

# The Generation-Skipping Transfer Tax Florida Fellows Institute

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# Defined Terms and Concepts

- Transferor
- Generation Assignment
- Interest
- Trust and Trustee
- Skip Person
- Non-skip Person
- Direct Skips
- Taxable Terminations
- Taxable Distributions

# Problem 1

## Who is the Transferor?

### §2652(a)

- In the case of property subject to the estate tax, the decedent
- In the case of property subject to the gift tax, the donor.

### Reg. §26.2652-1(a)(2)

- A transfer is subject to gift tax if a gift tax is imposed under §2501(a) without regard to exemptions, exclusions, deductions and credits.

# Gift Splitting

## Who is the transferor?

For gift tax purposes:

- §2513(a)(1) - A gift made by one spouse to any person other than his spouse shall, for all purposes of this chapter, be considered as made one-half by him and one-half by his spouse.
- §2513(a)(2) - Paragraph (1) shall apply only if both spouses have signified . . . their consent to the application of paragraph (1) in the case of all such gifts made during the calendar year by either when married.
- Reg. §26.2652-1(a)(4) - (4) *Split-gift transfers*. In the case of a transfer with respect to which the donor's spouse makes an election under section 2513 to treat the gift as made one-half by the spouse, the electing spouse is treated as the transferor of one-half of the entire value of the property transferred by the donor . . .

# Split Gifts

## Who is the Transferor?

Reg. §25.2513-1(b)(4) – For **gift tax** purposes:

(4) If one spouse transferred property in part to his spouse and in part to third parties, the consent is effective with respect to the interest transferred to third parties only insofar as such interest is ascertainable at the time of the gift and hence severable from the interest transferred to his spouse. See §25.2512-5 for the principles to be applied in the valuation of annuities, life estates, terms for years, remainders and reversions.

# Split Gifts

## Who is the Transferor?

Reg. §26.2652-1(a)(4) – for **Generation-Skipping Transfer Tax Purposes:**

*(4) Split-gift transfers.* In the case of a transfer with respect to which the donor's spouse makes an election under section 2513 to treat the gift as made one-half by the spouse, the electing spouse is treated as the transferor of *one-half of the entire value* of the property transferred by the donor, *regardless of the interest the electing spouse is actually deemed to have transferred under section 2513*. The donor is treated as the transferor of one-half of the value of the entire property. See §26.2632-1(c)(5) Example 3, regarding allocation of GST exemption with respect to split-gift transfers subject to an ETIP.

PLR 201523003 and PLR 201724007 - If split gift election is erroneously made on a gift tax return, once the period of limitations under §2501 has expired with respect to the return, the amount of each donor's taxable gift is final and may not be adjusted (Treas. Reg. §25.2504-2(b)). PLR concludes that the split gift election will also be effective for determining the identity of the transferor.

# Crummey Powers

## Who is the Transferor?

Reg. § 26.2652-1(a)(5) Example 5:

- *Example 5. Effect of lapse of withdrawal right on identity of transferor.* T transfers \$10,000 to a new trust providing that the trust income is to be paid to T's child, C, for C's life and, on the death of C, the trust principal is to be paid to T's grandchild, GC. The trustee has discretion to distribute principal for GC's benefit during C's lifetime. C has a right to withdraw \$10,000 from the trust for a 60-day period following the transfer. Thereafter, the power lapses. C does not exercise the withdrawal right. The transfer by T is subject to Federal gift tax because a gift tax is imposed under section 2501(a) (without regard to exemptions, exclusions, deductions, and credits) and, thus, T is treated as having transferred the entire \$10,000 to the trust. On the lapse of the withdrawal right, C becomes a transferor to the extent C is treated as having made a completed transfer for purposes of chapter 12. Therefore, except to the extent that the amount with respect to which the power of withdrawal lapses exceeds the greater of \$5,000 or 5% of the value of the trust property, T remains the transferor of the trust property for purposes of chapter 13.

# Lapse of Crummey Power Who is the Transferor?

## If Value of Trust Did Not Increase Before Lapse

Amount Subject to Withdrawal by a Beneficiary	\$15,000
5% of \$75,000	\$ 3,750
Greater of 5% or \$5000	\$ 5,000
Amount of Lapse Treated as a Transfer	\$10,000
Portion of Trust as to Which Each Beneficiary is Transferor	13.33%
5 Beneficiaries Are Transferors as to	66.67%
Tina is Transferor as to	33.33%



# Crummey Power

## Who is the Transferor?

### If Value of Trust Increased Before Lapse

Amount of Lapse Treated as a Transfer	\$10,000
Value of Trust at time of lapse	\$80,000
Portion of Trust as to Which Each Beneficiary is Transferor	12.50%
5 Beneficiaries Are Transferors as to	62.50%
Tina is Transferor as to	37.50%

# QTIP/Reverse QTIP

## Who is the Transferor?

Special Rule for Certain QTIP Trusts - § 2652(a)(3):

### **(3) Special election for qualified terminable interest property.**

In the case of—

(A) any trust with respect to which a deduction is allowed to the decedent under section 2056 by reason of subsection (b)(7) thereof, and

(B) any trust with respect to which a deduction to the donor spouse is allowed under section 2523 by reason of subsection (f) thereof,

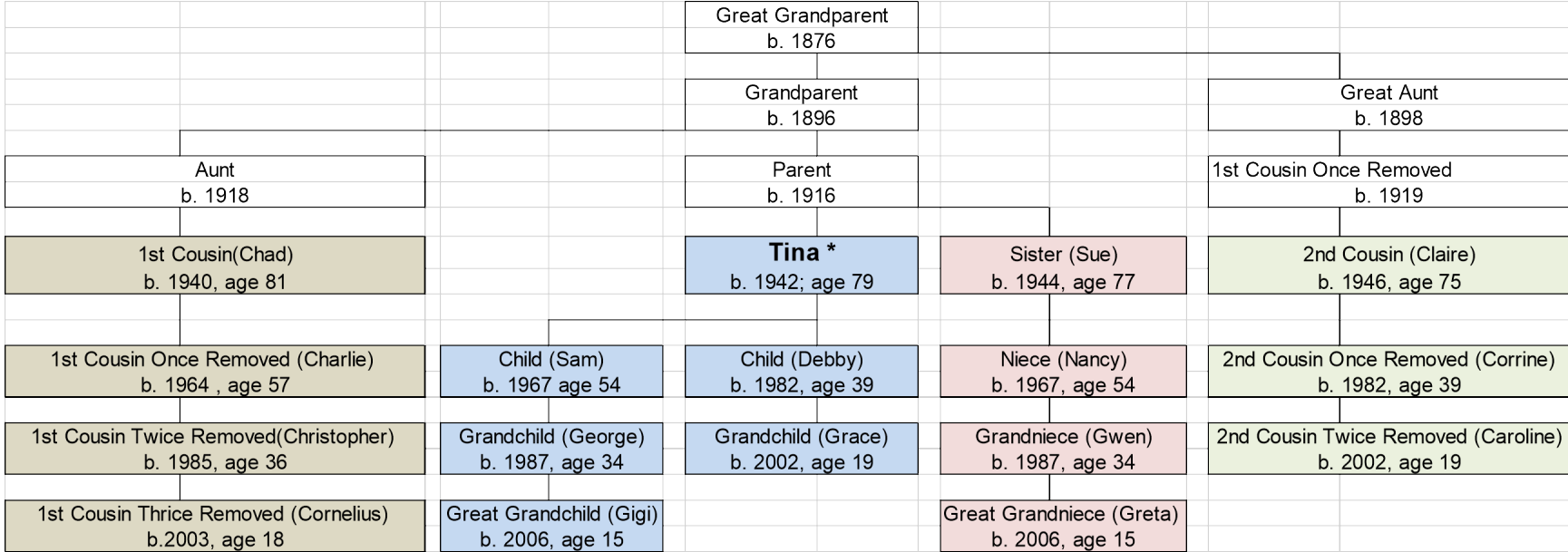
the estate of the decedent or the donor spouse, as the case may be, may elect to treat all of the property in such trust for purposes of this chapter as if the election to be treated as qualified terminable interest property had not been made.

Reg. § 26.2652-1(a)(3): Special rule for certain QTIP trusts. Solely for purposes of chapter 13, if a transferor of qualified terminable interest property (QTIP) elects under §26.2652 -2(a) to treat the property as if the QTIP election had not been made (reverse QTIP election), the identity of the transferor of the property is determined without regard to the application of sections 2044, 2207A, and 2519.

# Generation Assignment

- §2651 - Contains Rules for Generation Assignment
- §2651(b) - Family assignment rules; based on position in family tree
- §2651(d) - Non-family assignment rules; based on age differentials
- §2651(f)(1) - Multiple generation assignments
- §2651(f)(2) - Interests through entities
- §2651(f)(3) - Generation assignment of certain charities and governmental entities - applies to §511(a)(2) organizations, charitable trusts described in §511(b)(2) and governmental entities. §511(a)(2) organizations include all organizations that are exempt from taxation under §501(a).

# Family Tree



# Generation Assignment Adoption

## **§2651(b)(3)(A)**

A legal adoption shall be treated as a relationship by blood.

## **§2651(b)(3)(B)**

A relationship by the half blood shall be treated as a relationship by the whole blood.

## **§2651(c)**

An individual who has been married at any time to an individual described in subsection (b) shall be assigned to the generation of the individual so described.

## **§2651(f)(1)**

Except as provided in regulations, a person assigned to more than 1 generation shall be assigned to the youngest such generation.

# Generation Assignment Entities

## **§2651(f)(3)**

Any (A) organization described in section 511(a)(2), (B) charitable trust described in section 511(b)(2), and (C) governmental entity shall be assigned to the transferor's generation.

## **§2651(f)(2)**

Except as provided in (f)(3), if an estate, trust, partnership, corporation, or other entity has an interest in property, each individual having a beneficial interest in such entity shall be treated as having an interest in such property and shall be assigned to a generation under section 2651.

# What is an Interest?

## **§2652 (c) Interest.**

### **(1) In general.**

A person has an interest in property held in trust if (at the time the determination is made) such person—

(A) has a right (other than a future right) to receive income or corpus from the trust,

(B) is a permissible current recipient of income or corpus from the trust and is not described in section 2055(a), or

(C) is described in section 2055(a) and the trust is—

(i) a charitable remainder annuity trust,

(ii) a charitable remainder unitrust within the meaning of section 664,

or

(iii) a pooled income fund within the meaning of section 642(c)(5) .

# “Interest” Diagram

Right (other than future right) to receive income or corpus

Permissible current recipient of income or corpus

Except 2055(a)

Is described in 2055(a) AND the trust is a CRAT, CRUT, or PIF



# What is an Interest?

## Certain Items Disregarded under §2652(c)

### **(2) Certain interests disregarded.**

For purposes of paragraph (1), an interest which is used primarily to postpone or avoid any tax imposed by this chapter shall be disregarded.

### **(3) Certain support obligations disregarded.**

The fact that income or corpus of the trust may be used to satisfy an obligation of support arising under State law shall be disregarded in determining whether a person has an interest in the trust, if—

(A) such use is discretionary, or

(B) such use is pursuant to the provisions of any State law substantially equivalent to the Uniform Gifts to Minors Act.

# What is a Trust?

## §2652(b)

- **Trust** - Any arrangement (other than an estate) that has substantially the same effect as a trust, including life estates and remainders, estates for years and insurance and annuity contracts
- **Trustee** - In the case of an arrangement that is not actually a trust, the person in actual or constructive possession of the property subject to the arrangement.

# What is a Trust?

## Contingent Transfer Rule

### Treas. Reg. §26.2652-1(b)

- Generally, a transfer as to which the identity of the transferee is contingent upon the occurrence of an event is a transfer in trust.
- Exception for property included in transferor's gross estate when the identity of the transferee will be determined within 6 months of death.

# When is an Individual a Skip Person?

## §2613(a)(1)

When he or she is assigned to a generation 2 or more generations below the transferor's generation assignment.

# When is a Trust a Non-Skip Person?

- If there are persons who have interests in the trust and one or more of them are non-skip persons - §2613(a)(2)(A) and §2613(b) OR
- If there are no persons who have interests in the trust and distributions could be made to a non-skip person\*  
§2613(a)(2)(B) and §2613(b)

\*other than distributions the probability of which are so remote as to be negligible; for this purpose, the probability that a distribution will occur is so remote as to be negligible only if it can be ascertained by actuarial standards that there is less than a 5 percent probability that the distribution will occur.

Reg §26.2612-1(d)(2)(ii)

# Definition of Direct Skip

- §2612(c): The term “direct skip” means a transfer subject to a tax imposed by chapter 11 or 12 of an interest in property to a skip person.
- Solely for purposes of determining whether any transfer to a trust is a direct skip, the rules of section 2651(f)(2) shall not apply.

# Direct Skip Gift

## Tina Pays All Taxes

Gift to Grace	\$1,000,000	
GST Tax @ 40% (§2641)		400,000
Gift Tax @ 40% (§2502(a))	400,000	
Gift Tax on GST Tax (§2515)	160,000	
Total tax on transfer	\$960,000	
Total tax as a % of gift		96%

# Direct Skip Gift

## Tina Pays Gift Tax, Grace pays GST

Formula for Determining the Net Gift:

$$X = GA - .40X$$

$$1.40X = GA$$

$$X = GA/1.40$$

Net Gift to Grace	\$714,285.71 (\$1,000,000 / 1+ .40)
GST Tax @ 40% (§2641)	\$285,714.29 (\$714,285.71 * .40)
Gift Tax @ 40% (§2502(a))	\$285,714.29 (\$714,285.71 * .40)
Gift Tax on GST Tax (§2515)	\$114,285.71 (\$285,714.29 * .40)
Total tax on transfer	\$685,714.29
Total tax as a % of gift	96%



# Direct Skip Bequest Tax Paid By the Estate

Taxable Estate	\$2,333,333*
Bequest to Grace	\$1,000,000
GST Tax (§2641)	\$ 400,000
Estate Tax (§2001)	\$ 933,333
Total taxes	\$1,333,333
Total taxes as % of bequest	133.33%
GST tax as % of bequest	40.00%

\* This is the smallest estate that will be sufficient to fund the bequest to Grace

# Direct Skip Bequest GST Paid by Grace

Taxable Estate	\$1,666,666.66*
Net bequest to Grace	\$ 714,285.71
GST Tax (§2641)	\$ 285,714.29
Estate Tax (§2001)	\$ 666,666.66
Total taxes	\$ 952,380.95
Total taxes as % of bequest	133.33%
GST tax as % of bequest	40.00%

\* This is the smallest estate that will be sufficient to fund the bequest to Grace

# Is the transfer to the Trust in Problem 1 a Direct Skip?

§2612(c)(2): Look-thru rules not to apply. Solely for purposes of determining whether any transfer to a trust is a direct skip, the rules of section 2651(f)(2) shall not apply.

Treas. Reg. §26.2612-1(f) ex. 3:

Withdrawal power in trust. T transfers \$50,000 to a new trust providing that trust income is to be paid to T's child, C, for life and, on C's death, the trust principal is to be paid to T's descendants. Under the terms of the trust, T grants four grandchildren the right to withdraw \$10,000 from the trust for a 60 day period following the transfer. Since C, who is not a skip person, has an interest in the trust, the trust is not a skip person. T's transfer to the trust is not a direct skip.

# What is a Taxable Termination?

A taxable termination is the termination (by death, lapse of time, release of power or otherwise) of an interest in property held in a trust unless

(A) a transfer subject to federal estate or gift tax occurs at the time of the termination [this is only in the regulations]

or

(B) immediately after such termination, a non-skip person has an interest in such property

or

(C) at no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person.\*

§2612(a) and Reg §26.2612-1(b)(1)

\*other than distributions the probability of which are so remote as to be negligible; for this purpose, the probability that a distribution will occur is so remote as to be negligible only if it can be ascertained by actuarial standards that there is less than a 5 percent probability that the distribution will occur. Reg §26.2612-1(b)(1)(iii)

# How is a Taxable Termination taxed?

Value of trust when taxable termination occurs	\$1,000,000
GST tax at 40% - §2641	400,000
Net remaining in trust	600,000
GST tax as a % of amount passing to beneficiaries	66.67%

The trustee has the obligation to pay the tax. §2603(a)(2)

# Taxable Distribution

## What is a Taxable Distribution?

A taxable distribution is any distribution from a trust to a skip person other than a taxable termination or a direct skip. §2612 (b)

The GST tax on Taxable Distributions is paid by the distributee. §2603(a)(1)

## What is the tax on a Taxable Distribution?

Distribution to George	\$10,000
GST Tax at 40%	\$4,000
Net to George	\$6,000
GST tax as % of George's net	66.67%

# Educational Trust (Variation)

## Planning Idea

**Object** – to create a grandchildren’s educational trust without incurring GST tax

**Suggestion** – Create a trust to pay charities selected by the trustees a 1% annuity at the end of each of the next 2 years; at the end of the 2-year term, provide that the trust property is to be used to pay the tuition expenses of Tina’s grandchildren.

Alternative – create a trust that pays nothing for two years; at the end of the 2-year period, the trustees can make payments to Tina’s grandchildren or charity.

## Why it Works

- The trust is not a skip person because no person has an interest in it and because future distributions may be made to non-skip persons. Therefore, the transfer funding the trust is not a direct skip.
- In the first variation, because no particular charity has the right to receive payments, no charity has an interest in the trust. In the second variation, no person has an interest in the trust. Therefore, the end of the 2-year charitable period will not be a taxable termination.
- Distributions to pay grandchildren’s tuition will not be taxable distributions. §2611(b)(1)

# Distribution to Another Trust

## **Trust Distributions to Non-Skip Person Trusts in Which No Person Has an Interest**

Reg. §26.2612-1(c)(2):

Solely for purposes of determining whether any transfer from a trust to another trust is a taxable distribution, the rules of §2651(e)(2) [sic] do not apply.



# Distribution at Death of Lineal Descendant

## Trust Distribution at Death of Lineal Descendant of Transferor

§2612(a)(2)

### **(2) Certain partial terminations treated as taxable**

If, upon the termination of an interest in property held in trust by reason of the death of a lineal descendant of the transferor, a specified portion of the trust's assets are distributed to 1 or more skip persons (or 1 or more trusts for the exclusive benefit of such persons), such termination shall constitute a taxable termination with respect to such portion of the trust property.

# Break

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# GST Exemption

- Each individual has a GST exemption amount allocable to any property of which she is the transferor - §2631(a)
- The amount for any year is equal to the basic exclusion amount under § 2010(c) for such year - §2631(c)

2007 - 2008	\$ 2,000,000
2009	\$ 3,500,000
2010 - 2011	\$ 5,000,000
2012	\$ 5,120,000
2013	\$ 5,250,000
2014	\$ 5,340,000
2015	\$ 5,430,000
2016	\$ 5,450,000
2017	\$ 5,490,000
2018	\$11,180,000
2019	\$11,400,000
2020	\$11,580,000
2021	\$11,700,000
2022	\$12,060,000

# GST Applicable Rate of Tax

The maximum Federal estate tax rate multiplied by the inclusion ratio of the transfer - §2641

Enactment to 2001	55%
2002	50%
2003	49%
2004	48%
2005	47%
2006	46%
2007 - 2009	45%
2010	0%
2011 - 2012	35%
2013 to present	40%

# Inclusion Ratio and Applicable Fraction

The **inclusion ratio** for any generation-skipping transfer is the number 1 reduced by: the applicable fraction of the trust with respect to which the transfer is made, or, in the case of a direct skip, the applicable fraction of the direct skip  
§2642(a)(1)

The **applicable fraction** is a fraction with:

a **numerator** equal to:

the amount of GST exemption allocated to the trust or the direct skip, and

a **denominator** equal to:

the value of the property transferred to the trust or involved in the direct skip,  
reduced by

any Federal estate or State death tax recovered from the trust attributable to the property,

and reduced further by

any charitable deduction allowed under §2055 or 2522 with respect to the property.

§2642(a)(2)

# Example: Direct Skip to George

In 2018, Tina gave \$500,000 to George

Tina timely allocates \$300,000 of her GST exemption to the gift.

The direct skip's applicable fraction is:

$$\begin{array}{r} \text{numerator} \\ \text{denominator} \end{array} \quad \frac{\$300,000}{\$500,000} = \frac{3}{5}$$

The direct skip's inclusion ratio is:

$$1 - 3/5 = 2/5$$

The GST applicable rate of tax is:

$$40\% \times 2/5 = 16\%$$

The GST tax on Tina's direct skip will be

$$\$500,000 \times 16\% = \$80,000$$

# Example: Transfer in Trust

Tina gave \$500,000 to trust for Sam and George.

Tina timely allocated \$300,000 of her GST exemption to the gift.

The trust's applicable fraction is:

$$\begin{array}{rcl} \text{numerator} & \underline{\$300,000} & = \underline{3} \\ \text{denominator} & \$500,000 & 5 \end{array}$$

The trust's inclusion ratio is:

$$1 - 3/5 = 2/5$$

Sam died in 2019. GST applicable rate of tax is:

$$40\% \times 2/5 = 16\%$$

If the trust is worth \$1,000,000 when Sam dies, the GST tax will be

$$\$1,000,000 \times 16\% = \$160,000$$

# Manual GST Exemption Allocation to Testamentary Direct Skip

1. An allocation of GST exemption to a testamentary transfer may be made at any time on or before the due date for the decedent's estate tax return and is to be made on the decedent's Federal estate tax return.

§2632(a)(1);

Reg. §26.2632-1(d)(1)

2. An allocation to such transfer made by the decedent's executor on a timely filed estate tax return is **effective** on the date of death.

Reg. §26.2632-1(d)(1)

3. For purposes of determining the denominator of the applicable fraction, the **value** of the transferred property is its value for Federal estate tax purposes.

Reg. §26.2642-2(b)



# Calculation of GST Tax on Direct Skip to George

If George...	Does Not Pay the GST Tax	Does Pay the GST Tax
Bequest to George	\$100,000	
GST Exemption Allocation	75,000	
Applicable Fraction	$\frac{3}{4}$	
Inclusion Ratio	$\frac{1}{4}$	
Maximum Estate Tax Rate	40%	
GST Tax Rate	10%	
Amount of GST Tax	10,000	

# Calculation of GST Tax on Direct Skip to George

If George...		Does Not Pay the GST Tax	Does Pay the GST Tax
Bequest to George	\$100,000	\$100,000	
GST Exemption Allocation	75,000		75,000
Applicable Fraction	3/4		3/4
Inclusion Ratio		1/4	1/4
Maximum Estate Tax Rate		40%	40%
GST Tax Rate		10%	10%
Amount of Direct Skip*		100,000	90,909
Amount of GST Tax	10,000		9,091

The amount of the Direct Skip is reduced by the GST taxes payable. §2623

\* To calculate the amount of the Direct Skip, divide the bequest by 1 plus the tax rate.  

$$\text{Amount of Bequest}/(1.1) = \text{Amount of Direct Skip}$$

# Automatic GST Exemption Allocation to Testamentary Direct Skip

Any portion of a transferor's GST exemption not allocated in a timely manner will be

- First allocated to direct skips occurring at her death.

§2632(e)(1)(A)

- And then allocated to trusts with respect to which she is the transferor and from which a taxable distribution or a taxable termination might occur at or after her death.

§2632(e)(1)(B)

- The allocation within each category is made in proportion to relative values.

§2632(e)(2)

# Automatic Allocation at Death

Bequest to George	\$ 100,000	2%
Bequest to Trust	<u>4,900,000</u>	98%
Total	\$5,000,000	

Portion of GST Exemption Allocated to George:  
 $2\% \times \$4,000,000 = \$80,000$

Portion of GST Exemption Allocated to Trust:  
 $98\% \times \$4,000,000 = \$3,920,000$

# GST Exemption Allocation to Residuary Bequest Following Pecuniary Bequest

§2642(b)(2)(A): If property is transferred as a result of the death of the transferor, the value of such property for purposes of subsection (a) *[i.e., for purposes of establishing the value of the transfer in the denominator of the applicable fraction]* shall be its value as finally determined for purposes of chapter 11; **except that, if the requirements prescribed by the Secretary respecting allocation of postdeath changes in value are not met, the value of such property shall be determined as of the time of the distribution concerned.**

§26.2642-2(b)(4) requires that “appropriate interest” be paid.

# Automatic GST Exemption Allocation to Inter Vivos Direct Skip

Amount of Gift to George	\$100,000
Automatic GST Exemption Allocation (\$2632(b))	\$100,000

## Calculation of GST Tax on Direct Skip to George:

Gift to George	\$100,000
GST Exemption Allocation	\$100,000
Applicable Fraction	1.00
Inclusion Ratio	- 0 -
Maximum Estate Tax Rate in 2016	40%
GST Tax Rate	0.00%
Amount of Direct Skip	\$100,000
Amount of GST Tax	- 0 -

# Timely Manual GST Exemption Allocation to Inter Vivos Trust

Amount of gift to trust	\$1,000,000
Value of trust property on date of GST exemption allocation	\$2,000,000
GST Exemption allocation on timely filed gift tax return	\$1,000,000

## Calculation of Inclusion Ratio:

Value of gift on date of gift	\$1,000,000
GST Exemption allocation	\$1,000,000

Numerator of Applicable Fraction – value of gift for Chapter 12 purposes (§2642(b)(1)*)	<u>\$1,000,000</u>
Denominator of Applicable Fraction	\$1,000,000

$$\text{Inclusion Ratio} = 1 - \$1,000,000/1,000,000 = 0\%$$

\* If GST exemption is allocated to an inter vivos gift on a timely filed gift tax return, the value of the property for purposes of determining the applicable fraction will be the value of the gift for chapter 12 purposes; the allocation is effective as of the date of the gift. §2642(b)(1)

# Late Manual GST Exemption Allocation to Inter Vivos Trust

	Property Increases in Value	Property Declines in Value
Amount of gift to trust	\$1,000,000	\$1,000,000
Value of trust property on date of GST exemption allocation	\$2,000,000	250,000
GST Exemption allocation on late filed gift tax return	\$1,000,000	250,000
Numerator – GST exemption allocated (§2642(b)(3)*)	<u>\$1,000,000</u>	<u>250,000</u>
Denominator – Value of Property When Allocation Made	\$2,000,000	250,000
Inclusion Ratio	1 - \$1,000,000/2,000,000 = 50%	1 - \$250,000/250,000 = 0%

\* If GST exemption is allocated to an inter vivos gift other than on a timely filed gift tax return, the value of the property for purposes of determining the applicable fraction will be the value of the property on the date the allocation is filed or, at the election of the transferor on the first day of the month during which the allocation is made; §2642(b)(3) and Reg. §26.2642-2(a)(2).



# Taxable Distribution from Trust with Inclusion Ratio of Other than Zero

Inclusion Ratio of Trust	50%
Highest Federal Estate Tax Rate at Time of Distribution	40%
Amount of Taxable Distribution	\$100,000
Applicable Generation-Skipping Transfer Tax Rate	20%
Amount of Generation-Skipping Transfer Tax	\$20,000

**Planning Principle – Avoid structuring trusts with inclusion ratios between zero and one.**

# Definitions and Rule

## **Definition of Indirect Skip - §2632(c)(3)(A)**

The term “indirect skip” means any transfer of property (other than a direct skip) subject to the tax imposed by chapter 12 made to a GST trust.

## **Definition of GST Trust - §2632(c)(3)(B)**

The term "GST trust" means a trust that could have a generation-skipping transfer with respect to the transferor (with six exceptions).

## **Automatic Allocation Rule -- §2632(c)(1)**

If any individual makes an indirect skip . . . Any unused portion of GST exemption shall be allocated to the transfer to the extent necessary to make the inclusion ratio for such property zero.

# §2632(c)(3)(B) exceptions

More than 25% of trust corpus –

**§2632(c)(3)(B)(i)** -- must be distributed to non-skip persons before they reach age 46 (or on a date before age 46 or an event that may reasonably be expected to occur before age 46), or

**§2632(c)(3)(B)(ii)** – must be distributed to non-skip person on the date of death of another person identified in the instrument who is more than 10 years older than such individuals, or

**§2632(c)(3)(B)(iii)** -- must be distributed to the estates of non-skip persons who die, or be subject to a general power of appointment exercisable by such individuals.

## §2632(c)(3)(B) exceptions (cont'd)

**§2632(c)(3)(B)(iv)** -- any portion of the trust would be included in the estate of a non-skip person if the non-skip person died immediately after the transfer [but see possible exception in flush language], or

**§2632(c)(3)(B)(v)** – the trust is a CLAT, CRAT, or CRUT, or

**§2632(c)(3)(B)(vi)** -- the trust is a CLUT which is required to make annual payments to charity and distribute principal to a non-skip person when the charity's interest terminates.

# §2632(c)(5) elections

**§2632(c)(5) and §26.2632-1(b)(2):** Can opt out with respect to:

- One or more or all current year transfers to a specified trust or trusts
- One or more or all future transfers made to a specified trust or trusts
- All future transfers made by the transferor to all trusts, whether or not in existence at the time

Can also elect to treat any trust as a GST trust for current transfers, future transfers, or all transfers

# The Estate Tax Inclusion Period (“ETIP”) Rule - §2642(f)

**General Rule** – No GST exemption may be made to transferred property if such property would be included in the gross estate of the transferor (other than by reason of §2035) if she died immediately after the transfer. §2642(f)(1)

**Effective Date of GST exemption allocation made during an ETIP** – If a GST exemption allocation is made in violation of the ETIP rule, the allocation is not effective until the end of the ETIP. Reg. § 26.2632-1(c)(1)(ii)

**Effective Date of GST exemption allocation made after an ETIP** – If a GST exemption allocation is made after the end of an ETIP, it is effective at the end of the ETIP if timely made (i.e., by the due date for the gift tax return for the period within which the ETIP ended) or (if not timely) on the date the allocation is made. Reg. § 26.2632-1(c)(1)(ii)

**ETIP Valuation Rule** – The value of property subject to an ETIP (for purposes of establishing the denominator of the Applicable Fraction) will be:

its estate tax value if the ETIP ends with the death of the transferor, or

its value at the end of the ETIP if a timely GST exemption allocation is made, or

its value on the date the GST exemption allocation is made if a late allocation is made after the end of the ETIP. §2642(f)(2)

**The Effect of the ETIP Rule on the Timing of Direct Skips** – If a Direct Skip is subject to the ETIP Rule, the Direct Skip is treated as occurring at the close of the ETIP period. §2642(f)(1)

# The Spousal ETIP Rule

## General Rule

Except as provided in regulations, an ETIP will also exist if the transferred property would be included in the gross estate of the transferor's spouse if the spouse died immediately after the transfer. §2642(f)(4)

If any part of a trust is subject to an ETIP, the entire trust is subject to the ETIP.

Reg. § 26.2632-1(c)(1)(iii)

## Two Regulatory Exceptions:

1. A spousal ETIP will not exist if the inclusion of transferred property in the spouse's estate would occur only because of the existence of a power to withdraw no more than the greater of \$5,000 or 5% of the trust corpus and the right ends within 60 days after the transfer to the trust. Reg. § 26.2632-1(c)(2)(ii)(B)
2. The property is transferred to a QTIP and a reverse QTIP election is made under §2652(a)(3). Reg. § 26.2632-1(c)(2)(ii)(C)

# Allocating GST Exemption to Charitable Lead Unitrusts

**Applicable Fraction's Numerator** – Amount of GST Exemption allocated to transfer

**Applicable Fraction's Denominator** – Value of Property Transferred minus Charitable Deduction §26.2642-1(c)(ii):

$$\$1,000,000 - \$714,849 = \$285,151$$

$$\frac{\$285,151}{\$285,151} = \frac{1}{1}$$

$$\text{Inclusion Ratio} \quad 1 - 1/1 = 0$$



# Allocating GST Exemption to Charitable Lead Annuity Trusts - §2642(e)

**Applicable Fraction's Numerator** = Adjusted GST Exemption ("AGSTE")

**Applicable Fraction's Denominator** = Value of Trust Property when Charitable Term ends

$$\text{AGSTE} = \text{GST Exemption Allocated to Trust} \times (1 + 7520 \text{ rate})^n$$

n = number of years between effective date of allocation and end of charitable term

Assume Tina allocates GST exemption of \$300,000 on a timely filed gift tax return for the CLAT when the 7520 rate is 2.40%:

$$\text{AGSTE} = \$300,000 \times (1 + 0.024)^3 = \$322,123$$

If, at the end of the charitable term, the trust property is worth \$600,000 after making the final annuity payment to charity, the Applicable Fraction would be

$$\frac{\$322,123}{\$600,000} \text{ and the inclusion ratio would be } 1 - \frac{\$322,123}{\$600,000} = 46.313\%$$

# Allocating GST Exemption to Charitable Remainder Trusts

Applicable Fraction =  $\frac{\text{Amount of GST Exemption Allocated}}{\text{Amount transferred} - \text{charitable deduction}}$

If Tina allocates GST exemption of \$897,032 to the trust, the Applicable Fraction would be

$$\frac{\$897,032}{\$897,032} = \frac{\$1,000,000 - \$102,968}{\$1,000,000 - \$102,968}$$

and the inclusion ratio would be  $1 - 1 = 0$

# Nontaxable Gifts

A direct skip that is a nontaxable gift under §2503(b) or 2503(e) will have an inclusion ratio of zero. **§2642(c)**

**However**, this rule does not apply to transfers in trust for an individual unless:

- (A) The trust is for the benefit of a single individual and no distributions may be made to anyone other than such individual during his or her life, and
- (B) All assets in the trust when the individual dies will be includable in the individual's gross estate.

# Effect of Withdrawal Power on Identity of Recipient of Gift

Reg. § 26.2612-1(F) Ex. 3:

Example 3. *Withdrawal power in trust.* T transfers \$50,000 to a new trust providing that trust income is to be paid to T's child, C, for life and, on C's death, the trust principal is to be paid to T's descendants. Under the terms of the trust, T grants four grandchildren the right to withdraw \$10,000 from the trust for a 60 day period following the transfer. Since C, who is not a skip person, has an interest in the trust, the trust is not a skip person. T's transfer to the trust is not a direct skip.

## Reg. § 26.2654-1(a)(1)

If a single trust consists **solely of substantially separate and independent shares for different beneficiaries**, the share attributable to each beneficiary (or group of beneficiaries) is treated as a **separate trust** for purposes of Chapter 13. The phrase "substantially separate and independent shares" generally has the same meaning as provided in § 1.663(c)-3. However, except as provided in paragraph (a)(1)(iii) of this section, a portion of a trust is not a separate share unless such share exists from and at all times after the creation of the trust.

## Reg. § 26.2654-1(a)(1)(iii)

Mandatory severances, For purposes of this section, if the governing instrument of a trust **requires** the division or severance of a single trust into separate trusts upon the future occurrence of a particular event not within the discretion of the trustee or any other person, and if the trusts resulting from such a division or severance are recognized as separate trusts under applicable state law, then each resulting trust is treated as a separate trust for purposes of Chapter 13. . . . Similarly, if the governing instrument **requires** the division of a single trust into separate shares under the circumstances described in this paragraph, each such share is treated as a separate trust for purposes of Chapter 13.

# Qualified Severance – Requirements 1 and 2

## **Reg. § 26.2642-6(b)**

- The severance is made pursuant to the terms of the trust instrument or local law.
- The severance is effective under local law.

# Qualified Severance – Requirement 3

There must be a severance date and that date must be either:

- The date selected by the trustee to value the assets in order to determine the funding of the separate trusts; or
- The court-imposed date of funding.

In order for there to be a severance date, funding of the separate trusts must commence immediately upon the severance date and must occur within a reasonable period of time after the severance date, but in no event more than 90 days.

The 90 day period is not available if the trust assets are easy to value and transfer.



# Qualified Severance – Requirement 4

- The trust must be severed on a fractional basis. The severance must not be based on a pecuniary amount.
- The fraction may be determined by means of a formula--for example, a fraction the numerator of which is the transferor's remaining GST exemption, and the denominator of which is the then value of all trust assets.
- If assets are divided on a non-pro rata basis, the assets must be allocated among the trusts based on the fair market value pre-severance without taking discounts to reflect marketability or minority discounts that arise because a resulting trust receives less than 100% of an asset held by the original trust.

# Qualified Severance – Requirement 5

## Reg. § 26.2642-6(b)

The terms of the resulting trusts must provide, **in the aggregate**, for the same succession of interests of beneficiaries as are provided in the original trust. In the case of a discretionary trust, this requirement is satisfied if two or more trusts are created each with the same distribution terms but with different beneficiaries so long as the assets are divided equally among the trusts on a per capita beneficiary basis. For example, a discretionary trust for the benefit of A, B, and C and the descendants of each can be divided into three separate trusts one for each of A, B, and C and their respective descendants.

# Qualified Severance – Requirements 6 & 7

6. In the case of a qualified severance of a trust with an inclusion ratio of **either one or zero**, each resulting trust will have an **inclusion ratio equal to the inclusion ratio of the original trust**.
7. If the trust to be severed has an **inclusion ratio of more than zero but less than one**, the trust must be severed initially into only **two resulting trusts** with one receiving a fraction of the value of the original trust equal to the applicable fraction and the other receiving the balance. The trust receiving the fractional share equal to the applicable fraction will have an inclusion ratio of zero; the other will have an inclusion ratio of one.

# Severing a Trust to Avoid GST Tax

Trust has value of \$2,000,000  
Trust has applicable fraction of  $\frac{1}{2}$   
Trust has inclusion ratio of 50%  
Trustee wants to distribute \$100,000 to skip person

## **Solution:**

Sever the trust into two separate trusts under the authority of §2642(a)(3).

Trust #1 will be equal to value of trust x applicable fraction = \$1,000,000

Trust #2 will be equal to the balance: \$1,000,000

The inclusion ratio of Trust #1 will be zero.

Therefore, the distribution of \$100,000 to the skip person may be made from Trust #1 without the payment of any GST tax.

# §2653(a): The Multiple Skip Rule

## General Rule – The Move Down Rule

- If property is held in trust immediately after the occurrence of a generation-skipping transfer with respect to the property, then
- The transferor of the trust will be treated as if he or she were assigned to the first generation above the highest generation of any person who has an interest in the trust immediately after the transfer.

# Predeceased Ancestor (or Parent) Exception

**General Rule** – If an individual is a descendant of a **parent** of a transferor and her parent who is descended from the transferor's parent is dead at the time a transfer subject to Chapter 11 or 12 occurs, the individual's generation assignment, for purposes of the transfer, shall move up to one generation below the lower of (1) transferor's generation or (2) the generation of the youngest living ancestor of the individual who is a descendant of the parent. §2651(e)(1)

**Expansion** – The rule also applies to the descendants of the parents of the transferor's spouse or former spouse.

**Limitation Applicable to Collaterals** – The rule is not available for individuals who are not descendants of the transferor (or the transferor's spouse or former spouse) if the transferor has living lineal descendants. §2651(e)(2)

**Limitation Applicable to Property Subject to Multiple Transfers** – If property is subject to a Chapter 11 or 12 tax with respect to the same transferor on more than one date, the determination as to whether an individual's ancestor is alive is made on the earliest such date.

**90 Day Rule** – In the case of transfers occurring at the death of a transferor, if an individual dies within 90 days of the death of the transferor, he or she will be deemed to have died before the transferor for purposes of the predeceased ancestor rule even if, in the case of a bequest to a trust, under the trust instrument he or she had been a trust beneficiary before death. Reg. §26.2651-1(a)(2)(iii)

# Redetermining the Applicable Fraction and the Inclusion Ratio When Additional GST Exemption Is Allocated to the Trust

## General Rule

1. The numerator of the Applicable Fraction will be an amount equal to the sum of the additional GST Exemption allocated **plus** the Nontax Portion of the trust.
2. The denominator of the Applicable Fraction will be the value of the trust property immediately after the allocation is made.

The “**nontax portion**” of the trust means an amount equal to the value of the trust assets multiplied by the amount of the Applicable Fraction immediately before the allocation is made.

Reg. §26.2642-4(a)

# Adding Exemption Example

$$\begin{array}{l} \text{New Numerator} = \underline{\text{Additional GST Exemption Allocated} + \text{Nontax Portion of Trust}} \\ \text{Denominator} = \qquad \qquad \qquad \$2,000,000 \end{array}$$

$$\text{Nontax Portion of Trust} = \$2,000,000 \times \text{Applicable Fraction pre-allocation}$$

$$\text{Applicable Fraction pre-allocation} = \frac{\$750,000}{\$1,000,000} = \frac{3}{4}$$

$$\text{Nontax Portion of Trust} = \$2,000,000 \times \frac{3}{4} = \$1,500,000$$

$$\begin{array}{l} \text{New Numerator} = \underline{\text{GST Exemption Allocated} + \$1,500,000} \\ \text{Denominator} = \qquad \qquad \qquad \$2,000,000 \end{array}$$

Therefore, a GST Exemption allocation of \$500,000 is required to produce an Applicable Fraction of 1 and an Inclusion Ratio of 0.



# Redetermining the Applicable Fraction and the Inclusion Ratio When Property Is Added to the Trust

## General Rule

1. The numerator of the Applicable Fraction will be an amount equal to the Nontax Portion of the trust.
2. The denominator of the Applicable Fraction will be the value of the trust property immediately after the addition is made to the trust.

The nontax portion of the trust means an amount equal to the value of the trust assets multiplied by the amount of the Applicable Fraction immediately before the allocation is made.

§2642(d) Reg. §26.2642-4(a)

# Additional Contribution to Trust Example

New Numerator = Nontax Portion of Trust

Denominator = \$1,200,000 + \$200,000

Nontax Portion of Trust = \$1,200,000 x Applicable Fraction pre-contribution

Applicable Fraction =  $\frac{\$800,000}{\$1,000,000}$

Nontax Portion of Trust = \$1,200,000 x  $\frac{800,000}{1,000,000}$  = \$960,000

New Numerator =  $\frac{\$960,000}{\$1,400,000}$  = .69 = 24/35

Denominator = \$1,400,000

Inclusion Ratio = 1 - 0.69 = 0.31

1 - 24/35 = 11/35

# Continued

Because no GST Exemption was timely allocated to trust after addition, the Applicable Fraction before the late allocation is 0.69.

The Nontax Portion immediately before the late allocation is

$$0.69 \times \$1,600,000 = \$1,097,143$$

Therefore, Tina would have to allocate \$502,857 worth of GST Exemption to achieve an Applicable Fraction of 1/1.

$$\text{Numerator} = \$502,857 + \$1,097,143 = \underline{\$1,600,000}$$

$$\text{Denominator} = 1,600,000$$

# Retroactive Allocations

## **General Rule – §2632(d)**

If a non-skip person assigned to the transferor's children's generation has an interest in a trust (including a future interest), is a descendant of a grandparent of the transferor, or of a grandparent of the transferor's spouse or former spouse, and dies before the death of the transferor, the transferor may allocate GST exemption to any previous transfer to the trust and, if the allocation is made on a timely filed gift tax return (determined as if the date of death was the date of the gift), the effective date of the allocation will be immediately before the death of the individual, the value of the property for purposes of establishing the denominator will be determined on the date of the original transfer and the amount of the transferor's unused GST exemption will be determined immediately before the death of the non-skip person.

# Late Allocation of GST Exemption

Numerator of Applicable Fraction (amount of GST exemption available)	<u>\$6,000,000</u>	
Denominator of Applicable Fraction (value on date of allocation, or the first day of the month of the month within which the allocation is made, at the election of donor)	\$10,000,000	
Applicable Fraction		6/10
Inclusion Ratio	4/10	

# Relief Provisions

**§2642(g)** – Directs IRS to provide by regulation circumstances and procedures under which extensions of time will be granted to make:

- (i) an allocation of GST exemption under §2642(b)(1) (allocation to inter vivos gifts) or (b)(2) (allocation to transfers at death)
- (ii) an election under §2632(b)(3) (election to have automatic GST exemption rule not apply to a direct skip) or (c)(5) (election to have automatic GST exemption rule not apply to an indirect skip or to any transfers made to a trust and to treat a trust as a GST trust).

**Notice 2001-50 (August 20, 2001)** - Taxpayers may use procedures applicable for requesting a private ruling under §301.9100 to seek relief under §2642(g).

# Relief Provisions (cont.)

## **Rev. Proc. 2004-46**

Establishes a simplified procedure for making late GST exemption allocations to pre-2001 gifts that were protected by the annual exclusion.

## **Prop. Reg. §26.2642-7 issued on April 17, 2008**

Establishes a procedure that will replace relief under 9100.

Identifies the standards that the IRS will apply in determining whether to grant extensions of time to allocate GST exemption and to make elections with respect to the automatic allocation rules.

Relief will be granted when the taxpayer establishes to the satisfaction of the IRS that the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice the interests of the Government.

# Effect of Modifications to Grandfathered Trusts

## **Reg. §26.2601-1(b)(4)**

The following will not cause a grandfathered trust to lose its GST exemption:

- (A) Exercise of discretionary powers
- (B) A court-approved settlement of a bona fide issue regarding trust administration or construction
- (C) A judicial construction to resolve an ambiguity or correct a scrivener's error
- (D) A modification that does not shift a beneficial interest to a lower generation beneficiary and does not extend the time for vesting



# Effect of Amendments to Trusts With Zero Inclusion Ratios

No guidance has been issued concerning modifications that may affect the status of trusts that are exempt from GST tax because sufficient GST exemption has been allocated to the trusts to result in an inclusion ratio of zero. At a minimum, a modification that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status of such a trust.

PLR 201418001

# Gifts by NRAs

## **GST Tax on Gifts by Non-Resident Aliens §26.2663-2(b)(2)**

(1)DIRECT SKIPS – Chapter 13 applies to a direct skip to the extent that the transfer of property by a NRA transferor was subject to the Federal estate or gift tax within the meaning of §26.2652- 1(a)(2).

Note: NRAs are not subject to gift tax on gifts of intangible personal property.

# Trusts Created by NRAs

## **GST Tax on Gifts by Non-Resident Aliens §26.2663-2(b)(2)**

### **(2) TAXABLE DISTRIBUTIONS AND TAXABLE TERMINATIONS.**

Chapter 13 applies to a taxable distribution or a taxable termination to the extent that the initial transfer of property to the trust by a NRA transferor, whether during life or at death, was subject to the Federal estate or gift tax within the meaning of section 26.2652- 1(a)(2).

The GST tax applies whether or not the skip person is a U.S. person.