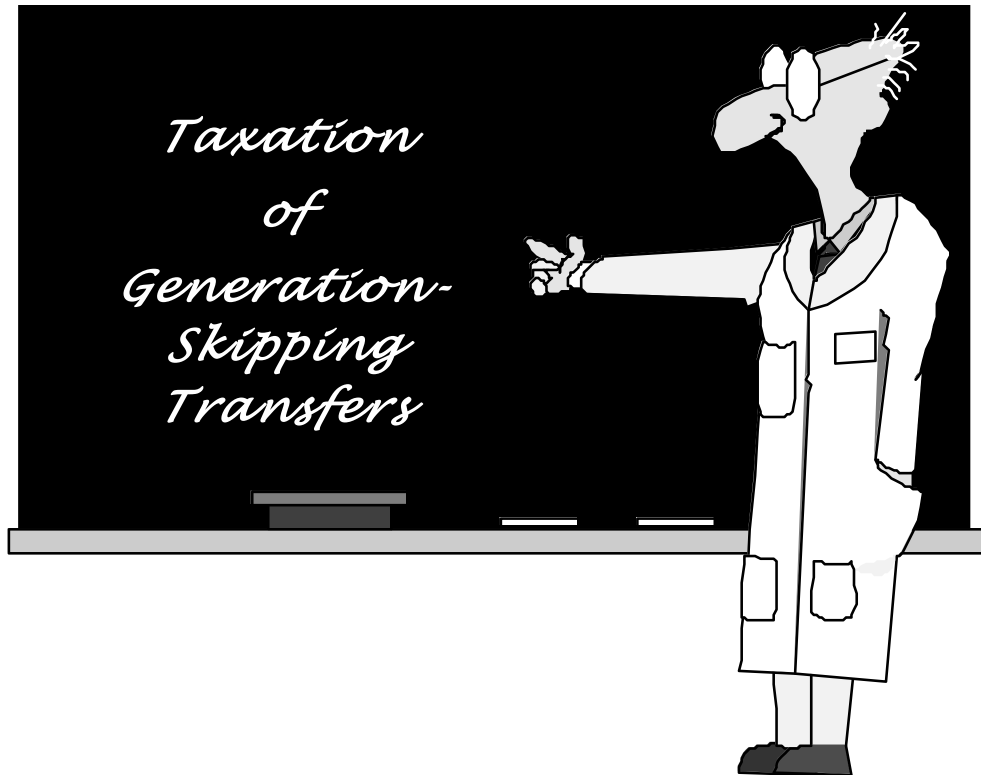
From A to Z

# GENERATION-SKIPPING TRANSFERS

By David F. Powell


Taxation
of
Generation-
Skipping
Transfers

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# I. GENERATION-SKIPPING TRANSFER TAX BASICS

Historical leniency in the rules which define the federal gross estate makes it possible for a trust beneficiary to have a substantial interest in (and authority over) trust property without causing the property to be included in the beneficiary's gross estate at death. Thus, without subjecting the child to estate tax exposure at death, a parent could create a trust for his child with the child having any or all of:

- the right to trust income for life;
- the right to demand such corpus as is reasonably necessary for the child's health, support, maintenance and education; and
- one or more inter vivos or testamentary special powers of appointment.

In like manner, at the child's death the trust could continue for the life of the settlor's grandchild and at his death for the life of that child's child, and so on. The Generation-Skipping Transfer [GST] tax was enacted to place a tax cost on this kind of transfer.

## A. OVERVIEW OF IMPORTANT TERMS

A general (albeit simplistic!) statement of the GST tax would be that it applies whenever property is transferred (directly or from a trust or a trust equivalent) to a person who is two or more generations younger than the transferor.

**Examples of generation-skipping transfers include:**

- an outright gift or bequest to a grandchild of the donor or testator;
- a distribution from a trust to the settlor's grandchild; or
- a termination of a life interest in a child when the remainder interest is in a grandchild.

Application of the GST tax to these and other transfers requires a mastery of several key terms and concepts.

### 1. Skip person

The GST tax applies only to transfers to persons who are two or more generations younger than the transferor. Such a person is called a "skip person."

Grandchildren and great-grandchildren are skip persons. So are grand-nephews and nieces.

A trust can also be a skip person. A trust is a skip person if:

- all persons having an interest in the trust are skip persons (e.g., a trust for the exclusive benefit of grandchildren and their descendants), or
- no one has a present interest and no distributions to non-skip persons can ever occur (e.g., a trust for the ultimate benefit of minor grandchildren where no distributions can be made until they attain the age of majority).[1]

### 2. Trust

A distribution from or a termination of an interest in a trust may be a taxable event under the GST tax. For this purpose, a trust includes "any arrangement (other than an estate) that has substantially the same effect as a trust."[2]

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[1] IRC § 2613(a); Treas. Regs. § 26.2612-1(d). In the application of this test, a possibility that property will be distributed to a skip person is disregarded if the probability of the distribution occurring is less then 5 percent. Treas. Regs. § 26.2612-1(d)(2)(ii).

| COMMENT |
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| Under IRC § 645, certain electing qualified revocable trusts are treated and taxed as if they were part of a decedent's estate. This treatment applies, however, only for purpose of the income tax; it does not apply for purposes of the GST tax. |

**"Trust" includes:**

- legal term and life interests,
- insurance and annuity contracts,
- custodianships,[3] and
- outright bequests where the identity of the taker is contingent upon the occurrence of a future event.

**Exception:** An exception applies to a testamentary transfer that is contingent upon an event that must occur within 6 months of the transferor's death.

***Ex-1:*** T devises the residue of his estate per stirpes to such of his descendants as survive him by nine months. T is survived by a child C and a grandchild GC. What are the consequences under the GST tax if C dies 8 months after T? *Answers to the examples in this chapter begin on page 27.*

| COMMENT |
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| The result is different if C dies within 90 days of T. See ***Ex-5***, p. 11. |

### 3. Interest in trust

In determining whether a trust is a skip person and in applying a number of other provisions of the GST tax, it is necessary to identify who has an "interest in trust."

A person has an interest in a trust only if she:

- has a present right to receive income or principal; or
- is a current permissible distributee of trust property.[4]

***Ex-2:*** T transfers property in trust to pay the income to C for life, remainder to GC.

1. Do either C or GC have an interest in this trust?

2. Would the answer change if GC had a power to withdraw $14,000 from the trust for a 60 day period after the transfer by T?

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2 Treas. Regs. § 26.2652-1(b)(1).

3 See Treas. Regs. § 26.2652-1(b)(2), Example 1.

4 IRC § 2652(c)(1); Treas. Regs. § 26.2612-1(e)(1). A charity has an interest if the charity has the right to current distributions of income or principal or the trust is a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund. IRC § 2652(c)(1)(C); Treas. Regs. § 26.2612-1(e)(1)(iii).

### a) Nominal interests

In some situations, imposition of the GST tax is deferred as long as a non-skip person continues to have an interest in trust.[5] To prevent abuse, the Code provides that an interest is to be disregarded if it is used primarily to postpone or avoid the GST tax.[6] This is the case if a significant purpose for the creation of the interest is the postponement or avoidance of the GST tax.[7]

### b) Support obligation

A person whose legal obligations could be satisfied out of trust income or principal has an interest in trust.

**Exception:** A person does not have an interest in trust merely because a trustee has the discretionary authority to make distributions in satisfaction of the person's obligation of support.[8]

## 4. Transferor

The identity of the transferor determines who meets the definition of a skip person and whose exemption must be allocated to a transfer if it is to be exempted from the tax. In general, the transferor is the person who was most recently subject to the federal estate or gift tax on the property.[9]

| COMMENT |
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| If the donor's spouse consents to split a gift, each spouse will be treated as the transferor of half.[10] |

### a) Estate or gift tax exposure

Whenever a transfer is made in trust the initial transferor will be the testator in the case of a testamentary transfer or the donor in the case of an inter vivos one.

- Thereafter, if the trust property is subject to either the gift or the estate tax, the transferor will be redetermined and any previously allocated exemption to the trust will be lost.[11]
- Thus, if a trust beneficiary has a general power to appoint trust property, the beneficiary will become the transferor at the earlier of her death or when she exercises or releases the power.[12]

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5 For more on this, see "*Terminations where nonskip persons have an interest*" on p. 15.

6 IRC § 2652(c)(2). Treas. Regs. § 26.2612-1(e)(2)(ii).

7 The regulatory test focuses on "*a*" rather than "*the*" significant purpose. Under this test, an interest is disregarded if it serves several significant purposes only one of which is to postpone or avoid the GST tax.

8 IRC § 2652(c)(3); Treas. Regs. § 26.2612-1(e)(2)(i). See also Treas. Regs. § 26.2612-1(f), Example 15.

9 Treas. Regs. § 26.2652-1(a)(1). See also, PLR 9622035 (except to the extent the proceeds are attributable to pain and suffering or reimbursement for medical expenses, a decedent is not the transferor of wrongful death proceeds payable to a skip person at the decedent's death).

10 IRC § 2652(a)(2); Treas. Regs. § 26.2652-1(a)(5). This is true even though the interest the consenting spouse is actually deemed to have transferred under IRC § 2513 is less than half of the total value of the property transferred as would be the case with the creation of a ten year GRAT with the remainder in a third person. See Treas. Regs. § 26.2652-1(a)(6), Examples 2 and 11.

11 A redetermination of the transferor does not occur upon the transfer of a term interest in a trust by the holder of the term interest since the transfer, although subject to the gift tax, does not affect the rights of other beneficiaries. Treas. Regs. § 26.2651-1(a)(6), Example 4.

12 The regulations provide that an exercise of a nongeneral power of appointment is treated as a transfer subject to the gift or estate tax by the holder of the power if the power is exercised in a manner that postpones vesting for a period exceeding that permitted by the common law Rule Against Perpetuities, measured from the creation of the power. Treas. Regs. § 26.2652-

***Ex-3:*** T leaves property in a trust the terms of which give Child an income interest for life and a joint power exercisable with BANK to appoint trust property at her death to her creditors. In default of appointment the trust continues for Grandchild for life with remainder to Great-grandchild.

1. Will either child's death or a subsequent distribution to Grandchild be a taxable event under the GST tax?

2. Suppose Child and BANK could appoint "only to the extent the aggregate federal estate tax and GST tax due as a result of the child's death can be reduced." Is this type of "formula general power of appointment clause" an effective means of avoiding GST taxes at the child's death?

| COMMENT |
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| Intentionally subjecting property to the estate tax may yield a better result than having it subjected to the GST tax. In addition to the formula approach illustrated in the previous example, other methods of doing this include:<br>1. The trustee could have authority to distribute principal to beneficiaries.<br>2. Trustees could be authorized to create a general power in a beneficiary (or to terminate one that was previously created at the drafting stage).[13]<br>3. A beneficiary with a special power of appointment could exercise the power to create a general inter vivos power in someone else.[14] |

***Ex-4:*** T creates a discretionary trust for the benefit of his children and grandchildren. The children and grandchildren have Crummey withdrawal powers. What impact will the lapse of these powers have on the identity of the transferor of this trust for GST tax purposes?

### b) Reverse QTIP election

When a Decedent's estate plan involves the creation of a QTIP trust for a surviving spouse, the Decedent will be the initial transferor of the trust. Subsequetly, the surviving spouse will become the transferor of the QTIP trust at her death because the

1(a)(4). In effect, the holder of the power is treated as having retransferred the property to the trust. To accommodate those states that have enacted the Uniform Statutory Rule Against Perpetuities, the regulations also provide that the retransfer rule is not triggered by an exercise that can postpone vesting for a term of years that will not exceed 90 years. This rule does not, however, apply to an exercise which can postpone vesting for a period measured by the longer of the common law rule or 90 years. See Treas. Regs. § 26.2652-1(a)(6), Examples 9 and 10.

13 There is some potential risk in doing either of these. It is possible that a trustee's power to create a general power is itself a general power in the beneficiary. And care must be exercised to insure that an authority in a trustee to terminate a general power does not result in a taxable lapse if the authority is exercised. For more on these matters, see e.g., Covey, Practical Drafting 2053 (January 1990).

14 See IRC §§ 2041(a)(3) and 2514(d).

trust will be included in the surviving spouse's estate under IRC section 2044. However, a separate "reverse" QTIP election is available under the GST.[15] When made, the election results in the decedent remaining to be treated as the transferor of the QTIP trust for GST purposes.

- Once made, the reverse QTIP election is irrevocable.[16]
- The election is made on the gift or estate tax return on which the estate or gift tax QTIP election is made.[17]
- It must be made as to all property in the trust.[18]

| COMMENT |
| --- |
| The IRS may grant a discretionary extension of time under Treas. Regs. §§ 301.9100-1 and -3 for making the reverse QTIP election.[19] For more on the planning considerations involved in the use of the reverse QTIP election, see "*Planning For The GST Tax*", beginning on p. 31. |

## B. GENERATION ASSIGNMENT

The GST tax is concerned only with transfers to persons who are two or more generations below the generation assigned to the transferor.

Thus, each person with an interest in a trust must be assigned to a generation so that a determination can be made whether transfers to that person would invoke a tax.[20]

### 1. Lineal descendants, spouses and other persons

a) **Lineal descendants** of the transferor's grandparents or of the grandparents of the transferor's spouse are assigned to the generation that their relationship would intuitively dictate.

| COMMENT |
| --- |
| In the application of this rule, adopted persons are treated as natural kindred and relatives of the half-blood are treated as relatives of the whole-blood.[21] |

b) **Charities and spouses** (current and former) of the transferor are assigned to the same generation as the transferor.[22]

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15 IRC § 2652(a)(3).

16 Treas. Regs. § 26.2652-2(a).

17 Treas. Regs. § 26.2652-2(b). The reverse QTIP election may not be made with respect to property qualifying for the marital deduction under IRC § 2056(b)(5). Treas. Regs. § 26.2652-2(a). If a protective QTIP election is made, a protective reverse QTIP election must also made if the election is to be effective. Treas. Regs. § 26.2652-2(b).

18 Treas. Regs. § 26.2652-2(a). A special transitional rule applies in the case of QTIP for which a reverse QTIP election under IRC § 2652(a)(3) was made prior to December 27, 1995. As to such trusts, the transferor or the transferor's personal representative may elect to treat the trusts as two separate trusts -- one with a zero inclusion ratio and one with an inclusion ratio of one. The election must be filed in the same place in which the original return was filed on or before June 23, 1996. The election is made by attaching a statement to a copy of the return on which the reverse QTIP election was made. The statement must identify the values of the two separate trusts. See Treas. Regs. § 26.2652-2(c).

19 See e.g., PLR 200118037 (five year extension).

20 See generally, IRC § 2651.

21 IRC § 2651(b)(3).

22 IRC §§ 2651(e)(3); 2651(c)(1).

c) **Current or former spouse of a lineal descendant** of a transferor is the same generation as the lineal descendant.[23]

d) **Other natural persons** are assigned to a generation by age differential.

- Persons whose age is within twelve and a half years of the transferor are assigned to the transferor's generation.
- Persons whose age is from twelve and a half to thirty-seven and a half years of the transferor are assigned to a generation one below or above that of the transferor.
- Thereafter, a new generation occurs at twenty-five year intervals.[24]

## 2. Exception for predeceased ancestor

In the case of a direct skip to or for the benefit of a lineal descendant of the transferor (or the current or former spouse of the transferor) the generation assignment of the donee is determined by disregarding the generation of any predeceased individual who is both an ancestor of the donee and a descendant of the transferor (or the spouse).[25]

For events occurring after 1997, the rule also applies to taxable terminations and distributions. In addition, the rule covers situations where certain collateral heirs of the transferor (or the current or former spouse of the transferor) predecease.

| COMMENT |
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| With respect to taxable terminations and distributions, the rule applies only when the predeceasing parent was dead at the time the gift or estate tax was first imposed with respect to the transferor's transfer to the trust.<br>With respect collateral kindred, the rule applies only if:<br>1. The transferor had no descendants alive at the time of the transfer; and<br>2. The predeceasing person is a descendant of the parent of the transferor (or of the current or former spouse of the transferor). |

***Ex-5:*** T’s will provides for a bequest of $100,000 to her daughter C if she survives T by 120 days; otherwise the $100,000 is to go to C's child GC. T and C die simultaneously and under state law, C is deemed to have predeceased T.

1. Is the bequest to GC a direct skip?

2. Suppose C survived T but only for 30 days?

3. Suppose C survived T by 100 days?

---

23 IRC § 2651(c)(2).

24 IRC § 2651(d).

25 IRC § 2651(e); See also Treas. Regs. § 26.2612-1(a)(2). In the case of a direct skip to a trust, the altered generation assignment continues to apply to terminations of interests in and distributions from the trust. If a transferor makes an addition to an existing trust which would have qualified for the predeceased parent rule had it been made to a separate trust with identical terms, the addition is treated as being held in a separate trust for GST tax purposes. Treas. Regs. § 26.2612-1(a)(2)(ii). For more on the rules applicable to a single trust that is treated as two or more separate trusts, see “*Single trust treated as separate* trusts,” infra p. 156.

**Note:** IRC § 2612(c)(2) referred to in this note was eliminated by the 1997 TRA. Former subsection (c)(3) was renumbered as (c)(2). The new expanded predeceased ancestor rule may be found in IRC § 2651(e).

4. Suppose C filed a qualified disclaimer of her interest under T's will seven months after T's death?

***Ex-6:*** T devises property to a QTIP trust to pay the income to Spouse for life, then to distribute all property per stirpes to such of T's lineal descendants as survive Spouse. No election under IRC § 2652(a)(3) is made with respect to this trust. If, at the death of Spouse, T's descendants are two children, C-1 and C-2, and GC (the child of deceased child, C-3),

1. Will the one-third passing to GC be a taxable event under the GST tax?

2. On the assumption that C-3 died before T, would the answer change if T's personal representative had made an election under IRC § 2652(a)(3)?

3. Suppose in this latter case, that C-3 had survived T but had predeceased Spouse. Assume further that T dies in 1998. Would the result be the same?

| DRAFTING TIP |
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| In the third scenario, the GST could have been avoided had Spouse been given a special testamentary power of appointment. She could have exercised the power to appoint the trust property in equal shares to C-1 and C-2 and then made a compensating gift in the form of a direct skip to GC from independent sources. |

## 3. Multiple skips

Where property held in trust is subject to a GST and thereafter remains in the trust, the generation of the transferor is dropped down to the generation immediately above the highest generation of any person holding an interest in the trust.[26]

| COMMENT |
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| Note the difference between this rule and the Predeceased Ancestor Rule, discussed previously. Unlike the latter, the Multipe Skip Rule does not change the identity of the transferor. It changes only the generation to which the transferor is assigned. |

***Ex-7:*** T creates a trust to pay income to C for life, then to GC for life, then to GGC in fee. After the trust is created, C dies. Thereafter, the trustee distributes trust income and some trust principal to GC. Still later, GC dies and the trust property is distributed to GGC. What are

26 IRC § 2653. If no person holds an interest, the generation of the transferor is dropped down to the generation immediately above the highest generation of all persons who may subsequently hold an interest in the trust. Treas. Regs. § 26.2653-1(a).

the GST tax consequences of C's death, the distributions to GC, and the termination of the trust at GC's death?

| COMMENT |
| --- |
| The result in this example would be similar if C was not a beneficiary and the initial income interest went to GC. In that event, the creation of the trust would be a direct skip and the generation assigned to T would be one generation above GC. Accordingly, subsequent distributions to GC would not be taxable distributions because GC would no longer be a skip person.[27]<br><br>Note that this effect can be used as a planning technique. Suppose for example, that the initial beneficiaries of the trust had been T's great-grandchildren and more remote descendants but that the trust provided that a year after the trust is created, T children and grandchildren also become beneficiaries. Under the multiple skip rule, subjecting the trust to the GST tax as a direct skip at its creation will mean that the generation assigned to T would change to that of his grandchildren immediately after the creation of the trust with the result that subsequent distributions to grandchildren and great-grandchildren will not be taxable events. |

## C. TRIGGERING EVENTS

There are three triggering events under the GST tax:

- direct skips,
- taxable terminations, and
- taxable distributions.

### 1. Direct skips

A direct skip occurs when a transfer, that is subject to the gift or estate tax, is made to a skip person.[28]

An outright gift or bequest to a grandchild whose parents are still alive is an example.[29] So too is a transfer to a trust that is itself a skip person.

***Ex-8:*** GP transfers property to a revocable inter vivos trust retaining the income for life with remainder to GC. Does a taxable event occur at GP's death and if so, what kind?

***Ex-9***: GP creates a trust to pay the income to C for life, remainder to GC. Both C and GC have Crummey withdrawal powers. Is the creation of this trust a taxable event under the GST tax?

27 Treas. Regs. § 26.2653-1(b), Example 1.

28 IRC § 2612(c).

29 Treas. Regs. § 26.2612-1(f), Example 1. A gift to a Great-grandchild yields the same tax. That is, there is no penalty imposed for double skips. Treas. Regs. §§ 26.2612-1(a)(1), 26.2612-1(f), Example 2.

## 2. Taxable terminations

In general, a taxable termination occurs at the termination of any interest in a trust.[30]

In most instances, this occurs at the expiration of an interest because of the death of its owner or because of the failure of some contingency. But a distribution from a trust can also be a taxable termination. This will be the case when:

- A partial distribution of trust property is made to a skip person at the death of a lineal descendant of the transferor;[31] or
- A total distribution of all trust property to a skip person.

| COMMENT |
| --- |
| For this purpose, a total distribution occurs even though the trustee retains sufficient funds to pay the expenses of winding up the trust or to pay the GST taxes on the distribution.[32] |

***Ex-10:*** Parent creates a trust for Child for life, then to grandchild for life with remainder to great-grandchild. Child dies. Some years later, but during grandchild's lifetime, the trustee makes a discretionary distribution to great-grandchild. What are the GST tax consequences of these events?

**COMMENT**

To present a more complete picture, here is the proper classification of a number of other events that might occur relating to the trust described in this example:

1. A distribution to child during her life is not a GST; child is not a skip person.
2. A partial distribution to grandchild during child's life is a taxable distribution.
3. A total distribution to grandchild during child's life is a taxable termination.
4. No distribution to grandchild after child's death is a GST because the generation assigned to transferor will be changed at child's death to that of child under the multiple skip rule of IRC § 2653.

***Ex-11:*** Grandparent transfers property in trust to spray the income to such one or more of Grandparent's descendants as are from time to time living. At the death of the first of grandparent's two children, half of the trust principal is to be distributed to grandchildren. At the death of the second of the children, the trust is to terminate and all remaining trust property is to be distributed to the grandchildren. Classify the GST event that occurs at the death of the first child.

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30 Where more than one interest terminates at the same time as a result of the same event, there is only one taxable termination. Treas. Regs. § 26.2612-1(b)(3). See also Treas. Regs. § 26.2612-1(f), Example 10.

31 Treas. Regs. § 26.2612-1(b)(2).

32 Treas. Regs. § 26.2612-1(f), Example 9.

### a) Trusts which can't benefit skip persons

No taxable termination occurs at the termination of an interest if at no time thereafter a distribution (including a terminating distribution) may be made to a skip person.[33]

Thus, no taxable termination will occur at the death of a life tenant if:

- the trust terminates at that point in favor of nonskip persons; or
- the trust continues for the exclusive benefit of nonskip persons.

| CAUTION |
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| This will not be the case if the trust continues for nonskip persons one or more of whom has a power of appointment (general or special) that could be exercised in favor of a skip person. |

### b) Terminations where nonskip persons have an interest

No taxable termination occurs at the termination of an interest if one or more nonskip persons continue to have an interest in the trust.[34] In that event, the GST tax is deferred until the termination of all interests in nonskip persons.

| COMMENT |
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| In the application of this rule, an interest is disregarded if a significant purpose for its creation is the postponement or avoidance of the GST tax.[35] |

***Ex-12:*** Grandparent transfers property in trust to spray the income to such one or more of Grandparent's descendants as are from time to time living. At the death of the last of Grandparent's two children, all trust principal is to be distributed to grandchildren.

1. Does a GST event occur at the death of the first of Grandparent's children?

2. How about at the death of the second child?

| DRAFTING TIP |
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| In this last example, if the second child had a special power to appoint the trust property at his death, it might be possible to further defer the taxable termination by having the child appoint an income interest in the property to a nonskip person such as the child's spouse or a charity,[36] with the remainder going to Grandchild. For this to work, however, it would have to be shown that postponement of the GST tax was not a principal purpose of the appointment. |

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33 Treas. Regs. § 26.2612-1(b)(1)(iii). A possibility of a distribution to a skip person is disregarded if there is less than a 5 percent probability that the distribution will occur. Treas. Regs. § 26.2612-1(b)(1)(iii).

34 Treas. Regs. § 26.2612-1(b)(1)(ii).

35 Treas. Regs. § 26.2612-1(e)(2)(ii).

36 Although the charitable interest need not be a qualifying lead interest, distributions of income to the charity must be required. A discretionary interest in a charity does not give the charity an "interest" in the trust. IRC § 2652(c)(1)(B).

| COMMENT |
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| Where a taxable termination is unavoidable, consideration should be given to selling any low basis assets before the termination occurs. This will save GST taxes on the income taxes payable on the sale. |

### c) Terminations subject to estate or gift tax

In general, no taxable termination occurs at the termination of an interest if the termination is subject to either the gift or the estate tax. Instead, the termination will result in a new transferor being determined with respect to the trust.[37]

**Exception:** In the case of a QTIP trust for which the election to have the first spouse treated as the transferor is made pursuant to IRC § 2652, even though the QTIP property is taxable in the estate of the surviving spouse, the first spouse remains the transferor for GST purposes. Accordingly, a taxable termination can occur at the death of the surviving spouse. (See *Ex-6, p. 12.*)[38]

## 3. Taxable distributions

A taxable distribution occurs when a distribution of income[39] or corpus of a trust is made to a skip person and the distribution is neither a direct skip nor a taxable termination.[40]

***Ex-13:*** Parent creates a trust to pay the income to Child for life with remainder to Grandchild. During Child's life, the trustee is directed to distribute $14,000 annually to Grandchild to help defer her living expenses in Europe where she is attending school.

1. Will the distributions be a taxable event under the GST tax?

2. Would the answer be the same if the Grandchild had been given a Crummey withdrawal power over $14,000 and the distribution occurred as a consequence of her exercise of the withdrawal power?

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IRC § 2654(a)(2) provides for a basis adjustment to fair market value for taxable terminations that occur as a result of someone's death. This adjustment will be available where the appointment is made for the life of an individual nonskip person but not where the appointment is to a charitable lead trust.

37 IRC § 2612(a); Treas. Regs. § 26.2612-1(b)(1)(i).

38 See Treas. Regs. § 26.2652-1(a)(6), Example 6; Rev. Rul. 92-26, 1992-1 C.B. 314.

39 The GST tax imposed on distributions of trust income is deductible but only to the extent such tax is imposed on a transfer which is included in the gross income of the distributee. IRC §§ 164(a)(5); 164(b)(4). For guidance on the deduction, see IRS Announcement 91-43, IRB 1991-11 at 29.

40 IRC § 2612(b). A distribution from one trust to another trust is a taxable distribution only if the recipient trust is itself a skip person. Treas. Regs. § 26.2612-1(c)(2). For the rules for determining when a trust is a skip person, see "*Skip person*", infra p. 120.

| COMMENT |
| --- |
| In this last case, if Grandchild permitted the withdrawal power to lapse, she would be treated as having received a distribution from the trust to the extent the power exceeds the greater of $5,000 or 5 percent of the value of the trust.[41] |

## D. EXEMPTIONS AND EXCLUSIONS

Much like the gift tax, the GST tax has a set of exclusions and exemptions. These include exclusions for medical and tuition payments, an exclusion similar to the gift tax annual exclusion and the all important per transferor GST exemption ($5,450,000 for 2016).

### 1. Section 2503(e) equivalents

Transfers or distribution which if made inter vivos would qualify for the IRC § 2503(e) gift tax exclusion are excluded from the GST tax.[42]

| COMMENT |
| --- |
| Accordingly, consideration should be given to expressly authorizing the trustee to pay such expenses with respect to skip persons in any trust for which skip persons are potential beneficiaries and which is not otherwise exempt from the GST tax |

### 2. Section 2503(b) exclusion

A lifetime direct skip is exempt from the GST tax to the extent it qualifies for the IRC § 2503(b) gift tax annual exclusion.[43]

**Limitation:**

- For this rule to apply to a gift in trust the gift must be tax-vested in a single beneficiary.
- This requires that the trust be for the exclusive benefit of a single beneficiary during life and that the trust property be includible in the beneficiary's gross estate if the beneficiary dies before termination.[44]

| CAUTION |
| --- |
| The typical irrevocable life insurance trust with Crummey invasion powers does not meet these requirements. To exempt the trust from GST tax exposure, the inclusion ratio of the trust must be kept at zero through periodic allocations of the transferor's GST exemption. This may require filing gift tax returns even though they might not otherwise be required. |

### 3. GST exemption

Every person has a cumulative lifetime exemption that may be used to shelter transfers from the GST tax.[45] Use of the exemption and the rules relating to its allocation are examined further in "*The GST Tax Exemption*" on page 31.

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41 See Treas. Regs. §§ 26.2612-1(c)(1); 26.2652-1(a)(6), Example 5.

42 IRC § 2611(b)(1).

43 IRC § 2642(c)(1).

44 IRC § 2642(c)(2); Treas. Regs. § 26.2642-1(c)(3).

45 IRC § 2631(a).

| COMMENT |
| --- |
| The amount of the GST exemption is tied to the amount of the applicable exclusion amount under the estate tax. Accordingly, it is $5,450,000 for 2016. [46] |

## E. COMPUTING THE GST TAX

The GST tax is calculated by multiplying the taxable amount times the applicable rate.

### 1. Taxable amount

The taxable amount is the fair market value of the property subject to the direct skip, taxable distribution or taxable termination.[47]

- For taxable terminations and distributions, (but not direct skips) the taxable amount also includes the money that will ultimately be used to pay the GST tax.
- Accordingly, for a residuary bequest to a skip person, the taxable amount is that portion of the residue which when subjected to the GST tax will leave enough in the residue to pay the tax involved.

***Ex-14:*** In a year when the maximum estate tax rate is 40 percent, D dies with a will in which he leaves the residue of his estate (worth $2,400,000 after payment of estate taxes but before reduction for any GST tax on the transfer) to GC. Assuming no GST exemption is allocated to this transfer, what is the taxable amount for this testamentary direct skip?

### 2. Applicable rate

The applicable rate is equal to the maximum estate tax rate (40 percent for 2015)[48] times the inclusion ratio.[49]

| COMMENT |
| --- |
| Accordingly, if the inclusion ratio is zero, so is the applicable rate. Conversely, if the inclusion ratio is one, the applicable rate is equal to the maximum estate tax rate. |

### 3. Inclusion ratio and applicable fraction

The inclusion ratio is equal to one minus the applicable fraction.[50]

- The numerator of the applicable fraction is the GST exemption allocated to the trust or direct skip.

[46] Under a special rule, the GST exemption for 2010 is $5,000,000.

[47] In the case of taxable distributions and taxable terminations, the taxable amount is determined by deducting various expenses. See IRC §§ 2621(a); 2622(b). If any of these expenses would also be deductible for purposes of the trust's income tax, they may be deducted for that purpose only if an election waiving them for purposes of the GST tax is made. IRC § 642(g).

[48] The maximum estate tax rate is the maximum rate set forth in IRC § 2001(c) without regard to IRC § 2001(c)(3). Treas. Regs. § 26.2641-1.

[49] Under a special rule, the applicable rate for GST events that occur in 2010 is zero.

[50] The applicable fraction is rounded to the nearest one-thousandth. Treas. Regs. § 26.2642-1(a).

- The denominator is equal to the GST value of the property transferred to the trust (or involved in the direct skip) reduced by any federal or state death taxes charged to and actually recovered from the trust and any charitable deductions allowed with respect to the property.

In the case of a direct skip, the denominator is also reduced by any portion of the transfer that is a nontaxable gift.[51]

| COMMENT |
| --- |
| This reduction is available for a direct skip to a trust only if the trust is tax-vested in the individual. This requires that the trust be for the exclusive benefit of a single beneficiary during life and that the trust property be includible in the beneficiary's gross estate if the beneficiary dies before termination.[52] |

***Ex-15:*** In 2016, T transfers $14,000 to a trust for his grandchild. The trust qualifies for the annual exclusion under IRC § 2503(c).

1. What is the applicable fraction for this trust?

2. How would your answer change if the transfer had been $16,000?

***Ex-16:*** T transfers $70,000 to a newly created trust for his five children and grandchildren. The children and grandchildren have Crummey withdrawal powers so T is entitled to 5 annual exclusions for his transfer. Since all of the transfer is excluded from the gift tax, T need not worry about the transfer for purposes of the GST tax either, right?

## 4. GST value of lifetime transfers

For purposes of calculating the denominator of the applicable fraction, the value of property transferred during life is its fair market value on the effective date of the allocation.[53]

**Timely filed returns:** For allocations made on a timely filed gift tax return, this means the value of the denominator will be determined by the fair market value as finally determined for purposes of the gift tax.[54]

**Late returns:** In the case of an allocation made after the due date of the gift tax return, this will be the date on which the allocation is actually made.

- However, a transferor may elect to treat the allocation as having been made on the first day of the month during which the late allocation is made.

---

[51] A gift to an individual is nontaxable to the extent it qualifies for the IRC § 2503(b) annual exclusion (after taking into account the split gift provision) or it qualifies for the IRC § 2503(e) exclusion for direct payments of college tuition or medical expenses. Treas. Regs. §§ 26.2642-1(c)(1) and (3).

[52] IRC § 2642(c)(2); Treas. Regs. § 26.2642-1(c)(3). Charitable lead annuity trusts are subject to special treatment. See IRC § 2642(e); Treas. Regs. § 26.2642-3.

[53] Treas. Regs. § 26.2642-2(a)(1).

[54] Treas. Regs. § 26.2642-2(a)(1).

- This election is not effective with respect to a life insurance policy or a trust holding a life insurance policy if the insured has died.[55]

| COMMENT |
| --- |
| This election is convenient since it will seldom be possible to know the value of a transfer on the day that an allocation becomes effective. |

## 5. GST value of testamentary transfers

With some qualifications, estate tax value is used to value the denominator of the applicable fraction of property included in a decedent's gross estate.

| COMMENT |
| --- |
| This includes the effect of any special valuation methods actually elected by the estate, although qualified real property may be valued using IRC § 2032A only if the required recapture agreement specifically provides for recapture of the GST tax.[56] |

### a) Pecuniary bequests to skip persons

If a pecuniary bequest is satisfied in cash, the value of the transfer for purposes of calculating the denominator of the applicable fraction is the amount of the pecuniary bequest.

This is also true of pecuniary bequests that are satisfied in kind provided the bequest is satisfied:

1. at date of distribution values, or
2. with property that is fairly representative of the net appreciation and depreciation in all of the assets that could have been used to satisfy the bequest.[57]

Otherwise, the value of the bequest for purposes of determining the denominator is the date of distribution value of the property used to fund the bequest, not the amount of the pecuniary bequest itself.[58]

### b) Residual transfers following pecuniary bequests to nonskip persons

#### (1) Where pecuniary bequest is satisfied in cash

The value of a residual transfer following a pecuniary bequest that is satisfied in cash is the estate tax value of all of the property that could have been used to satisfy the pecuniary amount (e.g., residue plus property used to satisfy the pecuniary gift) reduced by the value of the pecuniary amount.

If the pecuniary bequest carries an appropriate interest rate, its value is the face amount of the bequest; otherwise its value is based on present value using the applicable IRC § 7520 rate.[59]

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55 Treas. Regs. § 26.2642-2(a)(2). The election is not effective until it is actually filed with the IRS. The election is made on the Form 709 by stating that the election is made, the applicable valuation date, and the fair market value of the assets as of that date. Treas. Regs. § 26.2642-2(a)(2).

56 IRC § 2624(b) and (c). See also Treas. Regs. § 26.2642-2(b)(1).

57 Treas. Regs. § 26.2642-2(b)(2)(i).

58 Treas. Regs. § 26.2642-2(b)(2)(ii).

59 Treas. Regs. § 26.2642-2(b)(3)(i).

| COMMENT |
| --- |
| A pecuniary bequest carries an appropriate interest rate if:<br>• it carries a statutory rate of interest under local law or a rate that falls between 80 and 120 percent of the applicable IRC § 7520 rate;[60] or<br>• the entire bequest is funded (or property is irrevocably set aside for later funding) within 15 months of the decedent's death;[61] or<br>• the governing instrument or applicable local law requires that the executor or trustee allocate to the pecuniary payment a prorata share of the income earned by the estate or trust during the period between valuation and funding.[62] |

#### (2) Where pecuniary bequest is satisfied in kind

In the case of a residual transfer following a pecuniary bequest that may be satisfied in kind, the regulations provide that the value of the denominator for purposes of determining the applicable fraction is the date of distribution value of the property used to satisfy the residual transfer unless the pecuniary gift must be satisfied

(a) with property using date of distribution values or

(b) with property that is fairly representative of net appreciation or depreciation.[63]

| COMMENT |
| --- |
| Assuming one of these is met, what is the appropriate method for valuing the residuary transfer? Apparently the bequest will be valued as if it were satisfied in cash. That is, if the bequest carries an appropriate interest rate, its value will be the face amount of the bequest; otherwise its value will be based on present value using the applicable IRC § 7520 rate. |

### 6. Charitable lead annuity trusts

In determining the applicable fraction with respect to a charitable lead annuity trust:

a) the denominator of the fraction is the value of the property immediately after the termination of the charitable interest,[64] and

b) the numerator is the adjusted GST exemption. This is equal to the GST exemption allocated to the transfer increased by an amount equal to the interest that would accrue to the exemption had it been invested at a rate equal to that used to determine the charitable deduction for the actual period of the charitable annuity.[65]

***Ex-17:*** T transfers $1,000,000 to a CLAT which pays an 8% lead interest to Charity for 20 years. Payments are made in one installment

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[60] Treas. Regs. § 26.2642-2(b)(4)(i).

[61] Treas. Regs. § 26.2642-2(b)(4)(ii)(A).

[62] Treas. Regs. § 26.2642-2(b)(4)(ii)(B).

[63] Treas. Regs. § 26.2642-2(b)(3)(ii).

[64] Treas. Regs. § 26.2642-3(a)(2).

[65] Treas. Regs. §§ 26.2642-3(a)(1); 26.2642-3(b). In the case of a late allocation, the compounding begins on the date of the allocation.

at the end of the year. The remainder at the expiration of the 20 year term goes to T's grandchild GC.

1. Assuming an IRC § 7520 interest rate of 7.2 percent, what is the amount of the charitable deduction T may claim on his gift tax return?

2. Assuming T allocates GST exemption to this trust in an amount equal to the taxable gift, what will be the adjusted GST exemption for this trust at the expiration of the lead interest?

| CAUTION |
| --- |
| If this compounding produces an exemption greater than that needed to yield a zero inclusion ratio, the excess is lost.[66] |

3. Could T use a formula allocation to avoid the over or under allocation of GST exemption to the CLAT?

## 7. Redetermination of the applicable fraction

After a transfer to a trust is made, a number of events can occur which require that the applicable fraction be redetermined. Three of the more common of such events include:[67]

- a subsequent allocation of additional exemption,[68]
- the addition of more property to a trust,[69] and
- a consolidation of two or more trusts with the same transferor.[70]

**In each case:**

a) the denominator of the new applicable fraction will equal the value of the property in the trust after the event causing the redetermination, and

b) the numerator will equal the sum of the value of the nontax portion of the trust and any additional exemption allocated at the time of the event.[71]

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66 Treas. Regs. § 26.2642-3(b).

67 Other events which require a redetermination of the applicable fraction include distributions of property to a skip person during an ETIP and the imposition of a recapture tax under IRC § 2032A. As to the former, see Treas. Regs. § 26.2642-4(b), Example 5.. As to the latter, see Treas. Regs. § 26.2642-4(a)(4).

68 Treas. Regs. § 26.2642-4(a). This includes a subsequent allocation of exemption at the death of the transferor to a trust created by the transferor and which is included in the transferor's gross estate and with respect to which an allocation was previously made at a time when the trust was not subject to an ETIP. Treas. Regs. § 26.2642-4(a)(3). This situation might arise where exemption is allocated upon the transfer of an insurance policy to in insurance trust and the policy proceeds are subsequently included in the transferor's gross estate under IRC § 2035.

69 Treas. Regs. § 26.2642-4(a)(1).

70 Treas. Regs. § 26.2642-4(a)(2).

71 In the case of a consolidation of two or more trusts, the numerator of the new applicable fraction will equal the sum of the nontax portions of all of the trusts being consolidated. Treas. Regs. § 26.2642-4(a)(2).

| COMMENT |
| --- |
| The nontax portion is equal to the old applicable fraction times the value of the trust immediately before the event. |

***Ex-18:*** During life, T creates a GST trust of $200,000 and allocates $100,000 of exemption to it resulting in an inclusion ratio of one-half. Subsequently, when the trust is worth $500,000, T allocates an additional $100,000 of exemption to the trust. What is the redetermined applicable fraction and the resulting inclusion ratio for this trust?

***Ex-19:*** In 1993, T creates a Crummey trust and funds it with property worth $10,000. T makes a timely allocation of $10,000 of exemption to the trust resulting in an applicable fraction of 1 and an inclusion ratio of zero. In 1994, when the trust is worth 15,000, T makes an additional transfer to the trust of $10,000. What is the redetermined applicable fraction for this trust?[72]

## F. TRANSFERS BY NONRESIDENT ALIENS

IRC § 2663 authorizes the Service to promulgate regulations applying the GST tax to transfers by nonresident aliens (NRA). The regulations do this but only with respect to transfers by the NRA that are subject to the Federal estate or gift tax.[73]

| COMMENT |
| --- |
| Every NRA transferor is allowed a GST exemption of $5,450,000. Under the 1997 TRA, the exemption was indexed for inflation in $10,000 increments beginning in 1999. |

***Ex-20:*** T (a NRA) transfers property worth $600,000 to GC. Two thirds of the property is property situated in the United States (and therefore subject to the Federal gift tax) and one third is property situated outside the United States (and therefore not subject to the Federal gift tax. To what extent is the transfer subject to the GST tax?

### 1. Transfers of both U.S. and foreign situs property

In the case of transfers in trust that consist only partly of property subject to the Federal gift or estate taxes, then numerator of the applicable fraction is determined under a special rule.

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72 For an example of a Crummey trust involving both timely and late allocations of GST exemption, see Treas. Regs. § 26.2642-4(b), Example 2.

73 Treas. Regs. §§ 26.2663-2(b)(1); 26.2663-2(b)(2). See Treas. Regs. § 26.2652-1(a)(2) for the rules controlling when a transfer of property is subject to the gift or estate taxes. See also Treas. Regs. § 26.2663-2(e) for a transitional rule applicable to GST exemption allocations on transfers by an NRA which occurred after December 23, 1992 and before December 27, 1995.

- The numerator is equal to the sum of the GST exemption allocated to the trust plus the value of the nontax portion of the trust.[74]
- The nontax portion of the trust is a fraction of the trust the numerator of which is the value of the property that is not subject to the Federal gift or estate taxes and the denominator of which is the value of the entire trust.[75]

***Ex-21:*** T (a NRA) transfers property worth $500,000 to a trust to pay income to C for life, remainder to GC. Of the total transfer, only $400,000 consists of property subject to the Federal gift tax.

1. What is the applicable fraction for this trust if T allocates no exemption to the trust?

2. What is the applicable fraction if T allocates $100,000 of GST exemption to the trust on a timely filed gift tax return?

3. What is the applicable fraction if T allocates $100,000 of GST exemption to the trust in 1999 when the trust is then worth $800,000?

## 2. Transfers by an NRA during an ETIP

The ETIP rules apply to a transfer by a NRA only if the property transferred is subsequently included in the transferor's gross estate. Otherwise, the nontax portion of the trust and the applicable fraction are determined as of the date of the initial transfer.[76]

***Ex-22:*** T (a NRA) transfers property worth $500,000 to a 10 year grantor retained annuity trust with remainder at the expiration of the term period to go to GC. Of the $500,000 transferred to the trust, only $400,000 is subject to the Federal gift tax. T allocates $100,000 of GST exemption to the transfer on a timely filed gift tax return.

1. What is the applicable fraction if T dies in year 6 and $500,000 of the then $800,000 value of the trust is included in T's gross estate?

2. What would be the applicable fraction if T survives the term period and the trust terminates in favor of GC at that time?

[74] Treas. Regs. § 26.2663-2(c)(1)(i).

[75] Treas. Regs. § 26.2663-2(c)(2).

[76] Treas. Regs. § 26.2663-2(c)(1)(3).

## G. EFFECTIVE DATES OF GST TAX

In general, the generation-skipping transfer tax applies to testamentary transfers after October 22, 1986, and to lifetime transfers after September 25, 1985.[77] Correspondingly, it does not apply to irrevocable transfers made on or before that date.[78]

| COMMENT |
| --- |
| From a tax standpoint, grandfathered trusts should be kept in existence as long as possible. In this regard, it may be possible to avoid a scheduled termination of a grandfathered trust by exercising a special power of appointment to appoint the trust property in continuing trust. If this is attempted, care must be exercised to insure the appointment complies with the Rule Against Perpetuities. |

***Ex-23:*** Prior to 1985, T created a trust in which his child C had a life interest and a general testamentary power of appointment. In default of appointment, the trust was to continue for the benefit of C's descendants for as long as the Rule Against Perpetuities allows.

1. If C dies without exercising his power, will the trust remain grandfathered under the GST tax?

2. If C exercised his power to appoint trust property to his grandchildren, will the GST tax apply to the appointment?

**COMMENT**

The Service has issued final regulations[79] which attempt to clarify when modifications of grandfathered trusts can be made without affecting the grandfathered status of the trust. Under the regulations, a safe harbor is provided for:

- Modifications occurring through court orders in construction proceedings that resolve genuine ambiguities in trust terms;
- Modifications occurring through court-approved settlements of bona fide controversies over the administration or terms of a trust but only if the settlement results from an arm's-length negotiation and falls within the reasonable outcomes under the governing instrument and applicable state law;
- Distributions of principal to a new trust for the benefit of succeeding generations provided that vesting of principal is not postponed beyond the perpetuities period applicable to the distributing trust; and

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[77] In addition, the GST tax does not apply to:

- Testamentary transfers under a will executed before October 23, 1986, if the decedent died before 1987.
- Transfers under a trust to the extent the trust property is included in the decedent's gross estate, the GST is caused by the decedent's death, and the decedent was incompetent to change the trust on October 22, 1986 and at all times thereafter.

[78] See generally, Treas. Regs. § 26.2601-1. This shelter extends to the income and appreciation as well, but not to post September 25 additions. See E Norman Peterson Marital Trust, 102 T.C. 790 (1994) (failure to exercise a general power of appointment in trust created before September 26, 1985 is a constructive addition to the trust, citing Temp. Regs. § 26.2601-1(b)(1)(v)(A). Compare PLR 9627020 (waiver of IRC § 2207A recovery right from QTIP trust is not a constructive addition).

[79] Treas. Regs. § 26.2601-4(b)(4).

- Any other modification that neither shifts beneficial interests down generations nor postpones vesting of a beneficial interest beyond the originally applicable perpetuities period.

With respect to this last criteria, Regs. § 26.2601-1(b)(4)(i)(D)(2) provides that administration of a trust in conformance with applicable state law that defines the term income as a unitrust amount, or which permits the trustee to make equitable adjustments between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries, will not be considered to shift a beneficial interest in a trust.[80]

[80] See also the example under Treas. Regs. § 26.2601(b)(4)(i)(E).

## ANSWERS—THE GST TAX BASICS

Ex-1. **Answer –** The alternate gift on the basis of the survivorship condition is treated as a transfer in trust under the GST tax. Accordingly, C's death results in a taxable termination of his interest. Had the survivorship period been six months or less, no taxable termination would have occurred at C's. See Treas. Regs. § 26.2652-1(b)(2), Examples 2 and 3.

Ex-2. **First question –** C has an interest in the trust because C is a current distributee of trust income. GC, however, has no interest in the trust. Treas. Regs. § 26.2611-1(f), Example 14.

**Second question –** Yes, the answer would change. GC would have an interest in the trust because GC would have a right to current distributions. See Treas. Regs. § 26.2612-1(f), Example 3.

Ex-3. **First question –** No in both cases. Since Child's testamentary power is a general power, IRC § 2041 will require the trust property to be included in her gross estate at her death. At that point, Child becomes the transferor of the trust. Treas. Regs. § 26.2652-1(a)(1). Consequently, distributions to Grandchild after the death of Child are not subject to the GST.

**Second question –** Apparently, yes. See PLR 9527024.

Ex-4. **Answer –** The lapse of the Crummey powers will cause the holder to become the transferor of the property subject to the lapse only to the extent the lapse exceeds the greater of $5,000 or 5 percent of the value of the trust property. Treas. Regs. § 26.2652-1(a)(6), Example 5.

Ex-5. **First question –** No. The predeceased ancestor rule applies when C dies simultaneously with the transferor and is presumed by state law or the terms of the instrument to have predeceased T.

**Second question –** The predeceased ancestor rule also applies if C dies within 90 days of T and is treated as having predeceased under the governing instrument or applicable local law. Treas. Regs. § 26.2612-1(a)(2)(i).

**Third question –** The predeceased ancestor rule does not apply if C actually survives T by more than 90 days. Treas. Regs. § 26.2612-1(a)(2)(i). Nevertheless, because the condition placed on C is less than 6 months, C will not be viewed as having an interest in the bequest. As a result, the distribution to GC is a direct skip, not a taxable termination.

**Fourth question –** Likewise, the predeceased ancestor rule does not apply when C actually survives but is treated as having predeceased under local law as a result of a qualified disclaimer. Treas. Regs. § 26.2612-1(a)(2)(i). However, because C disclaimed, the GST tax will be applied as if C never had the disclaimed interest. Accordingly, the taxable event under the GST tax will be a direct skip; not a taxable termination. See Treas. Regs. § 26.2612-1(e)(3).

**Comment:** There may be an exception. Suppose the devise was "to C" or "to C if she survives me"? Suppose further that C survived T by only a month. The Service has indicated informally that the predeceased ancestor rule would apply if C's personal representative made a qualified disclaimer within 90 days of T's death.

Ex-6. **First question –** No. In the absence of an IRC § 2652(a)(3) election, Spouse will be treated as the transferor of the QTIP trust. Since the QTIP property is taxable in Spouse's estate, the transfer to GC constitutes a direct skip to which the predeceased ancestor rule of IRC § 2612(c)(2) applies. Rev. Rul. 92-26, 1992-1 C.B. 314. See also Treas. Regs. § 26.2612-1(f), Example 5.

**Second question –** It depends on when T died. With an IRC § 2652(a)(3) election, T will be treated as the transferor of the QTIP trust. Therefore, the event at Spouse's death is a taxable termination, not a direct skip.

If T died before 1998, the predeceased child rule of IRC § 2612(c)(2) would not apply. See Treas. Regs. § 26.2652-2(d), Example 1. Accord Rev. Rul. 92-26, 1992-1 C.B. 314.

However, after 1997, the predeceased ancestor rule applies to taxable terminations and distributions (as well as to direct skips) provided the ancestor is dead at the time the transfer creating the interest occurs. Since C-3 died before T, the predeceased ancestor rule would

apply and GC would not be a skip person. Accordingly, no taxable termination occurs at Spouse's death.

**Third question –** The result here is different. Even after 1997, for the predeceased ancestor rule to apply to a taxable termination or distribution, the ancestor has to be dead at the time the transfer for which a gift or estate tax is imposed is made with respect to the trust. Technically, that occurred twice – once at T's death and again at the death of Spouse. But IRC § 2651(e)(1)(B) provides that it is the earlier one that matters. Accordingly, the predeceased ancestor rule does not apply.

**Comment**: A somewhat similar situation can arise where T creates a 10 year GRAT with the remainder going to GC. Under prior law, if T died before the expiration of the 10 year term so that the property was included in T's gross estate, the predeceased ancestor rule applied if C (GC's parent) predeceased T, whether or not C was alive at the initial creation of the trust. After 1997, the predeceased ancestor rule applies only if C dies before the creation of the trust. It does not apply if C is alive at that time but dies before T.

Ex-7. **Answer –** A taxable termination occurs at the death of Child. Thereafter, the generation assignment of the transferor is deemed to be that of Child. IRC § 2653. Consequently, distributions to grandchild after child's death are not subject to the GST tax. However, a second taxable termination occurs at the death of grandchild when the trust terminates in favor of great-grandchild. See Treas. Regs. § 26.2653-1(b), Example 2.

Ex-8. **Answer –** Assuming GP's parents are alive at GP's death, a direct skip occurs at that time. The event is a direct skip because the trust property is subject to the estate tax at GP's death. IRC §§ 2036(a)(1); 2038. However, if P (GC's parent and GP's child) is dead at GP's death, the predeceased child rule will insulate the transaction from the GST tax. IRC § 2612(c)(2).

Ex-9. **Answer –** No. Even though GC is a skip person, the trust is not because a nonskip person C has an interest in the trust. Treas. Regs. § 26.2612-1(f), Example 3.

Ex-10. **Answer –** The facts indicate two taxable events under the GST tax -- a taxable termination at the death of Child and a second event when the distribution is made to great-grandchild. That distribution is classified as a taxable termination if all trust property was distributed; otherwise it is a taxable distribution. See Treas. Regs. § 26.2612-1(f), Examples 8, 9, and 12.

Ex-11. **Answer –** The distribution at the death of the first child is a taxable termination because it occurs at the death of a lineal descendant of the transferor. This is true even though Grandparent's second child, a nonskip person, continues to have an interest in the remaining trust property. See Treas. Regs. § 26.2612-1(f), Example 11.

Ex-12. **First question –** No. No distribution occurs at the death of the first child and that child's death is not a taxable termination because her sibling (a nonskip person) continues to have an interest in the trust.

**Second question –** Yes. A taxable termination will occur when the second child dies.

Ex-13. **First question –** Yes. The annual distributions to grandchild are taxable distributions because they are neither direct skips nor taxable terminations. Accord Treas. Regs. § 26.2612-1(f), Example 12.

**Second question –** Yes, the answer is the same. See Treas. Regs. § 26.2612-1(f), Example 13.

Ex-14. **Answer –** The answer is $1,714,286 on which D's estate will owe GST taxes of $685,714. The former number is calculated by dividing the residue ($2,400,000) by one plus the applicable rate. Since the transfer occurs in a year when the maximum estate tax rate is 40 percent and no GST exemption is allocated to the transfer, the denominator in the calculation is 1.40.

Ex-15. **First question –** On these facts, the denominator of the applicable fraction is zero (the value of the property transferred less the nontaxable portion). The inclusion ratio is also zero. See Treas. Regs. §§ 26.2642-1(c)(3); 26.2642-1(d), Example 2.

**Second question –** As a lifetime direct skip, T is deemed to have allocated $2,000 of GST exemption to this transfer unless he elects otherwise. Assuming he doesn't, the inclusion ratio will remain zero. But if T elects not to allocate exemption, the numerator of the applicable fraction is zero and the denominator is $2,000. This yields an applicable fraction of zero and an inclusion ratio of one. Treas. Regs. § 26.2642-1(d), Examples 3 and 4.

Ex-16. **Answer –** Wrong! Since the trust is not "tax vested" in a single beneficiary, no portion of this transfer is a nontaxable gift for purposes of the GST tax. Unless exemption is allocated to this transfer, the trust will have an inclusion ratio of one.

Ex-17. **First question –** The charitable deduction for T's transfer to the CLAT would be $834.504, resulting in a taxable gift at the creation of the trust of $165,496 ($1,000,000 - $834,504).

**Second question –** If T filed a timely gift tax return and allocated $165,496 of exemption to this trust, the adjusted GST exemption at the expiration of the 20 year lead interest would equal $664,788 ($165,496 plus interest at the rate of 7.2 percent compounded annually for 20 years). Accordingly, the CLAT would not have a zero inclusion ratio if the value of the property in the trust at the expiration of the lead interest exceeded that amount.

**Third question –** No. Formula allocations made with respect to a charitable lead annuity trust are valid only if they are dependent on values as finally determined for Federal estate or gift tax purposes as opposed to the value of the CLAT at the expiration of the lead interest. Treas. Regs. § 26.2632-1(b)(2)(i).

Ex-18. **Answer –** The new numerator of the applicable fraction is $350,000 ($100,000 plus the old fraction of 1/2 times $500,000) and the denominator is $500,000 (the value of the trust at the time of the allocation). The new applicable fraction is 7/10 and the new inclusion ratio is 3/10. See Treas. Regs. § 26.2642-4(b), Example 1.

Ex-19. **Answer –** It depends. If T fails to allocate additional exemption to the trust, the applicable fraction will change to 3/5 ($15,000 divided by $25,000) and the inclusion ratio will change to 2/5. If T makes a timely allocation of an additional $10,000 of exemption, the applicable fraction will remain at 1 ($25,000/$25,000) and the inclusion ratio will remain zero. Accord, Treas. Regs. § 26.2642-4(b), Example 2.

Ex-20. **Answer –** Only two-thirds of transfer is subject to the GST tax. Treas. Regs. § 26.2663-2(b)(1). See also Treas. Regs. § 26.2663-2(d), Example 1.

Ex-21. **First question –** The applicable fraction is 2/10ths determined as follows:

The nontax portion of the trust is $100,000/$500,000 or 20 percent. The applicable fraction is the value of the nontax portion (20 percent of $500,000) divided by $500,000 (the value of the property transferred to the trust). Treas. Regs. § 26.2663-2(d), Example 4.

**Second question –** The applicable fraction is 4/10ths determined as follows:

The numerator of the applicable fraction is equal to the sum of $100,000 (the value of the nontax portion, see previous question) and the $100,000 of exemption allocated to the transfer. The denominator of the applicable fraction is $500,000, the value of the property transferred to the trust. See Treas. Regs. § 26.2663-2(d), Example 3.

**Third question** – The applicable fraction is $260,000/$800,000 (.325) determined as follows:

The $260,000 numerator of the applicable fraction is equal to the $100,000 exemption allocation plus the value of the recomputed nontax portion of the trust. This latter is equal to 20 percent of the $800,000 date of allocation value of the trust. The denominator of the fraction is the same $800,000. Treas. Regs. § 26.2663-2(d), Example 5.

Ex-22. **First question** – The applicable fraction is .50 determined as follows:

Since the property is included in T's gross estate, the ETIP rule applies and the nontax portion of the trust as well as the applicable fraction are determined at T's death. At that time, the nontax portion is $300,000/$800,000 (or .375). The denominator of the applicable fraction is $800,000 and the

numerator is $400,000. This latter is the $100,000 of exemption plus $300,000 (the value of the nontax portion of the trust). Treas. Regs. § 26.2663-2(d), Example 6.

**Second question** – The applicable fraction is 1, determined as follows:

Since T survived the term of the trust, nothing was includible in his gross estate. Accordingly, the nontax portion and the applicable fraction are determined at the time of the initial transfer to the trust. The nontax portion is .8 ($400,000/$500,000). The denominator and numerator of the applicable fraction are both $500,000. The numerator is equal to $400,000 (the value of the nontax portion) plus the $100,000 of exemption allocated to the transfer. Treas. Regs. § 26.2663-2(d), Example 7.

Ex-23. **First question** – No. See Peterson Marital Trust v. Comm., 78 F.3d 795 (2d Cir. 1996).

**Second question** – Not according to the 8th and 9th Circuit. See Simpson v. U.S., 183 F.3d 812 (8th Cir. 1999); Bachler v. U.S., 281 F.3d 1078 (9th Cir. 2002), rev'g 126 F. Supp.2d 1279 (N.D. Cal 2000).

**Caution:** New Treas. Regs. § 26.2601-4(b)(4) is inconsistent with the result in the Simpson and Bachler cases. The validity of the GST effective date regulations was sustained by a divided Tax Court in Estate of Gerston v. Comm., 127 T.C. 139 (2006). More recently, the Tax Court decision was affirmed by the Sixth Circuit in Estate of Gerston v. Comm., 507 F.3d 435, 2007 WL 3307024 (6th Cir. 2007).

# II. PLANNING FOR THE GST TAX

The primary consideration in planning for the GST tax is to insure that the GST tax exemption is effectively utilized.

- This in turn requires a consideration of how the exemption is allocated and the rules relating to when a single trust may be split into (or be treated as) two or more separate trusts.
- For married persons, the reverse QTIP election must also be considered.

## A. THE GST TAX EXEMPTION

Every person has a cumulative lifetime exemption ($5,450,000 for 2016) that may be used to shelter transfers from the GST tax.[81] Use of the exemption is discretionary; it must be allocated[82] to a particular transfer before the exemption becomes effective. [83]

### 1. GST exemption basics

The key to the effectiveness of the GST exemption lies in the following truism relating to the calculation of the GST tax.

> **No GST tax occurs on distributions from or terminations of interests in a trust having an inclusion ratio of zero.**

And this is true regardless of the value of the property in the trust at the time of the distribution or termination. Thus, careful use of the exemption allocation can be used to shelter GSTs of far greater value than the exemption itself. [84]

> ***Ex-24:*** Grandparent transfers $5,450,000 in trust to pay income to Parent for life, remainder to Grandchild. Grandparent elects to allocate all $5,450,000 of his exemption to this transfer. Subsequently, Parent dies. At that time the trust is worth $20,000,000? What is the inclusion ratio for this trust at Parent's death. *Answers to the examples in this chapter begin on page 58.*

### 2. Allocating the exemption

In general, the GST tax exemption may be allocated to a GST by the transferor or the transferor's executor at any time from the date of the transfer to the due date of the transferor's estate tax return (including extensions actually granted).[85]

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81 IRC § 2631(a). Under the TRA 2010, the amount of the GST exemption is indexed for inflation from 2010 beginnin in 2012.

82 In many cases, the GST exemption is automatically allocated unless a contrary intention is expressed in the donor's gift or estate tax return. See "*Allocating the exemption*", beginning on p. 148.

83 Under TRA 2010, the GST exemption for transfers in 2010 is also $5,000,000. However, if the transfer is a GST event (that is a direct skip, taxable distribution, or taxable terminatin) the rate of tax for the event is zero.

84 When exemption is allocated to property held in trust, the allocation applies to the trust itself rather than to any particular assets in the trust. Treas. Regs. § 26.2632-1(a). Accordingly, an inclusion ratio of zero is achieved only when the exemption allocated to the trust equals the GST value of the property transferred to it.

85 IRC § 2632(a). Timely and late allocations made during the transferor's life are made on Form 709. After the transferor's death, Form 709 is used to make a timely allocation to a lifetime transfer that is not included in the transferor's gross estate. Form 706 is used to make all other allocations. Treas. Regs. §§ 26.2632-1(b), 26.2632-1(d). For additional guidance, see Treas. Regs. § 301.9100-7T. In PLR 9433013, the Service denied relief for a late allocation under Treas. Regs. § 301.9100-1 because the time for making the allocation is fixed by statute.

The procedures for making the allocation and its impact if made, vary with the type of transfer and the timing of the allocation.

**Comment**

Under Treas. Regs. § 301.9100-3, the Service may extend the time for making certain regulatory elections when the time for making the election is not prescribed by statute. With the enactment of TRA 2010, for GST events occurring prior to 2013, IRC § 2642(g)(1) deems the exemption allocation to be regulatory and directs the IRS to issue regulations detailing the circumstances and procedures under which an extension of time will be granted. The IRS has done this in Notice 2001-50, 2001-34 I.R.B.189.

In addition, IRC § 2642(g)(2) now provides that substantial compliance with the statutory and regulatory rules for allocating the GST exemption is sufficient.[86]

## a) Allocations during the transferor's life

### (1) Allocations during the estate tax inclusionary period

Except in the case of a QTIP trust for which the IRC § 2652(a)(3) reverse QTIP election is made, an elective or automatic allocation of GST exemption during an ETIP does not become effective until the ETIP terminates.[87]

#### (a) ETIP Defined

The estate tax inclusionary period (ETIP) is that period of time after a lifetime transfer when any portion of the transfer would be includible in the gross estate of the transferor or the transferor's spouse other than by reason of IRC § 2035.[88]

**Exceptions**

1. An ETIP does not arise because of a power of withdrawal in the transferor's spouse if:
   - the power does not exceed the greater of $5,000 or 5 percent of the trust corpus, and
   - the power lapses within 60 days after the transfer to the trust.[89]
2. Transferred property is not considered as being includible in the gross estate of the transferor or the transferor's spouse if "the possibility that the property will be included is so remote as to be negligible."[90]

#### (b) Termination of ETIP

An ETIP terminates at the earlier of:

- The death of the transferor;
- The time at which no portion of the property would be includible in the gross estate of the transferor (other than by reason of IRC § 2035); or

86 In particular, IRC § 2642(g)(2) states that "[a]n allocation of GST exemption under section 2632 that demonstrates an intent to have the lowest possible inclusion ratio with respect to a particular transfer or 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."

87 Nevertheless, the allocation during the ETIP is irrevocable. IRC § 2642(f)(1); Treas. Regs. § 26.2632-1(c)(1). Direct skips during an ETIP are treated as having occurred at the expiration of the ETIP. Treas. Regs. § 26.2632-1(c)(4).

88 Treas. Regs. § 26.2632-1(c)(2)(i)(A).

89 Treas. Regs. § 26.2632-1(c)(2)(ii)(B).

90 This test is met if there is less than a 5 percent probability of inclusion. Treas. Regs. § 26.2632-1(c)(2)(ii)(A).

| COMMENT |
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| For this purpose, the donor spouse is treated as the transferor of both portions of a split gift. |

- The time that a taxable event actually occurs, but only with respect to the property involved in the taxable event.[91]

***Ex-25:*** T transfers $50,000 to a discretionary trust for her husband and their 9 children and grandchildren. Each of the beneficiaries has a Crummey withdrawal power over $5,000. Will an allocation of exemption by T at the creation of the trust be effective?

***Ex-26:*** T transfers property to an inter vivos QTIP trust.

1. When does the ETIP period end for this transfer if T makes both a gift tax QTIP election under IRC § 2523(f) and the reverse QTIP election under IRC § 2652(a)(3)?

2. Suppose T did not make the reverse QTIP election?

3. Suppose T did not make a QTIP election for gift tax purposes?

***Ex-27:*** T transfers $500,000 to a grantor retained annuity trust with a 10 year term. At the expiration of the term, the trust property is to pass to his Grandchild. T's spouse consents to split the gift.

1. When will the ETIP period for this transfer end?

2. Suppose that three years after the creation of the GRAT, T sells the annuity interest to child C?

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91 With respect to an ETIP arising because of an interest or power held by the transferor's spouse, on the first to occur of the spouse's death or the time at which no portion of the property would be includible in the spouse's gross estate (other than by reason of IRC § 2035). Treas. Regs. § 26.2632-1(c)(3).

| COMMENT |
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| In *Ex-27*, if T dies during the term of the GRAT, the trust property will be taxed in his estate and the transfer to Grandchild will qualify as a direct skip. If T survives the term period, however, the distribution to Grandchild will not qualify as a direct skip. As a result, unless C was dead at the creation of the trust (in which case the predeceased child exception would apply), the GST tax will be calculated on a tax inclusive basis. All things considered, it would be better for T to make his generation-skipping transfers in other ways. |

### (2) Automatic allocation to lifetime direct skips

If a direct skip occurs during the life of the transferor, any unused GST exemption is automatically allocated to the transfer.[92] A transferor may prevent this automatic allocation by indicating that intent on a Form 709 or by timely reporting the transfer and paying the appropriate GST tax.[93]

> ***Ex-28:*** T transfers $50,000 to a trust in a direct skip. T does not file a timely gift tax return electing out of the automatic GST allocation rule. Subsequently, after the due date for a gift tax return has passed, T and T's spouse file an initial gift tax return on which T's spouse consents to split the gift. Whose unused GST exemption is automatically allocated to this transfer?

### (3) Automatic allocation to indirect skips

Under IRC § 2632(c), in the absence of a contrary election, the unused portion of a transferor's GST exemption[94] is automatically allocated to indirect skips made by the transferor during life. In general, the allocation is effective at the time of the indirect skip.

#### (a) Indirect skip defined

##### (i) IN GENERAL

An indirect skip is any transfer of property (other than a direct skip) to a GST trust that is subject to the gift tax.[95] A GST trust is any trust that could have a GST event with respect to the transferor.[96]

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92 IRC § 2632(b); Treas. Regs. § 26.2632-1(b)(i). The automatic allocation is effective as of the date of the transfer to which it relates.

93 Treas. Regs. § 26.2632-1(b)(1)(i). A Form 709 is timely filed if it is filed on or before the date prescribed in IRC § 6075(b) for reporting a taxable gift (including any extensions actually granted). The automatic allocation (or the election to prevent one) is irrevocable after that date. Treas. Regs. § 26.2632-1(b)(1)(ii). But see Treas. Regs. § 26.2632-1(b)(1)(iii) (an election to prevent automatic allocation filed on or before January 26, 1996, does not become irrevocable until July 24, 1996.

94 The unused portion of the transferor's GST exemption is the portion of the exemption that has not previously been allocated (automatically or otherwise). See IRC § 2632(c)(2).

95 IRC § 2632(c)(3)(A).

96 IRC § 2632(c)(3)(B)

### (ii) Exceptions

The term GST trust does not include any of the following trusts:

a) **Exception 1:** A trust where the instrument provides that more than 25 percent of the trust corpus must be distributed to (or may be withdrawn by) one or more nonskip persons:

- Before they attain the age of 46; or
- On or before one or more dates specified in the instrument that will or (as specified in regulations) reasonably may be expected to occur before the nonskip persons attain the age of 46.[97]

b) **Exception 2:** A trust where the instrument provides that more than 25 percent of the trust corpus must be distributed to (or may be withdrawn by) one or more nonskip persons who survive the death of a person specified in the instrument by name or class description who is more than 10 years older than the nonskip person or persons.[98]

c) **Exception 3:** A trust where the instrument provides that more than 25 percent of the trust corpus must be distributed to the estate or estates of (or is subject to a general power of appointment held by) one or more nonskip persons if one or more of them dies on or before a date or event described in a) or b) above.[99]

d) **Exception 4:** A trust any portion of which would be included in the gross estate of some nonskip person other than the transferor if such person died immediately after the transfer to the trust.[100]

e) **Exception 5:** A charitable lead annuity trust, a charitable remainder annuity trust, or a charitable remainder unitrust.[101]

f) **Exception 6:** A charitable lead unitrust the noncharitable beneficiary of which is a nonskip person.[102]

***Ex-29:*** H establishes an irrevocable trust for his child. The trust provides for an outright distribution to the child at age 40. If the child dies before that age, all trust property is to be distributed to the child's issue.[103]

1. Is this trust a GST trust to which the automatic allocation rules apply?

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97 IRC § 2632(c)(3)(B)(i).

98 IRC § 2632(c)(3)(B)(ii).

99 IRC § 2632(c)(3)(B)(iii).

100 IRC § 2632(c)(3)(B)(iv).

101 IRC § 2632(c)(3)(B)(v).

102 IRC § 2632(c)(3)(B)(vi).

103 This and the other examples dealing with the new automatic allocation of GST exemption to indirect skips are based on examples created by David Dreyer of Jones Foster Johnston & Stubbs, P.A. Many thanks for his generous permission to use them.

2. Would the answer change if the instrument provided that outright distribution to the child could be suspended by the trustee if the child becomes disabled or frequently uses illegal substances?

***Ex-30:*** H establishes an irrevocable trust for the benefit of W for life, and at her death, outright to H's issue, per stirpes. W is age 30, and H has 3 children ages 18, 21, and 25.

1. Is this trust a GST trust to which the automatic allocation rules apply?

2. Would the answer change if W had a testamentary power of appointment exercisable in favor of H's issue?

***Ex-31:*** H establishes an irrevocable trust for the benefit of W for life. At W's death, the property is to be divided among H's issue, per stirpes and distributed one-half at age 30 and the balance at age 35. If any beneficiary survives W, and dies before reaching 35, the beneficiary has a general power of appointment over that beneficiary's portion. W is age 41, and the children are 21, 25 and 30. Is this trust a GST trust to which the automatic allocation rules apply?

***Ex-32:*** H establishes an irrevocable trust for the benefit of child for life, and upon child's death to grandchildren. The trust provides that child has the right to appoint trust assets in favor of creditors of the child's estate over any portion of the trust for which a GST tax would otherwise be incurred in the absence of such power. Is this trust a GST trust to which the automatic allocation rules apply?

### (iii) SPECIAL RULE FOR LIMITED WITHDRAWAL AND OTHER POWERS

In determining whether a trust is a GST trust to which the automatic allocation rules apply:

- Property is not considered to be includible in the gross estate of, or subject to a right of withdrawal by, a nonskip person if or to the extent the power does not exceed the amount of the gift tax annual exclusion.

- It is to be assumed that powers of appointment held by nonskip persons will not be exercised.[104]

***Ex-33:*** H establishes an irrevocable pot trust for the benefit of his 10 grandchildren and their descendants and funds the trust with $100,000. All 10 grandchildren have Crummey withdrawal powers. Will GST exemption be automatically allocated to this trust at its creation?

***Ex-34:*** H establishes an irrevocable pot trust for the benefit of his children and their descendants. The trust is to last as long as permitted by state law.[105] H's child has a Crummey withdrawal right which is limited to the amount of a single annual exclusion. The child also has a special testamentary power of appointment to appoint trust property.

1. If the child's withdrawal power lapses after 30 days, is this trust a GST trust to which the automatic allocation rules apply?

2. Would the answer change if child's power was a hanging power?

### (b) Special rule for transfers involving an ETIP

With respect to transfers to which the ETIP rules of IRC § 2642(f) apply, the transfer itself is deemed to occur at the expiration of the ETIP. Accordingly, the value of the property involved in the transfer and probably the question of whether the transfer itself is an indirect skip (see below) is to be determined at that time.[106] For more on the ETIP rules, see "*Allocations during the estate tax inclusionary period*", supra p. 32.

***Ex-35:*** H establishes a QPRT to last for the shorter of H's life or for a period of 10 years. At the termination of the trust, the trust property is distributable to H's child if H survives to the date or termination; otherwise the trust is to revert to H's estate. Will GST exemption be automatically allocated to this trust at its creation?

***Ex-36:*** In 1999, H (age 60) established a $800,000 zeroed-out GRAT, retaining a qualified annuity interest

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104 IRC § 2632(c)(2)(B) (flush language at the end).

105 Which in Florida is 360 years. See Fla. Stat. § 689.225(2)(f) (2016).

106 See IRC § 2632(c)(4).

for 5 years. The GRAT provides that at the termination of the term, the trust assets are to be distributed to H's child, but if the child is deceased to the child's issue. H's child was 30 years old at the inception of the trust. H's child dies in 2002. At that time, the property in the GRAT is worth $500,000. At the expiration of the 5 year term, the GRAT (worth $300,000) is distributed to C's child. How do the new automatic allocation rules of IRC § 2632(c) apply to these facts?

### (c) Electing in or out of the automatic allocation rules

IRC § 2632(c)(5)(A) provides that an individual may elect not to have the automatic allocation rules apply to a GST trust where they otherwise would apply or to elect to have rules apply to a trust where they would otherwise not apply. Either election may be made as to a specific transfer, or if preferred, as to all transfers made to a particular trust.[107]

***Ex-37:*** In December of 2001, H transfers $100,000 to an irrevocable insurance trust which meets the definition of a GST trust. On April 16th of 2002, the value of the trust is $20,000. Can H make a late allocation of $20,000 of exemption or do the new automatic allocation rules preclude doing this?

## (4) Retroactive allocations

Under IRC § 2632(d),[108] a transferor may make a retroactive allocation of his or her unused GST exemption to a previous transfer in trust if:

- A beneficial interest (current or future) is held by a nonskip person who is a child, niece, nephew, or child of a first cousin of either the transferor or of the transferor's current or former spouse; and
- The beneficiary dies before the transferor.

The allocation must be made on a timely filed gift tax return for the year of the nonskip person's death. The determination of the amount of the transferor's unused GST exemption and the effective date of the retroactive allocation of it both occur immediately before the death of the nonskip person. The allocation itself, however, is based on the gift tax value of the transferred property at the time of the original transfer.[109]

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107 The election out of the automatic allocation rules with respect to a particular indirect skip may be made on a timely filed gift tax return for the calendar year the transfer is made (or deemed to be made under the ETIP rule). IRC § 2632(c)(5)(B)(i). The election out of automatic allocations for a particular trust or into automatic allocation for a particular transfer or trust may be made on a timely filed gift tax return for the calendar year for which the election is to become effective. IRC § 2632(c)(5)(B)(ii). For additional guidance, see Treas. Regs. § 26.2632-1(b)(2).

108 With the enactment of TRA 2010, this section applies to transfers made from 2001 to the end of 2012.

109 For additional discussion of new IRC § 2632(d), see Harrington, McCaffrey, Plaine & Schneider, Generation-Skipping Transfer Tax Planning After the 2001 Act: Mostly Good News, Vol. 95 No. 3 J. Tax. 143 at 160 (September 2001).

***Ex-38:*** T transfers property worth $100,000 to a discretionary trust for the benefit of T's spouse S and his child C. The trust provides that all trust property is to be distributed to C at S's death or, if C is not living, to C's children then living. No GST exemption is allocated to the trust at the time of its creation. C dies several years later, survived by T, S, and a child GC. At that time, the property in the trust is worth $500,000.

1. May T make a retroactive allocation of GST exemption to this trust?

2. How much exemption must T allocate to give the trust a zero inclusion ratio?

#### (5) Other lifetime allocations

For lifetime GSTs for which an automatic allocation is not in effect, an election to allocate GST exemption may be made on a timely filed Form 709[110] (in which case it is effective as of the date of the transfer) or on a late Form 709 (in which case it is effective from the date of filing).[111]

In either case, the allocation, which may be expressed as a formula, is void to the extent:

- it is made to a trust having no GST tax potential, or
- it exceeds the amount necessary to obtain an inclusion ratio of zero.[112]

### b) Allocations after the death of the transferor

A transferor's personal representative may allocate any unused GST exemption at a transferor's death.[113] An attempted allocation is void to the extent it is made with respect to a trust that has no GST tax potential.[114]

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110 A voluntary allocation of GST exemption must state the value of the assets in the trust to which the exemption is being allocated if either:

- the trust will have an inclusion ratio other than zero, or
- regardless of the inclusion ratio, the allocation is not made on a timely filed Form 709. Treas. Regs. § 26.2632-1(b)(2)(i).

An allocation may be modified on a subsequent amended Form 709 only if the form is filed before the last date on which a timely-filed form could be filed. See Treas. Regs. §§ 26.2632-1(b)(2)(ii), 26.2632-1(b)(2)(iii), Examples 1 and 2. After that date, the allocation is irrevocable. Treas. Regs. § 26.2632-1(b)(ii).

111 A late allocation made at the same time as an event giving rise to a taxable event is treated as occurring immediately prior to the event. See Treas. Regs. §§ 26.2632-1(b)(2)(ii)(A)(1); 26.2632-1(b)(iii), Example 4. If it is unclear whether an allocation is late or timely, the allocation is effective first to the extent it would be timely for any transfer disclosed on the return, then as a late allocation and finally as to any transfer not disclosed on the return as to which the allocation would be timely. Treas. Regs. § 26.2632-1(b)(2)(ii). For an example applying this priority scheme, see Treas. Regs. § 26.2642-4(b), Example 4.

112 Treas. Regs. § 26.2632-1(b)(2)(i). See also Treas. Regs. § 26.2642-4(b), Example 3. This rule does not apply to charitable lead annuity trusts. See Treas. Regs. § 26.2642-3(b) discussed infra p. 137.

113 In general, the allocation with respect to property included in the transferor's gross estate is made on the transferor's estate tax return and is effective as of the date of the transferor's death. As for lifetime transfers that are not included in the transferor's gross estate, a timely allocation of exemption is made on Form 709 and a late allocation is made on Form 706. A timely allocation is effective as of the date of the transfer. A late allocation is effective as of the date the allocation is filed. Treas. Regs. § 26.2632-1(d)(1).

114 Treas. Regs. § 26.2632-1(d)(1).

If the time for filing the transferor's estate tax return passes without his personal representative having allocated all of his exemption, any unused exemption is automatically allocated:

1. first to testamentary direct skips and
2. then to transfers in trust that have a potential for subsequent GST tax exposure,[115] other than a QTIP trust for which no reverse QTIP election is made.[116]

Within each category, the allocation is made prorata on the basis of the values of the nonexempt portion of each transfer.

| COMMENT |
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| A prorata allocation across several transfers is unwise because no distribution or termination in any trust will be entirely tax free. It is a better use of the exemption to allocate it so that one or more trusts are entirely exempt. To do this, the executor must make an affirmative allocation on a timely filed estate tax return. An allocation is void if the Form 706 is filed late.[117] |

## B. SINGLE TRUST TREATED AS SEPARATE TRUSTS

Generally a single trust must be treated as one trust for purposes of the GST tax. However, in three situations explored next, a single trust is treated as two or more separate trusts.[118]

**COMMENT**

Where separate treatment applies the inclusion ratio for each share is determined separately of the other shares. Unless the governing instrument provides otherwise, however:

- Additions to and distributions from the trust are allocated prorata among the separate trusts,[119] and
- Any automatic allocation of GST exemption is allocated prorata among the separate shares.[120]

### 1. Single trust with multiple transferors

If a single trust has more than one transferor, the portion of the trust attributable to each transferor is treated as a separate trust.[121]

> ***Ex-39:*** H dies with a will that creates a QTIP eligible trust of $1,500,000 for the benefit of his spouse W. H's personal representative makes a partial QTIP election with respect to 2/3rds of this trust.

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115 IRC § 2632(e).

116 Treas. Regs. § 26.2632-1(d)(2) exempts from automatic allocation "any trust that will have a new transferor with respect to the entire trust prior to the occurrence of any GST with respect to the trust." A trust is also exempted from automatic allocation if during the 9 month period after the transferor's death, no GST has occurred and after such period no GST is possible.

117 Treas. Regs. § 26.2632-1(d)(2).

118 The effect of separate treatment is limited to the GST tax. It does not apply for other purposes such as the filing of returns, the payment of tax or for the computation of any other tax. Treas. Regs. §§ 26.2654-1(a)(1)(i); 26.2654-1(a)(2)(i).

119 Treas. Regs. § 26.2654-1(a). See also Treas. Regs. § 26.2654-1(a)(5), Example 7.

120 Treas. Regs. § 26.2654-1(a)(4). A pro rata allocation may be avoided by exercising the election to opt out of the automatic allocation. The transferor can opt out as to either share.

121 Treas. Regs. § 26.2654-1(a)(2). See also Treas. Regs. § 26.2652-2(c) creating a special transitional rule for certain QTIP property under which a single trust is treated as having two separate transferors.

1. Assuming no reverse QTIP election is made, how is this trust treated for GST tax purposes?

2. Suppose that at W's death some years later, when the value of the property in the QTIP trust is $1,800,000, W dies with a will that leaves an additional $600,000 to this trust. What portion of the trust is W the transferor of after the additional contribution?

## 2. Substantially separate and independent shares

Each share of a single trust that consists substantially of separate and independent shares for different beneficiaries is treated as a separate trust.[122]

| COMMENT |
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| The phrase "substantially separate and independent shares" has the same meaning as provided in Treas. Regs. § 1.663(c)-3 subject to the added requirement that the shares must exist at all times after the creation of the trust. A trust that is includible in its entirety in the gross estate of its grantor is treated as created at the date of the grantor's death. |

***Ex-40:*** T creates a trust to last until his grandchild attains majority or dies. Until that time the trust income is to be distributed equally to T's child (or his estate) and the grandchild. No distributions of principal may be made until the trust terminates. At termination, the trust principal is to be divided equally between the child and the grandchild (or their estates). Does this trust qualify for separate share treatment under the GST tax?

***Ex-41:*** T creates a trust for the benefit of children and grandchildren. The trustee has discretion to spray income and principal among the beneficiaries until the youngest child attains age 21 at which time the trust provides that separate shares are to be maintained for each line of lineal descent. Will the separate shares be treated as separate trusts for purposes of the GST tax?

## 3. Certain pecuniary gifts from trusts

A required pecuniary gift at the death of the transferor from a trust includible in the transferor's gross estate is a separate and independent share if:

a) The trustee is required to pay appropriate interest to the beneficiary,[123] and

[122] Treas. Regs. § 26.2654-1(a)(1)(i).

[123] See the comment under "*Residual transfers following pecuniary bequests to nonskip persons*", supra p. 136 for the meaning of "appropriate interest."

b) If the gift is payable in kind at other than date of distribution values, the trustee is required to allocate assets fairly representative of the appreciation or depreciation in the trust as a whole.

> ***Ex-42:*** At her death, T's revocable inter vivos trust divides into two shares on the basis of a formula gift that allocates a pecuniary amount to T's surviving spouse and a residual amount to a credit shelter trust. The terms of the trust authorize the trustee to fund the gift in cash or in kind using date of distribution values. Will the pecuniary gift to the spouse be treated as a separate share?

## C. DIVISION OF SINGLE TRUST INTO SEPARATE TRUSTS

A single trust with separate shares or multiple transferors may be divided into separate trusts at any time.[124] Otherwise, the rules which control the ability to sever a trust for GST tax purposes will depend on when the severance is attempted.

### 1. Regulatory severances

Under the regulations, a division of a single trust into separate trusts will be recognized for purposes of the GST tax only if the trust was included in the transferor's gross estate (or was created under the transferor's will) and:

a) The trust is severed pursuant to a direction in the governing instrument providing that the trust is to be divided upon the death of the transferor; or

b) The instrument does not direct or require severance but the severance occurs pursuant to a discretionary authority granted under either the governing instrument or under local law; and

1. The terms of each new trust provide for the same succession of interests and beneficiaries as the original and
2. The severance occurs (or a reformation proceeding, if required, is commenced) prior to the due date of the transferor’s estate tax return (including extensions) and either
   - the new trusts are severed on a fractional basis; or
   - in the case of a severance on the basis of a pecuniary amount, the severance by that method is required by the terms of the governing instrument and the pecuniary payment meets the requirements for a pecuniary payment from a trust to be treated as a separate share.[125]

Where a valid severance occurs, GST exemption may be allocated to either or both of the separate trusts.[126]

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124 Treas. Regs. § 26.2654-1(a)(3). Thus, the service has ruled that a single trust with two transferors may be segregated into separate trusts with two different inclusion ratios. See PLR 200039003.

125 See "*Certain pecuniary gifts from trusts*," on p. 157.

126 Treas. Regs. § 26.2654-1(b)(3).

| COMMENTS |
| --- |
| A fractional severance need not be funded pro rata with a portion of each asset provided only that funding is based on the fair market values on the date of severance or in a manner that fairly reflects the appreciation or depreciation in the value of the assets as of that date.[127] |

***Ex-43:*** T's will leaves the residue of his estate to his revocable inter vivos trust.

1. If T's trust contains a formula pecuniary marital gift under which the trust is divided into separate QTIP and credit shelter trusts, will the division be recognized as creating two separate trusts for GST tax purposes?

2. Suppose that after the initial split, T's personal representative divides the QTIP trust into two shares, one consisting of $400,000 and one holding the balance. As to the former, the personal representative makes an IRC § 2652(a)(3) reverse QTIP election. Will the split of the QTIP trusts be recognized for GST purposes?

## 2. Qualified (i.e., statutory) severances

IRC § 2642(a)(3) provides a statutory basis for dividing trusts for GST tax purposes.

Under the section, a trust severance will be recognized for GST tax purposes if it is a "qualified severance". A qualified severance means the division of a trust and the creation of two or more trusts by any means available under the governing instrument or local law[128] if:

a) The severance is effective under local law;[129]

b) The single trust is divided on a fractional basis; [130]

c) Funding of the severed trust commences immediately and is completed within a reasonable time not to exceed 90 days after the date of the severance;[131]

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[127] Treas. Regs. § 26.2654-1(b)(1)(ii)(C)(1). As written, the regulations do not appear to apply the appropriate interest or funding requirements to a mandatory severance.

[128] Including court ordered severances. Treas. Regs. § 26.2642-6(d)(1). On the authority to split trusts under the Florida Trust Code, see Fla. Stat. § 736.0417 (2016), effective July 1, 2007. On the authority to split trust under prior law, see Fla. Stat. § 737.403(1)(b) (2016) and (c).

[129] Treas. Regs. § 26.2642-6(d)(2).

[130] Pecuniary severances are not permitted. However, formula severances are. Thus a severance could be phrased in terms of a fraction with a numerator equal to a transferor's unused GST tax exemption and a denominator equal to the fair market value of the trust's assets as of the date of severance. Treas. Regs. § 26.2642-6(d)(4).

[131] The date of a severance is either the date selected by the trustee as of which the trust assets are to be valued for purposes of the severance or the court-imposed date of funding in the case of a court ordered severance. Treas. Regs. § 26.2642-6(d)(3).

| COMMENT |
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| It is not necessary to fund the trust with a pro rata percentage or portion of each asset. Non-pro rata funding is permissible provided the trust receives the appropriate fraction or percentage of the total (undiscounted)[132] fair market value of the trust assets as of the date of severance.[133] |

d) 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;[134] and

e) If the trust to be severed has an inclusion ratio of either 0 or 1, the resulting trusts must have the same inclusion ratio as the original trust;[135] and

> ***Ex-44:*** T establishes a trust with income and principal distributable in the discretion of the trustee to or for the benefit of T's two children (C1 and C2) and their descendants. The trust which has an inclusion ratio of 1 is to last until the death of the last of T's two children at which time trust income and principal is to be distributed to T's descendants per stirpes (i.e., half to C1's descendants and half to C2's descendants). If T splits the trust into two trusts, both with an inclusion ratio of 1, but one of which provides for discretionary distributions of income and principal to C1 and his descendants with remainder to C1's descendants at his death and the second of which provides similarly for C2 and C2's descendants, will the split constitute a qualified severance?

> ***Ex-45:*** T establishes a trust with income payable to child C for life with remainder at C's death to such of C's descendants as C appoints by will. The trust further provides however, that if the inclusion ratio of the trust at C's death is greater than 0, C's power may also be exercised in favor of the creditors of his estate as to the fraction of the trust equal to the trust's inclusion ratio. If, at a time when the inclusion ratio of the trust is .60, will a severance of the trust on a 40/60 basis where C's power to distribute to the creditors of his estate extends only to the 60 percent trust be a qualified severance?

> ***Ex-46:*** T establishes a 10-year trust with income payable in equal shares to N (a nonskip person) and S (as skip person). At the expiration of the 10-year term, trust principal is distributable half to N (or to N's descendants) and half to S (or to S's descendants). The trust has an inclusion ratio of .50. If Trustee splits the trust in a qualified severance into two trusts, one for N and his descendants and one for S and her descendants, what advice would you give Trustee to minimize GST tax implications of the split?

[132] The prohibition against using discounted values appears in Treas. Regs. §§ 26.2642-6(d)(4) and 26.2642-6(k)(1).

[133] Treas. Regs. § 26.2642-6(d)(3). See also Treas. Regs. § 26.2642-6(j), Ex. 5. In general, a non-pro rata funding of a qualified or regulatory severance will not result in a sale or exchange for income tax purposes provided the severance and the non-pro rata funding of it are authorized by an applicable state statute or by the governing instrument. Treas. Regs. § 1.1001-1(h)(1)..

[134] Treas. Regs. § 26.2642-6(d)(5).

[135] Treas. Regs. § 26.2642-6(d)(6)

# III. PUTTING IT ALL TOGETHER: JOHN AND MARY SAMPLE – A CASE STUDY

Where the combined estates of both spouses is less than a single GST exemption, their estates may be planned without concern for the GST. The automatic GST exemption allocation rules will eliminate all potential GST exposure.

For marital estates larger than a single GST exemption, the primary planning objective is to fully utilize the GST exemption of both spouses through the creation of one or more trusts that are totally exempt. Estates of this size may be divided into three categories, according to the planning desires of the clients.

- Plans where the GST tax is of prophylactic concern only.
- Plans involving a single generational skip only.
- Plans involving dynastic trusts that will last for multiple generations.

Plans in the first category are typified by clients whose planning at the death of the first spouse contemplates a marital share passing to a QTIP trust and a nonmarital share passing to a Family Trust. Both trusts provide for an outright per stirptual distribution to descendants at the death of the surviving spouse.

- Here, the primary planning concern is to protect the distribution of the Family Trust from inadvertent GST tax exposure in the event that property passes to a skip person as a consequence of the terminating per stirptual distribution.
- Once again, the automatic allocation rules may be adequate to the task, although some planning, particularly the use of special testamentary powers, can be helpful.[136]

Plans in the second and third categories share some common planning features, but dynastic plans offer a better platform for this lecture, so that is what we will consider in our case study, below.

## A. BACKGROUND INFORMATION AND ASSUMPTIONS

Consider the initial planning and postmortem decisions of John and Mary Sample. They estimate that they have estates of $20,000,000 and $5,000,000 respectively.[137] Their marriage of 25 years is secure. Neither has been married previously. They have several adult children and young grandchildren. John and Mary are interested in passing their wealth on to their descendants in a tax efficient means.

### 1. Assumptions

Since both the Applicable Exclusion Amount and the GST Exemption are indexed for inflation, it is impossible to predict the amount of either that will apply at John's and Mary's deaths. However, we need to make some assumptions for illustration purposes. So we will assume that (<u>except as affected by their prior gifts and future lifetime transfers described below</u>), the first of John and Mary to die will do so in a year when the applicable exclusion amount and GST exemption are both $6.000,000 and that the corresponding numbers at the death of the survivor of then will be $7,000,000.

### 2. Prior Gift Giving History

Some years ago, John and Mary made a sizeable split gift to their children. Because the gift exceeded the gift tax annual exclusion, each of John and Mary used $1 million of their

136 See the "Drafting Tip" following **Ex-6**.

137 John's estate includes the face value of a $3 million life insurance policy he currently owns and which he will be transferring to an ILIT as part of his estate planning.

Applicable Exclusion Amount. There have been no other gifts by John and Mary and they are not interested in additional outright gifts at this time.

## 3. Trust Characteristics

Planning for John and Mary will involve the creation of several trusts – both inter vivos and testamentary. Consistent with efficient GST tax planning, GST exemption will be allocated in such a manner that each of the trusts will have an inclusion ratio of either 0 (an exempt trust) or 1 (a nonexempt trust). In all cases, if the amount of exemption to be allocated to a trust exceeds the GST value of the property in the trust, the trust will be split into exempt and nonexempt portions prior to the exemption allocation. Authority to make the split will appear in all trusts John and Mary create.

### a) Exempt trusts

Exempt trusts created by John or Mary will be dynastic.

- By their terms, they will last until 21 years after the death of the last to die of the descendants of the settlor's grandparents alive at the creation of the trust involved.[138]

| COMMENT |
| --- |
| In Florida, John and Mary could have provided that their trusts would last for a fixed period of up to 360 years.[139] However, if the specified period is longer than 90 years, they would not be able to prohibit trust modifications in the best interests of the beneficiaries under Fla. Stat. § 736.04115 or to authorize nonjudicial modification under Fla. Stat. § 736.0412. |

- The trustees will have discretionary authority to distribute or apply income and principal for the health, education, maintenance, or education of the descendants of John and Mary from time to time living.

- If an independent trustee is serving, distributions may also be made in the best interest of the descendants without regard to the HEMS standard.

- Provision will be made for the appointment of an independent trustee in the event one is needed and for a trust protector who will have the ability to modify the trust to reflect unanticipated changes.

### b) Nonexempt trusts

Most nonexempt trusts created before the death of the survivor of John and Mary will begin life as a marital trust.

After the death of the surviving spouse, nonexempt trusts (or the nonexempt portion of a larger trust) will be divided per stirptually into separate trusts for each line of lineal descent.

- With respect to each separate trust, the distributions of trust income and principal may be made at the discretion of the trustee to the child or any descendant of the child from time to time living.

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[138] The perpetuities provision in John's revocable living trust will be slightly different. It will reference the descendants alive at the time the trust becomes irrevocable (typically at John's death.)

[139] See Fla. Stat. § 689.225(2)(f) (2016).

- Since distributions to a grandchild or more remote descendant, before the death of the child for whom the trust was created will be GST events, it is expected that distributions to these skip persons will be limited to distributions in direct payment of the skip persons' tuition or uninsured medical bills.

- Each child for whom a separate trust is created, will have a general testamentary power of appointment over his or her separate trust. In default of appointment, the trust property will remain in the trust for the benefit of the child's descendants.

## B. Additional Lifetime Transfers

John's planning recommendations involve the creation of two additional inter vivos trusts: A lifetime QTIP trust for Mary and an Irrevocable Life Insurance Trust.

### 1. John's ILIT

John's plan includes the transfer of an existing $3 million life insurance policy to an irrevocable trust.[140] During Mary's life, the beneficiaries of the trust include Mary and the descendants of John from time to time living.

- At Mary's death, trust property is to be distributed as Mary appoints through the exercise of a special testamentary power of appointment and in default of appointment, the trust divides into separate dynastic trusts, one for each line of descent.
- Because the ILIT (and the separate dynastic trusts resulting from it) will be exempt trusts, there is no need to worry about whether the division of the trust satisfies the requirements for a qualified severance under IRC § 2642(a)(3).[141]

#### a) Qualifying for the Gift Tax Annual Exclusion

Each of John's descendants (and perhaps Mary as well) will have Crummey withdrawal powers In this manner, the initial transfer of the policy to the trust and subsequent transfers John makes to cover premium payments will qualify for the annual exclusion.

- The powers held by the descendants will be hanging powers and will be restricted in amount to the amount of a single gift tax annual exclusion.
- To avoid creating an ETIP, Mary's withdrawal power (if any) will be restricted in amount to the greater of $5,000 or 5% of the trust and will lapse after 60 days.[142]

140 Assuming Jpohn survives this transfer by at least 3 years, the transfer of the policy to the ILIT will reduce John's estimated estate from $20 million to $17 million.

141 See "*Qualified (i.e., statutory) severances*", p. 46.

142 See "*ETIP Defined*".p. 34.

| COMMENTS |
| --- |
| There is a downside to giving Mary a withdrawal power. If she were to die during a withdrawal period, some of the trust will be included in her gross estate. As to that portion, there will be a change of transferor under the GST tax rules and John's prior exemption allocation to that portion will have been wasted. The problem does not exist if Mary dies outside of the withdrawal period for the year of her death. Prudence suggests that Mary not have a withdrawal power unless it is absolutely necessary. This necessity should not exist when the withdrawal powers of other beneficiaries are hanging powers. If, despite this, Mary is to be given a withdrawal power, the withdrawal period should be as short as possible. |

#### b) Dealing with the GST Exemption

John will want his ILIT to be exempt from the GST tax. To do this, he must insure that GST exemption is properly allocated because neither his initial transfer of the policy to the trust nor any subsequent contributions he makes to cover the annual premiums will qualify for exclusion under the GST Tax.[143]

John should not rely solely on the automatic allocation rules because of the uncertainties those rules create for trusts having Crummy withdrawal powers.[144] Instead, John should file a Form 709 and either elect in or elect out of the automatic allocation regime.[145]

- The simplest approach would be for John to elect into automatic allocation for all transfers he makes to the trust. The downside is that an automatic allocation is based on the value of the property he transfers as finally determined for gift tax purposes. So, if he transfers $70,000 to the trust each year to cover premium payments, each year he will use exemption in an equivalent amount.
- An alternative approach would be for John to opt out of automatic allocation. Then each year he would need to make a discretionary allocation on a form 709. But if this return is filed late (i.e., on April 16th), the allocation will be made to the value of the transfer on the date of the allocation. If the $70,000 has already been used to pay the policy premium, the allocation can be made to the increase in the policy value (the interpolated terminal reserve value) resulting from the premium payment. This should be less than $70,000. The downside is that this approach requires vigilance and discipline.

### 2. John's Inter Vivos QTIP Trust for Mary

If Mary dies before John, some of her GST exemption will be wasted because she does not have an estate of sufficient size to fully utilize her exemption and the portability rules do not apply to the GST tax. John will address this "order of death risk" by creating a $2 million inter vivos QTIP trust for Mary.

#### a) Intermediate distributions to John after Mary's death

Given the size of the transfer John will be making to the QTIP trust, he may want the trustee to have discretion to make distributions of income or principal back to him if he survives Mary. Any such distributions would not be tax efficient, but John may want to authorize them, just in case. In Florida, the trustee may be given discretion to distribute to John without subjecting the trust to the reach of John's creditors as a self-

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143 See "*Section 2503(b) exclusion*", p. 18.

144 See"Special rule for limited withdrawal and other powers", p 39.

145 Election options and procedures are discussed in Treas. Regs. § 26.2632-1(b)(2).

settled trust[146] and as a consequence, without causing the trust to be included in John's gross estate at his death.[147]

#### b) Integrating Mary's GST tax Exemption

No reverse QTIP election will be made with respect to John's inter vivos QTIP trust so Mary will become the transferor of the trust at her death. At that point she can allocate exemption to either or both of the QTIP trust or to an exempt trust she creates with her own property.

- Since Mary's and John's beneficiaries are the same, the simplest approach would be for her to augment the QTIP trust with $4 million of her own property.
- In other situations, Mary might choose to create a separate exempt trust for her own estate. In that event, John's QTIP may need to be split into exempt and nonexempt portions at Mary's death. Because the split will occur at Mary's death and the QTIP trust will be included in her gross estate, the split can qualify as a regulatory split and need not meet the more stringent requirements of a qualified severance.[148]

| COMMENT |
|---|
| In either of the above situations, any nonexempt property could pass to the descendants per stirpes, either outright or in separate nonexempt trusts. In the latter situation, each child will have a general testamentary power of appointment to avoid GST tax exposure at their death. |

## C. JOHN AND MARY'S TESTAMENTARY LAN

### 1. Updating the numbers

John and Mary began with estimated estates of $20 million and $5 million respectively. However, John has transferred a $3 million insurance policy to his ILIT and property worth $2 million to an inter vivos QTIP trust so he is left with an estate of $15 million.

Assuming John dies before Mary, under the assumptions made earlier the applicable exclusion amount for the year of John's death will be $6 million and for the year of Mary's death, $7 million. However, these numbers must each be reduced by $1 million to reflect the large split gift John and Mary made to the children.

Likewise, the assumptions made earlier are that the GST exemption for the year of John's death will be $6 million and for the year of Mary's death, $7 million. However, John has used some of his exemption to implement his ILIT. For illustration purposes, we will assume that this will reduce John's available GST exemption to $5 million.

### 2. The marital deduction plan

John's pour over will makes specific gifts worth $200,000 to various persons, none of whom is a skip persons under the GST tax. The balance of John's estate is devised to his revocable Living Trust.

- If Mary predeceases John, an amount equal to John's remaining unused GST exemption is to be added to John's exempt ILIT and the balance is to be added

146 See Fla. Stat. §. 736.0505(3) (20162016).

147 See Treas. Regs. § 25.2523(f)-1(f), Examples 9 - 11.

148 See *"Division of single trust into separate trusts"*, p. 45.

per stirpes to the separate nonexempt trusts Mary created at her death, or if none, to separate nonexempt trusts created as part of John's revocable Living Trust.

- If Mary survives John, his revocable Living Trust contains a formula gift under which John's $14,800,000 trust ($15 million reduced by $200,000 for the specific gifts to nonskip persons) is divided into a $4,800,000 Family Trust and a $10,000,000 Marital Trust.

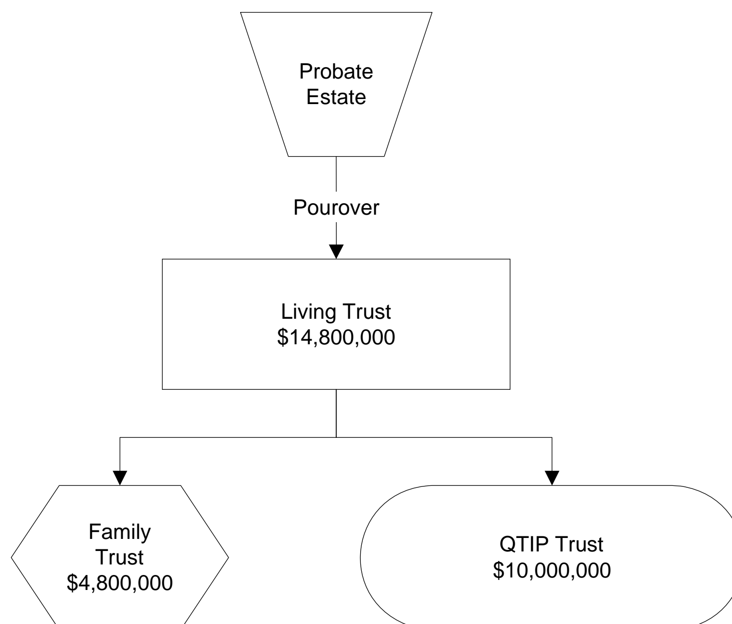


*Fig. 1. At death, John's revocable trust splits into marital and nonmarital shares. John has used $200,000 of his remaining applicable exclusion amount for specific gifts.*

## 3. Insuring recognition of the Marital/Family share split

The initial concern with plans of this type is whether the split of the revocable trust into two trusts will be honored for GST tax purposes. If it isn't, an automatic or directed allocation of $4,800,000 of exemption to the Family Trust will not result in a zero inclusion ratio since the Family and QTIP trusts would be treated as a single trust for GST purposes.

### a) Appropriate interest

The severance of the living trust will not normally meet the requirements for a qualified severance under IRC § 2642(a)(3).

- In many cases, the division between family and marital shares will be accomplished by way of a pecuniary formula. Qualified severances must be done on a fractional basis.
- In addition, it would rarely be the case that the Family and QTIP trusts would provide for the same succession of interests as is required for a qualified severance.

Accordingly, the severance into family and marital shares must be done in accordance with the detailed regulatory requirements for when a split of a trust included in the transferor's gross estate will be recognized for GST purposes

Among the requirements is that pecuniary gifts carry appropriate interest under applicable state law or the terms of the governing instrument. Because it is often unclear whether the appropriate interest requirement is met under state law,[149] particularly when the pecuniary gift appears in a revocable trust, the instrument should be drafted to insure compliance with the appropriate interest requirement.

| COMMENT |
| --- |
| The provision under discussion here can provide either that the pecuniary gift is to share in fiduciary income or that it is to bear interest. In general, the former will be preferable because the Trust gets a deduction when it distributes income. No deduction is available if a trust pays interest on a pecuniary gift. |

### b) Providing for an eligible funding mechanism

In addition to the appropriate interest requirement discussed above, the split of a revocable trust into Marital and Family Trusts must be accomplished by an appropriate funding mechanism.

- In the case of a fractional share formula, it is not necessary to fund the two shares with a pro rata portion of each asset. The instrument (or state law)[150] can permit non-pro rata funding provided the instrument requires either that the assets be valued at date of funding values or that the assets selected be fairly representative of the net appreciation or depreciation in the value of all trust assets available for funding.[151]
- In the case of a pecuniary formula, the instrument must provide that assets used in kind to fund the pecuniary gift be valued either on the date of funding or in a manner that fairly reflects the net appreciation of depreciation in the value of all assets available for funding.[152]

| COMMENT |
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| With one exception, the funding mechanism in a marital formula gift will comply with the GST tax requirements if it meets the requirements for the marital deduction. A pecuniary formula gift with minimum worth funding is the exception. That funding mechanism is not allowable for GST tax purposes. Accordingly, its use in any estate with even a potential for GST tax exposure is problematic. |

## 4. Reverse QTIP election options

Before the time for filing John's estate tax return, John's personal representative must decide how to allocate John's GST exemption. Two approaches are considered. One allocates exemption to the Family trust and the other doesn't.

- Under both, John's personal representative will split John's QTIP Eligible trust into an Exempt QTIP trust and a Nonexempt QTIP trust.

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149 The requirement is met if state law provides that the pecuniary gift bears interest or that a pro rata share of fiduciary accounting income is to be allocated to the gift. For a chart summarizing the law of all 50 states on this, see Covey, Practical Drafting 4853 – 4863 (April 1997).

150 On the authority of a trustee or personal representative to make non-pro rata distributions in Florida, see Fla. Stat. § 733.810(5) (2016).

151 Treas. Regs. § 26.2654-1(b)(1)(ii)(C)(1).

152 See Treas. Regs. § 26.2654-1(b)(1)(ii)(C)(2). See also Treas. Regs. § 26.2654-1(a)(1)(ii).

- Using the reverse QTIP election to continue John as the transferor after Mary's death, John's personal representative will then allocate John's GST exemption to the Exempt QTIP trust giving it an inclusion ratio of zero.

### a) Nonexempt Family Trust

Under the first of the two approaches, John's personal representative will split the trust so that the Exempt QTIP trust will be sufficiently large to use all of John's remaining $5 million GST exemption.

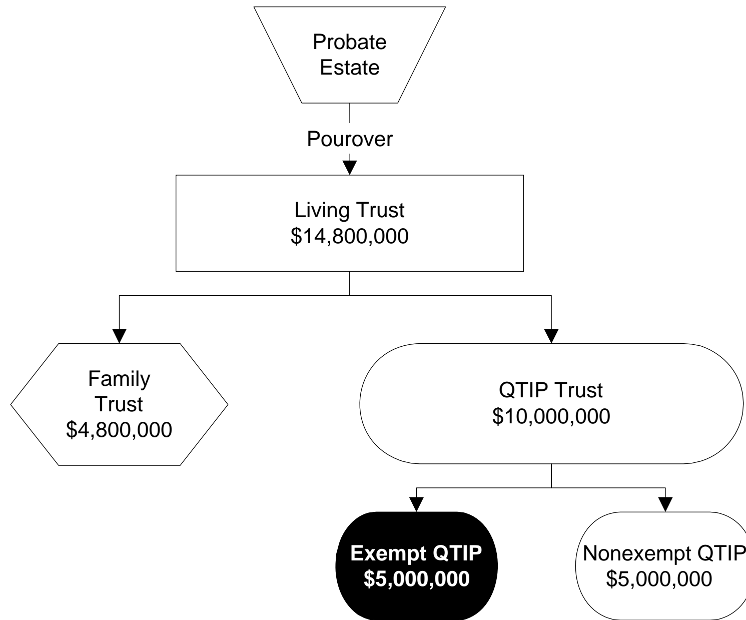


*Fig. 2 Reverse QTIP with no GST exemption allocated to Family trust*

| COMMENT |
|---|
| This approach leaves the property in the Family trust available for the use of nonskip persons without wasting John's GST exemption. This would be particularly useful if John's spouse was not a US citizen. In that case, it may be better to use the Family trust to provide for the spouse during life because distributions of principal from either of the QTIP trusts would be subject to a QDOT-estate tax. |

### b) Exempt Family Trust

Under the second approach, $4,800,000 of John's $5 million exemption would be allocated to the Family trust and the reverse QTIP election would be used to create an Exempt QTIP trust equal to the remaining $200,000 of John's exemption.

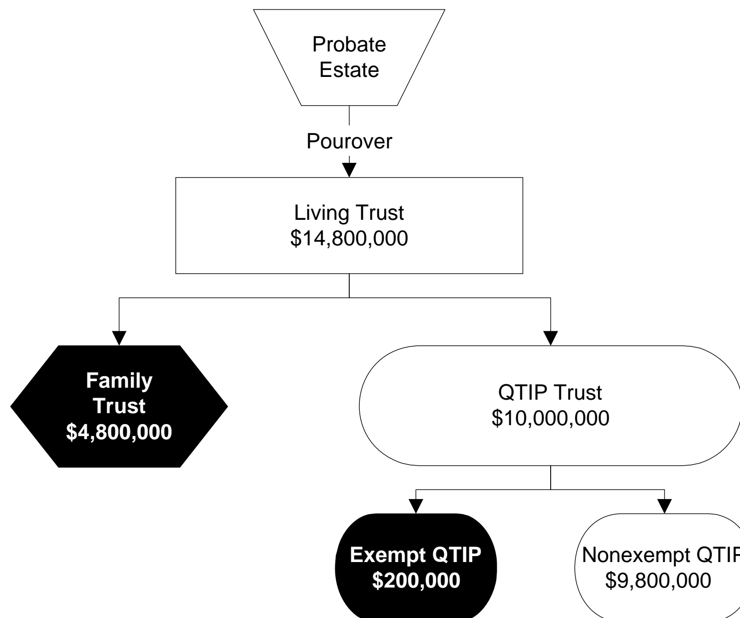


*Fig. 3 Reverse QTIP with exempt Family trust*

### c) Comparing approaches

Of the two approaches to using John's GST exemption, the second will generally be the preferable.

- Distributions to skip persons from the Family Trust during the life of the surviving spouse may be necessary or desirable. If the Family Trust is exempt, those distributions may be made tax free.
- Additionally, exempting the Family Trust makes greater use of the exemption because both the principal and the trust income can be used for skip persons. The income of a QTIP trust must be distributed to the surviving spouse.

### d) Unification of GST exemption and Unified Credit

Since 2004, the amount of the GST exemption has been tied to the amount of the estate tax applicable exclusion amount. In some cases, this will mean that the value of the Family Trust will exactly equal the amount of GST exemption and it will be unnecessary to make any reverse QTIP election to avoid wasting GST exemption.

- This will not always be the case, however, because gifts to nonskip persons either during the decedent's life ar at his death may consume unified credit resulting in a Family Trust that is smaller than the remaining GST exemption.
- Then too, it is possible for the Family Trust to exceed the remaining GST exemption. This could occur, for example, if the decedent allocated GST exemption to nontaxable gifts to a Crummey trust created during life.[153] In that event, it may be necessary to split the Family Trust in anticipation of an allocation of GST exemption at the decedent's death.

[153] See IRC § 2642(c)(2) discussed in "*Section 2503(b) exclusion*" on p. 133.

## 5. Formulating the split

Since a reverse QTIP election cannot be made with respect to only a portion of a trust, if the above plan is to be properly implemented the QTIP trust must be severed into exempt and nonexempt portions prior to the making of the reverse QTIP election. The severance raises a number of drafting issues.

### a) Mandatory or discretionary severance

While it is permissible to merely authorize the severance in anticipation of the election, it is probably preferable to require it. Accordingly, what is needed is a provision that directs the severance of any trust where the GST exemption to be allocated to the trust exceeds the value of the property in the trust.

### b) Fractional or pecuniary severance

One of the advantages of directing severance before the allocation of GST exemption is that the severance can be accomplished within the strictures of the regulations as opposed to the qualified severance rules of IRC § 2642(c)(3).[154] This avoids the requirement in that section that the severance be done on a fractional basis. With appropriate attention to the funding mechanism, either a fractional or a pecuniary severance is permissible. In either case, the severance method should be specified in the instrument.

### c) The funding methodology

It is critical that the instrument provide for a valid funding method for the severance.[155] If it doesn't, the severance will not be recognized for GST tax purposes and the allocation of exemption to the "exempt" portion will not result in a zero inclusion ratio.

## 6. Integrating Mary's exemption

At Mary's death, her estate will begin with a balance of $5 million. Her plan calls for specific gifts of $300,000 to nonskip persons which will bring the balance in her estate down to $4,700,000. At that point, Mary's personal representative will need to decide how best to allocate Mary's available $7 million GST Exemption. There are three available targets for the exemption allocation:

- Mary's revocable trust.
- John's inter vivos QTIP trust.
- John's Nonexempt testamentary QTIP trust.

If Mary's intended beneficiaries (her descendants) differed from those of John, Mary's plan would contemplate the funding of an exempt trust from the assets in her own trust and Mary's personal representative would probably have a fiduciary duty to allocate exemption to that trust before either of John's QTIP trusts. So that is the approach shown in Fig. 4 below.

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[154] Under the qualified severance rules of IRC § 2642(c)(3) it is possible to sever a trust on a fractional basis after GST exemption has been allocated to it. See "*Qualified (i.e., statutory) severances*" on p. 159.

[155] See "*Division of single trust into separate trusts*". P. 42.

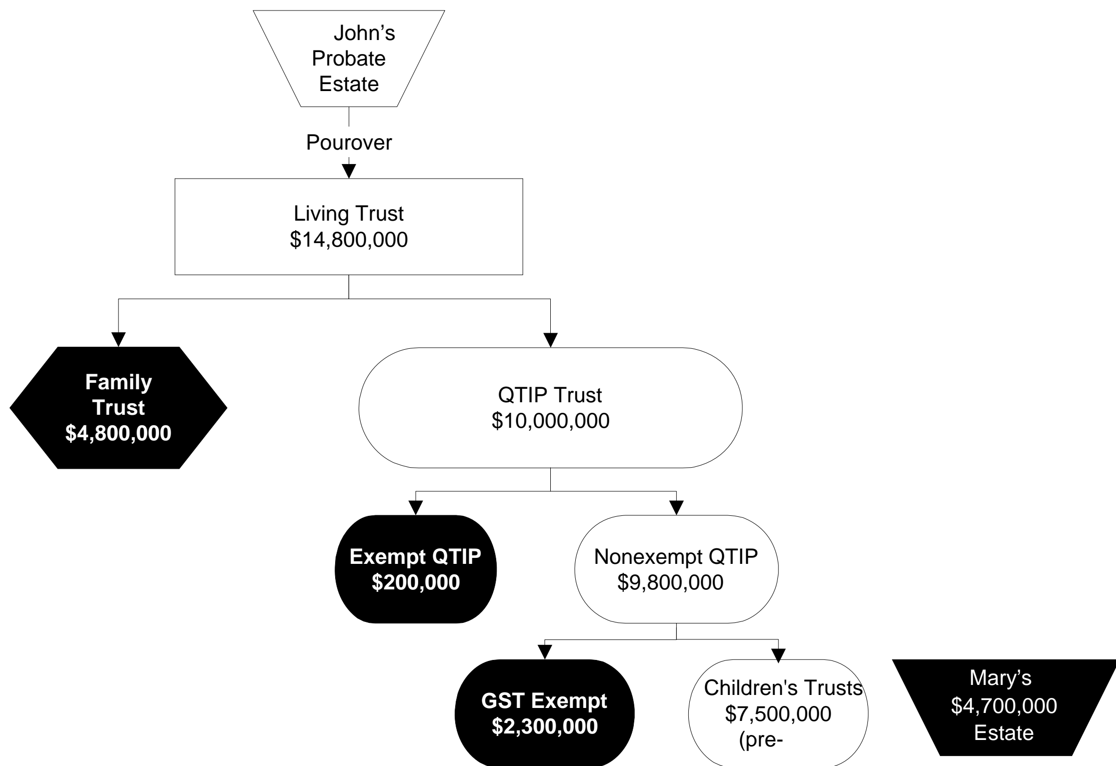


*Fig. 4 At Mary's death before taxes are apportioned.*
*John 't Exempt ILIT and Nonexempt inter vivos QTIP trusts are not shown.*

## 7. Planning for Mary's taxes

At her death, Mary's gross estate will amount to $17 million, as follows

- Her own estate of $5 million.
- John's Inter Vivos QTIP trust of $2 million.
- John's Exempt Testamentary QTIP trust of $2,300,000.
- John's Nonexempt Testamentary QTIP trust of $7,500,000

Ignoring deductions Mary's estate will owe taxes of $4,400,000 none of which is attributable (on a marginal basis) to Mary's own property.[156]

[156] IRC § 2207A gives Mary's personal representative a right of contribution from John's QTIP trust for her estate taxes attributable to the property in the QTIP trusts. The contribution is measured on a marginal basis. It is equal to the excess of Mary's taxes with the QTIP property included over what her taxes would have been without the QTIP property. Since Mary's estate without the QTIP property ($5,000,000) is less than the unused $6 million applicable exclusion amount at her death, none of the $4,400,000 of taxes is attributable to Mary's own property.

#### a) In Mary's plan

Unless Mary waives the right of contribution provided in IRC § 2207A, her estate can seek contribution for the taxes attributable to John's QTIP trusts from the trustees of those trusts. So Mary's will should expressly instruct her personal representative to exercise the right of contribution. In addition, Mary's will should provide that the any taxes attributable to her own property (none in this example) should be paid from the nonexempt portion of her estate.

#### b) In John's plan

John's plan can facilitate Mary's right of contribution for the taxes attributable to his QTIP trusts by directing the trustee of the trusts to either pay the taxes directly or to distribute property to Mary personal representative for the purpose of paying the taxes. To avoid wasting GST exemption, however, John should direct that the taxes are to be paid from his nonexempt QTIP trust rather than from one to which his exemption has been allocated.[157]

## D. OTHER DRAFTING CONSIDERATIONS

Some additional clauses can be helpful in facilitating this type of plan. Note that since it will always be unclear which spouse will die first, the following should appear in the Wills (or revocable trusts) for both spouses.

### 1. Direction to sever nonexempt QTIP

John's trust instrument should direct the trustee of the Nonexempt testamentary QTIP trust to sever that trust upon certification by the surviving spouse's Personal Representative of the amount of GST exemption that will be allocated to the trust. Again, the severance should be required and an appropriate severance methodology should be specified to insure that the severance will be respected for GST tax purposes.

### 2. Authority to allocate exemption to trust created by spouse

Mary's personal representative should be given the authority to allocate GST exemption to the nonexempt QTIP trust (that is to any nonexempt trust that is includible in her gross estate under IRC § 2044).

### 3. Direction to personal representative as to tax elections

To minimize the potential for confusion or conflict, the wills should direct personal representative to make federal estate and GST tax elections as instructed by the trustees of the client's revocable trusts.

### 4. Discretionary distributions from marital trusts

John's Will or Trust should include a provision setting the priority for discretionary distributions to Mary. In this regard, note that what began as a single QTIP trust could wind up as any of the following:

- A QTIP trust for which the QTIP election was made and which is not exempt from the GST tax (MD);
- A QTIP trust for which no QTIP election was made and which is not exempt from the GST tax (NMD);

[157] Despite some early concerns on the point, it is now clear that such a provision will not be treated as a constructive addition to John's exempt QTIP trusts. Treas. Regs. §§ 26.2652-1(a)(3), Treas. Regs. § 26.2652-1(a)(5), Examples 6 and 7. See also PLR 9627020 (waiver of recovery rights under IRC § 2207A is not a constructive edition to pre-GST tax trust).

- A QTIP trust for which the QTIP election was made but which is exempt from the GST tax (MDX);
- A QTIP trust for which no QTIP election was made but which is exempt from the GST tax (NMDX)

In general, distributions to Mary should come first from the MD trust and only as a last resort from the NMDX trust. As between the NMD and MDX trusts, the choice is less clear. Distribution priority from these trusts could be left to the discretion of the trustee.

### 5. Discretionary distributions to persons other than the spouse

The Will or Trust should direct that distributions to other beneficiaries be made from a nonexempt trust unless the distribution would be a taxable distribution under the GST tax in which case it should be made from an exempt trust.

### 6. Merger of like trusts at Mary's Death

At Mary's death, it may be advisable to merge John’s Family and exempt QTIP trusts into a single trust. If the beneficiaries of John's and Mary's trusts are similar, the merger could also include the exempt trust although this single trust would be treated as two separate trusts for GST purposes.[158] In any event, an authority to merge trusts should be included in the trust instruments.

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[158] Treas. Regs. § 26.2654-1(a)(2).

## ANSWERS—PLANNING FOR THE GST TAX

Ex-24. **First question –** Zero. No GST tax is payable at the death of Parent even though the value of the trust property at that time exceeds $5,450,000.

Ex-25. **Answer –** It depends. The allocation is effective only if the period in which the withdrawal power lapses is 60 days or less. Otherwise, the withdrawal power in T's husband will create an ETIP which will not terminate until the power lapses. Treas. Regs. § 26.2632-1(c)(2)(ii)(B).

Ex-26. **First question –** T may allocate exemption to the transfer without regard to the ETIP restrictions. Treas. Regs. § 26.2632-1(c)(2)(ii)(C).

**Second question –** If the reverse QTIP election is not made, the surviving spouse is the transferor and the ETIP terminates at the death of the surviving spouse.

**Third question –** If T did not make a gift tax QTIP election, there is no ETIP at all since the trust will not be included in the estate of either spouse. Accordingly, T may allocate exemption immediately to the trust.

Ex-27. **First question –** The IRC § 2642(f)(1) ETIP for both portions of the gift ends at the earlier of T's death or the expiration of the 10-year term. See Treas. Regs. §§ 26.2632-1(c)(3), Treas. Regs. § 26.2632-1(c)(5), Examples 1 and 3.

**Second question –** Whether or not the transfer by T is for full consideration, the ETIP will end at the time of the sale because thereafter nothing would be included in T's gross estate (except perhaps by reason of IRC § 2035). See Treas. Regs. § 26.2632-1(c)(5), Example 4.

Ex-28. **Answer –** T and T's spouse will each have $25,000 of exemption automatically allocated to the transfer to the trust. Treas. Regs. § 26.2632-1(b)(2)(iii), Example 5.

Ex-29. **First question –** No. Exception 1 (IRC § 2632(c)(2)(B)(i)) applies.

**Second question –** Probably. The power to withhold distributions means that Exception 1 no longer applies unless the yet to be issued regulations make an exception for this common type of provision. Accordingly, consideration should be given to opting out of the automatic allocation rules. See "*Electing in or out of the automatic allocation rules*", infra p. 154.

Ex-30. **First question –** No. Exception 2 applies. W is more than 10 years older than the youngest of H's children and that child is entitled to more than 25 percent of the trust at W's death.

**Second question –** No, the answer remains the same because it is assumed that W's power will not be exercised. See IRC § 2632(c)(3) (flush language at the end).

Ex-31. **Answer –** Yes (for the reasons detailed below) but it shouldn't be. Here again, consideration should be given to opting out of the automatic allocation rules. See "*Electing in or out of the automatic allocation rules*", infra p. 154..

Exception 1 doesn't apply because in most cases W's death could not be reasonably expected to occur before the kids reach 46. Exception 2 doesn't apply either. Although W is more than 10 years older than the children, the only portion of the trust that (as of the trust's creation) is certain to be distributed at her death is half of the oldest child's one-third portion of the trust. That would amount to 16.7 percent of the trust, well short of the 25 percent required by the exception. Finally, Exception 4 doesn't apply either because no portion of the trust would be included in a nonskip person's estate if the nonskip person died immediately after the transfer to the trust.

**Comment:** The result in this example is different if two or more of H's children were 30 at the creation of the trust, or if one of the children was 35 at that time. In either of these scenarios, Exception 2 would apply and the trust would not be a GST trust.

Ex-32. **Answer –** No. A GST trust is a trust that has the potential of having a GST event with respect to the transferor. See IRC § 2632(c)(3)(B). Because of the general power to appoint to creditors, no GST

event could ever occur with respect to this trust where H would be the transferor of the event. So this is not a GST trust.

Ex-33. **Answer –** Yes, but not under the indirect skip rule of IRC § 2632(c). This trust is a skip person because all beneficiaries having an interest in the trust are skip persons. See IRC § 2613(a) discussed in "*Skip person*", supra p. 120. Accordingly, exemption is automatically allocated under IRC § 2632(b).

Ex-34. **First question –** Yes because the child's withdrawal power is ignored for purposes of determining whether a nonskip person has a right of withdrawal under Exceptions 1 or 2 and for purposes of determining whether a portion of the trust is includible in a nonskip person's gross estate under Exception 4. See IRC § 2632(c)(3) (flush language at the end).

**Second question –** Maybe. In the first year of the trust, child's withdrawal right can be ignored for the purposes described in the first question because it will not exceed a single gift tax annual exclusion. If a portion of the power hangs into the second year, however, the child's power will exceed a single annual exclusion and the trust will no longer be a GST trust under Exception 4. That is, a portion of the trust would be included in the child gross estate immediately after the transfer to the trust in the second year.

Note also, that it is possible that the trust will not be a GST trust in the first year either. Although the child's withdrawal power is ignored for purposes of Exceptions 1, 2 and 4, it is not ignored for purposes of determining whether more than 25 percent of the trust corpus is subject to a general power of appointment held by a nonskip person. (See Exception 3).

Ex-35. **Answer –** No because this trust has no potential for a GST event.

Ex-36. **Answer –** First, the trust is a GST trust because property at the expiration of the term could be distributed to a skip person (as in fact happened under the facts). The trust involves an ETIP because the trust would be included in H's gross estate were he to die during the five year term. IRC § 2632(c)(4) provides that the indirect skip to the trust is deemed to occur at the termination of the ETIP. That happens at the end of the term when the property is distributed to the grandchild. The automatic allocation occurs immediately before that distribution. The property subject to the indirect skip is valued at the same time. So, only $300,000 of exemption will be allocated.

Ex-37. **Answer –** Before 2001, H could have allocated to the $20,000 value on April 16th by waiting to that date to file his 709. This (alone) won't work now because if the 709 is not filed on time, the automatic allocation rules will apply and $100,000 will be allocated to the trust. To accomplish what H wants, he must first file a timely 709 and elect out of the automatic allocation rules as to this transfer. Then he must file another 709 on April 16th to make the late allocation. If H anticipates that the issue will be recurring each year he transfers money to the trust for the payment of premiums, H should elect out of the automatic rules as to all transfers to the trust.

Ex-38. **First question –** Yes, provided only that T has unused GST exemption with which to make the allocation.

**Second question –** The answer is $100,000. That amount of exemption will give the trust a zero inclusion ratio.

Ex-39. **First question –** This trust will be treated as two trusts with W as the transferor of a two-thirds share and H as the transferor of a one-third share. If W later makes an addition to the trust, the relative shares of A and B must be recalculated. See Treas. Regs. § 26.2654-1(a)(5), Example 5.

**Second question –** The answer is 3/4ths. When an individual makes an additional contribution to a trust of which the individual is not the sole transferor, the portion of the trust attributable to each separate trust is determined by multiplying the new value of the single trust ($2,400,000) by a fraction the numerator of which is the value of the separate trust immediately after the contribution (2/3rds of $1,800,000 plus $600,000) and the denominator of which is the total value of all property in the single trust after the contribution ($2,400,000). See Treas. Regs. §§ 26.2654-1(a)(2)(ii); 26.2654-1(a)(5), Example 6.

Ex-40. **Answer –** Yes. The shares of the child and the grandchild are separate and independent shares. See Treas. Regs. § 26.2654-1(a)(5), Example 1. But see also Example 2 (separate treatment is not permitted when the trustee has the power to spray income in the final year of the trust).

Ex-41. **Answer –** No because the shares did not exist from and at all times after the creation of the trust. Accordingly, any allocation of GST exemption to one of the shares will apply with respect to all of the shares which will be viewed as a single trust. Treas. Regs. § 26.2654-1(a)(5), Example 8.

**Comment:** On the possibility that this trust could be severed into separate trusts for GST tax purposes, see "*Qualified (i.e.*, statutory) severances", infra p. 159.

Ex-42. **Answer –** Only if the division into shares occurs within 15 months of T's death or the governing instrument or local law require the trustee to pay an appropriate interest on the gift.

**Comment:** What is the significance of separate share treatment in this example? If separate treatment is not available, the property used to satisfy the bequest to the spouse will be in the denominator of the applicable fraction of the residual trust. In this case, a correspondingly higher amount of exemption would have to be allocated to the residual trust to achieve a zero inclusion ratio and much of that exemption would be wasted on the distribution to the spouse.

Ex-43. **First question –** Yes. See Treas. Regs. § 26.2654-1(b)(4), Example 2.

**Second question –** Yes, assuming the funding requirements for discretionary splits are complied with.

Ex-44. **Answer –** Yes, provided that each trust contains a gift over to the other trust in the event that there are not surviving descendants of a child at the child's death. See Treas. Regs. § 26.2642-6(j), Ex. 2. See also the requirements for a severance of a discretionary trust to qualify as a qualified severance in Treas. Regs. § 26.2642-6(d)(5).

Ex-45. **Answer –** Assuming all of the other requirements for a qualified severance are met, the answer is yes. See Treas. Regs. § 26.2642-6(j), Ex 10..

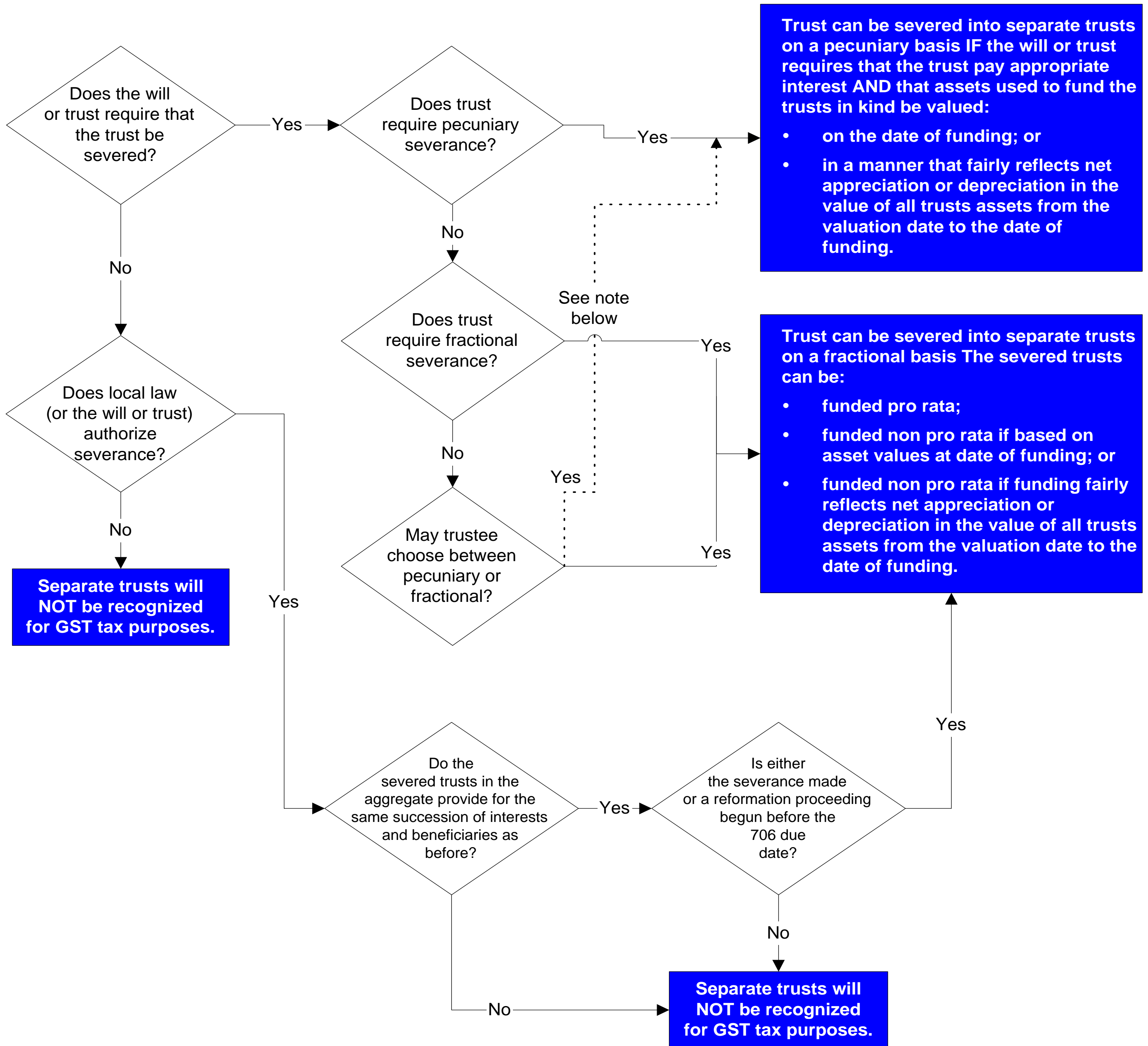
Ex-46. **Answer –** Well, first of all, since the trust has an inclusion ratio of .50, one of the trusts after the severance must have a 0 inclusion ratio and one must have an inclusion ration of 1. Since S is a skip person, the Trustee should designate S's trust as the one having the 0 inclusion ratio. The regulations provide that a qualified severance is deemed to precede any GST event that results from the severance itself. See Treas. Regs. § 26.2652-6(g)(2). Accordingly, no GST tax will be due as a consequence of the trust severance. Accord Treas. Regs. § 26.2642-6(j), Ex. 8..

# APPENDIX A: GRAPHICAL DECISION TREES

This appendix contains a series of graphical decision trees that make application of some of the more difficult GST rules more comprehensible. These were developed in conjunction with Bruce Stone of Goldman Felcoski & Stone P.A.. For each tree, start at the upper left and proceed according to the appropriate answer. The decision trees cover the following areas:

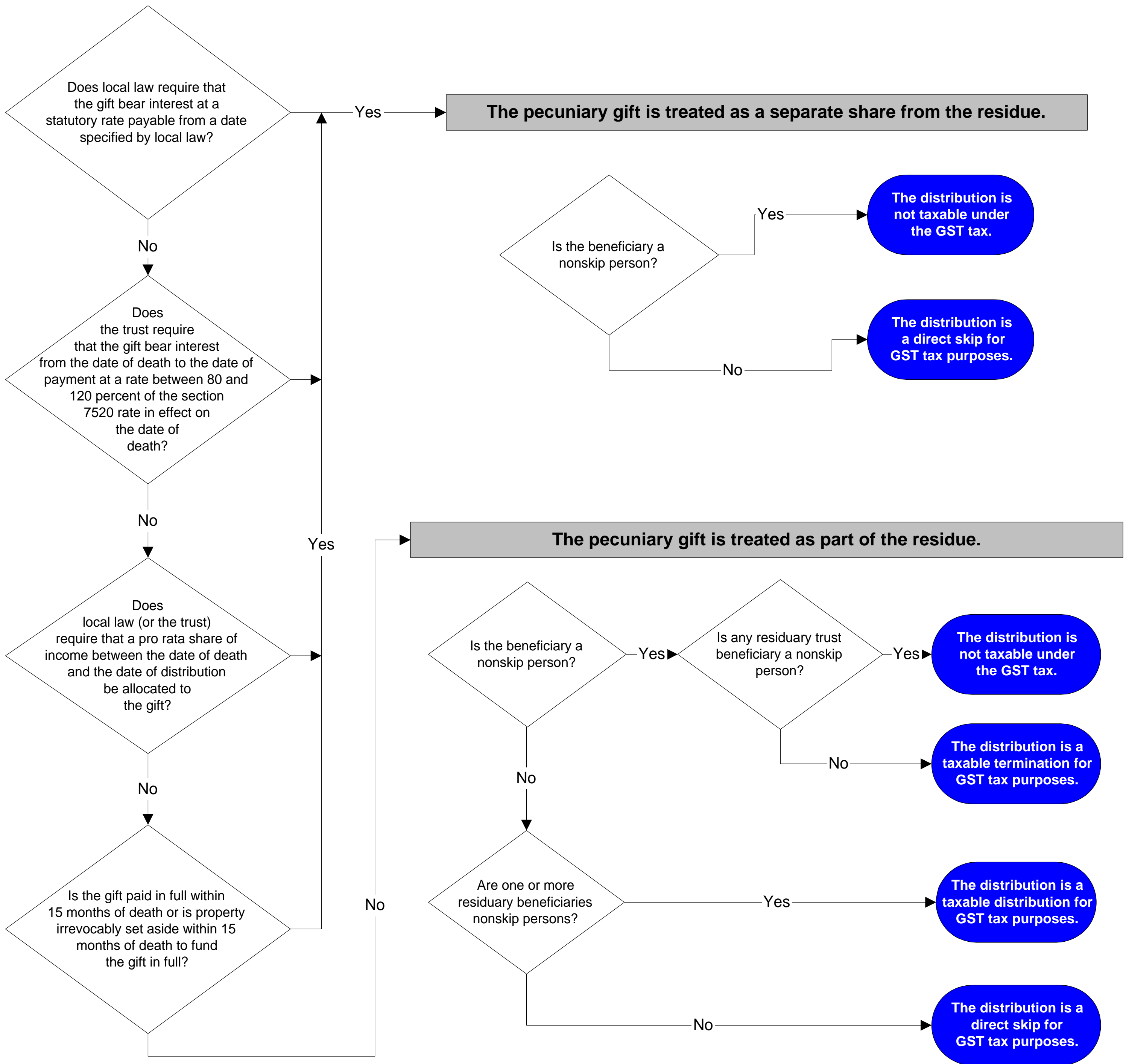
| Appendix | Description |
|---|---|
| **A-1** | **Severing Trusts Included in the Gross Estate**<br>This decision tree simplifies the complex rules in the GST regulations covering when a trust that is included in the gross estate of a transferor can be split into more than one trust and be treated as separate trusts for GST tax purposes. These rules can apply to the basic split that occurs through a marital formula contained in a revocable trust as well as other splits, including one done in anticipation of a reverse QTIP election. |
| **A-2** | **Distribution of Pecuniary Gift From Inter Vivos Trust Included in Gross Estate**<br>This decision tree covers the characterization of distributions in satisfaction of pecuniary gifts from a revocable inter vivos trust. For GST tax purposes, pecuniary gifts under a will or revocable inter vivos trust are either treated as separate from other gifts or not. For gifts in a will, the issue is one of valuation. For gifts in a revocable trust, the issue is more important; it involves the characterization of the distribution for GST tax purposes. This decision tree covers the characterization of distributions in satisfaction of pecuniary gifts from a revocable inter vivos trust. |
| **A-3** | **Severing Trusts Not Included in the Gross Estate**<br>This decision tree is a companion one to that in A-1. This tree covers the severance of a trust other than at the time the trust is included in the gross estate of the transferor. |
| **A-4** | **Determining the Denominator of the Applicable Fraction for Pecuniary GST Gifts at Death**<br>Assuming a pecuniary gift under a will or trust is treated as separate from other gifts in the instrument (See A-2), this decision tree can be used ascertain how the denominator for that applicable fraction with respect to the gift is to be valued. This, of course, will be necessary only if the beneficiary of the pecuniary gift is a skip person. |
| **A-5** | **Determining the Denominator of the Applicable Fraction for Residuary GST Gifts at Death**<br>Use this decision tree to determine the value of the denominator of the applicable fraction for residuary gifts which follow one or more separate pecuniary gifts. |

# Appendix A-1
# Severing Trusts Included in the Gross Estate

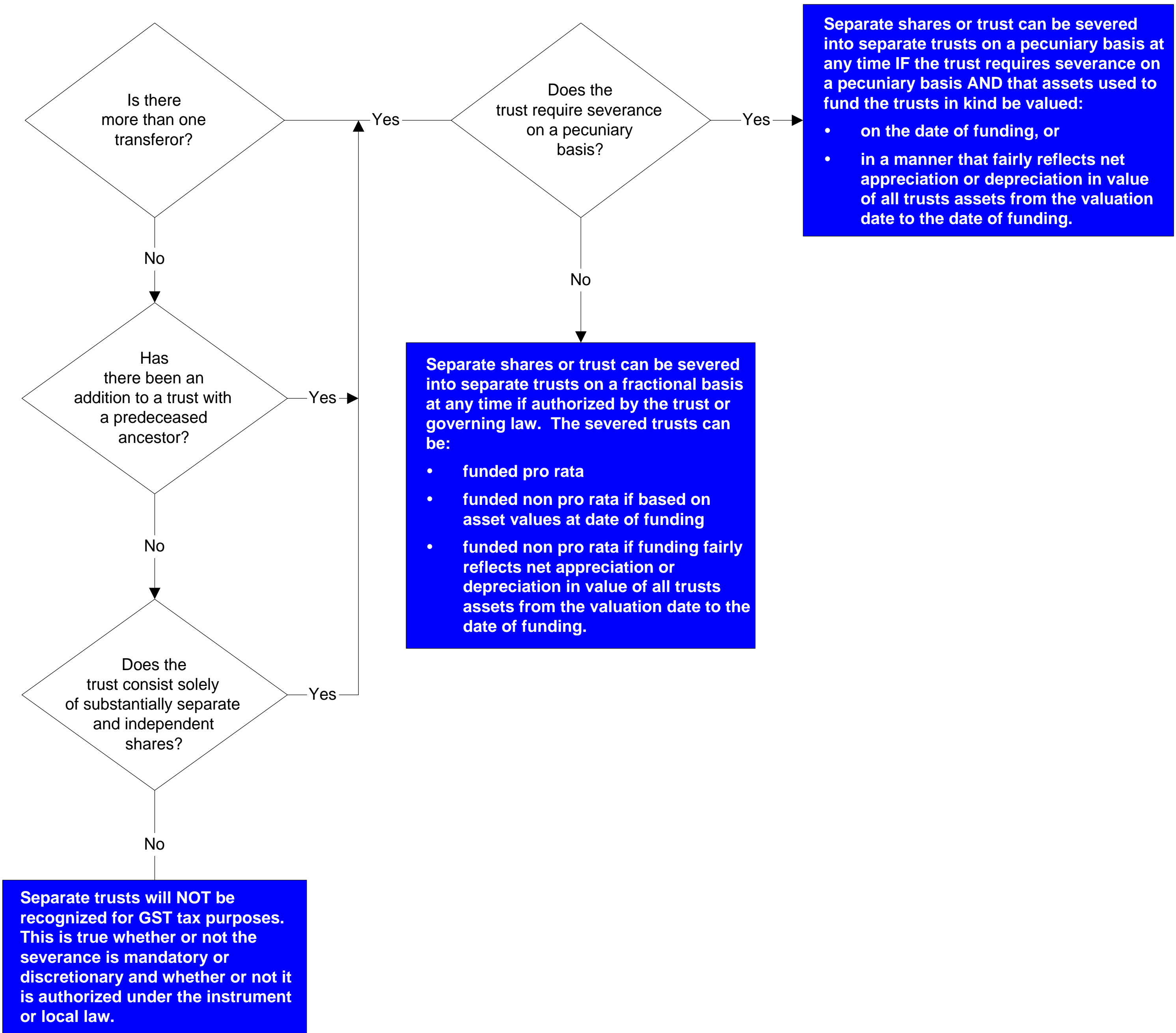



**Note: Treas. Reg. § 26.2654-1(b) appears to authorize a pecuniary split if the instrument directs either that the trust be split or that it be split on a pecuniary basis. If so, the choice between a fractional or a pecuniary split may be left to the discretion of the trustee as long as the split itself is required.**

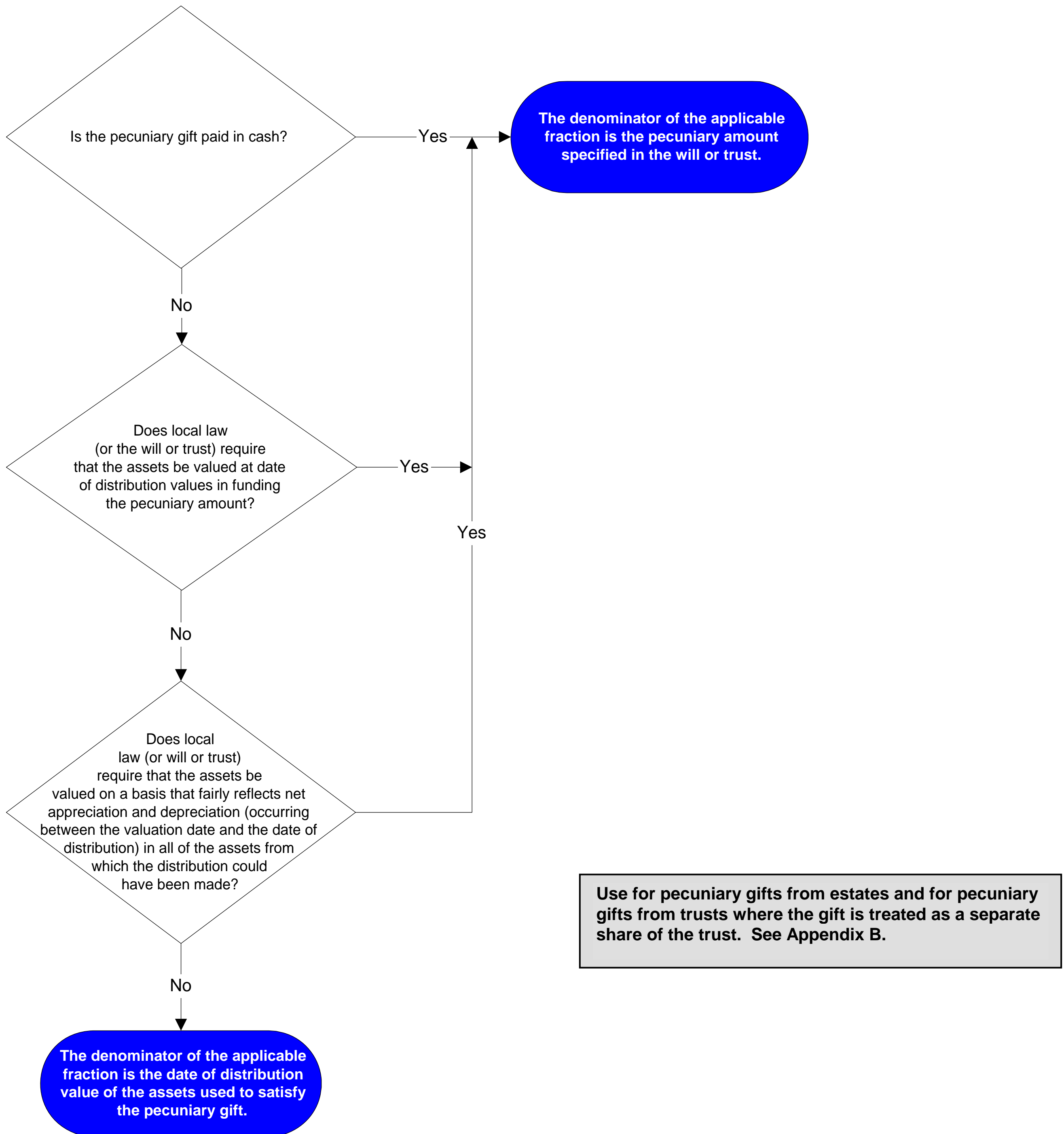
# Appendix A-2
# Distribution of Pecuniary Gift From Inter Vivos Trust Included in Gross Estate



## Appendix A-3
## SEVERING TRUSTS NOT INCLUDED IN THE GROSS ESTATE



# Appendix A-4
# Determining the Denominator of the Applicable Fraction for Pecuniary GST Gifts at Death



# Appendix A-5
# Determining the Denominator of the Applicable Fraction for Residuary GST Gifts at Death