of Reg. 26.2612-1(e). The trust is not a skip person because Nicole (a nonskip person) has an interest in the trust.

Nonskip Person

801.44 A nonskip person is any person who is not a skip person [IRC Sec. 2613(b)]. An example of a nonskip person is a person assigned to a generation one level below the transferor or to the same, or higher, level than the transferor. This means a transferor's ancestors, children, and spouse are nonskip persons.

801.45 A trust is a nonskip person if a nonskip person holds an interest in the trust, even if other interests in the trust are held by skip persons. Also, a trust is a nonskip person if a distribution may be made to a nonskip person.

Example 801-7: Interest in trust held by a nonskip person.

Gladys establishes a trust to make annual distributions to her child, Sally. The trustee also has the power to make discretionary distributions to Sally's children (i.e., Gladys' grandchildren). The trust is a nonskip person because a nonskip person, Sally, holds an interest in the trust.

Generation Assignments

801.46 A beneficiary's status as a skip or a nonskip person is determined by the beneficiary's generation relative to the transferor.

801.47 Lineal Descendants. In most cases involving GSTs, generation assignments are based on family relationships [IRC Sec. 2651(b)]. A lineal descendant of a transferor's grandparent is assigned to a generation by comparing (a) the number of generations between the descendant/donor and the grandparent to (b) the number of generations between the transferor and the grandparent [IRC Sec. 2651(b)(1)]. For transfers between family members, the generation assignment is relatively obvious. A spouse, brothers, and sisters are one generation. Their children, nieces, and nephews are the next generation. The grandchildren are the next generation and so on. See Appendix 8A for a flowchart showing family generation assignments.

801.48 A spouse (or former spouse) of the transferor is assigned to the same generation as the transferor [IRC Sec. 2651(c)(1)]. A spouse (or former spouse) of the transferor's parent is assigned to the same generation as the parent. Parents are assigned to the same generation as their siblings (aunts and uncles of the transferor) [IRC Sec. 2651(c)(2)].

801.49 For assigning generations to beneficiaries, a relationship by legal adoption is treated as a relationship by blood and a half-blood relationship is treated as a whole blood relationship [IRC Sec. 2651(b)(3)].

801.50 Persons Who Are Not Lineal Descendants. Individuals not assigned to generations based on family relationships are assigned to generations based on their age relative to the age of the transferor.

801.51 An individual not more than 12½ years younger than the transferor is assigned to the transferor's generation [IRC Sec. 2651(d)(1)]. An individual more than 12½ years but not more than 37½ years younger is assigned to the first generation below the transferor [IRC Sec. 2651(d)

(2)]. Thereafter, a new generation begins every 25 years [IRC Sec. 2651(d)(3)]. A good example of generation assignments can be found in Ltr. Rul. 200150003.

Example 801-8: Generation assignments for nondescendants.

Tim, age 72, creates an irrevocable trust to pay income to his butler, Geoffrey, age 56, for life with the remainder on Geoffrey's death to pass to Geoffrey's son, Herbert, age 32. The transfer to Geoffrey will result in no GST tax because Geoffrey is assigned to the first generation below Tim (i.e., Geoffrey is 16 years younger than Tim which places him in the next generation because 16 is greater than 12½ and not more than 37½ years younger than Tim).

However, Geoffrey's death will result in a taxable termination, because his son is a skip person. Herbert is a skip person because he is more than 37½ years younger than Tim and is assigned to the second generation below Tim.

801.52 Generation assignment could be an issue for unmarried partners. If the transferor's partner is more than 37½ years younger than the transferor, transferring assets to a partner could be costly. The transferor could be subject to both estate or gift tax and generation-skipping transfer tax on the transfer.

Example 801-9: Generation assignment for unmarried partner.

Don, age 70, transfers $15 million to an irrevocable trust to pay income to his partner, Pat, age 30, for life. Pat is given a general power of appointment to name a remainder beneficiary at her death. Don has both a taxable gift and a generation-skipping transfer on creation of the trust because Pat is more than 37½ years younger than Don and is assigned to the second generation below him.

Planning Tip: If Don and Pat were married, they would be in the same generation and, therefore, there would be no generation-skipping transfer. In addition, Don could receive the gift tax marital deduction for the transfer to a spouse. See section 1102 for additional discussion of the marital deduction.

801.53 Special Rule for Predeceased Parents and Other Collateral Relatives. There is an exception to the direct skip rule for the children of deceased parents (commonly referred to as the predeceased parent exception). A direct skip transfer to a transferor's grandchild does not cause GST tax if the grandchild's parent is deceased at the time of the transfer. In addition, transfers to collateral heirs are permitted when the transferor has no living lineal heirs at the time of the transfer. The exception also applies to taxable distributions and taxable terminations in favor of a grandchild or other lineal descendant when the original transfer in trust is made after the death of the grandchild's or other lineal descendant's parent [IRC Sec. 2651(e)].

801.54 Note: For transfers after July 17, 2005, a 90-day rule applies when determining if an individual's parent is deceased at the time of a testamentary transfer. A parent will be treated as having predeceased the transferor if that parent dies no later than 90 days after a transfer occurring because of the transferor's death [Reg. 26.2651-1(a)(2)(iii)].

801.55 Regulations clarify that to the extent of a QTIP election, the remainder beneficiary's interest would be deemed established at the death of the income beneficiary (otherwise, a remainder beneficiary of a QTIP trust would not benefit from the predeceased parent rule if the remainder beneficiary's parent is alive when the QTIP is established, but is deceased when the income beneficiary's interest terminates) [Reg. 26.2651-1(a)(3)].

Example 801-10: GST exception for transfers to collateral heirs.

Diane is a successful business owner who never married and has no children. Diane's sister, Nancy, had one child, Monica. Monica had two children, Jane and June. Monica was killed years ago in an automobile accident. Diane wants to give 20% of her business to Jane (Diane's grandniece) in the current year.

The exception for transfers to collateral heirs applies because Jane's mother, Monica, was not alive at the time of the transfer *and* Diane had no living lineal descendants.

Example 801-11: GST exception for taxable distributions or terminations.

Previously, Nancy established a trust for the benefit of her son, James, for life with the remainder to be split among all of her grandchildren. At the time of the gift, Nancy had already allocated all of her GST tax exemption to other transfers. James has two children, and Nancy's predeceased daughter, Mary, had two children.

The income from the trust is payable to James during his life. When he dies, the trust will be distributed equally to the four grandchildren.

James died in the current year. A taxable termination occurred at his death. However, because the trust was funded after Mary's death, her two children are moved up a generation and trust distributions to them do not cause GST tax. Therefore, only half of the trust is subject to GST tax.

Note: If Mary had been alive when the trust was funded, the entire trust would have been subject to GST tax on James's death.

END OF DOCUMENT -

802 Overview of the Generation-skipping Transfer (GST) Tax

802.1 The GST tax is imposed on direct transfers to beneficiaries more than one generation below that of the transferor and on certain transfers involving trusts having beneficiaries more than one generation below that of the transferor. The term *trust* includes any arrangement (other than an estate) that has substantially the same effect as a trust, such as life estates and remainders, estates for a term of years, and insurance and annuity contracts. Determining whether a transfer of property is a generation-skipping transfer is made by reference to the most recent transfer subject to estate or gift tax. The GST tax is assessed at the highest transfer tax rate (e.g., currently 40%). The tax is assessed in addition to any estate or gift tax that applies to the transfer. See section 801 for a discussion of key definitions pertaining to the GST tax.

802.2 The GST tax applies to the following types of transfers:

a. Direct skips (see paragraph 802.3).

b. Taxable distributions (see paragraph 802.10).

c. Taxable terminations (see paragraph 802.13).

Direct Skips

802.3 A direct skip occurs when property subject to either the estate tax or gift tax is transferred to a *skip person* [IRC Sec. 2612(c)(1)]. (Note that only one direct skip occurs when a single transfer of property skips two or more generations.) A transfer to a trust is a direct skip (occurring at the time of the transfer) if all of the beneficiaries with an interest (as the term is defined at paragraph 801.38) in the trust are skip persons. Generally, *skip persons* are individuals who are two or more generations younger than the transferor. Generation assignment and skip persons are discussed in greater detail in section 801.

802.4 There are three types of direct skips—*inter vivos* direct skips, direct skips at death, and direct skips at death from a trust. As the name implies, *inter vivos* direct skips are transfers made directly to a skip person during the life of the transferor. *Inter vivos* direct skips include direct outright transfers from the transferor to a skip person, as well as transfers to a trust that qualifies as a skip person. A direct skip at death occurs when property included in the transferor's gross estate is transferred to a skip person. As with *inter vivos* direct skips, the skip person may be either an individual or a trust qualifying as a skip person. A direct skip can also occur when property from a trust included in the transferor's gross estate is transferred to a skip person.

802.5 A special rule exists for transfers to a grandchild whose parent died prior to the transfer. If a transferor's child dies while the transferor is still alive, that child's descendants are moved up one generation for determining if a generation-skipping transfer has occurred [IRC Sec. 2651(e)]. In addition, collateral heirs with a deceased parent are moved up one generation if the transferor has no living lineal heirs at the time of the transfer. For a discussion of this exception, see paragraph 801.53.

802.6 In the case of a direct skip, the transferor or the transferor's estate is liable for the GST tax [IRC Sec. 2603(a)(3)]. If the direct skip is made from a trust, the trustee is treated as the transferor and is responsible for paying the tax from the trust. The trustee can be held personally responsible if the tax is not paid. [IRC Sec. 2603(a)(2)]. The amount subject to GST tax is the value of property received by the transferee [IRC Sec. 2623]. The tax base for computing the GST tax for a direct skip is the amount received by the transferee and does not include the GST tax (similar to the computation of the gift tax).

802.7 However, the GST tax paid by the transferor on a taxable gift that is a direct skip increases the amount of the taxable gift for gift tax purposes by the amount of the GST tax (IRC Sec. 2515). The amount of the GST tax on a lifetime direct skip is subject to *gift* tax. Using a direct skip during a person's lifetime to transfer property can be an expensive proposition for a client if the client's GST tax exemption has already been used.

Example 802-1: Double taxation lifetime direct skip.

Barry Townsend wants to give his granddaughter Amanda $1 million. He has allocated all of his GST tax exemption to other current and prior year gifts. To accomplish this, $1,960,000 of property is required, calculated as follows:

Amount of gift	$1,000,000

Gift tax ($1,000,000 × 40%)	$400,000	
GST tax ($1,000,000 × 40%)	400,000	
Gift tax on GST tax ($400,000 × 40%)	160,000	
Total tax		960,000
Total property required		$1,960,000

802.8 Likewise, the GST tax is part of the transferor's gross estate (as is the estate tax) if a direct skip is made at death—a costly proposition.

Example 802-2: Tax cost of direct skip made at death.

Barry Townsend died in the current year and left a specific bequest of $1 million to his granddaughter, Amanda. He had allocated all of his GST tax exemption to other transfers. Assuming a 40% tax rate, the GST tax on the bequest is $400,000 ($1 million × 40% GST tax rate). The $1 million bequest is also subject to estate tax because his taxable estate plus prior taxable gifts exceed his basic exclusion amount. Because the $400,000 GST tax must be paid out of the assets of the estate, it too will be subject to estate tax. Therefore, the gross amount of estate property required to provide Amanda with a net bequest of $1 million is $2,333,333 {[1 ÷ (1 − .40)] × $1,400,000}. This means the tax cost of the net $1 million bequest is $1,333,333. The total tax and net bequest is computed as follows:

Gross estate property required		$2,333,333
Estate tax ($2,333,333 × .40)	$933,333	
GST tax ($1,000,000 × .40)	400,000	
Total tax		(1,333,333)
Net bequest		$1,000,000

802.9 Planning Tip: The GST tax exemption amount increased from $12.06 million in 2022 to $12.92 million in 2023. This additional exemption may be allocated to existing trusts. If an existing trust has an inclusion ratio between 1 and zero, planners should consider allocating any unused exemption amount to the trust when the allocation will reduce the inclusion ratio to zero. This additional move increases the tax advantage without additional giving. Section 805 discusses a late allocation of the GST tax exemption.

Taxable Distributions

802.10 A *taxable distribution* is any distribution (other than a taxable termination or a direct skip) from a trust to a skip person [IRC Sec. 2612(b)]. The amount subject to tax is the value of the property received by the transferee (recipient), reduced by any expense incurred by the recipient in connection with the determination, collection, or refund of the GST tax imposed on the distribution [IRC Sec. 2621(a)].

802.11 The recipient of the distribution is liable for the GST tax on taxable distributions [IRC Sec. 2603(a)]. If the trust pays any of the GST tax (including any penalties and interest on the tax), the payment is treated as an additional taxable distribution because the recipient is liable for the tax [IRC Sec. 2621(b)]. The additional distribution is treated as having been made on the last day of the calendar year of the taxable distribution [Reg. 26.2612-1(c)(1)]. If the recipient is subject to income tax on the distribution (e.g., a distribution of current income), an income tax deduction is allowed for the GST tax paid by the recipient [IRC Sec. 164(a)(4)].

Example 802-3: Payment of GST tax on a taxable distribution.

Susan (now deceased) created a trust that allows the trustee discretion to distribute income and principal to her daughter, Sally, and to her granddaughter, Jessica. Susan previously used all of her GST tax exemption for other transfers. Therefore, the trust's inclusion ratio is one. The trust distributed $150,000 to Jessica in the current year. Jessica must pay GST tax of $60,000 on the distribution (based on the 40% GST tax rate) leaving her with a net of $90,000.

Example 802-4: Grossing up the amount of the distribution to compensate for the GST tax.

Assume the same facts as in Example 802-3 except the trustee wants Jessica to receive $150,000 net of the GST tax. To accomplish this, the distribution amount is determined by multiplying the net amount to be received by one divided by one minus the tax rate. For this example, {[1 ÷ (1 − .40)] × [$150,000 (net to be received)]} = $250,000. The trust should distribute $250,000 to Jessica, on which she will pay $100,000 of GST tax if the trustee wants to provide her with a net distribution of $150,000 ($250,000 − $100,000).

802.12 Observation: If the individual making the original transfer is still alive, any unallocated GST tax exemption may be allocated to the trust, based on date of allocation values, to reduce the inclusion ratio of the trust. See section 805 for additional information about making a late GST tax exemption allocation.

Taxable Terminations

802.13 A *taxable termination* is the termination (because of death, lapse of time, release of power, or otherwise) of an interest (defined in section 801) in property held in trust, unless [IRC Sec. 2612(a)(1); Reg. 26.2612-1(b)]—

a. a transfer subject to the federal estate or gift tax occurs in connection with property held in trust at the time of the termination;

b. a nonskip person has an interest in the property immediately after the termination; or

c. at no time after the termination may a distribution (including distributions on termination) be made to a skip person. For this purpose, it is sufficient that the probability of a distribution to a skip person be less than 5%, determined actuarially.

802.14 The less than 5% actuarial probability test, also referred to as the *remoteness test*, appears in the GST tax regulations in two places other than the one mentioned in paragraph 802.13. In Reg. 26.2612-1(d)(2)(ii) the test is used to determine whether a trust distribution could be made to a nonskip person (see paragraph 801.40). The test appears again in Reg. 26.2632-1(c)(2)(ii)(A), where it is used in the definition of the *estate tax inclusion period* (ETIP) (see paragraph 808.3). See paragraph 801.42 for additional discussion of the probability test.

802.15 If a transfer meets the definition of both a direct skip and a taxable termination, it is treated as a direct skip [Reg. 26.2612-1(b)(1)].

802.16 Certain partial terminations are also treated as taxable terminations. Property distributed to a skip person in a partial termination is treated as a taxable termination if [IRC Sec. 2612(a)(2)]
—

a. an interest in trust property terminates because of the death of the transferor's lineal descendant, and

b. because of the death, the property is distributed to at least one skip person (or a trust for their exclusive benefit).

802.17 A simultaneous termination of more than one interest creates only one taxable termination [Reg. 26.2612-1(b)(3)]. Therefore, only one GST tax is payable.

Example 802-5: Illustration of a partial taxable termination.

Terry creates an irrevocable trust requiring trust income to be paid annually to his children, Ann and Billy. When the first child dies, half of the trust principal is to be paid to Terry's grandchildren. The balance of the trust principal is to be paid to Terry's grandchildren on the death of the surviving child (e.g., either Ann or Billy). If Ann dies before Billy, the distribution occurring on the termination of Ann's interest in the trust is a partial taxable termination and not a taxable distribution. It is a taxable termination because the distribution of a portion of the trust occurs as a result of Ann's death (a lineal descendant of Terry). The partial termination occurs regardless of the fact that the trust continues to exist and that Billy, a person other than a skip person, thereafter continues to hold an interest in the trust.

802.18 The taxable amount of a taxable termination is the value of the property received in the termination, reduced by any expenses, indebtedness, and taxes attributable to the property (IRC Sec. 2622). The trustee is responsible for paying the tax from the trust on taxable terminations. The trustee can be held personally responsible if the tax is not paid [IRC Sec. 2603(a)(2)].

Example 802-6: Computing the GST tax on a taxable termination.

Steve created an irrevocable trust in 2000. The trust is to distribute income to Steve's son, Michael, for life. On Michael's death, the trust will terminate with the remainder distributed to Michael's daughter, Samantha (Steve's granddaughter). Steve, who died two years ago, had previously used all of his GST tax exemption and did not allocate any GST tax exemption to this trust.

Michael dies in the current year when the trust property has a value of $1 million. On Michael's death, a taxable termination occurs and the trustee is liable for GST tax of $400,000 ($1 million × 40% GST tax rate). Samantha receives the remainder of $600,000 on the termination.

802.19 Observation: It is sometimes difficult to differentiate a taxable distribution from a taxable termination (e.g., where a distribution to a skip person also terminates a non-skip person's interest). If the distribution completely terminates the non-skip person's interest, the transfer should be considered a taxable termination [Reg. 26.2612-1(f), Example 9].

When the GST Tax Does Not Apply

802.20 Exclusions and Exemptions from GST Tax. Several exclusions and exemptions from the GST tax allow certain transfers to avoid GST taxation. These exclusions and exemptions are summarized as follows:

a. *GST Tax Exemption.* All individuals are allowed a lifetime exemption of $12.92 million for 2023 ($12.06 million for 2022) from the GST tax. This exemption can be allocated to any property transferred by the transferor. See section 803 for a discussion of allocating the GST tax exemption. Spouses can elect to split *inter vivos* transfers and treat them as made half by each spouse. See section 807 for a discussion of gift splitting by spouses.

b. *Direct Skips Qualifying for Gift Tax Exclusion Also Qualify for the GST Tax Annual Exclusion.* Direct skip transfers that are nontaxable gifts for gift tax purposes because of the annual gift tax exclusion ($17,000 for 2023, $16,000 for 2022) have an inclusion ratio of zero, resulting in no GST tax. Therefore, grandparents can currently make GST tax-free gifts to their grandchildren of up to $17,000 per donee per year [$34,000 if gift-splitting between spouses is elected (see section 307 for coverage of the annual gift tax exclusion)]. The annual GST tax exclusion applies only to direct skips to individuals and certain qualifying trusts. Transfers to a trust that qualify as a present interest eligible for the gift tax annual exclusion will qualify for the GST annual exclusion only if [IRC Sec. 2642(c)(2)]—

(1) the trust is solely for the benefit of one skip person (see the discussion of separate share trusts at paragraph 809.5);

(2) the trust assets will be included in the skip person's gross taxable estate if the skip person dies during the term of the trust; and

(3) at the end of the term, the trust will be distributed to the skip person.

Planning Tip: For a gift to qualify for the annual GST tax exclusion, it must also qualify for the annual gift tax exclusion. Care should be taken in the timing of gifts. Using the annual gift tax exclusion (but not the annual GST tax exclusion) for a gift to a trust (for the benefit of a particular skip person) early in the year will prevent the annual GST tax exclusion being used later in the year because the annual gift tax exclusion for that particular skip person has already been used. In a calendar year, gifts to a particular skip person that qualify for both the GST and gift tax annual exclusion should be made before making gifts to that skip person that qualify only for the annual gift tax exclusion.

Note: Most *Crummey* trusts do not qualify for the GST tax annual exclusion (as illustrated in Example 802-7). Although the *Crummey* trust does not qualify for the GST tax annual exclusion, it may likely be a GST trust. Therefore, the lifetime GST tax exemption may be automatically allocated to the trust. See section 804 for a discussion on the automatic allocation rules.

c. *Tuition and Medical Transfers.* Certain transfers for tuition or medical expenses are not generation-skipping transfers [IRC Sec. 2611(b)]. For example, payments from grandparents for the tuition of their grandchildren are not generation-skipping transfers (nor are they taxable gifts) if they are paid directly to the educational institution. See section 305 for a discussion of transfers for educational and medical purposes. In addition, contributions to a qualified tuition program (described in IRC Sec. 529) or education savings account (described in IRC Sec. 530) are treated as completed gifts of a present interest and are eligible for the gift tax annual exclusion [IRC Secs. 529(c)(2) and 530(d)(3)]. Therefore, if a donor actually uses the gift tax annual exclusion, the contributions would qualify for the GST tax annual exclusion and would not be subject to GST tax (i.e., no GST tax would be due and no GST tax exemption would have to be allocated to them).

Planning Tip: The gift tax exclusion for direct transfers to pay tuition and medical expenses only applies to payments made directly by the donor. However, the generation-skipping transfer tax exclusion also applies to any payments or distributions by trusts in payment of these expenses. Therefore, a trust provision authorizing the trustee to make these payments may be beneficial.

d. *Previous GSTs.* Transfers of property that were previously subject to the GST tax are excluded to the extent the transferee in the prior GST was in the same or younger generation as the current transferee and the transfer does not have the effect of avoiding GST tax [IRC Sec. 2611(b)(2)].

Observation: The GST tax does not attach to the property itself, but rather it attaches to the transfer. Having the transfer of property initially subject to gift or estate taxes does not mean that the same property cannot later be subject to GST tax in succeeding generations. For example, if property was properly included in a grandparent's estate and subject to both estate and GST tax when a distribution was made outright to a grandchild, and the grandchild later makes a distribution of the same property to the grandchild's grandchildren, the property would again be subject to the GST tax. A GST tax exemption for a transfer in trust will exempt the assets in the trust until distributions are made to the beneficiaries.

e. *Double Skip-exclusion.* A transfer to a skip person more than two generations below the transferor (e.g., a great-grandchild) is only subject to one level of GST tax. For example, if a donor transfers assets to a trust for the benefit of a great-grandchild, the transfer is a direct skip. GST tax is imposed only once although two generations are skipped (see Example 810-2).

f. *Mentally Incompetent.* A transfer to a direct skip trust created under a will or revocable trust that was executed before October 22, 1986, and the individual was legally incompetent on October 22, 1986, and at all times thereafter until death [Reg. 26.2601-1(b)(3)].

g. *Grandfathered Trusts.* Trusts that were irrevocable as of September 25, 1985, are exempt from the GST tax to the extent there are no additions or modifications to the trust after that date. See paragraphs 802.23 and 809.11 for a discussion of grandfathered trusts.

802.21 Caution: As discussed in paragraph 802.20, item b, even though the annual *gift* tax exclusion may apply when transfers are made to the trust, the annual GST tax exclusion may not. Planners should be aware of the different requirements and make recommendations accordingly.

Example 802-7: Gifts to trust qualifying for gift tax annual exclusion but not GST tax annual exclusion.

Nancy wants to give $15,000 a year to each of her three children and seven grandchildren. After Nancy's children tell her that the grandchildren are too young to receive a large sum of cash each year, Nancy decides to establish a trust for their benefit. She creates a trust naming her children and grandchildren as beneficiaries. The trust calls for mandatory equal distributions to each of the grandchildren after 15 years (Nancy believes the grandchildren will be old enough to handle the money at that time). It also provides *Crummey* withdrawal rights to all children and grandchildren. According to the terms of the trust, if any child or grandchild dies, their share of the trust is equally divided among the surviving beneficiaries.

Nancy funded the trust with $15,000 annual gifts per child and grandchild for 10 years (i.e., $1.5 million). After 15 years, the trust's assets are valued at $3 million.

Unfortunately, the annual gifts of $15,000 to the trust do not qualify for the GST tax annual exclusion because the trust is (1) not solely for the benefit of one skip person (the trust benefits Nancy's children who are not skip persons as well as *seven* grandchildren) and (2) the trust assets will not necessarily be includable in the skip person's estate if the skip person dies during the term of the trust.

However, Nancy's lifetime GST tax exemption may be automatically allocated to this trust under the rules for automatic allocation to indirect skips (see paragraph 804.7). If Nancy does not want to use her GST tax exemption, she can elect out of the automatic allocation rules on her timely filed gift tax return (see paragraph 804.22). (Affirmatively, allocating the GST tax exemption to lifetime transfers is discussed in section 803.)

802.22 Observation: If there is a lapse of a withdrawal right, the holder of that lapsed right becomes the transferor only to the extent the withdrawal right exceeds $5,000 or 5% (a *five and five* power) of the value of the trust property [Reg. 26.2652-1(a)(5), Example 5].

802.23 Grandfathered Trusts. Grandfathered trusts are trusts that were irrevocable as of September 25, 1985. Grandfathered trusts are exempt from the GST tax to the extent there are no additions or modifications to the trust after that date. Modifications to these trusts that change the quality, value, or timing of any of the trust powers, beneficial interests, or rights originally provided under the terms of the trust will cause the trust to lose its grandfathered status.

802.24 Caution: The GST tax will apply to trusts that were irrevocable on September 25, 1985, if additions or modifications are made after that date [Reg. 26.2601-1(b)(1)(i)].

802.25 To reduce the number of ruling requests on modifications of exempt GST tax trusts, the IRS issued regulations detailing four modifications that will not cause a trust to lose its exempt status (Reg. 26.2601-1):

a. The distribution of trust principal from an exempt trust to a new trust (or retention of trust principal in a continuing trust) if either (1) the existing governing instrument grants the trustee authority to make these distributions without the consent or approval of any beneficiary or court, or (2) state law (when the exempt trust became irrevocable) permitted distributions or retention in a continuing trust and the terms of the new trust or continuing trust do not extend the time for vesting of any beneficial interest.

b. A court-approved settlement of a bona fide controversy relating to the administration of a trust or the construction of the terms of a trust instrument. This applies only if the settlement is the product of an arm's length negotiation and the settlement is within the range of reasonable outcomes under the governing instrument and state law (Ltr. Rul 201418001).

c. A court order in a construction proceeding (i.e., a determination of a settler's intent as of the date the trust instrument became effective) that resolves an ambiguity in the terms of a trust instrument. This applies only if the proceeding involves a bona fide issue and the court's decision is consistent with the applicable state law. This has been used by the IRS to allow modifications to trusts created by decedents who used ambiguous pre-1986 law to allocate GST tax exemptions (Ltr. Ruls. 201322025 and 201938004).

d. Allowing a trust to be modified as long as the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the modification. Also, the modification cannot extend the time for vesting of any beneficial interest in the trust beyond the period provided in the original trust (Ltr. Ruls. 201122007, 201345026, and 201448018).

802.26 Caution: The IRS no longer issues any letter rulings about modifications to grandfathered trusts. Irrevocable trusts created on or before September 25, 1985 (e.g., grandfathered trusts) that had terms modified after that date and whose modifications agreed to one of the listed examples in the regulations are included in the no-rule area of Rev. Proc. 2023-3, Section 3.01 (117).

Example 802-8: Clarifying an ambiguous term in the trust instrument.

In 1982, Donna Webb established an irrevocable trust for the benefit of her children, Ann and Lance. The trust terminates on the death of the last to die of Ann and Lance. At termination, the principal is to be distributed to their issue.

The language in the instrument is unclear as to whether trust principal is to be distributed to Donna's grandchildren or to other *issue* of Ann and Lance. The trustee requested a court rule to remove the ambiguity.

The court issued a ruling consistent with state law and determined the *issue* is Ann and Lance's children (both natural born and adopted). This ruling does not result in a *modification* of the trust and the trust remains grandfathered and therefore exempt from GST tax.

802.27 A modification of an irrevocable trust will shift a beneficial interest if the modification results in either (a) an increase in the amount of a GST or (b) the creation of a new GST. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a lower generation beneficiary, the effect of the instrument on the date of the modification is measured against the effect of the instrument immediately before the modification. If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust to a lower generation beneficiary [Reg. 26.2601-1(b)(4)].

802.28 If the modification is administrative in nature and only indirectly increases the amount transferred (because of lower administration costs or income taxes) the modification will not be considered a shift in a beneficial interest in the trust.

802.29 In addition to the regulations, the IRS has privately ruled that a reformation of a GST trust to redefine trust income using a unitrust amount will not cause a loss in the trust's GST grandfathered status (Ltr. Ruls. 200150016, 200148034, 200150016, and 200211008).

802.30 Taxpayers have litigated (resulting in a split of authority) whether the exercise, release, or lapse of a general power of appointment created under a grandfathered trust causes the donee of the power to become the transferor for GST tax purposes. The 8th and 9th Circuits held that the exercise of a general power of appointment created under a grandfathered trust by a donee in favor of skip persons was exempt from GST tax because the transfer was made from a trust that was irrevocable on September 25, 1985 [*Simpson*84 AFTR 2d 99-5349 (8th Cir. 1999); *Bachler*89 AFTR 2d 2002-1267 (9th Cir. 2002)]. Conversely, the 2nd and 6th Circuits held that a lapse of a general power of appointment (resulting in trust property passing to skip persons) was a transfer by the power holder/donee subject to GST tax (i.e., the donee became the transferor) [*Peterson Trust*77 AFTR 2d 96-1184 (2nd Cir. 1996); *Gerson*100 AFTR 2d 2007-6593 (6th Cir. 2007)]. The Supreme Court has declined to rule on the issue.

802.31 Regulations provide that the grandfather provision does not apply to a transfer of property pursuant to the exercise, release, or lapse of a general power of appointment (and treated as a taxable transfer for estate or gift tax purposes). Rather, the a transfer will be deemed a transfer by the power holder when the action becomes effective, and not a transfer under the grandfathered irrevocable trust [Reg. 26.2601-1(b)(1)(i)]. The Tax Court (affirmed by the 6th Circuit) agreed with the law as interpreted by this regulation [*Gerson*100 AFTR 2d 2007-6593 (6th Cir. 2007)]. Likewise, the 6th Circuit affirmed a District Court ruling that a lapse of a general power of appointment that occurs after September 25, 1985, of an interest in a pre-GSTT trust is treated as a taxable transfer and is not grandfathered [*Timken*105 AFTR 2d 2010-1732 (6th Cir. 2010)].

802.32 Planning Tip: For certain grandfathered trusts that grant the first generation beneficiary a nongeneral testamentary power of appointment, a special power of appointment granted to a skip person by the original power holder can extend the trust for several generations. This limited power of appointment will not be treated as an addition to the trust as long as the power does not postpone vesting beyond the time permitted by the rule against perpetuities. Therefore, grandfathered trusts providing for the exercise of a power of appointment provide a unique opportunity to extend further the grandfathered nature of the original transfer. As a result beneficiaries of a grandfathered trust with a special power of appointment should consider spending from other available sources of money before taking distributions from the trust.

Example 802-9: Extending the term of grandfathered trusts with a limited power of appointment.

An irrevocable trust was created by Bob's will in 1979. No additions to principal have been made since its inception. At his death, Bob had one son, Buster, and one grandson, Bill. Buster, who was named the trustee, was given a special testamentary power to appoint the trust principal among his spouse, his issue and/or a charitable organization. In Buster's will, Bill (a skip person for GST tax purposes) is given a special power to appoint the trust principal for the health, education, maintenance and support of his then-living issue. Bill's exercise of his limited power will not postpone vesting beyond 21 years after the death of Buster and Bill.

The limited power of appointment given to Bill in Buster's will is not treated as an addition to trust principal. Therefore, the GST tax does not apply because the trust is grandfathered and there were no deemed additions made since September 25, 1985 [Reg. 26.2601-1(b); Ltr. Rul. 9414024].

Computation of the GST Tax

802.33 The GST tax is the product of the *taxable amount* and the *applicable rate*.

802.34 Taxable Amount. The *taxable amount* of a GST is generally the value of the property received by the transferee and depends on whether the transfer was a direct skip, a taxable distribution, or a taxable termination.

802.35 For direct skips, the taxable amount is the value of the property received by the recipient (IRC Sec. 2623). For lifetime gifts, this is usually the value of the property (as determined for gift tax purposes) on the date of the gift. (However, see section 808 for direct skips that are subject to an estate tax inclusion period.) Testamentary transfers are valued on the date of death or, if elected, the alternate valuation date. Because direct skip GSTs are tax-exclusive, the value subject to GST tax is the net amount (i.e., after transfer and GST taxes) received by the recipient. See

Example 802-1 and Example 802-2. The donor (for lifetime gifts) or the executor (for testamentary transfers) is liable for the GST tax on direct skips. (See paragraph 802.37 for direct skips from trusts.)

802.36 For a taxable distribution, the taxable amount is the value of the property received reduced by any expenses incurred by the recipient in connection with the determination, collection, or refund of the GST tax on the distribution [IRC Sec. 2621(a)]. See Example 802-3 and Example 802-4. The recipient is liable for the GST tax on taxable distributions. Therefore, a trust's payment of the GST tax is treated as an additional taxable distribution and is included in the *taxable amount* [IRC Sec. 2621(b)].

802.37 For a taxable termination, the taxable amount is the value of the terminated property interest passing to the skip person reduced by the type of deductions allowed under IRC Sec. 2053(a), which include expenses, indebtedness, taxes, administration expenses, and claims that are attributable to the property (IRC Sec. 2622). See Example 802-6. The trustee is liable for paying the GST tax on taxable terminations or direct skips from trusts.

802.38 Applicable Rate. The *applicable rate* is the maximum federal estate tax rate (currently 40%) multiplied by the inclusion ratio, which equals one minus the *applicable fraction*. In computing the applicable fraction (which must be rounded to the nearest one-thousandth), the numerator is the amount of the GST tax exemption allocated to the trust or to the property transferred in a direct skip. The denominator is the value of property transferred to the trust or involved in the direct skip, reduced by the sum of (a) any federal estate tax or state death tax attributable to the property that is actually recovered from the trust, and (b) any charitable deduction allowed for this property (IRC Sec. 2642). Expressed algebraically—

$$\text{Applicable fraction} = \frac{\text{Amount of GST tax exemption allocated to trust or transferred property}}{\text{(Value of property transferred)} - \text{(state and federal estate taxes attributable to the property and recovered from the trust + charitable deductions allowed)}}$$

Example 802-10: Calculation of GST tax.

When Tom died, $13 million was transferred to a trust for the benefit of his grandchildren. Because all the trust beneficiaries are skip persons, the transfer is a direct skip that triggers the GST tax on the initial transfer of property, as opposed to later when a distribution is made to the beneficiaries. At the time of the transfer, Tom's $12.92 million GST tax exemption (for 2023) was allocated to this trust. Assuming no death taxes attributable to the trust or charitable deductions, the calculation of the GST tax is calculated as follows:

Applicable fraction	$\$12{,}920{,}000/\$13{,}000{,}000$	=	.994
Inclusion ratio	1 − .994	=	.006
Applicable rate (in 2023)	.006× 40%	=	0.2%

Therefore, the GST tax is 0.2% of $13 million, or 26,000.

802.39 The IRS confirmed that the applicable rate for GST tax is zero when the transfer occurred in 2010 and the decedent elected out of the estate tax (Ltr. Rul. 201352001). The GST tax applied because the transfer to a trust was considered a direct skip.

Additional GST Considerations

802.40 Disclaimer. A disclaimer that results in property passing to a person at least two generations younger than the transferor can cause the GST tax to be imposed. Likewise, disclaiming property may prevent the GST tax if the property would pass to a nonskip person. (See section 305 for a discussion of disclaimers.)

802.41 Section 303 Redemption. The GST tax is treated as an estate tax for the Section 303 redemption rules when a redemption of corporate stock is used to pay the tax, for a Section 6166 election when the property is a closely held business interest, and for Section 2032A valuation when the special use valuation rules apply. (For information on Section 303 redemptions, see the discussion beginning at paragraph 1404.24.)

802.42 Basis in Property. When the GST tax results from an *inter vivos* gift, the recipient's basis of the property received is increased (but not above the property's FMV) by the GST tax attributable to the excess of the property's fair market value over its basis prior to the transfer. For testamentary transfers, the transferee's basis is determined under the usual rules (i.e., generally the fair market value at the date-of-death or alternate valuation date) [IRC Sec. 2654(a)].

802.43 GST Tax Filing Requirements. The GST tax filing requirements vary depending on the type of transfer involved. Key Issue 29A of PPC's 706/709 Deskbook provides additional coverage of the filing requirements associated with GSTs.

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803 Maximizing the Benefit of the GST Tax Exemption through Lifetime Use

Using the GST Tax Exemption during Lifetime

803.1 Each transferor is currently allowed a GST tax exemption ($12.92 million for 2023, $12.06 million for 2022) [IRC Sec. 2631(a) and (c)]. This means each individual may transfer $12.92 million (during life or at death) of property without these transfers being subject to the GST tax. Only the transferor or the transferor's executor (in the case of an estate) may irrevocably allocate the GST tax exemption to the transferred property [IRC Sec. 2631(a)].

803.2 GST planning primarily revolves around the allocation of the exemption to transferred property. The exemption is allocated to property or trusts and not to transferors. Therefore, once the exemption is allocated, any further generation-skipping transfers of the exempted property remain exempt from the GST tax. The exemption generally is allocated based on the property's value on the date of the gift for lifetime transfers or on the date of death for testamentary transfers. An expanded discussion of the effective date of the allocation is included later in this section.

803.3 Statutory provisions govern the allocation of the GST tax exemption if the transferor or executor fails to allocate the exemption to a particular transfer. See section 804 for a discussion of the automatic allocation of the GST tax exemption rules.

803.4 Generally, a person is more likely to receive a greater benefit if the GST tax exemption is used during the person's lifetime as opposed to waiting until death. For example, if a person waits until death to use the exemption, it will shelter only $12.92 million in 2023 ($12.06 million for 2022) of assets valued at the date of death. However, if a person allocates the exemption while alive to transferred property valued at $12.92 million at the time of transfer, and if the property appreciates in value, then the exemption will shelter a greater amount of assets from the GST tax. Therefore, the most fundamental planning strategy for allocating the GST tax exemption is to allocate it to assets with the greatest appreciation potential.

Example 803-1: Increased value of exempted property is exempt from the GST tax.

In 1998, John transferred property worth $1 million to a trust and allocated his entire $1 million GST tax exemption to the trust. A taxable termination occurs in the current year when the value of the trust property has increased to $6 million. Even though the trust property has increased in value, the entire $6 million of property is exempt from the GST tax on the taxable termination.

803.5 For years after 1998, the lifetime GST tax exemption has increased either through inflation indexing or statutory increases. The increased GST tax exemption applies to all generation-skipping transfers (i.e., direct skips, taxable terminations, and taxable distributions) made after 1998. Furthermore, if the individual making the transfer is still alive, any increase in the exemption may be allocated to a current transfer or prior transfers in trust. See section 805 discussing the late allocation of the GST tax exemption.

803.6 Observation: The 2017 Tax Cuts and Jobs Act temporarily doubled the GST tax exemption amount from $5 million to $10 million (adjusted for inflation) for the estates of decedents dying and gifts made after 2017 and before 2026. The increased exemption amounts are scheduled to sunset after 2025, returning to $5 million per person (adjusted for inflation).

Example 803-2: Using the increased GST tax exemption.

Jeff transferred $2.5 million to a trust in 1995 and allocated his entire $1 million GST tax exemption to the trust, resulting in an inclusion ratio of .60. Assume the current value of the trust assets is $6 million. If Jeff is still alive in 2023, he is permitted to make an additional allocation of $3.6 million of GST tax exemption (60% of FMV) to the trust, resulting in a new inclusion ratio of zero {1 − [($2.4 million + 3.6 million) divided by $6 million]}.

803.7 Warning: See section 802 and Example 802-1 for a discussion of when a direct skip during lifetime results in double taxation.

803.8 Recomputing the Applicable Fraction and Inclusion Ratio. The applicable fraction, and therefore the inclusion ratio, is required to be recomputed when additional property is transferred to an existing trust [IRC Sec. 2642(d)(1)].

803.9 The numerator of the recomputed applicable fraction is the sum of (a) the amount of the GST tax exemption allocated to the additional property transferred to the trust and (b) the *nontax portion* of the trust immediately before the additional transfer [IRC Sec. 2642(d)(2)(A)]. The nontax portion is the product of (a) the value of all of the property in the trust (before the additional transfer) and (b) the applicable fraction (before the additional transfer) [IRC Sec. 2642(d)(3)].

803.10 The denominator of the recomputed applicable fraction is the sum of (a) the value of the property involved in the transfer (reduced by the sum of any federal estate tax or state death tax attributable to the property and recoverable from the trust, and any charitable deduction allowed for the property), and (b) the value of all property in the trust immediately before the transfer [IRC Sec. 2642(d)(2)(B)].

Example 803-3: Recomputing the inclusion ratio because of additional transferred property.

Several years ago, George Carlson created a trust with property worth $1.2 million and allocated his remaining $900,000 GST tax exemption to the trust. This resulted in an applicable fraction of .750 ($900,000 ÷ $1.2 million) and an inclusion ratio of .250 (1 − .750).

The trust property had appreciated to $1.3 million in the current year (before the additional transfer). The GST exempted portion of the trust is $975,000 ($1.3 million × .750).

In the current year, George contributed an additional $600,000 to the trust. If George does not allocate any of the remaining GST tax exemption to the current-year transfer, the recomputed applicable fraction is .513 [$975,000 ÷ ($600,000 + $1.3 million)] and the recomputed inclusion ratio is .487 (1 − .513).

If George allocates an additional $925,000 of GST tax exemption to the transfer, the recomputed applicable fraction is 1.0 [($925,000 + $975,000) ÷ ($600,000 + $1.3 million)] and the recomputed inclusion ratio would be zero (1 − 1).

803.11 Planning Tip: The GST tax exemption amount increased from $12.06 million in 2022 to $12.92 million in 2023. This additional exemption may be allocated to existing trusts. If an existing trust has an inclusion ratio between one and zero, planners should consider allocating any unused exemption amount to the trust when the allocation will reduce the inclusion ratio to zero. This additional move increases the tax advantage without additional giving. Section 805 discusses a late allocation of the GST tax exemption.

803.12 The applicable fraction and inclusion ratio must also be recomputed if additional GST tax exemption is allocated to property held in a trust created by the transferor and the trust assets are included in the transferor's estate. The numerator of the recomputed applicable fraction is equal to the value of the nontax portion of the property immediately before the death of the transferor, increased by the amount of the exemption allocated by the executor [Reg. 26.2642-4(a)(3)]. The denominator is the value of the trust property at the date of death [Reg. 26.2642-4(b), Ex. 1].

803.13 Charitable lead annuity trusts (CLATs) must use a special rule for allocating the GST tax exemption. This rule requires that if the GST tax exemption had been allocated earlier, CLATs revalue assets to recompute the applicable fraction when the charitable interest ends [IRC Sec. 2642(e)]. See section 501 in the Tax and Planning Advisory *Charitable Giving* topic for a discussion of allocating the GST tax exemption of a CLAT. This adjustment does not apply to unitrusts (CLUTs).

803.14 Warning: When no GST tax exemption is available, using a trust that has one or more skip persons as beneficiaries can increase the total transfer tax burden if the GST tax is imposed when the nonskip person dies and the nonskip person (e.g., adult child) is not in the maximum estate tax bracket. The GST tax is imposed at the maximum estate tax rate. However, overall transfer tax savings can be realized by subjecting the assets to estate tax in the nonskip person's estate rather than the GST tax owed on a taxable termination, if the nonskip person's gross estate is less than the exemption amount.

Example 803-4: Net transfer tax savings by avoiding a taxable termination.

Alice created an irrevocable trust to distribute income to her daughter, Betty, for life. On Betty's death, the trust will terminate with the remainder going to Betty's daughter, Claire (Alice's granddaughter). Alice has allocated all her GST tax exemption to other transfers, so a taxable termination will occur when Betty dies and GST tax will be owed. If Betty dies in the current year when the net value of the trust is $1.5 million, assuming a 40% GST tax rate the trustee would be liable for $600,000 ($1.5 million × 40%) of GST tax and Claire would receive $900,000 ($1.5 million − $600,000).

<u>Variation:</u> If Alice had left the assets to Betty outright (when the assets were worth $1.5 million at Betty's death and the balance of Betty's estate was minimal), then Betty's $5,113,800 (for 2023) credit against estate tax could shelter $12.92 million (in 2023). Therefore, Claire would receive the entire $1.5 million instead of $900,000, a significant savings in overall transfer tax compared to that of the trust arrangement.

Planning Tip: Giving Betty a general testamentary power of appointment over the trust could avoid the GST tax. See planning tip at paragraph 801.16.

Incentive Trusts for Skip Persons

803.15 Incentive trusts are structured for distributions to be tied to the beneficiaries' behavior. Grantors use these trusts when they are concerned about the potential loss of ambition or incentive for a beneficiary who receives a substantial amount of money (or property). Depending on the desires of the grantor and the behavior he or she hopes to encourage, an incentive trust may reward achievement of certain goals (e.g., completing college, establishing a career, or community service). Alternatively, the beneficiary may be provided access to distributions only if certain behavior is avoided (e.g., using drugs or alcohol). These trusts are discussed in greater detail in section 414.

803.16 Incentive trusts may be useful when making transfers to grandchildren. Planners may want to include a provision to allow the grantor's children to reevaluate the incentives and behavior for grandchildren and great-grandchildren. This will allow flexibility in adapting to changing circumstances within the family and within society.

Example 803-5: Incentive trusts for grandchildren.

Mabel Conner funded a trust for the benefit of her 10 grandchildren. She transferred $1 million to the trust and allocated $1 million of her GST tax exemption to the trust. The provisions of the trust encourage the grandchildren to obtain a college degree before reaching the age of 30. Distributions ($100,000) are allowed to each grandchild as they complete college. When the last grandchild reaches age 30, the remaining assets are distributed equally to each grandchild who has completed college. Because Mabel allocated her GST tax exemption to the trust, none of these distributions are subject to GST tax.

803.17 Observation: Some advisors are hesitant to recommend incentive trusts due to the challenges associated with drafting, as well as the concern about using money as an external motivation to achieve personal goals. These planners encourage using mission statements that set forth the client's values, which provide guidance to the trustee in exercising discretion over trust distributions.

Leveraging the GST Tax Exemption with Life Insurance

803.18 The benefits of the GST tax exemption can be maximized by allocating it as early as possible to property with significant appreciation potential. One way to leverage a transferor's GST tax exemption is to allocate the exemption to the transfer of a life insurance policy to a trust. Because the transfer of a life insurance policy involves the gift of an asset with a relatively low current value, that will balloon into a substantial asset when the transferor dies, the exemption can shelter a disproportionately large amount of future value (i.e., proceeds). If the exemption is used to shelter all transfers to the trust, the entire amount of insurance proceeds related to those transfers will be exempt from the GST tax.

Example 803-6: Leveraging GST tax exemption with a life insurance trust.

In December 2000, Elijah transferred $1 million to a trust for the benefit of his grandchild, Casey. The trust used the $1 million to purchase an $8 million paid up life insurance policy on Elijah's life. Elijah allocated $1 million of his available GST tax exemption to the transfer. Therefore, the trust's inclusion ratio is zero. At Elijah's death, the trust will receive $8 million.

The entire amount is exempt from the GST tax because the $1 million GST tax exemption allocated to the initial transfer shelters the entire value of the death benefit.

803.19 Observation: Using second-to-die life insurance policies will provide maximum leveraging of the GST tax exemption because the premiums are lower than if separate policies were purchased for an equivalent amount.

803.20 If the policy in the life insurance trust requires paying additional premiums, additional planning is required to ensure the availability of the gift tax and GST tax annual exclusion and/or to ensure the appropriate allocation of the GST tax exemption. As noted at paragraph 802.20, several provisions must be in place for gifts to the trust to qualify for both the gift tax and GST tax annual exclusion. Without the availability of the GST tax annual exclusion, an allocation of the transferor's GST tax exemption to every transfer to the trust (e.g., transfers of cash to the trust that will be used to pay life insurance premiums) will be necessary to prevent GST tax.

Example 803-7: GST tax exemption allocation with life insurance trusts.

Several years ago, Scott set up a life insurance trust for the benefit of his two children and four grandchildren. Scott transfers $30,000 to the trust each year so that the trust can pay the annual insurance premiums on a $3 million policy. Although the trust includes *Crummey* withdrawal provisions to ensure the availability of the gift tax annual exclusion, Scott's annual gifts to the trust do not qualify for a GST tax annual exclusion because the trust has more than one beneficiary and also has nonskip beneficiaries.

Scott allocated $30,000 of his GST tax exemption on his gift tax return each year he contributed to the trust. Scott died in the current year. Because Scott allocated a portion of his GST tax exemption to 100% of the gifts made to the trust, the distributions from the trust are exempt from GST tax. (If Scott had not allocated a portion of his GST tax exemption and had any GST tax exemption that had not been allocated elsewhere, the deemed allocation rules would have applied to allocate the exemption to the transfers. See section 804 for a discussion on the automatic allocation rules.)

803.21 Caution: Allocating GST tax exemption to trusts that own term life insurance policies could be wasted if the insured survives the term of the policy.

Dynasty Trusts

803.22 The GST tax exemption can be leveraged by maximizing the duration of a trust to which the GST tax exemption is allocated. A long-term trust, sometimes known as a dynasty trust, can be used to pass significant wealth (often generated by insurance proceeds) through multiple generations without the imposition of estate, gift, and GST taxes. A dynasty trust continues as long as is legally possible (under state law) and provides income and principal to beneficiaries without actually transferring ownership of the trust property to the beneficiaries. The trust invests proceeds that have been sheltered by the GST tax exemption in appreciating assets (e.g., artwork and residences, for the beneficiaries' use). If the beneficiaries use the trust assets, it does not result in GST tax because the assets are sheltered by the exemption. Additionally, because distributions are left to the discretion of the trustee, the assets are insulated from divorce actions and creditor claims. Dynasty trusts are discussed in greater depth in section 415.

803.23 Rule against Perpetuities. The trust continues as long as is legally possible under state law. Many states enacted a *rule against perpetuities*, which sets a finite limit on the duration of a trust. In these states, a trust must terminate and distribute assets no later than 21 years after the death of the last to die of all identified beneficiaries who were living when the trust was created. Beneficiaries will normally be the creator's grandchildren, so the trust will remain in existence until 21 years after the death of the last of the settlor's grandchildren, and the assets therefore will be distributed to the great-grandchildren. The trust can be terminated sooner, and the assets distributed to the settlor's grandchildren.

803.24 A growing number of states have no rule against perpetuities. Theoretically, trusts created in these states could last forever. Other states still apply a rule against perpetuities, but have carved out special, extended maximum terms for dynasty trusts; for example, Florida's rule permits a maximum term of more than 300 years. See section 415 for additional discussion of these trusts.

Valuation Discounts

803.25 The benefits of the GST tax exemption may be further increased when certain valuation discounts are applied to the fair market value of the property transferred. Reducing the value of a lifetime gift means that a lesser amount of GST tax exemption is needed to reduce the inclusion ratio to zero. See section 703 for coverage of valuation discounts.

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804 Automatic Allocation Rules for GST Tax Exemption

804.1 Statutory provisions govern the allocation of the GST tax exemption if the transferor or executor fails to allocate the exemption to a particular transfer. Several elections are available to avoid the automatic allocation of the GST tax exemption (see paragraph 804.23). This section discusses the statutory provisions for allocating the GST tax exemption.

Lifetime Direct Skips

804.2 Direct skips made during life use up the GST tax exemption first. If an individual makes a lifetime direct skip (whether outright or in trust), any unused portion of the GST tax exemption is automatically allocated to the transferred property to the extent necessary to make the inclusion ratio zero [IRC Sec. 2632(b)(1)]. The unused portion of the GST tax exemption is determined by subtracting from $12.92 million for 2023 ($12.06 million for 2022) the sum of the amounts previously allocated by the transferor, including deemed allocations to direct skips [IRC Sec. 2632(b)(2)]. If the amount of the direct skip exceeds the unused portion of the exemption, the entire unused portion of the exemption is allocated to the transferred property [IRC Sec. 2632(b)(1)].

804.3 Note: The inclusion ratio is the fraction used to determine the GST tax rate applicable to the transfer. A zero inclusion ratio will result in no GST tax. The mechanics of calculating the inclusion ratio are discussed in sections 801 and 802.

804.4 Electing Out of the Automatic Allocation Rule. The transferor can elect out of the automatic exemption allocation rule described in paragraph 804.2. The election is made by describing on a timely filed gift tax return the transfer and the extent to which the automatic allocation does not apply. Also, a timely filed gift tax return with payment of the GST tax as shown on the return for the direct skip is sufficient to elect out of the automatic allocation rules [Reg. 26.2632-1(b)(1)(i)]. The automatic allocation of the exemption or the election out of the automatic allocation, whichever is applicable, is irrevocable after the due date (including extensions) of the gift tax return [Reg. 26.2632-1(b)(1)(ii)].

804.5 Planning Tip: The ability to elect out of the automatic exemption allocation rule for lifetime direct skips is an important planning tool. The GST tax exemption may be more valuable when allocated to transfers of property or to trust property that are more likely to appreciate in value. Once an inclusion ratio is determined for a trust, the ratio remains constant (unless there are additional contributions to the trust) even though the trust assets may appreciate in value.

Example 804-1: Electing out of the automatic allocation rule for lifetime direct skips.

In May 2000, Craig made a direct skip transfer of $1,030,000 to his grandson, Tommy. Craig did not elect out of the automatic exemption allocation rules.

Craig transfers $1 million to another trust two months later. Under the terms of this trust, income is payable to Craig's daughter, Lucy, with the remainder payable to Lucy's child, Tommy. Lucy died in the current year when the trust assets are worth $8.5 million.

GST tax will be imposed on the entire $8.5 million taxable termination of the trust at Lucy's death. All of Craig's GST tax exemption ($1,030,000) was allocated to the 2000 direct skip to Tommy because Craig failed to elect out of the application of the automatic allocation rules. Because all of the GST tax exemption was automatically allocated to the direct skip, no unused exemption was available when Craig transferred property to the second trust in 2000.

If Craig had elected out of the automatic allocation rules in 2000, he would have paid GST tax on the $1.03 million direct skip to his grandson, but would have had all of the GST tax exemption to allocate to the property transferred to the second trust. An allocation would have eliminated the GST tax on the $8.5 million taxable termination of the trust because the exemption would have sheltered the appreciation of the trust property.

Note: If Craig is living at the time of the termination, his increased GST tax exemption amount for 2023 may be allocated to the trust prior to its termination (because the transfer to the trust was not a direct skip) to reduce the trust's inclusion ratio and, therefore, the amount of GST tax due on the termination.

804.6 Practice Tip: Example 804-1 illustrates the dilemma estate planners face when recommending how to allocate a client's GST tax exemption. Effective allocation of the exemption requires the planner's best educated guess about the potential for future GST events, so that the exemption can be applied to transfers with the greatest appreciation potential. Planners should discuss current generation-skipping transfers with clients before allocating the exemptions and thoroughly document each discussion.

Lifetime Indirect Skips

804.7 Generally, for transfers after 2000, any unused portion of the individual's GST tax exemption is automatically allocated (i.e., a deemed allocation is made) to *indirect skips* made to GST trusts during life to the extent necessary to produce the lowest possible inclusion ratio for the property [IRC Sec. 2632(c)(1)].

804.8 Planning Tip: These indirect skips are generally transfers to trusts that may produce a taxable distribution or taxable termination. In the past, many planners have neglected to advise clients to allocate GST tax exemption to these transfers, subjecting the client to potential GST taxes (and planners to potential malpractice suits). This provision is designed to minimize the risk that the exemption will not be allocated to these transfers.

804.9 Practice Tip: As illustrated in Example 804-1, there may be situations where the taxpayer will want to preserve the GST tax exemption to offset future transfers or situations where a late allocation of the GST tax exemption would be more appropriate. In these situations, it may be beneficial to elect out of the deemed allocation rules. See paragraph 804.22 for a discussion of electing out of the deemed allocation rules.

804.10 Indirect Skip. An *indirect skip* is any transfer of property (other than a direct skip subject to the gift tax) made to a GST trust [IRC Sec. 2632(c)(3)(A)].

804.11 GST Trust. A *GST trust* is a trust that could have a generation-skipping transfer tax consequence to the transferor (e.g., a taxable termination or taxable distribution) unless [IRC Sec. 2632(c)(3)(B)]—

a. the trust instrument provides that more than 25% of the trust principal must be distributed to, or may be withdrawn by, one or more individuals who are nonskip persons—

(1) before they reach age 46;

(2) on or before one or more dates specified in the trust instrument that will occur before they reach age 46; or

(3) upon the occurrence of an event that, in accordance with regulations to be issued, may reasonably be expected to occur before they reach age 46;

b. the trust instrument provides that more than 25% of the trust principal must be distributed to or may be withdrawn by one or more individuals who are nonskip persons and who are living on the date of death of another person identified in the instrument (by name or by class) who is more than 10 years older than these individuals;

c. the trust instrument provides that, if one or more individuals who are nonskip persons die on or before a date or event described in item a or b, more than 25% of the trust principal either must be distributed to the estate or estates of one or more of these individuals or is subject to a general power of appointment exercisable by one or more of these individuals;

d. any portion of the trust would be included in the gross estate of a nonskip person (other than the transferor) if the person died immediately after the transfer;

e. the trust is a charitable lead annuity trust, charitable remainder annuity trust, or charitable remainder unitrust; or

f. the trust was allowed a deduction under IRC Sec. 2522 (presumably a charitable lead unitrust) for the amount of an interest in the form of the right to receive annual payments of a fixed percentage of the net fair market value of the trust property (determined yearly) and which is required to pay principal to a nonskip person if the person is alive when the payments terminate.

804.12 When Exceptions Will Not Apply. With regard to indirect skips, the value of property transferred to a GST trust will not be includable in the gross estate of a nonskip person or subject to a right of withdrawal by a nonskip person to the extent this right is restricted to the gift tax annual exclusion amount. It is further presumed for indirect skips that powers of appointment held by nonskip persons will not be exercised [IRC Sec. 2632(c)(3)(B)].

804.13 Planning Tip: Generally, a *Crummey* trust with a withdrawal right of the gift tax annual exclusion amount or less per transferee will be a GST trust if there is a beneficiary who is a skip person and the automatic allocation will occur. In many cases, *Crummey* trusts will have beneficiaries who are both nonskip and skip persons, but the skip persons (i.e., grandchildren) are *not* intended to receive the trust property in the normal course of events. Therefore, planners may need to elect out of the automatic allocation rules for these types of trusts. See paragraph 804.22.

804.14 Caution: Annual exclusion gifts to a *Crummey* ILIT will not qualify for the GST tax annual exclusion. This causes an allocation of the donor's GST tax exemption to each gift. When annual exclusion *Crummey* gifts have been made to an ILIT over the years, it is likely that the donor's remaining gift tax exclusion amount and the donor's remaining GST tax exemption are not the same.

804.15 The deemed allocation rules relating to indirect skips apply to the unused portion of an individual's GST tax exemption. Generally effective for transfers after 2000, the unused portion of an individual's GST tax exemption is that portion of the exemption that has not previously been [IRC Sec. 2632(c)(2)]—

a. allocated by the individual;

b. treated as allocated because of a direct skip under IRC Sec. 2632(b); or

c. treated as allocated because of a previous indirect skip to a GST trust under IRC Sec. 2632(c)(1).

804.16 Election to Treat Trust as GST Trust. The automatic allocation of the exemption to indirect skips applies to transfers made to a GST trust. An individual may elect to treat any trust as a GST trust for transfers made by the individual to the trust [IRC Sec. 2632(c)(5)(A)(ii)]. The election is made on a timely-filed gift tax return for the calendar year for which the election is to become effective [IRC Sec. 2632(c)(5)(B)(ii)].

804.17 Planning Tip: This election is beneficial if a taxpayer makes annual gift tax exclusion gifts to a non-GST trust, wants to allocate the GST tax exemption, but does not want to file annual gift tax returns to allocate the GST tax exemption. By making the election to treat the trust as a GST trust, the GST tax exemption is automatically allocated to transfers made to the trust, therefore eliminating the need to file Form 709 in future years only to allocate the exemption (although there may be other reasons for filing Form 709). Practitioners should consider filing Form 709 to report the automatic allocation each year.

Example 804-2: Deemed allocation when no affirmative GST exemption made

Diane created a revocable trust for her benefit. At Diane's death, the trust became irrevocable. The trust instrument provided for outright gifts to grandchildren and then continued with the trust income payable to Diane's three children for life. At the death of the last child, the trust terminates and distributes the remainder to the grandchildren. The executor timely filed Form 706 but did not affirmatively allocate Diane's GST tax exemption to the trust. However, because Diane had not allocated any of her GST tax exemption to lifetime transfers, her entire GST exemption was available at death, and the IRS privately ruled that it would be deemed allocated, first to the direct bequests to Diane's grandchildren and second to the trust (Ltr. Rul. 202244003).

804.18 Irrevocable Life Insurance Trusts. Most irrevocable life insurance trusts will not fall under any of the exceptions noted at paragraph 804.11. Therefore, planners should assess whether the automatic allocation of GST tax exemption is appropriate.

804.19 Planning Tip: Some life insurance trusts may be GST trusts and the transferor's GST tax exemption will be automatically allocated to the trust. If the transferor does not want the GST tax exemption allocated to the trust, a formal election out of the allocation should be made as discussed beginning at paragraph 804.22.

804.20 Practice Tip: In the authors' opinion, planners should assume that all irrevocable trusts are GST trusts. If the trust is unlikely to have a generation-skipping transfer, the planner may then elect out of the automatic allocation (requiring a Form 709, even if the gifts are covered by *Crummey* withdrawal powers). Alternatively, if the planner determines that an allocation to the gift is appropriate, an election can be made to allocate the exemption to all future contributions to the same trust. See Key Issue 24A of PPC's 706/709 Deskbook for a discussion of Form 709 filing requirements.

804.21 Indirect Skips Subject to an Estate Tax Inclusion Period (ETIP). An indirect skip to a trust that is subject to an ETIP is subject to the deemed allocation rules. In the case of an ETIP, the GST tax exemption is automatically allocated at the end of the ETIP based on the value of the property at the termination of the ETIP [IRC Sec. 2632(c)(4)]. See section 808 for additional discussion of allocating the GST tax exemption when an ETIP is involved.

804.22 Electing Out of the Deemed Allocation Rules for Indirect Skips. An individual may elect out of the application of the automatic allocation rules for an indirect skip [IRC Sec. 2632(c)(5)]. The election will be considered timely if filed on a timely-filed gift tax return for the calendar year in which—

a. the first transfer to be covered by the election out was made, or

b. the ETIP closes (for transfers subject to an ETIP).

804.23 There are actually five separate GST elections that a transferor can make to opt out of the automatic allocation rules [Reg. 26.2632-1(b)(2)(iii)(A)]:

a. *Election Not to Have the Automatic Allocation Rules Apply to Prior-year Transfers Subject to an ETIP.* Prior-year transfers that are subject to an ETIP must be specifically described or identified in the election out statement. This election will not cover future transfers to the trust. However, see item e. Because the GST tax exemption cannot be allocated until the ETIP closes, the election out can free the GST tax exemption to be allocated to other transfers. When the ETIP closes, the GST tax exemption can be affirmatively allocated at that time. See section 808 for additional discussions of ETIPs.

b. *Election Not to Have the Automatic Allocation Rules Apply to One or More (or All) Current-year Transfers.* This election by itself will only cover current-year transfers. However, see item e. Donors typically make this election to preserve their GST tax exemption for future years.

c. *Election Not to Have the Automatic Allocation Rules Apply to One or More (or All) Future-year Transfers.* This election by itself will only cover future transfers and not current transfers.

However, see item e. This election can be terminated.

d. *Election Not to Have the Automatic Exemption Rules Apply to All Future-year Transfers to All Trusts.* All future transfers made by the transferor to all trusts (whether or not the trust is in existence at the time of the election). This election by itself will only cover future transfers to all trusts unless this election is terminated.

e. *Any Combination of the Previously Discussed Four Elections.* If a transferor is certain that the GST tax exemption should not be allocated to a particular trust, the elections out for current-year transfers and all future transfers (this will prevent a gift tax filing requirement if future transfers are made to the trust) should be made.

804.24 Termination of Election Out. The election out (i.e., election not to automatically allocate GST tax exemption) can be terminated in a subsequent year by attaching a statement to a timely filed gift tax return for the year for which the first transfer was made to which the election out is lifted (even if a gift tax return would not otherwise be required). This results in the automatic allocation rules applying to the described current transfer and all future transfers made by the transferor to the trust (unless and to the extent another election out of the automatic allocation rules is made in the future). The termination of an election out does not prevent the transferor from making another election out in the same or any subsequent year [Reg. 26.2632-1(b)(2)(iii)(E)]. See Election E303 in PPC's 706/709 Deskbook for further details.

Determining Value of Estate Assets for the Generation-Skipping Transfer (GST) Tax Exemption Allocation

804.25 Date of death value will apply to property transferred as a result of the death of the transferor. However, under some circumstances, the property will be valued at date of distribution rather than date of death [IRC Sec. 2642(b)(2)(A)].

804.26 Planning Tip: The generation-skipping transfer (GST) tax lifetime exemption can be allocated to transfers on the basis of a formula [Reg. 26.2632-1(b)(2)]. This is usually the best way, because the value of the property or trust may be adjusted after the filing of the gift or estate tax return.

Transfers at Death

804.27 If the transferor dies and the executor fails to allocate the decedent's GST tax exemption, the unused exemption is automatically allocated first to direct skips occurring at death (e.g., specific bequests) and then to trusts from which a taxable distribution or taxable termination may occur after the transferor's death [IRC Sec. 2632(c)(1)]. However, if the executor allocates the exemption, the allocation must be made by the due date (including extensions) for filing the federal estate tax return [Reg. 26.2632-1(d)]. Therefore, the executor must take care to make an allocation of the exemption amount in a timely manner that causes the desired result; otherwise, the automatic allocation provisions will determine the manner of allocation.

804.28 Warning: Estate planners should be aware that different funding (e.g., true worth pecuniary or fairly representative pecuniary) will cause different GST tax consequences. See section 1110 for a discussion of the various funding options. See the discussion beginning at paragraph 801.34 on using noncash property to fund a pecuniary bequest and the resulting impact on the applicable fraction.

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805 Late Allocation of The GST Tax Exemption

805.1 If the GST tax exemption is not automatically allocated to a transfer or if an express allocation is not timely made, transferors have additional options to consider. A late allocation can be made, as explained in paragraph 805.2. Alternatively, the IRS is directed to grant extensions of time to make the election to allocate the GST tax exemption (or to elect out of the automatic allocation rules), as discussed beginning at paragraph 805.6. Additionally, a retroactive allocation of the GST tax exemption can be made if there is an unnatural order of death (i.e., a child dies before a parent and assets pass to a grandchild because of this unnatural order of death). These rules are discussed in section 806.

Late Allocation of the GST Exemption

805.2 If an allocation of the exemption is required to be made on a gift tax return and the gift tax return is not timely filed, the value of the property for allocating the GST tax exemption is the value on the date the gift tax return is filed [IRC Sec. 2642(b)(3)]. Fortunately, the regulations provide some relief to the practical impossibility of both knowing the value of the transfer and preparing the notice of allocation of the exemption (which is attached to the gift tax return) on the same day the gift tax return is filed. The transferor may elect to value the transferred property as of the first day of the month in which the late allocation occurs [Reg. 26.2642-2(a)(2)]. However, an election is not available to a life insurance policy or a life insurance trust if the insured individual has died.

805.3 Late allocations may be beneficial if the value of the transferred property has declined. The allocation is effective when the gift tax return (Form 709) is filed. However, a transferor's GST tax exemption is automatically allocated to lifetime transfers (after 2000) to trusts (both direct skip and nonskip transfers) under the deemed allocation rules (see section 804 for a discussion of the automatic GST tax exemption allocation rules). As a result, taxpayers will have to elect out of the deemed allocation rules to make an intentional late allocation of the transferor's GST tax exemption.

Example 805-1: Late allocation of the GST exemption to a life insurance trust.

In 1998, Jan Tucker created an irrevocable trust for the benefit of her grandchildren. Jan's children are permissible income beneficiaries; therefore, transfers to the trust are not direct skips. The trust holds a life insurance policy, worth $300,000 at date of transfer, payable at Jan's death. Since 1998, Jan has transferred $10,000 to the trust each year to pay the annual premium. The annual transfers do not qualify for the GST tax annual exclusion and Jan did not allocate the GST tax exemption to the transfers before 2001. Because the automatic allocation of GST tax exemption to these trusts did not apply before 2001, transfers to the trust for the first three years are not sheltered from future GST tax.

Jan made her annual transfer to the trust in May 2023. Although she had not previously allocated any of her GST tax exemption to this GST trust, unless she elected out of the automatic allocation rules, $230,000 of Jan's GST tax exemption ($10,000 each year in 2001–2023) was allocated to the trust under the automatic exemption allocation rules of IRC Sec. 2632(c).

Her estate planner advises her of the consequences of not allocating enough of her GST tax exemption *before death* to make the trust have a zero inclusion ratio. Jan has two possible options. If Jan can prove that she intended to make the GST tax exemption allocation every year as transfers were made to the trust, she can request an extension of time to make the allocation. If an extension is granted, she can allocate her GST tax exemption as of the date of each transfer (i.e., $300,000 plus $10,000 per year for 1998–2000). This would use another $330,000 of her GST tax exemption.

Her other option is to make a late allocation of her GST tax exemption. Because a portion of her exemption was automatically allocated to the transfers after 2000, the current inclusion ratio of the trust must be determined at each of the previous transfer dates. To determine the inclusion ratio, the policy's value immediately before each of the transfers and the value of the policy at the time of the late allocation must be obtained. Generally, this information can be obtained from the life insurance company that carries the policy. The trust's inclusion ratio must be calculated each time an allocation of the GST tax exemption is made.

A summary of the applicable fractions and inclusion ratios for years 2001 through 2023 follows. See the calculation worksheet at Appendix 8C.

Date of transfer	Policy value before transfer (obtained from life insurance co.)	GST Tax Exemption Allocated	Applicable fraction (after transfer)	Inclusion ratio (after transfer)
5/15/2001	$330,000	$10,000	.029	.971
5/15/2002	$335,000	$10,000	.057	.943
5/15/2003	$340,000	$10,000	.084	.916
5/15/2004	$345,000	$10,000	.110	.890
5/15/2005	$350,000	$10,000	.135	.865
5/15/2006	$355,000	$10,000	.159	.841
5/15/2007	$360,000	$10,000	.182	.818
5/15/2008	$365,000	$10,000	.204	.796
5/15/2009	$370,000	$10,000	.225	.775
5/15/2010	$375,000	$10,000	.245	.755
5/15/2011	$380,000	$10,000	.264	.736
5/15/2012	$385,000	$10,000	.283	.717
5/15/2013	$390,000	$10,000	.301	.699
5/15/2014	$395,000	$10,000	.318	.682
5/15/2015	$400,000	$10,000	.335	.665
5/15/2016	$405,000	$10,000	.351	.649
5/15/2017	$410,000	$10,000	.366	.634
5/15/2018	$415,000	$10,000	.381	.619
5/15/2019	$420,000	$10,000	.395	.605

Date of transfer	Policy value before transfer (obtained from life insurance co.)	GST Tax Exemption Allocated	Applicable fraction (after transfer)	Inclusion ratio (after transfer)
5/15/2020	$425,000	$10,000	.409	.591
5/15/2021	$430,000	$10,000	.422	.578
5/15/2022	$435,000	$10,000	.435	.565

Jan's Form 709 (i.e., her gift tax return) will be filed on April 15, 2024. The policy has a value on April 1, 2023, of $440,000. Because the inclusion ratio is .565, Jan must make a late allocation of $248,600 to ensure that the assets in the trust will not be subject to GST tax.

Date of transfer	Policy value before transfer (obtained from life insurance co.)	GST Tax Exemption Allocated	Applicable fraction (after transfer)	Inclusion ratio (after transfer)
4/1/2023	$440,000	$248,600	1.0	-0-

In this example, Jan uses less of her GST tax exemption (i.e., $468,600) by making a late allocation of her GST tax exemption instead of requesting an extension of time for making the GST tax exemption allocation and using $560,000 of her exemption.

805.4 Planning Tip: Making an intentionally late allocation during the transferor's life may be beneficial for a transfer to an irrevocable life insurance trust. This is because a timely filed allocation would use the value of the trust assets and the amount being transferred to the trust at the time of transfer. If the allocation is made later, after the cash transfer has been used to pay the life insurance premium, the value will be lower because the interpolated terminal reserve value or cash surrender value will generally be less than the cash used to pay the premium. The downsides to this planning opportunity include the following:

1. The insured might die after the date of timely allocation has passed and before the late allocation is made, therefore subjecting the entire value to GST tax.

2. Some insurance companies will not issue Form 712 (the form obtained from the life insurance company with the value of the life insurance policy) unless there has been a death or transfer of the policy.

3. It is difficult to make all the necessary calculations and file the gift tax return after Form 712 has been received and before the end of the month in which the late allocation is being made.

805.5 Planning Tip: When making a late allocation of exemption to a life insurance trust, a formula approach should be considered (e.g., "the amount necessary to produce an inclusion rate of zero"). This will solve the timing problem, although the calculations will still be necessary to determine how much of the GST tax exemption was allocated.

Example 805-2: Late allocation of the GST tax exemption to depreciated assets.

Randy made a gift of 100 shares of ABC stock to a trust for his son, Justin, and his daughter, Jill. Randy's grandchildren also have an interest in the trust, but only after Randy's children die. On the date of the gift, the shares were worth $200,000. Randy's gift tax return was due on April 15 of the next year. On that date and on the first day of May, the shares were worth $150,000. If Randy filed his gift tax return on time and made a timely allocation of his GST tax exemption, he would have to allocate $200,000 of his GST tax exemption to produce a zero inclusion ratio for the trust. If Randy filed a GST tax exemption allocation on May 1 (i.e., a late allocation), he would allocate $150,000 of his GST tax exemption to produce a zero inclusion for the trust.

Observation: An assumption is made that this is not a GST trust. If this is a GST trust, the automatic allocation rules would apply and the GST tax exemption would be automatically allocated to this trust at the time of transfer to the trust. GST trusts are discussed in section 804.

Relief Provided for Inadvertent Late Allocation of GST Tax Exemption

805.6 If an election to allocate the GST tax exemption is made on a gift tax return filed timely for a transfer to a trust, the value on the date of transfer to the trust is used for determining the allocation. However, if the allocation relates to a specific transfer not subject to the automatic allocation rules and is not made on a timely-filed gift tax return, the value on the date of allocation must be used. Historically, many practitioners have failed to recognize the need to allocate the GST tax exemption for nonskip transfers to trusts, which has often resulted in a future taxable distribution or taxable termination. As a result, their clients have been required to use additional GST tax exemption to shelter the transfer from GST tax if the value of the trust property appreciated in value.

805.7 Regulation Section 9100 Relief. Relief for failing to timely allocate an individual's GST tax exemption is available under the Section 9100 regulations. A transferor can request an automatic extension of six months from the due date of a return, excluding extensions, to make an election that should have been made on a timely filed return (Reg. 301.9100-2).

805.8 To qualify for relief under Reg. 301.9100-2, the transferor must have timely filed the required return for the year the election should have been made and must take corrective action within the six-month extension period. Corrective action includes filing an amended return and attaching the required statements or forms for making the election. The return, statement, or form filed should include the statement at the top of the documents: "FILED PURSUANT TO REG. SEC. 301.9100-2."

805.9 Observation: The Section 9100-2 relief primarily benefits donors who timely filed a gift tax return reporting the transfer for gift tax purposes but failed to allocate GST tax exemption to the transfer and discovered the error by the extended due date of the return. Section 9100-2 does not provide relief when the failure to allocate GST tax exemption is discovered in a later year (e.g., when a taxable distribution or taxable termination occurs).

805.10 Post-2000 Relief Requests. Although relief for failing to timely allocate GST tax exemption is available under Reg. 301.9100-2, the timeframe for requesting relief is limited and the requirements for obtaining relief may be difficult to satisfy. However, for post-2000 requests for relief from failure to allocate, the IRS is directed to grant extensions of time to make the election to allocate the GST tax exemption or to elect out of the automatic exemption allocation rules [IRC Sec. 2642(g)]. (See section 804 for a discussion of the automatic exemption allocation rules.) If relief is granted, the gift tax or estate tax value of the transfer to trust will be used for making the allocation.

805.11 The IRS is directed to consider all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer and other factors as the IRS deems relevant. Generally, the extension will be granted if the taxpayer acted reasonably and in good faith and if granting the relief will not prejudice the government's interests (Notice 2001-50, modified by Rev. Proc. 2004-46). For determining whether to grant relief, the time for making the allocation (or election) is treated as if not expressly prescribed by statute [IRC Sec. 2642(g)(1)(B)]. Therefore, taxpayers may seek an extension of time to make an allocation under Reg. 301.9100-3.

805.12 Proposed regulations provide specific guidance and procedural requirements for seeking an extension of time through the private letter ruling program for various GST tax exemption allocations (Prop. Reg. 26.2642-7).

805.13 If relief is granted, the allocation or election will be considered effective as of the date of the transfer (or first transfer, in the case of the election for treatment as a GST trust). In addition, any allocation made as a result of granted relief will be limited to the amount of the transferor's remaining GST tax exemption as of the date of the transfer. A request for relief does not extend or reopen the statute of limitations for assessing or collecting transfer tax. Likewise, a request is not considered a claim for refund of GST tax. Requests for relief under the regulations will be granted when the taxpayer establishes that the transferor acted reasonably and in good faith and the grant of relief will not prejudice the interests of the government. (Both requirements are explained in nonexclusive lists of examples.)

805.14 Circumstances in which relief will not be granted are also identified. The regulations, which will become effective when published as final, will replace relief provisions under Reg. 301.9100-3 and render Notice 2001-50 obsolete.

805.15 Simplified Procedures for Pre-2001 Annual Exclusion Gifts. Taxpayers are allowed an alternative to the private letter ruling process to obtain an extension of time to allocate the generation-skipping transfer tax exemption (Rev. Proc. 2004-46). The alternative method can be used if the taxpayer meets the following requirements:

a. On or before December 31, 2000, the taxpayer made or was deemed to have made a transfer by gift to a trust from which a GST may be made.

b. No taxable distributions have been made and no taxable terminations have occurred.

c. The transfer qualified for the annual exclusion under IRC Sec. 2503(b) and the transfer, when added to the value of the other gifts to that donee in the same year, did not exceed the annual exclusion for the year.

d. No GST tax exemption was allocated to the transfer.

e. The taxpayer has an unused GST tax exemption available to allocate to the transfer.

805.16 Note: For a discussion about a simplified procedure for requesting relief from the failure to make a reverse QTIP election, see paragraph 807.13.

805.17 See Key Issue 29E of PPC's 706/709 Deskbook for a discussion of the simplified procedure requirements and Form 709 filing requirements.

805.18 Practice Tip: The IRS has issued several private letter rulings allowing the late allocation of the GST tax exemption. The rulings reflect a reluctance to penalize taxpayers for the inadvertent failure to allocate the GST tax exemption. In most of the rulings, the taxpayer relied on a competent tax practitioner (attorney or CPA) to prepare everything necessary to be filed with the IRS, including any allocation of GST tax exemption (Ltr. Ruls. 200506003, 200720006, 200825016, 200953017, and 201027040).

805.19 Practice Tip: Planners must make sure all forms are filed and that elections are made in a timely manner. (See Key Issue 29G of PPC's 706/709 Deskbook for specific filing instructions.) The IRS has noted that a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer relied on a qualified tax professional, and the tax professional failed to make, or advise the taxpayer to make, the election. To avoid liability, practitioners must be sure that appropriate and timely GST tax exemption allocations are made in accordance with the client's wishes. The authors suggest documenting advice provided to clients and conversations regarding the client's understanding of the GST tax exemption allocation.

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806 Retroactive Allocation of the GST Tax Exemption

806.1 If prior generation-skipping transfer gifts have been made in excess of the transferor's GST tax exemption, the temporary increase in the GST tax exemption provided in the 2017 Tax Cuts and Jobs Act can be used to improve the inclusion ratio by making a retroactive allocation of the GST tax exemption amount [footnote in the Joint Committee on Taxation's blue book (JCS-1-18), issued December 20, 2018].

806.2 A transferor normally will not allocate GST tax exemption to a trust the transferor expects will benefit only nonskip persons. Unexpected circumstances, however, may cause the GST tax to apply. This could happen, for example, when the transferor's child suddenly dies and the trust terminates in favor of the transferor's grandchild. Therefore, before 2000, if no GST tax exemption had been allocated to the trust, the GST tax would be due even if the transferor had an unused portion of the generation-skipping transfer tax exemption.

806.3 For deaths of nonskip persons occurring after 2000, the GST tax exemption can be allocated retroactively when there is an *unnatural order of death*, which occurs when a lineal descendant of the transferor predeceases the transferor (e.g., the son or daughter predeceases his or her parent). In that event, the transferor (if he or she is still alive) can allocate any unused generation-skipping transfer tax exemption to any previous transfer(s) to the trust on a chronological basis [IRC Sec. 2632(d)(1)].

806.4 A transferor can retroactively allocate the generation-skipping transfer tax exemption to a trust where a beneficiary—

a. is a nonskip person;

b. is a lineal descendant of the transferor's grandparent or a grandparent of the transferor's spouse;

c. is a generation younger than the generation of the transferor; and

d. dies before the transferor.

Note: This unnatural order of deaths does not qualify for the predeceased parent exception discussed in paragraph 801.55 because the transferor's child is alive at the time of the transfer.

806.5 The GST tax exemption will be allocated under this rule retroactively. The applicable fraction and inclusion ratio will be determined based on the value of the property on the date the property was transferred to the trust [IRC Sec. 2632(d)(2)(A)]. The allocation will be deemed to be effective immediately before the nonskip person's death [IRC Sec. 2632(d)(2)(B)].

Example 806-1: Retroactive allocation of the GST tax exemption.

Thomas created a trust that provides the trustee a discretionary right to distribute income to Marla (Thomas' spouse) or to accumulate income. On Marla's death, the trust will terminate and the principal is to be distributed to Thomas' descendants, *per stirpes*. When the trust was created, Thomas had four children. The trust is funded with $1 million and no GST tax exemption was allocated to the trust. The trust is not a GST trust.

Later, when the trust had a value of $2 million, one of Thomas' children (Jared) died. Thomas and Marla are still alive. Jared has children (which are grandchildren of Thomas).

If Thomas has at least $250,000 of unallocated GST tax exemption (immediately before Jared's death), he can retroactively allocate his exemption to 25% (the percentage that passes to Jared's children) of the original transfer. To do this, a gift tax return must be filed for the year of Jared's death and $250,000 of Thomas' GST tax exemption allocated to the trust. The trust should then be divided in a qualified severance into two trusts, one with 25% of the trust value and a GST inclusion ratio of zero, and the other with 75% of the trust's value and a GST inclusion ratio of one. The two trusts must provide for the same succession of interest (i.e., Marla must be the discretionary income beneficiary of both trusts and Jared's children the beneficiary of the 25% trust and Thomas' three children the beneficiaries of the 75% trust). See section 809 for a discussion of severing a trust into separate trusts.

Gift Splitting and the Retroactive Allocation of the GST Tax Exemption

806.6 If the initial gift to trust was split under IRC Sec. 2513 (see section 807), the deemed allocation rules do not apply, and if the spouse dies before the beneficiary, the benefit of the retroactive allocation of the GST tax exemption can only be obtained for one half of the trust.

Example 806-2: Gift splitting and the retroactive allocation of the GST tax exemption.

Assume the same facts in Example 806-1 except that Thomas and Marla elected to split gifts on the original transfer. Further assume that Marla died before Jared. Thomas would only be able to retroactively allocate $125,000 of his GST tax exemption. And, the inclusion ratio would be .5 instead of zero. The same result would occur if Thomas died before Jared (and Marla survived). Because each spouse is considered the transferor of half of the property, Marla could allocate $125,000 of her GST tax exemption and the inclusion ratio would be .5.

806.7 Caution: Planners should exercise caution when recommending gift-splitting for trusts that may qualify for retroactive allocation of the exemption. When the gift-splitting election is made, the election applies for GST tax purposes also. Therefore, each spouse is considered the transferor of half of the entire property transferred.

806.8 Observation: An election under IRC Sec. 2513 treats gifts as made one-half by each spouse. However, for GST tax purposes, under Reg. 26.2652-1(a)(4) the electing spouse is treated as the transferor of one-half of the entire value of the property transferred by the donor, regardless of the interest the electing spouse is actually deemed to have transferred. In Ltr. Rul. 201811003, when a preparation error on the gift tax return allocated ¾ of a gift to the donor and ¼ of the gift to the spouse, and because the gift tax statute of limitations had expired, the IRS only allowed the donor a late GST tax exemption allocation of ½ of the total gift instead of the ¾ reported on the gift tax return.

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808 Allocating the GST Tax Exemption to Property Subject to an Estate Tax Inclusion Period

808.1 Certain transfers that are completed gifts when made may subsequently be included in the transferor's gross estate (e.g., the transferor retains the power to alter beneficial enjoyment of the property causing it to be included in his gross estate under IRC Sec. 2038). Such property is subject to an estate tax inclusion period (ETIP), and an allocation of the GST tax exemption is not effective until the termination of the ETIP.

808.2 An ETIP is any period during which (should death occur) the value of the transferred property would be included in the gross estate of either (a) the transferor, or (b) the spouse of the transferor [Reg. 26.2632-1(c)(2)].

808.3 Transferred property that would be included in the transferor's gross estate under IRC Sec. 2035 (adjustments for transfers made within three years of death) is not subject to an ETIP [Reg. 26.2632-1(c)(2)(i)]. In addition, the ETIP rules do not apply when the possibility that the property will be included in the estate of the transferor or the transferor's spouse is so remote as to be negligible. This would occur if there is less than a 5% probability of the property being included in the gross estate [Reg. 26.2632-1(c)(2)(ii)]. Also, property transferred to a spouse will not be subject to an ETIP where the only power possessed by the spouse is a right to withdraw no more than the greater of 5% or $5,000, and the withdrawal right terminates within 60 days of the transfer [Reg. 26.2632-1(c)(2)(ii)(B)]. See the discussion beginning at paragraph 801.40 for additional information about the 5% actuarial probability test (the remoteness test).

808.4 An ETIP terminates on the first of the following to occur [Reg. 26.2632-1(c)(3)]:

a. The transferor's death.

b. The time when the property would no longer be included in the transferor's gross estate, determined without regard to IRC Sec. 2035 (or where a spouse is treated as transferor because of gift splitting, when the property would no longer be included in the donor spouse's estate).

c. A GST of the property.

d. In the case of an ETIP arising because of an interest held by the transferor's spouse, at the death of the spouse or the time at which no portion of the property would be included in the spouse's gross estate (excluding IRC Sec. 2035), whichever occurs first.

808.5 Observation: The ETIP rules do not apply to a QTIP trust for which the reverse QTIP election was made [Reg. 26.2632-1(c)(2)(ii)(C)]. See section 807 for coverage of the reverse QTIP election.

Example 808-1: ETIP postpones GST tax exemption allocation effective date.

Homer transferred $4 million to a trust for the benefit of his son Tom and his granddaughter Henrietta. He did not elect out of the automatic allocation of his GST tax exemption. At his death, the trust terminates and the property passes to Henrietta. Homer is the trustee with discretionary powers over accumulations and distributions of income. If Homer allocates $1 million of his GST tax exemption to this trust at the time of the transfer, the allocation, though irrevocable, will not be effective at that time because the transfer is subject to an ETIP (i.e., the trust would be includable in his gross estate under IRC Sec. 2036 because of his retained power).

If Homer dies in the current year when the trust is worth $13 million, the transfer of the trust assets to Henrietta would be a taxable termination. Because the ETIP terminates at Homer's death, the previous allocation of Homer's $1 million GST tax exemption is effective in the year of Homer's death. The automatic allocation rules will apply $11.92 million (assuming the GST tax exemption is $12.92 million in the year of Homer's death) of Homer's GST tax exemption to the trust, effective immediately prior to the taxable termination. However, because the value of the trust assets has increased to $13 million, there will be a GST tax liability when the trust terminates because the inclusion ratio is greater than zero.

Allocating the GST Tax Exemption to Transfers Subject to an ETIP

808.6 An allocation of the GST tax exemption to property subject to an ETIP is irrevocable and is effective as of the termination of the ETIP if the allocation is made by the due date for filing Form 709 for a gift occurring at the time of the ETIP termination [Reg. 26.2632-1(c)(1)].

808.7 For an indirect skip after 2000, the GST tax exemption is automatically allocated to gifted property (e.g., GST trusts) subject to an ETIP based on the value of the property at the close of the ETIP. The allocation is deemed effective on and after the close of the ETIP [IRC Sec. 2632(c)(4); Reg. 26.2632-1(b)(2)(i)]. An election to not allocate the GST tax exemption must be made on a timely filed Form 709 for the year in which the ETIP terminates [IRC Sec. 2632(c)(5)].

808.8 Observation: Preventing an inadvertent failure to allocate the GST tax exemption may be a good reason to allocate a portion of the exemption to transfers of property subject to the ETIP rules. However, because any GST tax exemption allocation is irrevocable (even if ineffective because it was made during the ETIP) and because any exemption allocated to property subject to the ETIP rules will probably result in too much or too little exemption allocated (even if some type of formula allocation is used), allocation of the exemption is at best risky. While a GST tax exemption overallocation would result in a loss of some of the exemption, an underallocation would eventually result in GST tax due.

808.9 Caution: Clients attempting to allocate a portion of their GST tax exemption to property subject to the ETIP provisions must understand that their allocation is irrevocable. This irrevocability could result in the total loss of the exemption allocated if the transferor dies during the ETIP.

Example 808-2: Loss of the GST tax exemption allocated to property subject to the ETIP rules.

Nancy funds a trust with $5,000,000 when she is age 69. The trust provides for income payments to Nancy for her life with the remainder passing to her favorite grandchild, David, when Nancy dies. If David predeceases Nancy, the remainder passes to David's parents. To limit the GST tax liability while accounting for the expected appreciation in the trust's assets, Nancy allocates her entire GST tax exemption to the trust. Because Nancy retains an interest in the trust, it is subject to the ETIP rules. Unfortunately, three years later David is killed in an automobile accident. Because Nancy irrevocably allocated her entire GST tax exemption to the trust, her GST tax exemption was wasted.

Note: In this example, if the parents had other children (other grandchildren of Nancy) who would receive the trust's remainder but for the fact that the parents were contingent beneficiaries, the parents could disclaim their interest in the trust. Disclaiming the property would revive the previously wasted exemption and the property would then pass to the other grandchildren GST tax free if the value of the trust property at the close of the ETIP did not exceed the amount of GST tax exemption allocated to the trust.

808.10 Planning Tip: Instead of allocating the exemption to transfers subject to the ETIP rules, planners should consider provisions that will effectively allow the client to schedule the termination of the ETIP. Once the ETIP is terminated, the GST tax exemption may be allocated by an affirmative election without some of the risks associated with previous allocation (e.g., underallocation or overallocation of the exemption amount). Practitioners should document and track all transfers subject to an ETIP so that a GST tax exemption allocation can be made at the end of the ETIP.

808.11 Direct Skip Subject to ETIP. If a direct skip transfer is subject to an ETIP, the direct skip is treated as occurring at the termination of the ETIP [Reg. 26.2632-1(c)(4)] and the deemed allocation rules will apply. (See section 804.) Therefore, the GST tax will be imposed on the transfer when the ETIP terminates. The gift tax portion of the transfer is reported on Form 709 in the year of the actual transfer. The GST portion of the transfer is reported at the time the ETIP terminates. See Key Issue 30C of PPC's 706/709 Deskbook for additional information on reporting transfers of property subject to an ETIP.

808.12 Caution: The termination of an ETIP can cause a GST tax liability if the value of the ETIP at termination exceeds the GST tax exemption available for allocation.

808.13 If the ETIP terminated as a result of something other than the donor's death, the GST portion of the transfer is reported on Form 709 for the year in which the termination occurred. (Note that if the ETIP terminated as a result of the donor's death, the transfer is reported on Form 706.)

Example 808-3: Allocating the GST tax exemption to a direct skip subject to an ETIP.

Five years ago, Perry transferred $300,000 to an irrevocable trust for the benefit of his three grandchildren. [Therefore the trust is treated as a skip person (see paragraph 801.38).] Perry retained the discretionary right to sprinkle trust income and principal among the grandchildren. Because Perry's power to alter beneficial enjoyment of the trust would cause the trust to be included in his estate under IRC Secs. 2036 and 2038, the transfer was subject to an ETIP. On January 10 of the current year, when the trust was valued at $400,000, Perry relinquished his discretionary power to distribute trust income and principal. As a result of his relinquishment of these powers, the property would not be included in his estate if he died (excluding IRC Sec. 2035, see section 316 for a discussion on gifts made within three years of death) and, therefore, the ETIP is terminated. Because the initial transfer to the trust was a direct skip subject to an ETIP, the GST is deemed to occur on January 10 of the current year when the ETIP terminated.

Because this is a direct skip at the termination of the ETIP, the automatic allocation rules relating to a direct skip apply. See section 804 for a discussion of the automatic allocation rules for lifetime direct skips [Reg. 26.2632-1(c)(4)]. As a result, $400,000 would be automatically allocated to the trust [assuming Perry has not already allocated all of his GST tax exemption. The trust will have a zero inclusion ratio.

808.14 Other Transfers Subject to an ETIP. Lifetime transfers in trust (other than direct skips) may result in future taxable distributions or terminations. Therefore, the donor may allocate a portion of his or her GST tax exemption to contributions to the trust to eliminate any future GST tax. To the extent the transfer to the trust is subject to an ETIP, the allocation of the GST tax exemption (irrevocable) cannot be effective until the close of the ETIP.

Example 808-4: Other lifetime transfers subject to an ETIP.

Linda transferred $150,000 to an irrevocable trust for the benefit of her son, Len. Linda retained the discretionary right to allocate income or principal to Len. Len has a general power of appointment over the trust assets. The trust instrument allows the trustee to make discretionary distributions to Len's children (Linda's grandchildren).

Because someone other than a skip person has an interest in the trust, the transfer to the trust is not a direct skip subject to the GST tax. However, the transfer may result in a future taxable distribution because the trust assets may be distributed to Linda's grandchildren. Therefore, Linda may want to allocate a portion of her GST tax exemption to the trust so that a future distribution of trust assets to her grandchildren would not be taxable. Unfortunately, Linda's discretionary power to distribute income or principal to her son will cause the value of the trust to be included in her estate under IRC Sec. 2036 or 2038. Therefore, the transfer is subject to an ETIP and the irrevocable allocation of her lifetime exemption is not effective until the ETIP terminates.

Impact of the ETIP Rules on GRITs, GRATs, and GRUTs

808.15 The negative impact of an ETIP is particularly important for transfers to GRITs, GRATs, and GRUTs. (These are split-interest transfers where the grantor gifts the remainder interest in property to a beneficiary and retains the income interest for life or a term of years. See sections 406 and 408 for additional coverage of these trusts.) If the transferor dies prior to the end of the trust's term, the IRS is likely to assert that some portion of the value of the trust property is includable in his gross estate under IRC Sec. 2036 (see paragraph 406.25). Therefore, GRITs, GRATs, and GRUTs are transfers that are subject to an ETIP. If a donor names a grandchild as beneficiary of one of these trusts, none of the donor's GST tax exemption can be effectively allocated to the trust until the expiration of the ETIP.

Example 808-5: GRAT transfers are subject to an ETIP.

Jerry transfers $1 million cash to a 10-year GRAT. Pursuant to the trust agreement, Jerry will receive $50,000 per year from the GRAT during its term. At the end of the trust term, the remainder interest in the trust will pass to Jerry's grandson, Jesse. Assume the value of the remainder interest transferred to Jesse was $683,145 at the time the trust was funded. (See section 409 for a discussion of valuing the remainder interest in a GRAT.)

Although the transfer of the remainder interest to Jesse was a taxable transfer subject to gift tax, any allocation of Jerry's GST tax exemption will be ineffective because the transfer is subject to an ETIP. Therefore, Jerry's exemption cannot be allocated effectively to the trust until the ETIP terminates. Assuming the trust earns 6% on its investments over the 10-year term, the value of the remainder interest would be $1,131,808 at the end of the trust term. If the GRAT terminates in 2023 and Jerry allocates $1,131,808 of his GST tax exemption, there will be no GST tax when distributions are made to Jesse.

808.16 Planning Tip: To minimize the harsh effects that result when grandchildren are named beneficiaries of GRITs, GRATs, or GRUTs, taxpayers could limit beneficiaries of ETIP transfers to the grantor's children. Also, consider structuring multi-generational transfers in steps. For instance, a GRAT could be established by a parent for a child. If the child has children, the child can take the remainder interest and set up a GRAT with the grandchildren as remainder beneficiaries. The grandchildren could then transfer the assets to a long-term exemption trust (see section 803) for the benefit of additional generations. In addition, the GST tax consequences can be minimized by giving the remainder beneficiary (i.e., a child) a general power of appointment with a gift to the grandchildren if the power is not exercised.

808.17 Observation: There are some issues that remain unclear regarding the allocation of GST tax exemption to a trust at the end of an ETIP or electing out of the automatic allocation rules at the end of the ETIP as represented by Example 808-6.

Example 808-6: Allocation of GST tax exemption at GRAT termination.

Bob Smith established a GRAT that pays an annuity interest to him or his estate for 10 years. Bob survives the term of the GRAT. When the annuity interest terminates, the GRAT is separated into two trusts, Trust A and Trust B. Trust A will benefit Bob's children and grandchildren. Trust B will benefit Bob's children. At the GRAT's termination, Trust A will receive assets equal to Bob's remaining GST tax exemption. Trust B will receive the balance of the assets, if any.

The original transfer to the GRAT is an indirect skip to a GST trust. The GST tax exemption will be automatically allocated when the ETIP terminates. If the automatic allocation rules apply to all the assets remaining in the GRAT at termination, Bob should elect out of the automatic allocation rules and affirmatively allocate GST tax exemption only to the assets going into Trust A at the end of the ETIP.

If the automatic allocation rules apply only to the transfer of assets into Trust A (because Trust B is not by definition a GST trust), Bob does not need to do anything affirmatively. The automatic allocation rules will apply to the transfer to Trust A.

808.18 The taxpayer in this situation should elect out of the automatic allocation rules and affirmatively allocate GST tax exemption only to the assets going into the trust with skip beneficiaries at the end of the ETIP. The election not to have the automatic allocation rules apply can be made on the initial Form 709 filed to report the gift, or later, but must be made before the due date of Form 709 for the calendar year in which the ETIP terminates [Reg. 26.2632-1(c)(1)]. See Key Issue 30C in PPC's 709 Deskbook for additional discussion of the ETIP. Planners should watch for further guidance regarding these issues.

808.19 Planning Tip: Even though the ETIP rules prevent leveraging of the GST tax exemption by using certain lifetime transfers (e.g., GRATs and GRUTs), it is still possible to leverage the GST tax exemption with appreciating property. (A sale to an intentionally defective grantor trust may accomplish goals similar to those for a GRAT without imposing the ETIP rules. See the discussion in section 410.) The most fundamental planning strategy when allocating the GST tax exemption is to allocate the exemption to assets with the greatest potential for appreciation, that may include life insurance. See section 803 for a discussion of using life insurance to leverage the GST tax exemption.

Impact of the ETIP Rules on Charitable Trusts

808.20 Charitable trusts in which the grantor retains an interest and grants an interest (or contingent interest) to a skip person are also subject to the ETIP rules. Therefore, the planner should exercise caution when allocating the GST tax exemption due to the risks associated with the irrevocable allocation (see discussion beginning at paragraph 808.6).

808.21 Charitable lead annuity trusts are treated differently than other trusts for allocating the exemption. For determining the inclusion ratio for charitable lead annuity trusts, the applicable fraction has a numerator equal to the adjusted GST tax exemption and a denominator equal to the value of all property in the trust immediately after the termination of the charitable lead annuity [IRC Sec. 2642(e)]. The adjusted GST tax exemption is the GST tax exemption allocated to the trust, increased by interest at the rate used in determining the amount of the deduction under IRC Sec. 2055 or 2522 for the actual period of the charitable lead annuity. The amount of the GST tax exemption allocated to a CLAT is not reduced even if it is ultimately determined that the allocation of a lesser amount of the GST tax exemption would have resulted in a zero inclusion ratio (Reg. 26.2642-3). Charitable lead annuity means any interest in the form of a guaranteed annuity for which a deduction was allowed under IRC Sec. 2055 or 2522.

Example 808-7: Allocation of GST tax exemption to a CLAT.

Ken creates a CLAT for a 10-year term with the remainder payable to his grandchild. Ken timely allocates some of his GST tax exemption to the trust, which he expects will ultimately result in a zero inclusion ratio. However, at the end of the charitable lead interest, because the property has not appreciated to the extent Ken anticipated, the numerator of the applicable fraction is greater than the denominator. The inclusion ratio for the trust is zero. No portion of the excess GST tax exemption allocated to the trust is restored to Ken or to Ken's estate.

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809 Maximizing the Exemption by Using Multiple Trusts

809.1 An effective GST planning strategy is to keep property protected by the GST tax exemption separate from property that is not protected. This typically is done by using trusts. This section discusses initially structuring multiple trusts or severing an existing trust to have one or more exempt trusts and one or more nonexempt trusts.

Inclusion Ratios of Multiple Trusts

809.2 The trusts used to separate transferred property should be structured to have an inclusion ratio of either 1 or 0. The inclusion ratio is the fraction used to determine the GST tax rate applicable to the transfer. An inclusion ratio of zero will result in no GST tax. (The mechanics of calculating the inclusion ratio are discussed in sections 802 and 801.) If a trust has an inclusion ratio between 0 and 1, the GST tax exemption is wasted on a distribution to a nonskip person because unprotected assets could have been distributed to a nonskip person without GST tax consequences.

809.3 Conversely, two separate trusts with an inclusion ratio of zero and 1, respectively, permit trust distributions to be made in a manner that maximizes the allocation of the GST tax exemption. The trust with the inclusion ratio of zero is used to provide benefits only for skip persons (e.g., grandchildren of the transferor), while the trust with the inclusion ratio of 1 is used to provide benefits for nonskip persons (e.g., children of the transferor). The two trusts can be funded on a fractional non prorata basis provided the division fairly reflects post-death appreciation or depreciation [Reg. 26.2654-1(b)(1)(i); Ltr. Rul. 9617029].

Example 809-1: Using separate trusts to eliminate GST tax.

Tom, a widower, has an after tax estate valued at $15 million. He wants his child, Tim, to enjoy the assets during life and when Tim dies for the estate to be split equally between his grandchild, Tammy and a charity. He does not want a qualified charitable remainder trust because he wants to allow principal distributions to Tim.

If Tom put $15 million in a trust in the current year when his remaining GST tax exemption is $6 million and allocated all of his GST tax exemption to the trust, the inclusion ratio would be .60 [1 − ($6 million ÷ $15 million)]. If Tim dies in the following year, Tammy's share of the trust will be subject to GST tax of 24% (40% GST tax rate times .60 inclusion ratio).

However, splitting the estate into two separate trusts could avoid GST tax. One trust (for $6 million) could be for the benefit of Tim, during life, and then for Tammy. Tom could allocate $6 million of his GST tax exemption to that trust. The other trust would be funded with $9 million, but because it eventually goes to charity (a nonskip person), it is not subject to GST tax. Note that the other trust should be a qualified charitable remainder trust with an annuity or unitrust amount to Tim so that this qualifies for the charitable deduction. (However, this would prevent principal distributions to Tim.) See section 401 in the Tax Planning and Advisory *Charitable Giving* topic for additional discussion of charitable remainder trusts.

Funding Multiple Trusts

809.4 Another planning strategy using two trusts with respective inclusion ratios of zero and 1 is to fund the zero inclusion ratio trust with property expected to appreciate over the long term. Distributions from this trust can then be made GST tax free to skip persons, and any remaining appreciated property at the conclusion of the trust can pass to the skip persons without incurring the GST tax.

Example 809-2: Using two trusts with inclusion ratios of 0 and 1 to reduce the GST tax.

Mabel establishes Trust A for the benefit of her granddaughter, Melanie. Under the terms of the trust, the trustee may distribute income and principal at the trustee's discretion. When Melanie reaches age 25, the trust will terminate and any remaining assets will be distributed to Melanie. Mabel funds Trust A with $11 million of property expected to appreciate over the years. She allocates $11 million of her GST tax exemption to Trust A, resulting in an inclusion ratio of zero.

Mabel establishes Trust B with $350,000 for the primary benefit of her daughter, Mildred. Under the terms of the trust, the trustee will make annual distributions of $50,000 to Mildred for 10 years or until the trust principal is exhausted, whichever comes first. Any remaining assets at the end of the 10-year period are to be distributed to Mildred's daughter, Melanie. No GST tax exemption is allocated to this trust, resulting in an inclusion ratio of 1.

There is no GST tax liability on the taxable distributions to Melanie from Trust A because the trust's inclusion ratio is zero. This is the result regardless of how much the assets of Trust A appreciate in value. In addition, there will be no GST tax on the annual distributions from Trust B to Mildred, a nonskip person. Any residual assets available for distribution to Melanie on termination of Trust B will be subject to GST tax.

Single Trust Treated as Separate for GST Purposes

809.5 The Internal Revenue Code provides specific rules for determining when a single trust may be treated as separate trusts for GST purposes. The first rule provides that portions of the trust attributable to different transferors are treated as separate trusts [IRC Sec. 2654(b)(1), Ltr. Rul. 201422007]. The treatment of separate portions of a single trust as separate trusts for GST purposes does not permit treatment of those portions as separate trusts for any other purposes under the Code (i.e., no separate income tax returns are to be filed for the separate portions).

809.6 Planning Tip: The ability to treat a single trust as separate trusts for GST purposes is a powerful planning tool because the transferor has the opportunity to allocate the GST tax exemption to the separate trusts in a manner that will maximize the exemption benefit.

809.7 Multiple Transferors for a Single Trust. Portions of a single trust attributable to different transferors are treated as separate trusts for GST purposes. The regulations provide a formula to determine the separate trust's share when a contribution is made to an existing trust. If a person makes a contribution to a single trust and the person is not the sole transferor, the portion of the single trust attributable to each separate trust is determined by multiplying the value of the single trust immediately after the contribution by a fraction. The numerator is the value of the separate trust immediately after the contribution. The denominator is the value of all property in the single trust immediately after the transfer [Reg. 26.2654-1(a)(2)].

Example 809-3: More than one transferor for the same trust.

Paul Norse transfers $100,000 to a trust. Bob James transfers $50,000 to the same trust. Because the trust has more than one transferor, it is treated as two separate trusts for GST purposes. Because Paul contributed two-thirds ($100,000 ÷ $150,000) of the initial value of the trust, two-thirds of the trust principal is treated as a separate trust for which he is the transferor. Likewise, one-third of the trust principal is treated as a separate trust for which Bob is the transferor because he contributed one-third of the initial value of the trust.

Example 809-4: Additional contributions to a trust with more than one transferor.

Assume the same facts as in Example 809-3. Paul contributes an additional $60,000 to the trust when the value of the trust's assets has increased to $180,000. The portion of the trust attributable to each grantor's separate trust must be recomputed at the time of the additional contribution. The portion of the trust attributable to Paul's separate trust immediately after the contribution is three-fourths (the value of the separate trust immediately after the contribution divided by the value of all the property in the single trust immediately after the contribution); stated mathematically, it is $[(\frac{2}{3} \times \$180{,}000) + \$60{,}000] \div \$240{,}000 = \frac{3}{4}$. Therefore, it follows that the portion attributable to Bob's separate trust after Paul's addition is one-fourth $(1 - \frac{3}{4})$. Bob's share can also be stated mathematically as $(\frac{1}{3} \times \$180{,}000) \div \$240{,}000 = \frac{1}{4}$.

Example 809-5: Distributions from a trust with more than one transferor.

Assume the same facts as in Example 809-4. Shortly after Paul's additional $60,000 contribution, $50,000 is distributed to a beneficiary of the trust. Without a specific provision in the trust document that charges the distribution against the contribution of Paul or Bob, three-fourths of the distribution is treated as coming out of the separate trust of which Paul is the transferor and one-fourth of the distribution as coming out of the separate trust of which Bob is the transferor.

Substantially Separate and Independent Shares for Different Beneficiaries

809.8 If a single trust consists solely of substantially separate and independent shares for different beneficiaries, the share attributable to each beneficiary (or group of beneficiaries) is treated as a separate trust for GST purposes. The term *substantially separate and independent shares* generally has the same meaning as provided in Reg. 1.663(c)-3 for fiduciary income tax purposes. Basically, that definition provides that separate shares exist if distributions to the beneficiaries from the trust are to be made in substantially the same manner as if separate trusts had been created for the beneficiaries. In addition, a portion of a trust is not a separate share unless the share exists at the outset of the trust and at all times thereafter [Reg. 26.2654-1(a)(1)(i)].

Example 809-6: Distributions made as if separate trusts were created.

Ben dies and his will directs that his residuary estate be placed in a trust. Under the terms of the trust instrument, the trustee is to divide the residuary estate into separate shares (which are not separate trusts under applicable local law) for each of Ben's grandchildren. The trustee is given discretion for each share for distributing income or principal.

The share attributable to each beneficiary is treated as a separate trust for GST purposes because distributions of the trust are to be made in the same manner as if separate trusts had been created.

Example 809-7: Separate shares treated as separate trusts.

Susan transfers $200,000 to a trust. Under the terms of the trust instrument, income is to be paid in equal shares for 10 years to Susan's son, Justin, and her granddaughter, Jessica (or their respective estates). At the conclusion of the 10 years, the principal is to be distributed to Justin and Jessica in equal shares.

The shares of Justin and Jessica in the trust are separate and independent; therefore, they are treated as separate trusts for GST purposes.

Example 809-8: Separate shares not treated as separate trusts.

Assume the same facts as in Example 809-7 except the trustee has the discretionary power to distribute the income in any proportion between Justin and Jessica during the last year of the trust. Because the shares of Justin and Jessica are not separate and independent shares throughout the entire term of the trust, they are not treated as separate trusts for GST purposes.

809.9 Under a special rule, a beneficiary's right to receive payment of a pecuniary (fixed-dollar) amount from a trust that is includable in the transferor's gross estate is a separate and independent share of the trust [Reg. 26.2654-1(a)(1)(ii)]. To be treated as a separate and independent share, the trustee must pay appropriate interest on the pecuniary amount or the amount must be paid or permanently set aside within 15 months after the date of death [Reg. 26.2642-2(b)(4)(ii)]. If the pecuniary amount is payable in kind at a value other than the date-of-distribution value, the trustee must pay the amount with assets that fairly reflect the net appreciation or depreciation (occurring from the date of death to the date of payment) in the value of the assets that are available to pay the amount.

Example 809-9: Pecuniary payment treated as a separate share.

Hector creates a revocable trust. The trust instrument provides that on Hector's death, $500,000 is payable to his spouse, Maria, with the balance of the principal to be held in the trust for the benefit of Hector's grandchildren. The value of the trust is includable in Hector's gross estate at his death. Pursuant to the trust provisions, the $500,000 payment to Maria is to be made in cash.

For GST purposes, the trust is treated as created at Hector's death and the $500,000 pecuniary amount is treated as a separate share of the trust. The result would be the same had the pecuniary amount been paid with noncash assets using their date-of-distribution value. Because the balance of the principal to be held in trust for Hector's grandchildren is subject to the GST tax, the separate share rule allows the executor of Hector's estate to apply his GST tax exemption to only the portion of the trust that will eventually pass to his grandchildren. There is no need to *waste* any of the GST tax exemption on the $500,000 pecuniary amount that will pass to Hector's wife.

Severing a Trust

809.10 For certain trusts, property protected by the GST tax exemption (exempt property) may be treated as a separate trust from property not so protected (nonexempt property).

809.11 September 25, 1985 Trusts. For the severance of a trust that was irrevocable on September 25, 1985, special rules apply to determine the inclusion ratio when additions are made after that date. The trust is deemed divided into a portion not subject to GST tax (inclusion ratio of zero) and the rest subject to GST tax with an inclusion ratio determined under Reg. 26.2642-6(g) [Reg. 26.2601-1(b)(1)(iv)(A)].

809.12 Qualified Severances. Prior to 2001, *inter vivos* trusts could not be severed into multiple trusts to accommodate a GST tax exemption allocation unless they met the separate share rule or had multiple grantors. Effective for trust severances occurring after 2000, a trust can be severed in a *qualified severance*. A *qualified severance* is the division of a single trust into two or more trusts that complies with the following guidelines [IRC Sec. 2642(a)(3)(B)(i); Reg. 26.2642-6]:

a. The single trust is divided on a fractional basis. Each new trust must be funded with assets equal to a percentage of the total value of the trust assets. The separate trusts can be funded on a nonprorata basis as long as the funding is based on the total fair market value of the trust's assets on the date of severance.

Note: Regulations define the *date of severance* as the date selected (by court order or discretion) for determining the value of the trust assets, provided that funding is commenced immediately and occurs within a reasonable time (no more than 90 days) after the selected date of severance [Reg. 26.2642-6(d)]. The regulations also clarify that discounts and other reductions are not allowed for funding purposes for interests in closely held corporations, partnership interests, or other single assets [Reg. 26.2642-6(d)(4)].

b. The terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust. If the trustee has the discretionary power to make nonprorata distributions to beneficiaries, the separate trusts will be deemed to have the same succession of interests of beneficiaries if—

(1) the terms of the separate trusts are the same as the terms of the original trust,

(2) the severance does not shift a beneficial interest in the trust to any beneficiary in a lower generation than the person or persons who held the beneficial interest in the original trust, and

(3) the severance does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

c. The trust was severed pursuant to local law or the trust instrument.

d. The severance is effective under local law.

Example 809-10: Severance of a discretionary trust.

Jerry established a discretionary trust for the benefit of his children, Amy, Ben, and Chuck and their descendants. The remainder will be divided equally among the three families. If the trust is severed, the requirement in paragraph 809.12, item (b)(2) is satisfied if the trust is divided into three separate trusts of equal value, with one trust established for the benefit of Amy and her descendants, one trust for the benefit of Ben and his descendants, and one trust for the benefit of Chuck and his descendants.

809.13 If a trust has an inclusion ratio greater than zero and less than one, a severance will be qualified if the single trust is initially divided into only two trusts, one of which receives a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance. In this case, the trust receiving the fractional share will have an inclusion ratio of zero and the other trust will have an inclusion ratio of one [Reg. 26.2642-6(d)(7)(ii)].

809.14 Qualifying severances allow more than two resulting trusts when the original trust has an inclusion ratio between zero and one. The resulting trusts in the aggregate would have to receive a pro rata share of the total value of the original trust (as of the date of severance) equal to the fraction used to determine the inclusion ratio of the original trust immediately before the severance. The trust(s) receiving the pro rata share has an inclusion ratio of zero, and each of the other resulting trusts would have an inclusion ratio of one. In addition, the trustee may designate the beneficiary of each resulting trust, as long as it preserves the original interest in the trust [Reg. 26.2642-6(d)(7)(iii)]. See Reg. 26.2642-6(j), Example 9.

809.15 Zero GST Taxable Termination. A taxable termination is avoided in a qualified severance because the *taxable event* is deemed to occur immediately after the severance. No GST tax is triggered when the resulting trust (i.e., skip person) has a zero inclusion ratio after the severance. See Reg. 26.2642-6(j), Example 8.

809.16 Note: A qualified severance can include a trust in which the beneficiary is granted a contingent testamentary general power of appointment that is dependent on the trust's inclusion ratio [Reg. 26.2642-6(j) , Example 10].

809.17 Election to Sever a Trust. A trustee may elect to sever a trust in a qualified severance at any time prior to the termination of the trust [Reg. 26.2642-6(f)]. However, the qualified severance is effective when the trust is divided into two or more separate trusts and to taxable events that occur after the severance is made [Reg. 26.2642-6(c)]. The severance is reported by filing Form 706-GS(T). See Key Issue 29F of PPC's 706/709 Deskbook for additional discussion of the election requirements and a sample election.

809.18 Planning Tip: New trust instruments should permit qualified severances. This is especially important if state law does not permit these severances.

809.19 Other Nonqualifying Severances. Other severances will be treated as separate trusts for GST tax assuming they are separate trusts under state law. The inclusion ratio for the trusts stays the same before and after the severance although the GST tax exemption can be separately allocated to any of the trusts [Reg. 26.2642-6(h)].

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810 Skipping Multiple Generations to Save Transfer Taxes

810.1 Once the GST tax exemption has been used, clients often think this is the end of the GST planning. This section discusses examples of how using a trust for skipping multiple generations can save transfer tax.

Example 810-1: Transfer to children causes multiple tax.

Carol is a 90-year old widow, with one child (Megan), three grandchildren, and eight great-grandchildren. She previously gifted all of her basic exclusion amount and allocated all of her GST tax exemption. Her current estate plan leaves her entire $23.9 million estate to Megan. Megan has significant assets of her own and is trying to get an estate plan in place to transfer her assets to her children and grandchildren. Megan's children also have assets in excess of the estate/gift tax exclusion amount because of previous transfers from Carol.

With Carol's current plan, assuming a 40% estate tax rate, her estate will pay $9.56 million in estate tax and leave Megan $14.34 million. If Megan holds these assets until death, another $5,736,000 in estate tax will be paid, leaving $8,604,000 to Megan's children. If Megan's children hold these assets until death, another estate tax of $3,441,600 could be paid, leaving about $5,162,400 to Carol's great grandchildren. Compare these results to Example 810-2.

Example 810-2: Skipping multiple generations reduces overall transfer tax.

Assume the same facts as in Example 810-1. However, instead of leaving the assets to Megan, Carol leaves them to her great-grandchildren. Carol's estate would still pay the estate tax of $9.56 million and would also pay GST tax of $5,736,000, leaving $8,604,000 million to Carol's great-grandchildren. This type of transfer will allow one generation to be skipped without paying additional GST tax.

810.2 Caution: The recommendation in Example 810-2 could cause tension among the family members that were skipped and should be considered in the total estate plan.

810.3 Planning Tip: Assets placed in trusts for grandchildren and future generations may be available to nonskip persons without causing the assets to be included in the nonskip person's estate. If the trustee is given broad discretion over the trust's assets, the trust could purchase assets from the child (nonskip person), providing funds for the child. Likewise, the trust may purchase a business venture that is managed by the child. The business should not be included in the child's gross estate and any appreciation in the investment benefits the grandchildren.

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811 Planning for the Income Tax Effects of the GST Tax

811.1 As with the estate and gift taxes, the GST tax may affect the transferor's and/or transferee's income tax liability. This section briefly discusses the GST tax—

a. when income in respect of a decedent (IRD) is involved,

b. when GST taxes are paid by a recipient of a trust distribution, and

c. its effect on the basis of transferred property.

GST Tax and IRD

811.2 Although income in respect of a decedent (IRD) is not defined in the Code, the term generally refers to gross income a decedent was entitled to at the time of death but was not included in his or her final income tax return (or any prior return) under his or her regular method of accounting [Reg. 1.691(a)-1(b)]. Examples of IRD include the following items: accrued wages, interest, dividends, and royalties; retirement plan and IRA income; and uncollected income on installment notes. When an amount a decedent was entitled to receive qualifies as IRD, it is generally subject to income, estate, and possibly GST tax. See Key Issue 31D of PPC's 706/709 Deskbook for a more detailed discussion of IRD.

811.3 To partially mitigate the effect of double taxation, IRC Sec. 691(c) allows the estate (or successor who collects the IRD) to deduct the federal estate and GST tax attributable to it as an itemized deduction [IRC Sec. 67(b)(7)]. It is also deductible in computing AMT. To calculate the GST tax deduction allocable to the IRD, the IRD is reduced by allocable deductions in respect of the decedent, and the GST tax is calculated "with and without" the amount of net IRD included in the amount subject to the generation skipping transfer tax. The difference is referred to as the IRD deduction and is available only in the year(s) the IRD is included in income.

811.4 Note: Any increase in the value of an IRA between date of death and date of distribution is not IRD. The amount of IRD to be used in computing the IRD deduction is the amount subject to estate and/or GST and income tax [IRC Sec. 691(c)]. In addition, the deduction is available to the taxpayer who reports IRD in income, even if 100% of the associated estate or GST tax is borne by someone else. The deduction is allocated when there are multiple beneficiaries.

811.5 Observation: The federal estate tax on IRD is reported on Line 16 of Schedule A (Form 1040). Note that a taxpayer must have more itemized deductions than the standard deduction to benefit from this deduction.

Itemized Deduction for Tax Paid on Distributions of Income

811.6 Under IRC Sec. 164(a)(4), the federal GST tax imposed on distributions of income (paid from a generation-skipping transfer trust) is deductible. This deduction is allowed to the extent that the tax is imposed on a transfer which is included in the gross income of the recipient (i.e., the distributee) and which is not an accumulation distribution under IRC Sec. 666 [IRC Sec. 164(b)(4)(A)].

811.7 The IRS issued a set of procedures for calculating and claiming the deduction in IRS Ann. 91-43. A copy of the calculation is to be attached to the taxpayer's income tax return.

811.8 Observation: The GST tax deduction is not included in the $10,000 ($5,000 for marrieds filing separately) itemized deduction limitation for combined state/local property, state/local/ foreign income, and (if elected) general sales tax imposed by the 2017 Tax Cuts and Job Act [IRC Sec. 164(b)(6)(B)].

811.9 Worksheet to Compute the Deduction for Tax paid on IRD. See Practice Aid PA-89 for a worksheet to compute the federal estate tax deductions attributable to the receipt of income in respect of a decedent under IRC Sec. 691.

Effect of Gift and GST Tax on Donee's Basis

811.10 The donee's basis in donated property is increased by any gift tax attributable to appreciation in the property's value while held by the donor. The increase in basis for the gift tax paid is an amount (not in excess of the tax so paid) that bears the same ratio to the amount of gift tax paid as the net appreciation in value of the gift bears to the amount of the gift. Net appreciation in value of any gift is the amount by which the FMV of the gift exceeds the donor's adjusted basis immediately before the gift [IRC Sec. 1015(d)(6)].

811.11 A similar basis increase exists for any GST tax paid that was attributable to the appreciation element. It is applied only after the previously mentioned gift tax adjustment and may not increase the basis of the property beyond the property's FMV on the date of transfer (IRC Sec. 2654).

811.12 Note: The basis adjustment discussed previously does not apply to taxable terminations that occur at the death of the donor. In these cases, the basis is adjusted to the FMV of the property.

Example 811-1: Basis increased for gift and GST tax paid.

Linda transferred 10,000 shares of ABC Corp. common stock to her granddaughter, Ashlynne, on September 30 of the current year. Ashlynne's basis in the stock is determined considering the following facts:

FMV on September 30: $110 a share.

Linda's tax basis in the 10,000 shares: $2 a share.

Stock appreciation while held by Linda: $1,080,000 ($108 per share × 10,000 shares)

Linda is married and no gift-splitting election is made.

Linda has previously allocated her entire lifetime GST tax exemption to other transfers.

Linda used her gift and GST tax annual exclusion on a cash gift made to Ashlynne.

Linda's taxable gifts are taxed at a 40% tax rate.

Amount of gift		$1,100,000
Gift tax	$440,000	
GST tax	440,000	
Gift tax on GST tax	176,000	
Total tax		$ 1,056,000

The increase in basis for the gift and GST taxes is calculated as follows:

$1,080,000/1,100,000 × $440,000 = $432,000

$1,080,000/1,100,000 × $440,000 = $432,000

$1,080,000/1,100,000 × $176,000 = $172,800

Ashlynne's basis equals:

Linda's basis immediately prior to the gift	$20,000
Increase in basis for the gift tax paid	432,000
Increase in basis for the GST tax paid	432,000
Increase in basis for the gift tax paid on the GST tax	172,800
Ashlynne's tentative basis in the stock transferred	$1,056,800

The basis cannot be adjusted to higher than the fair market value of the property transferred. Ashlynne's basis in the stock is $1,056,800 because it is less than $1.1 million (the stock's FMV).

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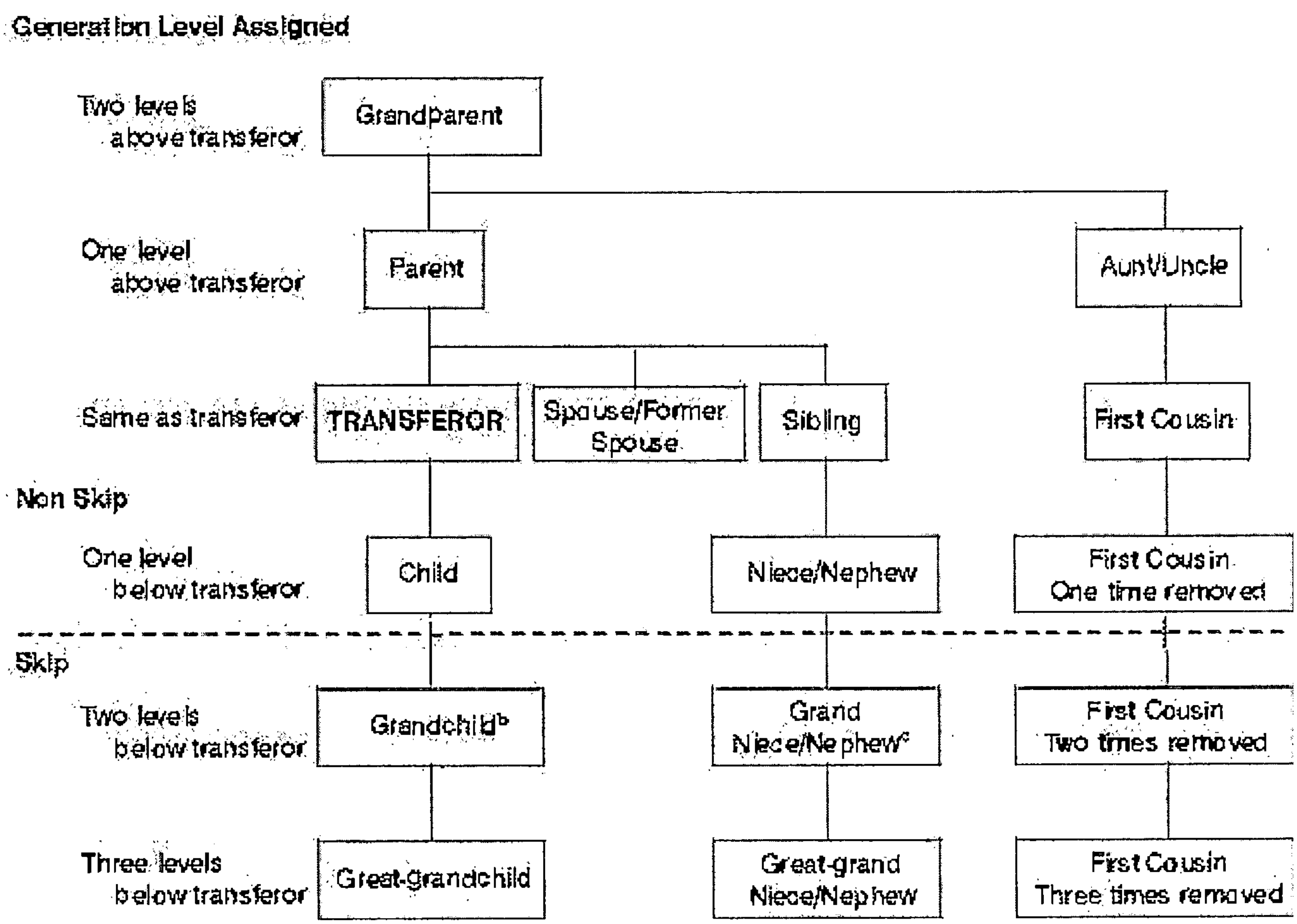
Appendix 8A Family Generation Assignments

APPENDIX 8A

Family Generation Assignments [a]

(See section 801)



Notes:

[a] All relationships shown are relative to the transferor.

b The generation assignment may change if a child (one level below the transferor) predeceases the transferor. (See paragraph 801.53.)

c If the transferor has no living lineal heirs at the time of the transfer, the predeceased parent generational step-up will apply if the niece/nephew is deceased at the time of the transfer. (See paragraph 801.54.)

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APPENDIX 8B

Advantages and Other Considerations of Generation-skipping Transfer Tax Planning

Advantages

1. Federal transfer tax savings (see section 803).

2. Incentive trusts (for desired behavior of beneficiaries) (see section 803).

3. Gift-splitting by spouses (see section 807).

4. Transferor can elect out of the automatic exemption allocation rules (see section 804).

5. Reverse QTIP election available so the GST tax exemption of the first to die is not wasted (see section 807).

6. Late allocation of the GST tax exemption may be better than no allocation (especially in the case of life insurance) (see section 805).

7. Dynasty trusts can be used for several generations (see section 803).

Other Considerations

1. Double taxation on lifetime gifts if all of the GST tax exemption is already used (see section 802).

2. Administrative costs associated with establishing a plan.

3. Concept of GST is often too complex to explain to clients.

4. Difficult for parents to think about skipping their children and/or grandchildren when implementing a wealth transfer plan.

5. The potential for higher transfer cost than expected if the GST tax exemption is allocated to assets that do not appreciate at the same rate as other assets, which are not GST tax exempt.

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APPENDIX 8C

Calculation of Trust's Inclusion Ratio

(See Example 805-1)

Calculation of Trust's Inclusion Ratio—Automatic Allocation in 2021

1. Value of property currently transferred to the trust—May 15, 2021	$10,000
2. Federal estate taxes, state death taxes, and other charges attributable to current transfer and paid by the trust	-0-
3. Charitable deduction allowed on the current transfer to the trust	-0-
4. Line 1 − line 2 − line 3	10,000
5. Value of trust property immediately prior to the current transfer (enter -0- if there were no prior transfers to the trust or if no prior GST tax exemption allocation made)	430,000
6. GST tax exemption allocated to current transfer of property (automatic allocation)	10,000
7. Applicable fraction for trust immediately prior to the transfer (enter -0- if there were no prior transfers to the trust)	.409

8. Nontax portion of trust before current transfer (line 5 × line 7)	175,870
9. Line 6 + line 8 (numerator of applicable fraction)	185,870
10. Line 4 + line 5 (denominator of applicable fraction)	440,000
11. Applicable fraction (line 9 ÷ line 10)	.422
12. Inclusion ratio (1 − line 11)	.578

Calculation of Trust's Inclusion Ratio—Automatic Allocation in 2022

1. Value of property currently transferred to the trust—May 15, 2022	$10,000
2. Federal estate taxes, state death taxes, and other charges attributable to current transfer and paid by the trust	-0-
3. Charitable deduction allowed on the current transfer to the trust	-0-
4. Line 1 − line 2 − line 3	10,000
5. Value of trust property immediately prior to the current transfer (enter -0- if there were no prior transfers to the trust or no prior GST tax exemption allocation made)	435,000
6. GST tax exemption allocated to current transfer of property (automatic allocation)	10,000
7. Applicable fraction for trust immediately prior to the transfer (enter -0- if there were no prior transfers to the trust)	.422
8. Nontax portion of trust before current transfer (line 5 × line 7)	183,570
9. Line 6 + line 8 (numerator of applicable fraction)	193,570
10. Line 4 + line 5 (denominator of applicable fraction)	445,000
11. Applicable fraction (line 9 ÷ line 10)	.435

12. Inclusion ratio (1 − line 11)	.565

Calculation of Trust's Inclusion Ratio—Late Allocation in 2023

1. Value of property currently transferred to the trust	$-0-
2. Federal estate taxes, state death taxes, and other charges attributable to current transfer and paid by the trust	-0-
3. Charitable deduction allowed on the current transfer to the trust	-0-
4. Line 1 − line 2 − line 3	-0-
5. Value of trust property immediately prior to the current transfer (enter -0- if there were no prior transfers to the trust or no prior GST tax exemption allocation made)	440,000
6. Late GST tax exemption allocation	248,600
7. Applicable fraction for trust immediately prior to the transfer (enter -0- if there were no prior transfers to the trust)	.435
8. Nontax portion of trust before current transfer (line 5 × line 7)	191,400
9. Line 6 + line 8 (numerator of applicable fraction)	440,000
10. Line 4 + line 5 (denominator of applicable fraction)	440,000
11. Applicable fraction (line 9 ÷ line 10)	1.00
12. Inclusion ratio (1 − line 11)	0.00

END OF DOCUMENT -

THE ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001: ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAX LAW CHANGES

Vol. 76, No. 1 January 2002 Pg 41 David Pratt and Elaine M. Bucher Tax

Pursuant to the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "act"), significant changes have been made to the estate, gift, and generation-skipping transfer (GST) tax provisions of the Internal Revenue Code of 1986, as amended (the "code"). Some of the most important provisions of the act from an estate planning perspective result in the gradual phase-out and eventual "temporary" repeal of the federal estate and generation-skipping transfer taxes. However, pursuant to the sunset provisions of the act, all changes made by the act become void on January 1, 2011, and the transfer tax laws that were in effect prior to the act was signed will be reinstated. Accordingly, the changes made by the act are only temporary. Complicating matters even further is the probability that Congress will make additional changes to the transfer tax provisions of the code over the next nine years.

As a result of the changes made and uncertainty caused by the act, estate planning will become complicated for many individuals. Estate planning must encompass three different phases: 1) the increase in estate and GST tax exemptions and concomitant decrease in transfer tax rates; 2) the repeal of the estate and GST taxes; and 3) the reinstatement of the transfer tax laws as they existed prior to the act. This article reviews the pertinent provisions of the act from an estate planning prospective[1] and provides suggestions for practitioners to consider when reviewing and implementing their clients' estate plans.

Increase in Exemption Amounts for Estate, Gift and GST Taxes; Reduction of Estate, Gift and GST Tax Rates; Repeal of Estate and GST Taxes

Under the law prior to the enactment of the act, the applicable exclusion amount for estate tax purposes is $675,000.[2] The act increased the $675,000 applicable exclusion amount to $3.5 million over the next eight years.[3] In 2002 and 2003, the applicable exclusion amount will be $1 million; in 2004 and 2005, it will be $1.5 million; in 2006, it will be $2 million; and in 2009, it will be $3.5 million.[4] In 2010, the exclusion will no longer apply because the act repeals the estate tax on January 1, 2010.[5] However, there is a sunset provision in the act which reinstates the estate tax on January 1, 2011.[6] If the estate tax were reinstated at that time, the estate tax laws, as they existed before the act, would apply (which means that the applicable exclusion amount would be reinstated at $1 million[7]).

The GST tax exemption in 2001 was $1,060,000;[8] such exemption will be indexed for inflation in 2002 and 2003, and then increased until 2009 in accordance with the schedule discussed in the preceding paragraph relating to the increase in the applicable exclusion amount.[9] In 2010, the GST tax exemption will no longer apply because the act repeals the GST tax on January 1, 2010, subject to the sunset provision discussed above.[10] In addition, in 2002 through 2009, the GST tax rate for a given year will parallel the maximum estate tax rates discussed in the following paragraph.[11]

As the applicable exclusion amount for estate tax purposes and the GST tax exemption for GST tax purposes increase, the estate and GST tax rates are reduced under the act. Under the old law, the lowest estate tax rate was 18 percent; such rate was imposed upon the first $10,000 of cumulative taxable transfers.[12] The highest estate tax rate was 55 percent; such rate was imposed upon cumulative taxable transfers in excess of $3 million.[13] Furthermore, cumulative transfers between $10 million and $17,184,000 were subject to an additional five percent surtax;[14] estates in excess of $17,184,000 were subject to a flat 55 percent tax rate on all amounts above the applicable exclusion amount for the given year.[15] In addition, the GST tax was imposed at the maximum federal estate tax rate.[16] Pursuant to the act, in 2002, the five percent surtax and the rates in excess of 50 percent are repealed.[17] In addition, the maximum estate tax rates will be reduced over the next eight years; such maximum rates are as follows: 49 percent in 2003, 48 percent in 2004, 47 percent in 2005, 46 percent in 2006, and 45 percent in 2007, 2008, and 2009.[18] Again, pursuant to the sunset provision discussed above, in 2011, the highest estate and GST tax rates would be reinstated at 55 percent, and the five percent surtax would return.

The act does not repeal the federal gift tax. Specifically, under the law prior to the enactment of the act, the current gift tax exemption is equivalent to the current applicable exclusion amount for estate tax purposes ($675,000).[19] For transfers subject to the federal gift tax occurring in 2002 and thereafter, the gift tax exemption will be $1 million.[20] Moreover, the maximum gift tax rates will decrease beginning in 2003; such rates are identical to the estate tax rate reductions discussed above.[21] In 2010, when the estate tax is repealed, the gift tax rate will be equal to the highest income tax rate, which is scheduled to be 35 percent.[22]

Replacement of State Death Tax Credit with Federal Estate Tax Deduction

Prior to the act, a credit was allowed against the federal estate tax for any estate, inheritance, legacy or succession taxes (hereinafter referred to as "death taxes") actually paid to any state or the District of Columbia with respect to any property included in a decedent's gross estate.[23] The maximum allowable credit for state death taxes was determined under a graduated rate table; the top rate was 16 percent.[24] Pursuant to the act, the state death tax credit is reduced by the following percentages: 25 percent in 2002, 50 percent in 2003, and 75 percent in 2004.[25] In 2005, the state death tax credit is repealed and a new deduction for death taxes actually paid is effectuated.[26] The state death taxes must have been paid and claimed before the later of: 1) four years after the filing of the federal estate tax return (Form 706); and 2)(a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final; (b) the expiration of the period of extension to pay estate taxes over time under §6166 of the code; or (c) the expiration of the period of limitations in which to file a claim for refund or 60 days after a decision of a court in which such refund suit has become final.[27]

Transition to Modified Carry-Over Basis for Property Received at Death

Under the old law, property passing from a decedent's estate generally takes a "stepped-up" basis, which means that the basis of property passing from a decedent's estate to a transferee is generally the fair market value of the property on the date of the decedent's death (or, the fair market value on the alternate valuation date, if elected, which is the earlier of six months after the decedent's death or the date the property is sold or distributed).[28] When a donor makes a lifetime gift to a donee, such donee takes a "carryover" basis, which means that the basis in the hands of the donee is the same as it was in the hands of the donor.[29] If gift tax is paid by the donor with respect to the gift, the basis of property increases in the hands of the donee by the amount of the gift tax paid.[30] However, the basis of property subject to a lifetime gift may not exceed the property's fair market value on the date of the gift.[31]

Under the act, in 2010, when the estate tax is repealed, property passing from a decedent's estate will no longer take a stepped-up basis.[32] Instead, the carryover basis rules will apply to property acquired from the decedent. Such property will receive a basis equal to the lesser of the adjusted basis of the decedent (carryover basis) or the fair market value of the property on the date of the decedent's death.[33]

It is possible for property to obtain a stepped-up basis (in 2010) under the act in certain circumstances. A decedent's estate is permitted to step up the basis of assets transferred by up to a total of $1,300,000 of appreciated property and a decedent's estate is permitted to step up the basis of appreciated property transferred to a surviving spouse by an additional $3,000,000.[34] The transfer to a surviving spouse can be made as an outright transfer or into a qualified terminable interest property trust.[35] The estate of nonresidents who are not U.S. citizens are entitled to step up the basis of appreciated property by up to $60,000.[36] such "stepped-up" amounts are adjusted annually for inflation after 2010.[37] Further, a basis increase will be allocable on an asset-by-asset basis.[38] The executor of the decedent's estate may determine which assets and to what extent each asset receives a basis increase, but the basis of an asset cannot be adjusted above its fair market value.[39] The effective date of this modified carryover basis regime is January 1, 2010, the year in which the estate and generation-skipping transfer taxes are repealed.[40]

Simplification of GST Tax Provisions

The act simplifies many of the complicated GST tax provisions of the code; many professionals opined that the GST tax provisions, as they previously existed, were the cause of malpractice suits.[41] Specifically, the act addresses the following six areas regarding the GST tax: deemed allocation of the GST tax exemption to lifetime transfers that are not direct skips; retroactive allocation of the GST tax exemption; severance of trusts holding property having an inclusion ratio greater than zero; modification of certain valuation rules; relief provisions; and substantial compliance.

· *Deemed Allocation of the GST Tax Exemption to Lifetime Transfers that are not Direct Skips*

Prior to the act, GST tax was imposed on transfers, either directly or through a trust, to a "skip person" (*i.e.*, a beneficiary in a generation more than one generation below that of the transferor).[42] Transfers subject to the GST tax include direct skips, taxable terminations, and taxable distributions.[43] If an individual makes a direct skip during his or her lifetime, his or her GST tax exemption is automatically allocated to such direct skip to the extent necessary to make the inclusion ratio equal to zero.[44] An individual could elect out of the automatic allocation rules.[45]

In comparison, for lifetime transfers made to a trust that are not direct skips, the transferor could allocate his or her GST tax exemption on a timely filed gift tax return.[46] The value of the property at the time of the transfer would be the amount of GST tax exemption allocated.[47] If the individual failed to allocate his or her GST tax exemption to the transfer on a timely filed gift tax return, the portion of the trust that would be exempt from the GST tax would be the value of the property at the time the gift tax return was ultimately filed.[48] Pursuant to the act, some relief is provided to taxpayers regarding the allocation of his or her GST tax exemption. Specifically, an individual's GST tax exemption will be automatically allocated to transfers made during life that are "indirect skips" to the extent necessary to produce the lowest possible inclusion ratio for such property.[49] An indirect skip is a transfer of property (that is not a direct skip) subject to the gift tax that is made to a "GST Trust."[50] A GST Trust is any trust that could have a GST with respect to a transferor, with six exceptions.[51]

An individual may elect not to have the automatic allocation rules apply to an indirect skip, and such election will be deemed timely if filed on a timely filed gift tax return for the calendar year in which the transfer was made or deemed to have been made or on such date prescribed by the Secretary of the Treasury.[52] Furthermore, an individual can elect not to have the automatic allocation rules apply to any or all transfers made by such individual to a particular trust and can elect to treat any trust as a GST Trust with respect to any or all transfers made by the individual to such trust.[53] such election must be made on a timely-filed gift tax return for the calendar year for which the election is to become effective.[54] These new automatic allocation rules apply to transfers of property made after December 31, 2000.[55]

• *Retroactive Allocation of the GST Tax Exemption*

Regarding the allocation of GST tax exemption, if an individual creates a trust whereby the benefit of such trust inures to nonskip persons only, it is likely that the individual will not allocate his or her GST tax exemption to the trust. However, if such nonskip person dies prematurely so that such person's descendants benefit from the trust, GST tax would be due upon the death of the nonskip person if the transferor did not previously allocate his or her GST tax exemption.

Under the act, if there is an "unnatural order of deaths," GST tax exemption may be allocated retroactively, if certain conditions are satisfied.[56] In making such retroactive allocation, the applicable fraction and inclusion ratio is based on the value of the property on the date that such property was transferred to the trust.[57] This means, for example, that if a child of the transferor who is a beneficiary of a trust created by the transferor dies prematurely, the transferor may allocate his or her GST tax exemption to a previous transfer to the trust on a chronological basis. The retroactive allocation rule applies to deaths of nonskip persons after December 31, 2000.[58]

An allocation of GST tax exemption may be made at any time up to the filing of the transferor's estate tax return (Form 706).[59] As discussed above, if the allocation of GST tax exemption occurs on a timely filed gift tax return, the value on the date of the transfer is used to determine the GST tax exemption allocated.[60] However, if the allocation of GST tax is not made on a timely filed gift tax return, the value of the trust on the date of the allocation is used.[61]

• *Severance of Trusts Holding Property Having an Inclusion Ratio Greater than Zero*

Prior to the act, a trust could only be severed into two or more trusts (presumably one with an inclusion ratio of zero and one or more with an inclusion ratio of one) only if the trust was severed according to a direction in the governing instrument, or if the trust was severed pursuant to the trustee's discretionary powers, but only if certain other conditions were satisfied.[62] A trustee could not establish inclusion ratios of zero and one by severing a trust that was subject to the GST tax after the trust had been created.[63]

Pursuant to the act, a trust can be severed in a "qualified severance."[64] such a severance is defined as the division of a single trust and the creation of two or more trusts if the single trust is divided on a fractional basis, and if the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust.[65] In addition, if a trust has an inclusion ratio of greater than zero and less than one, a severance is a qualified severance only if the single trust is divided into two trusts, one of which received a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance.[66] In such case, the trust receiving such fractional share shall have an inclusion ratio of zero and the other trust shall have an inclusion ratio of one.[67] A trustee may elect to sever a trust in a qualified severance at any time.[68] A qualified severance may occur after December 31, 2000.[69]

• *Modification of Certain Valuation Rules*

Prior to the act, the inclusion ratio of a trust was determined using gift tax values for allocations of GST tax exemption made on timely filed gift tax returns and estate tax values for allocations of GST tax exemption made to transfers at death.[70] The Treasury Regulations provided that, with respect to taxable terminations and taxable distributions, the inclusion ratio became final on the later of the period of assessment with respect to the first transfer using the inclusion ratio or the period for assessing the estate tax with respect to the transferor's estate.[71]

The act provides that when GST tax exemption is allocated on a timely-filed gift tax return or automatically allocated, the value of the property for purposes of determining the inclusion ratio shall be its finally determined gift or estate tax value, as the case may be.[72] In the case of an allocation of GST tax exemption that is deemed to be made at the conclusion of an estate tax inclusion period (ETIP), the value for purposes of determining the inclusion ratio shall be its value at that time.[73] The modified valuation rules shall apply to transfers subject to gift or estate tax made after December 31, 2000.[74]

• *Relief Provisions*

Pursuant to the act, with regard to requests for extensions pending on, or filed after, December 31, 2000, the Secretary of the Treasury is authorized, and encouraged, to grant extensions of time to allocate GST tax exemption and to grant exceptions to the time requirement, regardless of whether the period of limitations has expired. If relief is granted, then the gift tax or estate tax value of the transfer of property to the trust would be used for determining the amount of GST tax exemption that is allocated.[75] The act provides that in determining whether to grant an extension, the Treasury Secretary shall consider "all relevant circumstances, including evidence of intent contained in the trust instrument. . . ."[76]

• *Substantial Compliance*

The act provides that, with regard to transfers subject to estate or gift tax made after December 31, 2000, substantial compliance with the statutory and regulatory requirements for allocating GST tax exemption will suffice to establish that GST tax exemption was allocated to a particular transfer or a particular trust. If a taxpayer demonstrates substantial compliance, then so much of the transferor's unused GST tax exemption will be allocated to the extent it produces the lowest possible inclusion ratio.[77] Similar to the Relief provisions, the act provides that in determining whether there has been substantial compliance, the Treasury Secretary shall consider "all relevant circumstances, including evidence of intent contained in the trust instrument. . . ."[78]

Planning Points

In light of the "sunset" provision and the probability that Congress will make additional changes to the estate, gift and GST tax laws over the next eight years, practitioners should consider adding flexibility to their documents. In addition, practitioners should meet with their clients every one to two years to review their clients' estate plans, as the plan could be altered by the increase in the estate and GST tax exemptions. The following are suggestions for practitioners to consider when reviewing and implementing their clients' estate plans; it is by no means an exhaustive list.

1) *Caps on Credit Shelter and GST Trusts.* For a married couple with a combined net worth that exceeds the applicable exclusion amount, a typical plan would leave the applicable exclusion amount of the first spouse to die to a trust for the benefit of the surviving spouse and/or the deceased spouse's other family members. Such a trust is typically known as a credit shelter, bypass or exemption equivalent trust, and is not included in the surviving spouse's gross estate upon the surviving spouse's demise. In addition, very often a client may leave an amount equal to his or her GST tax exemption to his or her grandchildren, either outright or in trust.[79]

As the applicable exclusion amount increases, practitioners should consider advising clients to cap the amount that could be distributed to a credit shelter trust, especially in situations when the beneficiaries of the applicable exclusion amount are different from the beneficiaries of the balance of the estate. Very often the beneficiaries will be different in a second marriage situation. Similarly, as the GST tax exemption amount increases, practitioners may want to advise clients to cap the amount that could be distributed to or in trust for grandchildren.

In anticipation of the potential repeal of the estate and GST taxes in 2010, in situations when the beneficiaries of the applicable exclusion amount and/or GST tax exemption amount are different from the beneficiaries of the balance of the estate, practitioners should consider advising clients to put in a minimum amount that should be distributed to the beneficiaries of the applicable exclusion amount and/or GST tax exemption amount. This way, the clients can be sure that the beneficiaries of the applicable exclusion amount and/or GST tax exemption amount will receive assets even if the estate and GST taxes are repealed.

2) *"Bubble" Clients.* For married couples with combined assets that are less than twice the applicable exclusion amount (as increased in 2002, 2004, 2006, and 2009), practitioners should consider advising clients to leave assets outright to a surviving

spouse with disclaimer provisions into a credit shelter trust for the surviving spouse's benefit. Such a plan may be preferential to the use of a credit shelter trust when the credit shelter trust may no longer be necessary because of the increased applicable exclusion amount. Of course, practitioners must continue to be cognizant of the possibility that the applicable exclusion amount may revert to $1,000,000 in 2011.

3) *Income Provisions in Credit Shelter and GST Trusts*. Very often, the payment of income to the beneficiary of a credit shelter and/or a GST trust is discretionary, rather than mandatory, so that income does not accumulate in the beneficiary's estate. Such accumulated income would be subject to estate tax upon the beneficiary's demise, unless it was spent or gifted by the beneficiary during the beneficiary's life. In light of the possibility that the beneficiary may not have a taxable estate because of the increase in the applicable exclusion amount, practitioners should consider advising clients that mandatory income in the credit shelter trust and GST trusts may be more appropriate than discretionary income provisions. Of course, such mandatory income would be exposed to the beneficiary's creditors, if any, whereas the discretionary income may not necessarily be exposed to creditors, depending on the provisions of the trust.

4) *Independent Trustees*. Practitioners should consider including a provision in trusts which would allow an independent trustee to modify or terminate a trust if it no longer meets its purpose. For example, if an irrevocable gifting trust was established to reduce a client's estate tax exposure and the estate tax is repealed, it may no longer be necessary to maintain such a trust. A trustee or beneficiary could be given the authority to appoint an independent trustee who is not a "related or subordinated party" as those terms are defined in §672(c) of the code.

5) *Intangibles Tax Trusts*. As a result of the reduction in the state death tax credit and the resultant loss of revenue to the State of Florida, it is possible that the State of Florida may increase the rate of the intangible personal property tax. Practitioners should continue to discuss the use of intangible tax trusts with their clients in order to avoid such tax.[80]

6) *Residency Planning*. As a result of the phase-out of the state death tax credit, in some states, such as New York, a resident's estate may pay more estate taxes under the new law. In such states, the estate tax is imposed regardless of the availability of the credit because the state's estate tax may not necessarily be directly tied to the federal estate death tax credit. When the credit is phased out, the combined federal and State estate tax will actually increase. Practitioners should consider advising their clients who reside in such a state to become residents of Florida, which is a pure "pick-up" state death tax credit state.

7) *"2010" Provision*. Practitioners should consider advising clients to include a provision in their documents which leaves their assets to trusts for their beneficiaries if they die in 2010. The use of such trusts may avoid the imposition of estate and GST tax on the assets in such trusts if the estate and GST tax is reinstated in 2011. If assets are left to a trust for the surviving spouse, such a trust should be designed to qualify as a QTIP trust in order to qualify for the $3,000,000 step-up in basis for assets left to a surviving spouse.

8) *"Value" Provisions*. Many clients have documents which use "estate tax value" as a reference point. For example, one may leave a certain amount of assets, "as finally determined for federal estate tax purposes," to certain beneficiaries. Practitioners should consider including language which indicates that if the estate tax is repealed, the estate tax laws that existed prior to the repeal should be used for these purposes.

Conclusion

While the act includes comprehensive changes to the transfer tax system, it is unknown which changes will become permanent and, once certain changes take effect, whether they will sunset on January 1, 2011, causing the transfer tax laws to revert to their pre-act form. Accordingly, practitioners should review their clients' estate plans and consider modifying existing documents to provide additional flexibility in this uncertain time.

[1] While this article summarizes many of the changes made to the estate and gift tax laws by the act, a review of all such changes is beyond the scope of this article. Specifically, the changes that are not discussed in this article are the qualified family owned business interest rule (also known as QFOBI), conservation easements, qualified domestic trusts (also known as QDOTs), installment payment of estate tax for estates with an interest in a closely held business and reporting requirements in connection with transfers made during life and at death.

[2] I. R.C. §2010(c) (2001). The applicable exclusion amount is commonly referred to as the exemption amount or unified credit equivalent. Prior to the enactment of the act, the applicable exclusion amount was scheduled to increase to $1,000,000 by the year 2006. In 2002, it was scheduled to increase to $700,000; in 2004, it was scheduled to increase to $850,000; in 2005, it was scheduled to increase to $950,000; and in 2006, it was scheduled to increase to $1,000,000.

[3] Section 521(a), Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16 (2001) (hereinafter cited as the "act"); I.R.C. §2010(c).

[4] *Id.*

[5] & sect;521(a) of the act; I.R.C. §2210(a).

[6] & sect;901 of the act.

[7] *See supra* note1.

[8] I. R.C. §2631(a). The Taxpayer Relief Act of 1997, Pub. L. No. 105-34 (1997), included a provision which would index the exemption, beginning in 1999, for inflation. In 1999, it was increased to $1,010,000. Rev. Proc. 98-61, 1998-52 I.R.B. 18. In 2000, it was increased to $1,030,000. Rev. Proc. 99-42 I.R.B. 568. In 2001, it was increased to $1,060,000. Rev. Proc. 2001-3 I.R.B. 337.

[9] & sect;521(c) of the act; I.R.C. §§2631(a) and 2631(c).

[10] & sect;501(b) of the act; I.R.C. §2664.

[11] I. R.C. §§2641(a).

[12] I. R.C. §2001(c).

[13] *Id.*

[14] The five percent surtax was imposed to phase out the tax brackets lower than 55percent.

[15] I. R.C. §2001(c), as amended by §501(a), The Taxpayer Relief Act of 1997, Pub. L. No. 105-34 (1997).

[16] I. R.C. §2641(a)(1).

[17] & sect;511(a) of the act; I.R.C. §2001(c).

[18] & sect;511(c) of the act; I.R.C. §2001(c).

[19] I. R.C. §§2010(c) and 2505(a).

[20] & sect;521(b) of the act; I.R.C. §2505(a).

[21] & sect;511(c) of the act; I.R.C. §2001(c).

[22] & sect;511(d) of the act; I.R.C. §2502(a). Interestingly, §2502(a) does not refer to the Code's schedule of income tax rates; it states "35%." §511(d) of the act. On the other hand, §511(d) of the act refers to the "Maximum Individual Rate After 2009."

[23] I. R.C. §2011(a).

[24] I. R.C. §2011(b).

[25] & sect;531(a) of the act; I.R.C. §2011(b).

[26] & sect;532(a) of the act; I.R.C. §2011(g).

[27] & sect;532(b) of the act; I.R.C. §2058(b).

[28] I. R.C. §1014(a).

[29] I. R.C. §1015(a).

[30] I. R.C. §1015(d).

[31] I. R.C. §1015(a).

[32] & sect;541 of the act; I.R.C. §1014(f).

[33] & sect;542(a) of the act; I.R.C. §1022(a).

[34] & sect;542(a) of the act; I.R.C. §§1022(b) and 1022(c).
[35] & sect;542(a) of the act; I.R.C. §1022(c). *See also* I.R.C. §2056(b)(7).
[36] & sect;542(a) of the act; I.R.C. §1022(b).
[37] & sect;542(a) of the act; I.R.C. §1022(d).
[38] *Id.*
[39] *Id.*
[40] & sect;542(a) of the act; I.R.C. §1022(a).
[41] *See, e.g.,* Proposals for Certain Amendments to the Generation-Skipping Transfer Tax, by members of the American Institute of Certified Public Accountants and other professional organizations (1998).
[42] I. R.C §§2601, 2611, 2612 and 2613.
[43] I. R.C. §2611.
[44] I. R.C. §2632(b).
[45] *Id.*
[46] Treas. Reg. §26.2632-1(b)(2)(i).
[47] Treas. Reg. §26.2632-1(b)(2)(ii).
[48] Treas. Reg. §26.2642-2(a)(2). Such treasury regulation also provides a convenience rule which allows a taxpayer to elect to use the value of the trust's property as of the first day of the month the late return is filed instead of the value as of the date the return is actually filed.
[49] & sect;561(a) of the act; I.R.C. §2632(c).
[50] *Id.*
[51] *Id.* A discussion of the six exceptions is beyond the scope of this article.
[52] *Id.*
[53] *Id.*
[54] *Id.*
[55] & sect;561(c) of the act.
[56] The retroactive allocation will apply (1) where the beneficiary is a non-skip person; (2) where the beneficiary is a lineal descendant of the transferor's grandparent or a grandparent of the transferor's spouse; (3) where the beneficiary is a generation younger than the generation of the transferor; and (4) where the beneficiary dies before the transferor. §561(a) of the act; I.R.C. §2632(c).
[57] *Id.*
[58] & sect;561(c) of the act.
[59] Treas. Reg. §26.2632-1(a).
[60] Treas. Reg. §26.2632-1(b)(2)(ii).

[61] & sect;561(a) of the act; I.R.C. §2632(c).
[62] Treas. Reg. §26.2654-1.
[63] *Id.*
[64] & sect;562(a) of the act; I.R.C. §2642(a).
[65] *Id.*
[66] *Id.*
[67] *Id.*
[68] *Id.*
[69] & sect;562(b) of the act.
[70] I. R.C. §2642(b).
[71] Treas. Reg. §26.2642-5(b).
[72] & sect;563(a) of the act; I.R.C. §2642(b).
[73] & sect;563(b) of the act; I.R.C. §2642(b).
[74] & sect;563(c) of the act.
[75] & sect;§564(a) and 564(b) of the act; I.R.C. §2642(g).
[76] *Id.*
[77] *Id.*
[78] *Id.*
[79] It should be noted that such an amount can be left in trust for children. Such a trust, if properly structured, would not be included in the child's gross estate upon the child's demise.
[80] *See* Lester Law, *Florida Intangible Tax—The Real Voluntary Tax*, 74 Fla. B.J. 34 (Nov. 2000).

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This article is submitted on behalf of the Tax Law Section, Louis T.M. Conti, chair, and Michael D. Miller and Lester B. Law, editors.

FIDUCIARY ALLOCATIONS OF THE GENERATION-SKIPPING TRANSFER TAX EXEMPTION

Vol. 76, No. 9 October 2002 Pg 59 Robert S. Williams Tax

Every individual has a generation-skipping transfer tax exemption ("GST exemption"), currently $1,100,000[1] for 2002, which may be allocated by such individual or his personal representative to any property with respect to which such individual is considered the transferor,[2] and any allocation, once made, is irrevocable.[3] A personal representative makes this allocation on Schedule R of IRS Form 706 by the due date for filing IRS Form 706 (including extensions).[4] In the event the decedent failed to timely make an allocation of the GST exemption during his lifetime, the Internal Revenue Code provides for a deemed allocation of GST exemption to any transfers made during his lifetime which are considered direct skips.[5] As a result, a personal representative has the responsibility of allocating a decedent's remaining GST exemption to all transfers where the decedent is considered the transferor, except for direct skips occurring during the decedent's lifetime. In the event a personal representative fails to allocate a decedent's remaining exemption, the code provides for an automatic "deemed" allocation.[6]

Duty to Minimize Taxes

Personal representatives have a general duty to minimize the overall tax burden on an estate and its beneficiaries, which is derived from the duty to conserve estate property and to make the property reasonably productive.[7] This duty runs to the entire group of interested persons, including estate creditors as well as beneficiaries of the estate and any inter-vivos trusts created by the decedent.[8] Personal representatives, in making tax elections, may not generally favor one beneficiary over another;[9] rather, the powers and discretions of personal representatives are to be exercised in a manner consistent with the testator's intention, and act as fairly and impartially as between the beneficiaries of a decedent's estate.[10] In an effort to fulfill their responsibilities to allocate the GST exemption among various transfers, personal representatives should seek to minimize the overall tax burden that will be imposed on all generation-skipping transfers ("GSTs"). allocating the GST exemption based purely on the expected tax consequences, specifically ignoring the issue of who will be liable for the tax, and thereby minimizing the impact this tax will have on the value of all of the transfers, personal representatives can fulfill their duty to minimize taxes and, at the same time, fulfill their duty to act fairly and impartially as between the interested persons.

Any remaining GST exemption should be allocated to all of a decedent's GSTs using a formula that distributes the exemption to the various types of GSTs on a priority basis which will result in the least amount of GST tax being imposed on all of the GSTs in the aggregate.[11]

Generation-Skipping Transfers

There are some general observations that should be made with respect to the various types of GSTs, which impact how the GST exemption should be allocated. First of all, when the exemption is allocated to a particular GST, the goal is to allocate enough exemption to the transfer so that there will not be any GST tax on that transfer. This is accomplished by allocating a sufficient amount of exemption to produce an inclusion ratio equal to zero.[12] If the inclusion ratio for a particular GST equals zero, there is no GST tax on the transfer, or, in the case of a trust, any subsequent distribution. If the inclusion ratio is greater than zero, then there will be GST tax due on the transfer, or, in the case of a trust, subsequent distributions, relative to the inclusion ratio.[13] If the inclusion ratio is equal to one, then the entire transfer, or, in the case of a trust, subsequent distributions, are subject to the GST tax. As a general matter, trusts should be either wholly exempt or wholly nonexempt, with an inclusion ratio of either zero or one.[14]

There are three types of GSTs under the Internal Revenue Code each having different tax results: 1) direct skips, 2) taxable distributions, and 3) taxable terminations.[15] Direct skips are generally inter-vivos transfers made by a donor,[16] and taxable terminations and taxable distributions involve trust arrangements.[17]

Direct skips are usually capable of being reasonably valued, and the GST exemption may be correspondingly allocated to this value to produce an inclusion ratio of zero. Direct skips do not include transfers to nonskip persons, thus there is no potential for wasting the exemption.[18] Administratively, the efficient use of the exemption and the ultimate taxation of a direct skip are readily determinable, thereby making an allocation decision less subject to inefficiencies. However, an important difference between the various types of GSTs involves the computation of the tax base. The taxable amount in the case of a direct skip equals the value of the property received by the beneficiary.[19] Thus direct skips where the tax is paid out of the property constituting the direct skip are valued, for

GST tax purposes, net of any GST tax. allocating the remaining exemption to other types of GSTs that are taxed on a tax-inclusive basis (no reduction of the taxable amount is made for the fact that the tax will be borne by the property constituting the transfer), one can effectively reduce the overall taxable transfers, and the overall GST tax incurred by all of the interested persons in the aggregate.

Direct skips where the tax is paid from a source other than the property constituting the direct skip are taxed on the entire value of the property received by the transferee. Taxable distributions and taxable terminations are also tax-inclusive, and no tax base reduction is made when the tax is paid out of the transferred property.

Taxable distributions are generally less capable of being closely valued. For example, in the case of a charitable remainder unitrust ("CRUT"), there is some potential for wasting the exemption if the income beneficiary does not actually receive, over the life of the trust, the present value of his or her life interest (plus accrued interest thereon). When allocating the exemption to a CRUT to produce an inclusion ratio of zero, the actuarially determined present value of the income beneficiary's interest in the trust is used.[20] If the income beneficiary actually receives less than the actuarially determined present value (plus accrued interest thereon) of his interest in the form of distributions, then there will be a wasting of the GST exemption. If, on the other hand, the income beneficiary actually receives more than the actuarially determined present value (plus accrued interest thereon) of his interest in the CRUT, then the opposite will be true.

The main point one should get from this is that there is less certainty in allocating the exemption to a CRUT, and it is generally less efficient to allocate the exemption to a transfer with uncertain tax results as opposed to direct skips where the tax results are fairly certain. However, one is not required to presume that there will be a mortality loss, as opposed to a mortality gain, in allocating the exemption to a CRUT.[21] If it is reasonable to believe that the income beneficiary will live a normal life expectancy, then one should accept the mortality assumptions used to determine the present value of his interest in the CRUT.

Another important consideration with respect to a CRUT is the administrative reporting costs that would be incurred in conjunction with the payment of GST taxes. In the case of a direct skip or a taxable termination, the tax is reported and paid only once upon the occurrence of the direct skip or the taxable termination. However, each year the trustee of a CRUT is required to file information returns with both the Internal Revenue Service and the beneficiary, and the beneficiary, in return, is required to file a tax return and to pay the GST tax.[22] These additional tax reporting costs should be considered in determining how the use of the GST exemption can be maximized. In the event a CRUT is completely sheltered from GST taxes, the trustee and the beneficiary will not have to bear these costs. In the event a CRUT is not completely covered by exemption, then one of the direct costs will be these reporting expenses that can be eliminated by sheltering the CRUT from the payment of GST taxes.

Taxable terminations tend to present more problems and can be wasteful and inefficient. A significant problem is created because such trusts are typically established for the benefit of both skip and nonskip persons. In order to cover taxable remainder interests (skip interests) with enough exemption to prevent the potential payment of GST tax, one will have to allocate enough exemption to cover the entire value of the trust (including nonskip interests).[23] Both the income and remainder interests would have to be covered so that the inclusion ratio will be brought down to zero. In other words, to prevent the payment of GST tax on the taxable remainder interest, the exemption must also cover the nontaxable income interest.

In addition, in deciding to allocate the GST exemption to a trust from which a taxable termination may occur, one must consider whether the remainder interest will ever be subject to the GST tax. It is always possible that the income beneficiaries will exhaust the trust corpus, thereby eliminating the remaindermen's interests.[24] Also, before a transfer is subject to GST taxes, it must be subject to either estate or gift taxes.[25] The value of a trust that will ultimately be included in the gross estate, and thus subject to estate taxes, should be reduced by the value of the consideration given by any beneficiary in return for his interest.[26] This consideration amount can reduce the value subject to estate taxes, thereby reducing the value subject to GST taxes. The value of a GST, for purposes of the GST tax, is similarly reduced by the amount of consideration provided by the transferee, and thus should also allow for the reduction of the amount subject to GST taxes.[27] Therefore, any allocation of the exemption to such interests will result in a wasting of the exemption because the interest will never be subject to GST taxes.

Transfer Subject to Estate Taxes

As discussed above, before a testamentary transfer is subject to GST taxes, it must be subject to estate taxes. In general, the gross estate of a decedent who was a citizen of the United States at the time of his death includes the value of all property, whether real or personal, tangible or intangible, and wherever situated, beneficially owned by the decedent at the time of his death.[28] Where a decedent makes certain transfers during his life and retains certain rights or "strings" with respect to the transferred property, the value of the retained interests are also included in the gross estate.[29] If, however, the transfer was made for full and adequate consideration in money or money's worth, then the value of the transfer will not be included in the gross estate.[30]

In the event the transferee gives valuable consideration for the transfer and this value is less than the total value of the transfer, then there is an inclusion in the gross estate of the excess value going to the transferee.[31]

The significance of the above is that it supports the argument that the value, or some portion thereof, of a trust may be excluded from the gross estate, and thus not subject to estate taxes. The portion so excluded from the gross estate should also be excluded from any GST tax (unless such transfer was subject to gift taxes).

Modified Deemed Allocation Method

As with most decisions, the decision to do nothing has its consequences. In allocating the GST exemption to various transfers, personal representatives may choose not to make any allocation, in which case the Code proscribes the method for the allocation of the exemption.[32] Under these deemed allocation provisions of the Code, any unused GST exemption remaining at death is allocated first to direct skips occurring at death and next to trusts from which a taxable distribution or a taxable termination may occur.[33]

In all practicality, if one decides to let the deemed allocation rules apply, then the $1,100,000 exemption will be allocated as follows:

1) First to direct skips during life;

2) Then to direct skips occurring at death; and

3) Finally, to taxable distributions and terminations.[34]

choosing not to exercise the right to allocate the exemption, a personal representative will, in essence, elect the above allocation method.

The drawbacks to this method are that all direct skips occurring at death are treated equally, whereby those direct skips which bear the tax are treated equally with those direct skips that do not bear the tax. Also, taxable terminations are treated equally with the taxable distributions, thereby potentially resulting in only a portion of each of the trusts being covered by the exemption, and requiring the trusts to report and pay some GST tax.

Personal representatives should start with the "deemed" allocation method proscribed by the code, and then deviate in those instances where there is a legitimate reason to do so, the objective being to maximize the use of the GST exemption among all of the interested persons.[35] In other words, the goal is to minimize all direct costs associated with the reporting and paying of GST taxes, including the GST tax itself, that will be incurred by any interested person.[36]

For example, the first tier, under the "deemed" allocation, consists of an allocation of the available portion of the exemption to GSTs that occurred during the decedent's lifetime. Since personal representatives do not possess any discretion in deciding whether to allocate to lifetime direct skips, no change in the statutory scheme should be made.[37]

The next tier, under the "deemed" allocation, consists of direct skips occurring at death. As was previously discussed, the exemption is most effectively used when allocated to direct skips where the GST tax is paid by a source other than the property constituting the direct skip, because any other allocation will, or at least will have the potential to, waste the exemption and/or increase overall taxes. Therefore, the tier should be deviated from to differentiate between direct skips that will pay the GST tax from the property constituting the GST and those that do not pay the GST tax.

The GST tax on direct skips is computed by multiplying the applicable tax rate times the inclusion ratio and then multiplying this amount times the "net amount" received by the skip person. This "net amount," in the case of a direct skip that bears the GST tax, excludes the portion of the value of the GST that equals the GST tax amount that will be paid from the property constituting the direct skip. In the case of a direct skip that does not bear the GST tax, the "net amount" equals the entire value of the GST (no reduction is made for the amount of the GST tax). moving direct skips that pay the GST tax to a lower tier you will reduce the aggregate value of all GSTs that are subject to GST tax, and thereby reduce the overall amount of GST taxes being borne by all interested persons in the aggregate.

The next tier under the "deemed" allocation approach lumps taxable distributions together with taxable terminations, in which the remaining exemption is allocated ratably among these types of GSTs.[38] Personal representatives should deviate from the "deemed" allocation to correct for the significant wasting of the exemption and corresponding increase in overall taxes as a result of allocating the exemption to taxable terminations.

The issue of prioritizing the tiers as between each other is best analyzed by considering the direct costs that will be borne by all interested persons, and allocating the exemption to those transfers which will produce the most direct costs. The priority that results in the greatest value to all interested persons should then be used to minimize direct costs to all the beneficiaries as a group, *i.e.*, by minimizing overall taxes and administrative charges. In summary, the modified deemed allocation method will allow most of the value of the transfers made by a decedent to reach the hands of the intended beneficiaries, rather than the pocket of the government.

[1] The GST exemption is indexed for inflation through the end of 2003, and is the same as the unified credit amount for tax years 2004 through 2009.
[2] I.R.C. §2631(a) (emphasis added).
[3] I.R.C. §2631(b).
[4] I.R.C. §2632(a)(1).
[5] I.R.C. §2632(b).
[6] I.R.C. §2632; Regs. §26.2632-1.
[7] *In re Veith's Estate* , 26 Fla. Supp. 145, 148-8 (County Judge's Ct. 1965); Carrico & Bondurant, *Equitable Adjustments: A Survey and Analysis of Precedents and Practice* , 36 Tax Law, 545-6 (1983) .
[8] Fla. Stat. §733.602(1).
[9] Carrico & Bondurant, *supra* note 7.
[10] *In re Veith's Estate,* 26 Fla. Supp. at 149.
[11] Of course, this method assumes that the transferor does not wish to prefer one beneficiary over another. If this is the case, the estate planner should specifically address the preference(s) in the clients estate planning documents.
[12] *See* I.R.C. §2642(a); Regs. §26.2642-1.
[13] Technically, the inclusion ratio affects the GST tax base, not the tax rate; however, the result is the same.
[14] For discussion of the point, *see* John K. McNulty, Federal Estate and Gift Taxation in a Nutshell §15 (5th ed. 1994).
[15] *See* I.R.C. §2601 *et seq* . and the Regulations thereunder.
[16] I.R.C. §2612(c).
[17] I.R.C. §2612(a) & (b).

[18] I.R.C. §2612(c)(1)(assuming a formulary allocation method is employed).
[19] I.R.C. §2623.
[20] *See* I.R.C. §2642(a)(2)(B)(assuming the remainder is deductible under I.R.C. §2055 or §2522).
[21] This assumes that the personal representative is not aware of any facts regarding the income beneficiary's life expectancy which would lead to the conclusion that the normal mortality assumptions would be an inappropriate basis for determining his remaining life. In such a case, this specific information should be used to determine what risks will be associated with his unexpected mortality.
[22] Regs. §26.2662-1(b)(1) and Regs. §26.2662-1(c)(1).
[23] Regs. §26.2642-1(c).
[24] *See In Re Estate of Jacobs* , 614 N.Y.S.2d 866 (1994)(discussing the assumptions necessary to compute the remainder interest in a trust where the remainder is a taxable termination).
[25] *See* I.R.C. §2652(a)(1)(A). In order to have an interest subject to GST taxes there must be a transferor. A transferor is defined to mean the decedent in the case of property subject to estate taxes. If the property is not subject to estate taxes or gift taxes, then there should not be any transferor.
[26] I.R.C. §§2036, 2038, and 2043. *See* I.R.C. §2053(a)(4) and the Regulations thereunder, which provide for a reduction in the value of the gross estate inclusion for nonprobate assets rather than calling for a deduction from the gross estate. However, this reduction is limited by I.R.C. §2053(c)(1)(A), when founded on a promise or agreement, to the extent that they were contracted bona fide and for adequate and full consideration in money or money's worth.
[27] I.R.C. §2624(d), which provides that the value of the property transferred is reduced by the amount of consideration provided by the transferee.
[28] I.R.C. §2033 and Regs. §20.2033-1.
[29] I.R.C. §§2036 and 2038.
[30] *Id* .
[31] I.R.C. §2043.
[32] *See* I.R.C. §2632(c) and the new final Regs. (effective December 27, 1995) issued thereunder.
[33] *Id* .
[34] I.R.C. §2632.
[35] Reference to interested persons herein means all beneficiaries of both probate and nonprobate assets which can potentially be subject to the GST tax where the decedent is considered the transferor.

[36] *See* Jerold I. Horn, *Favored Transfers for GST Purposes*, The American Law Institute (1991).
[37] Regs. 26.2632-1(b).
[38] I.R.C. §2632(c).

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Tax

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Ten Common GST Planning Mistakes

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Abstract

The federal generation-skipping transfer (GST) tax is arguably one of the most complex and nuanced transfer tax regimes in existence. Even when practitioners have accounted for the federal estate and gift tax regime, the GST tax has a separate application and is often disregarded or forgotten. Because of the many ways that the GST tax can apply directly or indirectly to a transfer, it can surface unintentionally or unexpectedly in an existing or new estate plan. Without proper planning, the GST tax can derail intended planning results by unnecessarily depleting family wealth. The current GST tax rate is the same as the federal estate and gift tax rates; thus, it deserves careful attention and management in the estate planning process. With proper GST planning, families have a greater chance of preserving dynastic wealth for generations.

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This Article assumes a basic understanding of the generation-skipping transfer (GST) tax rules. Its purpose is to combat the "GST tax anxiety" that many practitioners may experience by building on that basic understanding and raising awareness of ten common GST planning mistakes. The Authors hope that by avoiding these common mistakes practitioners might provide better planning advice to clients to meet their wealth, succession, and tax goals.[1]

I. Mistake #1—Disregarding the GST Tax

A threshold mistake is to disregard the GST tax altogether. Ignoring the GST tax may stem from the practitioner (1) determining that mentioning the GST tax to the client would derail progress with an already complicated tax planning discussion; (2) not being well versed in the GST tax rules; or (3) being unaware of the existence of the GST tax system, given it has only been around since 1986.

A. *History and Application*

Congress enacted the original GST tax regime in 1976, but the modern estate tax dates back to 1916 and the gift tax to 1924. The original GST tax regime proved to be so complicated that it was retroactively repealed when Congress enacted the current GST tax on October 22, 1986.[2] Although enacted in 1986, the tax applied retroactively to lifetime transfers made after September 25, 1985.[3] This answers two possible reasons for the dearth of discussion on the GST tax: its complexity and its enactment as an afterthought to the estate and gift tax regime.

[1] Because the content of this Article was finalized as of January 24, 2021, any changes or developments in the law occurring after that date are not reflected herein.

[2] Tax Reform Act of 1986, Pub. L. No. 99-514, § 1431(c), 100 Stat. 2085, 2717.

[3] Reg. § 26.2601-1(a)(2).

Although the GST tax is often overlooked, it can apply to a client's estate plan in a variety of ways, and a plan's exposure to the GST tax must be managed. Prior to the GST tax, multi-generational trusts could be used to avoid estate tax as the beneficial interest in trust assets passed from generation to generation.[4] To address this form of tax avoidance, the GST tax generally applies to gratuitous transfers to individuals two or more generations younger than the donor and to trusts for the benefit of such individuals. The GST tax applies in addition to any applicable estate and gift taxes and is intended as a backstop to the estate tax to ensure that transfer tax is assessed on the transfer of assets at each generation.[5] Good GST planning minimizes transfer taxes due and maximizes proceeds available to intended beneficiaries.

B. *Terminology*

As a backbone to ensuring good GST planning, practitioners need to understand the terminology of the GST tax, some of which has unavoidably been used already in this Article. A "generation-skipping transfer" (GST) is, generally, a transfer to an individual who is assigned to a generation that is two or more generations below the generation of the transferor (a.k.a., a "skip person") or to a trust for the benefit of only skip persons.[6]

1. *The Transferor*

The first step in analyzing whether a GST has occurred is correctly identifying the transferor of the gift. This identification affects generational assignments of the beneficiaries and whose GST exemption can be allocated to a particular transfer. The "transferor" is the person disposing of the property, either directly or indirectly through a trust, by a transfer subject to the estate or gift tax.[7] Many times, determining the identity of the transferor is straight forward, but there are a few rules that complicate the determination and warrant discussion.

a. *QTIP Trusts.* Generally, if an individual gifts property to a trust for the benefit of his or her spouse and a qualified terminable interest property (QTIP) election is made to qualify transfers to such a trust for the marital deduction, the beneficiary spouse (and not the donor spouse) becomes the transferor for GST tax purposes. As a result, the donor spouse may not allocate his or her GST exemption to the transfer. Rather, the beneficiary spouse may allocate his or her GST exemption to the property held in the trust upon his or her death. An exception to this general rule applies if the donor spouse

[4] If a multi-generational trust were not used and assets passed from generation to generation outside of trusts, estate tax would be imposed on the assets on the transfer to each generation.

[5] I.R.C. § 2601.

[6] *See* I.R.C. §§ 2611, 2612.

[7] I.R.C. § 2652(a).

makes a "reverse QTIP election." If a reverse QTIP election is made, the donor spouse is treated as the transferor for both gift and GST tax purposes and, therefore, may allocate his or her GST exemption to the transfer.[8]

b. *Gift-Splitting*. If spouses elect to split gifts for a particular year, both spouses are treated as the transferor with respect to 50% of the transferred property.[9] Thus, even if all of the gifted property comes from one spouse's separate property, 50% of such property is treated as being gifted by each spouse, and each spouse may allocate his or her GST exemption only to 50% of the transferred property.

c. *Powers of Appointment*. If someone has a taxable power of appointment over property, the exercise, release, or lapse (in excess of the greater of $5,000 or five percent of the value of the property subject to the power of appointment)[10] of that power of appointment shifts the identity of the transferor to the holder of the power of appointment for GST tax purposes.[11]

2. *The Recipient*

Once the identity of the transferor has been determined, the analysis turns to the identity of the recipient of the gifted property. A GST will occur only if the recipient is a "skip person." As previously discussed, both a natural person and a trust can be a "skip person." A natural person is a skip person if he or she is assigned to a generation that is two or more generations below the generation assigned to the transferor.[12] A trust is a skip person if (1) only skip persons hold an interest in the trust or (2) no distribution from the trust will be made to a non-skip person.[13] A person has an "interest" in a trust only if he or she has a right, other than a future right, to receive income or principal or he or she is a permissible current recipient of income or principal (except charities) for GST tax purposes.[14] A "non-skip person" is anyone who is not a skip person.[15]

To determine whether an individual is a skip person, one needs to know the generation assignments of the individuals involved in the transfer. An individual's generation assignment depends on (1) the individual's relationship to the transferor and (2) the individual's age compared to that of the transferor.[16]

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[8] I.R.C. § 2652(a)(3).
[9] I.R.C. § 2652(a)(2).
[10] I.R.C. §§ 2041(b)(2), 2514(e).
[11] I.R.C. §§ 2041, 2514, 2652(a).
[12] I.R.C. § 2613.
[13] I.R.C. § 2613(a).
[14] I.R.C. § 2652.
[15] I.R.C. § 2613(b).
[16] *See* I.R.C. § 2651.

3. *Generation Assignment*

Most of the generation assignments are intuitive. The transferor, his or her spouse, siblings (whole, half, or adopted) and their spouses, first cousins and their spouses, and those with a similar relation to the transferor are assigned to the transferor's generation.[17] Children of the transferor and their spouses, the transferor's nephews and nieces and their spouses, and the transferor's first cousins once removed and their spouses are assigned to the generation that is one generation below the transferor.[18] Grandchildren of the transferor and their spouses, grandnephews and grandnieces of the transferor and their spouses, and grandchildren of first cousins and their spouses, are assigned to the generation that is two generations below the transferor.[19]

Some of the generation assignments, however, are not as intuitive and require further knowledge of the rules. For those not related to the transferor by blood, marriage, or adoption, a generation is considered to be 25 years.[20] As a result, anyone who is no more than 12½ years older or younger than the transferor is assigned to the same generation as the transferor.[21] Anyone more than 12½, but no more than 37½, years younger than the transferor is assigned to the generation that is one generation below the transferor.[22] Anyone more than 37½, but no more than 62½, years younger than the transferor is assigned to the generation that is two generations below the transferor.[23]

Several additional rules, such as the "predeceased parent rule" and the "generation move down rule," alter the generation assignments discussed above. These rules make sense when keeping in mind that the GST tax is designed to collect transfer tax at each generational level as wealth passes from one generation to the next.

The "predeceased parent rule" changes the generation assignment when there is an unnatural order of deaths within a family line, such as a child's predeceasing his or her parent. When a lineal descendant of the transferor's parent, or a lineal descendant of the parent of the transferor's spouse or former spouse, is deceased at the time that the transfer subject to estate or gift tax occurs, the decedent's children may be reassigned to the generation of the decedent.[24] As a result, those children will no longer be skip persons and transfers to them will not be GSTs. For example, if client's daughter dies being survived by her son, a gift from client to that grandson would not be subject to GST tax because of the predeceased parent rule.

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[17] I.R.C. § 2651.
[18] I.R.C. § 2651.
[19] I.R.C. § 2651.
[20] I.R.C. § 2651(d).
[21] I.R.C. § 2651(d)(1).
[22] I.R.C. § 2651(d)(2).
[23] I.R.C. § 2651(d).
[24] I.R.C. § 2651(e)(1).

The "generation move down rule" changes the generation assignment when a GST occurs (whether or not the GST tax actually applies) and, immediately after such transfer, the property is held in a trust. Immediately after a GST takes place with respect to property within a trust, the generation assignment of the beneficiaries of the trust is adjusted so that the generation of the transferor is assigned to the first generation above the highest generation of any person who has an interest in that trust.[25] For example, assume that client creates a trust for a grandson, who is the sole beneficiary. The transfer to the trust is subject to both gift and GST tax, as the trust is a skip person. When the trustee makes a distribution out of the trust to the grandson, there is no GST because the generation of client, the transferor, has moved down to the generation that is one generation above the grandson's generation.

Once the above rules are mastered, the determination of who is and is not a "non-skip person" becomes easy.

4. *Generation-Skipping Transfer*

Knowing the generation assignment rules enables one to return to the definition of a "generation-skipping transfer." Three different types of generation-skipping transfers may occur: a direct skip, a taxable termination, and a taxable distribution.[26] A "direct skip" is a gift or bequest to a skip person.[27] A taxable termination occurs when (1) a person's interest in a trust terminates; (2) no non-skip person has an interest in the trust; and (3) a skip person could benefit from the trust.[28] A taxable distribution is any distribution from a trust to a skip person (other than a direct skip or a taxable termination).[29]

Some transfers, although otherwise satisfying the definition of GSTs, are excluded from the GST tax regime. Payments for a skip person's educational or medical expenses directly paid to the institution providing the educational or medical services are not subject to GST tax.[30] Similarly, distributions of property previously subject to GST tax when the transferee of a prior transfer is of the same generation as, or a lower generation than, a current transferee are not subject to GST tax.[31] Other exclusions from GST tax concern the predeceased parent and generation move down rules, discussed above. Finally, the so-called "GST-tax annual exclusion," which is similar to the gift-tax annual exclusion, may apply; however, as will be discussed later in this

[25] I.R.C. § 2653(a).
[26] I.R.C. § 2611.
[27] I.R.C. § 2612(c).
[28] I.R.C. § 2612(a).
[29] I.R.C. § 2612(b).
[30] I.R.C. § 2611(b)(1) (*cf.* I.R.C. § 2503(e)).
[31] I.R.C. § 2611(b)(2).

Article, several specific requirements must be satisfied in order for transfers to trusts to qualify for the GST annual exclusion.[32]

Even if a transfer is not excluded from GST tax, many clients will not be subject to the tax because of the historically high GST-exemption amount. Currently, an $11.7 million exemption is available to each transferor to exempt transfers from the GST tax.[33] If the GST tax is payable, a maximum tax rate of 40% applies to the transfer.[34]

II. Mistake #2—Assuming the GST Tax Does Not Apply

While disregarding the GST tax may be an issue, even practitioners who routinely engage in GST tax planning for clients may make the common mistake of assuming the GST tax will never surface in the estate plan. Many times, the client's situation does not currently trigger GST tax. For example, clients with a taxable estate have three adult children who are married without children. At this point in time, one might determine any GST tax planning to be unnecessary because the clients do not have grandchildren. The practitioner then drafts the client's documents accordingly—often explaining this rationale through an example of the client walking out of the office and getting hit by a bus or a similar example of an unexpected immediate death.

But what if incorporating GST tax planning into the estate plan is on the relatively near horizon for the client? Building off the example in the previous paragraph, in two years, clients have two grandchildren. With all of the flexibility built into wills and trust instruments to account for facts that are not currently in the client's fact pattern (and may never be), there should also be default provisions in estate planning documents that address the potential need for future GST tax planning.

As previously mentioned, failing to account for a potential transfer subject to the GST tax can result in unnecessarily depleting family wealth. Proactive GST tax planning, similar to many of the trustee or executor powers allowing multiple maneuvers, can mitigate complications in trust and estate administration. Below are examples that the Authors have compiled from their respective planning practices.[35]

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[32] *See infra* Part VI.A.

[33] Rev. Proc. 2020-45, 2020-46 I.R.B. 1016.

[34] I.R.C. §§ 2602, 2641. Section 2641(a) provides that the GST tax rate is 40% ("the maximum Federal Estate tax rate") multiplied by the "inclusion ratio" defined in section 2642(a)(1). The inclusion ratio is one minus the "applicable fraction" as defined in section 2642(a)(2). The numerator of the applicable fraction is the GST exemption allocated to the original transfer, and the denominator is the value of the transferred property (reduced by estate taxes and charitable deductions payable out of that transfer). Thus, if the applicable fraction is 1/1 (*i.e.*, the exemption equals the net value of the transferred property), the inclusion ratio is zero (one minus the applicable fraction of 1/1), and the GST tax rate is 40% multiplied by zero.

[35] The authors are providing these examples in the context of education; they are not intended to serve as legal advice and, consequently, should not be relied on as such.

A. *Efficient Use of GST-Exempt Property*

A few of the GST tax planning provisions concern the efficient use of GST-exempt property, meaning the appropriate use of trust assets that are not exempt from GST tax and the preservation of assets that are exempt from GST tax. Example language includes:

> Considerations for Trustee when Making Discretionary Distributions. In determining whether or not to exercise any discretionary power to distribute income or principal of any trust created hereunder, including the power to distribute income or principal of any trust created hereunder pursuant to an ascertainable standard, the Trustee may, but shall not be required to . . . (iv) take into account whether the trust is exempt from any Federal or state estate tax or the GST tax.
>
> Discretion for GST-Exempt and Nonexempt Trusts. The Trustee shall consider the tax implications of making distributions from a GST-Exempt Trust for a beneficiary if a Nonexempt Trust hereunder for such beneficiary has not been exhausted.

Similarly, many documents will also direct that taxes be paid from assets that are not exempt from GST tax when possible.

B. *Delaware Tax Trap*

To prevent the triggering of the Delaware tax trap[36] when engaged in GST tax planning, practitioners may want to include a provision similar to the following if a limited power of appointment might be exercised.

> Perpetuities Savings Clause. If a beneficial interest created by the exercise of this power of appointment is not indefeasibly vested no later than the day preceding the last day on which the recipient trust [insert name of trust] could exist if the law which is applicable to such trust requires its termination within a period of time shorter than provided by the terms of the appointing trust [insert name of trust], the interest shall, on that date, vest indefeasibly in the person(s) who own that contingent or defeasible interest, or if the

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[36] The "Delaware Tax Trap" stems from a unique provision in the Code that treats the "holder" of a power of appointment as the owner, for estate tax purposes, of the assets over which such power is actually exercised if such exercise creates a new power of appointment that can be exercised under applicable local law so as to (1) delay the vesting of any interest in the property subject to the new power or (2) suspend the absolute ownership of the property subject to the new power, in either case for a period ascertainable without regard to the date of creation of the first power. I.R.C. §§ 2041(a)(3), 2514(d). While seemingly complicated on its face, this provision generally applies when the applicable state rule against perpetuities extends the perpetuities period as a result of the use of a power of appointment to grant a new power of appointment. *See, e.g.*, DEL. CODE ANN. tit. 25, § 501(a).

person(s) or share(s) cannot be ascertained, each such interest shall vest indefeasibly in the then income beneficiaries of the trust or share, in proportion to their income interests, or if their proportions are not fixed, then completely in the person(s) in the nearest degree of relationship to me, or, if none is related, in the person(s) of the closest generation to me (under the rules in Section 2651 of the Internal Revenue Code).

C. *Promoting Tax Efficiency*

To prevent mixed inclusion ratio trusts,[37] practitioners may want to include provisions allowing for the division of trusts into GST-exempt and nonexempt trusts and the granting of authority to hold any receipt of property in a separate trust if such receipt in an existing trust would terminate the wholly GST-exempt status of a trust.[38] This authority is not as common as it should be within documents, as the problem of tainting a GST-exempt trust is common when assets from a trust created under one instrument are added to a trust created under another instrument. The following provision is an example of language that may be included in a trust for the purposes discussed above.

<u>Division of Trusts</u>.

(1) <u>Separate</u>. To hold any property distributed to them hereunder in one or more separate trusts, either on identical terms or, to the extent that the terms of the trust are severable into distinctly separate shares, on terms reflecting such separate shares. Furthermore, if anyone transferring property to a trust created hereunder directs the Trustee, by an instrument in writing delivered to the Trustee, to hold all or part of the property being transferred as a separate trust, the Trustee shall hold such property as a separate trust. Any such direction shall be effective as of the date specified in the writing.

(2) <u>Division</u>. To divide any trust, pro rata or non-pro rata, created hereunder into two (2) or more separate trusts (based on the fair market value of the trust assets at the time of the division). If a trust is held as, or divided into, separate trusts, the Trustee may, at any time after such division into separate trusts and/or prior to a combination of such trusts, (a) make different tax elections (including the allocation of GST tax exemption) with respect to each separate trust, (b) distribute principal and/or income and exercise any other discretionary powers with respect to such separate trusts differently, (c) invest the principal and/or income of such separate trusts differently, and (d) take any and all other actions consistent with such trusts

[37] A mixed inclusion ratio trust is a trust with respect to which GST exemption was allocated only to a portion of the value of the assets contributed to the trust, such that the trust is neither wholly exempt from GST tax nor wholly subject to GST tax.

[38] State statutes commonly include a provision authorizing the trustee to divide a trust into two or more trusts. *See, e.g.*, FLA. STAT. § 736.0417; 760 ILCS 3/417; MICH. COMP. LAWS § 700.7417. These provisions may be utilized to divide a trust with a mixed inclusion ratio into two separate trusts, one with an inclusion ratio of one and one with an inclusion ratio of zero.

being separate entities. Further, the donee of any power of appointment with respect to a trust so divided may exercise such power differently with respect to the separate trusts created by the division.

(3) Considerations. In connection with the foregoing, the Settlor anticipates that the Trustee may hold property as one or more separate trusts or divided trusts hereunder for both tax and administrative reasons.

Mitigating potential GST tax exposure is important when drafting trust provisions. Aside from giving the trustee discretion to apply appropriate GST exemption to protect against GST events, the settlor of the trust may consider including a provision that can be triggered to give the beneficiary enough power over his or her trust share to cause inclusion in such beneficiary's estate for federal estate tax purposes. This maneuver would cause the grantor to move down a generation for GST tax purposes so that no GST event occurs when distributions are made to a beneficiary's descendants. Including a provision in a trust that gives a beneficiary a general power of appointment in certain instances can accomplish this planning.

With the estate and GST tax rates being equal and the exemption amounts being so high, this provision's greatest value may be the income tax efficiency. The estate inclusion triggered by the general power of appointment would allow the trust assets over which the beneficiary has such a power to obtain a step-up in basis at death to help save income taxes for future beneficiaries. Rather than being specific to GST tax efficiency, this provision allows for general tax efficiency through authorizing an independent trustee to grant a beneficiary a general power of appointment.

The following example provision will intentionally trigger estate inclusion for GST avoidance planning purposes.

> Authority to Grant General Power of Appointment. Notwithstanding any other provisions restricting powers of appointment in this Trust Agreement, the Independent Trustee of a trust hereunder, in the Independent Trustee's sole and absolute discretion, may grant the Primary Beneficiary of such trust, in the best interests of the Primary Beneficiary, the power to appoint the then-remaining balance of the income and principal of such trust, if any, in such manner, in such estates, in trust or otherwise, as the Primary Beneficiary may have designated, including to the Primary Beneficiary's estate, in the Primary Beneficiary's Will by specific reference to this general power of appointment; provided, however, the Independent Trustee, in the Independent Trustee's sole and absolute discretion, may also restrict or revoke the Primary Beneficiary's general power of appointment granted in this paragraph in the best interests of the Primary Beneficiary.

In a similar effort to provide flexibility and promote tax efficiency, the following provision would allow an amendment by an independent trustee for a number of reasons, including changes in the tax law.

> Trust Protection. The Independent Trustee may amend the provisions of this Trust Agreement at any time, for the sole purposes of addressing (a) any changes in Federal or state income, estate, or GST tax system or regulations thereto, arising as a result of applicable case law or legislative changes in Federal or applicable state law, (b) changes in the Federal or applicable state law that affect the Trustee's administration of any trust created hereunder, (c) any perceived ambiguities in the language of this Trust Agreement, as determined by the Independent Trustee, in the Independent Trustee's sole and absolute discretion, and (d) any scrivener errors that might otherwise require court construction, modification, or reformation; provided, however, that, unless granted under another provision of this Trust Agreement, the Independent Trustee shall be prohibited from making any amendments that would result in (a) the increase, reduction or any change in any beneficial interests under this Trust Agreement, or (b) the inclusion of any trust created hereunder in the Trustee's or any other person's estate, if such trust were not intended to be so included in such person's estate prior to such amendment.

Many practitioners provide this authority to a trust protector or trust advisor, instead of an independent trustee, and some would say that the use of a trust protector or trust advisor avoids the application of a fiduciary standard.[39]

D. *Expressing GST Intent*

The inclusion of a trust provision regarding the settlor's intent that automatic allocations of the GST exemption should apply may be helpful in the future even though such an intention may be overridden through affirmative elections on the settlor's gift tax return. Another benefit of such a provision is that it forces the drafting attorney to fully consider the intended GST tax status of the trust. Lastly, when compared to the "Division of Trust" provision described above, the following provision provides stronger language preventing mixed inclusion ratio trusts.

> GST Intent. The Settlor intends that automatic allocation of the Settlor's GST exemption under Section 2632(c)(1) of the Code will [not] apply to property transferred to a trust created hereunder, unless the Settlor makes a different allocation or election effective under the Code at any time. If GST tax exemption is allocated to a trust created hereunder which would result in a trust with an inclusion ratio greater than zero (0) and less than one (1), then the Trustee shall divide such trust into a GST-Exempt Trust and a Nonexempt Trust.

[39] State law should be consulted to determine whether a trust protector, or the equivalent under a directed and divided trusteeship regime, is considered a fiduciary.

E. *Using the GST Exemption*

As mentioned above, a reverse QTIP election would change the identity of the transferor from the surviving spouse to the decedent spouse who created and funded the QTIP trust.[40] In effect, this election enables the maximization of the decedent's GST exemption. For documents that contain "QTIPible" trusts, the following provision provides flexibility.

> Reverse QTIP Election. Notwithstanding any other provision of this Trust Agreement, if and to the extent that the Settlor's Personal Representative or the Trustee, as the case may be, makes a Reverse QTIP Election, then the Settlor directs the Trustee to hold the property to which the Reverse QTIP Election applies in a separate trust upon the same terms and conditions and for the same uses and purposes as are set forth in Article [VI]. If the Trustee makes a QTIP Election, then the Trustee shall be further authorized (but shall not be required) to make an election pursuant to Section 2652(a)(3) of the Code (and similar Section(s) of any other Federal revenue laws) to treat the trust or any part of the trust created under Article [VI] as though no such election pursuant to Section 2056(b)(7) of the Code had been made.

Continuing with the theme of flexibility and ensuring separation of GST-exempt and nonexempt portions of the trust, the following provision authorizes the trustee to allocate the GST exemption after a decedent's death in case the executor forgets to do so or, alternatively, affirms the trustee's authority to allocate GST exemption if the trustee is a statutory executor.

> Allocation of GST Exemption. The Trustee shall be authorized (but shall not be required) to elect exemption from the applicability of Section 2632(b) of the Code, and the Trustee shall be authorized to allocate, in accordance with the provisions of Section 2632(a) of the Code, any unused portion of the GST exemption available to the Settlor (or to the Settlor's estate) under Section 2631 of the Code to any dispositions of property under this Trust Agreement or to any dispositions of property outside of this Trust Agreement in such manner and in such amounts and proportions as the Trustee shall, in the Trustee's sole and absolute discretion, deem appropriate. All determinations by the Trustee as to the proper allocation of such unused exemption shall be conclusive and binding upon all persons having or claiming any interest in the Settlor's estate. If GST exemption is allocated to a trust created hereunder which would result in a trust with an inclusion ratio greater than zero (0) and less than one (1), then the Trustee shall divide such trust into a GST-Exempt Trust and a Nonexempt Trust.

The above GST tax planning provisions are not universally applicable to all clients, but similar to other types of powers- and savings-type clauses in

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[40] I.R.C. § 2652(a)(3); Reg. § 26.2652-1(a)(5). *See supra* Part I.B.1.a.

wills and trust instruments, they should be considered to avoid the GST tax or mitigate its application when unanticipated.

III. Mistake #3—Default Formula Drafting with No "Plan B" and a Bad "Plan B"—Portability

Even when there is an obvious need for GST planning, practitioners often make mistakes in structuring their GST tax planning approaches.

A. *Formula Drafting*

Many revocable living trusts are drafted with formula bequests that direct a GST-exempt trust to be funded with assets having a value equal to the decedent's maximum available GST exemption. If history is any indication, the GST tax rules may change again in the next round of tax reform. This unpredictability requires that practitioners use caution when drafting living trusts and to anticipate changing GST tax exemption amounts and the possible repeal of the GST tax itself. Below are three common scenarios in which having a default GST-exempt trust-funding formula may create unintended and problematic consequences for the client and his or her family.

- If the trust agreement directs that a GST-exempt trust be funded for the benefit of grandchildren and a GST-nonexempt trust be funded for the benefit of children, and the GST tax were to be repealed, all trust property may be inadvertently directed to only one class of beneficiaries per the terms of funding formula.

- If the GST exemption increases, a trust agreement that directs that the GST-exempt trust be funded with the GST-exemption amount (or a variation of the amount) may result in inadvertent "overfunding" of such a trust.

- If the GST exemption decreases, a trust agreement that directs that the GST-exempt trust be funded with the GST-exemption amount (or a variation of the amount) may result in an inadvertent "underfunding" of such a trust.

B. *Relying on Portability*

The introduction of portability to the transfer tax world beginning in 2011 has allowed for many married clients to defer transfer tax planning until the death of the surviving spouse. Simply put, portability allows an individual to "port" (or transfer) upon death any of his or her gift and estate tax exemption not used by the individual during life or upon death to his or her surviving spouse. Thus, portability generally allows a married couple to fully utilize both of their gift and estate tax exemptions, even when the first spouse to die owns assets at the time of death having a value equal to less than his or her remaining estate tax exemption or his or her estate plan leaves his or her assets to the surviving spouse or charity so that his or her remaining estate tax exemption is not used. Prior to portability, any gift and estate tax exemption not used during life or upon death was lost. Although portability may have simplified estate tax planning for some individuals, it may lead to a loss of the GST exemption because portability is not applicable to the GST exemption. Although portability allows for the use of both spouses' estate tax exemptions, if an individual does not use his or her GST exemption during life or at death, it is forever lost. Accordingly, it is imperative that practitioners consider the GST tax consequences of utilizing portability and communicate the consequences of doing so to their clients.

IV. Mistake #4—Mandatory Distributions from a GST-Exempt Trust

Even if an estate plan is structured to maximize the use of a client's GST exemption (*e.g.*, by funding a trust for the benefit of descendants and allocating GST exemption to the trust so that the trust has an inclusion ratio of zero), the particular distribution provisions of the trust may cause the well-intended plan to be inefficient from a GST tax perspective. This would occur, for example, if the dispositive provisions of the trust provided for mandatory distributions of income or principal to the trust beneficiaries. Examples of these types of distribution provisions include provisions requiring all of the trusts income to be distributed to one or more beneficiaries each year and provisions requiring mandatory distributions of principal to the beneficiaries upon the occurrence of a particular event (*e.g.*, attaining a particular age or graduating from college). A better approach from a GST tax perspective would exclude any provision requiring distributions of income or principal and give the trustee discretion to make distributions to the beneficiaries.[41] Only in a rare situation would good reason exist to force distributions out of a GST-exempt trust, and this is especially true only if another trust exists from which distributions may be made that is not GST exempt.[42]

If distributions must be made from a GST-exempt trust to a beneficiary who is a non-skip person, the GST exemption that was allocated to the distributed assets is essentially wasted. The reasons for this are twofold. First, the

[41] Of course, the client's goals come first (and you cannot always let the tax tail wag the dog), so if the client has a good reason for a mandatory distribution from a GST-exempt trust, then that wish should be honored. If, however, the client is able to recognize that his or her goals can be achieved without the need for mandatory distributions (*e.g.*, through a discretionary trust and a letter of wishes), then the client can achieve not only the specified goal, but also tax efficiency and creditor protection.

[42] A better approach would be to first fully exhaust assets that are not GST exempt (and would therefore be subject to GST tax upon the non-skip person beneficiary's death). Only after all non-exempt assets are exhausted should distributions be made to a non-skip person from a GST-exempt trust.

assets could have passed directly from the settlor to the non-skip person without the use of any GST exemption. As a result, the distribution of assets from a trust to which the GST exemption was allocated is inefficient. Second, the assets in the GST-exempt trust are removed from the transfer tax system and will pass from generation to generation without the imposition of transfer tax. However, if assets are distributed to a beneficiary who is a non-skip person, the assets will be included in the non-skip person beneficiary's estate (to the extent the distributed assets are not consumed by the non-skip person beneficiary during his or her life). Thus, the non-skip person beneficiary would need to allocate his or her GST exemption (a second allocation of GST exemption to the same assets) to the assets in order for them to pass from generation to generation without the imposition of transfer tax.

V. Mistake #5—Tainting the Exempt Status of GST Grandfathered Trusts

Moving from these common drafting mistakes to the administration of older trusts, a common mistake is to taint the GST-exempt status of a grandfathered trust. A "grandfathered trust" is a trust that was irrevocable on or before September 25, 1985, the effective date of the modern GST tax.[43] These trusts are not subject to the GST tax provided certain changes have not been made to the trust since that date.[44]

A. *Grandfathered Trust Status*

Determining whether a trust is a grandfathered trust is key to ensuring that its GST-exempt status is not tainted, with the result that a portion of the trust assets become subject to the GST tax. If the trust was executed prior to September 25, 1985, the practitioner must determine whether the trust was irrevocable on or before that date. All trusts in existence on September 25, 1985, are considered irrevocable unless (1) on September 25, 1985, the settlor held a power with respect to the trust that would have resulted in gross estate inclusion under section 2038;[45] (2) the settlor retained a power to alter the shares of trust beneficiaries;[46] or (3) the trust holds life insurance on the settlor's life and the settlor possessed incidents of ownership in the policy that would result in gross estate inclusion under section 2042.[47]

A special set of rules apply if the trust at issue is a testamentary trust created under a will or revocable trust instrument. Testamentary trusts will be irrevocable only if (1) no amendments were made after October 21, 1986, that

[43] Reg. § 26.2601-1(a), -1(b)(1)(i).

[44] Reg. § 26.2601-1(a), -1(b)(1)(i).

[45] Reg. § 26.2601-1(b)(1)(ii)(B).

[46] Reg. § 26.2601-1(b)(1)(ii)(B), -1(b)(1)(ii)(D).

[47] Reg. § 26.2601-1(b)(1)(ii)(C).

resulted in the creation of or increase in the amount of a GST; (2) no addition was made to the testamentary trust after October 21, 1986, that resulted in the creation of or increase in the amount of a GST; and (3) the decedent who created the testamentary trust died before January 1, 1987.[48]

After determining that a trust is grandfathered, the practitioner will want to avoid certain changes to the trust to preserve its grandfathered status. Two types of changes that taint the exempt status are (1) additions to the trust and (2) modifications of the trust occurring after September 25, 1985.[49]

B. *Additions*

Grandfathered status is generally tainted if an actual or constructive "addition" to the trust has been made after September 25, 1985.[50] If an actual or constructive addition has been made to a grandfathered trust after this date, a pro rata portion of subsequent GSTs will be subject to the GST tax.

Avoiding an actual addition is relatively straight forward, but a constructive addition can unknowingly taint the grandfathered trust status. A "constructive addition" occurs upon (1) the taxable release, exercise, or lapse of a general power of appointment over the trust; (2) the release or exercise of a nongeneral power of appointment that extends the vesting period beyond the perpetuities period that originally applied to the trust; or (3) the creation of a second power of appointment that may be exercised to extend the vesting beyond the perpetuities period that originally applied to the trust.[51]

Notwithstanding the foregoing, the exercise of a nongeneral power of appointment (most commonly called a "limited power of appointment") is not a constructive addition if two conditions are met: (1) the power was created in a grandfathered trust and (2) the power is not exercised in a manner that may postpone or suspend the vesting, absolute ownership, or power of alien-

[48] Reg. § 26.2601-1(b)(2)(i).

[49] In addition to determining the grandfathered status of a trust, a practitioner should determine whether the trust qualifies as a Gallo trust. The requirements of a Gallo trust are not outlined in any section of the Code or the regulations, but are contained in an amendment to the Tax Reform Act of 1986 that implemented the modern GST tax. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1433(b)(3), 100 Stat. 2085, 2731, as amended by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1014(h)(2)–(4), 102 Stat. 3342, 3567–68. Named for the Gallo wine family who lobbied for the exception, generation-skipping transfers from a trust for the benefit of one grandchild funded with up to $2 million prior to January 1, 1990, will not be subject to GST tax unless (1) additions have been made to the trust after December 31, 1989, or (2) the trust was modified after December 31, 1989, beyond the modifications permitted in the grandfathered-trust safe-harbor regulations.

[50] Reg. § 26.2601-1(b)(1)(iv).

[51] *See* Reg. § 26.2601-1(b)(1)(v)(B)(*2*).

ation of an interest in property beyond what is commonly known as the federal perpetuities period.[52] Note, however, that the exercise of a power of appointment is subject to different rules than a trustee's exercise of a fiduciary power, which would encompass decanting or modification of a grandfathered trust, as detailed below.[53]

C. *Modifications and Decanting*

To ensure that a grandfathered trust remains GST exempt through a trust modification after September 25, 1985, the modification should be within one of the modification safe harbors set forth in the Treasury regulations.[54] Jeopardizing grandfathered trust status via a trust modification has become increasingly more common as decanting has increased in popularity.

The first safe harbor for modifying a grandfathered trust provides that a distribution of principal from a grandfathered trust to a new trust will not cause the new trust to be subject to GST tax (*i.e.*, the new trust will inherit the grandfathered trust status of the decanted trust) if either (1) the terms of the governing instrument of the grandfathered trust authorize distributions to the new trust without the consent or approval of any beneficiary or court or (2) at the time that the grandfathered trust became irrevocable (which had to have been prior to September 25, 1985), state law governing the trust authorized distributions to the new trust without the consent or approval of any beneficiary.[55] Also, the terms of the new trust cannot extend the time for vesting of any beneficial interest beyond a period measured by 21 years after the death of any life in being at the time that the grandfathered trust became irrevocable.[56]

The second safe harbor to avoid adversely affecting the grandfathered status of a trust applies in connection with a court-approved settlement that was the product of arm's-length negotiations and is within the range of reasonable outcomes under the governing instrument and applicable state law.[57]

The third safe harbor provides for a judicial construction of a trust instrument if the judicial action involved a bona fide issue and the construction is

[52] *See* Reg. § 26.2601-1(b)(4)(i)(A)(*2*).

[53] *See* Reg. § 26.2601-1(b)(1)(v)(B) (exercise of special power of appointment); Reg. § 26.2601-1(b)(4)(i)(D) (modifications of trust pursuant to trustee action).

[54] Reg. § 26.2601-1(b)(4).

[55] Reg. § 26.2601-1(b)(4)(i)(A).

[56] *See* Reg. § 26.2601-1(b)(4)(i)(A)(*2*). The exercise of a special power does not violate the federal perpetuities period if the vesting, absolute ownership, or power of alienation of an interest in property may not be suspended or postponed beyond either (1) any life in being at the date of creation of the grandfathered trust plus twenty-one years and a period of time for gestation or (2) a ninety-year period beginning on the date of the creation of the trust. *See* Reg. § 26.2601-1(b)(1)(v)(B)(2).

[57] Reg. § 26.2601-1(b)(4)(i)(B).

consistent with applicable state law that would be applied by the highest state court.[58]

The fourth safe harbor, a catch-all provision, prevents termination of grandfathered trust status for any modifications to a trust that does not (1) shift a beneficial interest in the trust to any beneficiary who occupies a generation lower than the generation occupied by the person or persons who held the beneficial interest prior to the modification and (2) extend the time for vesting of any beneficial interest in the trust past the period provided for in the grandfathered trust.[59]

Before making changes to an older trust, practitioners should check the date of the trust to determine the trust's qualification as a grandfathered trust in order to avoid subjecting trust assets to the GST tax by failing to comply with the grandfathered trust addition and modification rules.

VI. Mistake #6—Nontaxable Gifts, the GST Annual Exclusion, *Crummey* Powers, and Hanging Withdrawal Rights

Similar to additions to grandfathered trusts, other types of transfers require special attention to avoid GST planning mistakes. Nontaxable gifts generally do not attract GST tax. As a result, an affirmative allocation of GST exemption to a nontaxable gift is generally not necessary to avoid GST tax, and the automatic allocation rules are generally inapplicable. Nontaxable gifts include gifts qualifying for the gift-tax annual exclusion under section 2503(b) and gifts for medical or educational expenses under section 2503(e).

Determining whether a transfer to or on behalf of an individual is a nontaxable gift is relatively straightforward. Determining whether a transfer to a trust is a nontaxable gift is much more complicated and mistaken assumptions are often made.

A. *Annual Exclusion and* Crummey *Powers*

Gifts to a trust qualify for the gift-tax annual exclusion (and such gifts are therefore nontaxable gifts) if the beneficiaries have a present interest in the trust. A beneficiary will have a present interest in a trust if the beneficiary has "[a]n unrestricted right to the immediate use, possession, or enjoyment of property or the income from the property."[60] The most common way for beneficiaries to have a present interest in a trust is for the trust agreement to provide each trust beneficiary with a power to withdraw a portion of each contribution made to the trust each year (typically limited, with respect to each beneficiary, to the gift-tax annual exclusion amount). These withdrawal powers are commonly referred to as *Crummey* Powers.[61] By including

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[58] Reg. § 26.2601-1(b)(4)(i)(C).

[59] Reg. § 26.2601-1(b)(4)(i)(D).

[60] Reg. § 25.2503-3(b).

[61] *See* Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968).

Crummey Powers in a trust, the transferor is able to make transfers to the trust each year free of the gift tax in an amount equal to the gift-tax annual exclusion multiplied by the number of beneficiaries with a *Crummey* Power.

The mistaken belief that a transfer to a trust which qualifies for the gift-tax annual exclusion also qualifies for the GST-tax annual exclusions (with the assumed result that neither the automatic allocation rules apply to allocate the GST exemption to the transfer nor an affirmative allocation of the GST exemption is necessary to make the trust GST exempt) is surprisingly common. As discussed above, in addition to qualifying for the gift-tax annual exclusion (generally by the inclusion of *Crummey* Powers in the trust), a transfer to a trust qualifies for the GST-tax annual exclusion only if the trust is a "section 2642(c) trust." A trust will qualify as a section 2642(c) trust only if (1) the trust is for the benefit of a single beneficiary who is a skip person and (2) if the beneficiary dies during the term of the trust, the trust assets would be included in the beneficiary's gross estate.[62]

Most trusts that include *Crummey* Powers are for the benefit of multiple beneficiaries in order to maximize the amount of assets the transferor can contribute to the trust each year free of the gift tax. Because these trusts are not for the benefit of a single beneficiary, the trusts do not qualify as section 2642(c) trusts; consequently, transfers to such a trust cannot qualify for the GST-tax annual exclusion (despite such transfers qualifying for the gift-tax annual exclusion). Rather, the transferor's GST exemption would be automatically allocated to the trust with respect to each contribution made to the trust in each year during which the trust is a GST trust.[63] The failure to recognize that the GST exemption is automatically allocated to a trust can have significant adverse effects on future estate planning transactions.

For example, assume that client (who is not married) creates a trust for the benefit of his four children and six grandchildren (the "Gifting Trust"). With respect to all contributions made to the Gifting Trust in a particular year, each of the client's ten descendants has a right to withdraw up to $15,000 (the gift-tax annual exclusion amount).[64] As a result, client can gift up to $150,000 per year to the Gifting Trust without using any gift tax exemption. Client has made a $150,000 gift to the Gifting Trust each year for the past twenty years, resulting in $3 million of tax-free gifts to the Gifting Trust. Client's accountant, who has been preparing his gift tax returns each year, has assumed that transfers to the Gifting Trust qualified for the GST-tax annual exclusion and, as a result, has failed to account for any reduction in client's GST exemption.

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62 *See* I.R.C. § 2642(c)(2).

63 Because distributions from such trusts typically may be made to or for the benefit of a grandchild or more remote descendant of the transferor (*i.e.*, a skip person), the trust would be a GST trust, unless one of the exceptions (discussed above) applied.

64 For purposes of this example, assume that the gift-tax annual exclusion amount for each year during which client made a gift to the trust was $15,000.

In a later year, client, desiring to use all of his $11.7 million gift and GST exemptions, creates a new trust (the "Grandchildren Trust") solely for the benefit of his grandchildren (the trust is a skip person) and gifts $11.7 million to the Grandchildren Trust. Client believes that he has made a transfer to the Grandchildren Trust that is free from both gift and GST tax, but because the Gifting Trust did not qualify as a section 2642(c) trust (it had multiple beneficiaries), $3 million of client's GST exemption has been automatically allocated to the Gifting Trust over the past 20 years. As a result, client had only $8.7 million of GST exemption remaining when he made the gift to the Grandchildren Trust, with the result that $3 million of the gift is subject to GST tax.

B. *Hanging Powers*

An eye-opening trap concerns hanging withdrawal rights, which can switch on and switch off the GST status of a trust. As noted above, a trust is excluded from the definition of a GST trust if any portion of the trust would be included in the gross estate of a non-skip person if such person died immediately after the transfer to the trust. Often, each of the *Crummey* Powers for all of the transferor's descendants are structured to lapse after a certain period of time up to the greater of five percent of the trust principal and $5,000 each year to avoid having an estate inclusion for a *Crummey* beneficiary. The balance of the withdrawal right in excess of such an amount (commonly referred to as a "hanging power") does not lapse and may be withdrawn in subsequent years (in addition to the amount otherwise subject to withdrawal in that particular year). These types of trusts are often long-term trusts intended to benefit all of the transferor's descendants and to be exempt from GST tax. At the creation of the trust, the trust is a GST trust, qualifying for automatic allocations of the GST exemption.

A common occurrence would disqualify this type of trust from being a GST trust, prohibiting automatic allocations of the GST exemption. This switch could happen if, at any time, a child of the transferor has the power to withdraw (in the aggregate) more than the annual exclusion amount. If the aggregate amount that a child may withdraw in a particular year exceeds the gift-tax annual exclusion amount, a portion of the trust would be included in the child's gross estate if the child were to die immediately after the transfer to the trust, thus causing the trust to cease to be a GST trust.

For example, assume that a transferor transfers $100,000 to an irrevocable trust for the transferor's descendants. In Year 1, the transferor's child has a withdrawal right over $15,000 (the annual exclusion amount) of the gift to the trust, and this right lapses only to the extent of $5,000. The next year, the transferor transfers an additional $100,000 to the trust. In Year 2, the child has the right to withdraw $15,000 of the Year 2 contribution, plus the hanging amount of $10,000 from Year 1. As a result, the child has a withdrawal right of $25,000 in Year 2—exceeding the gift-tax annual exclusion amount. If the child were to die in Year 2, he or she would have an estate tax inclusion for a portion of the trust. This possibility of an estate tax inclusion means that the trust does not qualify as a GST trust in Year 2 and for so long as a non-skip beneficiary has a withdrawal right exceeding the gift-tax annual exclusion amount.

This fact pattern highlights (1) the narrowness of the definition of a GST trust because this is a trust to which the transferor would most likely want automatic allocations of the GST exemption to be made and (2) the risks in relying on the automatic allocation of the GST exemption. Controlling the GST status of a trust through elections and affirmative allocations is wise.

VII. Mistake #7—Neglecting to Allocate the GST Exemption

Despite the benefits of taking control of GST allocations through election statements and affirmative allocations, many practitioners fail to properly allocate the GST exemption on the gift tax return. Often, a practitioner will rely on the default allocation rules when an affirmative allocation should be made for a variety of reasons. Properly allocating a sufficient GST exemption to a transfer will exempt that transfer from GST tax or ensure that trust assets will not be subject to GST tax.

A. *Affirmative Allocations*

An affirmative allocation of the GST exemption may be made at any time before the date prescribed for filing the estate tax return, including extensions.[65] If property is to be held in trust, the allocation of the GST exemption is made to the entire trust rather than to specific trust assets.[66] A timely allocation of the GST exemption is made on a timely filed gift tax return for transfers during life and on a timely filed estate tax return for transfers at death.[67] For a timely allocation of the GST exemption, the property transferred or the trust to which the property is transferred will be exempt from the GST tax if the amount of the GST exemption allocated is equal to the value of the property transferred on the date of the transfer.[68]

An affirmative allocation of the GST exemption to a lifetime transfer to a trust is made by filing a Notice of Allocation with the gift tax return reporting the gift. The Notice of Allocation must be filed by the return preparer and must fulfill specific requirements set forth in the regulations and instructions to the gift tax return. There are different rules depending on the type of election: an election in,[69] an election out of direct skips,[70] and an election out of

[65] I.R.C. § 2632(a)(1).
[66] Reg. § 26.2632-1(a).
[67] I.R.C. §§ 2642(b)(1), (2).
[68] I.R.C. §§ 2642(b)(1), (2).
[69] *See* I.R.C. § 2632(c)(5)(A)(ii).
[70] I.R.C. § 2632(b)(3).

indirect skips.[71] On a Notice of Allocation, the practitioner must clearly identify the trust and the trust's EIN, if known, state the value of the assets at the effective date of the allocation, state the amount of the GST exemption allocated or the formula used, and state the inclusion ratio of the trust.[72] Often, gift-tax return preparers skip Schedule D, Computation of Generation-Skipping Transfer Tax, for any number of reasons, or do not include a Notice of Allocation, or both.

For an affirmative allocation of GST exemption at death, the decedent's executor may allocate the decedent's GST exemption that the decedent did not use during life.[73] The executor would make allocations to trusts being funded at death on Schedule R of the decedent's estate tax return. Similar to gift tax returns, tax preparers often skip completing or including a Schedule R.

B. *Automatic Allocations*

One of the main reasons that tax return preparers may skip detailing the GST allocation on gift and estate tax returns is the availability of automatic allocations of the GST exemption. Just as portability provides a false sense of security for estate tax planning, so does the automatic allocation rules for GST tax planning. Both sets of rules help when the tax planning is neglected, but those rules also allow practitioners to avoid analysis of the rules to truly maximize the benefits of the assets.

The purpose of the automatic allocation rules is to avoid inadvertent GST tax when it is anticipated that the taxpayer would have wished to allocate the GST exemption. Starting in reverse, at death, the automatic allocation rules apply to allocate the decedent's unused GST exemption, pro rata, to direct skips and then, to the extent that any GST exemption remains, pro rata, to trusts from which a taxable termination or taxable distribution may occur.[74]

During lifetime, a taxpayer's unused GST exemption will be automatically allocated to any direct skip transfer (including direct skip transfers in trust), unless the taxpayer elects out of the automatic allocation rules. If property is transferred to a trust, the transfer is a direct skip only if the trust is a skip person.[75] The automatic allocation rules work well for direct skips, but have some defects for indirect skips. An "indirect skip" is a transfer to a GST trust (other than a direct skip trust).[76] A taxpayer's unused GST exemption will be automatically allocated to any transfer to a GST trust.[77]

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[71] I.R.C. § 2632(c)(5)(A)(i).

[72] Reg. § 26.2632-1(b)(4)(i).

[73] *See* Reg. § 26.2632-1(a).

[74] *See* I.R.C. § 2632(e)(1).

[75] Reg. § 26.2612-1(a).

[76] I.R.C. § 2632(c)(3)(A); Reg. § 26.2632-1(b)(2)(i).

[77] I.R.C. § 2632(c)(1).

A "GST trust" is broadly defined as any trust that could have a GST with respect to the transferor. Despite its broad definition, certain trusts that otherwise satisfy the general definition of a GST trust are excluded from treatment as GST trusts. Examples include: (1) age 46 trusts;[78] (2) ten year age difference trusts;[79] (3) partial estate tax inclusion trusts;[80] (4) non-skip person estate tax inclusion trusts;[81] (5) charitable lead annuity trusts; (6) charitable remainder annuity trusts or charitable remainder unitrusts;[82] and (7) charitable lead unitrusts if the non-charitable remainder beneficiary is a non-skip person.[83]

The complex definition of a GST trust can be under-inclusive in some circumstances by failing to attract GST exemption to transfers to which allocation is desired, and over-inclusive in other circumstances by allocating the GST exemption to transfers to which an allocation is not desired. Common mistakes involving this imperfect definition of a GST trust are detailed herein concerning trusts with withdrawal rights and trusts subject to the estate tax inclusion period (ETIP). Due to the imprecise manner in which the automatic allocation rules function, practitioners need to be wary of relying on such rules for lifetime transfers.

Best practice is to first determine the desired GST tax status of a trust and then to make an election either in or out of the automatic allocation rules. If the trust is intended to be GST exempt, an appropriate amount of GST exemption should then be affirmatively allocated to the transfer. Proceeding in this manner (as opposed to relying on the automatic allocation rules) forms a record for review when the GST status may be in question.

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[78] I.R.C. § 2632(c)(3)(B). An age 46 trust is one that provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons (1) before the date that the individual attains the age of 46, (2) on or before one or more dates specified in the trust that will occur before the date that such individual attains the age of 46, or (3) on the occurrence of an event that, in accordance with regulations prescribed by the Treasury Secretary, may reasonably be expected to occur before the date that such individual attains the age of 46.

[79] I.R.C. § 2632(c)(3)(B)(ii). A ten year age difference trust is one that provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are (1) non-skip persons and (2) living on the date of death of another person identified in the trust who is more than 10 years older than such individuals.

[80] I.R.C. § 2632(c)(3)(B)(iii). A partial estate tax inclusion trust is one that provides that, if one or more individuals who are non-skip persons die on or before a date or event described in the first two exceptions noted above (*see supra* notes 78–79), more than 25% of the trust corpus either (1) must be distributed to the estate or estates of one or more of such individuals or (2) is subject to a general power of appointment exercisable by one or more of such individuals.

[81] I.R.C. § 2632(c)(3)(B)(iv).

[82] I.R.C. § 2632(c)(3)(B)(v).

[83] I.R.C. § 2632(c)(3)(B)(vi).

C. *Notice of Allocation*

Below are samples of the elections in and out of GST allocation on a gift tax return.

> [Name of Trust with name of Settlor and Trustee, address and EIN]
>
> A. Pursuant to Internal Revenue Code Section 2632(c)(5)(A)(ii) and Treasury Regulation Section 26.2632-1(b)(3)(ii), the taxpayer elects for the automatic allocation rules of Section 2632(c) to apply to the transfer by the taxpayer described on Schedule A, Part 3, Item ___, and to any future transfers to any trusts created under the [Name of the Trust], including the trust under [specific provision of the specifically named trust] and any other trusts that may be created under [specific other provisions of the specifically named trust]. As a result of this election, the inclusion ratio of the [Name of the Trust] is zero, and [Name of the Trust] shall be treated a GST trust.

Or for the election out:

> [Name of Trust with name of Settlor and Trustee, address and EIN]
>
> B. Pursuant to Internal Revenue Code Section 2632(c)(5)(A)(i)(II) and Treasury Regulation Section 26.2632-1(b)(2)(iii)(B), the taxpayer elects for the automatic allocation rules of Section 2632(c) not to apply to the transfer by the taxpayer described on Schedule A, Part 3, Item ___ and to any future transfers to any trusts created under the [Name of the Trust], including the trust under [specific provision of the specifically name trust] and any other trusts that may be created under [specific other provisions of the specifically name trust]. As a result of this election, the inclusion ratio of the [Name of the Trust] is one.

VIII. Mistake #8—Incompatibility of the GST-Exemption Allocation during the ETIP

One specific time period that causes a common mistake in allocating the GST exemption is during the ETIP. Often, practitioners do not realize that the GST exemption generally cannot be effectively allocated during the ETIP.[84] The ETIP is that period of time during which, if the transferor or the transferor's spouse dies, the assets of the trust would be included in either of their estates.[85] A trust will not be subject to the ETIP rule if (1) the possibility that the property will be included in the estate of the transferor or the transferor's spouse is so remote as to be negligible (*i.e.*, less than a five percent

[84] I.R.C. § 2642(f).

[85] Reg. § 26.2632-1(c)(2)(i).

actuarial chance),[86] (2) the transferor's spouse possesses a power of withdrawal that is limited to the greater of $5,000 or five percent of the trust principal and this right terminates no later than 60 days after the transfer to the trust,[87] or (3) a reverse QTIP election is made with respect to the transfer.[88]

As mentioned above, a reverse QTIP election makes the decedent, instead of the surviving spouse, the transferor for GST tax purposes.[89] Without this election, the transferor's spouse would need to wait until death to allocate the GST exemption, and the transferor may not maximize the use of the GST exemption.

Non-QTIP trusts reveal how not knowing the ETIP rule can be costly. Even if an attempt were made to allocate the GST exemption to a trust during the ETIP, the allocation of the exemption will not be effective until the end of the ETIP, potentially leading to the allocation of much more of the transferor's GST exemption than anticipated or having a mixed inclusion ratio trust. For example, the ETIP rule prevents allocating the GST exemption to a grantor retained annuity trust (GRAT) during the annuity period because, if the transferor were to die, the GRAT assets would generally be included in the transferor's estate. Accordingly, GRATs are typically not intended to be GST exempt. When the remainder beneficiary of the GRAT is a skip person or a GST trust, the transferor's GST exemption will be automatically allocated to the transfer of the presumably appreciated GRAT assets at the end of the GRAT term.

To prevent the GST exemption from being automatically allocated at the end of the ETIP, the transferor should file an election-out statement, electing out of the automatic allocation rules. Many tax preparers miss the requirement that transfers subject to the ETIP must be reported on Part 1 of Schedule D of the gift tax return in the Computation of GST tax as described below. The ETIP rule provides another reason that reliance on automatic allocations of the GST exemption is imprudent.

IX. Mistake #9—Gift-Splitting

Gift-splitting can also lead to mistakes in allocating the GST exemption.[90] If spouses elect to gift split, a transfer of property made by only one spouse is

[86] Reg. § 26.2632-1(c)(2)(i)(A).

[87] Reg. § 26.2632-1(c)(2)(i)(B).

[88] Reg. § 26.2632-1(c)(2)(ii)(C).

[89] I.R.C. § 2652(a)(3). *See supra* text Part I.B.1.a.

[90] The requirements of splitting gifts are: (1) at the time of the gift, each spouse must be a U.S. citizen or a U.S. resident; (2) at the time of the gift, the spouses must be married; (3) if, during the same year as that of the gift, the spouses divorce, they may still elect to split gifts made while they were married provided neither remarries during the same calendar year; and (4) both of the spouses must signify their consent to the election to split gifts. I.R.C. § 2513(a).

treated as if made 50% by each spouse, and all transfers made by either spouse during the year for which the election is made (other than transfers to each other) are deemed split for that year.[91] As a result, each spouse becomes the transferor of 50% of the property for GST tax purposes, which may result in the automatic (and potentially unknowing) allocation of the non-donor spouse's GST exemption.

A gift-splitting election may be made either on a timely filed gift tax return or on a late filed return, if such return is the first return filed by either spouse for the calendar year in which the gift was made.[92] If the gift-splitting election is made on a late filed gift tax return, unintended GST tax consequences can result. The reason for this is that, as a result of the gift-splitting election, each spouse is treated as the transferor of 50% of the property for GST tax purposes.[93]

If the transfer is made to a skip person or a GST trust, the automatic allocation rules result in each spouse's GST exemption being automatically allocated to 50% of the transferred property. If the trust to which the transfer is made is intended to be GST exempt, then there should be no adverse consequences. In contrast, if the trust is not intended to be GST exempt, issues may arise. When a gift-splitting election is made on a late filed gift tax return, the taxpayers do not have the ability to elect out of the automatic allocations rules. Accordingly, irrespective of whether the trust is intended to be GST exempt, both spouses' GST exemption will be automatically allocated to the trusts. Thus, practitioners should pay close attention to GST consequences when advising clients with respect to gift-splitting and how to report it on a gift tax return.

X. Mistake #10—Incorrect or Careless Reporting of the Generation-Skipping Transfer and Computing of the GST Tax

With the filing of gift tax returns each year comes the common mistake of incorrect or careless reporting of the GSTs. Schedules A and D of a gift tax return pose particular problems for preparers who are not well versed in reporting GSTs and the allocation of the GST exemption.

A. *Schedule A*

The GST planning mistake for Schedule A on the gift tax return is reporting a transfer to a trust on the wrong Part of the Schedule. This error may be a consequence of the evolution of Schedule A over the years or a preparer's failure to understand the nuances of the GST tax rules. Schedule A forces a preparer to properly identify the specific aspects of the GST tax that apply to a transfer in order to select Part 1, 2, or 3 on which to report the gift. Part 1

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[91] I.R.C. § 2513.
[92] I.R.C. § 2513(b)(2).
[93] *See* Reg. § 26.2632-1(b)(4)(iii), Ex. (5).

is for gifts that are subject to the gift tax and not the GST tax. Part 2 is for direct skips, and Part 3 is for indirect skips. Thus, the preparer needs to know those GST terms to choose the correct part on which to report the transfer.

Part 1 of Schedule A may be erroneously used for a GST if the preparer does not realize that the gift may be subject to the GST tax. This Part, however, is not the one that typically causes confusion—Parts 2 and 3 do.

Part 2 of Schedule A is for direct skips, subject to both the gift and GST taxes. In the gift tax return context, a "direct skip" is a transfer of an interest in property to a skip person subject to gift tax.[94] Part 2 also provides a box in column C to be checked if the taxpayer is electing out of the allocation of the GST exemption for the gift. If the box is unchecked, the taxpayer's exemption sufficient to exempt that transfer from the GST tax is automatically allocated to the gift.[95] Additionally, an explanation must be attached to the gift tax return describing the transaction and the extent to which the automatic allocation should not apply to the gift. As an alternative to providing such an explanation, the taxpayer must pay the GST tax with a timely filed gift tax return.[96]

Part 3 of Schedule A is for "indirect skips," which are transfers to a GST trust subject to the gift tax.[97] As detailed above, determining whether the trust qualifies as a GST trust to which automatic allocation would apply is sometimes difficult. Similar to Part 2, Part 3 has a check-the-box election under column C that is often overlooked. If this Part 3 box is unchecked, the taxpayer's GST exemption is automatically allocated to the gift.[98] Part 3 has additional elections that may be made by checking the appropriate box in column C.[99] The instructions for the gift tax return explain these three elections, which must be detailed on an "election statement."

Without checking the box, automatic allocations apply. Election 1 prohibits an automatic allocation of GST exemption to that specific, current transfer. Election 2 prohibits the automatic allocation of the GST exemption to the current transfer and all other transfers to that trust in the future. Election 3 is helpful because qualification for a GST trust is not always clear. Election 3 deems the trust to be a GST trust for which all transfers to the trust are automatically allocated the taxpayer's GST exemption.[100] Even if a practitioner is diligent to ensure that the correct boxes are checked to elect out of a GST allocation, the practitioner must not overlook the need to include an election statement.

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[94] I.R.C. § 2612(c).

[95] I.R.C. § 2632(b).

[96] *See* INTERNAL REVENUE SERV., INSTRUCTIONS FOR FORM 709 (Aug. 7, 2020), https://www.irs.gov/pub/irs-pdf/i709.pdf [https://perma.cc/J4DJ-GYVM].

[97] I.R.C. § 2632(c)(3)(A).

[98] I.R.C. § 2632(c).

[99] I.R.C. § 2632(c)(5).

[100] Reg. § 26.2632-1(b)(2)(iii)(A).

Avoiding these common reporting mistakes on Schedule A of the gift tax return requires a firm knowledge of the GST tax laws and the gift tax return instructions.

B. *Schedule D*

While tax return preparers often do their best to complete Schedule A of the gift tax return, they often demonstrate their indifference to the GST tax by ignoring the Computation of Generation-Skipping Transfer Tax under Schedule D of the gift tax return. Often Schedule D is left blank.

Part 1 of Schedule D is for reporting the GSTs as reported on Schedule A of the gift tax return to determine the nontaxable portions of any transfers and net transfers. Because of the confusion that exists regarding Schedule A, any potential mistakes from Schedule A are magnified in Schedule D. The fear of being stuck with the conclusions shown in column E for the net transfers may lead many gift-tax return preparers to leave Part 1 of Schedule D blank. More understandably, because of the complexity of Part 1, a preparer may simply have forgotten to report a transfer subject to the ETIP on this Part 1.

Allocating the GST exemption is very complex. Part 2 requires knowledge of many of the rules discussed above that commonly cause mistakes including: (1) a check-the-box election for reverse QTIP elections; (2) on line 4 of Part 2, reporting the amount of GST exemption allocated from gifts listed on Part 2 of Schedule A; (3) on line 5 of Part 2, reporting the amount of automatic GST exemption allocated from gifts listed on Part 3 of Schedule A, (4) opting out of those rules; and (5) allocating the GST exemption affirmatively using Notices of Allocation. In combination, the complex GST tax rules required to complete the GST Exemption Reconciliation correctly often leads to mistakes; an ability to decipher and master the GST tax rules is the only means to avoid these mistakes.

XI. Conclusion

Avoiding the mistakes outlined in this Article will strengthen a practitioner's advice by minimizing GST tax exposure for clients and their intended beneficiaries. An appreciation of these common mistakes and the complex and nuanced rules under the GST tax regime will enable a practitioner to maximize the assets available for clients to transfer to their chosen beneficiaries. By gathering the necessary facts, becoming versed in the GST tax rules, and avoiding the common mistakes outlined in this Article, a practitioner will be better equipped to provide holistic advice to the client.

Internal Revenue Code

§ 2611 Generation-skipping transfer defined.

(a) In general.

For purposes of this chapter, the term "generation-skipping transfer" means—

(1)

a taxable distribution,

(2)

a taxable termination, and

(3)

a direct skip.

(b) Certain transfers excluded.

The term "generation-skipping transfer" does not include—

(1)

any transfer which, if made inter vivos by an individual, would not be treated as a taxable gift by reason of section 2503(e) (relating to exclusion of certain transfers for educational or medical expenses), and

(2)

any transfer to the extent—

(A) the property transferred was subject to a prior tax imposed under this chapter,

(B) the transferee in the prior transfer was assigned to the same generation as (or a lower generation than) the generation assignment of the transferee in this transfer, and

(C) such transfers do not have the effect of avoiding tax under this chapter with respect to any transfer.

END OF DOCUMENT -

Checkpoint Contents
Federal Library
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Code, Regulations, Committee Reports & Tax Treaties
Internal Revenue Code
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Subtitle B Estate and Gift Taxes §§2001-2801
Chapter 13 TAX ON GENERATION-SKIPPING TRANSFERS §§2601-2664
Subchapter B Generation-Skipping Transfers §§2611-2613
§2612 Taxable termination; taxable distribution; direct skip.

Internal Revenue Code

§ 2612 Taxable termination; taxable distribution; direct skip.

(a) Taxable termination.

(1) General rule.

For purposes of this chapter, the term "taxable termination" means the termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in a trust unless—

(A) immediately after such termination, a non-skip person has an interest in such property, or

(B) at no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person.

(2) Certain partial terminations treated as taxable.

If, upon the termination of an interest in property held in trust by reason of the death of a lineal descendant of the transferor, a specified portion of the trust's assets are distributed to 1 or more skip persons (or 1 or more trusts for the exclusive benefit of such persons), such termination shall constitute a taxable termination with respect to such portion of the trust property.

(b) Taxable distribution.

For purposes of this chapter, the term “taxable distribution” means any distribution from a trust to a skip person (other than a taxable termination or a direct skip).

(c) Direct skip.

For purposes of this chapter—

(1) In general.

The term “direct skip” means a transfer subject to a tax imposed by chapter 11 or 12 of an interest in property to a skip person.

(2) Look-thru rules not to apply.

Solely for purposes of determining whether any transfer to a trust is a direct skip, the rules of section 2651(f)(2) shall not apply.

END OF DOCUMENT -

Internal Revenue Code

§ 2613 Skip person and non-skip person defined.

(a) Skip person.

For purposes of this chapter, the term "skip person" means—

(1)

a natural person assigned to a generation which is 2 or more generations below the generation assignment of the transferor, or

(2)

a trust—

(A) if all interests in such trust are held by skip persons, or

(B) if—

(i) there is no person holding an interest in such trust, and

(ii) at no time after such transfer may a distribution (including distributions on termination) be made from such trust to a non-skip person.

(b) Non-skip person.

For purposes of this chapter, the term “non-skip person” means any person who is not a skip person.

END OF DOCUMENT -

Internal Revenue Code

§ 2621 Taxable amount in case of taxable distribution.

(a) In general.

For purposes of this chapter, the taxable amount in the case of any taxable distribution shall be—

(1)

the value of the property received by the transferee, reduced by

(2)

any expense incurred by the transferee in connection with the determination, collection, or refund of the tax imposed by this chapter with respect to such distribution.

(b) Payment of GST tax treated as taxable distribution.

For purposes of this chapter, if any of the tax imposed by this chapter with respect to any taxable distribution is paid out of the trust, an amount equal to the portion so paid shall be treated as a taxable distribution.

Internal Revenue Code

§ 2622 Taxable amount in case of taxable termination.

(a) In general.

For purposes of this chapter, the taxable amount in the case of a taxable termination shall be —

(1)

the value of all property with respect to which the taxable termination has occurred, reduced by

(2)

any deduction allowed under subsection (b) .

(b) Deduction for certain expenses.

For purposes of subsection (a) , there shall be allowed a deduction similar to the deduction allowed by section 2053 (relating to expenses, indebtedness, and taxes) for amounts attributable to the property with respect to which the taxable termination has occurred.

Internal Revenue Code

§ 2623 Taxable amount in case of direct skip.

For purposes of this chapter, the taxable amount in the case of a direct skip shall be the value of the property received by the transferee.

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Internal Revenue Code

§ 2624 Valuation.

(a) General rule.

Except as otherwise provided in this chapter, property shall be valued as of the time of the generation-skipping transfer.

(b) Alternate valuation and special use valuation elections apply to certain direct skips.

In the case of any direct skip of property which is included in the transferor's gross estate, the value of such property for purposes of this chapter shall be the same as its value for purposes of chapter 11 (determined with regard to sections 2032 and 2032A).

(c) Alternate valuation election permitted in the case of taxable terminations occurring at death.

If 1 or more taxable terminations with respect to the same trust occur at the same time as and as a result of the death of an individual, an election may be made to value all of the property included in such terminations in accordance with section 2032 .

(d) Reduction for consideration provided by transferee.

For purposes of this chapter, the value of the property transferred shall be reduced by the amount of any consideration provided by the transferee.

END OF DOCUMENT -

Internal Revenue Code

§ 2631 GST exemption.

(a) General rule.

For purposes of determining the inclusion ratio, every individual shall be allowed a GST exemption amount which may be allocated by such individual (or his executor) to any property with respect to which such individual is the transferor.

(b) Allocations irrevocable.

Any allocation under subsection (a) , once made, shall be irrevocable.

(c) GST exemption amount.

For purposes of subsection (a) , the GST exemption amount for any calendar year shall be equal to the basic exclusion amount under section 2010(c) for such calendar year.

END OF DOCUMENT -

Internal Revenue Code

§ 2632 Special rules for allocation of GST exemption.

(a) Time and manner of allocation.

(1) Time.

Any allocation by an individual of his GST exemption under section 2631(a) may be made at any time on or before the date prescribed for filing the estate tax return for such individual's estate (determined with regard to extensions), regardless of whether such a return is required to be filed.

(2) Manner.

The Secretary shall prescribe by forms or regulations the manner in which any allocation referred to in paragraph (1) is to be made.

(b) Deemed allocation to certain lifetime direct skips.

(1) In general.

If any individual makes a direct skip during his lifetime, any unused portion of such individual's GST exemption shall be allocated to the property transferred to the extent necessary to make the inclusion ratio for such property zero. If the amount of the direct skip exceeds such unused portion, the entire unused portion shall be allocated to the property transferred.

(2) Unused portion.

For purposes of paragraph (1) , the unused portion of an individual's GST exemption is that portion of such exemption which has not previously been allocated by such individual (or treated as allocated under paragraph (1) or subsection (c)(1)) .

(3) Subsection not to apply in certain cases.

An individual may elect to have this subsection not apply to a transfer.

(c) Deemed allocation to certain lifetime transfers to GST trusts.

(1) In general.

If any individual makes an indirect skip during such individual's lifetime, any unused portion of such individual's GST exemption shall be allocated to the property transferred to the extent necessary to make the inclusion ratio for such property zero. If the amount of the indirect skip exceeds such unused portion, the entire unused portion shall be allocated to the property transferred.

(2) Unused portion.

For purposes of paragraph (1) , the unused portion of an individual's GST exemption is that portion of such exemption which has not previously been—

(A) allocated by such individual,

(B) treated as allocated under subsection (b) with respect to a direct skip occurring during or before the calendar year in which the indirect skip is made, or

(C) treated as allocated under paragraph (1) with respect to a prior indirect skip.

(3) Definitions.

(A) Indirect skip. For purposes of this subsection , the term "indirect skip" means any transfer of property (other than a direct skip) subject to the tax imposed by chapter 12 made to a GST trust.

(B) GST trust. The term "GST trust" means a trust that could have a generation-skipping transfer with respect to the transferor unless—

(i) the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons—

(I) before the date that the individual attains age 46,

(II) on or before one or more dates specified in the trust instrument that will occur before the date that such individual attains age 46, or

(III) upon the occurrence of an event that, in accordance with regulations prescribed by the Secretary, may reasonably be expected to occur before the date that such individual attains age 46,

(ii) the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons and who are living on the date of death of another person identified in the instrument (by name or by class) who is more than 10 years older than such individuals,

(iii) the trust instrument provides that, if one or more individuals who are non-skip persons die on or before a date or event described in clause (i) or (ii) , more than 25 percent of the trust corpus either must be distributed to the estate or estates of one or more of such individuals or is subject to a general power of appointment exercisable by one or more of such individuals,

(iv) the trust is a trust any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer,

(v) the trust is a charitable lead annuity trust (within the meaning of section 2642(e)(3)(A)) or a charitable remainder annuity trust or a charitable remainder unitrust (within the meaning of section 664(d)), or

(vi) the trust is a trust with respect to which a deduction was allowed under section 2522 for the amount of an interest in the form of the right to receive annual payments of a fixed percentage of the net fair market value of the trust property (determined yearly) and which is required to pay principal to a non-skip person if such person is alive when the yearly payments for which the deduction was allowed terminate.

For purposes of this subparagraph , the value of transferred property shall not be considered to be includible in the gross estate of a non-skip person or subject to a right of withdrawal by reason of such person holding a right to withdraw so much of such property as does not exceed the amount referred to in section 2503(b) with respect to any transferor, and it shall be assumed that powers of appointment held by non-skip persons will not be exercised.

(4) Automatic allocations to certain GST trusts.

For purposes of this subsection , an indirect skip to which section 2642(f) applies shall be deemed to have been made only at the close of the estate tax inclusion period. The fair market value of such transfer shall be the fair market value of the trust property at the close of the estate tax inclusion period.

(5) Applicability and effect.

(A) In general. An individual—

(i) may elect to have this subsection not apply to—

(I) an indirect skip, or

(II) any or all transfers made by such individual to a particular trust, and

(ii) may elect to treat any trust as a GST trust for purposes of this subsection with respect to any or all transfers made by such individual to such trust.

(B) Elections.

(i) Elections with respect to indirect skips. An election under subparagraph (A)(i)(I) shall be deemed to be timely if filed on a timely filed gift tax return for the calendar year in which the transfer was made or deemed to have been made pursuant to paragraph (4) or on such later date or dates as may be prescribed by the Secretary.

(ii) Other elections. An election under clause (i)(II) or (ii) of subparagraph (A) may be made on a timely filed gift tax return for the calendar year for which the election is to become effective.

(d) Retroactive allocations.

(1) In general.

If—

(A) a non-skip person has an interest or a future interest in a trust to which any transfer has been made,

(B) such person—

(i) is a lineal descendant of a grandparent of the transferor or of a grandparent of the transferor's spouse or former spouse, and

(ii) is assigned to a generation below the generation assignment of the transferor, and

(C) such person predeceases the transferor,

then the transferor may make an allocation of any of such transferor's unused GST exemption to any previous transfer or transfers to the trust on a chronological basis.

(2) Special rules.

If the allocation under paragraph (1) by the transferor is made on a gift tax return filed on or before the date prescribed by section 6075(b) for gifts made within the calendar year within which the non-skip person's death occurred—

(A) the value of such transfer or transfers for purposes of section 2642(a) shall be determined as if such allocation had been made on a timely filed gift tax return for each calendar year within which each transfer was made,

(B) such allocation shall be effective immediately before such death, and

(C) the amount of the transferor's unused GST exemption available to be allocated shall be determined immediately before such death.

(3) Future interest.

For purposes of this subsection , a person has a future interest in a trust if the trust may permit income or corpus to be paid to such person on a date or dates in the future.

(e) Allocation of unused GST exemption.

(1) In general.

Any portion of an individual's GST exemption which has not been allocated within the time prescribed by subsection (a) shall be deemed to be allocated as follows—

(A) first, to property which is the subject of a direct skip occurring at such individual's death, and

(B) second, to trusts with respect to which such individual is the transferor and from which a taxable distribution or a taxable termination might occur at or after such individual's death.

(2) Allocation within categories.

(A) In general. The allocation under paragraph (1) shall be made among the properties described in subparagraph (A) thereof and the trusts described in subparagraph (B) thereof , as the case may be, in proportion to the respective amounts (at the time of allocation) of the nonexempt portions of such properties or trusts.

(B) Nonexempt portion. For purposes of subparagraph (A) , the term "nonexempt portion" means the value (at the time of allocation) of the property or trust, multiplied by the inclusion ratio with respect to such property or trust.

END OF DOCUMENT -

Internal Revenue Code

§ 2641 Applicable rate.

(a) General rule.

For purposes of this chapter, the term "applicable rate" means, with respect to any generation-skipping transfer, the product of—

(1)

the maximum Federal estate tax rate, and

(2)

the inclusion ratio with respect to the transfer.

(b) Maximum Federal estate tax rate.

For purposes of subsection (a) , the term "maximum Federal estate tax rate" means the maximum rate imposed by section 2001 on the estates of decedents dying at the time of the taxable distribution, taxable termination, or direct skip, as the case may be.

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§2642 Inclusion ratio.

Internal Revenue Code

§ 2642 Inclusion ratio.

(a) Inclusion ratio defined.

For purposes of this chapter—

(1) In general.

Except as otherwise provided in this section , the inclusion ratio with respect to any property transferred in a generation-skipping transfer shall be the excess (if any) of 1 over—

(A) except as provided in subparagraph (B) , the applicable fraction determined for the trust from which such transfer is made, or

(B) in the case of a direct skip, the applicable fraction determined for such skip.

(2) Applicable fraction.

For purposes of paragraph (1) , the applicable fraction is a fraction—

(A) the numerator of which is the amount of the GST exemption allocated to the trust (or in the case of a direct skip, allocated to the property transferred in such skip), and

(B) the denominator of which is—

(i) the value of the property transferred to the trust (or involved in the direct skip), reduced by

(ii) the sum of—

(I) any Federal estate tax or State death tax actually recovered from the trust attributable to such property, and

(II) any charitable deduction allowed under section 2055 or 2522 with respect to such property.

(3) Severing of trusts.

(A) In general. If a trust is severed in a qualified severance, the trusts resulting from such severance shall be treated as separate trusts thereafter for purposes of this chapter.

(B) Qualified severance. For purposes of subparagraph (A) —

(i) In general. The term "qualified severance" means the division of a single trust and the creation (by any means available under the governing instrument or under local law) of two or more trusts if—

(I) the single trust was divided on a fractional basis, and

(II) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust.

(ii) Trusts with inclusion ratio greater than zero. If a trust has an inclusion ratio of greater than zero and less than 1, a severance is a qualified severance only if the single trust is divided into two trusts, one of which receives a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance. In such case, the trust receiving such fractional share shall have an inclusion ratio of zero and the other trust shall have an inclusion ratio of 1.

(iii) Regulations. The term "qualified severance" includes any other severance permitted under regulations prescribed by the Secretary.

(C) Timing and manner of severances. A severance pursuant to this paragraph may be made at any time. The Secretary shall prescribe by forms or regulations the manner in which the qualified severance shall be reported to the Secretary.

(b) Valuation rules, etc.

Except as provided in subsection (f) —

(1) Gifts for which gift tax return filed or deemed allocation made.

If the allocation of the GST exemption to any transfers of property is made on a gift tax return filed on or before the date prescribed by section 6075(b) for such transfer or is deemed to be made under section 2632(b)(1) or (c)(1) —

(A) the value of such property for purposes of subsection (a) shall be its value as finally determined for purposes of chapter 12 (within the meaning of section 2001(f)(2)), or, in the case of an allocation deemed to have been made at the close of an estate tax inclusion period, its value at the time of the close of the estate tax inclusion period, and

(B) such allocation shall be effective on and after the date of such transfer, or, in the case of an allocation deemed to have been made at the close of an estate tax inclusion period, on and after the close of such estate tax inclusion period.

(2) Transfers and allocations at or after death.

(A) Transfers at death. If property is transferred as a result of the death of the transferor, the value of such property for purposes of subsection (a) shall be its value as finally determined for purposes of chapter 11; except that, if the requirements prescribed by the Secretary respecting allocation of post-death changes in value are not met, the value of such property shall be determined as of the time of the distribution concerned.

(B) Allocations to property transferred at death of transferor. Any allocation to property transferred as a result of the death of the transferor shall be effective on and after the date of the death of the transferor.

(3) Allocations to inter vivos transfers not made on timely filed gift tax return.

If any allocation of the GST exemption to any property not transferred as a result of the death of the transferor is not made on a gift tax return filed on or before the date prescribed by section 6075(b) and is not deemed to be made under section 2632(b)(1)

(A) the value of such property for purposes of subsection (a) shall be determined as of the time such allocation is filed with the Secretary, and

(B) such allocation shall be effective on and after the date on which such allocation is filed with the Secretary.

(4) QTIP trusts.

If the value of property is included in the estate of a spouse by virtue of section 2044 , and if such spouse is treated as the transferor of such property under section 2652(a) , the value of such property for purposes of subsection (a) shall be its value for purposes of chapter 11 in the estate of such spouse.

(c) Treatment of certain direct skips which are nontaxable gifts.

(1)

In general. In the case of a direct skip which is a nontaxable gift, the inclusion ratio shall be zero.

(2) Exception for certain transfers in trust.

Paragraph (1) shall not apply to any transfer to a trust for the benefit of an individual unless—

(A) during the life of such individual, no portion of the corpus or income of the trust may be distributed to (or for the benefit of) any person other than such individual, and

(B) if the trust does not terminate before the individual dies, the assets of such trust will be includible in the gross estate of such individual.

Rules similar to the rules of section 2652(c)(3) shall apply for purposes of subparagraph (A) .

(3) Nontaxable gift.

For purposes of this subsection , the term “nontaxable gift” means any transfer of property to the extent such transfer is not treated as a taxable gift by reason of—

(A) section 2503(b) (taking into account the application of section 2513), or

(B) section 2503(e) .

(d) Special rules where more than 1 transfer made to trust.

(1) In general.

If a transfer of property is made to a trust in existence before such transfer, the applicable fraction for such trust shall be recomputed as of the time of such transfer in the manner provided in paragraph (2) .

(2) Applicable fraction.

In the case of any such transfer, the recomputed applicable fraction is a fraction—

(A) the numerator of which is the sum of—

(i) the amount of the GST exemption allocated to property involved in such transfer, plus

(ii) the nontax portion of such trust immediately before such transfer, and

(B) the denominator of which is the sum of—

(i) the value of the property involved in such transfer reduced by the sum of —

(I) any Federal estate tax or State death tax actually recovered from the trust attributable to such property, and

(II) any charitable deduction allowed under section 2055 or 2522 with respect to such property, and

(ii) the value of all of the property in the trust (immediately before such transfer).

(3) Nontax portion.

For purposes of paragraph (2) , the term "nontax portion" means the product of—

(A) the value of all of the property in the trust, and

(B) the applicable fraction in effect for such trust.

(4) Similar recomputation in case of certain late allocations.

If—

(A) any allocation of the GST exemption to property transferred to a trust is not made on a timely filed gift tax return required by section 6019 , and

(B) there was a previous allocation with respect to property transferred to such trust,

the applicable fraction for such trust shall be recomputed as of the time of such allocation under rules similar to the rules of paragraph (2) .

(e) Special rules for charitable lead annuity trusts.

(1) In general.

For purposes of determining the inclusion ratio for any charitable lead annuity trust, the applicable fraction shall be a fraction—

(A) the numerator of which is the adjusted GST exemption, and

(B) the denominator of which is the value of all of the property in such trust immediately after the termination of the charitable lead annuity.

(2) Adjusted GST exemption.

For purposes of paragraph (1) , the adjusted GST exemption is an amount equal to the GST exemption allocated to the trust increased by interest determined—

(A) at the interest rate used in determining the amount of the deduction under section 2055 or 2522 (as the case may be) for the charitable lead annuity, and

(B) for the actual period of the charitable lead annuity.

(3) Definitions.

For purposes of this subsection —

(A) Charitable lead annuity trust. The term "charitable lead annuity trust" means any trust in which there is a charitable lead annuity.

(B) Charitable lead annuity. The term "charitable lead annuity" means any interest in the form of a guaranteed annuity with respect to which a deduction was allowed under section 2055 or 2522 (as the case may be).

(4) Coordination with subsection (d) .

Under regulations, appropriate adjustments shall be made in the application of subsection (d) to take into account the provisions of this subsection .

(f) Special rules for certain inter vivos transfers.

Except as provided in regulations—

(1) In general.

For purposes of determining the inclusion ratio, if—

(A) an individual makes an inter vivos transfer of property, and

(B) the value of such property would be includible in the gross estate of such individual under chapter 11 if such individual died immediately after making such transfer (other than by reason of section 2035),

any allocation of GST exemption to such property shall not be made before the close of the estate tax inclusion period (and the value of such property shall be determined under paragraph (2)). If such transfer is a direct skip, such skip shall be treated as occurring as of the close of the estate tax inclusion period.

(2) Valuation.

In the case of any property to which paragraph (1) applies, the value of such property shall be—

(A) if such property is includible in the gross estate of the transferor (other than by reason of section 2035), its value for purposes of chapter 11, or

(B) if subparagraph (A) does not apply, its value as of the close of the estate tax inclusion period (or, if any allocation of GST exemption to such property is not made on a timely filed gift tax return for the calendar year in which such period ends, its value as of the time such allocation is filed with the Secretary).

(3) Estate tax inclusion period.

For purposes of this subsection , the term “estate tax inclusion period” means any period after the transfer described in paragraph (1) during which the value of the property involved in such transfer would be includible in the gross estate of the transferor under chapter 11 if he died. Such period shall in no event extend beyond the earlier of—

(A) the date on which there is a generation-skipping transfer with respect to such property, or

(B) the date of the death of the transferor.

(4) Treatment of spouse.

Except as provided in regulations, any reference in this subsection to an individual or transferor shall be treated as including a reference to the spouse of such individual or transferor.

(5) Coordination with subsection (d) .

Under regulations, appropriate adjustments shall be made in the application of subsection (d) to take into account the provisions of this subsection .

(g) Relief provisions.

(1) Relief from late elections.

(A) In general. The Secretary shall by regulation prescribe such circumstances and procedures under which extensions of time will be granted to make—

(i) an allocation of GST exemption described in paragraph (1) or (2) of subsection (b) , and

(ii) an election under subsection (b)(3) or (c)(5) of section 2632 .

Such regulations shall include procedures for requesting comparable relief with respect to transfers made before the date of the enactment of this paragraph .

(B) Basis for determinations. In determining whether to grant relief under this paragraph , the Secretary shall take into account all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Secretary deems relevant. For purposes of determining whether to grant relief under this paragraph , the time for making the allocation (or election) shall be treated as if not expressly prescribed by statute.

(2) Substantial compliance.

An allocation of GST exemption under section 2632 that demonstrates an intent to have the lowest possible inclusion ratio with respect to a transfer or a trust shall be deemed to be an allocation of so much of the transferor's unused GST exemption as produces the lowest possible inclusion ratio. In determining whether there has been substantial compliance, all relevant circumstances shall be taken into account, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Secretary deems relevant.

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THE ROLE OF FEDERALISM IN ADMINISTERING A NATIONAL SYSTEM OF TAXATION

*Robert T. Danforth**

I. INTRODUCTION

> There is no federal general common law.[1]

> State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed.[2]

> By erasing the careful line between state laws that purport to disclaim or exempt property interests after the fact, which the federal tax lien does not respect, and state laws' definition of property and property rights, which the federal tax lien does respect, the Court . . . creates a new federal common law of property. This contravenes the previously settled rule that the definition and scope of property is left to the States.[3]

This Article addresses the intersection between the federal tax laws and the state laws on which administration of the tax laws depend. Under our federal system of government, state laws generally prescribe the rights and duties arising from a transaction, while federal law determines the tax consequences that attend the state law rights and duties. The interplay of these two bodies of law generates multiple tensions. For example, to what extent must a federal court defer to the judgment of a state court concerning a state law matter with federal tax implications? To what extent are state-to-state variations in law respected by those charged with administering federal tax laws, given the countervailing desire for national uniformity in tax law application? To what extent should federal law discourage state legislative "gaming" of the tax system—*i.e.*, state legislative efforts designed specifically to achieve federal tax advantages for its residents (or others availing themselves of favorable state law)? This Article considers these tensions by examining two contrasting legal developments. The first is the gaming phenomenon, which the Article examines specifically in the context of the federal tax laws concerning gratuitous transfers. The second is an apparent

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[1]Erie R.R. Co. v. Tompkins, 304 U.S. 64, 78 (1938). My apologies to Justice Brandeis, who wrote these words concerning the duties owed to a trespasser in a diversity-of-citizenship case, not a federal tax case. Nevertheless, when a question of state law must be decided in a federal tax case, the federal court performs essentially the same function as in a diversity-of-citizenship case—the federal court "may be said to be, in effect, sitting as a state court." Commissioner v. Estate of Bosch, 387 U.S. 456, 465 (1967) (citing *Erie*). *Bosch* is discussed *infra* at notes 25-28 and accompanying text.

[2]Morgan v. Commissioner, 309 U.S. 78, 80 (1940). *See also infra* notes 20-24 and accompanying text (discussing *Morgan*).

[3]United States v. Craft, 535 U.S. 274, 294 (2002) (Thomas, J., dissenting). *See also infra* notes 91-117 and accompanying text (discussing *Craft*).

judicial trend toward a federal common law of property rights, with a focus on how that trend may affect the traditional primacy of state law concerning such matters.

The Article begins with an overview of the traditional rules governing the interplay of state law and federal tax law. It then examines several recent state legislative efforts to craft laws producing favorable federal transfer tax[4] and related income tax consequences. Next, the Article critically examines a trend in the federal courts away from the primacy of state law concerning property rights having federal tax implications. That is followed by a consideration of the extent to which the latter trend may undermine the tax advantages intended to accompany the recent state legislative developments. The Article observes that some of these developments may not withstand federal judicial scrutiny but criticizes this likely result as raising federalism concerns. Finally, the analysis concludes by asserting that public policy concerns about the gaming phenomenon should be addressed by Congress, not the federal courts.

II. INTERPLAY BETWEEN STATE LAW AND FEDERAL TAX LAW

The Internal Revenue Code (the Code) is national in application, but it taxes transactions governed predominantly by state law. As a general rule, state law determines the nature and quality of transactions, property rights, and other potentially taxable interests and events, while federal tax law determines the tax consequences of those interests and events. A simple example involving a gratuitous transfer illustrates the point. Suppose a settlor establishes and funds a trust for the benefit of herself and her children. The trust is irrevocable, and the trust authorizes the trustee to pay income and principal for the benefit of the settlor and the settlor's children in such amounts as the trustee deems appropriate. The settlor names a corporate fiduciary as trustee. Is the settlor's transfer to the trust a taxable gift?

The Code imposes a tax each calendar year "on the transfer of property by gift during such . . . year by any individual."[5] The regulations provide, however, that "incomplete" transfers shall be not be treated as taxable gifts, elaborating on this proposition as follows:

> A gift is incomplete in every instance in which a donor reserves the power to revest the beneficial title to the property in himself. A gift is also incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard.[6]

[4]This Article uses the term "transfer taxes" to denote collectively the three federal taxes on gratuitous transfers of property, *i.e.*, the federal estate, gift, and generation-skipping transfer taxes. *See also infra* notes 40-44 and accompanying text (describing the basic operative features of the generation-skipping transfer tax).

[5]I.R.C. § 2501(a)(1).

[6]Reg. § 25.2511-2(c).

Bearing in mind the federal rules stated in the Code and the regulations, in what respects would state trust law affect the gift taxation of this transaction?

Suppose state law provides trust settlors with an unqualified right to remove and replace corporate trustees, except as otherwise provided in the trust instrument. Assuming the trust instrument is silent on this issue, the settlor in our case would hold the removal and replacement power, which presumably would give her the ability to substitute herself as trustee. Under these circumstances, a federal court would likely hold that her transfer to the trust was *incomplete* for gift tax purposes—by virtue of her ability to serve as trustee, she would indirectly hold "the power to . . . change the interests of the beneficiaries as between themselves."[7]

Disregarding the state law removal power for the moment, the gift taxation of this transaction would also be affected by state law concerning creditors' rights. In most of the United States, state law provides that the creditors of a settlor who reserves to herself a discretionary interest in a trust can reach the assets of the trust to satisfy the settlor's debts.[8] The standard formulation of this rule appears in section 156(2) of the Restatement (Second) of Trusts: "Where a person creates for his own benefit . . . a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit."[9] Moreover, in most United States jurisdictions, even if the trust were to include a so-called spendthrift provision,[10] the assets of the trust could be still be reached by the creditors of the settlor.[11]

Assuming that the general state law rules concerning creditors' rights applied to the trust in our example, a federal court would likely hold that the settlor's transfer to the trust was incomplete for gift tax purposes,[12] even if state law did

[7]*See, e.g.*, Reg. §§ 20.2036-1(b)(3), 20.2038-(a)(3) (stating the analogous proposition in the context of the estate tax). Note as well that, although her power would be held as a "fiduciary," *see* Reg. § 25.2511-1(c), her power would not in this case be "limited by a fixed or ascertainable standard," *see id.*; Reg. § 25.2511-1(g)(2) (providing examples of fixed or ascertainable standards).

[8]*See* Robert T. Danforth, *Rethinking the Law of Creditors' Rights in Trusts*, 53 HASTINGS L.J. 287, 293 (2002).

[9]RESTATEMENT (SECOND) OF TRUSTS § 156(2) (1959); *see also* RESTATEMENT (THIRD) OF TRUSTS § 60 cmt. f (2003) (stating that the settlor's creditors "can reach the maximum amount the trustee, in the proper exercise of fiduciary discretion, could pay to or apply for the benefit of the settlor"); UNIF. TRUST CODE § 505(a)(2) (2000) (stating that a "creditor . . . of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit").

[10]The following is typical:

> To the extent permitted by law, the principal and income of this trust shall not be liable for the debts of any beneficiary or subject to alienation or anticipation by a beneficiary.

[11]The second Restatement describes the rule as follows:

> Where a person creates for his own benefit a trust with a provision restraining the voluntary or involuntary transfer of his interest, his transferee or creditors can reach his interest.

RESTATEMENT (SECOND) OF TRUSTS § 156(1) (1959); *see also* RESTATEMENT (THIRD) OF TRUSTS § 58(2) (2003) (stating that "[a] restraint on the voluntary and involuntary alienation of a beneficial interest retained by the settlor is invalid"); UNIF. TRUST CODE § 505(a) (2000) (creditors can reach settlor's interest "[w]hether or not the terms of a trust contain a spendthrift provision").

[12]*See* Outwin v. Commissioner, 76 T.C. 153, 163-68 (1981) (concerning a trust subject to Massachusetts law).

not grant our settlor a trustee removal and replacement power. The court's reasoning would be as follows: A transfer is incomplete for gift tax purposes to the extent the "donor reserves the power to revest the beneficial title to the property in himself."[13] Our settlor "could at any time obtain the economic benefit of the trust [assets] simply by borrowing and then forcing her creditors to look to her interest in the trust . . . for a source of repayment."[14]

These examples illustrate the traditional, respective roles of state and federal law—state law determines the nature of the settlor's reserved rights in the trust, while federal law determines the tax consequences of those reserved rights. In these examples, and as will typically be the case, the primacy of state law concerning property interests is implicit in the Code and regulations. More rarely, the Code or regulations expressly incorporate state law in defining certain terms or in prescribing certain tax consequences.[15] For example, section 2704(b) of the Code requires that certain restrictions on the right to liquidate a family-owned business entity be disregarded for transfer tax purposes.[16] Under section 2704(b), a transferred interest in a family-owned corporation or partnership is valued without regard to any "applicable restriction," generally speaking a restriction—subject to lapse after the passage of time or subject to removal by the transferor or a member of the transferor's family—that "effectively limits the ability of the corporation or partnership to liquidate."[17] To constitute an applicable restriction, the restriction must be "more restrictive than the limitations [on the ability to liquidate] that would apply under the State law generally applicable to the entity in the absence of the restriction."[18] Thus, what constitutes an applicable restriction in a particular partnership or corporation depends expressly on the default rules concerning liquidation rights under the law of the state under which the entity was formed.[19]

The primacy of state law concerning property rights is subject to an important limitation: it is the substance—not the nomenclature—of state law that determines a particular tax result. The leading illustration of this point is *Morgan v. Commissioner*,[20] in which the Supreme Court was asked to construe the term "general power of appointment" in the predecessor to present Code section 2041, which subjected to estate tax "any property passing under a general power

[13]Reg. § 25.2511-2(c).

[14]*Outwin*, 76 T.C. at 162 (citing Paolozzi v. Commissioner, 23 T.C. 182 (1954)).

[15]*See generally* 1 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS § 4.1.3 (3d ed. 1999) [hereinafter BITTKER & LOKKEN].

[16]The effect of "disregard[ing]" restrictions on liquidation rights is to increase the value of the transferred interest for transfer tax purposes. *See* RICHARD B. STEPHENS ET AL., FEDERAL ESTATE AND GIFT TAXATION ¶ 19.05[1], at 19-159 to 19-160 (8th ed. 2002) [hereinafter STEPHENS ET AL.].

[17]I.R.C. § 2704(b)(2)(A).

[18]Reg. § 25.2704-2(b); *see also* Reg. § 25.2704-2(b)(3)(B) (noting "the term 'applicable restriction' shall not include . . . any restriction imposed, or required to be imposed, by any Federal or State law").

[19]*See also infra* notes 50-52 and accompanying text (discussing state legislative developments in response to section 2704(b)).

[20]309 U.S. 78 (1940).

of appointment exercised by the decedent . . . by will."[21] At her death, the decedent in *Morgan* possessed the power to appoint by will the property held in two trusts established by her father. The terms of the trusts permitted her to appoint to any person, but the powers were exercisable by will only, not *inter vivos*. The executor argued that, because the powers could only be exercised at death, under Wisconsin law the powers were "special"—not general—and thus did not trigger application of the relevant estate tax provision. The Court rejected this argument, stating:

> [W]e hold that the powers are general within the intent of the Revenue Act . . . , notwithstanding they may be classified as special by the law of Wisconsin.
>
> State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed. Our duty is to ascertain the meaning of the words used to specify the thing taxed. If it is found in a given case that an interest or right created by local law was the object intended to be taxed, the federal law must prevail no matter what name is given to the interest or right by state law.[22]

The Court then observed that "[n]one of the revenue acts had defined the phrase 'general power of appointment,'" but that Congress could be expected to have in mind a power exercisable in favor of the power holder's estate, which is the attribute typically associated with a general testamentary power.[23] Because, under Wisconsin law, the decedent in *Morgan* could have exercised her power in favor of her estate, the Court held that the power was taxable as a general power, notwithstanding the "limited power" nomenclature of Wisconsin law.[24]

A regularly recurring problem concerning the primacy of state law is the extent to which a federal court must defer to the judgment of a state court concerning a state law matter with federal tax implications. Suppose the executor in *Morgan*, wishing to avoid estate taxation of the trusts established by the decedent's father, successfully obtained a state court declaratory judgment that, under Wisconsin law, a power exercisable in favor of "any person" cannot be exercised in favor of the power holder's estate. Would a federal court later considering the estate tax question consider itself bound by the state court decision? The answer generally is "no." In *Commissioner v. Estate of Bosch*,[25] the

[21] *Id.* at 79 & n.1 (quoting former Code section 302(f)). The present version of the statute subjects to estate tax property subject to a general power of appointment, whether exercised or not. I.R.C. § 2041(a)(2). Moreover, unlike the provision considered in *Morgan*, the present statute defines "general power of appointment," thus obviating the *Morgan* inquiry. I.R.C. § 2041(b)(1).

[22] *Morgan*, 309 U.S. at 80-81.

[23] *Id.* at 81.

[24] *Id.* at 82-83. Note that the case affirms the central importance of state law in two respects. First, although the Court declined to be bound by Wisconsin's categorization of general and special powers, the Court acknowledged that state law determines the substantive attributes of the property interests subject to taxation. Second, when deciding what Congress meant by its use of the term "general," the Court implicitly based its decision on what the term usually means under state law. *See* 1 BITTKER & LOKKEN, *supra* note 15, § 4.1.4 at 4.12.

[25] 387 U.S. 456 (1967).

Supreme Court announced that, when considering federal tax questions, federal courts owe only limited deference to prior state court proceedings:

> [E]ven in diversity cases this Court has . . . held that while the decrees of "lower state courts" should be "attributed some weight . . . the decision [is] not controlling . . ." where the highest court of the State has not spoken on the point. . . . [T]his Court [has] further held that "an intermediate appellate state court . . . is a datum for ascertaining state law which is not to be disregarded by a federal court *unless it is convinced by other persuasive data that the highest court of the state would decide otherwise.*" . . . Thus, under some conditions, federal authority may not be bound even by an intermediate state appellate court ruling. It follows here then, that when the application of a federal statute is involved, the decision of a state trial court as to an underlying issue of state law should *a fortiori* not be controlling. This is but an application of the rule of *Erie R. Co. v. Tompkins* . . . , where state law as announced by the highest court of the State is to be followed. This is not a diversity case but the same principle may be applied for the same reasons, *viz.*, the underlying substantive rule involved is based on state law and the State's highest court is the best authority on its own law. If there be no decision by that court then federal authorities must apply what they find to be the state law after giving "proper regard" to relevant rulings of other courts of the State. In this respect, it may be said to be, in effect, sitting as a state court.[26]

In the words of Professor Paul L. Caron, federal courts have generally interpreted "proper regard" to mean "no regard," with the result that in tax cases, federal courts essentially substitute their judgment for the decisions of state trial courts concerning matters of state law.[27] At best, the "proper regard" standard has led to abject confusion among the lower federal courts.[28]

III. STATE LEGISLATIVE GAMING[29] OF TAX LAWS

A. *Background*

Since the beginnings of our national tax laws, state-to-state variations in law have produced disparate federal tax consequences. On occasion, state legisla-

[26]*Id.* at 465 (citations omitted) (emphasis in original). The "proper regard" standard is derived from the legislative history of the estate tax marital deduction. *See id.* at 463-64.

[27]Paul L. Caron, *The Federal Courts of Appeals' Use of State Court Decisions in Tax Cases: "Proper Regard" Means "No Regard,"* 46 OKLA. L. REV. 443, 445 (1993). Professor Caron, the leading authority on this subject, advocates a "bottom-up" approach to *Bosch*, under which federal courts would give "the same deference to state trial court decisions as would be given to an appeal in the state court system." Paul L. Caron, *The Role of State Court Decisions in Federal Tax Litigation:* Bosch, Erie, *and Beyond*, 71 OR. L. REV. 781, 845-46 (1992); *see also* Paul L. Caron, *The Federal Tax Implications of* Bush v. Gore, 79 WASH. U. L.Q. 749, 777-86 (2001) (elaborating on the bottom-up approach).

[28]*See* BORIS I. BITTKER ET AL., FEDERAL ESTATE AND GIFT TAXATION 42-43 (8th ed. 2000) (citing cases).

[29]Using the mildly pejorative term "gaming" is not unintentional. Although state legislation to achieve federal tax advantages is not always objectionable, legislation enacted following inadequate consideration of its effects on non-tax state policy—that is, the tax tail wagging the dog—is objectionable.

tures adopt laws whose principal purpose is to produce favorable federal tax consequences. The most historically prominent example occurred in response to the Supreme Court's decision in *Poe v. Seaborn*,[30] in which the Supreme Court ruled that a husband and wife who were residents of a community property state could each report one-half of the total family income on a separate return. Under the relevant community property laws, the income of either spouse was treated as belonging equally to the other. Based on this characteristic of state law, the Court decided that separate income tax reporting was appropriate.[31] The decision in *Poe* contrasted starkly with the Court's decision in *Lucas v. Earl*[32] in the previous term, in which the taxpayer entered into a contract with his wife, the terms of which provided that the future income of either spouse would be treated as belonging equally to both. The contract was binding under state law. The Court nevertheless held that income was required to be taxed to the spouse who earned it, not to the spouse to whom the rights to the income had been assigned.[33] Thus, the Court disallowed the spouses' attempt to split their income between them for income tax purposes.

The disparate results under *Seaborn* and *Earl* prompted several common law property jurisdictions to enact (or to consider enacting) community property laws for the purpose of enabling their residents to take advantage of the income splitting opportunities presented by *Seaborn*.[34] With these developments in mind, in 1948 Congress amended the Code to permit all married couples to aggregate their income on a single joint return, on which the income was taxed at twice the rate at which a single person would be taxed on one-half the aggregate income.[35] The joint return thus removed the disparate treatment of married persons in community property and common law property states. Not surprisingly, a number of states repealed their recently enacted community property laws in the wake of the 1948 legislation.[36]

[30]282 U.S. 101 (1930).

[31]*Id.* at 110, 113, 118. The federal income tax has always been calculated by reference to a progressive rate schedule, under which higher levels of income are taxed at progressively higher rates. The advantage of splitting income between two related taxpayers is that less of the income is taxed at the higher rates, leading to a lower aggregate tax burden for the family unit.

[32]281 U.S. 111 (1930).

[33]*Id.* at 113-15. *Earl* constitutes the classic statement of the "assignment-of-income" doctrine, under which gratuitous anticipatory transfers of rights to income are ineffective to shift income tax liability to another. On the other hand, gratuitous transfers of *property* (such as shares of dividend-paying stock) usually *are* effective to shift liability for taxes on income from the property.

[34]*See* Stanley Surrey, *Federal Taxation of the Family—The Revenue Act of 1948*, 61 HARV. L. REV. 1097, 1104 (1948). Not all such legislative efforts were successful. In *Commissioner v. Harmon*, 323 U.S. 44 (1944), the Court ruled that Oklahoma's *elective* community property law was not effective in attributing half of the taxpayer's income to his wife. The opt-in, opt-out characteristic of the Oklahoma law was more analogous to *Earl* than to *Seaborn*. *See also infra* notes 55-59 and accompanying text (discussing the elective community property rules recently enacted in Alaska).

[35]*See* Surrey, *supra* note 34, at 1106-07. *See also infra* note 53 (discussing other 1948 tax law developments).

[36]*See* Surrey, *supra* note 34, at 1111 & n.60.

B. *Recent Developments*

The last several years have witnessed some conspicuously tax-motivated state legislative developments, particularly in the area of the federal transfer taxes and related income tax rules.[37] This section of the Article reviews the four most important of these developments.

1. *Repeal of the Rule Against Perpetuities*

The most prominent development has been the widespread partial or absolute repeal of the rule against perpetuities,[38] overtly designed to permit taxpayers to take maximum advantage of their exemptions under the generation-skipping transfer (GST) tax.[39] Some background is helpful in understanding the significance of this development.

The GST tax, a companion to the federal estate and gift taxes, generally taxes gratuitous transfers that skip a generation—such as a transfer from a grandfather to his grandchild. The tax was enacted primarily to prevent wealthy taxpayers from skipping generations as a means of reducing the aggregate estate tax and gift tax burden for their families.[40] The Code grants each taxpayer a $1,000,000 exemption[41] from the tax. All transfers within the exemption amount are free from the tax, regardless of the number of generations skipped.[42] Consequently, the greatest advantage is made of one's GST exemption through transfers structured to avoid transfer taxation in as many generations as possible. The standard mechanism for such transfers is the trust, because a transferor can grant a beneficial interest in a trust, with the interest structured to avoid transfer taxation during the beneficiary's lifetime or at death.

Until recently in most jurisdictions, a trust for the benefit of family members could last no longer than the period prescribed by the rule against perpetuities—in most cases, approximately 90 or 100 years.[43] Nevertheless, a trust designed to last for the longest period permitted by the rule against perpetuities affords

[37]*See* Mitchell M. Gans, *Federal Transfer Taxation and the Role of State Law: Does the Marital Deduction Strike the Proper Balance?*, 48 EMORY L.J. 871, 877-81 (1999) (criticizing several such developments as examples of the tax law's "overemphasis" on state law).

[38]Ira Mark Bloom, *The GST Tax Tail is Killing the Rule Against Perpetuities*, 87 TAX NOTES (TA) 569, 571-73 (Apr. 24, 2000).

[39]*See id.*

[40]Note that by making a transfer directly to his grandchild, the grandfather in our example has eliminated the estate and gift taxes that otherwise would have been incurred at his child's generation if the transferred property had first passed to the child and then to the grandchild.

[41]I.R.C. § 2631(a), (c). The $1,000,000 GST exemption is indexed to inflation. As of 2003, the actual amount of the exemption is $1,120,000. Rev. Proc. 2002-70, 2002-2 C.B. 845. The exemption amount is scheduled to increase to $1,500,000 in 2004, to $2,000,000 in 2006, and to $3,500,000 in 2009. *See* I.R.C. §§ 2010(c), 2631(c).

[42]CAROL A. HARRINGTON ET AL., GENERATION-SKIPPING TRANSFER TAX ¶ 9.04[2] (2d ed. 2001) [hereinafter HARRINGTON ET AL.].

[43]*See* UNIF. STATUTORY RULE AGAINST PERPETUITIES § 1, cmt., (2001) (noting that the 90-year period designated in the uniform rule approximates the typical period prescribed by lives in being plus 21 years).

significant transfer tax advantages. Consider, for example, a senior family member who transfers property equal in value to his GST exemption to a trust for the benefit of his descendants designed to last approximately 100 years. Assuming a six percent after-income-tax return, after 100 years the value of the trust—undiminished by transfer taxes—would grow to approximately $369 million.[44]

In the last several years, numerous states have abolished their rules against perpetuities, in many cases overtly for the purpose of attracting trust business from states that have retained the rule.[45] Trust companies in these states promote the creation of so-called dynasty trusts—trust that will last potentially forever and whose growth will be augmented by avoiding all transfer taxes.[46] Needless to say, astronomical amounts of wealth theoretically can be accumulated transfer-tax free in such trusts. Consider, for example, in a dynasty trust lasting for *only* 300 years—with an after-income-tax return of six percent, a $1,000,000 investment in that time would grow to the tidy sum of approximately $50 *trillion*![47]

2. *Restrictions on Entity Liquidation Rights*

Another recent development involves state legislative efforts designed to help taxpayers achieve substantial discounts when valuing family owned business interests for transfer tax purposes. As discussed earlier, section 2704(b) of the Code requires certain restrictions on liquidation rights in family-owned business entities to be disregarded for transfer tax purposes.[48] "Applicable restrictions" on liquidation rights—generally speaking limitations on liquidation rights that are more restrictive than the default rules under state law—are disregarded under section 2704(b), producing an enhanced value of the business interest for transfer tax purposes. An example illustrates the point: Suppose a senior family

[44]Bloom, *supra* note 38, at 575. *See also* HARRINGTON ET AL., *supra* note 42, ¶ 9.04[1][a], at 9-46 (providing additional examples, based on an assumed after-tax growth rate of seven percent). Using the formula *value of trust=x(1.06)ⁿ*, with x=$1.0 million, and n=100 years, if the trust earnings were compounded only annually the trust would grow to approximately $339 million over 100 years.

Richard A. Oshins and Jonathan Blattmachr compare the results that can be obtained under a "Megatrust"[SM] with the results assuming a 50% estate tax imposed every 30 years. Based on an average after-income-tax growth rate of eight percent for 120 years, $1,000,000 subject to estate tax in each generation would grow to approximately $640 million, while the same amount placed in the authors' Megatrust[SM] would grow to more than $10 *billion*. Richard A. Oshins & Jonathan Blattmachr, *The Megatrust[SM]: An Ideal Family Wealth Preservation Tool*, TR. & EST., Nov. 1991, at 20, 22-23 & Ex. 1.

[45]*See* Bloom, *supra* note 38, at 572-73. Using the formula *value of trust=x(1.06)ⁿ*, with x=$1.0 million, and n=300 years, if the trust earnings were compounded only annually the trust would grow to approximately $39 trillion over 300 years.

[46]*See, e.g.*, The First National Bank in Sioux Falls, *Dynasty Trust Services, available at* http://www.fnbsf.com/trust/index.php?id=30 (last visited Mar. 21, 2004) (describing the transfer tax advantages of establishing a trust in South Dakota); Wachovia Corporation, *Dynasty Trusts: Securing Your Wealth for Generations, available at* http://www.wachovia.com/wealth/page/0,,507_650_1704_1716,00.html (last visited Mar. 22, 2004) (describing the transfer tax advantages of establishing a trust in Delaware).

[47]Bloom, *supra* note 38, at 575.

[48]See *supra* notes 16-19 and accompanying text.

member transfers to her child a limited partnership interest in a family-owned limited partnership established under the law of State X. Assume that the default rule under the State X limited partnership statute permits a limited partner to withdraw from the partnership and receive the liquidation value of her interest. If the partnership agreement were to restrict the withdrawal right of a limited partner, this restriction would be ignored for valuation purposes under section 2704(b). As a general proposition, the value of a limited partnership interest without a withdrawal right would be considerably lower than the value of a limited partnership with a withdrawal right.[49]

Recall that section 2704(b) and its regulations make express reference to state law in determining what constitutes an applicable restriction.[50] Not surprisingly, many state legislatures have read this as an invitation to enact limited partnership statutes designed to achieve favorable results under section 2704(b).[51] For example, in 1997 the Virginia General Assembly modified its limited partnership statute to provide that "[a] limited partner may withdraw from a limited partnership *only* at the time or upon the happening of events specified in writing in the partnership agreement."[52] Thus, in Virginia, there is no default rule granting a withdrawal right to a limited partner. Consequently, any restrictions on withdrawal rights in the limited partnership agreement would *not* constitute applicable restrictions for purposes of section 2704(b).

3. *Consensual Community Property*

A third recent state law development seeks to take advantage of a federal income tax anomaly—section 1014(b)(6) of the Code.[53] Under that section, any

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[49]In most cases the former would be eligible for substantial lack-of-control and lack-of-marketability discounts from the underlying fractional value of the entity. *See* Kenneth P. Brier & Joseph B. Darby III, *Family Limited Partnerships: Decanting Family Investment Assets Into New Bottles*, 49 TAX LAW. 127, 129-30 (1995) (explaining that, for an interest in a family limited partnership holding non-business assets, liquidation value will typically be greater than the value of the interest itself).

[50]*See supra* notes 18-19 and accompanying text.

[51]*See generally* Gans, *supra* note 37, at 880-81, 881 & n.40, 883 (discussing this development and arguing that, by permitting states to manipulate federal tax results, Congress "abdicates its responsibility to determine federal tax policy").

[52]VA. CODE ANN. § 50-73.38 (Michie 2002) (emphasis added). Before 1997, the default rule under section 50-73.38 granted a limited partner a withdrawal right as follows:

> A limited partner may withdraw from a limited partnership at the time or upon the happening of events specified in writing in the partnership agreement. If the agreement does not specify in writing the time or the events upon the happening of which a limited partner may withdraw or a definite time for the dissolution and winding up of the limited partnership, a limited partner may withdraw upon not less than six months' prior written notice to each general partner at his address on the books of the limited partnership . . . .

VA. CODE ANN. § 50-73.38 (Michie 1996). *See also* 1997 Va. Acts ch. 188.

[53]Section 1014(b)(6) was enacted in 1948 as part of an effort to remove certain disparities in the income tax treatment of married couples in common law and community property law jurisdictions. Under the laws in effect as of 1948, in general in a common law jurisdiction up to one-half of a decedent's property could pass to the surviving spouse and qualify for the estate tax marital deduction, thus generating no estate tax with respect to that portion of the decedent's estate, but nevertheless affording the surviving spouse a basis adjustment under section 1014. The purpose of section

property representing a surviving spouse's share of community property owned with the deceased spouse receives an income tax basis equal to its fair market value. In most cases—because asset values will have appreciated during the spouses' lifetimes—the provision grants the surviving spouse a "stepped-up" basis in his or her share of community property. Moreover, by virtue of other portions of section 1014, the decedent's share of the community—which in many cases passes to the surviving spouse along with the share that the surviving spouse owns—will likewise have received a stepped-up basis at death. This so-called double basis step up may be contrasted with the typical result in a common law property jurisdiction. Assume, for example, that a couple living in a common law property jurisdiction owns property as tenants in common. At the death of the first spouse to die, only the decedent's share in the property will receive a stepped-up basis. The surviving spouse's share will remain as it was before the decedent's death.[54]

In 1998 Alaska enacted legislation authorizing married Alaska residents to classify any portion of their property as community property.[55] The legislation also authorizes married non-Alaskans to classify property as Alaska community property by transferring it to a community property trust and designating the property as community property in the trust agreement.[56] The principal objective of the legislation was to take advantage of the double basis step up under section 1014(b)(6).[57] Although the elective nature of the statute raises some doubts about its effectiveness for this purpose,[58] for a couple in a stable marriage, there would be little disadvantage in seeking the potential basis adjustment benefits of the statute.[59]

1014(b)(6) was to produce a roughly analogous result in community property jurisdictions with respect to the one-half share of the community owned by the surviving spouse (which is not considered part of the decedent's estate and thus would not be subject to estate taxation at the decedent's death). *See* 2 BITTKER & LOKKEN, *supra* note 15, ¶ 41.4.4, at 41-42; Arthur W. Andrews, *Community Property With Right of Survivorship: Uneasy Lies the Head That Wears a Crown of Surviving Spouse for Federal Income Tax Basis Purposes*, 17 VA. TAX REV. 577, 579 n.10 (1998). Current law allows an unlimited estate tax deduction for property that passes to the surviving spouse. *See* I.R.C. § 2056(a). Thus, current law permits the following anomalous results: a decedent in a community property jurisdiction may leave his or her entire share of the community to the surviving spouse, with the consequence that the estate owes no estate tax and, under section 1014, the surviving spouse benefits from a basis adjustment with respect to both the decedent's share and the surviving spouse's share of the community property; in a common law property jurisdiction, if the decedent leaves all of his or her property to the surviving spouse, the estate also owes no estate tax, but the surviving spouse enjoys a basis adjustment with respect to only the portion of the couple's property owned by the decedent.

[54]*See supra* note 53.

[55]Jonathan G. Blattmachr, Howard M. Zaritsky, & Mark L. Ascher, *Tax Planning With Consensual Community Property: Alaska's New Community Property Law*, 33 REAL PROP. PROB. & TR. J. 615, 617-18 (1999).

[56]*Id.* at 617.

[57]*See id.* at 617.

[58]*Id.* at 624-31; *see also infra* notes 154-55 and accompanying text (discussing the likelihood that a federal court would respect the Alaska legislation).

[59]*See* Blattmachr et al., *supra* note 55 at 631-32 (describing probable tax effects if Alaska community property does not fall with section 1014(b)(6)); *see also id.* at 646-47 (explaining that non-tax effects of Alaska community property rules would appeal mostly to couples in long-term, stable marriages).

4. *Asset Protection Trusts*

As a final example of state laws designed to achieve federal transfer tax advantages, consider the recent state legislation authorizing so-called asset protection trusts (APTs)—trusts in which the settlor retains a discretionary interest and the assets of which ostensibly are sheltered from the claims of the settlor's creditors.[60] To understand the transfer tax consequences of APTs, some background on the law of creditors' rights in trusts is instructive.

Until recently in the United States, a settlor could not establish a trust for her own benefit (sometimes called a "self-settled trust") that would effectively shield the trust assets from the claims of the settlor's creditors. Creditors' rights in a self-settled trust were enforced (and, in most jurisdictions, are still enforced) through application of two widely accepted principles. First, a spendthrift provision[61] in a self-settled trust is ineffective to prevent a creditor from reaching the settlor's interest directly from the trustee.[62] Second, the creditor of a settlor who reserves to herself a discretionary interest in a trust can effectively force the trustee to distribute to the creditor the maximum amount that could be distributed to the settlor which—in the case of a wholly discretionary trust—would be all of the assets of the trust.[63]

In recent years several states have enacted legislation permitting self-settled APTs. The background of this development has been chronicled adequately elsewhere;[64] its chief purpose has been to attract for domestic corporate fiduciaries the assets of settlors seeking creditor protection—assets that would otherwise have been transferred to trust companies operating offshore.[65] A secondary purpose of the domestic APT legislation has been to allow settlors to create trusts for their own benefit that will be excluded from their estates for estate tax purposes. The estate tax analysis proceeds along the following lines. If the assets of a self-settled discretionary trust can be reached by the settlor's creditors, the trust assets will be includible in the settlor's estate under both sections 2038 and 2036: under section 2038(a)(1)[66] because the settlor will be deemed to hold a

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[60]*See* Danforth, *supra* note 8, at 312-18 (describing the state legislation).

[61]*See supra* note 10.

[62]*See supra* note 11 and accompanying text; *see also* Danforth, *supra* note 8, at 291-93 (describing both the rule stated in the text as well as the contrary rule for trusts established for the benefit of persons other than the settlor).

[63]*See* Danforth, *supra* note 8, at 293-94.

[64]*See generally* Randall J. Gingiss, *Putting a Stop to "Asset Protection" Trusts*, 51 BAYLOR L. REV. 987 (1999); Henry J. Lischer, Jr., *Domestic Asset Protection Trusts: Pallbearers to Liability?*, 35 REAL PROP., PROB. & TR. J. 479 (2000); Stewart E. Sterk, *Asset Protection Trusts: Trust Law's Race to the Bottom?*, 85 CORNELL L. REV. 1035 (2000); Karen E. Boxx, *Gray's Ghost—A Conversation About the Onshore Trust*, 85 IOWA L. REV. 1195 (2000).

[65]*See* Danforth, *supra* note 8, at 306-18 (describing offshore APT legislation and the domestic laws enacted in response).

[66]Section 2038(a)(1) provides in pertinent part that:

> the gross estate shall include the value of all property . . . [t]o the extent of any interest therein of which the decedent has at any time made a transfer . . . by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power . . . to alter, amend, revoke, or terminate.

power to revoke, exercisable *indirectly* by incurring debt and then relegating his creditors to collecting from the trust;[67] under section 2036(a)(1)[68] because the settlor will be deemed to hold a right to the trust income, for essentially the same reason;[69] and under section 2036(a)(2)[70] because the settlor will be deemed to hold a right to designate the persons who shall enjoy the trust income, again for essentially the same reason.[71] With respect to APTs, the argument goes, the settlor will *not* be deemed *indirectly* to hold a power to revoke for purposes of section 2038(a)(1), a right to income for purposes of section 2036(a)(1), or a right to designate the beneficiaries for purposes of section 2036(a)(2), because state law prevents the settlor's creditors from satisfying their claims from the assets of the trust.[72] Thus, as long as the settlor does not *directly* retain any powers described in section 2038(a)(1),[73] a right to income as described in section 2036(a)(1),[74] or a right to designate as contemplated by section 2036(a)(2), the trust assets should be excluded from the settlor's estate.

The authority supporting this position is scant[75] but is consistent with more substantial authority concerning the analogous gift tax question, that is, whether

[67]Rev. Rul. 1977-378, 1977-2 C.B. 347.

[68]Under section 2036(a)(1):

> [t]he value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer . . . by trust or otherwise, under which he has retained for his life . . . the possession or enjoyment of, or the right to the income from, the property . . . .

[69]*See* Estate of Paxton v. Commissioner, 86 T.C. 785, 818 (1986) (applying Washington creditors' rights law).

[70]Section 2036(a)(2) includes in the gross estate:

> the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer . . . by trust or otherwise, under which he has retained for his life . . . the right . . . to designate the persons who shall possess or enjoy the property or the income therefrom.

[71]*Cf.* STEPHENS ET AL., *supra* note 16, & 4.08 [5][a] (stating that a power under section 2036(a)(2) may be retained "indirectly").

[72]*See generally* John K. Eason, *Home From the Islands: Domestic Asset Protection Trust Alternatives Impact Traditional Estate and Gift Tax Planning Considerations*, 52 FLA. L. REV. 41, 73-100 (2000).

[73]That is, a power to "alter, amend, revoke, or terminate." I.R.C. § 2038(a)(1).

[74]It is clear that a self-settled APT will *not* be excluded from the settlor's estate if the settlor retains a *mandatory* interest in trust income. I.R.C. § 2036(a)(1). To achieve estate tax exclusion, the settlor must retain no more than a *discretionary* interest in income. Whether a discretionary income interest by itself triggers section 2036(a)(1) is a matter of some debate, although the better view is that it does not. *See* STEPHENS ET AL., *supra* note 16, at ¶ 4.08[4][c]. Notwithstanding the retention of a mere discretionary interest under the terms of the trust, if a pattern of distributions suggests an arrangement (between the settlor and the trustee) that the settlor is to receive all income, section 2036(a)(1) will apply. *See id.*

[75]*See* Estate of German v. United States, 7 Cl. Ct. 641 (1985); Estate of Uhl v. Commissioner, 241 F.2d 867 (7th Cir. 1957), *rev'g* 25 T.C. 22 (1955). In *German*, because the government could "not establish[] that under Maryland law creditors of the settlor could have reached the trust income . . . of her discretionary trust," the Claims Court denied the government's motion for summary judgment on the issue of inclusion under section 2036(a)(1). *German*, 7 Cl. Ct. at 645. One cannot be certain from this decision whether the court would have ruled against section 2036 inclusion if Maryland law established conclusively that the settlor's creditors could *not* reach her interest. Slightly stronger

a transfer to a self-settled trust that is immune from the claims of the settlor's creditors is complete for gift tax purposes.[76] In a private ruling involving the Alaska APT legislation, the Service ruled that a transfer to a domestic APT is a complete gift for gift tax purposes, but it refused to rule on the estate tax inclusion question.[77]

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authority may be found in *Uhl*, in which the Seventh Circuit reversed the Tax Court's finding that, under Indiana law, the settlor's creditors could have reached his discretionary interest in a self-settled trust; on this basis, the court was unwilling to rule that the entire trust was includible under section 2036. 241 F.2d at 870-71. The decision is based primarily on the government's failure to prove Indiana law favorable to its position; it therefore provides only marginal support for non-inclusion under the circumstances of taxpayer-favorable state law.

[76]*See* Herzog v. Commissioner, 116 F.2d 591 (2d Cir. 1941); Rev. Rul. 1976-103, 1976-1 C.B. 293; Rev. Rul. 1977-378, 1977-2 C.B. 347. In *Herzog*, the settlor transferred property to a trust, the terms of which authorized the trustees to distribute income to the settlor, the settlor's wife, and (after the death of the wife) the settlor's children, at such times and in such shares as the trustees deemed appropriate. Following the settlor's death, the trust continued for the benefit of the wife if she survived the settlor and otherwise terminated in favor of the settlor's descendants. At issue was to what extent the settlor's transfer to the trust constituted a completed gift for purposes of the gift tax. The question whether the settlor's creditors could reach the income interest of the trust was relevant to the completed gift question, because, if under state law the settlor's creditors could reach the entire income interest, then the settlor would be deemed to have made a completed taxable gift only with respect to the remainder interests. The court decided that, under applicable state law, the settlor's creditors could not reach the income of the trust; thus, the transfer was properly characterized as a completed gift of both the income interest and the remainder interest. *Herzog*, 116 F.2d. at 593-96.

In Revenue Ruling 1976-103, the taxpayer created a self-settled trust in a state in which the trust assets were subject to creditors' claims; citing *Paolozzi v. Commissioner*, 23 T.C. 182 (1954), the Service ruled that the creditors' right to reach the trust assets rendered the transfer incomplete for gift tax purposes. The ruling further stated that,

> [i]f and when the grantor's dominion and control ceases, such as by the trustee's decision to move the situs of the trust to a State where the grantor's creditors cannot reach the trust assets, then the gift is complete for . . . gift tax purposes.

Rev. Rul. 1976-103, 1976-1 C.B. 293.

More directly on point is Revenue Ruling 1977-378, which concerned a self-settled, discretionary trust in a state whose laws protected the trust assets from creditors. Citing *Herzog*, the ruling states that,

> [w]hether [the grantor] would enjoy any of the . . . income depended entirely on the trustee, who, in his uncontrolled discretion, could deprive him of it completely. . . .
>
> In the instant case, the grantor has parted with dominion and control over the property that the grantor transferred into trust. Although the trustee has an unrestricted power to pay trust assets to the grantor, the grantor cannot require that any of the trust's assets be distributed to the grantor nor can the grantor utilize the assets by going into debt and relegating the grantor's creditors to the trust. . . . Accordingly, the Federal gift tax is applicable to the entire value of the property transferred to the trust by the grantor.

The ruling further clarified a prior ruling "to remove any implication that an entirely voluntary power held by a trustee to distribute all of the trust's assets to the grantor is sufficient to render a gift incomplete in whole or in part." Rev. Rul. 1977-378, 1977-2 C.B. 347.

[77]P.L.R. 1998-37-007 (June 10, 1998). The Service takes the position that a private ruling is binding on the Service only with respect to the taxpayer who requested it.

IV. TOWARD A FEDERAL COMMON LAW OF PROPERTY RIGHTS?

This Part of the Article considers two distinct, but related developments. It first examines two recent Supreme Court decisions expanding the reach of the section 6321 general federal tax lien;[78] the Article criticizes these cases as evincing a trend away from the traditional primacy of state law concerning property rights and their federal tax implications. Next, this Part critically examines federal case law and other authorities concerning whether the federal tax lien may be enforced against a spendthrift trust. These developments, too, represent encroachments on the traditional primacy of state law concerning property rights and federal taxation. Both developments are indirectly relevant to the state legislative gaming phenomenon; they suggest that some of these legislative efforts may not produce the favorable tax results that their proponents assert. It is to this question that the Article turns in Part V.

A. *The Supreme Court's Decisions in Drye and Craft*

The general federal tax lien under section 6321 arises after the Service has assessed a tax and the taxpayer has failed to pay it after notice and demand for payment.[79] The lien attaches to "all property and rights to property" of the taxpayer. The term "property and rights to property" is not defined in the Code or the regulations; thus, as one might rightly expect, the reach of the general tax lien in a particular case largely depends on the taxpayer's property rights under state law. To take a simple example, consider a parcel of land, the chain of title to which establishes that it was owned by the taxpayer's recently deceased father. If, under state law, the taxpayer is the father's sole heir and assuming no superior claims to the property by reason of debts, taxes, or expenses incurred by the father's estate, the land would be considered the taxpayer's property for purposes of section 6321. Consider the even simpler example of a receivable arising from a business transaction. In this case, the role of state law in determining the taxpayer's property is so obvious as to be not a matter of discussion.

It is in this context that the Court undertook a somewhat more challenging question—whether the general tax lien attaches to a disclaimed interest in a decedent's estate. The taxpayer's mother died intestate in 1994, a resident of Arkansas, leaving a $233,000 estate. The taxpayer was his mother's sole heir. At his mother's death, the taxpayer was insolvent and owed approximately $325,000 in unpaid federal tax assessments. Several months after his mother's death, the taxpayer disclaimed his interest in the estate. As is the case in most jurisdictions, under Arkansas law the disclaimer created the legal fiction that the disclaimant

[78]Section 6321 provides:

> If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

[79]*See* I.R.C. §§ 6201(a), 6203, 6303(a), 6321.

had predeceased his mother, causing his interest in the estate to pass instead to his daughter. At issue before the Court was whether the disclaimed interest constituted property of the taxpayer for purposes of section 6321.

In a unanimous opinion, the Court in *Drye v. United States*[80] held that the disclaimer did not defeat the federal tax lien. Responding to the taxpayer's argument that state law should control in determining whether the disclaimed interest constituted property, the Court described the traditional roles of state and federal law as follows:

> We look initially to state law to determine what rights the taxpayer has in the property the Government seeks to reach, then to federal law to determine whether the taxpayer's state-delineated rights qualify as "property" or "rights to property" within the compass of the federal tax lien legislation.[81]

The Court concluded that, notwithstanding the state law "fiction that the [taxpayer] predeceased"[82] his mother, the reality was that the taxpayer survived his mother and, at his mother's death, the taxpayer held "a valuable, transferable, legally protected property right to the property at issue."[83] According to the Court, the Arkansas disclaimer statute gave the taxpayer "a right of considerable value—the right either to inherit or to channel the inheritance to a close family member (the next lineal descendant),"[84] under the circumstances the taxpayer's daughter. The Court further stated that a disclaimant "inevitably exercises dominion over the property. He determines who will receive the property—himself if he does not disclaim, a known other if he does. . . . This power to channel the estate's assets warrants the conclusion that [the taxpayer] held 'property' or a 'righ[t] to property' subject to the Government's liens."[85]

Drye is reminiscent of *Morgan*[86] and its distinction between substance and nomenclature; the Court in *Drye* ignored the state law fiction that the taxpayer had predeceased his mother and focused on the substance of the transaction. In substance, the taxpayer survived his mother and, by doing so, had a right to receive her estate. But *Drye* also disregarded a more subtle—and yet substantial—aspect of state disclaimer law: that disclaimers play an integral role in the planning and disposition of decedents' estates, a matter traditionally reserved to the states. By allowing the imposition of the lien on the disclaimed property, the Court essentially permitted the lien to attach to property that, under state law, properly belonged to the taxpayer's daughter.[87] More significantly, the lien may

[80]528 U.S. 49 (1999).
[81]*Id.* at 58.
[82]*Id.* at 53 (citing ARK. CODE ANN. §§ 28-2-101, 28-2-107 (1987)).
[83]*Id.* at 59 (citing with approval the observations of the Eighth Circuit in earlier proceedings).
[84]*See id.* at 60.
[85]Drye v. United States, 528 U.S. 49, 61 (1999) (citation omitted).
[86]*See supra* notes 20-24 and accompanying text.
[87]This characterization admittedly overstates the benign role of the daughter. In fact, after the disclaimer, the daughter immediately transferred the disclaimed assets into a discretionary, spendthrift trust for the benefit of herself, her mother, and the taxpayer. Under state law, the assets of the trust would be sheltered from the claims of the beneficiaries' creditors.

have disturbed the reasonable expectations of the taxpayer's mother concerning the proper ordering of her affairs.

To illustrate the point, consider the following, presumably fictional, scenario. The mother in *Drye*, aware of her son's tax debt and insolvency, does not wish to leave him her modest estate, only to have the assets liquidated for distribution to the government. After consulting an estate-planning lawyer, she considers several alternative estate plans. One option, the estate planner tells her, would be to execute a will directing her executor (someone other than the son) to make the following alternative distributions of her residuary estate: to her son if he survives her, but only if her son is solvent at her death, otherwise to her granddaughter if she survives her. This plan, the lawyer assures her, would immunize her assets from the government's claim, because the son would have no enforceable right to receive the assets (assuming that he remains insolvent). Another option, the planner advises the mother, would be to omit her son altogether, by leaving her property to the granddaughter, but include precatory language in the will requesting that the granddaughter make gifts to her father if those gifts would not be subject to attachment by the government. The mother's lawyer explains that this arrangement would create only a moral—not a legal—obligation for the granddaughter to make the anticipated gifts. A third option would be a somewhat more sophisticated plan. The mother would execute a will leaving her estate to a wholly discretionary trust (with an independent trustee) for the benefit of the son, his wife, and his daughter (essentially the same trust in fact established by the taxpayer's daughter in Drye).[88] The planner advises the mother that, under state law, an individual beneficiary of a wholly discretionary trust for multiple beneficiaries cannot compel trust distributions to himself, and that this characteristic of her son's interest in the trust should also protect her assets from the government's claim.[89]

Now suppose that the mother, having been advised of these alternative plans, asks whether there is a simpler, less expensive alternative that will also accomplish her essential objective—to leave her property to her son, but only if he is solvent, and otherwise to her granddaughter. Her estate planner informs her that, if she dies intestate, under Arkansas law her property will pass to her son if he survives her, and otherwise to the son's daughter. The planner also informs the mother that Arkansas law authorizes the son to disclaim his interest, and that for purposes of determining the rights of all persons to the estate, the son would then be treated as having predeceased the decedent. The mother opts for this

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The creation of the post-disclaimer trust suggests that the case might have been resolved on simpler grounds. Under Arkansas law—as under the law of most jurisdictions—a valid disclaimer must be executed gratuitously, *i.e.*, without consideration. *See* ARK. CODE ANN. § 28-2-102(3) (1987) (providing that the right to disclaim is barred by "[a]n acceptance of the [disclaimed] property or interest or a benefit thereunder"). The daughter's immediate transfer of the disclaimed assets into a trust for the benefit of the disclaimant looks suspiciously like a *quid pro quo*, which under the Arkansas disclaimer statute would likely render the disclaimer ineffective.

[88] *See supra* note 87.

[89] *See infra* notes 141-43 and accompanying text.

relatively simple, cost-free estate plan—one based entirely on the default rules of Arkansas law. In hindsight, of course, the mother would have been ill-advised to allow her estate to pass by intestacy and through the disclaimer mechanism.

This presumably fictional, though plausible, scenario illustrates that disclaimers are an integral part of estate planning on which estate planners and their clients rely for purposes of carrying out a client's intent. Under Arkansas law, disclaimed property does not *belong* to the disclaimant; it belongs to the person to whom it passes. By disregarding this aspect of state disclaimer law, the Court in *Drye* failed to take into account the legitimate interests of both the taxpayer's mother and the taxpayer's daughter. Considering the problem especially from the mother's perspective, it is her prerogative to dispose of her estate as she wishes. Had she received competent advice, and if she were competent to write a will, it is inconceivable that she would have left her property unconditionally to her son, only to have neither her son nor her granddaughter enjoy any of its benefits. Instead, she would have employed one of the testate plans earlier described, defeating the government's claim according to her wishes.

Only a few years after *Drye*, the Court again considered a question concerning the reach of section 6321. A husband and wife, residents of Michigan, owned a parcel of land as tenants by the entirety. In Michigan, as is true in most states that recognize this form of ownership, property held as tenants by the entirety is subject to attachment by the spouses' *joint* creditors but not the creditors of an individual spouse.[90] Over a period of several years, the husband failed to file income tax returns, giving rise to deficiency assessments against the husband, but not the wife. When the husband failed to pay the deficiencies, a section 6321 lien attached to all of the husband's "property and rights to property."

Shortly following the attachment of the government's lien, the couple executed a quitclaim deed transferring their joint interest in the property to the wife. A few years later, the wife attempted to sell the property, but a title search revealed the lien. The government agreed to release the lien on the condition that the wife place half the proceeds in escrow pending determination of the government's rights to the property. The wife brought an action to quiet title to the escrow account, giving rise to the litigation that wound its way to the Supreme Court, resulting in a 6-3 decision supporting the government.

The majority in *United States v. Craft*[91] presented the question essentially as follows: "[w]hether the interests of respondent's husband in the property he held as tenants by the entirety constitutes 'property [or] rights to property' for pur-

[90]*See* Sanford v. Bertrau, 169 N.W. 880, 881 (Mich. 1918); *see* ROBERT T. DANFORTH, TAXATION OF JOINTLY OWNED PROPERTY, TAX MANAGEMENT: ESTATES, GIFTS & TRUSTS PORTFOLIOS, A-6 (BNA 1998). In a minority of the states that recognize tenancies by the entirety, the lien of a creditor of one spouse can attach to the property, but subject to the rights of the other spouse—*i.e.*, the lien cannot be levied upon until the entireties estate ends (by joint consent of the spouses, by divorce, or by death of the non-debtor spouse). *Id.*

[91]535 U.S. 274 (2002).

poses of [section 6321]."[92] Acknowledging that the lien statute "creates no property rights but merely attaches consequences, federally defined, to rights created under state law,"[93] the majority first looked to state law to determine the nature of the husband's rights in the property. After reviewing the history of tenancies by the entirety, the majority concluded that the husband held substantial rights in the property—in the words of the majority, the "sticks" included in the "bundle of sticks"[94] constituting the parcel of land: the right to use the property, exclude others from using it, and share in its income; the right of survivorship; the right to become a tenant in common upon divorce; the right to sell or encumber the property, with his wife's consent; the right to withhold consent from selling or encumbering the property.[95] Having determined the husband's rights in the property under state law, the majority next considered whether those rights constituted "property" or "rights to property" within the meaning of section 6321. The majority concluded that they did, discounting (both expressly and implicitly) several relevant attributes of Michigan law—the husband's inability to convey his interest without his wife's consent, the husband's inability to defeat his wife's right of survivorship, and the immunity of the property from the husband's creditors.

Justice Thomas, joined by Justices Stevens and Scalia, issued a scathing dissent. Justice Thomas criticized the majority for focusing on only certain attributes of ownership of the husband:

> [T]he Court proposes that so long as sufficient "sticks" in the bundle of "rights to property" "belong to" a delinquent taxpayer, the lien can attach *as if the property itself belonged to the taxpayer*....
>
> This amorphous construct ignores the primacy of state law in defining property interests, eviscerates the statutory distinction between "property" and "rights to property" drawn by § 6321, and conflicts with an unbroken line of authority from this Court, the lower courts, and the IRS.[96]

Citing the traditional primacy of state law in determining the nature of a taxpayer's property interests, Justice Thomas observed that:

> the Government's lien under § 6321 "cannot extend beyond the property interests held by the delinquent taxpayer"... under state law. Before today, no one disputed that the IRS, by operation of § 6321, "steps into the taxpayer's shoes," and has the same rights as the taxpayer in property or rights to property subject to the lien.... I would not expand "the nature of the legal interest" the taxpayer has in the property beyond those interests recognized under state law.[97]

Justice Thomas's principal and most compelling criticism was that the property in question simply did not "belong" to the taxpayer—"pursuant to Michigan

[92] *Id.* at 278.
[93] *Id.* (quoting United States v. Bess, 357 U.S. 51, 55 (1958)).
[94] *Id.* at 278-79.
[95] *Id.* at 282.
[96] United States v. Craft, 535 U.S. 274, 291 (2002) (Thomas, J., dissenting) (emphasis added).
[97] *Id.* at 291-92 (Thomas, J., dissenting) (citations omitted).

law, . . . property held as a tenancy by the entirety does not belong to either spouse, but to a single entity composed of the married persons."[98] Justice Thomas then criticized the majority for relegating this attribute of Michigan property law to the *Drye* category of state-law "fictions"—those attributes of state law that are not controlling for federal tax purposes. According to Justice Thomas, the *Drye* analysis might have made sense in considering a state law disclaimer rule, because the taxpayer in *Drye* admittedly had a right to his inheritance in the first place; thus, *Drye* was concerned with whether the state law "fiction" could be used to "undo a vested right in an estate that the taxpayer already held."[99] But, Justice Thomas argued, ignoring the attributes of tenancies by the entirety constituted a much more dramatic usurpation of the state's prerogative to define and qualify property rights:

> Extending this Court's "state law fiction" jurisprudence to determine whether property or rights to property *exist* under state law in the first place works a sea change in the role States have traditionally played in "creating and defining" property interests. By erasing the careful line between state laws that purport to disclaim or exempt property interests after the fact, which the federal tax lien does not respect, and state laws' definition of property and property rights, which the federal tax lien does respect, the Court does not follow *Drye*, but rather creates a new federal common law of property. This contravenes the previously settled rule that the definition and scope of property is left to the States.[100]

Justice Thomas further argued that the majority, through its bundle-of-sticks metaphor, failed to distinguish between "property" and "rights to property," as used by section 6321. According to Justice Thomas, by cataloging the various rights to property held by the taxpayer—*i.e.*, the sticks in the bundle—the majority improperly concluded that the parcel of land constituted property of the taxpayer. While the federal tax lien might have attached to one of the husband's separate *rights* in the property—his right to income, for example—Justice Thomas argued, it could not properly attach to the property itself.[101] In formulating this argument, Justice Thomas analogized the husband's interest in the tenancy by the entirety to a partner's interest in a partnership: a lien arising from a tax deficiency of an individual partner attaches to the partner's interest in the partnership, not to the underlying partnership assets.[102] In conclusion, Justice Thomas argued:

> [W]hile the majority characterizes Michigan's view that the tenancy by the entirety property does not belong to the individual spouses as a "state law fiction," our precedents . . . hold that state, not federal, law defines property

[98] *Id.* at 292 (Thomas, J., dissenting).
[99] *Id.* at 293 (Thomas, J., dissenting).
[100] *Id.* at 293-94 (Thomas, J., dissenting) (emphasis in original).
[101] *Id.* at 294-99 (Thomas, J., dissenting).
[102] United States v. Craft, 535 U.S. 274, 295 n.4 (2002) (Thomas, J., dissenting).

> interests. Ownership by "the marriage" is admittedly a fiction of sorts, but so is a partnership or corporation. There is no basis for ignoring this fiction so long as federal law does not define property, particularly since the tenancy by the entirety property remains subject to lien for the tax liability of *both* tenants.
>
> Just as I am unwilling to overturn this Court's longstanding precedent that States define and create property rights and forms of ownership, . . . I am equally unwilling to redefine or dismiss as fictional forms of property ownership that the State has recognized in favor of an amorphous federal common-law definition of property.[103]

A microcosm of the majority's and dissent's disagreement is contained in their differing views on the relevance of how partnership assets are treated for tax lien purposes. As noted earlier, Justice Thomas sees a tenancy by the entirety as properly analogous to a partnership—the tax deficiencies of a single partner give rise to a lien not against the partnership assets, but rather against the interest of the partner; the tenancy by the entirety state-law fiction should be respected to the same extent as the partnership fiction. The majority's response to this argument is to acknowledge that its decision does disparately treat tenancy by the entirety property and partnership property. This disparity, however, the majority argues, arises not from its decision in *Craft* but rather from the Court's earlier decision in *United States v. Rodgers*.[104] Moreover, it is the theory of the *dissent*, not the majority, "that departs from partnership law, as it would hold that the . . . lien does not attach to the husband's interest in the entireties property at all, whereas the lien may attach to an individual's interest in partnership property."[105]

To understand the majority's point requires a brief introduction to *Rodgers*,[106] in which the Court held that the government could enforce its tax lien against property subject to the Texas homestead rights of the taxpayer's surviving spouse. The taxpayer and his wife owned a residence as community property in Texas. The government assessed taxes, interest, and penalties against the taxpayer, which remained unpaid as of his death. Oversimplifying somewhat, the Texas homestead laws essentially gave to the widow a life estate in the taxpayer's share of the community, with a remainder interest in the husband's share having passed at the taxpayer's death to the beneficiaries of his estate.[107] The Court ruled that the government could enforce its lien against the homestead property, although the widow would need to be compensated for the value of the life estate of which she had been deprived.[108] Of key importance to the majority in *Craft* was that the taxpayer in *Rodgers* had no unilateral right to alienate the homestead property and that the Court approved enforcement of the lien despite

[103] *Id.* at 301 (Thomas, J., dissenting) (citations omitted).
[104] *Id.* at 286 (citing United States v. Rodgers, 461 U.S. 677 (1983)).
[105] *Id.*
[106] 461 U.S. 677 (1983).
[107] *See id.* at 685.
[108] *Id.* at 697-99.

this.[109] In other words, *Rodgers* approved granting the government somewhat greater rights in the property than those held by the taxpayer.

Putting aside the question whether *Rodgers* was properly decided,[110] there is a significant distinction between the homestead rights at issue in *Rodgers* and the tenancy by the entirety at issue in *Craft*. A tenancy by the entirety gives the surviving spouse a right of absolute ownership of both the spouse's share and the decedent's share in the property, as opposed to the functional equivalent of a life estate in the decedent's share. Stated another way, the community property interest in *Rodgers* was descendible at the taxpayer's death, subject to the homestead rights of the surviving spouse, while a tenancy by the entirety interest is not descendible at all. Allowing the taxpayer's lien to be enforced against the homestead property in *Rodgers* did not deprive the surviving spouse of anything of monetary value;[111] the Rodgers majority properly recognized that the spouse must be compensated for the actuarial value of her interest, equivalent to a life estate in the taxpayer's one-half share. On the other hand, permitting the government a lien against tenancy by the entirety property may deprive the non-debtor spouse of a valuable property interest. Consider a simple example. A husband and wife own real property as tenants by the entirety. The Service assesses a tax deficiency against the husband (but not the wife) and, under the authority of *Craft*, obtains a lien against the property. The government seeks a judicial sale of the property. At the sale, the court orders the wife to receive a portion of the proceeds equal to the value of her interest in the property, taking into consideration the spouses' relative ages[112] and thus the actuarial likelihood that the wife will survive her husband. Note, however, that if the wife in fact survived her husband, she would have become the outright owner of the property. Under those circumstances, the earlier enforcement of the lien would have, in retrospect, deprived her of a valuable property interest, likely not the case in *Rodgers*.[113] The majority in *Craft* never mentioned that the husband died before its decision and that the decision thus permitted the government to enforce its lien to the financial detriment of the surviving spouse.

Moreover, contrary to the criticisms of the majority in *Craft*, the dissent's views of tenancies by the entirety and partnerships are not incompatible. Carry-

[109] *Craft*, 535 U.S. at 284.

[110] *Rodgers*, too, raises federalism concerns. *See infra* notes 116-17 and accompanying text.

[111] *But see infra* note 113.

[112] *See* DANFORTH, *supra* note 90, at A-20 (describing actuarial valuation of interests in tenancies by the entirety). This is admittedly only one of several possible ways for a court to determine the value of the wife's interest. *See* Steve R. Johnson, *After* Craft*: Implementation Issues*, 96 TAX NOTES (TA) 553, 564-68 (July 22, 2002) (describing three alternative methods for valuing a spouse's interest in entirety property).

[113] Of course, the spouse in *Rodgers* could have lost the actuarial gamble associated with valuing her interest—she might have lived longer than her actuarial life expectancy and, in retrospect, have been inadequately compensated for the loss of her life interest. On the other hand, she might just as easily have *won* the gamble, by *failing* to live for her actuarial life expectancy.

ing the dissent's approach to its logical conclusion, the government, through its lien, would obtain a right to precisely that which was held by the taxpayer.[114] This would mean that, without the consent of the taxpayer's spouse, the property could not be sold during the spouse's lifetime and, conversely, without the consent of the government, the spouse could not sell the property. If the taxpayer survived his spouse, the government could recover the taxpayer's deficiency. On the other hand, if the spouse survived the taxpayer, the surviving spouse would take the property free of the government's lien. If the taxpayer and the spouse desired to sell the property during their lifetimes, they could do so only by obtaining the government's consent, which would require them first to satisfy the government's lien.[115] This approach would be consistent with the dissenter's view that the government should step into the shoes of the taxpayer and should obtain no greater rights in the property than the taxpayer held himself.

The majority in *Craft* relied considerably on *Drye*'s refusal to give controlling effect to state law fictions. But the majority in *Craft* failed to recognize a significant distinction between the fictions at issue in the two cases. In *Drye*, Arkansas law characterized the taxpayer-disclaimant as having predeceased his mother for purposes of determining his rights to her estate. In substance, however, it was clear that the taxpayer did *not* predecease his mother and, consequently, had an absolute right to receive his interest in the mother's estate. This state law fiction is reminiscent of the distinction between substance and nomenclature in *Morgan*. By contrast, in *Craft* the state law fiction that the *couple* (as opposed to each spouse individually) owned the property was correct as a matter of substance, in the same manner that an entity—such as a partnership or a corporation—rather than its partners or shareholders, owns the property titled in its name. In both cases, no co-owner has an unrestricted power to dispose of his or her share of the property held by the entity. Even more importantly, an interest in a tenancy by the entirety is subject to the absolute right of survivorship of the co-owner spouse. As a result of *Craft*, the government has significantly greater rights in the taxpayer's property than does the taxpayer himself.

Finally, even if, as the majority asserted, its decision in *Craft* had its basis in *Rodgers*, *Rodgers* itself raises significant federalism concerns. Most importantly, *Rodgers* disregarded substantive limitations that state law imposed on the power of the taxpayer (and his successors in interest) to dispose of his property interest during his spouse's lifetime. A decision properly respectful of state law would have permitted the government's lien to attach to the property but would have

[114]Without deciding the question, Justice Thomas assumed that the government's lien could attach to the separate "rights to property" held by the taxpayer, even though the lien could not attach to the parcel of land itself. *Craft*, 535 U.S. at 294 n.2, 298 (Thomas, J., dissenting).

[115]The value to be assigned to the lien would be a matter of negotiation between the government, the taxpayer, and the taxpayer's spouse. Actuarial principles may suggest that, due to a disparity in the ages of the spouses or other factors, the value of the taxpayer's interest may be more or less than the value of the spouse's interest.

granted the government no greater powers in the property than those held by the taxpayer—in other words, the government would have been required to wait until the surviving spouse's death to enforce its lien. This approach would have placed the government in no worse and no better position than other creditors, would not have placed an undue hardship on the government,[116] and would have adequately protected the interest of the government in enforcing the tax laws[117] while at the same time demonstrating proper deference to Texas law.

B. *The Common Law of Federal Tax Liens and Spendthrift Trusts*

Although Justice Thomas decried the creation of "a new federal common law of property,"[118] *Craft* was by no means the first instance of a federal court redefining state property rights for the purpose of enforcing the general tax lien—federal courts have done so for years with respect to taxpayers' interests in spendthrift trusts, with apparently little notice. This section of the Article critically examines the leading cases and other authorities in this area after first introducing briefly the concept of a spendthrift trust.

As a general rule, except as otherwise provided by law or by the governing instrument, a beneficiary's interest in a trust is freely transferable, either gratuitously or for consideration.[119] A transfer of a beneficiary's interest can occur *voluntarily*, as in the case of a gift, sale, or granting of a security interest, or *involuntarily*, as in the case of attachment by a creditor. To protect a beneficiary from his or her own improvidence, most trusts include a spendthrift provision, precluding both voluntary and involuntary transfers of the beneficiary's interest.[120] Another tool for protecting a beneficiary interest is to make the interest wholly discretionary by, for example, authorizing the trustee to distribute income and principal in such amounts and for such purposes as the trustee deems appropriate. As a practical matter, a beneficiary holding a discretionary interest is unable to compel distributions from the trust; a creditor standing in the beneficiary's shoes would similarly be unable to compel distributions to either the beneficiary or itself.[121]

It has long been accepted that spendthrift provisions are ineffective with respect to federal tax liens.[122] The leading federal case for this proposition is

[116]Note that the property could not have been sold as long as the lien remained in place. If the spouse desired to sell the property, she would be forced to negotiate with the government for the lien's release.

[117]Assuming, as would usually be the case, that the property appreciated in value during the spouse's lifetime, the delay in enforcing its lien should not cause the government financial harm.

[118]United States v. Craft, 535 U.S. 274, 294 (2002) (Thomas, J., dissenting).

[119]*See generally* Danforth, *supra* note 8, at 291.

[120]*See supra* note 11 and accompanying text.

[121]*See* Danforth, *supra* note 8, at 292.

[122]*See* IIA AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, THE LAW OF TRUSTS § 157.4 (4th ed. 1987) (citing cases) [hereinafter SCOTT ON TRUSTS (4th ed.)]; *see also* I AUSTIN WAKEMAN SCOTT, THE LAW OF TRUSTS § 157.4 (1939); RESTATEMENT (SECOND) OF TRUSTS § 157(d) cmt. e (1959); *see also* RESTATEMENT (THIRD) OF TRUSTS § 59 cmt. a (2003); UNIF. TRUST CODE § 503(c) cmt. (2001).

United States v. Dallas National Bank,[123] and its reasoning is typical of cases considering this question. The taxpayer was the beneficiary under a Texas testamentary trust and was subject to federal tax deficiencies concerning income realized from non-trust transactions. The terms of the trust required the trustee to distribute to the taxpayer a fractional share of the trust income,[124] and the trust included a spendthrift provision, which was valid under Texas law.[125] At issue in the case was whether the beneficiary's interest in the trust constituted "property" for purposes of the federal tax lien. The court cited *Morgan v. Commissioner*[126] for the proposition that state law is controlling in defining the nature and extent of the beneficiary's property interests and that, accordingly, whether the beneficiary's interest constituted property "must be determined by the law of Texas."[127] Notwithstanding the validity of spendthrift provisions under Texas law, the court stated that they would not be controlling in the case of a federal tax lien:

> Although the testatrix intended to create an estate which would not be subject to seizure, sale, or execution for debts of any kind or character by placing such restraint upon the corpus and income, and such provisions in a will are valid under the Texas law and are respected by the courts, this would not prevail against the fastening of a lien by the Federal Government for unpaid taxes on any property owned by the delinquent taxpayer.
>
> . . . Having been enacted within the scope of the power delegated to the Federal Government, the Internal Revenue statutes are a part of the supreme law of the land. If they are in conflict with State law, constitutional or statutory, the latter must yield.
>
> The provisions of the will of an individual which seek to exempt from debts property bequeathed for the benefit of another cannot rise higher than a statutory or constitutional exemption provided by a State.[128]

Thus, in effect relying on the Supremacy Clause[129] for its authority, the court ruled that the government's lien could attach to the taxpayer's income interest. Similarly, in *Leuschner v. First Western Bank & Trust Co.*,[130] the court approved the government's argument that,

> [U]nder the Income Tax Amendment to the Federal Constitution, Amend. 16, a lien for unpaid income tax may be levied and collected from all property or income received by a person, irrespective of private agreements or laws of the

[123] 152 F.2d 582 (5th Cir. 1945); *see also* United States v. Dallas National Bank, 164 F.2d 489 (5th Cir. 1947) (later proceedings concerning enforcement question).

[124] 152 F.2d at 584-85 (indicating that, although the beneficiary did not hold title to the trust property, she was "to receive . . . a proportionate part of the net revenues"). The balance of the trust income was payable to other beneficiaries. *Id.* at 584.

[125] *Id.* at 585 & n.2.

[126] 309 U.S. 78 (1940). *See also* supra notes 20-24 and accompanying text (discussing *Morgan*).

[127] 152 F.2d at 584.

[128] *Id.* at 584-85.

[129] U.S. CONST. art. VI, § 1, cl. 2.

[130] 261 F.2d 705 (9th Cir. 1958).

> states to the contrary. . . . [The California statute validating the use of spendthrift provisions] attempts to provide an exemption for the beneficiary which is valid as to creditors. In view of the paramount amendment, [the income of the trust] cannot be isolated from the lien of the United States.[131]

Citing to the first Restatement for its support, the court concluded that "[t]here is no doubt that the paramount right to collect taxes of the federal government overrides a state statute providing for exemptions."[132]

The problem with the reasoning in both of these opinions is that there simply is no supreme federal law stating that an interest in a trust subject to a spendthrift provision is property for purposes of the tax lien. The courts' reasoning only begs the question: yes, if the Code expressly included spendthrift trust interests in its definition of property for purposes of the tax lien, the Code provision would trump both state law and the provisions of any trust; in fact, however, the Code simply imposes the lien on the taxpayer's "property," leaving it to state law to determine what that property is. By concluding without statutory support that the spendthrift provision can be ignored, the courts are, in effect, writing a common law of property for federal tax purposes.[133]

The defective reasoning in *Dallas National Bank* and *Leuschner* can be explained in part by both courts' references to a spendthrift provision as an "exemption." In other words, the courts saw the spendthrift provision as being comparable to a state law that exempts from creditors' claims certain categories of property, such as an interest in a homestead or a life insurance policy.[134] But exemptions and spendthrift provisions are distinguishable in several important respects. First, if a statute grants an exemption to a particular category of property, the exemption applies whether or not the property was acquired gratuitously or for consideration. In most cases, exempt property has been acquired for consideration by the person to whom the exemption applies. Thus, for example, a person who invests in a policy of insurance on his life himself enjoys the benefit of the exemption. On the other hand, a spendthrift provision that is valid under state law arises with respect to a gratuitous transfer from someone other than the beneficiary.[135] Second, whether a person owns exempt property is generally within the control of the person who acquired the property. Thus, the

[131]*Id.* at 707.

[132]*Id.* at 707-08, citing RESTATEMENT TRUSTS § 157 (Supp. 1948).

[133]This misunderstanding is also reflected in the Uniform Trust Code. The Comment to section 503 (setting forth exceptions to the enforceability of spendthrift provisions) states that "[f]ederal preemption guarantees that certain federal claims, such as claims by the Internal Revenue Service, may bypass a spendthrift provision no matter what this Code might say." UNIF. TRUST CODE § 503 cmt. (2000). The reference in section 6321 to property and rights to property implicitly depends on state property law definitions; thus, section 6321 is not an example of preemption. Section 6321 would preempt state law if it expressly included in the definition of property an interest in trust subject to an otherwise valid spendthrift provision.

[134]*See generally* Danforth, *supra* note 8, at 341-43 (discussing state exemption laws).

[135]In only a few United States jurisdictions is a settlor permitted to create a valid spendthrift trust for the benefit of himself. In all other jurisdictions, a spendthrift provision in a self-settled trust is ineffective. *See* Danforth, *supra* note 8 and accompanying text.

purchaser of the insurance policy in our example could have chosen to invest his money in other, non-exempt assets. In the case of a spendthrift trust, on the other hand, the beneficiary has no choice in the matter; the spendthrift provision was included in the trust by the settlor, and its continued effectiveness is not within the control of the beneficiary. In fact, the prevailing view is that a spendthrift provision is ineffective if it purports to limit *only involuntary* transfers of the beneficiary's interest;[136] in other words, the provision will protect the beneficiary's interest from his or her creditors only if it also prevents the beneficiary from making a voluntary transfer of the interest.

Most importantly, an exemption exists by state legislative grace; calling a spendthrift provision an exemption thus bolstered the reasoning of decisions such as *Dallas National Bank* and *Leuschner* that the Supremacy Clause should preclude its effectiveness against a tax lien. If the Code imposes a lien on a taxpayer's property, the Supremacy Clause logically should prevent the states from saying that the lien does not apply to certain categories of property. On the other hand, a spendthrift provision exists because a settlor has imposed restrictions on the beneficiary's enjoyment of the property. A spendthrift provision thus serves to define the nature and extent of the interest that the beneficiary received; it is an intrinsic element of the property interest itself. Using *Dallas National Bank* as an example, the taxpayer did not own an outright interest in the trust property, nor did the taxpayer own an unqualified right to income from the property. Instead, the beneficiary owned an *inalienable* right to income—a valuable property right, yes, but one made less valuable by the spendthrift provision. Its inalienability was as much a characteristic of the property as was the fact that it was held in trust.

Despite the deficiencies in their reasoning, cases such as *Dallas National Bank* and *Leuschner* express the prevailing view,[137] including the approach taken by Professor Scott and the Restatements.[138] A contrary view concerning a related question was adopted by the Minnesota Supreme Court. In upholding a spendthrift clause against the claim of a spouse for alimony and child support, the court criticized the Restatement position that spendthrift provisions are ineffective with respect to certain categories of creditors; the importance of certain categories of claims, the court reasoned, "should not . . . transcend the right of

[136] *See, e.g.*, 2A Scott on Trusts (4th ed.), *supra* note 122, § 152.3, at 113-

[137] *See, e.g.*, LaSalle National Bank v. United States, 636 F. Supp. 874, 875-76 (N.D. Ill. 1986) (refusing to give effect to Illinois statute providing that trust established in good faith may not be attached by the beneficiary's creditor); United States v. Riggs National Bank, 636 F. Supp. 172, 175-77 (D. D.C. 1986) (refusing to give effect to spendthrift provision or to provision under which beneficiary forfeited his interest in trust upon attempt to attach the beneficiary's interest); *In re* Orr, 180 F.3d 656, 662-64 (5th Cir. 1999) (refusing to give effect to spendthrift provision); Merchantile Trust Co. v. Bert, 58 F. Supp. 701, 704-06 (D. Md. 1944) (refusing to give effect to spendthrift provision); Bank One Ohio Trust Co. v. United States, 80 F.3d 173, 176 (6th Cir. 1996) (refusing to give effect to spendthrift provision); *In re* Rosenberg's Will, 199 N.E. 206, 206-08 (N.Y. 1935) (refusing to give effect to New York statute providing that trust interest could not be assigned).

[138] *See supra* note 122 and accompanying text.

the donor to do as he pleases with his own property."[139] Thus, according to the court, it is the nature of the interest held in trust, not the nature of the claim, that should be controlling.[140]

The approaches of *Dallas National Bank*, *Leuschner*, and other cases concerning spendthrift provisions may be contrasted with the federal courts' approach to discretionary interests in trust. For example, in *In re Wilson v. United States*,[141] the taxpayer was the beneficiary of a testamentary trust, the terms of which granted the trustee absolute discretion concerning distributions of income to the taxpayer. Any income not distributed during the taxpayer's lifetime was to be distributed to her descendants at her death. The trust gave the taxpayer no rights to any distributions to principal. The trust also included a standard spendthrift provision. At issue was whether the taxpayer's interest in the income of the trust constituted "property" or "rights to property" within the meaning of section 6321.

Citing numerous authorities to this effect, the court stated that, under Texas law, because the beneficiary of a discretionary trust cannot demand trust distributions, the beneficiary's creditors similarly have no right to reach the trust assets, except to the extent that distributions to the beneficiary actually occur.[142] Thus, the court concluded, the taxpayer's discretionary interest in the trust did

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[139]Erickson v. Erickson, 266 N.W. 161, 164 (Minn. 1936).

[140]The court elaborated on these points as follows:

> We are not impressed with the soundness of [the Restatement position]. In the case at bar it would be an attempt to judicially interpret into the language of the donor, provisions contrary to his actual intent as expressed. When unrestrained by statute it is the intent of the donor, not the character of the donee's obligation, which controls the availability and disposition of his gift. The donee's obligation to pay alimony or support money, paramount though it may be, should not, in our opinion, transcend the right of the donor to do as he pleases with his own property and to choose the object of his bounty. Our conclusion does not arise out of any anxiety for the protection of the beneficiary. In the absence of statute and within the limits as to perpetuities, a donor may dispose of his property as he sees fit, and this includes corpus or principal as well as income. . . . As a general proposition, when a donor leaves the interest of the beneficiary assignable or transferable it may be reached by creditors. If by appropriate language the right to transfer is completely restrained, then such interest may not be reached by creditors. . . . To hold otherwise would be to defeat the testator's or donor's right and his manifest intent. If alimony or support money is to be an exception to the protection offered by spendthrift provisions, it must be by some justifiable interpretation of the donor's language by which such implied exception may be fairly construed into the instrument of trust. It cannot logically arise out of the character of the obligation. . . . The obligation for alimony and support money may be of higher rank than other debts, but it is nevertheless an obligation in the nature of a debt, and if, as here, no assignment could be made, if no title could reach the beneficiary until the actual receipt of funds, then equity may not enforce claims of any nature against it. This court may not by imputing a constructive intent or by a constructive exception thwart the manifest purpose of the donor.

Id.

[141]140 B.R. 400 (Bankr. N.D. Tex. 1992).

[142]*Id.* at 404-06. In dictum, the court also approved the effectiveness of the spendthrift provision. *See id.* at 406, 407. This aspect of the opinion was not essential to its ultimate conclusion, because the discretionary language alone was sufficient to shelter the trust assets from the government's claim.

not constitute "property" or "rights to property" for purposes of section 6321. The government's lien would attach only at such time as the trustee, in its discretion, made a distribution to the taxpayer. *Wilson* is typical of how federal courts view discretionary trusts.[143]

What accounts for the differing treatments of spendthrift provisions and discretionary interests in trusts? For several important reasons, a discretionary interest in a trust has a much stronger case for immunity from the government's lien. First, if the trustee in its discretion could withhold all distributions from the beneficiary, it is difficult to see how the beneficiary has "property" or "rights to property" within the meaning of section 6321. The beneficiary may never receive *any* distributions; thus, the beneficiary may be characterized as holding a mere hope or expectancy, not a property right.[144] Second, allowing the government to reach the property held in a discretionary trust may infringe on the interests of persons other than the taxpayer. In *Wilson*, for example, to the extent the trustee determined in its discretion not to distribute income to the taxpayer, the withheld income was to be distributed at the taxpayer's death to her descendants. In this respect, refusing to grant the government access to the taxpayer's interest recognized that the interest did not belong exclusively to the taxpayer. Third, with a discretionary trust, the income tax liability associated with the trust income will, generally speaking, be incurred by the beneficiary only to the extent that the trustee distributes income to the beneficiary. To the extent in-

[143]*See, e.g.*, Magavern v. United States, 550 F.2d 797, 801-02 (2d Cir. 1977) (finding that beneficiary had right to compel distributions; implying that a wholly discretionary interest would be immune from the government's claim); Texas Commerce Bank Nat'l Ass'n, 908 F. Supp. 453, 458-59 (S.D. Tex. 1995) (holding that taxpayer's discretionary interest in a trust was not subject to section 6321 lien).

[144]This admittedly overstates the beneficiary's inability to compel distributions. Under some circumstances a trustee's refusal to make distributions under a wholly discretionary standard might be considered unreasonable and thus an abuse of discretion. Whether broadly stated discretionary authority may relieve a trustee of the requirement that its exercise of discretion be reasonable has been the subject of significant debate. *Compare* RESTATEMENT (SECOND) TRUSTS § 187 cmt. j (1959) (stating that words of "'absolute' or 'unlimited' or 'uncontrolled' discretion are not interpreted literally but are ordinarily construed as merely dispensing with the standard of reasonableness," and that "[i]n such a case the mere fact that the trustee has acted beyond the bounds of a reasonable judgment is not a sufficient ground for interposition by the court") *with* RESTATEMENT (THIRD) OF TRUSTS § 50 reporter's note on cmt. c (2003) (observing that cases are difficult to find in which extended discretionary language has been construed to excuse unreasonable conduct) *and* GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 560 (rev. 2d ed. 1980) (stating that "[t]he authorities do not appear to support the Restatement [Second] position that there is no requirement or reasonableness in the exercise of a power granted in the trustee's absolute discretion"). Note that even the Restatement (Second) demands reasonable conduct of a trustee if the discretionary grant of authority does not include language such as "absolute" or "unlimited." *See* RESTATEMENT (SECOND) TRUSTS § 187 cmt. e (1959) (stating that, under these circumstance, a court will interfere with a trustee's exercise of power if the trustee "acts beyond the bounds of a reasonable judgment"); *see also* 3 SCOTT ON TRUSTS (4th ed.), *supra* note 122, § 187 (same). In light of the fact that a trustee is a fiduciary, the better view is that the trustee's conduct must always be reasonable, regardless of the breadth of discretion granted. As a practical matter, however, a creditor standing in the shoes of the beneficiary of a wholly discretionary trust would face an even greater challenge than the beneficiary in compelling the trustee to make distributions.

come is accumulated, the trustee incurs the tax liability.[145] In the case of a beneficiary holding a *mandatory* income interest, on the other hand, in general the beneficiary incurs the liability for taxes on trust income.[146] It is possible, therefore, that a beneficiary holding a mandatory income interest with a spendthrift provision would be delinquent in paying taxes on income earned *by the trust itself.* Denying the government a lien under these circumstances would seem particularly unfair.[147]

Another distinction between discretionary interests and spendthrift provisions, as articulated by Professor Scott, is that the former defines "the character of the beneficiary's interest," while the latter is a "restraint on . . . alienation" of an interest.[148] In describing the latter as a *restraint*, rather than an element of *character,* Professor Scott's formulation supports the position that at times spendthrift provisions can be disregarded—a *restraint* seems more like an *exemption,* which the Supremacy Clause would override in the case of a federal claim. In some respects, however, Professor Scott's formulation is tautological—inalienability could just as easily be considered an element of character which a federal court should be bound to respect given the traditional deference to state law concerning matters of property rights.

Giving effect to spendthrift provisions in the context of the federal tax liens would be understandably offensive to many—the beneficiary would be permitted to enjoy his or her interest in trust while at the same time avoiding the payment of taxes. Yet this approach would put the government in no worse position than other creditors, including some with equally sympathetic claims.[149] Moreover, the approach would not forever prevent the government from recovering the taxpayer's deficiency—any amounts distributed to the taxpayer would immediately become subject to the government's lien.

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[145]*See* Robert T. Danforth, *A Proposal for Integrating the Income and Transfer Taxation of Trusts,* 18 VA. TAX REV. 545, 551-52 (1999).

[146]*See id.*

[147]Note, however, that cases refusing to give effect to spendthrift provisions for purposes of section 6321 do not limit their rulings to situations such as this. The reasoning of those cases applies equally to taxpayer-beneficiaries who are delinquent with respect to taxes on income earned *outside* the trust.

Moreover, the unfairness of the situation described in the text could be remedied by means other than a blanket refusal to respect spendthrift provisions in the context of federal tax liens. One means would be to impose a withholding requirement on trustees in the case of mandatory income interests. *Cf.* HOWARD M. ZARITSKY & NORMAN H. LANE, FEDERAL INCOME TAXATION OF ESTATES AND TRUSTS ¶ 6.07[5] (3d ed. Supp. 2001) (describing the withholding requirements that apply to certain foreign trusts). A second would be to disregard spendthrift provisions under the circumstances described—*i.e.*, when the tax deficiency relates to the income of the trust.

[148]SCOTT ON TRUSTS (4th ed.), *supra* note 122, § 155, at 154.

[149]Consider, for example, a creditor whose claim arose from a tort committed by the beneficiary. Only a small handful of authorities would disregard a spendthrift provision under those circumstances. *See* RESTATEMENT (THIRD) OF TRUSTS § 59, cmt. a reporter's note (2003) (not including an exception to spendthrift provisions for tort claims; describing scant support for an exception); UNIF. TRUST CODE § 503 cmt. (2000) (noting that an exception for tort claims has "not generally been recognized").

Most importantly, while respecting spendthrift provisions with respect to the tax lien may be offensive as a matter of policy, it is not the role of the courts to create policy in this context. The proper solution is not for the courts to develop federal rules of property law, but rather for Congress to expressly include spendthrift trusts as "property" for purposes of section 6321. Until Congress does so, the role of the courts should be to respect state law in determining what constitutes the property of the taxpayer.

V. VIABILITY OF LEGISLATIVE GAMING

To what extent does the development of a federal common law of property undercut state legislative efforts to achieve favorable federal tax consequences?[150] Part V briefly considers this question with respect to the legislative developments described in Part III.

Considering first the repeal of the rule against perpetuities, is this state law development susceptible to the *Drye* argument that it creates a mere property law fiction, which a federal court may disregard in enforcing the tax laws? Or is the development of a type that could be defeated through the Supremacy Clause analysis illustrated by *Dallas National Bank* and *Leuschner*? These questions would likely arise in the context of a Service effort to subject a long-term or perpetual trust to transfer taxation.[151] Such an effort likely would not be successful, nor should it be. A law permitting trusts of unlimited duration can hardly be characterized as a fiction and certainly not in the manner used in *Drye* or *Craft*. As for the Supremacy Clause argument, it would be difficult to square with Congress's express creation of a GST exemption, and Congress and the Treasury's failure to establish any durational limits on the use of the exemption.[152]

[150]One must acknowledge the point that all of the cases discussed in Part IV arose in the context of the federal tax lien and thus are not directly apposite in resolving the transfer tax liability and income tax basis issues discussed in Part V. Stated another way, the government's concerns about *enforcement and collection* may be distinguishable from its concerns about tax *liability*; perhaps federal courts owe greater deference to state law in one context than in the other. The Article does not attempt to resolve this question; instead, it assumes that the development of a federal common law evidenced in the lien cases is equally likely to occur in the contexts discussed in Part V.

[151]One can only speculate as to the nature of the government's argument. The government might argue, for example, that when Congress allowed each taxpayer a GST exemption, it assumed that state perpetuities laws would limit the tax savings that could be enjoyed from use of the exemption. State laws allowing the creation of perpetual trusts undermine Congress's purposes, the government might argue, and thus should be disregarded in determining the effectiveness of the exemption. Consequently, the argument might proceed, a GST tax should be imposed on the trust assets at the conclusion of the period prescribed by the common law rule.

[152]At one time the GST regulations included a provision which caused transferred property to lose the benefit of the GST exemption if a non-general power of appointment was exercised in a manner that postponed vesting of the property beyond a specified perpetuities period. *See* HARRINGTON ET AL., *supra* note 42, ¶ 2.02[1][d] (discussing former Reg. § 26.2652-1(a)(4)). The provision was deleted in 1997, apparently to prevent the use of non-general powers to create an unintended transfer tax advantage. *Id.* (stating that deletion of the provision eliminated a planning "loophole"). No other provision in the Code or the regulations purports to establish any durational limits on the use of the exemption.

What about state legislative efforts to avoid the "applicable restriction" rule of section 2704(b)? Would a federal court view a state law default rule limiting the liquidation rights of a limited partner as a mere fiction, as that concept was developed in *Drye* and *Craft*? Would a federal court find persuasive a Supremacy Clause argument? Although it would not be the appropriate result, a federal court might very well view a favorable state law default rule as a fiction that could be ignored by virtue of the fact that the partners in the entity had a choice about *which state's* default rules to adopt. Because the partners could have chosen state law granting more liberal default liquidation rights, the more restrictive default rules selected by the partners should be ignored, with the result that the restrictions imposed in the partnership agreement should be treated as applicable restrictions. But this analysis would be faulty, because it would ignore the myriad other substantive legal consequences that accompany the selection of state law for partnership formation—state case law on the fiduciary duties of the partners, to mention one important example. A Supremacy Clause argument would be completely without merit. In the words of Professor Mitchell M. Gans, by explicitly referencing state law in section 2704(b) and thus permitting states to manipulate federal tax results, Congress, "abdicate[d] its responsibility to determine federal tax policy."[153] If permitting states to manipulate tax results is wrong in a normative sense, Congress (not the courts) should impose a solution, by amending section 2704(b) to remove its reference to state law.

Turning next to Alaska's consensual community property law, the elective character of the law suggests that a federal court might very well view Alaska community property status as a fiction, which the court would then disregard for purposes of applying section 1014(b)(6).[154] Because Alaska community property status is elective, there is a close analogy to the disclaimer statute at issue in *Drye*—spouses availing themselves of the Alaska legislation, in the same manner as the taxpayer in *Drye*, have the power to determine the character of their interests in property. A federal court would thus likely find such state law property characteristics not controlling for federal tax purposes. But a court taking this approach would be disregarding the traditional primacy of state law concerning property law matters and would be ignoring the significant substantive, non-tax consequences of having elected community property status.[155] The

[153]Gans, *supra* note 37, at 883.

[154]Note especially that a couple's decision to elect community property status is revocable. *See* ALASKA STAT. §§ 34.77.090(e), 34.77.100(e) (Michie 2003); Jonathan G. Blattmachr & Howard M. Zaritsky, *Alaska Consensual Community Property Law and Property Trust*, EST. PLANNING 65, 66 (Nov. 1998) (noting that spouses may "transmute property back from community property to separate property"); *see also* Blattmachr et al., *supra* note 55, at 622-631 (setting forth arguments for and against the effectiveness of Alaska's legislation for purposes of section 1014(b)(6)).

[155]Presumably a federal court should *not* be bound to respect state community property legislation that produces no meaningful substantive change in the state's marital property laws. *But see* Blattmachr et al., *supra* note 55, at 618-20 (describing the significant substantive features of Alaska community property). In other words, state legislation ostensibly creating a "community property" system, but making no substantive changes to its previous common law property system, should be treated as mere nomenclature and thus not controlling for federal tax purposes. *See supra* notes 20-24 and accompanying text (discussing *Morgan*).

proper role of the courts in this context is to respect Alaska's decision to create a community property scheme; if the benefits of section 1014(b)(6) are inappropriate as a matter of policy, the proper solution is to amend or repeal section 1014(b)(6).

Finally, consider the state legislation authorizing self-settled APTs. As noted earlier,[156] one of the purposes of APT legislation is to permit settlors to create discretionary[157] trusts for their own benefit that will be excluded from their estates for estate tax purposes. For this objective to be achieved, a settlor's estate would need to succeed in arguing that by virtue of applicable creditors' rights law, the settlor retained no indirect power to revoke or control the enjoyment of the trust and no indirect right to income for purposes of sections 2038(a)(1), 2036(a)(1), and 2036(a)(2).

The success of this argument depends entirely on whether a federal court is willing to respect the state legislature's decision to permit settlors to create trusts for their own benefit that are sheltered from the claims of their creditors. As discussed earlier, in jurisdictions following the traditional rule regarding creditors' rights in self-settled trusts, a settlor would be deemed to hold a right to revoke the trust, a right to control the enjoyment of the income, and a right to income by virtue of the settlor's ability to incur debt and then relegate his creditors to recovering from the trust.[158] This analysis, in theory, would be inapplicable in a jurisdiction that permits self-settled APTs. Is this change in state law, and its attendant change in the estate tax consequences of self-settled trust, one that will be respected by federal courts? Would the law be considered a property rights fiction in the sense articulated by *Drye* and *Craft*? Or would a Supremacy Clause argument of the type articulated in cases such as *Dallas National Bank* and *Leuschner*, persuade a court that the estate tax laws somehow trump state creditors' rights laws?[159]

A federal court might subscribe to an argument that proceeds along the following lines. Notwithstanding state law purporting to immunize APTs from the claims of creditors, the government would argue, APTs are not immune from the claims of the *government* for purposes of the federal tax lien, citing cases such as *Dallas National Bank* and *Leuschner*.[160] Assuming that the federal court is

[156]*See supra* notes 66-77 and accompanying text.

[157]As earlier discussed, a retained *mandatory* income interest triggers inclusion under section 2036(a)(1). *See supra* note 74.

[158]*See supra* notes 66-71 and accompanying text.

[159]For purposes of this discussion, the Article ignores the possibility that a federal court would find the state APT legislation ineffective to shelter assets from creditors' claims generally, although there are serious questions about whether APTs are effective in achieving their principal objective. *See* Danforth, *supra* note 8, at 318-26 (describing arguments against the effectiveness of APTs). *But see id.* at 348-66 (arguing that, at least to a limited extent, APTs *should* be respected). If a federal court for any reason determined that APTs were *not* immune from creditors' claims, it would be an easy step to conclude that the assets were includible in the settlor's estate. *See supra* notes 66-71 and accompanying text.

[160]The government would need to distinguish cases such as *Wilson*, *supra* notes 141-43 and accompanying text, presumably by arguing that *Wilson* should not apply in the case of self-settled trusts.

willing to accept this proposition as correct, it opens the door to two alternative theories for includibility. The first theory would depend on extending the federal lien jurisprudence to federal tax litigation concerning creditors' rights generally. Under this theory, the government would argue that, for all federal tax purposes (not just for purposes of the scope of the tax lien), a federal court may independently determine the extent to which assets are immune from creditors' claims. The government would bolster this argument with references to the federal tax laws being the supreme law of the land, to the need for tax law uniformity across state lines, and to the risks that APT legislation pose to enforcement of the estate tax.[161] If the court accepts this theory, it would be willing to rule that APTs are not immune from creditors' claims for purposes of estate taxation. The court would then rely on established authority[162] to hold that exposure of trust assets to the settlor's creditors triggers inclusion in the settlor's estate.

Under the second theory, the government would argue that, if APTs are not immune from the federal tax lien, an APT should be includible in the settlor's estate on that basis alone. By failing to pay her taxes, the government would assert, the settlor of an APT could relegate the government to seeking collection from the trust assets. The government would then argue, based on established authority,[163] that exposure of the trust assets to the government as creditor triggers inclusion in the settlor's estate. This argument could be bolstered by the same points made in connection with the first theory and also by observing that the settlor personally bears the tax liability on the income generated by the trust, not just the income that she earns outside of the trust.[164]

Neither theory is consistent with the traditional primacy of state law concerning property rights that have federal tax implications. If one views APTs as presenting a transfer tax abuse, the proper solution is for Congress (not the courts) to expand the estate tax rules to trigger inclusion of self-settled discretionary trusts,[165] irrespective of their creditors' rights status under state law.

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[161]The final point would presumably focus on the fact that if APTs are excluded from settlors' estates, this would enable settlors to avoid transfer taxation on the appreciation that occurs between the date of the transfer to an APT (which constitutes a taxable gift) and the date of the settlor's death. Of course, this proposition is true with respect to any completed gift that is later excluded from the donor's estate. What will bother the government in the APT context is that the settlor may continue to enjoy the benefits of the transferred property after the APT has been created.

[162]*See supra* notes 66-71 and accompanying text.

[163]*See supra* notes 66-71 and accompanying text.

[164]*See* I.R.C. § 677(a)(1) (providing that, for income tax purposes, the settlor is treated as the owner of assets held in a trust, the income of which may be distributed to the grantor, if the power of distribution is held by a nonadverse party). Most APTs have corporate fiduciaries as trustees; a corporate fiduciary is a "nonadverse party" for purposes of section 677(a)(1). *See* I.R.C. § 672(b).

[165]*See* Charles D. Fox IV & Michael J. Huft, *Asset Protection and Dynasty Trusts*, 37 REAL PROP., PROB. & TR. J. 287, 335-36 (2002) (noting that, if the Service loses in its litigation attempts to include APTs for estate tax purposes, the Service may seek legislation applying section 2036(a)(1) to discretionary interests).

VI. CONCLUSION

Recent decisions such as *Drye* and *Craft* (and the not-so-recent *Dallas National Bank* and *Leuschner*) represent encroachments on the traditional primacy of state law in defining property rights that have federal tax implications. In cases involving the federal tax lien, federal courts should respect state definitions of property and rights to property and grant the government no greater rights in property than those held by the taxpayer himself. If this approach leads to abuse or raises other tax policy concerns, the remedies should come from Congress, not the courts. With respect to legislative gaming, federal courts, as did the Court in *Morgan*,[166] should distinguish between substance and nomenclature and thus respect state law developments that produce significant, non-tax effects. If the results offend tax policy, again the solutions should come from Congress.

[166] *See supra* notes 20-24 and accompanying text.

RECENT DEVELOPMENTS

Recent Developments

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Estate Freeze Provisions of the Revenue Reconciliation Act of 1990

The federal budget fiasco that ran (much too) late into 1990 produced a mammoth piece of legislation, the Omnibus Budget Reconciliation Act of 1990,[1] containing, as Title XI of OBRA '90, the Revenue Reconciliation Act of 1990.[2] In addition to well-publicized tax increases, RRA '90 includes a fair number of fairly narrowly drawn tax provisions. One of them is our topic here.

It is an interesting topic in at least two respects. First, it is an unusual topic for *The Journal of Corporate Taxation* inasmuch as it is an estate and gift tax provision. Second, it replaces in toto and retroactively repeals one of the more ill-advised "tax reforms" of recent years, Section 2036(c) . This provision is the well-known anti-estate freeze provision that has caused much difficulty for all who have come in contact with it.

While estate and gift tax rules are unusual topics for this journal, Section 2036(c) , and its replacement, Sections **2701** through 2704 , have been and remain important for corporate tax practitioners. The importance increases because the tax threat is in an area that many corporate tax practitioners do not consider part of their responsibility; yet, seeking estate and gift tax advice on "routine" matters is not all that common. The danger, then, is simply missing a major issue.

The replacement of Section 2036(c) by, as we shall see, something more measured if not simpler reflects both substantive deficiencies in former Section 2036(c) and, I believe, procedural deficiencies in the process by which it was enacted. The substantive difficulty with Section 2036(c) is that it was not drafted to fit the problem perceived to exist with "estate freezes." Former Section 2036(c) [3] provided, in general, that, if property having a disproportionately large share of appreciation potential in an "enterprise" is transferred while an interest or right in the enterprise is retained, then the transferred property is includable in the transferor's gross estate at his death at its value then.[4] Early on it was painfully obvious to many thoughtful practitioners that Section 2036(c) had to go. In its October 13, 1990, draft committee report, the Senate Finance Committee forthrightly agreed:

> The committee believes that an across-the-board inclusion rule is an inappropriate and unnecessary approach to the valuation problems associated with estate freezes. The committee believes that the amount of any tax on a gift should be determined at the time of the transfer and not upon the death of the transferor.[5]

Why was the towel thrown in on Section 2036(c) ? Obviously, it was deemed substantively flawed beyond redemption three years after it was enacted. But why did it become law? That is a complex topic with no single clear answer, but I would like to suggest that a good part of the problem lies with the process, or lack thereof, by which it was initially enacted. This provision came essentially out of nowhere to be included in RRA '87. A House-passed provision not carried forward at all by the Senate was substantially modified in conference.[6]

While it was known that "estate freezes" were a target for tax reform, and not entirely without justification in my view, no broad-based deliberative process, formal or informal,[7] was part of the birthing process. I have no doubt that those who worked on the provision, especially staff members of the Joint Committee on Taxation, did the best they could, but no relatively small group of people working in a short period could fully understand enough to have a decent chance to produce good legislation. This was a very important change—more than was realized I suspect—and it did not receive the attention it should. There are many reasons for this, only a few known to a lawyer in Maine who served in the Treasury Department fifteen years ago, but at bottom I think that it is no coincidence that the new corporate and partnership valuation rules, which have their genesis in an American Bar Association (ABA) task force seeking a measured response to a perceived problem,[8] a came out much better than the first, sudden provision. Having a good process that pays sustained attention to the topic at hand is important. It is ironic that there was a good process at work in replacing Section 2036(c) [9] that come to fruition out of the chaos surrounding the 1990 budget negotiations. What remains to be seen is how much of an improvement the new provision is in the real world. I have some questions that will be answered only by working with this provision when it affects real people and the businesses they have nurtured.

With that introduction to the forest, let us now look at the trees in considering the replacement to Section 2036(c) . This discussion is not comprehensive in coverage. I am writing this from the point of view of this journal and its readers and so focus on the effect on corporations and their shareholders. There are additional provisions only noted in passing or even not at all that will be important in many cases, particularly those addressed to partnerships[10] and trusts.[11] In addition, this is a new statute with little to guide us other than the words in which it was enacted. Finally, this selective survey seeks to do nothing more than provide an introduction to the new statutory pattern. It seeks only to pave the way for more detailed, situation-based analysis by practitioners doing what is done every day.

Section 2036(c) Replaced by New Rules Focusing on Gift Tax Valuation at Time of Transfer

The basic orientation of the estate freeze provisions has been completely changed. It now[12] focuses on the potential for abuse by focusing on the gift tax consequences at the time of a transfer.[13] An amendment to the statute of limitations for the gift tax ensures that the new valuation rules will not go into repose absent the IRS's being given clear notice that their applicability may have been triggered.[14] This means that a routine aspect of future estate tax audits may well be looking for gifts subject to the new rules that were made many years earlier.

New Section **2701** (a)(1) , which contains the new general rule, announces the change with its introductory phrase: "Solely for purposes of determining whether a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family[15] is a gift (and the value of such transfer) ...." The reader parsing the statute knows at the outset that the value of certain gifts is what is at issue here. The statute goes on to explain when it applies and what it mandates for gift tax valuation when applicable.[16]

Scope of New Provision

The new valuation rules generally apply where the transferor, or an applicable family member,[17] immediately after the transfer in question, holds "any right" in respect of one of two specified kinds of "applicable retained interest"[18] (ARI). Before even leaving Section **2701** (a) to learn of applicable retained interests, and more, the drafters of this legislation tell us of four exceptions that may make further inquiry unnecessary.

Statutory Exceptions

The first exception, found in the last sentence of Section **2701** (a)(1) , makes the general rule of Section **2701** (a)(1) inapplicable "to the transfer of any interest for which market quotations are readily available (as of the date of transfer) on an established securities market." While there are some internal complexities here that are familiar,[19] the gravamen of the exception clearly is that stock traded on the New York Stock Exchange (NYSE) and its kindred may be transferred without fear of having an unexpected gift tax result. This makes common sense because there is little room to argue over the value of publicly traded securities. Symmetry is provided by the next provision. Section **2701** (a)(2)(A) excepts rights with respect to ARIs where "market quotations are readily available (as of the date of the transfer) for such interest on an established securities market." Note that the first exception applies to any "interest" while the latter applies to ARIs, which may be different.

The third and fourth exceptions are also related. Section **2701** (a)(2)(B) excepts rights with respect to ARIs "of the same class as the transferred interest." Thus, the draft Senate Report tells us, the new valuation rules do not apply to "a gift of common stock if the transferor only retains rights of that class of common stock."[20] The fourth exception is for retained interests if "such interest is proportionally the same as the transferred interest, without regard to nonlapsing differences in voting power."[21] Here, too, the draft Senate Report provides a useful illustration. It states that the exception would be available where "the retained and transferred interests consisted of two classes of common stock, which shared in all distributions, liquidation and other rights in a two to one ratio." The exception parallels the identical interest rule for cases where the relative difference is constant.

The Two Statutory Predicates

If one of the four exceptions does not provide a ready out from having to obey the first law of statutory construction and read on, one must fully engage the substance of Section **2701** . This brings us back to the two predicates to the application of new Section **2701** :

(1.) The existence of an ARI[22]

(2.) The ARI's being held by the transferor or an applicable family member

As noted at the outset, the statute gives us two different definitions of ARIs. Under the first definition, an ARI exists where there is "any interest in an entity with respect to which there is ... a distribution right" where immediately before the transfer in question the transferor and applicable family members[23] held, directly and under attribution rules,[24] control of the entity.[25] Under the second definition, an ARI exists where there is "any interest in an entity with respect to which there is ... a liquidation, put, call, or conversion right."[26] To my way of thinking, the first rule is the primary rule and the second rule is an anti-avoidance rule. This can be seen by thinking in terms of a classic estate freeze in which the transferor retains preferred stock while gifting common stock to children.

Both of these definitions are further elaborated in the statute. The second category of rights is generally defined as any of the named rights or any similar right, "the exercise or nonexercise of which affects the value of the transferred interest,"[27] but specifically does not include "any right which must be exercised at a specific time and at a specific amount."[28]

The class of ARIs known as distribution rights is more complex in definition, involving several concepts that must be run down to understand fully this new concept. But it is useful to start out having in mind that dividend rights on the preferred stock retained in the classic estate freeze are distribution rights. The first statutory concept we encounter is that of "control" of the corporation in question. For this we need only look to Section **2701** (b)(2)(A) , which tells us that, again in the case of a corporation, control means holding 50 percent or more of its stock, measured by vote or by value. The second basic concept found on the face of Section **2701** (b)(1)(A) —that of "distribution right"—involves a chain of definitions. We start by looking to Section **2701** (c)(1) for the meaning of the key term, "distribution right." There we are told that, in the case of a corporation, the term means "a right to distributions from a corporation with respect to its stock,"[29] with two stated exceptions of interest to corporations.[30]

The first exception is for a right to distributions with respect to "any junior equity interest,"[31] defined simply as common stock in the case of corporations.[32] This exception, of course, goes to the essence of the estate freeze concept. Common stock, as the junior equity interest in a corporation, by definition, has appreciation potential and cannot carry out freezing the value of the retained interest. The second exception is for "any liquidation, put, call, or conversion right."[33] This exception seems intended to keep the two elements of the definition of an ARI separate.

More important than the two stated exceptions are exceptions implicit in limiting the reach of distribution rights to rights to distributions in respect of stock. This language, in sharp contrast to the broad approach of former Section 2036(c) , does not seem to pick up rights under debt, leases, or compensation arrangements.[34] Equity masquerading as debt ,[35] and even lease or compensation arrangements, apparently are at risk of being recharacterized as stock and then treated as an ARI if the other characteristics of an ARI are present. But, in general, there is a major difference between the old and new statutory approaches to estate freezes, with the new plainly being more focused. There can be no doubt that new is also improved.

At this point, we know that the trigger to the new gift tax valuation rules is the retention of an ARI, which is either a distribution right (i.e., dividend and liquidation rights on preferred stock) in the case of a controlled corporation or the holding of certain rights. Before moving on to the valuation consequences, we should note one potential trap for the unwary: the definition of "transfer."

While the classic estate freeze involves the retention of preferred stock after transferring common, less direct methods could achieve the same end. Indeed, that seems to explain the reach of the definition of an ARI to the enumerated rights. Protecting the fisc against such clever[36] or devious[37] end runs is the goal of the expanded definition of "transfer" found in Section **2701** (e)(5) . Unless contrary regulations are forthcoming, the definition of transfer is expanded to cover "a contribution to capital or a redemption, recapitalization, or other change in the capital structure," but only in certain cases.

The limited scope of the broadened definition of "transfer" reflects, I think, the skill, and confidence in that skill, of the drafters of the new estate freeze rules.[38] These named capital events only constitute a transfer that may trigger the new valuation rules where their circumstances suggest concern that there is an abusive estate freeze being attempted. Specifically, a transfer results from a named capital event where the taxpayer or an applicable family member receives an ARI in the relevant entity pursuant to the capital event or, under regulations, holds an ARI in the entity immediately after the transfer. Further, except in the case of contributions to capital, the expanded definition of transfer does not apply where "the interests in the entity held by the transferor, applicable family members, and members of the transferor's family before and after the transaction are substantially identical."[39] While there is more technical complexity here than can be covered in these pages, this anti-device rule is tailored with some care. It stands in marked contrast to the blunderbuss approach taken in former Section 2036(c) and found all too often in tax legislation of recent years.

At this point then, we are ready to consider the valuation rules found in Section **2701** .

Valuation Rules

There are two basic valuation provisions in Section **2701** . The primary rule adjusts the value of the gift at the time of the transfer. The secondary rule functions as a backstop and permits giving certain flexibility, in the form of elections, to taxpayers. It applies to increase the tax collector's take on the later happening of a transfer tax event, such as death.

There is a basic quirk in the approach to the gift tax valuation of retained interests under the basic rule of Section **2701** (a) . The interest that is valued in the statute is the *retained* interest,[40] not the *transferred* interest that is the object of the gift tax. "The rules rely on present law principles that value residual interests by subtracting the value of preferred interests from the value of the entire corporation or partnership."[41] Thus, the gift tax transfer amount is the value of the interest transferred less the value of the retained interest (the ARI).

The general rule for the value of the retained interest is startling on first reading. Section **2701** (a)(3)(A) provides that the value of any right subject to the new rules "shall be treated as being zero." Using the residual valuation principal, this means that the value of the transferred interest is its full fair market value. Where the general rule applies, then, the goal of an estate freeze of passing along future equity growth while retaining high value rights to reduce current gift tax costs is completely frustrated. The only way to avoid full current gift tax on the transfer is to come within an exception to the general rule of zero value. There is one exception of general applicability and another more limited in scope.

The general exception to the zero value is for "a distribution right which consists of a right to receive a qualified payment."[42] We have already encountered the phrase "distribution right" above, but need to learn what makes up the subset of distribution rights known as "qualified payments." As one would expect, there is a statutory definition, complete with flexibility in the form of two elections.

In general, and consistent with the classic estate freeze resulting in the transferor holding preferred stock, a "qualified payment" is "any dividend payable on a periodic basis under any cumulative preferred stock ... to the extent that such dividend ... is determined at a fixed rate."[43] A variable rate bearing "a fixed relationship to a specified market interest rate"[44] is also permitted. These rules both seem aimed at facilitating valuation of the retained interest and, residually, the transferred interest.[45] If, and there does not seem to be any direct guidance in the statute or limited official legislative history I have seen, this valuation is to be done on a present value basis,[46] with reference to the yield on market preferred stocks, the dividend rate on a classic estate freezing preferred will have to, be high enough for the retained interest to attract a high value and thus leave a low value for the gifted interest. Considering that the preferred dividend will not be tax deductible to the corporation, the estate freeze might turn out to have a high after-tax income tax cost. If the new valuation rules have an Achilles' heel, it may be here. Forthcoming regulations from the IRS will, soon I hope, give examples of valuation techniques—I would prefer a safe harbor approach—so that the practical, dollars and cents, effect can be judged.[47] Variable rates provide more complex questions, and I would be disappointed not to get guidance from the IRS promptly. Unless and until there is guidance, using a variable rate benchmark will be too risky for many in all but the most compelling cases.

I have the nagging suspicion that, notwithstanding the spectacular demise of the public junk bond market in 1990, that having the retained interest as debt[48] on which deductible interest (under current law, at least)[49] is paid may be more attractive. Even though there are obvious valuation issues here, these would be resolved, at least for now, on traditional grounds.[50] If my concerns are well founded, there may be a further outcry, not without force if made moderately, to soften the valuation rules based on the policy decision that intergeneration transfers of family businesses are to be encouraged.

Reflecting the intellectual rigor of the new rules are the two elections permitted under the fixed dividend rule. The first permits a transferor, or applicable family member, to treat payments as not being "qualified payments."[51] The second permits the same electors the option of treating "any distribution right" as a qualified payment payable in an amount and at a time specified in the election. This election is restricted, as one might expect, to amounts and times that are not inconsistent with the terms of the underlying instrument creating the distribution right.[52] While both these rules will obviously affect the up-front gift tax on the transfer to which they appertain, they also allow ameliorating the effect of the backup compounding rules described below. They do provide flexibility, but I am not sure without working through some real world scenarios of their practical extent.

Two rules remain to be noted under the general valuation rule. One is the so-called minimum valuation rule. The other is what I think of as the multiple possibilities rule. Under the first rule, the value of a transferred junior equity interest (common stock, in the case of corporations[53]) is determined as if the total value of all junior equity interests is 10 percent of the sum of the value of all equity interests (stock, in the case of a corporations[54]) in the entity plus indebtedness owed to the transferor (or applicable family member). The purpose of this rule, we are told, "is intended to reflect the 'option value' of the right of the residual interest to future appreciation."[55] The discounted present value of future cash flows ought to reflect risk and, thus, the "option value," at least in theory, so I am inclined to think of this as a de minimis rule intended to prevent overreaching under the new rules in setting the value of the transferred interests too low. It seems to say that the transferred equity interest in a classic estate freeze carries with it at least 10 percent of the value of the entity. Given the low value that seems likely to be attached to retained interests in many cases, I wonder how important this rule is practically.

The multiple possibilities rule resolves the problem of valuation where several scenarios are possible. The statute tells us to use the combination that produces the lowest value. Specifically, where an ARI confers a distribution right that is a qualified payment and there is at least one liquidation, put, call, or conversion right with respect to the ARI, then we are told to value all rights (both distribution and otherwise, it seems) "as if each liquidation, put, call, or conversion right were exercised in the manner resulting in the lowest value being determined for all such rights."[56] This provision, which was added in conference, is especially important because it gives value to a liquidation right on a classic preferred stock.[57] Related to this provision is the authority granted to the Treasury to promulgate regulations providing "that any applicable retained interest shall be treated as 2 or more separate interests for purposes of this section."[58]

Increased Tax On Subsequent Events

We now come to the backstop valuation rule, which works in tandem with the elections under the primary valuation rules noted above. The purpose of the backup rule is to require an increase in future transfer taxes where there are cumulative but unpaid distributions. Put another way, this rule polices the assumptions underlying the initial valuation at the time of transfer. The rule turns on there having been a nonzero valuation of a qualified payment under the multiple options valuation rule noted above.

The future taxable events subject to the second look are the death of the transferor where the ARI conferring the distribution right is includable in the gross estate of the transferor[59] or the inter vivos transfer of the ARI.[60] In addition, an election is allowed to prepay the increased transfer tax when there is a payment of any qualified payment after the four-year grace period noted above has run.[61] Transfers to spouses defer the day of reckoning. No tax is due in the case of a transfer to a spouse qualifying for the unlimited transfer tax marital deduction, but the spouse steps in the shoe of the transferor and thus become liable for the second look tax.[62]

Where the backup tax is due, it is measured by increasing the amount of the taxable transfer. The amount of the increase is the excess of the present value of qualified payments payable through the date of the backup taxable event over the present value of payments actually made when actually made,[63] except for a generous grace period under which "any payment of any distribution during the 4-year period beginning on its due date shall be treated as having been made on such due date."[64] Only qualified payments valued under the rule of Section **2701** (a)(3)(B) are subject to the future increase under the statute as enacted.[65] However,.the increase in the taxable amount is limited to the excess of the value of all interests junior to the ARI on the date of the second look taxable event over the value of those interests on the date of the initial transfer. Where the transferor did not hold all the shares outstanding of the class making up the ARI, the limit is proportionally reduced.[66]

Conclusion

So there we have Section **2701** , the replacement for the unlamented Section 2036(c) . I have two basic points to wind up this introductory essay on the new valuation rules. First, the new statute is a much better concept, and it is drafted quite well. That reflects extended periods of thought about estate freezes, and it should come as no surprise that thoughtful drafting produces better statutory language. Second, as noted several times above, the new rules of Section **2701** need to be tested against the crucible of real world situations. It may turn out that the zero value rule applies too often because the definition of qualified payments is too narrow. Similarly, qualified payments may be assigned too low a value because of the apparently applicable present value rules and the "magic" of compound interest once the period involved is several years. Indeed, as this article is being completed, the Wall Street Journal's "Enterprise" column headlined "Law Reviving 'Estate Freezes' Creates New Frustrations."[67]

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1 Pub. L. No. 101-508, 101st Cong., 2d Sess. (OBRA '90).

2 OBRA '90 § 11001(a). Title XI of OBRA '90 is referred to herein as RRA '90.

3 Section 2036(c) was enacted by § 10402(a) of the Revenue Reconciliation Act of 1987 (RRA '87) and amended in significant respects by § 3031 of the Technical and Miscellaneous Revenue Act of 1988.

4 After lengthy labor, the IRS made known its views on many of the complexities and ambiguities of former § 2036(c) in Notice 89-99, 1989-2 C.B. 422 . The notice, as it finally emerged, was in many respects a laudable effort by the IRS to make the Congress's ill-conceived and poorly executed statute work.

5 At 58, printed in ALI-ABA, Estate Planning in the Late 1990s, at 46. The draft Senate Report is referred to as such herein, as are the ALI-ABA Materials.

6 See S. Rep. No. 495, 100th Cong., 1st Sess. 994-997 (1987).

7 While many are rightly concerned that there be a formal process open to all, the concern I am expressing here is the narrower one that the process, formal or informal, be open enough so that the resulting statute ties into outside reality and fits into the extraordinarily complex Internal Revenue Code we now have.

8 See L. Plaine, "The Replacement to Section 2036(c) —Chapter 14," in ALI-ABA Materials, at 113.

9 I speak here only of § **2701** , which was the child of the ABA task force. I understand that the remainder of Chapter 14 enacted by RRA '90 cannot claim this pedigree.

10 These rules tend to follow the corporate rules, mutatis mutandis, and are intermingled with them in the statute.

11 See I.R.C. § 2702 .

12 The new valuation rules apply to transfers after October 8, 1990. RRA '90 § 11602(e)(1)(A)(i). Old § 2036(c) is repealed (RRA '90 § 11602(a)), effective as to transfers of property made after December 17, 1987. RRA '90 § 11602(c). Old § 2036(c) generally applied to decedents dying after December 31, 1987, in the case of transfers made after December 17, 1987. RRA '87 § 10402(b). Thus is the repeal of old § 2036(c) retroactive.

13 The opening shot in the estate freeze wars may have been fired by the IRS. See Rev. Rul. 83-120, 1983-2 C.B. 170 (valuation of common and preferred stock in estate freezes, suggesting lower values for preferred).

14 If a gift of property where the valuation is determined under the new valuation rules (including the backup tax under § **2701** (d), discussed below) is not shown as required on a gift tax return, the gift tax may be assessed, or a proceeding to enforce its collection started, at any time unless the relevant item was disclosed in the return, or in a statement attached to the return, "in a manner adequate to apprise the Secretary of the nature of such item." I.R.C. § 6501(c)(9) .

15 A "member of the family," with respect to a transferor, is the transferor's spouse, a lineal descendant of the transferor or his or her spouse, and the spouse of any lineal descendant. I.R.C. § **2701** (e)(1) . This definition should be carefully distinguished from that of an "applicable family member."

16 Although there is nothing explicit in the statute or legislative history, the literal language, and perhaps logical consistency as well, would seem to require that the new valuation rules apply for purposes of the generation-skipping tax imposed by § 2601 . IRS regulations are expected to address this question, as well as questions under §§ 303 and 6166 . Until the regulations are released, these are areas of uncertainty.

17 An "applicable family member," with respect to any transferor, is the transferor's spouse, their ancestors, and the spouse of any ancestors. I.R.C. § **2701** (e)(2) . This definition should be distinguished from the definition of a "member of the family."

18 See I.R.C. § **2701** (a)(1) .

19 Cf. I.R.C. § 453(f)(2) .

20 At 62, printed in ALI-ABA Materials, at 50.

21 I.R.C. § **2701** (a)(2)(C) .

22 I.R.C. § **2701** (a)(1)(A) .

23 See I.R.C. §2701(e)(1) .

24 See I.R.C. § **2701** (e)(3) .

25 I.R.C. § **2701** (b)(1)(A) .

26 I.R.C. § **2701** (b)(1)(B) .

27 I.R.C. § **2701** (c)(2)(A) .

28 I.R.C. § **2701** (c)(2)(B)(i) . Also excluded from the second class of rights making up ARIs are nonlapsing, fixed conversion rights into the same class of stock as the transferred stock (ignoring nonlapsing differences in voting. rights) where the right has anti-dilution protection and where the right is subject to adjustments akin to those under § **2701** (d) for accumulated unpaid distributions. This exception is provided "because the full appreciated value of such right[s] will be subject to later transfer [i.e., estate and gift] tax." Draft Senate Report, at 63, printed in ALI-ABA Materials, at 51.

29 This echoes a phrase common in Subchapter C. See I.R.C. §§ 301(a) , 305(a) , 311(a) , 355(a)(1)(A)(i) ; cf. I.R.C. § 316(a) ("any distribution of property made by a corporation to its shareholders").

30 A third exception is for partnership guaranteed payments "of a fixed amount." I.R.C. § **2701** (b)(1)(B)(iii) .

31 I.R.C. § **2701** (a)(4)(A) .

32 I.R.C. § **2701** (a)(4)(B)(i) .

33 I.R.C. § **2701** (c)(1)(B)(ii) .

34 See Plaine, Note 8 *supra*, at 121.

35 Cf. I.R.C. § 385 and the all-pervasive thin capitalization doctrine in its many guises.

36 If you represent the taxpayer.

37 If you represent the government or are taking the high ground in a policy argument and, likely, do not have a client whose interests are immediately at stake.

38 After all, the limitation could have been, as it has countless times in the past fifteen years' overdose of tax legislation, left to regulations that, except in the most pressing cases, would not be issued for years and, until issued, would leave open important questions about the scope of the statute.

39 I.R.C. § **2701** (e)(5) .

40 See I.R.C. § **2701** (a)(1) .

41 H.R. Rep. No. 964, 101st Cong., 2d Cong. 150 (1990) (hereinafter Conference Report), *printed in* BNA Daily Tax Report, at S-61 (Oct. 30, 1990) (Special Supplement) (Explanation of Managers of OBRA '90) (DTR Spec. Supp.) and in ALI-ABA Materials, at 3; Draft Senate Report, at 61, *printed in* ALI-ABA Materials, at 49. Pagination for the Conference Report is to the hand-written numbers in the DTR Spec. Supp; there is no internal pagination in the ALI-ABA Materials.

42 I.R.C. § **2701** (a)(3)(A) .

43 I.R.C. § **2701** (c)(3)(A) . The ellipses elide parallel rules for partnerships.

44 I.R.C. § **2701** (c)(3)(B) . Note that the permission to use a variable index is not to any rate (including, e.g., preferred stocks), but, somewhat curiously, to *interest* rates.

45 Two new valuation rules will also apply. The first, found in § 2703, purports to restrict the use of corporate buy-sell arrangements. It provides that for purposes of the estate and gift tax provisions (Subtitle B), the value of property is determined without regard to options to acquire or use property for less than fair market value and to restrictions on sale and use. New I.R.C. § 2703(a) . This general rule does not apply to a bona fide business arrangement that is not a device for intrafamily transfers at less than fair market value and the terms of which are comparable to arm's-length arrangements incomparable transactions. I.R.C. § 2703(b) . The second rule, found in § 2704, in general, treats lapses in voting or liquidating rights of corporations and partnerships where the entity is controlled by the rights holder's family as a gift or asset includable in his gross estate, whichever is applicable. This provision is intended to reverse the decision in TC Memo 1987-8 PH TCM ¶87008 52 CCH TCM 1306 . It is not intended to affect minority or other discounts available under current law. Conference Report, Note 41 *supra*, at 68.

46 The method prescribed for calculating the backup tax on accumulated unpaid distributions (discussed below) apparently assumes that the initial calculation will be done on a present value basis. See I.R.C. § **2701** (d)(2)(A)(i)(II) .

47 This practical determination of financial results will be facilitated, as there now seems to be determination to do so at the highest levels of the IRS, by having relatively simple regulations. Repeating the endless regulations under § 1274 would be, in my view, a major error. If regulations cannot be written with clarity and conciseness so they may be readily understood by a practitioner under the usual time constraints, I question whether the regulations or the rules they interpret are worth having.

48 And not disguised equity.

49 See generally I.R.C. § 163 . Interest is generally deductible under § 163(a), but the exceptions to this general rule are growing, especially recently.

50 I wonder if paying interest timely at the minimum IRS rates will be protection against a lower-than-face gift tax valuation under current or future law.

51 I.R.C. § **2701** (c)(3)(C)(i) .

52 I.R.C. § **2701** (c)(3)(C)(ii) .

53 See I.R.C. § **2701** (a)(4)(B)(i) .

54 See I.R.C. § **2701** (a)(4)(b)(ii) .

55 Draft Senate Report, at 65, in ALI-ABA Materials, at 53.

56 I.R.C. § **2701** (a)(3)(B) .

57 Conference Report, Note 41 *supra*, at 154–155. Examples in the report illustrate the workings of this rule.

58 I.R.C. § **2701** (e)(7) ; see Conference Report, Note 41 *supra*, at 155-156 (containing two useful examples).

59 I.R.C. § **2701** (d)(3)(A)(i) .

60 I.R.C. § **2701** (d)(3)(A)(ii) .

61 I.R.C. § **2701** (d)(3)(A)(iii) .

62 See I.R.C. § **2701** (d)(3)(B) ; draft Senate Report, at 65, printed in ALI-ABA Materials, at 53.

63 I.R.C. § **2701** (d)(2)(A) .

64 I.R.C. § **2701** (d)(2)(C) .

65 I.R.C. § **2701** (d)(1) . See also I.R.C. § **2701** (d)(4)(A) (special rules for applicable family members, repeating the reference to § **2701** (a)(3)(B)).

66 I.R.C. § **2701** (d)(2)(B) .

67 Wall St. J., Jan. 11, 1991, at B2, col. 2-6. The article speaks of "heavy gift taxes" that "requires large cash payments" (i.e., dividends on preferred stock).

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600 Introduction

600.1 This topic focuses on planning techniques available to individuals with closely held business interests. See discussion starting at 401 and 501 for coverage of related planning techniques that may apply to the transfer of other property interests.

600.2 Although owners of nonfamily businesses are concerned about financial security, liquidity, taxes, and probate costs, they are probably not as concerned about shifting control of the business to family members. Instead, nonfamily business owners may be more concerned about liquidating the business interest at a fair price or implementing a buy-sell agreement with the other owners while limiting potential conflict among the remaining owners and the beneficiaries who would share in the liquidation proceeds.

600.3 Family business owners in a taxable estate situation may engage in a technique (estate freeze) that seeks to limit or reduce the owner's value of an interest in a business or other property for estate tax purposes by shifting future appreciation out of the property owner's gross estate. Appreciation is shifted into the estate of a younger generation family member using a recapitalization or reverse recapitalization that exchanges a single class of equity for two classes of equity, usually a voting preferred interest with a cumulative dividend (senior equity) and a nonvoting common interest (junior equity). Special valuation rules, sometimes referred to as the Chapter 14 rules, under IRC Secs. **2701** through 2704 were enacted to curb perceived abuses using estate freezes. This topic discusses this technique in light of the special valuation rules found in IRC Sec. **2701**.

600.4 This topic also covers specific transfer techniques that are useful in dealing with S corporation stock and limited liability companies.

600.5 Buy/sell agreements are often used for a smooth transition of business interests when an owner dies or retires. This topic looks at the validity of buy/sell agreements in light of special valuation rules aimed at ensuring a business purpose for these agreements in family transfer situations.

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601 Family Business Succession Planning

601.1 Passing the family business to family members to preserve a legacy and fund retirement is a common strategy. However, many family businesses do not successfully transition through the generations. Although a delay in starting the planning process and not using knowledgeable and experienced professionals will account for some of the failures, planning is not useful if the business fails because of relationship issues.

The Emotional Issues of Transferring the Family Business

601.2 Many business owners are torn between doing what is best for the future of the business and upsetting some or all of their family members. Common stumbling blocks the business owner should consider include the following:

- Misjudging the desire of a chosen successor to take over the business.
- Preventing clear leadership by giving equal ownership to several successors.
- Delaying the successor's ability to have authority.
- Not revealing the succession plan with enough time to allow for the company to adjust or to make modifications to the plan.
- Not letting go (e.g., continued presence in the business after retiring).
- Failing to create, or follow, a plan designed to transfer the business.
- Equality among children in and out of the business.

601.3 Appendix 6A covers some of the nontax challenges and resulting strategies for family business succession planning and Practice Aid PA-22 includes a succession planning checklist for family businesses.

601.4 Operating businesses, unlike other assets, must be actively managed to stay profitable. A combined management approach using family members along with non-family leaders in top management positions may be beneficial if the potential family successors lack the required business management skills.

601.5 If the spouse works for the client's business, receives shares as a gift, contributes capital to the business, in some other way is involved in its operation or ownership, or if the couple lives in a community property state, the spouse may have a claim to a share of ownership at the client's death or upon marital dissolution. Obviously, in addition to a marital agreement, clarity of ownership, fair compensation for the spouse's services rendered, and a proper transition plan for ownership upon death are the best ways to handle this (and other) family involvements. An employment agreement for the spouse might also be considered.

601.6 If the owner's family members are not active in the business, the owner may choose to move management of the business to non-family members while allowing the family member to retain stock ownership. Non-family members could participate in the appreciation of the business through phantom stock options and other compensation agreements tied to the success of the business.

Objectives of Succession Planning

601.7 Planning objectives for closely held businesses vary depending on the relationships among the owners. Planning for family-owned businesses is essential to—

- ensure the orderly transition of the management and ownership, which often means that the shareholder is willing to shift some, but not total, control of the company to family members;
- provide financial security for a surviving spouse or other family members;
- provide liquidity for payment of taxes or other death related expenses;
- provide future goals for long-time employees of the business who are not family members; and
- minimize estate and gift taxes and probate costs.

Special Problems of the Professional Service Business

601.8 A professional service business is like many other businesses in most ways. This discussion will focus on major estate planning issues peculiar to them.

601.9 A professional service business, unlike a manufacturing or retail business, is unique in that the primary product is not a tangible good. Upon the death of the principal owner of a closely held manufacturing or retail business, the heirs will be left with assets such as inventory, a building (or a lease), and, possibly, plant and equipment. In contrast, the owner of a personal service business will perhaps leave their heirs some tangible assets, such as furniture, fixtures, and equipment, but the major value of the business is in the expertise, reputation, and business contacts developed by the owner over a long period of time. To the extent that these assets are not lost by the owner's death, they will be represented by items such as customer lists, client records, and telephone numbers.

601.10 When a professional person practices in association with others, the form of business is often a partnership. In that case, the surviving partners or the partnership may acquire the deceased partner's interest under the terms of the partnership agreement. Some states permit professionals to practice as a professional corporation or service corporation. In that case, the stock of the deceased stockholder may be transferred by means of a stock purchase agreement or a redemption agreement. Where a professional practices in a partnership or corporation with others, the entity or the other professionals may make payments upon the professional's retirement. Such payments, which may be cast as *severance pay*, may in substance consist of the professional's accounts receivable at the time of retirement. These payments may also be payment for goodwill. If the professional dies before payments are completed, the remaining payments would be income in respect of a decedent under IRC Sec. 691(a).

601.11 Where the professional is a sole practitioner, special consideration should be given to the means of transfer upon their death. Rather than selling the assets individually, it would be easier to sell the stock of a corporation. The heirs would have a choice of selling the assets of the corporation or selling its stock.

601.12 Planning Tip: A professional practicing individually should consider incorporating to ease transfer of the business upon retirement or death. It is easier to transfer stock than to transfer individual assets. At least, incorporating the business gives the professional's heirs the option of transferring stock or assets.

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603 Valuing Certain Gifts of Family Owned Business Interests

603.1 If a transfer is subject to the special valuation rules of IRC Sec. 2701, the next step is to value the gift of the transferred junior interest. In the case of partnerships, either general or limited partners can have senior or junior rights. In the case of corporations, the preferred stock is considered the senior interest and the common stock is the junior interest. If a corporation has more than one class of preferred stock, it will be necessary to determine which class (or classes) of preferred stocks are *senior*. For example, one corporation had two classes of preferred stock and four classes of common stock. The transferor retained one class of preferred stock and transferred all of the other stock. The IRS ruled that IRC Sec. 2701 applied because the transferor retained one senior class of stock (Ltr. Rul. 9848006).

Valuing Transferred Junior Interest for Gift Tax Purposes

603.2 When IRC Sec. 2701 applies, the transferor's objective is to minimize the value assigned to the transferred interest (gift) and to maximize the value assigned to the interest retained by the transferor. The gift's value is determined using the subtraction (or residual) method of valuation [Reg. 25.2701-3(a)(1)]. Under this method, the value of the transferred interest is determined by subtracting the values of all family-held senior equity interests (e.g., preferred stock) from the fair market value of all family-held interests in the entity immediately before the transfer. The values of the senior equity interests retained by the transferor (and applicable family members) generally are determined under the special valuation rules. The balance is then allocated among the transferred interests and other family-held subordinate equity interests (e.g., common stock). Finally, any appropriate valuation discounts are subtracted from the value of the transferred shares to determine the amount of the gift subject to gift tax. (Valuation discounts are discussed in section 703.)

603.3 *Family-held* means owned directly or indirectly by the transferor, applicable family members (see paragraph 602.9), and any lineal descendants of the transferor's (or spouse's) parents (e.g., brothers, sisters, or nieces) [Reg. 25.2701-3(a)(2)(i)]. *Senior equity interest* means an equity interest that carries a distribution right to income or capital that is preferred over the rights of the transferred interest (e.g., preferred stock) [Reg. 25.2701-3(a)(2)(ii)]. A *junior equity interest* is one that is subordinate to an applicable retained interest (ARI).

603.4 The subtraction method of valuation involves a four-step process:

a. Determine the value of all family-held interests in the business.

b. Subtract the value of senior equity interests.

c. Allocate the remainder among transferred interests.

d. Determine the amount of the gift.

603.5 Step 1–Value All Family-held Interests. The first step is to determine the fair market value (FMV) of all family-held equity interests in the entity immediately after the transfer. The FMV is determined as if the interests are held by one individual, using a consistent set of assumptions [Reg. 25.2701-3(b)(1)(i)]. However, in the case of a contribution to capital, this simply means the FMV of the capital contribution [Reg. 25.2701-3(b)(1)(ii)]. The authors recommend an independent appraisal to determine this value.

603.6 Step 2–Subtract the Value of Senior Equity Interests. If the value in Step 1 does not relate to a contribution to capital, the following two amounts should be subtracted from the value determined in Step 1 [Reg. 25.2701-3(b)(2)(i)]:

• The FMV of all family-held senior equity interests other than applicable retained interests (ARIs) held by the transferor or applicable family members. Because these interests are not ARIs held by the transferor or applicable family members, they may be valued without applying the special valuation rules of IRC Sec. 2701 (i.e., valued using general valuation principles).

• The value of all ARIs held by the transferor or applicable family members. The value of these interests must be determined using the valuation rules of IRC Sec. 2701 (discussed in paragraph 603.8).

603.7 If the value in Step 1 relates to a contribution to capital, any ARI received in exchange for the contribution to capital should be subtracted.

603.8 Determining the Value of an Applicable Retained Interest (ARI). The value of the applicable retained interest (ARI) is determined using the general gift tax valuation rules (FMV under IRC Sec. 2512) with the following modifications [Reg. 25.2701-2(a)]:

• Any extraordinary payment right (right to compel liquidation, put, call, or lapsing conversion right) is valued at zero.

• Any distribution right in a controlled entity is valued at zero, unless it is a *qualified payment right*. (See paragraph 603.9.)

• A retained distribution right associated with a retained extraordinary payment right (e.g., put options, call options, or conversion rights) is valued by assuming that each extraordinary payment right is exercised in a manner that results in the lowest aggregate value for all rights, using general business valuation principles (consistent set of assumptions, due regard to the entity's net worth, prospective earning power, and other relevant factors). This provision is referred to as the *lower of valuation* rule.

603.9 Qualified Payment Right. Any distribution right in a controlled entity is valued at zero, unless it is a *qualified payment right*, which is the right to receive [Reg. 25.2701-2(b)(6)]—

• a dividend on cumulative preferred stock (or a comparable payment under any partnership interest), payable at least annually at a fixed rate;

• any other cumulative distribution payable at least annually to the extent determined at a fixed rate or as a fixed amount; or

• any distribution right for which an election is made to be treated as a qualified payment right pursuant to Reg. 25.2701-2(c)(2). (See paragraph 603.22 for discussion of this election.)

603.10 Qualified payment rights are valued using traditional valuation principles [Reg. 25.2701-1(a)(2)(iii)]. An example of a qualified payment is an annual cumulative preferred stock dividend. The dividend rate calculated must be fixed or calculated with reference to a specified market rate [IRC Sec. 2701(c)(3)]. The amount of the rate does not matter.

603.11 Planning Tip: To minimize gift tax, the transferor will want to value the retained interest as high as possible, because the higher the retained interest's value, the lower the value of the gift. Typically, a higher rate of return will produce a higher value, and a lower rate will produce a lower value. The authors suggest that the Section 7520 rate, published monthly by the IRS, should be a defensible rate of return. See Appendix 7D for a table of recent Section 7520 rates available at the time of publication.

603.12 Generally, if the cumulative preferred dividends are not paid within four years of when they are due, the taxable gifts of the transferor or the transferor's gross estate will be increased by the value of the unpaid distribution [IRC Sec. 2701(d)]. The value of the unpaid distribution is computed as if the distributions were paid when due and reinvested at a rate of return equal to the discount rate originally used in determining the value of the ARI. This rule is sometimes called the "compounding rule" and is discussed beginning at paragraph 604.20.

603.13 Observation: The requirements for annual distributions, coupled with the difficulty in valuing the applicable retained interest (ARI), preclude widespread use of estate freezes as an effective planning tool (see paragraph 600.3). In practice, IRC Sec. 2701 operates more as a trap for the unwary rather than a planning tool. Alternate ways to transfer business interests to family members include family partnerships using valuation discounts, private annuities, and self-canceling installment notes (SCINs). These techniques are discussed in sections 506, 503, and 502, respectively. Split-interest charitable trusts, discussed in sections 401 in the Tax Planning and Advisory *Charitable Giving* topic and 502 in the Tax Planning and Advisory *Charitable Giving* topic, and grantor retained annuity trusts, discussed in section 406, may also be appropriate techniques for transferring business interests.

603.14 Step 3–Allocate the Remainder among Transferred Interests. The value remaining after Step 2 is allocated among the transferred interests and other subordinate equity interests held by the transferor, applicable family members, and other members of the transferor's family [Reg. 25.2701-3(b)(3)]. If more than one class of family-held subordinate interest exists, the allocation is made beginning with the most senior class of subordinate equity interest in a way that will most fairly approximate their value if all rights valued at zero under IRC Sec. 2701 did not exist.

603.15 Step 4–Determine the Amount of the Gift. The amount allocated to the transferred interests in Step 3 is reduced by the amount of any consideration received by the transferor and for any minority, lack of marketability, or other valuation discount [Reg. 25.2701-3(b)(4)].

603.16 The regulations limit the minority discount to the discount that would have been allowed in the absence of IRC Sec. 2701. Presumably, this means that the availability of the minority discount cannot be expanded by IRC Sec. 2701 to any additional value resulting solely from applying IRC Sec. 2701. For example, if general valuation principles dictate that a transfer is valued at $100,000 and the subtraction (or residual) method of IRC Sec. 2701 results in a valuation of $125,000, determining the minority discount cannot take into account the additional $25,000 resulting from the application of IRC Sec. 2701.

603.17 The valuation rules of IRC Sec. 2701 are illustrated in the following examples.

Example 603-1: Value of gift when cumulative preferred stock is retained.

Charles Abbott owns 100% of the outstanding stock of Abbott Enterprises, Inc. (AEI). The FMV of AEI is $2 million. Immediately following a recapitalization of AEI, Charles owns 1,000 shares of cumulative preferred stock and 1,000 shares of common stock. The preferred stock's dividend rate is 10%. Charles transfers the common stock to his son, David. The FMV of the qualified payment right of the preferred stock and the liquidation participation right is $1.5 million, determined by an independent professional appraisal.

The value of the gift to the son is $500,000. This amount is determined under the residual (or subtraction) method as follows:

Step 1 Value of all family-held interests	$	2,000,000
Step 2 Subtract the value of senior equity interests (preferred)		(1,500,000)
Step 3 Allocate the remainder among transferred interests (common)		500,000
Step 4 Subtract discount, consideration, etc.		—
Amount of Gift		$500,000

Example 603-2: Value of gift when noncumulative preferred stock is retained.

Assume the same facts as in Example 603-1, except the preferred stock has a noncumulative dividend option and the election to treat it as cumulative is not made (see paragraph 603.22). Because the preferred stock is noncumulative, the potential payment of a dividend is not a *qualified payment right* and therefore is valued at zero. Any extraordinary payment rights in the stock (e.g., the right to compel liquidation, put options, or call options) are valued as though the noncumulative dividend right does not exist. These extraordinary payment rights are valued at zero. However, the liquidation participation right (not to be confused with a right to compel liquidation) does add value to the preferred stock. For ease of illustration, the liquidation right is valued at $200,000. Therefore, the amount of the gift in this example is computed as follows:

Step 1 Value of all family-held interests	$	2,000,000
Step 2 Subtract the value of senior equity interests (preferred)		(200,000)

Step 3 Allocate the remainder among transferred interests (common)	$	1,800,000
Step 4 Subtract discount, consideration, etc.		—
Amount of Gift		$1,800,000

Example 603-3: Value of retained interest using the *lower of* valuation rule.

Hal Jones owns all of the stock of Jones, Inc. The company has 1,000 shares of outstanding voting preferred stock that carries a per share cumulative annual dividend of 10% ($100) and the right to sell the stock (a put option) to Jones, Inc. for $800 per share at any time. Hal also owns 1,000 shares of outstanding nonvoting common stock. The FMV of Jones, Inc., is $1.7 million. This year, Hal gives the common stock to his daughter, Sophie. The FMV of the preferred stock is appraised at $1 million.

The preferred stock has an extraordinary payment right in the form of the put option that requires it to be valued by the *lower of* valuation rule. If the put option is immediately exercised, the value of the preferred stock will be $800,000 ($800 × 1,000 shares). Therefore, the retained interest is valued at $800,000, which is the lower of $1 million (the appraised value) or $800,000 (the option price).

The gift value of the common stock to Sophie is $900,000 computed as follows:

Step 1 Value of all family-held interests	$	1,700,000
Step 2 Subtract the value of senior equity interests (preferred)		(800,000)
Step 3 Allocate the remainder among transferred interests (common)		900,000
Step 4 Subtract discount, consideration, etc.		—
Amount of Gift		$900,000

603.18 Note: The *lower of* valuation rule was applied to a family partnership scenario in Ltr. Rul. 9417024.

603.19 Caution: Because of this *lower of* rule, adding rights that are extraordinary payment rights (e.g., put options, call options, or conversion rights) to the retained interest might actually lower the value of the retained interest, therefore increasing the value of the gift.

Example 603-4: Value of retained interest taking into account consideration paid to the transferor.

Assume the same facts as in Example 603-3, except Sophie pays her father $300,000 for the common stock.

The value of the gift of the common stock to Sophie is $600,000 computed as follows:

Step 1 Value of all family-held interests	$ 1,700,000
Step 2 Subtract the value of senior equity interests (preferred)	(800,000)
Step 3 Allocate the remainder among transferred interests (common)	900,000
Step 4 Subtract consideration paid for the stock	(300,000)
Amount of Gift	$600,000

Special Considerations

603.20 Three special provisions that should be considered when dealing with the valuation rules of IRC Sec. 2701 are the minimum value rule, the election to treat distribution rights as qualified payment rights, and the election to not treat distribution rights as qualified payment rights.

603.21 Minimum Value Rule. The minimum value rule prevents allocating too much value to the retained interest. This rule provides that the value assigned to a junior equity interest (e.g., common stock) cannot be less than a pro rata portion of 10% of the total value of all the equity interests in the entity and the total amount of any indebtedness owed to the transferor and applicable family members. Indebtedness for this purpose does not include short-term indebtedness incurred in the ordinary course of business (such as amounts payable for current services). It also does not include a corporate obligation to make future lease payments as long as they are made when due and represent full and adequate consideration for use of the leased property [Reg. 25.2701-3(c)(3)]. For a partnership, junior equity is any interest whose rights to income or capital are junior to other classes of equity interests [IRC Sec. 2701(a)(4)].

Example 603-5: Application of the minimum value rule.

Dave Johnson owns all of the 1,000 shares of cumulative preferred stock (and therefore includes a qualified payment right) and all of the 100 shares of common stock of Johnson, Inc. The preferred stock is valued at $950,000 and the common stock is valued at $50,000. Dave gives all of the common stock to his daughter, Julie. Normally, the value of the gift to Julie would be $50,000 as follows:

Step 1 Value of all family-held interests	$ 1,000,000
Step 2 Subtract the value of senior equity interests (preferred)	(950,000)
Step 3 Allocate the remainder among transferred interests (common)	50,000
Step 4 Subtract discount, consideration, etc.	—
Amount of Gift	$50,000

However, the minimum value rule provides that the value assigned to the common stock received by Julie cannot be less than 10% of the total value of all the equity interests in the company. The total value of all equity interests is $1 million, and 10% of this value is $100,000. Therefore, the value of the gift to Julie for gift tax purposes is $100,000 instead of $50,000.

603.22 Election to Treat Distribution Rights as Qualified Payment Rights. A holder of a distribution right that is not a qualified payment right (e.g., noncumulative preferred stock) may elect to treat all or part of the distribution right as if it were a qualified payment right (e.g., cumulative preferred stock) [Reg. 25.2701-2(c)]. Distributions that are qualified payment rights will be treated as such unless the transferor elects otherwise. See Key Issue 34C of PPC's 706/709 Deskbook for a discussion of this election. (See paragraph 603.25 for a discussion of subsequent revaluation of the gift when distributions are not made.)

603.23 Note: Applicable family members who are holders of distribution rights that would otherwise be treated as qualified payment rights (if held by the transferor) must affirmatively elect to have the payments treated as qualified payment rights.

603.24 Caution: No election is available to treat extraordinary payment rights (i.e., put options, call options, or conversion rights) as qualified payment rights.

Example 603-6: Electing to treat noncumulative preferred stock as cumulative preferred stock.

Hank Brown owns all of the outstanding stock of Brown Enterprises, Inc. Hank gives all of the common stock to his daughter, Cindy, and retains all of the 10% noncumulative preferred stock. An independent appraisal shows that the value of the preferred stock is $300,000 and the value of the common stock is $700,000.

The noncumulative preferred stock does not have a qualified payment right, and therefore the noncumulative dividend right is valued at zero for gift tax purposes under IRC Sec. 2701. However, the liquidation participation right of the preferred stock does provide value to the preferred stock. For ease of illustration, it is assumed the right is valued at $10,000. This means the value of the gift to Cindy is $990,000 as follows:

Step 1 Value of all family-held interests	$ 1,000,000
Step 2 Subtract the value of senior equity interests (preferred)	(10,000)
Step 3 Allocate the remainder among transferred interests (common)	990,000
Step 4 Subtract discount, consideration, etc.	—
Amount of Gift	$990,000

However, Hank may elect to treat the noncumulative preferred stock as if it has a qualified payment right (i.e., cumulative preferred stock). This election will cause the company to be legally obligated to make the distributions. But, the value of the gift to Cindy will be reduced to $700,000 as follows:

Step 1 Value of all family-held interests	$ 1,000,000

Step 2 Subtract the value of senior equity interests (preferred)	(300,000)
Step 3 Allocate the remainder among transferred interests (common)	700,000
Step 4 Subtract discount, consideration, etc.	—
Amount of Gift	$700,000

Example 603-7: Electing to treat partnership distribution right as a qualified payment right.

Joe Brown and his son, Charles, are partners in Brown and Son Partnership, to which Joe contributes an existing business. Under the terms of the partnership agreement, Joe is entitled to 80% of the net cash receipts of the partnership until he receives $2 million. At that point, he and Charles will each receive 50% of the partnership's cash flow. The retained distribution right of $2 million is valued at zero unless Joe makes the election to treat it as a qualified payment right. If Joe makes the election, he must receive the qualified payments in the amounts and at the times specified in the election [Reg. 25.2701-2(c)(2)].

603.25 Caution: If the distributions the transferor elected to treat as qualified payments are not made within four years of their specified payment date, the transferor's taxable gift (or the estate, in the event of death of the transferor) will be increased by the value of the unpaid distributions [IRC Sec. 2701(d)]. The value of the unpaid distributions is computed as if the distributions were paid when due and reinvested at a rate of return equal to the discount rate originally used in determining the value of the applicable retained interest. This rule is sometimes referred to as the compounding rule, which is discussed in paragraph 604.20.

603.26 Election to Not Treat Distribution Rights as Qualified Payment Rights. A holder of a distribution right that is a qualified payment right (e.g., cumulative preferred stock) may elect to treat all or part of the distribution right as if it were not a qualified payment right (e.g., noncumulative preferred stock) [IRC Sec. 2701(c)(3)(C)(i)]. This election may be useful when the holder of cumulative preferred stock is concerned that the company will not be able to pay scheduled dividends. By making the election to treat the stock as though it is noncumulative, the preferred shareholder avoids additional gift or estate tax consequences that will otherwise be imposed if qualified payments are not made within four years of their due date. However, the immediate effect of this election is to increase the transferor's gift tax at the time of the transfer. See Key Issue 34C of PPC's 706/709 Deskbook for additional discussion of this election.

Example 603-8: Electing to treat cumulative preferred stock as noncumulative preferred stock.

Chad White owns all of the outstanding stock of White Enterprises, Inc. Chad gives all of the common stock to his son, Bobby, and retains all of the cumulative preferred stock. An independent appraisal shows that the value of the preferred stock is $300,000 and the value of the common stock is $700,000. The company has an unpredictable sales history and Chad fears the company may not always be able to pay the dividends on the preferred stock or may not be able to pay them on time. Therefore, Chad elects to treat the cumulative preferred stock as though it does not have a qualified payment right (i.e., noncumulative preferred stock). For ease of illustration, it is assumed the preferred stock has a liquidation participation right of $10,000. As a result of the election, the value of the gift of common stock to Bobby is $990,000 as follows:

Step 1 Value of all family-held interests	$	1,000,000
Step 2 Subtract the value of senior equity interests (preferred)		(10,000)
Step 3 Allocate the remainder among transferred interests (common)		990,000
Step 4 Subtract discount, consideration, etc.		—
Amount of Gift		$990,000

Another result of Chad's election is that if the company does not pay preferred dividends in a timely manner, there are no additional gift or estate tax consequences imposed on Chad that otherwise would be imposed if the dividends were cumulative [IRC Sec. 2701(d)].

603.27 Observation: If the holder of the distribution right is an applicable family member instead of the transferor, no election is available. A transferor's *applicable family member* includes the transferor's spouse, any ancestor of the transferor or the transferor's spouse, and the spouse of any ancestor [Reg. 25.2701-1(d)(2)].

603.28 Note: The time for making an election by an applicable family member to have payments treated as qualified payments does not expire before the due date including extensions for filing the transferor's return of the tax imposed by IRC Sec. 2501 for the first calendar year. The election under IRC Sec. 2701(c)(3)(C)(i) is eligible for an automatic 12-month extension from the due date for filing this regulatory election [Reg. 301.9100-2(a)(1)]. Any return, statement of election, or other form of filing that must be made to obtain an automatic extension must provide the following statement at the top of the document, "FILED PURSUANT TO SECTION 301.9100-2" [Reg. 301.9100-2(d)].

603.29 Planning Tip: Assuming there is a good faith belief that the payments (under the distribution rights) will be made, it would appear that generally the election to treat distribution rights as qualified payment rights should be made. If the payments are made, the transferor will have the advantage of having reduced the value of the IRC Sec. 2701 transfer. If the payments are not made, and if the distribution rights have been valued at zero, the increase to the taxable gifts or taxable estate would have occurred anyway.

Valuing Lapsing Rights and Liquidation Restrictions

603.30 Before 1990, entities were created which allowed certain owners to have voting or liquidation rights that would lapse at the occurrence of a specified event, such as the owner's death. Thereafter, these ownership interests would not be worth as much as they otherwise would have if the lapsed rights had remained in effect. Partnership agreements could be drafted to virtually eliminate the ability of a limited partner to liquidate their interest. These restrictions would be used to depress the value of the transferred interests for gift tax purposes. To curb these perceived abuses, IRC Sec. 2704 provides valuation rules for lapsing rights and applicable restrictions. See section 704 for additional discussion of valuing lapsing rights and liquidation restrictions.

603.31 Lapsing Rights. A voting right is the right to vote on any matter of the entity. For a partnership, the right of a general partner to participate in management is a voting right [Reg. 25.2704-1(a)(2)]. The lapse of any voting or liquidation right in connection with a family-controlled corporation or partnership (see paragraph 603.35) will be treated as a transfer for estate and gift tax purposes (IRC Sec. 2704). The transferred amount is the value of the lapsed right. The value of the lapsed right is the excess of the value of all interests (determined as though voting and liquidation rights were nonlapsing) immediately prior to the lapse over the value of all interests after the lapse.

603.32 Note: Special rules apply to voting rights created *before* October 9, 1990.

Example 603-9: Valuation of lapsing rights when the shareholder dies.

Father owns voting preferred stock representing 100% of the vote of the corporation, with the voting rights lapsing at his death. Father passes the stock to Son at Father's death. At Father's death, the voting preferred stock is valued at $500,000, determined as if the voting rights would not lapse. After the lapse of the voting rights, the voting preferred stock is valued at $450,000. The resulting value of the lapsed voting rights is $50,000 ($500,000 –

$450,000). The amount included in Father's estate would be $500,000, the value of the preferred stock with the lapsed voting rights ($450,000) plus the value of the lapsed rights ($50,000). In short, Father's stock is valued as if the voting rights were nonlapsing.

Example 603-10: Valuation of lapsing rights when a partner dies.

Father owns a general partnership interest with the voting rights lapsing at his death. Father passes the partnership interest to Son at Father's death. At Father's death, the general partnership interest is valued at $500,000, determined as if the voting rights would not lapse. After the lapse of the voting rights, the partnership interest is valued at $450,000. The resulting value of the lapsed voting rights is $50,000 ($500,000 − $450,000). The amount included in Father's estate would be $500,000 [the value of the partnership interest with the lapsed voting rights ($450,000) plus the value of the lapsed rights ($50,000)]. In short, Father's partnership interest is valued for estate tax purposes as if the voting rights were nonlapsing.

603.33 Defining Liquidation Rights. IRC Sec. 2704 also curbs the ability to use liquidation restrictions to suppress the value of an interest in a closely held business. A liquidation right is a right that enables the holder to compel the entity to buy the holder's equity interest or a portion of it [Reg. 25.2704-1(a)(2)]. Any restriction that limits the ability of a corporation or partnership to liquidate is disregarded in a family context if—

- the transferor and family members control the entity, as defined in paragraph 603.35, and
- the restriction lapses after the transfer or can be removed by the transferor or family members (alone or together).

603.34 Note: A liquidation participation right under IRC Sec. 2701 is not the same as a liquidation right under IRC Sec. 2704 (i.e., the right to compel distribution, which is an extraordinary payment right).

Example 603-11: Disregarding a restriction that lapses.

Mother and her two daughters are the only partners in a partnership. The partnership agreement provides that the partnership cannot be dissolved. Mother dies and leaves her partnership interest to her son. The partnership interest is valued in Mother's estate without regard to the liquidation restriction because the two daughters and the son, as the only partners, could amend the partnership agreement to remove the liquidation restriction.

603.35 Definitions of Control and Family. In the case of a corporation, *control* means the holding of at least 50%, by vote or value, of the stock. In the case of a partnership, control means the holding of at least 50% of the capital or profits interest, or, in the case of a limited partnership, the holding of any general partnership interest. Family means an individual's spouse, ancestors, lineal descendants, siblings, and the spouse of any ancestor, lineal descendant, or sibling [Reg. 25.2704-1(a)(2)].

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604 Using a Corporate Recapitalization to Transfer Common Stock

604.1 A corporate recapitalization involves the issuing new classes of stock. Transfer tax savings result when the value assigned to the preferred stock retained by the original shareholder is maximized while the value assigned to the common stock transferred to another shareholder is minimized. When the transferee is a younger-generation family member, the values must be determined within the constraints of IRC Sec. 2701, as described in section 602. Accordingly, the successful use of this technique within a corporate structure involves deciding how to recapitalize the corporation and what rights or features to assign to the preferred stock.

604.2 The valuation limitations imposed by IRC Sec. 2701 on corporate recapitalizations (also referred to as corporate estate freezes) have limited the usefulness of corporate recapitalizations in conjunction with transfers to lineal family members. However, the corporate recapitalization is still useful when the Section 2701 rules are inapplicable. Transfers to unrelated parties or to collateral relatives (e.g., nephews, nieces, cousins) are not subject to IRC Sec. 2701, so the value of the shares transferred and the preferred shares retained by the original owner may be valued using traditional methods of valuation.

Example 604-1: Corporate Recapitalization

Parent and children each own common shares in a "C" corporation. This could occur where, earlier, parent gave these common shares to children. Parent then exchanges his common shares for preferred shares with a fixed liquidation value and set preferred cumulative dividend. Parent's shares, being fixed in value, now shift growth to the children's common shares. The parent's estate will still contain the value of the preferred shares, plus all dividends received, reduced by income tax thereon and increased by any growth from the investment of those dividends. The preferred dividend rate must be determined by appraisal.

604.3 When the Section 2701 rules apply and a recapitalization is considered, planners should consider the anticipated appreciation of the common stock in relation to the preferred stock's required dividend payout percentage. The anticipated appreciation must be greater than the required dividend payments to attain any estate tax benefit. The planner should also ensure that the cash flow requirements of a cumulative preferred dividend will not be a strain on the corporation's financial position.

How to Restructure the Corporation

604.4 Restructuring a corporation involves creating new classes of corporate stock, which may be accomplished in several different ways. This section briefly discusses two of the more common methods of creating additional classes of stock. Competent legal counsel should be retained when restructuring the corporation to ensure compliance with state and federal securities laws.

604.5 Restructuring typically has no immediate income tax consequences to the parties involved. However, the proposed transaction should be examined to ensure that adverse income tax consequences are avoided.

604.6 Creating Different Classes of Corporate Stock. A common method to create different classes of corporate stock is to have the directors and shareholders simply amend the corporate charter to authorize issuance of the desired stock. Shareholders then exchange their existing shares for the new class(es) of stock.

604.7 Preferred Stock Dividend. Another often-used approach is to declare a dividend of a specified number of shares of preferred stock for every share of common stock outstanding. This approach results in all present owners retaining their proportionate equity interest in the company because the preferred stock dividend is distributed proportionately to existing shareholders and the special valuation rules of IRC Sec. 2701 would not apply (see paragraph 602.26).

Assigning Attributes to the Preferred Stock

604.8 Certain attributes that can be assigned to the preferred stock as part of the corporate restructuring should be considered in light of the objectives of the preferred stock shareholders. Common objectives of the preferred shareholders include reducing the gift tax value of the common stock transferred to family members while retaining some degree of control of the corporation or, at other times, transferring some degree of control.

604.9 Voting versus Nonvoting. Maintaining voting rights with the retained preferred stock is appealing for an individual who has actively managed the affairs of a business for a period of time and who wishes to maintain some degree of control and participation in the business. However, maintaining control and participation would likely cause the stock to be included in the owner's gross estate at a higher value than if only nonvoting rights existed at the time of their death.

604.10 Cumulative versus Noncumulative Dividends. Making the preferred stock dividends cumulative has the advantages of assuring that the dividends will be paid, and in the case of a transfer of business ownership involving family members, the dividends are *qualified payments* under IRC Sec. 2701. As a result, additional value will be attributed to the retained preferred stock, and the value of the gifted shares will be minimized. The same result will occur if the transferor elects to treat noncumulative preferred shares as cumulative. (See paragraph 603.22.) However, if an election is made, dividends must be paid to avoid additional gift or estate tax consequences. (See paragraph 604.20 for additional discussion.)

604.11 Amount of Dividend. The value of cumulative preferred stock is affected by the size of the dividend associated with it. The larger the stated dividend rate or amount, the greater the value of the retained preferred stock (and the lesser the value of the transferred common stock for gift tax purposes). However, before a large dividend is assigned to the preferred shares, the planner and the client must analyze the corporation's cash flow situation and its ability to make the dividend payments. The dividends *must* be paid and are not deductible payments for tax purposes.

604.12 Extraordinary Payment Rights. In family transfer situations, extraordinary payment rights are valued at zero (i.e., will not increase the value of the preferred stock) (see paragraph 602.11). These rights include put options, call options, and rights to compel liquidation *and* do not add value to the retained preferred stock for gift tax valuation purposes. As discussed in paragraph 603.19, an extraordinary payment right can cause the value of the gift to increase. However, these rights should be given proper nontax consideration.

604.13 Mandatory Payment Rights. Mandatory payment rights add value to the retained preferred stock only if payment is to be made at a fixed price and at a fixed time. These rights are to be considered for shareholders who desire to retain control over the business through voting preferred stock but who also know when they wish to retire completely from the business.

Example 604-2: Using mandatory payment rights to increase the value of retained preferred stock.

Mike Mitchell owns all of the cumulative voting preferred stock and nonvoting common stock of Mitchell, Inc. His son, David, has done well in the business, and Mike transfers all of the common stock to David. The corporate charter is amended to allow the preferred stock to have a redemption right so that in three years, Mike must offer the stock to the company, and the company must redeem it for its stated par value of $2 million.

The redemption right is a mandatory payment right that will increase the value of Mike's retained preferred stock, and will lower the amount of the gift of the common stock to his son.

604.14 Liquidation Participation Rights. The right of a shareholder to participate in a liquidating distribution will enhance the value of the retained preferred stock. However, the right to compel liquidation is an extraordinary payment right and will add no value to retained preferred stock (in family transfer situations).

604.15 Nonlapsing Conversion Rights. The permanent right to convert the preferred stock into a fixed number of shares or a fixed percentage of shares of common stock will add value to the retained preferred stock. This type of permanent conversion right should be given serious consideration in almost all corporate restructurings involving a transfer of stock from an older individual to a younger person. It allows the older generation shareholder an opportunity to later change their mind and again participate in the growth of the company. For example, if the growth of the company greatly exceeded initial expectations, the older generation can recapture a share of the growth by exercising the conversion rights. However, the planner should also note that the exercise of these rights will ultimately decrease the value of the stock that initially was transferred to the children (because they will no longer own all of the common stock) and correspondingly increase the value of the interest held by the older generation.

The Compounding Rule and Other Drawbacks of a Corporate Recapitalization

604.16 Corporate recapitalizations involving older and younger-generation family members were very popular before the enactment of IRC Sec. 2701, especially when inflation (and appreciation potential) was high. Although this corporate *freeze* may still be appropriate in certain situations, the planner should consider the drawbacks of the technique, including the *compounding* rule, before recommending a recapitalization to any clients.

604.17 Observation: Currently this is not a widely used technique and the planner should also consider other options before recommending a recapitalization.

604.18 Gift Tax. The impact of the initial gift to the lower generation must be considered. The value of the gift will not be reduced by extraordinary payment or certain distribution rights for gift tax purposes under the Section 2701 special valuation rules. (See paragraph 603.8.)

604.19 Cash Flow. The cash flow needs of the business must be addressed. Imposing a cumulative preferred dividend requirement to increase the value of the retained preferred stock (and reduce the gift tax impact) could adversely affect the cash flow requirements for normal business operations. Any excess cash remaining after normal business operations may be needed to expand the business instead of paying dividends. Also, the nondeductibility of dividend payments for tax purposes will affect the cash flow requirements of the business, given that dividends must be paid with after-tax dollars.

604.20 Compounding Rule. When a qualified payment (e.g., dividend) is not paid and the right to receive the payment is transferred either during life or at death, the transferor's taxable gifts or taxable estate is increased by the adjusted value of the qualified payment [Reg. 25.2701-4(c)(1)]. The adjusted value of the payment is calculated as if the payment was made timely and reinvested at the same interest rate originally used to discount the value of the retained interest, compounded annually. Any actual payments made are deducted from the adjusted value. The hypothetical earnings on those payments (determined as if each payment were paid on its due date and reinvested as of that date at an appropriate discount rate) must also be included in the calculation.

604.21 If the transfer of the right to receive the qualified payment is made to the retained interest holder's spouse (either during the holder's lifetime or at the death of the holder), and the gift or estate marital deduction is allowed, the compound rule is not applied until the spouse's death (or subsequent transfer of the qualified payment right by the spouse).

604.22 If the payment is made late, the taxable gifts or taxable estate is still increased by the time-value of the deferral. The value of the deferral is calculated in the same way as the value of a payment never made, from the date the payment was initially due using the discount rate of interest originally used to calculate the retained interest, less payments actually made.

604.23 IRC Sec. 2701 provides a four-year grace period during which late payments made to the retained interest holder are treated as though they were made timely. Because they are treated as timely, no additional value for the deferral must be included in the retained interest holder's taxable gifts or taxable estate. The payments must be received while the holder is alive. Payments made within the four-year period but after the death of the retained interest holder do not qualify for the grace period treatment and are not treated as timely (i.e., the taxable estate will be increased by the time-value of the deferral).

604.24 Planning Tip: Because the four-year grace period does not apply after a subsequent lifetime transfer of the retained interest or the death of the retained interest holder, consider bringing the required payments up to date if the retained interest holder is terminally ill or if the holder is considering a lifetime transfer.

Example 604-3: Application of the compounding rule.

Nancy Simmons gives common stock in Simmons Corp. to her daughter, Ann, and retains preferred stock. The preferred stock includes the right to receive a $200,000 cumulative annual dividend which is a qualified payment right under IRC Sec. 2701. The dividend is payable on January 1 of each year. Assume the value of the preferred stock retained by Nancy, using the Section 7520 rate of 3% at the date of the transfer is $3 million. Nancy died

10 years after the first payment was due and none of the dividend payments were ever made.

If the dividend payments had been timely made and reinvested at the original discount rate of 3% compounded annually, the value of the ten unmade payments would be $2,361,559. Assuming Nancy's accumulated right to receive the ten unmade payments is already included in the estate at a value of $2 million (10 years × $200,000 annual dividend), the taxable estate will be increased under IRC Sec. 2701 by $361,559. The four-year grace period rule does not apply because the retained payments were not made to Nancy while she was alive.

Variation: Assume instead that Nancy was alive at the end of the 10-year period when Simmons Corp. paid her $2 million representing all past due dividends (10 years × $200,000). Nancy continued to receive her annual dividend from Simmons Corp. until her death five years later. At the end of the 10-year period when the $2 million payment was made, the four-year grace period rule treats the payments due from the four most recent years (years 7–10) as timely made. However, the six payments due before the four most recent years (years 1–6, for which the four-year grace period had expired) are not treated as timely. When Nancy died five years later, the value of the deferred payments was included in her estate.

The deferred value is calculated by treating the dividend payments as if they were invested at the time they were due (January 1 of each year) at the original discount rate of 3% compounded annually. The value of the first six unmade payments at the end of the tenth year is $1,499,732. From this amount, the $1,200,000 payment made in those years (6 years × $200,000) is deducted leaving a deferred value at the end of 10 years of $299,732. This amount continues to compound annually until the earlier of Nancy's death or the lifetime transfer of the stock. The increase in Nancy's taxable estate due to the fact that the first six payments were not made timely (or treated as timely through the use of the four-year grace period rule) is $347,472 ($299,732 compounded annually at 3% for five years before Nancy's death). At an effective federal estate tax rate of 40%, this results in additional tax of $138,989. The tax cost increases if Nancy resides in a state that imposes a state estate tax.

604.25 Planning Tip: If a corporation or partnership cannot make the required payments for a short time, debt instruments issued by the corporation or partnership may be used to fill the gap [Reg. 25.2701-4(c)(5)]. The debt may not have a term greater than four years and must include a rate of interest equal to or greater than the discount rate originally used to value the retained interest, compounded annually.

604.26 As noted in Example 604-3, the compounding rule ordinarily increases the taxable gifts of the individual retaining the qualified payment right (when transferred during the retained interest holder's lifetime) or the taxable estate of the retained interest holder (if the stock is held until death). However, the retained interest holder may elect to apply the compounding rules at an earlier period when making an actual payment [IRC Sec. 2701(d)(3)(A)(iii)]. If the taxpayer makes this election, the increase in the taxpayer's taxable gifts is determined for the payment for which the election was made as well as all previous unmade payments for which an election was available but not made. The election may not be advisable in certain circumstances, as discussed in the warning at paragraph 604.30. It is revocable only with the consent of the IRS.

Example 604-4: Election to apply the compounding rule before a lifetime transfer or the death of the retained interest holder.

Based on Example 604-3, assume that at the end of the 10-year period Nancy elects to apply the compounding rule. To apply the rule, Nancy increases the amount of her taxable gifts in year 10 by $299,732 and includes the appropriate election with her gift tax return. By including this amount in her taxable gifts in year 10, the $347,472 that would have been included in Nancy's estate without this election will no longer be included in her estate.

604.27 If the qualified payments are in arrears and all or a portion of the retained interest is transferred during the original holder's lifetime (except to the holder's spouse), the individual's taxable gifts are increased by the value of the payments not made.

Example 604-5: Transferring the retained interest during the original holder's lifetime.

Based on Example 604-3 and Example 604-4, assume that Nancy is still alive at the end of year 15 and she did not elect to apply the compounding rule at the end of year 10. At the end of year 15, Nancy decides to give equal shares of her preferred stock to her daughter, Ann, to her good friend, Emma, and to her favorite charity. The preferred stock is still worth $3 million at the end of year 15.

The calculation of the taxable gift begins with the value of the preferred stock, $3 million. Add to this amount the $347,742 representing the time value of the deferral of the first six required payments compounded through the end of year 15. This results in taxable gifts before the charitable deduction of $3,347,472. The charitable deduction of $1 million (one-third share of the value of the retained interest valued at $3 million) is deducted from this amount. The entire increase due to the late payments is a taxable gift by Nancy regardless of the recipient.

Example 604-6: Transferring the retained interest to a spouse.

Instead of giving the right to receive the qualified payments to those donees listed in Example 604-5, Nancy decides to give her retained interest to her spouse, Frank. Frank is a U.S. citizen, so the gift tax unlimited marital deduction may be used to offset the value of the gifted stock. Instead of Nancy's taxable gifts increasing by the $347,472, the unpaid deferral will continue to compound until transferred by Frank. When Frank dies or transfers the stock to someone else, his taxable estate or taxable gifts will include the $347,472, increased by 3% compounded annually for the remainder of the term the stock was held by Frank.

604.28 If the right to receive the qualified payments is transferred by the holder of the right during the holder's lifetime or by the holder's estate at death, the increase in the retained interest (preferred stock) holder's taxable gifts or taxable estate is limited to the proportional increase in value of the junior interests (common stock) originally transferred by the retained interest holder. This limit is equal to the increase in the value of all the junior interests starting from the date of the original transfer and ending on the date that the retained interest is transferred.

604.29 If the retained interest holder owns less than 100% of a class of a retained equity interest, the proportionate ownership percentage retained is multiplied by the total increase in the value of the junior interest (i.e., the common stock transferred) to arrive at the limit.

604.30 Warning: The limit on the increase of the taxable estate or taxable gifts of the retained interest holder is not available when the compound rule is electively applied as discussed at paragraph 604.26. Because the limit is not available, planners should analyze the value of the junior interest transferred to determine whether the election to apply the compounding rule should be made.

Example 604-7: Limit on the increase of the retained interest holder's taxable gifts or taxable estate.

Larry Stooge owns 100% of the Stooge Corporation. Immediately following a recapitalization of the company, Larry gives all of the common stock of the corporation to his son, Moe, and retains all of the newly issued preferred stock. The preferred stock includes the right to receive a cumulative annual dividend payment of $200,000 which is a qualified payment right under IRC Sec. 2701. The value of the preferred stock retained by Larry using a 5% discount rate is $3 million, while the value of the common stock transferred to Moe is $2.1 million. Larry died 10 years after the first payment was due, and none of the dividend payments were ever made.

If the payments had been made timely and reinvested at the original discount rate of 5% compounded annually, the value of the 10 unmade payments would be $2,641,357. Larry's unpaid payment rights at the time of his death were $2 million (10 years × $200,000 annual payment). The common stock transferred to Moe was valued at $2.7 million on the date of Larry's death. Without the previously discussed limitation, Larry's gross estate would include $641,357 attributable to the compounded value of the unpaid qualified payments on the date of death ($2,641,357) in excess of the face amount of the unpaid qualified payments ($2 million). However, the increase in the taxable estate is limited to the increase in the value of the junior interests from the date of the original transfer to the date of the second transfer (i.e., the date of Larry's death) which is $600,000 ($2.7 million − $2.1 million).

Variation: Instead of owning all of the stock in Stooge Corporation, Larry owned 90% of the company prior to the recapitalization and retained 90% of the preferred stock afterward. To calculate the limitation, 90% would be multiplied by the total increase in value of the common stock transferred to arrive at Larry's proportionate limit of $720,000 (90% × $800,000 increase in value of the common stock).

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606 Using a Partnership Recapitalization to Transfer Partnership Interests

606.1 When a closely held business is conducted within a partnership structure, a recapitalization of the partnership (also referred to as an estate freeze) is often the best way to transfer ownership of the business. Ideally, it allows the owner to retain control while minimizing transfer taxes.

Example 606-1: Partnership Freeze

A limited partnership is created with general partnership units and two types of limited partnership units: preferred and non-preferred. Parent contributes an asset to the partnership and receives back general partnership and preferred limited partner units. Parent also receives back non-preferred limited partner units and gives or sells them to the children or trusts for their benefit. Alternatively, the children could contribute assets for these units. Generally, the general partnership interest will represent one or two percent of the partnership value and will entitle the holder to that percentage of capital, income and appreciation. The general partner will manage the partnership. The preferred units will have a fixed liquidation value and are to receive a preferred return. Non-preferred (or growth) units are to receive all other income and appreciation. The preferred rate of return must be determined by appraisal. Also, note that the partnership must consider cash flow; it must be able to make the preferred distributions. If there is insufficient cash, the partnership must borrow it or distribute partnership assets.

606.2 Observation: The sale (rather than a gift) to a grantor trust may be preferable to avoid the concerns of assets contributed to a family limited partnership being includable in the donor's estate because of the retained interest [*Powell*]. See also section 410 for a discussion on intentionally defective grantor trusts.

606.3 Although IRC Sec. 2701 has limited the use of partnership recapitalizations in the same way it has limited corporate recapitalizations (as discussed at sections 602 and 604), the partnership recapitalization may be preferable to the corporate recapitalization. A significant advantage of the partnership recapitalization is that the distributions associated with the preferred retained partnership interest are not subject to the double taxation to which preferred stock dividends are subject (see paragraph 605.6). In addition, if guaranteed payments are used for the preferred partner in this strategy, the payments will reduce the partnership's taxable income to the other partners.

606.4 A partnership recapitalization involves creating new classes of partnership interests. Transfer tax savings result when the value assigned to the preferred partnership interest retained by the owner is maximized while the value assigned to the common partnership interest transferred to a (younger-generation) family member is minimized. Future appreciation accrues to the owner of the common partnership interest. However, the values must be determined within the constraints of IRC Sec. 2701, as described in section 602. Accordingly, the successful use of the recapitalization in a partnership structure involves deciding how to restructure the partnership and what rights or features to assign to the preferred partnership interest.

Creating Different Classes of Partners

606.5 The easiest way to accomplish a partnership recapitalization is to draft or amend the partnership agreement so that two classes of partners are created: a preferred partner and a common partner. For example, a preferred partner may be liable for all of the outstanding partnership debt; participate in the management; have the right to a guaranteed annual payment; have the right to compel liquidation of the partnership; and have the right to participate in liquidation distributions. These attributes are normally (but not always) associated with a general partnership interest. However, a common partner may be liable for partnership obligations only to the extent of their capital contributions or those liabilities expressly assumed; may not be allowed to participate in the management of the partnership; and may have to agree to restrictions on the transferability of their partnership interest. These attributes are normally (but not always) associated with a limited partnership interest.

Assigning Attributes to the Preferred Partnership Interest

606.6 Several attributes that can be assigned to the preferred partnership interest resulting from the partnership restructuring should be considered in light of the objectives of the preferred partners. As is the case with preferred shareholders in corporate recapitalizations, objectives of the preferred partners often include reducing the gift tax value of the common partnership interests transferred to family members and retaining some degree of control of the partnership or, at other times, transferring some degree of control.

606.7 Cumulative versus Noncumulative Distributions. Preference distributions made to a preferred partner may be cumulative or noncumulative. Making preferred distributions cumulative has the advantage of assuring that distributions will be paid and that the distributions are qualified payment rights for valuation purposes under IRC Sec. 2701. This causes additional value to be attributed to the retained preferred partnership interest (and minimizes the value of the transferred interests for gift tax purposes). The same result occurs if the transferor elects to treat noncumulative distribution rights as cumulative. However, if the election is made, distributions must actually be paid to avoid additional gift or estate tax consequences. (The election is discussed in paragraph 603.22.)

606.8 If the preferred partner receives a noncumulative preference distribution right, the partner's cash flow from the partnership is not fixed and is subject to the cyclical effects of partnership operations. Therefore, if the partnership does not have sufficient funds to make the preference distribution in any given year, the preferred partner's personal cash flow needs will suffer and the partnership is under no obligation to make up the shortfall in a subsequent year. Also, a noncumulative preference distribution right will not be a qualified payment right for gift tax valuation purposes. Accordingly, there is no gift tax advantage to a noncumulative payment right.

606.9 Because amounts distributed in a cumulative or noncumulative preferred partnership interest usually are dependent on the level of partnership profits, these amounts are treated as a distributive share of partnership profits. These payments ordinarily reduce partnership profits when determining the tax treatment of other distributions from the partnership.

606.10 Guaranteed Annual Payment. The right to a guaranteed payment (a payment to a partner for services as a partner or for using capital) associated with a preferred partnership interest is not a distribution right (see paragraph 602.12) and therefore adds value to the preferred partnership interest [Reg. 25.2701-2(b)(4)]. An added bonus of using a noncontingent guaranteed payment is that the partnership can deduct the guaranteed payment, assuming it qualifies as an ordinary and necessary business expense. However, the partner who receives the noncontingent guaranteed payment will be taxed on the full amount, regardless of the extent of partnership profits. The payment may be subject to self-employment tax and for years after 2012, the additional 0.9% Medicare tax if the partner's wages and self-employment income exceed certain threshold amounts [IRC Sec. 1401(b)(2)(A)].

606.11 If there is a guaranteed payment to the preferred partner, that partner needs to maintain at least a small percentage interest in partnership profits to ensure that they are deemed to be a partner and not a creditor. In addition, the planner should make certain that all affected parties understand that a guaranteed payment is a fixed obligation of the partnership that must be funded each year, even if it creates an operating loss for the partnership.

606.12 Extraordinary Payment Rights. When assigning value to the retained partnership interests, extraordinary payment rights are valued at zero. Therefore, rights such as put options, call options, and rights to compel liquidation do not add value to the retained preferred partnership interest when computing gift tax on the transferred shares. An extraordinary payment right can cause the value of the gift to increase. (See section 602 for an expanded discussion of extraordinary payment rights.) However, these rights should be given proper nontax consideration.

606.13 Mandatory Payment Rights. Mandatory payment rights add value to the retained preferred partnership interest only if payment is to be made at a fixed price and at a fixed time. These rights are to be considered for preferred partners who desire to retain control over the business through a general partnership interest but who also know when they wish to retire completely from the business.

> **Example 606-2: Using mandatory payment rights to increase the value of a retained preferred partnership interest.**
>
> Todd Thomas owns a preferred partnership interest and a common partnership interest in the Mitchell Enterprises partnership. His son, Harvey, has done well in the business, and Todd transfers the common partnership interest to Harvey. The partnership agreement is amended to allow the preferred partnership interest to have a redemption right that requires Todd to offer his partnership interest to the company in three years, and the company must redeem it for its stated value of $2 million. This redemption right is a mandatory payment right that will increase the value of Todd's retained preferred partnership interest, therefore lowering the amount of the gift of the common partnership interest to his son.

606.14 Caution: With the increased basic exclusion amount, planners must consider the potential income tax impact of gifting during lifetime (for a reduced value) versus holding the asset until death and heirs receiving a stepped up basis to the date of death value.

606.15 Liquidation Participation Rights. The right of a partner to participate in a liquidating distribution will enhance the value of the retained preferred partnership interest. However, the right to compel liquidation is an extraordinary payment right and will add no value to the retained preferred interest for tax purposes.

606.16 Preferred Liquidation Rights. In the classic partnership restructuring, the preferred partnership interest has a preferential right to receive liquidation distributions, but these are limited to the value of the partners' capital accounts. Because this is more than simply the right to participate in liquidation payments and affects the value of the transferred interest, it probably will be classified as an extraordinary payment right.

606.17 Nonlapsing Conversion Rights. The permanent right to convert the preferred partnership interest into a common partnership interest will add value to the retained preferred interest. This type of conversion right should be given serious consideration in almost all partnership restructurings because it allows the members of the older generation an opportunity to later change their minds and again participate in the growth of the company. However, the planner should also note that the exercise of these rights will ultimately decrease the value of the partnership that was initially transferred to the children (because they will no longer own all of the common partnership interests) and correspondingly increase the value of the interest held by the older generation, which may not be desirable for estate tax purposes.

606.18 Note: Interests of the same class are not subject to IRC Sec. 2701. In the case of partnerships, nonlapsing differences in management and limitations on liability are ignored [IRC Sec. 2701(a)(2)(C); Reg. 25.2701-1(c)(3)]. Therefore, a limited partnership interest and a general partnership interest can be of the same class—if the only differences between the two interests are nonlapsing differences for management and limitations on liability. However, these interests are not the same class if the transferor or applicable family members have the right to alter the transferee's liability.

Partnership Interests Created by Gift—Income Tax Issues

606.19 Special income tax rules apply to partnership interests acquired by gift. If a partnership interest is acquired by gift, the donee partner's distributive share of income is included in their gross income only if there has been an allowance for reasonable compensation for services rendered by the donor, and the donee's share of profits is proportional to their gifted capital interest [Reg. 1.704-1(e)].

> **Example 606-3: Reasonable compensation for services by donor.**
>
> Mitch works full time in the Jones Family Partnership, which brews craft beer. He makes $250,000 a year, which is reasonable based on his skill level and hours of service. Mitch gives his son, Bobby, a 10% interest in the partnership. Although Bobby does not work in the partnership business, he is treated as a partner and allocated 10% of the partnership income and expenses. This is because Mitch is paid a reasonable compensation for his services, and the allocations are in proportion to the donated capital.

606.20 Note: Compensation should be made as a guaranteed payment and not wages reported on Form W-2. Partners are not employees and should not be issued a Form W-2. See additional discussion in section 505 in the Tax Planning and Advisory *Family Partnerships* topic.

606.21 Allocations of profit or loss to a partner whose partnership interest was created by gift or purchase from a family member (the donor) are respected except to the extent that the allocation is determined without allowance for reasonable compensation for the donor's services.

Accordingly, if the donor partner is still active in the business, it is important that they receive reasonable compensation for services rendered.

Substantial Economic Effect

606.22 Substantial economic effect rules apply to partnerships to ensure that tax allocations of income, gain, loss, and deduction are consistent with actual allocations of economic results [Reg. 1.704-1(b)(2)]. Accordingly, the partner who receives the economic benefit of an income item should also be allocated the corresponding taxable income. Similarly, the partner who bears the economic loss should also be allocated the corresponding tax loss.

606.23 The typical partnership recapitalization should not create any problems under the substantial economic effect rules. The allocation of income or guaranteed payment providing the income stream to the older-generation partner will be accompanied by a corresponding distribution of cash and therefore will have no impact on the partner's capital account. The fair market value of the assets transferred by the preferred partner to a new partnership should be credited to their capital account at formation. A liquidating payment for this amount will subsequently zero out their capital account.

606.24 Caution: The planner should be aware of two problem areas:

- It will be necessary to have an arm's-length appraisal of the transferred assets at the time of transfer to establish the fair market value at the time of the recapitalization. Failure to establish a transfer at fair market value would provide grounds for the IRS to challenge any benefits which may result.

- The donor partner should not receive any allocation of partnership losses after the effective date of the recapitalization. This allocation would reduce the balance in their capital account to an amount less than any required liquidating distribution, violating the substantial economic effect rules (in which case the IRS could reallocate income among the partners).

606.25 The planner should review the substantial economic effect provisions of IRC Sec. 704(b) and the related regulations to ensure the partnership recapitalization complies with these rules. For additional information, see section 901 in the Tax Planning and Advisory *Partnerships* topic.

END OF DOCUMENT -

607 Transferring Ownership of an S Corporation

607.1 Many owners prefer to operate their businesses as S corporations because S corporations afford them the structure and protection (i.e., limited liability) of a regular "C" corporation but are taxed as pass-through entities. Therefore, unlike the earnings of a C corporation, an S corporation's earnings are generally not subject to corporate-level tax. Instead, items of income and loss pass-through to shareholders and are reported on their tax returns. See IRC Sec. 1366. Moreover, there are other, more subtle advantages to operating as an S corporation. For example, the proceeds from an insurance policy on a shareholder's life that are paid to the S corporation in order to fund the purchase of the decedent's shares are not subject to the IRC Sec. 55 alternative minimum tax.

607.2 The wealth transfer objectives for S corporation shareholders are typically the same as those for shareholders of all closely held corporations, including—

• ensuring the orderly transition of management and ownership, which often means that the shareholder is willing to shift some, but not total, control of the company to family members;

• providing estate liquidity;

• reducing income taxes for the shareholder and family members; and

• minimizing estate taxes and probate costs.

607.3 Representing an S corporation presents special problems because of the many requirements that must be met on an *ongoing* basis in order to qualify for S status. For example, an S corporation generally cannot have—

- more than a limited number of shareholders at any one time (i.e., 100 shareholders) [IRC Sec. 1361(b)(1)(A)];

- certain trusts as shareholders [IRC Sec. 1361(b)(1)(B)];

- a non-resident alien shareholder [IRC Sec. 1361(b)(1)(C)]; or

- more than one class of stock outstanding at any time [IRC Sec. 1361(b)(1)(D)].

607.4 Note: The authors suggest that the shareholders execute an agreement to preserve the S election by giving a right of first refusal or purchase option to the remaining shareholders. See section 612 for coverage of buy/sell agreements for S corporations.

Recapitalizations

607.5 The typical recapitalization for a corporation involves voting preferred stock issued to the parent and nonvoting common stock transferred (directly or indirectly) to the child. (See the discussion of the Section 2701 valuation rules in section 602.) The parent retains control via the voting feature and receives a steady stream of income due to the dividend feature of the preferred stock. Any future appreciation in the company's value is attributed to the common stock and therefore is not included in the parent's estate. This specific technique is not available to S corporations because of the one-class-of-stock requirement (see paragraph 607.7).

607.6 The valuation rules of IRC Sec. 2701 do not apply if the retained interest is the same class as the transferred interest or if the retained interest is proportionately the same as the transferred interest, except for nonlapsing differences in voting power. Therefore, the Section 2701 rules do not apply to a transfer of common stock when the transferor retains only common stock. The rules also do not apply to a transfer of nonvoting common stock when the transferor retains voting common stock (and vice versa), as long as the voting right is nonlapsing.

607.7 An S corporation can only have one class of stock [IRC Sec. 1361(b)(1)(D)]. The following types of stock are permitted: (a) voting and nonvoting common stock, (b) a class of common stock that is entitled to vote on certain issues only, or (c) groups of shares that differ for electing members of the board of directors (as long as all outstanding shares have identical distribution and liquidation rights). Therefore, while the one-class-of-stock limitation may prevent an S corporation from engaging in a preferred stock recapitalization, it also enables most S corporation dispositions and recapitalizations to avoid the Section 2701 valuation rules.

Example 607-1: Section 2701 valuation rules do not apply to an S corporation.

Helen is the sole shareholder of an S corporation that is recapitalized to create a new class of nonvoting common stock that has the same distribution and liquidation rights as the voting common stock. Helen exchanges part of her stock for the new nonvoting stock and gives the nonvoting stock to her daughter, Aubree. Although Helen has transferred an equity interest to a member of her family, IRC Sec. 2701 does not apply because of the same-class-of-stock exception. Therefore, the gift to Aubree is valued under general valuation principles, rather than the special valuation rules of IRC Sec. 2701.

607.8 Observation: Voting and nonvoting shares are not considered a separate class of stock.

Second Class of Stock Rule

607.9 When structuring transactions to meet the client's planning objectives, the planner must be aware of the unique tax traps posed by S corporations. For example, excessive distributions to a minority shareholder can terminate the corporation's S election if this results in the outstanding shares not having identical distribution rights. The determination of whether the outstanding shares confer identical distribution rights is based on the corporation's governing provisions (e.g., articles of incorporation, bylaws, state law, or binding agreements among the shareholders). If the governing provisions provide for identical distribution rights, distributions (whether actual or constructive) that differ in timing or amount are given appropriate tax treatment in accordance with their facts and circumstances but will not result in a second class of stock.

Example 607-2: Outstanding shares must have identical distribution rights.

An S corporation makes an unequal distribution to a 10% shareholder who is the child of the 90% shareholder. Assuming that the governing provisions provide for identical distribution rights (for example, the unequal distribution was not made pursuant to a binding agreement among the shareholders), the corporation's S status will not be affected. However, an IRS examination might recast the transaction as a pro rata distribution to the parent and child, followed by a taxable gift from the parent to the child.

Using an ESOP to Purchase Stock

607.10 Qualified employee benefit plans, including employee stock ownership plans (ESOPs), are permitted S corporation shareholders [IRC Sec. 1361(c)(6)]. An ESOP invests primarily in the employer's stock. The ESOP may borrow to buy the stock with the debt paid out of the employer's contributions to the ESOP. (See section 2005 in the Tax Planning and Advisory *Buying or Selling a Business* topic for more on ESOPs.)

607.11 The S corporation shareholder who wants to sell some or all of their interest in the business but does not have a buyer can use an ESOP to create a market for the shares. This can provide a source of funds to support the shareholder as well as the shareholder's family. The corporation establishes an ESOP for the benefit of its employees and funds it with annual tax-deductible cash contributions. The ESOP then uses the contributed cash to purchase qualifying employer securities from the shareholder. There are other advantages of selling company stock to an ESOP. These include the following:

• An ESOP can be used to establish a valuation history of the stock. If the company has an ESOP, the stock will be valued and well documented on an annual basis, providing a valuation history more likely to survive an IRS challenge. However, fair market value (FMV) for ESOP purposes is not necessarily FMV for estate tax purposes. For example, additional and/or larger discounts (such as for lack of marketability) may apply in estate tax situations.

• An ESOP can purchase a deceased shareholder's stock, providing a source of cash to pay estate taxes or administration expenses. There should be little or no gain on the sale under the current estate tax rules because the estate's basis in the stock is its FMV as of the date of the shareholder's death.

• If there are no family members interested in, or capable of, taking over the management of the business, it may be appropriate for the business owner to sell the stock to the employees. This provides some assurance to key employees that they can own a share of the company (through participation in the ESOP) and run the company. Additionally, it can relieve the employees's necessity for obtaining financing, which may be difficult for them.

• Most ESOP buy-outs are structured as stock purchases, not asset purchases. As a result, the business owner incurs capital gain tax rates on the sale of stock rather than potential ordinary income on depreciation recapture on the sale of assets.

• Selling the company to the ESOP allows the business to remain independent.

• Ownership by an ESOP allows the company to continue its corporate culture. If the company were purchased by an unrelated party, the corporate culture could change to that of the new owner.

607.12 Because the ESOP is a qualified retirement plan, the amount allocated to the participants' account is not included in their gross income in the year it is contributed. Instead, it accumulates tax free until a participant retires, dies, becomes disabled, or otherwise terminates employment. Then, the stock is converted to cash and the proceeds distributed to the participant.

607.13 Note: The ESOP rules governing distributions were amended to eliminate the participant's right to a stock distribution where the company is an S corporation. Use of this rule is dependent on the ESOP making the distribution in cash [IRC Sec. 409(h)(2)].

607.14 ESOPs that own S corporation stock are prohibited from allocating plan assets (including income) attributable to the stock to disqualified persons in a nonallocation year [IRC Sec. 409(p)]. Generally, a nonallocation year is any plan year during which disqualified persons own 50% or more of the number of the S corporation's outstanding shares.

607.15 A *disqualified person* is any person who owns, through the ESOP, at least 10% of the stock owned by the ESOP. For this purpose, a participant's ownership through the ESOP includes both shares allocated to their account and their proportionate share of any unallocated stock (based on the percentage used to make the plan's most recent stock allocation). A disqualified person is also a member of a group of family members who together own, through the ESOP, 20% of the number of shares owned by the ESOP. Stock options, warrants, restricted stock, stock appreciation rights, phantom stock, and similar rights that give the holder the right to acquire or receive the S corporation's stock or a future benefit based on the value of the S corporation's stock are defined as synthetic equity and are treated as actual ownership if the treatment results in a person being disqualified.

607.16 Observation: If the stock ownership is concentrated in one or two shareholders and there are few non-shareholder employees to participate in the ESOP, it is likely that the selling shareholders will be disqualified persons, triggering the prohibited allocation rules.

607.17 Caution: The consequences of an S corporation ESOP having a nonallocation year are severe. In the ESOP's first nonallocation year, regardless of whether a prohibited allocation occurs, the S corporation is liable for a 50% excise tax on the FMV of each disqualified person's stock in the ESOP (including synthetic equity) [IRC Sec. 4979A(a)(3)]. For any nonallocation year for which a prohibited allocation is made to a disqualified person, the allocated amount is treated as having been distributed to the disqualified person and the S corporation is liable for a 50% excise tax on the amount of the prohibited allocation.

607.18 Furthermore, if there is a nonallocation year, the amount of any prohibited allocation is deemed distributed to and taxed to the disqualified person [Reg. 1.409(p)-1(b)]. If there is a prohibited allocation, the ESOP violates IRC Sec. 4975(e)(7) and ceases to be an ESOP. In that event, any outstanding loan to the ESOP would cease to be an exempt loan and would be a prohibited transaction, subjecting the corporation to the excise taxes under IRC Sec. 4975. Finally, because the ESOP violates the qualification requirements of IRC Sec. 401(a), it would cease to be a qualified plan and become an ineligible S corporation shareholder. This would terminate the corporation's S election.

Gifting S Stock to Family Members

607.19 The simplest method to transfer value is an outright gift of S corporation stock to a family member. However, this approach includes a number of traps for the unwary. Some points for the planner to keep in mind are as follows:

- Ensure that a bona fide gift has occurred, which is a prime issue in any intrafamily gift situation. The donor must not retain any *strings* over the donated stock (such as an oral agreement that the donor will vote the gifted shares) that would reallocate the stock back for income tax purposes or cause inclusion of the stock in the donor's estate [Reg. 25.2511-2(b)].

• Realize that minors do not have the maturity, or may not be legally entitled under state law, to own S corporation stock in their own name. Alternative ways to structure a gift of stock to a minor include using an eligible trust, UGMA/UTMA account, or guardianship. (See paragraph 607.28.)

• Analyze possible adverse income tax consequences that may occur as a result of the gift of the S stock. The donor's ability to deduct pass-through losses is lost to the extent of basis attributable to the stock given away, as are suspended passive activity losses existing at the time of the gift, although the suspended losses will increase the tax basis for the donee [Reg. 1.1366-2(a)(5)].

• Determine if the kiddie tax rules apply. The kiddie tax will cause the unearned income of a child under age 19 to be taxed at the marginal income tax rates of their parents [IRC Sec. 1(g)]. If an eligible S corporation trust is used for a child through the age of 18 (or under age 23 for full-time students), in many cases the child will be considered the "owner" of the trust for tax purposes. If so, using the trust will not avoid the kiddie tax. See paragraph 311.25 for a discussion of the kiddie tax rules.

• Value the stock, which can be expensive and time-consuming due to appraisal and other professional fees. Furthermore, penalties can apply if the resulting value is significantly understated for tax purposes [IRC Sec. 6662(g)].

• Recognize the exception to the general rule that the donor'sbasis carries over to the donee. If the donor's basis exceeds the stock's FMV at the time of the gift, under IRC Sec. 1015(a), FMV is used for determining the donee's loss from a later disposition of the stock [Reg. 1.1366-2(a)(6)].

• Whenever S corporation stock is transferred, the planner must be certain that the transferee would not jeopardize the election. In addition to the limit on the number of shareholders, the planner should be sure that the donee is eligible to own the S corporation stock (i.e., an individual, estate, or trust that meets all nationality and eligibility requirements). See paragraph 607.28 for additional discussion of eligible S shareholders.

• Under IRC Sec. 1366(e), the family partnership rules of IRC Sec. 704(e) apply to family interests in S corporations, as discussed in paragraph 606.19. A family member who furnishes services or contributes capital to the partnership must receive reasonable compensation for their services. The IRS is authorized to adjust the allocation of S corporation income to achieve this result [Regs. 1.1366-3(a) and (b)]. For this, family members are limited to a shareholder's spouse, ancestors, lineal descendants, and trusts for the primary benefit of these persons.

• Consider the family member's level of activity in the business. If the family member receiving the stock is not active in the operations, the income from the S corporation will be passive income or loss. Additionally, if the income is considered passive, it will be considered net investment income subject to the 3.8% net investment income tax (NIIT) if the family member's adjusted gross income exceeds certain threshold amounts. See the discussion beginning at paragraph 1406.5 for additional information on the NIIT.

Paying Reasonable Compensation to Family Members

607.20 An income tax planning alternative to giving S stock is to shift S corporation income by employing the family member. While the employment tax rules include the FICA exemption for a child under age 18 employed by a parent, the exemption does not apply to a child employed by a corporation owned by a parent. This is a common planning technique, but it can generate a reasonable compensation issue that could affect all shareholders of the S corporation because their share of pass-through income or loss will be adjusted by any disallowed amount.

607.21 There is no rigid set of rules for measuring the reasonableness of compensation. No definition of *reasonable* is contained in the Code; the regulations provide only that reasonable compensation is an amount paid for like service by like enterprise under like circumstances [Regs. 1.162-7(b)(3) and 1.1366-3(a)]. Court cases have shown, however, that each situation must be resolved based on its unique facts and circumstances. Some Tax Court decisions have focused on the following five factors [*Exactospring Corp.*84 AFTR 2d 99-6977 (7th Cir. 1999); *Dexsil Corp.*81 AFTR 2d 98-2312 (2nd Cir. 1998),; *Rapco, Inc.*77 AFTR 2d 96-2405 (2nd Cir. 1996); *Mortex Manufacturing Co., Inc.*; *Elliotts, Inc.*52 AFTR 2d 83-5976 (9th Cir. 1983)]:

a. The character and financial condition of the corporation.

b. The role the shareholder plays in the corporation, including the employee's position, hours worked, and duties performed.

c. The corporation's compensation policy for all employees and the shareholder's individual salary history, including the corporation's internal consistency in establishing the shareholder's salary.

d. How the compensation compares with similarly situated employees of other companies.

e. Whether a hypothetical, independent investor would conclude that there is an adequate return on investment after considering the shareholder's compensation.

607.22 In these and other cases, the courts have also considered additional factors in deciding whether the amount of compensation is reasonable, including [*Eberl's Claim Service, Inc.*87 AFTR 2d 2001-2075 (10th. Cir. 2001); *Alpha Medical, Inc.*83 AFTR 2d 99-1922 (6th Cir. 1999); *Comtec Systems, Inc.*; *Boca Construction, Inc.*; *Menard, Inc.*103 AFTR 2d 2009-1280 (7th Cir. 2009), reversing TC Memo 2004-207]—

a. the employee's qualifications;

b. the size and complexity of the business;

c. a comparison of salaries paid to sales and net income;

d. general economic conditions;

e. the corporation's dividend history;

f. whether the employee and employer dealt at arm's length; and

g. corporate intent.

607.23 Observation: Employing family members instead of gifting stock allows the family member to avoid the passive activity loss limitations as well as the 3.8% net investment income tax (NIIT) on passive business income that could arise from being an inactive stockholder. (See the discussion beginning at paragraph 1406.5 for additional information on the NIIT.) However, the employed family member may still be subject to the additional 0.9% Medicare tax if their wages exceed certain threshold amounts [IRC Sec. 1401(b)(2)(A)].

607.24 Warning: The IRS can reallocate income and loss items if it is determined that an individual family member received unreasonable compensation for services [IRC Sec. 1366(e); Reg. 1.1366-3(a)].

Reallocation of S Corporation Income

607.25 If employing the family member is not feasible, a related method of shifting S corporation income is to reduce the amount of salary paid to the owner. This will increase the corporation's net income and shift pass-through income to the other shareholders, who are often children in a lower tax bracket. In addition to income splitting, if a shareholder receives wages that are considered to be on the low side of what is reasonable, the S corporation pass-through income, which is not subject to self-employment tax, will increase.

607.26 The risk of using this method is that IRC Sec. 1366(e) authorizes the IRS to reallocate income if the amount paid is unreasonable. This issue is similar to the reasonable compensation issue discussed previously, but focuses on *too little paid* rather than *too much paid*. The planner should follow the same rules detailed under the heading "Reasonable Compensation" to prove that the amount paid the parent is appropriate. For IRC Sec. 1366(e) to apply, it is not necessary that the recipient of the payment be a shareholder—all that is required is that the recipient be a member of the S shareholder's family. Furthermore, reallocation is not confined to salary payments. For example, IRC Sec. 1366(e) could apply to an interest-free loan to the S corporation by the parent of the corporation's sole shareholder.

607.27 A hidden danger may exist if the IRS reallocates income under IRC Sec. 1366(e). If the child files a tax return and the IRS reallocates income to the parent, the child will be entitled to a refund of income tax paid on the reallocated income, but only if the child's statute of limitations has not expired. The limitation mitigation rules of IRC Sec. 1311 do not apply because only income reported twice by a taxpayer and related taxpayer can be corrected. A parent and child are not considered related taxpayers for this purpose. Therefore, to protect the child when an IRS examination reallocates income to the parents' return, the planner should timely file a claim for refund on behalf of the child.

Estates and Trusts as S Corporation Shareholders

607.28 Other than individuals (who are U.S. residents) and estates, the entities permitted to be an S corporation shareholder include [IRC Sec. 1361(c)(2)]:

- Grantor trusts in which all income and principal is treated as owned by an individual who is a U.S. citizen or resident. The grantor trust does not have to qualify as an eligible S shareholder during periods it does not own S stock [Reg. 1.1361-1(h)(1)(i)].

  Caution: If a grantor *toggles off* the grantor status of an IDGT holding S corporation stock, the trust has 2½ months to make an ESBT or QSST election (see section 410 for a discussion of IDGTs).

  Note: In some cases, the parties may prefer trusts treated as grantor trusts for the beneficiaries' Section 678 trust. Therefore, the trusts will not have to comply with all of the requirements of a qualified Subchapter S trust (QSST) (discussed in a later bullet). In these cases, the beneficiary will be treated as the owner of their trust and the trust is a permitted S corporation shareholder, provided that all the trust's items, both ordinary income and capital gains, are included in the individual's income (Ltr. Rul. 200147044).

- Voting trusts which are created primarily to exercise the voting power of the owned stock. The beneficial owners of the trust must be treated as the owners of their portion of the trust [Reg. 1.1361-1(h)(1)(v)]. The beneficial owners must be U.S. citizens or residents. Each member of the voting trust is treated as an S corporation shareholder.

• Testamentary trusts that receive S stock pursuant to the terms of a will (but, in general, eligibility is limited to a two-year period of ownership from the day the stock is transferred to the trust by the estate). The decedent shareholder's estate is treated as the shareholder during the estate administration prior to the transfer of the stock to the trust.

• Trusts existing before death that met the requirements of the first bulleted item, and are 100% includable in the grantor's estate, and that continue in existence after death (although eligibility is limited to a maximum two-year period of ownership). A common example is a revocable living trust established as a means to avoid probate. (See section 404 for coverage of revocable living trusts.) As with testamentary trusts, the deceased grantor's estate is treated as the shareholder for most purposes. In this case, however, the trust rather than the estate reports its share of S corporation income, loss, deductions, and credits. Also, a revocable trust can elect to be treated as a part of the estate and qualify as an S corporation shareholder for the administration period (IRC Sec. 645). (See paragraph 1405.14.)

• *Qualified Subchapter S trusts* (or QSSTs), which are trusts that own stock in one or more S corporations and are treated as grantor trusts (for the S stock). The beneficiary must elect QSST status. The QSST must meet additional requirements. (QSSTs are discussed beginning at paragraph 607.31.) The income beneficiary is considered the shareholder.

• Electing small business trusts (ESBTs), created pursuant to IRC Sec. 1361(c)(2)(A)(v). Each potential income beneficiary is considered a shareholder. See the discussion beginning at paragraph 607.36.

• Charities formed under IRC Sec. 501(c)(3) and qualified retirement plans under IRC Sec. 401(a) are also eligible S corporation shareholders. S corporation pass-through items (and gain or loss on the sale of S corporation stock) are treated as unrelated business taxable income (UBTI) to the charity, regardless of the source or nature of the items at the corporate level. Although the UBTI issue may limit the number of charities choosing to hold S corporation stock, qualified retirement plans, such as an employee stock ownership plan (ESOP), may be used to purchase a business operated as an S corporation. Charitable remainder trusts are not included in the list of eligible trusts [IRC Sec. 1361(e)(1)(B)(iii)]. However, there appears to be no reason an ESBT could not qualify as a charitable lead trust.

Factors in Selecting a QSST or ESBT

607.29 Selection of an appropriate trust (to own S corporation stock) depends on the goals of the shareholder. For example, a grantor trust can be used if the goal is to avoid probate. The two trusts most often used are the QSST and the ESBT.

607.30 Note: For tax years beginning after 2017 and before 2026, estates and trusts may be able to deduct up to 20% of their qualified business income from pass-through entities under IRC Sec. 199A. The special rules and limitations restricting the deduction are beyond the scope of this topic (see section 703 of the Tax Planning and Advisory *Qualified Business Income Deduction* topic for an expanded discussion on the deduction for qualified business income).

607.31 Qualified Subchapter S Trust (QSST). The QSST is a trust subject to the following requirements [IRC Sec. 1361(d)]:

- There is only one income beneficiary of the trust during the life of the current income beneficiary, and that beneficiary is a U.S. citizen or resident. A married couple is treated as one beneficiary if they file a joint return, are both U.S. citizens or residents, and are both designated beneficiaries of a trust [Reg. 1.1361-1(j)(2)].

- All of the trust income is, or is required to be, distributed currently to the one income beneficiary. A provision in the trust agreement that authorizes the trustee to accumulate trust income in the event the trust does not hold any shares of an S corporation does not tarnish the trust's qualification as a QSST (Rev. Rul. 92-20).

- Any distributions of principal, including a termination distribution, must also go to that one beneficiary if made during the beneficiary's lifetime.

- The income interest of the beneficiary must terminate on the earlier of the beneficiary's death or the trust's termination.

- An election to be treated as an eligible S corporation shareholder is made separately for the stock of each S corporation held by the trust. This election is made by the trust's income beneficiary.

Observation: A new (successor) income beneficiary does not have to file an election to continue QSST status. However, the new beneficiary may affirmatively refuse to consent to the QSST election, which would invalidate the QSST election and thereby revoke the S election.

607.32 Examples of QSSTs include QTIP trusts as well as marital deduction trusts in which the surviving spouse is entitled to all trust income annually for life and has a general testamentary power of appointment at death [Reg. 1.1361-1(j)(4)]. QTIP trusts are discussed in section 1106.

607.33 A trustee may distribute income from the date of the last distribution to the date of the income beneficiary's death to either the deceased beneficiary's estate or the successor income beneficiary (Rev. Rul. 92-64).

607.34 Tax Consequences of a QSST. In a QSST, the income beneficiary is treated under IRC Sec. 678(a) as the owner of the portion of the trust that consists of S corporation stock. Therefore, the trust will treat the corporation stock as a grantor trust. Although the income beneficiary is treated as the owner of the portion of the trust that consists of the S corporation stock, the trust recognizes gain or loss when the S corporation stock is distributed [Reg. 1.1361-1(j)(8); Ltr. Rul. 9721020]. If the QSST also owns other assets, income and loss from those assets may be reported on Form 1041 (i.e., they are not automatically subject to the grantor trust provisions). However, all the income of the trust, including the income from other assets as well as from the S corporation, must actually be distributed or be required to be distributed to qualify as a QSST [IRC Sec. 1361(d)(3)(B)]. If the QSST disposes of the S corporation stock, the income beneficiary can deduct any suspended losses under the passive activity and at-risk rules. A detailed discussion of S corporation stock and its basis can be found in Chapter 19 of PPC's 1120S Deskbook.

607.35 Planning Tip: A QSST works well when the objective of the trust is to provide income to a beneficiary but not allow control and access to principal (as is often true when a minor child is the beneficiary), or when the objective is to provide income to one beneficiary but reserve principal for another beneficiary following the death of the first beneficiary. Generally, it is also preferred for trusts in which the beneficiary is in a relatively low income tax bracket.

Example 607-3: When to use a QSST.

Jason Ryan is a shareholder in Unique, Inc., a successful manufacturing company that has been an S corporation for several years. His mother, Lee is an elderly widow who requires expensive nursing care. Jason provides this support for his mother. Jason is considering a trust to hold about 20% of his Unique stock to deflect an income stream to support Lee. When Lee dies, Jason would like his two children to be successor income beneficiaries, with the trust terminating and the stock being distributed to the children when they reach age 35.

Jason's objective can be met by using a QSST. However, it will be necessary to have two trusts, because at Lee's death, Jason's two children would become income beneficiaries, and a QSST is permitted to have only one income beneficiary. Each trust should be drafted to provide income to Lee during her lifetime, income to a successor child of Jason's following Lee's death, and eventual principal distribution of the stock to the child at age 35.

Note: As discussed in paragraph 607.36, an ESBT can also hold S corporation stock. In this example, an ESBT would not meet Jason's tax-saving objective because an ESBT is taxed at the highest individual rate on its share of the corporation's pass-through income.

607.36 Electing Small Business Trust (ESBT). An *ESBT* is a trust that is permitted to own S corporation shares [IRC Sec. 1361(c)(2)(A)(v)]. An ESBT can provide that income will be distributed to (or accumulated for) one or more beneficiaries. If the trust accumulates income, this enhances the attractiveness of using S stock as a generation-skipping transfer device. Therefore, an individual can establish a trust to hold S corporation stock and split income among family members of others who are trust beneficiaries.

607.37 The price paid for this flexibility is that the trust (not the beneficiaries) is taxed on income related to the S corporation stock at the highest individual rate unless the income qualifies as long-term capital gains, in which case a capital gain rate applies, with no deduction for distributions to beneficiaries [IRC Sec. 641(c)(2)(A)].

607.38 Note: For 2022 and 2023, the top marginal income tax rate on ordinary income is 37% while the long-term capital gains may be taxed at a maximum 20%. Additionally, the trust could be subject to the additional 3.8% net investment income tax (NIIT). See paragraph 1406.5 for additional discussion of the NIIT.

607.39 To qualify as a small business trust, and therefore be an eligible S corporation shareholder, all of the following criteria must be met [IRC Secs. 1361(c)(2)(A)(v); 1361(e)]:

- All trust beneficiaries must be individuals, estates, or certain charitable organizations. Charitable remainder annuity and unitrusts [defined in IRC Sec. 664(d)] are not eligible ESBT shareholders [IRC Sec. 1361(e)(1)(B)(iii)]. Nonresident alien beneficiaries are allowed as beneficiaries but prior to 2018 they could not be potential current beneficiaries [Reg. 1.1361-1(m)(1)(ii)(D)].

  Caution: The rule that a nonresident alien cannot be an S shareholder remains in effect [IRC Sec. 1361(b)(1)(C)]. Consequently, the S election will terminate if a nonresident alien beneficiary acquires an ownership interest in the corporation.

  Observation: An ESBT should be able to qualify as a charitable lead trust (CLT). The IRS approved funding of a six-year CLT for a private foundation with S corporation stock. If the donor dies during the six-year term, the trust converts to an electing small business trust (Ltr. Rul. 199908002).

- No interest in the trust can be acquired by purchase (i.e., with a cost basis determined under IRC Sec. 1012) [IRC Sec. 1361(e)(1)(A)(ii)]. Therefore, an interest in the trust must generally be acquired by gift, bequest, or transfer in trust. Although the beneficiary cannot acquire an interest in the trust by purchase (including paying the gift tax on a transfer to trust), the trust can purchase S corporation shares to hold in the trust [Reg. 1.1361-1(m)(1)(iii)].

- A proper ESBT election is made. The trust (rather than the beneficiaries) must elect to be treated as an ESBT, and the election can be revoked only with IRS consent. No protective election is allowed.

607.40 An ESBT beneficiary does not include a person in whose favor a power of appointment could be exercised (unless the power is actually exercised) [Reg. 1.1361-1(m)(1)(ii)(c)].

607.41 If the trust does not meet the ESBT requirements, it may be possible to ask a local court to reform the trust so that it will qualify. For example, if a trust holding S corporation stock did not qualify as an ESBT because one of its beneficiaries was a disqualified trust, a state court could reform it so that only individuals were beneficiaries (Ltr. Rul. 9823032). Additionally, if the ESBT acquires an ineligible current beneficiary, it has 60 days to dispose of its stock to prevent termination of the S election.

607.42 Each *potential current beneficiary* of the trust is counted as a shareholder for the 100-shareholder limitation. If there are no potential current beneficiaries, the trust is counted as the shareholder. A potential current beneficiary generally is any person who is entitled to a distribution from the principal or income of the trust. A person entitled to—or in the discretion of another person, may—receive a distribution only after a specified time or when a specified event occurs (such as the death of a holder of a power of appointment) does not become a potential current beneficiary until the time arrives or event occurs [Reg. 1.1361-1(m)(4)].

607.43 Warning: Although there is no limit to the number of beneficiaries of an ESBT, the number of potential current beneficiaries when added to the number of all other S corporation shareholders, cannot exceed 100. In counting the number of shareholders, all members of a family are considered a single shareholder. If the ESBT acquires an impermissible shareholder as a potential current beneficiary, the trust has one year to dispose of the S corporation stock before the S corporation election is lost.

607.44 Observation: A nonresident alien (NRA) can be a potential current beneficiary of an ESBT. The NRA is counted in the 100-shareholder limit. However, the NRA is not considered a shareholder for the prohibition of an NRA shareholder in an S corporation [Reg. 1.1361-1(m)(4)].

607.45 Current powers of appointment can cause an inadvertent termination of S status. For example, if any person (e.g., the trustee or the beneficiary) has a general lifetime power of appointment over the trust, the corporation's S election will terminate if the number of potential current beneficiaries exceeds the 100-shareholder limit [Reg. 1.1361-1(m)(4)(vi)]. However, unexercised powers of appointment are disregarded and only those powers of appointment actually exercised during the year are used to determine the potential current beneficiaries of an ESBT [IRC Sec. 1361(e)(2)].

607.46 An attempt to temporarily waive, release, or limit a currently exercisable power of appointment will be ignored in determining who is a potential current beneficiary. However, if the holder of a power of appointment permanently releases the power in a manner that is valid under applicable local law, the persons who would be potential current beneficiaries solely because of the power will not be considered potential current beneficiaries after the date of the release [Reg. 1.1361-1(m)(4)(vi)(B)].

607.47 A discretionary power of a fiduciary who is not a beneficiary to spray or sprinkle trust distributions among beneficiaries will not be treated as a power of appointment [Reg. 1.1361-1(m)(4)(vi)(A)]. However, a power to add beneficiaries, regardless of who holds it, is generally considered a power of appointment but will be disregarded, for determining potential current beneficiaries, to the extent it is not exercised.

607.48 Tax Consequences of an ESBT. An ESBT is taxed differently than any other trust eligible to hold S corporation stock. The primary benefit of this type of eligible shareholder is its ability to accumulate income from the S corporation. The cost of this benefit is that the income from the S corporation will generally be taxed at the highest individual rate [IRC Sec. 641(c)(2)(C)(ii)]. However, being taxed at the highest individual tax rate may not be a significant issue because ordinary trust income is taxed at the highest individual rate (37%) once taxable income reaches $14,450 for 2023 ($13,450 for 2022). A distribution deduction is allowed in the normal way for non-S corporation income, and capital gain income qualifies for preferential income tax treatment in the usual way.

607.49 The taxable income of an ESBT consisting solely of stock in one or more S corporations includes [IRC Sec. 641(c)(2)(C)]—

- the S corporation items of income, loss or deduction allocated to it (i.e., passed through on Schedule K-1 of Form 1120S) as an S corporation shareholder,
- gain or loss from the sale of the S corporation stock, and
- any state or local income taxes and administrative expenses to the extent provided in regulations.

607.50 An ESBT is permitted to deduct any interest expense incurred to purchase S corporation stock for tax years beginning after 2006 [IRC Sec. 641(c)(2)(C)(iv)].

607.51 In addition, capital losses are allowed only to the extent of capital gains [IRC Sec. 641(c)(2)(D)] and the ESBT is generally subject to the same estimated tax payment rules as individuals [IRC Sec. 6654(l)]. The income distribution deduction and the personal exemption cannot reduce taxable income of an ESBT consisting solely of stock in an S corporation.

607.52 If the trust terminates before the end of the S corporation's tax year, the trust takes into account its pro rata share of S corporation items for its final year [IRC Sec. 1366(a)(1)].

607.53 When an ESBT holds other property in addition to S corporation stock, the portion of the trust consisting of stock in one or more S corporations is treated as a separate trust when figuring the income tax attributable to the S corporation stock. The taxable income attributable to this portion includes the three items listed in paragraph 607.49. Therefore, the trust consists of two portions which, for the sake of convenience, will be identified here as the "S Portion" and the "Other Portion." Also, if the trust is partially a grantor trust, that portion will represent a separate share (i.e., and be a third portion of a single trust).

607.54 Observation: If a nonresident alien (NRA) is a potential current beneficiary of an ESBT, all of the NRA's income is considered the "S Portion". None of the NRA's share of income is considered the grantor's share or "Other Portion" [Reg. 1.641(c)-1(b)].

607.55 The S Portion items are disregarded when figuring the tax liability of the Other Portion which is taxed under the normal trust taxation rules. Distributions from the Other Portion are deductible (limited to the DNI of the other portion) in computing the taxable income of that portion, but no distribution deduction is allowed in arriving at the S Portion's taxable income.

607.56 Note: Special rules apply for calculating what portion, if any, of an ESBT is subject to the net investment income tax (NIIT). The S portion and the non-S portions of the trust are treated separately when calculating the undistributed net investment income. However, the trust is treated as a single trust when determining the NIIT. See Key Issue 21B of PPC's 1041 Deskbook for additional discussion and an example illustrating the calculation of the NIIT for ESBTs.

Example 607-4: Calculating the income tax attributable to S corporation stock held within an ESBT.

The Trophy Trust holds S corporation stock as well as other assets and has elected to be an ESBT. The trust is considered to be two portions, S Portion, and Other Portion. During the tax year, the S portion was allocated $10,000 of ordinary income from the S corporation, and $4,000 was distributed by the S Portion to the beneficiary. The Other Portion received $15,000 in interest income and distributed that amount to the beneficiary.

The S Portion is taxed on $10,000 at 37% (for 2023) and the trust pays $3,700 in tax. The beneficiary receives the $4,000 distribution tax-free.

The Other Portion receives a $15,000 deduction for the distribution in arriving at taxable income. Although the trust pays no tax on Other Portion's income, the beneficiary includes the $15,000 distribution in income. The trust will be subject to the NIIT on the investment income under special calculation rules (see the note at paragraph 607.56).

607.57 Planning Tip: ESBTs should be used when the grantor would like to have more than one beneficiary or the ability to accumulate income at the trust level. Although income is taxed at the highest individual tax rate, that may not be a significant issue because ordinary trust income is taxed at that rate once taxable income reaches $14,450 in 2023 ($13,450 in 2022).

607.58 Perhaps a more common use of an ESBT is for a testamentary trust that cannot meet the QSST requirements. This happens when S corporation stock is transferred to a trust through the terms of a will or a revocable living trust. An ESBT would salvage the S corporation election by allowing the trust to be an eligible S corporation shareholder. In this situation, distributing the S corporation stock to an eligible shareholder (i.e., the trust beneficiaries) may be a means of avoiding the ESBT income tax rates.

607.59 A QSST should be considered when there is only one beneficiary and accumulation of income is not an issue.

Converting from or to an ESBT or QSST

607.60 The IRS has provided guidance on converting a QSST to an ESBT, as well as converting an ESBT to a QSST.

607.61 From a QSST to an ESBT. The QSST can be converted to an ESBT if the following requirements are met [Reg. 1.1361-1(j)(12)]:

- The trust is eligible to be an ESBT (see paragraph 607.39), except for the requirement that the trust not have a QSST election in place under IRC Sec. 1361(d)(2).

- The trustee and the current income beneficiary of the trust make the ESBT election for stock of each S corporation held by the trust and file it with both IRS Centers where the S corporation and the trust file their income tax returns.

- The trust has not converted from an ESBT to a QSST within the 36-month period before the effective date of the new ESBT election.

- The ESBT election is effective not more than 15 days and 2 months prior to the date the election is filed and cannot be more than 12 months after the date the election is filed. If an election specifies an effective date more than 15 days and 2 months prior to the date the election is filed, it will be effective 15 days and 2 months prior to the date on which it is filed. If an election specifies an effective date more than 12 months after the date on which the election is filed, it will be effective 12 months after the date it was filed.

607.62 Observation: Separate IRS permission to revoke the QSST election is not required when converting a QSST to an ESBT under Reg. 1.1361-1(j).

607.63 The conversion of a QSST to an ESBT generally does not result in the trust terminating its entire interest in an S corporation under IRC Sec. 1377(a)(2). However, for the S corporation pass-through rules, the QSST will be treated as terminating its interest in the S corporation, and the ESBT will be counted as a new shareholder. The last day the QSST will be a shareholder is the day before the effective date of the ESBT election, and the new ESBT will be a shareholder beginning on the effective date of the ESBT election [Reg. 1.1377-1(a)(2)(iii)].

607.64 From an ESBT to a QSST. An ESBT can be converted to a QSST if the following requirements are met [Reg. 1.1361-1(m)(7)]:

- The trust is eligible to be a QSST. [See IRC Sec. 1361(d) and paragraph 607.31 for the QSST eligibility requirements.]

- The trustee and the current income beneficiary of the trust make the QSST election explained in paragraph 607.31 for stock of each S corporation held by the trust and file it with both IRS Centers where the S corporation and the trust file their income tax return.

- The trust has not converted from a QSST to an ESBT within the 36-month period before the effective date of the new QSST election.

- The QSST election is effective up to 15 days and 2 months prior to the date on which the election is filed and cannot be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 15 days and 2 months prior to the date on which the election is filed, it will be effective 15 days and 2 months prior to the date on which it is filed. If an election specifies an effective date more than 12 months after the date on which the election is filed, it will be effective 12 months after the date it was filed.

607.65 Observation: Separate IRS permission to revoke the ESBT election is not required when converting an ESBT to a QSST under Reg. 1.1361-1(m)(7).

607.66 The conversion of an ESBT to a QSST generally does not result in the trust terminating its entire interest in an S corporation under IRC Sec. 1377(a)(2). However, for the S corporation pass-through rules, the ESBT will be treated as terminating its interest in the S corporation and the QSST will be treated as a new shareholder. The last day the ESBT will be a shareholder is the day before the effective date of the QSST election, and the new QSST will be a shareholder beginning on the effective date of the QSST election [Reg. 1.1377-1(a)(2)(iii)].

607.67 See Key Issue 6C of PPC's 1041 Deskbook for additional discussion of converting from or to an ESBT or QSST, and Appendix 6B for a comparison of QSST and ESBT features.

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