IV. FEDERAL GENERATION-SKIPPING TRANSFER TAX

A. Introduction

The generation-skipping transfer ("GST") tax is imposed on transfers to an individual who is two or more generations below the transferor (*e.g.*, a grandchild or more remote descendant) and certain trusts. The GST tax is one of the three federal transfer taxes, and was enacted to close a loophole in the transfer tax system. Prior to the enactment of the GST tax, after paying one transfer tax, an individual could pass property in trust through several generations free of any transfer tax. This loophole resulted from the fact that the estate tax does not apply to life estates created by others, and both the estate tax and the gift tax generally do not apply to trust distributions. By approximating the transfer taxes that would have been due if the trust property had been transferred at each generation level, the GST tax essentially closes the loophole.

The GST tax is imposed in addition to the estate tax and the gift tax. Unlike the progressive estate and gift tax rates, the GST tax rate is a flat rate equal to the maximum federal estate tax rate (45% before January 1, 2010, and 55% after December 31, 2010), making it an extremely expensive tax. Nevertheless, a practitioner can effectively reduce or even eliminate a client's GST tax liability through the effective use of exemptions and exclusions that are available to a client.

This Chapter discusses the following issues related to the GST tax:

- Determining generation assignment.
- Types of generation-skipping transfers.
- GST exemption and exclusions.
- Valuation for GST tax purposes.
- Calculation of GST tax.
- Rules for allocating GST exemption.
- Severance of trusts with inclusion ratios greater than zero.
- Related transfer tax provisions.
- Benefits of GST tax planning.

B. Some GST Terminology

1. Transferor and Transferee

Generally, the GST tax is imposed on transfers by a "transferor" to a "skip person." For transfers subject to estate tax, the "transferor," for GST tax purposes, is the decedent. For transfers subject to gift tax, the "transferor," for the GST tax purposes, is the donor. Internal Revenue Code ("IRC") § 2652(a). The "transferee," on the other hand, is the recipient of a transfer of property by the transferor.

2. Skip Person and Non-Skip Person

Every individual or trust can be categorized as a skip person or a non-skip person. A "skip person" is (a) an individual assigned to a generation two or more generations below the transferor, or (b) a trust in which all interests are held by skip persons or a trust in which no person holds an interest and from which no distribution may be made to a non-skip person. A "non-skip person" is any individual (or trust) who is not a skip person. IRC § 2613.

> **EXAMPLE:** T gives $50,000 to each of T's daughter, D, and T's grandson, G. For GST tax purposes, T is the transferor. With respect to T, D is a non-skip person because D is only 1 generation below T. G, however, is a skip person because G is 2 generations below T. Accordingly, T's transfer to G is a GST subject to the GST tax.

C. Determining Generation Assignment

All generation assignments are determined with respect to the transferor's generation. The rules for determining generation assignment are set forth in IRC § 2651, and depend upon the relationship between the transferor and the transferee.

1. Generation Assignment for Relatives

a. "Relatives". Generally, the rules regarding generation assignment for a transferor's relatives apply to transfers to: (1) the transferor's spouse or former spouse; (2) the lineal descendants (and their spouses and former spouses) of the transferor's grandparents; and (3) the lineal descendants (and their spouses and former spouses) of the transferor's spouse's grandparents. Accordingly, relatives as remotely related as first cousins and their descendants.

b. Spouse or Former Spouse. A present or former spouse of the transferor is assigned the same generation as the transferor. IRC § 2651(c)(1). This rule applies even if there is a substantial age difference between the spouses.

> **EXAMPLE:** T, age 85, gives $50,000 to T's wife, W who is age 25. Because T and W are deemed to be in the same generation, W is a non-skip person. T's gift is not subject to GST tax.

c. Descendant of Transferor's Grandparent. Generation assignment for relatives is based on family lines. A transferee who is a lineal descendant of a grandparent of the transferor is assigned to a generation by comparing: (1) the number of generations between the recipient and the grandparent; with (2) the number of generations between the transferor and the grandparent. IRC § 2651(b)(1). Accordingly, a transferor is at the same generation level as his or her siblings; one generation above his or her children, nieces and nephews; and two generations above his or her grandchildren, grandnephews and grandnieces.

> **EXAMPLE:** T gives $50,000 to each of T's sister, daughter, niece, granddaughter and grandniece. Only T's transfers to T's granddaughter and grandniece are transfers subject to GST tax because those individuals are skip persons (*i.e.*, two generations below T).

d. **Spouse (or Former Spouse) of Descendant of Transferor's Grandparent**. A spouse (or former spouse) of a descendant of a grandparent of the transferor is assigned the same generation as that descendant (again, regardless of substantial age differences between the decedent and his or her spouse). IRC § 2651(c)(2).

> **EXAMPLE:** At T's death, T's will leaves $50,000 to his great-grandchild, G who is age 25, and $50,000 to G's husband, H who is age 85. G is three generations removed from T. H is deemed to be at the same generation level as G (three generations removed from T). Accordingly, T's bequests to G and H are both GSTs.

e. **Descendant of Grandparent of Transferor's Spouse**. The same general rule for descendants of the transferor applies to descendants of the transferor's spouse. IRC § 2651(b)(2). This rule is intended to apply to step-relatives. Therefore, a transferor is at the same generation level as the transferor's spouse; one generation above the spouse's children, nieces and nephews (the transferor's stepchildren, stepnieces and stepnephews); and two generations above the spouse's grandchildren, grandnephews and grandnieces (the transferor's stepgrandchildren, stepgrandnephews and stepgrandnieces).

> **EXAMPLE:** T, age 85, and W, age 25, are married. B is W's child from a prior marriage. B has one child, C. T gives $25,000 to each of B and C. For GST tax purposes, B is T's stepchild and is 1 generation below T. C is T's stepgrandchild and is 2 generations below T. Accordingly, only T's gift to C is a GST.

f. **Spouse (or Former Spouse) of Descendant of Grandparent of Transferor's Spouse**. A spouse or former spouse of a descendant of a grandparent of the transferor's spouse is assigned the same generation as that descendant. IRC § 2651(c)(2).

> **EXAMPLE:** T, age 90, gives $50,000 to his stepchild, S, age 30, and $30,000 to S's wife, W, age 20. S is 1 generation removed from T. W is deemed to be at the same generation level as S (1 generation below T). S and W are both non-skip persons. Accordingly, no GST has occurred.

g. **Adoption/Half-Blood**. A relationship by legal adoption or by half-blood is treated the same as a whole-blood relationship. IRC § 2651(b)(3).

> **EXAMPLE:** T has a half-brother, B, who adopted C. For GST tax purposes, T and B are deemed to be whole-blooded brothers, and are deemed to be at the same generation level. For GST tax purposes, C is deemed to be T's nephew, and is deemed to be 1 generation below T.

h. **Special Rule for Individuals Assigned to More Than One Generation**. An individual that can be assigned to more than one generation under the above rules is assigned to the younger generation. IRC § 2651(f)(1); Treas. Reg. § 26.2651-2,-3.

> **EXAMPLE:** T was previously married to W1 but is now married to

W2. C is the child of T and W1. D is W2's child from a prior marriage. E is D's child. C and E marry. In this situation, E could be assigned to two different generations: E could be assigned to 2 generations below T because E is T's stepgrandchild, and E could be assigned to 1 generation below T because E is married to T's child, C. IRC § 2651(f)(1) resolves the conflict so that E is deemed to be 2 generations below T.

The adoption of an individual who is a descendant of a parent, spouse or former spouse of the adoptive parent will move the individual to a generation that is one generation below that of the adoptive parent for purposes of determining whether transfers from certain individuals to the adopted individual are subject to GST tax if the following requirements are satisfied:

- The individual is legally adopted by the adoptive parent.
- The individual is a descendant of a parent of the adoptive parent (or the adoptive parent's spouse of former spouse).
- The individual is under the age of 18 at the time of the adoption.
- The individual is not adopted primarily for GST tax-avoidance purposes.

Treas. Reg. § 26.2651-2.

EXAMPLE: T adopts T's minor grandchild, G, and transfers $100,000 to G. In the absence of the adoption, G would be assigned to 2 generations below T because G is T's grandchild. However, because of the adoption, G will be deemed to be 1 generation below T as long as T can prove that G was not adopted primarily for GST tax- avoidance purposes.

i. **Predeceased Ancestor Exception**. The predeceased ancestor exception acts to move up a transferee's generation assignment. IRC § 2651(e); Treas. Reg. § 26.2651- 1(a).

(1) **General Rule**. Specifically, under the predeceased ancestor exception, the transferee is treated as if he or she were a member of the generation which is one generation below the lower of: (a) the transferor's generation or (b) the generation assignment of the youngest living ancestor of the transferee who is also a descendant of a parent of the transferor (or the transferor's spouse or former spouse).

EXAMPLE: T gives $20,000 to T's grandchild, G. At the time of the gift, C (T's son and G's father) is deceased. G is moved up 1 generation so that G is treated as being 1 generation below T instead of 2. Accordingly, T's gift to G is not a GST subject to GST tax.

(2) **Requirements**. The predeceased ancestor exception applies only if the following requirements are met:

- With the exception below for certain collateral heirs, the transferee must be a descendant of a parent of the transferor, the transferor's spouse or the transferor's former spouse.

- The transferee's parent who is a descendant of the parent of the transferor (or the transferor's spouse or former spouse) must be deceased at the time the transfer is or was subject to gift tax or estate tax upon the transferor.
- The trust must not have made a reverse QTIP election under IRC § 2652. The predeceased ancestor rule is not needed in this situation because the transferor's GST exemption is usually allocated to the trust. Treas. Reg. § 26.2651-1(a)(3).

This exception also affects other generation assignments. When an individual's generation assignment is adjusted under this exception, a corresponding adjustment is made to the generation assignment of that individual's spouse, former spouse, descendants and the descendants' spouses or former spouses. IRC § 2651(e)(1); Treas. Reg. § 26.2651-1(a)(2)(i).

(3) **Exception For Certain Collateral Heirs**. The predeceased ancestor exception applies to an individual who is not a lineal descendant of the transferor, the transferor's spouse or the transferor's former spouse only if the transferor has no living descendants at the time of the transfer. IRC § 2651(e)(2); Treas. Reg. § 26.2651-1(b).

> **EXAMPLE:** T's nephew, N, is deceased. T gives $50,000 to N's son, G (T's grandnephew). At the date of the gift, T has one living descendant, a granddaughter. The predeceased ancestor exception does not apply to this transfer because T has one living descendant. Accordingly, G is a skip person with respect to T, and T's gift to G is treated as a GST. If T had no living descendants at the date of the gift, the predeceased ancestor exception would apply, G would be treated as 1 generation below T, and T's gift would not be subject to GST taxes.

(4) **Exception for QTIP Trusts**. The regulations provide an exception for remainder interests in trusts for which an election has been made under IRC § 2056, the qualified terminable interest property ("QTIP") election. The remainder beneficiary's interest is deemed established upon the death of the transferor's spouse (the income beneficiary), rather than upon the transferor's earlier death. Without this exception, a remainder beneficiary of a QTIP trust would not benefit from the predeceased ancestor exception in the event the remainder beneficiary's parent were alive when the QTIP was established but deceased when the income beneficiary's interest terminated. Treas. Reg. § 26.2651-1(a)(3).

(5) **Drafting For Predeceased Ancestor Exception**. The proposed regulations provide that a living descendant who dies no later than 90 days after a testamentary transfer is treated as having predeceased the decedent to the extent that either the governing instrument or applicable local law provides that such individual will be treated as predeceasing the decedent. Treas. Reg. § 26.2651-1(a)(2)(iii).

➔ **Planning Point:** Wills and trusts should include a provision that takes advantage of this rule.

2. Generation Assignment for Nonrelatives

a. **"Nonrelatives"**. Generally, the rules regarding generation assignment for nonrelatives apply to transfers to: (1) individuals outside of the transferor's family lines; and (2) individuals more remotely related to the transferor than first cousins and their descendants.

b. **Age Comparison**. Generation assignment for nonrelatives is determined based on the difference in age compared to the transferor. IRC § 2651(d).

(1) **12½ Years Younger or Less**. An individual who is 12½ years younger or less than the transferor is treated as being in the same generation as the transferor.

> **EXAMPLE:** T gives $50,000 to T's doorman, D, who is 5 years younger than T. D is treated as being in the same generation as T, and T's gift to D is not subject to GST taxes.

(2) **More Than 12½ Years Younger But Not More Than 37½ Years Younger**. An individual who is more than 12½ years younger but not more than 37½ years younger than the transferor is treated as being one generation below the transferor.

> **EXAMPLE:** T's will leaves $50,000 to T's friend, F, who is 20 years younger than T. F is treated as being 1 generation below T, and T's bequest to F is not subject to GST taxes.

(3) **More Than 37½ Years Younger**. An individual who is more than 37½ years younger than the transferor is treated as being more than one generation below the transferor and is, thus, a skip person for purposes of applying the GST tax rules.

> **EXAMPLE:** T's will leaves $50,000 to T's second cousin, C, who is 40 years younger than T. C is treated as being 2 generations below T, and T's bequest to F is subject to GST taxes.

3. Generation Assignment for Trusts

a. **Look-Through Rule**. An individual with a beneficial interest in a trust is assigned to a generation under the foregoing rules regarding generation assignment. IRC § 2651(f).

> **EXAMPLE:** T creates a trust for the lifetime benefit of T's grandchild, G. G is deemed to be 2 generations below T.

b. **Trust as a Skip Person**. A trust may be a skip person under two circumstances:

(1) **All Interests Held By Skip Persons**. A trust may be a skip person if all interests in the trust are held by skip persons. IRC § 2613(a)(2)(A). A person generally has an "interest" in a trust if he or she: (a) has a present right to receive trust principal or income; or (b) is a permissible current recipient of trust principal or income.

> **EXAMPLE:** T creates a trust for the lifetime benefit of T's grandson, G. At G's death, the trust remainder will be distributed to G's children. The trust qualifies as a skip person because all current interests in the trust are held by skip persons.

(2) No Person Holds Interest and No Distribution to Non-Skip Person. A trust may also be a skip person if: (a) no person holds an interest in the trust; and (b) at no time after the transfer may a distribution be made to a non-skip person. IRC § 2613(a)(2)(B).

> **EXAMPLE:** T creates a trust for the benefit of T's grandson, G. Income of the trust will accumulate until distributed to G at age 21 (or to G's estate if G dies prior to age 21). The trust is a skip person because no person has an interest in the trust, and no distribution can be made to a non-skip person under the trust terms.

D. Types of Generation-Skipping Transfers

1. Generally

There are three types of generation-skipping transfers subject to GST tax: (a) a direct skip; (b) a taxable termination; and (c) a taxable distribution. Categorizing a generation-skipping transfer is important because the type of transfer will determine the amount subject to GST tax and who is responsible for paying the GST tax.

TYPE OF TRANSFER	TAXABLE AMOUNT	LIABILITY FOR PAYMENT OF TAX	TAX EXCLUSIVE v. INCLUSIVE
Direct Skip (not from trust)	Value of property received by transferee	Transferor	Tax Exclusive
Direct Skip (from trust)	Value of property received by transferee	Trustee	Tax Inclusive
Taxable Termination	Value of entire trust property, less any deduction for certain expenses, indebtedness and taxes	Trustee	Tax Inclusive
Taxable Distribution	Value of the trust property distributed to the skip person, less any deduction for certain expenses incurred by the transferee related to the determination, collection or refund of the GST tax	Transferee	Tax Inclusive

2. Direct Skip

A "direct skip" is a transfer to a skip person that is subject to estate tax or gift tax. IRC § 2612(c).

> **EXAMPLE:** T gives $100,000 to each of T's son, T's grandson and an irrevocable gift trust for the lifetime benefit of T's granddaughter (remainder to the children of T's granddaughter). The transfer to T's son is not a direct skip because T's son is not a skip person. The transfers to T's grandson and the trust for T's granddaughter are direct skips.

a. Taxable Amount. The taxable amount of a direct skip is the value of the property received by the transferee. IRC § 2623.

> **EXAMPLE:** In the above example, the taxable amount of T's gift to T's grandson for GST tax purposes is $100,000.

b. Liability for GST Tax. The transferor is responsible for paying the GST tax on a direct skip (other than a direct skip from a trust). The trustee, however, is responsible for paying the GST tax on a direct skip from a trust. IRC § 2603(a).

c. Tax Exclusive v. Tax Inclusive. A direct skip (other than a direct skip from a trust) is tax exclusive. That is, the GST tax paid on such a direct skip is paid only on the transferred property and not the dollars used to pay the GST taxes. A direct skip from a trust, however, is tax inclusive because the GST tax is imposed on the dollars used to pay the tax.

3. Taxable Termination

A "taxable termination" is a termination (by death, lapse of time, release of power, or otherwise) of an interest held in trust, unless: (a) immediately after the termination, a non-skip person has an interest in the trust property; or (b) at or after the termination, no distribution may be made to a skip person. IRC § 2612(a).

> **EXAMPLE:** T creates a trust for the lifetime benefit of T's nephew, N. At N's death, the remainder of the trust is to be distributed to N's children. N's death is deemed to be a taxable termination of the trust. If the remainder of the trust were to be distributed to T's niece instead of N's children, N's death would not be a taxable termination because T's niece, a non-skip person, would receive an interest in the trust property.

a. Taxable Amount. The taxable amount of a taxable termination is the value of the entire trust property, less any deduction for certain expenses, indebtedness and taxes. IRC § 2622.

b. Liability for GST Tax. The trustee is responsible for paying the GST tax on a taxable termination. IRC § 2603(a)(2).

c. **Tax Inclusive**. A taxable termination is tax inclusive. That is, the GST tax paid on a taxable termination is paid on the transferred property and on the money used to pay the GST taxes.

4. Taxable Distribution

A "taxable distribution" is a distribution of income or principal from a trust to a skip person that is not a direct skip or a taxable termination. IRC § 2612(b). Distributions that are qualified transfers for medical expenses or tuition expenses under IRC § 2503(e) are not taxable transfers for GST purposes.

> **EXAMPLE:** T gives $100,000 to an irrevocable trust for the benefit of T's niece, N, and N's children. The trust is a non-skip person since N is a non-skip person and has an interest in the trust. T's transfer to the trust is not a direct skip. When distributions are made from the trust for the benefit of N's children, however, the distributions will be taxable distributions.

a. **Taxable Amount**. The taxable amount of a taxable distribution is the value of the trust property distributed to the skip person, less any deduction for certain expenses incurred by the transferee related to the determination, collection or refund of the GST tax. IRC § 2621(a). If the trustee pays any of the tax out of trust assets, the payment will be treated as an additional taxable distribution subject to GST tax. IRC § 2621(b).

b. **Liability for GST Tax**. The transferee is responsible for paying the GST tax on a taxable distribution. IRC § 2603(a)(1).

c. **Tax Inclusive**. A taxable distribution is tax inclusive. Because the transferee is liable for the GST tax, the transferee essentially is paying the GST tax out of the distributed property.

E. GST Exemption and Exclusions

1. GST Exemption

Every individual is entitled to a GST exemption which the individual (or the individual's executor) can allocate to any generation-skipping transfer with respect to which the individual is the transferor. IRC § 2631(a). The GST exemption amount is a lifetime amount. It is cumulative and does not renew annually (except to the extent the GST exemption amount increases by law).

> **EXAMPLE:** In 2003, T gives $1,120,000 to T's grandson, G. T allocates his entire GST exemption to the transfer so no GST tax is due. In 2009, T gives $2,380,000 to G. T can allocate T's remaining $2,380,000 GST exemption ($3,500,000 less $1,120,000 used exemption) to T's gift in 2009.

2. GST Tax Exclusion for Annual Exclusion Gifts

a. **Generally**. The gift tax annual exclusion under IRC § 2503(b) permits an individual to give an amount equal to the annual exclusion ($13,000 in 2009 and 2010) per donee without incurring any gift tax liability, provided that the gift is of a present interest. A "present interest" is an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain). A direct skip that qualifies for the gift tax annual exclusion under IRC § 2503(b) is excluded from GST tax under IRC § 2642. If the transfer is in trust, however, additional requirements must be met to qualify for the GST tax exclusion.

b. **Outright Gifts**. An outright gift to a skip person qualifies for the annual exclusion for both gift tax and GST tax purposes because it is a direct skip (a transfer to a skip person subject to gift tax) and because it qualifies as a present interest under IRC § 2503(b).

➔ **Planning Point:** A planned giving program that takes advantage of these exclusions can significantly reduce an individual's total transfer tax liability without using up any portion of the individual's GST exemption or applicable credit amount.

> **EXAMPLE:** T gives $10,000 a year in cash to each of T's 8 grandchildren for each of the 15 years before T's death. None of these gifts were subject to gift tax or GST tax because of the annual exclusion, T did not use up any of T's applicable credit amount or GST exemption by these gifts, and T effectively removed $1,200,000 from T's estate. Any income from or appreciation on the transferred assets is also removed from T's estate.

c. **Gifts in Trust**. In order for a transfer in trust to qualify for the annual exclusion for GST tax purposes, (1) the transfer must be a direct skip, (2) the trust must meet the requirements of the gift tax annual exclusion under IRC § 2503(b), and (3) the trust must meet the additional requirements imposed by IRC § 2642(c).

(1) **Direct Skip**. A transfer in trust must be a direct skip (*i.e.*, a transfer to a skip person subject to gift tax) to qualify for the annual exclusion for GST tax purposes.

(a) **Trust as Skip Person**. As discussed earlier, a trust is a skip person if: (1) all interests in the trust are held by skip persons; or (2) if no person holds an interest in the trust and at no time after the transfer may a distribution be made to a non-skip person.

(b) **Crummey Powers**. Granting a Crummey power of withdrawal to a skip person does not by itself make the transfer in trust a direct skip. A Crummey power of withdrawal is often given to a trust beneficiary to qualify a transfer to a trust for the gift tax annual exclusion. The trust beneficiary essentially is given the power to withdraw property contributed to the trust not exceeding the annual exclusion amount for a finite period of time (*e.g.*, 30 days). A transfer to a trust subject to a beneficiary's right of withdrawal is treated as a transfer to the trust, not to the beneficiary.

(2) **Annual Exclusion Requirement**. The transfer in trust must be a transfer of a present interest in property in order to qualify for the annual exclusion for both gift and GST tax purposes. A transfer in trust generally does not qualify as a present interest. There are ways, however, to qualify a transfer in trust for the present interest requirement:

(a) **IRC § 2503(c) Minor's Trust**. IRC § 2503(c) provides a statutory exception to the present interest requirement for certain trusts created for the benefit of a minor. Transfers to such a trust will qualify for the annual exclusion for gift and GST tax purposes.

(b) **Crummey Trust**. A trust beneficiary can be given a Crummey right to withdraw an amount up to the annual exclusion amount. Such a right will qualify the transfer for the annual exclusion for gift tax and GST tax purposes.

(3) **IRC § 2642(c) Requirements**. A transfer in trust will qualify for the annual exclusion for GST tax purposes if: (a) no part of the trust income or principal may be distributed to or for any person other than the skip person-beneficiary; and (b) the trust assets must be included in the skip person-beneficiary's gross estate if the skip person-beneficiary dies before the trust terminates. IRC § 2642(c).

➔ **Planning Point:** In order for the trust assets to be included in the skip person-beneficiary's estate, a general power of appointment usually is given to the beneficiary. To qualify for the annual exclusion for GST purposes, the trust must be created for the benefit of one beneficiary (or segregated into separate trusts if there are multiple beneficiaries).

3. GST Tax Exclusion for Education Expenses and Medical Expenses

IRC § 2503(e)(1) excludes from gift tax certain "qualified transfers." "Qualified transfers" include amounts paid by a donor to a qualifying educational institution or a medical provider on behalf of an individual for tuition expenses or medical care. A transfer that qualifies for this exclusion for gift tax purposes is excluded from GST tax under IRC § 2642.

➔ **Planning Point:** This exclusion is especially valuable for grandparents because their payments of a grandchild's tuition and medical expenses are: (a) unlimited in amount; (b) free of gift tax; (c) free of GST tax; and (d) remove significant amounts from their estates. In addition, the grandparents control the use of the gifts by making payments directly to the educational institution or medical provider.

a. **Unlimited Exclusion Amount**. The amount of the exclusion for such tuition and medical care expenses is unlimited. The exclusion is in addition to the gift tax annual exclusion.

b. **Payments Must Be Direct**. Payments of tuition expenses must be made *directly* to the educational institution to qualify for the exclusion. Similarly, payments of medical expenses must be made *directly* to the medical care provider to qualify for the exclusion.

EXAMPLE: T gives $20,000 to T's child, C, to pay for tuition at

Private University. T’s gift does not qualify for the exclusion for gift tax purposes or GST tax purposes because T paid C instead of paying Private University directly.

c. **Qualifying Educational Institution and Qualifying Education Expenses**. A “qualifying educational institution” is one that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where the educational activities are regularly carried on. Only tuition expenses qualif for the exclusion for education expenses. Expenses for books, supplies, dormitory fees, board, or other similar expenses do not qualify for the exclusion.

d. **Qualifying Medical Expenses**. “Qualifying medical expenses” include expenses incurred for the diagnosis, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure or function of the body or for transportation primarily for and essential to medical care. In addition, amounts paid for medical insurance qualify. The exclusion does not apply, however, with respect to any amounts reimbursed by medical insurance.

F. Valuation for GST Tax Purposes

1. General Rule

Generally, a transfer is subject to GST tax based on its fair market value on the date of generation-skipping transfer. IRC § 2624(a).

2. Value of Direct Skip Property Included in Transferor’s Gross Estate

The value of direct skip property included in a transferor’s gross estate reflects the alternate valuation or special use valuation under IRC §§ 2032 and 2032A. IRC § 2624(b).

3. Taxable Terminations Occurring At Death

If a taxable termination occurs because of the death of an individual, an alternate valuation election can be made to value the taxable termination on the alternate valuation date. IRC § 2624(c).

4. Reduction For Consideration Provided by Transferee

The value of property transferred is reduced by the amount of any consideration provided by the transferee. IRC § 2624(d).

G. Calculation of GST Tax

1. Nature

Like the estate tax and the gift tax, the GST tax is an excise tax on the transfer of property. The GST tax is a tax on a transferor’s privilege of being able to transfer property to a skip person.

2. Calculation

IRC § 2602 describes the computation of GST tax liability.

a. **Computation**. In general, GST tax liability is determined by multiplying the taxable amount by the applicable rate.

GST Tax Liability = Taxable Amount x Applicable Rate

(1) **Applicable Fraction**. In general, the "applicable fraction" is determined by dividing the amount of GST exemption allocated by the value of the property transferred, less any federal or state estate taxes paid from the trust property and any charitable deduction allowed. The applicable fraction is rounded to the nearest thousandth. The applicable fraction for a trust is determined when the trust is funded, and continues for the duration of the trust. Additions to a trust, however, may change the applicable fraction.

$$\textit{Applicable Fraction} = \frac{\textit{Amount of GST exemption Allocated}}{\textit{Value of Property Transferred - Any Federal or State Estate Taxes Paid From the Trust Property and Any Charitable Deductions Allowed}}$$

(2) **Inclusion Ratio**. The "inclusion ratio" is determined by subtracting the applicable fraction (rounded to the nearest thousandth) from 1. The inclusion ratio for a trust is determined when the trust is funded, and continues for the duration of the trust. Additions to a trust, however, may change the inclusion ratio.

Inclusion Ratio = 1 - Applicable Fraction

(3) **GST Tax Rate**. The GST tax rate is a flat rate equal to the maximum estate tax rate in effect. The GST tax rate was 45% for 2009. For 2010, the GST tax is repealed, and for 2011, the GST tax rate is scheduled to be 55%.

GST Tax Rate = Maximum Estate Tax Rate

(4) **Applicable Rate**. The "applicable rate" is determined by multiplying the GST tax rate by the inclusion ratio.

Applicable Rate = GST Tax Rate x Inclusion Ratio

(5) **Taxable Amount**. As discussed earlier, the "taxable amount" of a GST transfer depends on the type of transfer.

b. **Examples**. The following are some examples of how the GST tax is computed:

EXAMPLE: On January 5, 2009, T gives $4,000,000 to T's grandchild, G. T has not previously used any of T's GST exemption. T's gift is a direct skip because it is a transfer to a skip person (G) subject to gift tax. The taxable amount of a direct skip is the value of property received by the transferee, $4,000,000. T, as transferor, is responsible for paying the GST tax on the direct skip. T's GST tax liability is calculated as follows.

Applicable Fraction = $3,500,000/$4,000,000 = .875
Inclusion Ratio = 1 - .875 = .125
Applicable Rate = 45% x .125 = .05625
Tax = $4,000,000 x ..05625 = $225,000

➔ **Planning Point:** Since the applicable fraction and the inclusion ratio of a trust are determined at the time the trust is funded, if the transferor allocates GST exemption to the trust, the transferred property and any appreciation of the property in trust will be sheltered from GST tax.

EXAMPLE: T transfers $700,000 to a trust for the lifetime benefit of T's child, C. At C's death, the remainder is to be distributed to T's grandchild, G. T allocated GST exemption ($700,000) to T's transfer to the trust. C dies in 2009 when the trust property is worth $3,500,000. At C's death, a taxable termination occurs. The taxable amount of the taxable termination is $3,500,000 (the value of the trust property, assuming no deduction for expenses). The trust is responsible for paying the GST tax on the direct skip. The trust's GST tax liability is calculated as follows.

Applicable Fraction = $700,000/$700,000= 1
Inclusion Ratio = 1 - 1 = 0
Applicable Rate = 45% x 0 = 0
Tax = $3,500,000 x 0 = $0

H. Rules For Allocating GST Exemption

1. General Rule

Generally, every individual (or the individual's executor) can allocate the individual's GST exemption to any GST with respect to which the individual is a transferor. IRC § 2631(a).

EXAMPLE: On January 5, 2009, T gives $500,000 to a trust for the sole benefit of T's grandchild, G. T has previously used $200,000 of T's GST exemption. T can allocate $500,000 of T's $3,300,000 unused GST exemption ($3,500,000, less $200,000) to the transfer so that no GST tax is due.

a. **Time and Manner of Allocation.** GST exemption can be allocated at any time from the transfer date through the date for filing the individual's estate tax return (including extensions). GST exemption can be allocated on a Federal Gift (and Generation-Skipping Transfer) Tax Return (Form 709) or on a Federal Estate (and Generation-Skipping Transfer) Tax Return (Form 706).

b. **Timely Allocation v. Late Allocation**. Whether an allocation is timely or late will determine the effective date of allocation and the amount of GST exemption allocated.

(1) **Timely Allocation**. If the allocation is made on a timely filed return (including applicable extensions), the amount of GST exemption allocated relates back to the value of the transferred property as of the date of gift. An allocation made on a timely filed return can be modified up to the due date of the return. Treas. Reg. § 26.2632-1(b)(2). The Internal Revenue Service ("IRS") has been generous in allowing late allocations of GST exemption to be considered as having been made timely under Treas. Reg. § 301.9100.

(2) **Late Allocation**. If the allocation is made on a late filed return, however, the amount of GST exemption allocated is based on the value of the transferred property as of the date of allocation (the date the return was filed) unless the transferor elects the special valuation rule for such late lifetime allocations.

> **EXAMPLE:** On January 5, 2009, T gave $500,000 to a trust for the sole benefit of T's grandchild, G. If T timely files a gift tax return on or before April 15, 2010 (assuming no extensions) when the trust property is worth $600,000, T need only allocate $500,000 of GST exemption to the transfer. If T files a late return on October 10, 2010 when the trust property is worth $700,000, T must allocate $700,000 of GST exemption to make the inclusion ratio zero.

(a) **Special Valuation Rule for Late Lifetime Allocations**. Under the special valuation rule, if a transferor makes a late allocation, the transferor can, solely for purposes of determining the value of the trust assets, elect to treat the allocation as having been made on the first day of the month during which the late allocation is made (the "valuation date"). The election is not available, however, for a life insurance policy or a trust holding a life insurance policy. The transferor may make the election on Form 709 on which the allocation is made, and must state that the election is being made, the applicable valuation date and the fair market value of the trust assets on the valuation date. The election is effective when it is actually filed with the IRS. Treas. Reg. § 26.2642-2(a)(2).

(b) **Late Allocation Irrevocable**. A late allocation, once made, is irrevocable. Treas. Reg. § 26.2632-1(b)(2).

2. Deemed (Automatic) Allocation Rules

The deemed allocation rules are automatic rules that apply if an individual does not affirmatively allocate GST exemption to a transfer.

a. **Deemed Allocation to Certain Lifetime Direct Skips**. If an individual makes a direct skip during his or her lifetime, any unused portion of the individual's GST exemption is automatically allocated to the property transferred to the extent necessary to make the inclusion ratio zero (nontaxable for GST tax purposes) unless: (1) the individual elects out of this automatic allocation on a timely filed Form 709; or (2) the direct skip is to a trust with one skip person-beneficiary. IRC § 2632(b).

EXAMPLE: On January 5, 2009, T gives $500,000 to T's grandchild, G. T has previously used $200,000 of T's GST exemption. If T does not allocate GST exemption to this transfer, $500,000 of T's $3,300,000 unused GST exemption ($3,500,000 - $200,000) will be automatically allocated to the transfer unless T opts out of the allocation on a timely filed Form 709.

(1) **Election Out of Automatic Allocation**. An individual can elect out of this automatic allocation on a timely filed Form 709. Form 709 is timely filed if it is filed on or before April 15 of the year following the calendar year in which the transfer was made (including any extensions actually granted). If no such election is made by the filing due date, the automatic allocation under IRC § 2632(b) becomes irrevocable. Treas. Reg. § 26.2632- 1(b)(1)(ii).

(2) **Direct Skip to Trust With One Skip Person-Beneficiary**. As discussed earlier, under IRC § 2642(c)(2), the inclusion ratio is zero for a direct skip to a trust with only one skip person-beneficiary, if the trust property will be included in the beneficiary's estate. Since the inclusion ratio of such a trust is already zero, no automatic allocation of GST exemption is made to such a direct skip.

b. **Deemed Allocation to Certain Lifetime Transfers to GST Trusts**. IRC § 2632(c), effective for transfers made after December 31, 2000, which provides that if an individual makes an "indirect skip" during his or her lifetime, any unused portion of the individual's GST exemption is automatically allocated to the property transferred to the extent necessary to make the inclusion ratio zero (nontaxable for GST tax purposes) unless the individual elects out of this automatic allocation on a timely filed Form 709. IRC § 2632(c)(1) and (c)(5).

(1) **Indirect Skip**. An "indirect skip" is a transfer of property (other than a direct skip) to a GST trust if that transfer is subject to gift tax.

(2) **GST Trust**. A "GST trust" is a trust that could have a generation-skipping transfer except a trust where one of the characteristics listed below is true. Each of the following non-GST trusts involve situations where a non-skip person is likely to receive the trust property:

- 25% of the trust principal must be distributed to or may be withdrawn by one or more non-skip person(s): (a) before the non-skip person turns 46; (b) on or before one or more dates specified in the trust instrument that will occur before the non-skip person turns 46; or (c) on the occurrence of an event that may reasonably be expected to occur before the non-skip person turns 46.

EXAMPLE: T creates a trust for T's child, C. C can withdraw one-half of the trust property at age 40, and the balance at age 50. This trust is not a GST trust because C, a non-skip person, can withdraw more than 25% of the trust property before age 46 (one-half at age 40). Accordingly, no automatic allocation of GST exemption will be made.

- More than 25% of the trust principal must be distributed to or may be withdrawn by one or more non-skip person(s) who are living on the death of a person identified in the trust instrument who is more than 10 years older than the non-skip person.

  EXAMPLE: T creates a trust for T's child, C. At T's death, one-half of the trust property will be distributed to C. This trust is not a GST trust because more than 25% of the trust property (one-half) will be distributed to C, a non-skip person, on T's death (T, as C's parent, is more 10 years older than C). Accordingly, no automatic allocation of GST exemption will be made.

- If one or more non-skip person(s) die on or before a date described in the two paragraphs above, more than 25% of the trust principal must be distributed to the estate(s) of such non-skip person(s) or is subject to a general power of appointment exercisable by one or more of such non- skip person(s).
- The trust is includible in the gross estate of the non-skip person (other than the transferor) if such person died immediately after the transfer.

  EXAMPLE: T creates a trust for T's child, C. C has a testamentary general power of appointment over the trust property. The trust is not a GST trust because C's general power of appointment causes the trust to be included in the estate of C, a non-skip person. Accordingly, no automatic allocation of GST exemption will be made.

- The trust is a charitable lead annuity trust, charitable remainder annuity trust or charitable remainder unitrust.
- The trust is a charitable lead unitrust required to pay principal to a non- skip person if the non-skip person is alive at the end of the term.

For purposes of determining whether a trust is a "GST trust," the value of transferred property is considered not to be includible in the gross estate of a non-skip person or subject to a right of withdrawal by reason of such person's holding a right to withdraw an amount that does not exceed the IRC § 2503(b) annual exclusion amount ($13,000 for 2010).

EXAMPLE: T creates an irrevocable life insurance trust where T's children, A and B, each have a noncumulative annual right to withdraw an amount not to exceed the gift tax annual exclusion amount. This is a GST trust. GST exemption will be automatically allocated to the trust. The withdrawal right is not sufficient to make it a non-GST trust under one of the above exceptions.

➔ **Planning Point:** There is a possibility that if a client does nothing, a portion of the client's GST exemption might be allocated to a trust even though the trust is not intended to be generation-skipping, resulting in wasted GST exemption. In order to avoid this result, practitioners should advise clients to opt out of the automatic allocation rules (discussed below) by attaching a statement to a timely filed federal gift tax return (Form 709), regardless of whether the client otherwise needs to file a gift tax return.

➔ **Planning Point:** Determining whether a trust is a GST trust or non-GST trust under these rules is difficult. Accordingly, practitioners who draft trust instruments may wish to indicate whether the trust is a GST trust either in separate memorandum or in the document itself.

(3) **Elections**. An individual can elect out of automatic allocation of GST exemption (and affirmatively choose the amount, if any, to be allocated to a particular transfer) in the following situations:

- With respect to one or more prior year transfers that are still subject to an estate tax inclusion period ("ETIP"), which is discussed below;
- With respect to one or more (or all) current-year transfers to a specified trust or trusts;
- With respect to one or more (or all) future-year transfers to a specified trust or trusts;
- With respect to all transfers made by the transferor to all trusts (whether or not in existence at the time of the election out); and
- Any combination of the foregoing.

Treas. Reg. § 26.2632-1(b)(2)(iii).

The election out can be made by attaching an "election out statement" to a timely filed Form 709. Form 709 is timely filed if it is filed on or before April 15 of the year following the calendar year in which the transfer was made (including any extensions actually granted). IRC § 2632(c)(5). Once the filing deadline has passed, the operation of the automatic allocation rules cannot be reversed (unless Treas. Reg. § 301.9100 relief is granted by the IRS, discussed below). An election out applies only to the transfers described in the election, and does not apply to prior-year transfers (except with regard to prior-year transfers subject to the ETIP). These rules apply even if no return is otherwise required for the transfer. With regard to transfers subject to an ETIP, only until the passing of the due date of the return for the year in which the ETIP closes is the election out irrevocable. Treas. Reg. § 26.2632-1(b)(2).

➔ **Planning Point:** The regulations provide sample language for electing out of the automatic allocation rules. Treas. Reg. § 26.2632-1(b)(4)(iv), Ex. 1.

A transferor may also "elect in" to the automatic allocation provisions by making and filing an election to treat any trust as a GST trust. This election may be made on a timely-filed return and may apply to: (a) any or all current-year transfers to the trust; (b) any selected future- year transfers by the transferor to the trust; (c) all future transfers to the trust; or (d) any combination of (a)-(c). Treas. Reg. § 26.2632-1(b)(3).

A transferor may terminate an election made on a Form 709 for a prior year, to the extent that election applied to future transfers or to a transfer subject to the ETIP.

An election in or out may be terminated, and the operation of the automatic allocation rules may be overridden, for a particular transfer or series of transfers by a timely-filed amended gift tax return. Treas. Reg. § 26.2632-1(b)(2)(iii) and (b)(3)(iv).

c. **Deemed Allocation to Transfers at Death**. Generally, any unused portion of a deceased individual's GST exemption is automatically allocated first to direct skips at death and then to trusts with respect to which a taxable termination may occur or from which a taxable distribution may be made. Treas. Reg. § 26.2632-1(d)(2).

> **EXAMPLE:** At T's death in 2009, $750,000 is to be distributed to T's grandchild, G, and $450,000 is to be distributed to a trust for the benefit of T's child, C, and G. T previously used $800,000 of T's GST exemption, leaving $2,700,000 of unused GST exemption ($3,500,000 - $800,000). $750,000 of T's unused GST exemption will first be automatically allocated to the direct skip to G, and $450,000 of T's unused GST exemption will then be automatically allocated to the transfer to the trust.

3. Retroactive Allocation

IRC § 2632(d) provides as follows:

a. **Generally**. For the death of a non-skip person that occurs after December 31, 2000, a transferor may retroactively allocate his or her unused GST exemption to any previous transfer or transfers to a trust on a chronological basis if:

- A non-skip person has an interest or a future interest in a trust to which any transfer has been made;
- Such non-skip person (a) is a lineal descendant of a grandparent of the transferor or of a grandparent of the transferor's spouse or former spouse; and (b) is assigned to a generation below the transferor, and
- Such non-skip person predeceased the transferor.

b. **Retroactive Allocation Made in Calendar Year in Which Non-Skip Person's Death Occurs**. If the transferor's retroactive allocation is made on a timely filed gift tax return (if the gift occurred in the same calendar year as the non-skip person's death), then:

- The value of such transfer(s) for purposes of IRC § 2642(a) is determined as if the allocation had been made on a timely filed gift tax return for each calendar year within which each transfer was made;
- The allocation will be effective immediately before the non-skip person's death, and
- The amount of the transferor's unused GST exemption that is available for allocation is determined immediately before the non-skip person's death.

4. Estate Tax Inclusion Period (ETIP) Rules

The GST exemption cannot be allocated to a lifetime gift during the period (estate tax inclusion period or "ETIP") the gift would be included in the transferor's or transferor's spouse's estate (other than by reason of IRC § 2035) if the transferor died. IRC § 2642(f).

> **EXAMPLE:** T transfers $1,000,000 to a trust. Income of the trust is payable to T for 10 years, at which time the remainder is to be distributed to T's grandchild, G. A taxable termination would occur at the end of the 10-year period. T cannot, however, allocate GST exemption to the trust until after the 10-year ETIP because the trust property would be includible in T's estate under IRC § 2036 if T died during that period.

a. Exceptions. There are exceptions to this general rule:

(1) Less Than 5% Probability of Being Included in Gross Estate. The value of transferred property is not considered as being subject to inclusion 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. A possibility is so remote as to be negligible if it can be ascertained by actuarial standards that there is less than a 5% probability that the property will be included in the gross estate.

(2) Crummey Exception. The value of transferred property is not considered as being subject to inclusion in the gross estate of the transferor or the transferor's spouse if the spouse possesses with respect to any transfer to the trust a right to withdraw no more than the greater of 5% or $5,000 of the trust corpus, and the withdrawal right terminates no later than 60 days after the transfer to the trust.

b. ETIP. The ETIP terminates on the first to occur of the following:

- The transferor's death;
- The time at which no portion of the property is includible in the transferor's gross estate (other than by reason of IRC § 2035) or, in the case of an individual who is a transferor solely by reason of the gift-splitting election of IRC § 2513, the time at which no portion would be includible in the gross estate of the individual's spouse (other than by reason of IRC § 2035);
- The time of a GST; or
- For an ETIP arising by reason of an interest or power held by the transferor's spouse, at 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).

c. Effective Date of Allocation. An allocation of GST exemption to property subject to an ETIP that is made prior to termination of the ETIP cannot be revoked, but becomes effective on the termination date of the ETIP. An allocation of GST exemption on a gift tax return filed by the due date (if the ETIP termination were a taxable gift) is effective as of the ETIP termination date. An allocation of GST exemption after the due date of the gift tax return is effective as of the earlier of the date the gift tax return is filed or the date of the transferor's death.

> **EXAMPLE:** T transfers $1,000,000 to a trust on January 1, 1999. Income of the trust is payable to T for 10 years, at which time the remainder is to be distributed to T's grandchild, G. The ETIP is the 10-year period after the transfer, and terminates on January 1, 2009. If T allocates GST exemption prior to January 1, 2009, the allocation is irrevocable and does not become effective until January 1, 2009. If T allocates GST exemption on a gift tax return filed on or before April 15, 2010 (assuming no extensions), the allocation is effective as of January 1, 2009. If T allocates GST exemption on a late gift tax return filed on November 1, 2010, the allocation is effective as of November 1, 2010 (assuming T is still alive).

d. **Valuation**. Whether the property is includible in the transferor's gross estate will determine the value of the ETIP property and the amount of GST exemption that must be allocated. IRC § 2642(f)(2).

(1) **ETIP Property Includible in Transferor's Estate**. The value of ETIP property that is includible in the transferor's estate is its value for federal estate tax purposes.

(2) **ETIP Property Not Includible in Transferor's Estate**. The value of ETIP property that is not includible in the transferor's estate is its value at the termination date of the ETIP if the allocation is timely made (or its value on the date of allocation if the allocation is late).

5. Relief For Late Elections and Substantial Compliance

a. **Relief for Late Elections**. IRC § 2642(g)(1) grants an extension of time under certain circumstances to (1) make an allocation of GST exemption under IRC § 2642(b)(1); or (2) to elect out of automatic allocation rules for direct skips under IRC § 2632(b)(3) or indirect skips under IRC § 2632(c)(5). The relief for late elections applies for requests pending on or filed after December 31, 2000. The Regulations, yet to be promulgated, will describe the circumstances and procedure to obtain such relief.

➔ **Planning Point:** Treas. Reg. § 301.9100 relief is currently available for extensions of time to allocate GST exemption and elect out of automatic allocation of GST exemption. Notice 2001-50, 2001-34 I.R.B. 189. Until the IRS issues Regulations under IRC § 2642(g)(1), practitioners may wish to apply to the IRS for an extension of time under the procedures described in Treas. Reg. § 301.9100, and indicate that the extension request is being made under both IRC §§ 2642(g) and Treas. Reg. § 301.9100.

b. **Substantial Compliance**. An allocation of GST exemption under IRC § 2632 that shows an intent to have the lowest possible inclusion ratio with respect to a transfer to a trust will be deemed an allocation of so much of the transferor's unused GST exemption as produces the lowest possible inclusion ratio. The relief for substantial compliance applies to transfers subject to estate tax or gift tax made after December 31, 2000. IRC § 2642(g)(2).

➔ **Planning Point:** Evidence of intent to have the lowest possible inclusion ratio might include contemporaneous letters to or from advisors and transferors and indications on relevant federal gift tax returns or federal estate tax returns.

I. Severance of Trust With Inclusion Ratio Greater Than Zero

1. Background

A single trust with an inclusion ratio of between zero and one is not as desirable for tax purposes as two separate trusts with inclusion ratios of zero and one, respectively. A single trust with an inclusion ratio of between zero and one wastes GST exemption. A distribution from such a trust to a non-skip person would generate GST tax that would not otherwise be due if non- exempt assets were distributed to the non-skip person. In addition, a distribution to a skip person would still generate some GST tax that would not otherwise be due if the inclusion ratio were zero. Instead, a trust with an inclusion ratio of zero and a separate trust with an inclusion ratio of one would optimize the tax benefit of the GST exemption. The trust with an inclusion ratio of zero could be used to provide for skip person/beneficiaries, and the trust with an inclusion ratio of one could be used to provide for non-skip person/beneficiaries.

EXAMPLE: At T's death in 2009, after taxes, T's estate has $6,000,000. Through lifetime taxable gifts, T has lowered his unified credit to $1,000,000. T still has his full $3,500,000 GST exemption. T creates at death a credit shelter trust for the benefit of T's spouse, W, and T's descendants ($1,000,000), and a marital trust for the lifetime benefit of W ($5,000,000). Both trusts will be held for the benefit of T's descendants after W's death. $1,000,000 of T's GST exemption is allocated to the credit shelter trust, and the balance, $2,500,000, is allocated to the marital trust. Accordingly, the credit shelter trust is wholly exempt from GST tax because its applicable fraction is 1 ($1,000,000 allocated exemption divided by $1,000,000 trust property), and its inclusion ratio is zero. The marital trust is only partially exempt from GST tax because its applicable fraction is .5 ($2,500,000 allocated exemption divided by $5,000,000 trust property), and its inclusion ratio is .5. If W, a non-skip person, receives a trust distribution from the marital trust, some GST tax would be due, which wastes GST exemption. A better way to fund the trusts to maximize the use of GST exemption would have been to split the marital trust into a non-exempt marital trust ($2,500,000) and an exempt marital trust ($2,500,000) and to allocate the balance of T's GST exemption ($2,500,000) to the exempt marital trust. Then, the exempt marital trust would be wholly exempt from GST tax because its applicable fraction would be 1 ($2,500,000 allocated exemption divided by $2,500,000 trust property), and its inclusion ratio would be zero. The non-exempt marital trust would not to any extent be exempt from GST tax because its applicable fraction would be zero ($0 allocated exemption divided by $2,500,000 trust property), and its inclusion ratio would be 1. Now, W, a non-skip person, could receive principal distributions out of the non-exempt trust without there being any resulting waste of GST exemption.

2. Severance of Trusts for GST Purposes

After GST exemption has been allocated to an existing trust, the trust generally cannot be severed to create two separate trusts with inclusion ratios of zero and one, unless one of the exceptions below applies. IRC § 2654(b). Accordingly, separate trusts generally should be established for GST tax purposes before GST exemption is allocated.

➔ **Planning Point:** Practitioners should be careful that boilerplate language in the trust instrument does not inadvertently provide that a trust with an inclusion ratio of zero be combined with or added to a trust with an inclusion ratio of one.

a. **Separate Share Exception**. Substantially separate and independent shares of different beneficiaries in a trust will be treated as separate trusts for GST purposes. The shares must exist at all times from and after the creation of the trust. IRC § 2654(b)(2); Treas. Reg. § 26.2654-1(a).

b. **Multiple Transferor Exception**. Portions of a trust attributable to transfers from different transferors will be treated as separate trusts for GST purposes. The regulations provide rules on the treatment of additions to and distributions from such trusts. IRC § 2654(b)(1); Treas. Reg. § 26.2654-1(a)(2).

EXAMPLE: T gives $1,000,000 to a trust for T's descendants and allocates GST exemption to the trust so that the inclusion ratio is zero. When the trust property is worth $1,500,000, A transfers $3,000,000 to the trust but allocates no GST exemption to the transfer. The trust will be treated as two separate trusts for GST tax purposes: one-third will be attributable to T and have an inclusion ratio of zero, and the other two-thirds will be attributable to A and have an inclusion ratio of one.

c. **Exception for Qualified Severance Allowed**. IRC § 2642(a)(3) deems certain severances that occur after December 31, 2000 as qualified severances. If a trust is severed in a qualified severance, the two resulting trusts will be treated as separate for GST tax purposes. Regulations finalized in 2007 provide additional guidance regarding qualified severances. T.D. 9348, August 2, 2007. Under Treas. Reg. § 26.2642-6(a), the trusts resulting from a qualified severance (the "resulting trusts") may have an inclusion ratio that differs from the inclusion ratio of the original trust. Furthermore, certain actions such as the allocation of GST exemption to one resulting trust, a GST tax election made with respect to one resulting trust or the occurrence of a taxable distribution or termination with regard to a particular resulting trust will not have any GST tax impact on any other trust resulting from that severance.

(1) **"Qualified Severance" Defined**. A severance of a single trust (other than a division of a trust described in Treas. Reg. § 26.2654-1(b), discussed below) will be considered a qualified severance under IRC § 2642(a)(3) if: (a) it is divided on a fractional basis; and (b) the terms of the resulting trusts, in the aggregate, provide for the same succession of interests of beneficiaries as the original trust. The final regulations, under Treas. Reg. § 26.2642-6(d), provide the following additional requirements:

- The division is into two or more separate trusts pursuant to the terms of the trust instrument, or pursuant to applicable law;
- The severance is effective under local law;
- The appropriate date of severance is chosen, which is the effective date of the qualified severance and is either the date selected by the trustee as of which the trust assets are to be valued in order to determine the funding of the resulting trusts, or the court-imposed date of funding in the case of an order of the local court with jurisdiction over the trust ordering the trustee to fund the resulting trusts on or as of a specific date. For a date to be considered as the date of severance, the funding must be commenced immediately upon, and funding must occur within a reasonable time (but in no event more than 90 days) after, the selected valuation date.
- The original trust is severed on a fractional basis, such that each resulting trust is funded with a fraction or percentage of the original trust (not necessarily a pro rata portion of each and every asset held by the original trust), and the sum of those fractions or percentages is one or 100%, respectively (thus, a severance of a trust based on a pecuniary amount does not satisfy this requirement);

The final regulations provide examples illustrating the application of these requirements. Treas. Reg. § 26.2642-6(j).

With respect to trusts from which discretionary distributions may be made to any one or more beneficiaries, the requirement that the resulting trusts provide for the same succession of interests of beneficiaries as are provided in the original trust is met if:

- The terms of each resulting trust are the same as the terms of the original trust (even though each permissible distributee of the original trust is not a beneficiary of all of the resulting trusts);
- Each beneficiary's interest in the resulting trusts (collectively) equals the beneficiary's interest in the original trust, determined by the terms of the trust instrument or, if not, on a per capita basis;
- The severance does not shift a beneficial interest in the trust to any beneficiary in a lower generation (as determined under IRC § 2651) than the person or persons who held the beneficial interests in the original trust;
- The severance does not extend the time for the vesting of any beneficial interest in the trust beyond the period provided for in (or applicable to) the original trust.

This rule is intended to allow for the severance of trusts along family lines, which can be accomplished through a series of severances. For example, if two families are beneficiaries of one trust, the original trust may be severed first based on the inclusion ratio. Then, each resulting trust may be divided along family lines.

(2) **No Recognition Under IRC § 1001.** The final regulations also state that a qualified severance will not trigger gain or loss for income tax purposes under IRC § 1001 if the trustee is authorized under a state statute or the trust instrument to sever the trust and fund the resulting trusts on a non-pro rata basis (that is, without transferring a pro rata portion of each asset to each resulting trust). Treas. Reg. § 1.1001-1(h)(1)(i)-(ii). If IRC § 1001 does not apply, then, under IRC § 1015, the basis of the trust assets will be the same after the severance as before. Under IRC § 1223, the holding periods of the assets distributed to the resulting trusts will include the holding period of the assets in the original trust.

(3) **IRC § 2642(a)(3) and Treas. Reg. § 26.2654-1(b)**. Treas. Reg. § 26.2654-1(b) provides for the recognition of severances of separate shares of trusts and of discretionary severances that, although not provided for in the trust instrument, are necessary fully to utilize available tax benefits, such as the reverse QTIP election under IRC § 2652(a)(3). As explained in the Preamble to the 2007 final regulations, the difference between severances under Treas. Reg. § 26.2654-1(b) and under IRC § 2642(a)(3) is that the former applies to severances of testamentary trusts and revocable *inter vivos* trusts included in the transferor's gross estate, and such a severance is effective retroactively to the date of death, while the latter applies to severances that are effective prospectively from the date of severance and address severances that typically would occur after an irrevocable trust (whether *inter vivos* or testamentary) has been in existence for a period of time, regardless of whether the trust assets are includible in the transferor's gross estate).

(4) **Trusts With Inclusion Ratio Between Zero and One**. Under IRC § 2642(a)(3)(B)(iii) and Treas. Reg. § 26.2642-6(d)(7), in the case of a qualified severance occurring after GST exemption has been allocated to the trust (whether by affirmative allocation, a deemed allocation, or an automatic allocation pursuant to the rules contained in IRC § 2632) and the trust has an inclusion ratio that is greater than zero and less than one, the trust must be severed initially into two trusts, one with an inclusion ratio of zero and the other with an inclusion ratio of one.

> **EXAMPLE:** T gives $2,000,000 to a trust for T's descendants and allocates $500,000 of GST exemption to the trust so that the applicable fraction is 1/4 and the inclusion ratio is 3/4. A severance of the trust when the property is worth $4,000,000 will be qualified if the trustee severs the trust so that one trust receives a 1/4 fractional share of the trust property with an inclusion ratio of zero, and the other trust receives the balance of the property with an inclusion ratio of one.

An additional type of qualified severance is allowed under Treas. Reg. § 26.2642-6(d)(7)(iii). A trust with an inclusion ratio between zero and one may be severed in a qualified severance into more than two resulting trusts. One or more of the resulting trusts in the aggregate must receive that fractional share of the total value of the original trust as of the date of severance that is equal to the applicable fraction used to determine the inclusion ratio of the original trust immediately before the severance. The trust or trusts receiving such fractional share shall have an inclusion ratio of zero, and each of the other resulting trust or trusts shall have an inclusion ratio of one. The trustee may designate the beneficiary of each separate resulting trust, provided that the designation results in each beneficiary having the same beneficial interest (within the meaning of Treas. Reg. § 26.2642-6(d)(5)) after the severance as that beneficiary had in the original trust principal. See Treas. Reg. § 26.2642-6(j), Ex. 9.

(5) **Timing and Reporting of Severance**. A qualified severance can be made at any time before the termination of the trust. Taxpayers are not required to report a severance for it to be considered a qualified severance. The IRS adds, however, that "each severance should be reported to ensure that the provisions of Chapter 13 of the Code may be properly applied with regard to the trusts."

A qualified severance may be reported by filing a Form 706-GS(T), "Generation- Skipping Transfer Tax Return for Terminations," with the words "Qualified Severance" at the top of the form and a Notice of Qualified Severance attached. Treas. Reg. § 26.2642-6(e)(1).

J. Related Transfer Tax Provisions

1. Payment of GST Tax on Direct Skip Treated as Gift

With respect to a taxable gift that is a direct skip, the amount of the gift is increased by the amount of any GST tax on the transfer paid by the transferor. IRC § 2515.

> **EXAMPLE:** On January 5, 2009, T gives $4,000,000 to T's grandchild, G. T has not previously used any of T's GST exemption. T's gift is a direct skip because it is a transfer to a skip person, G, subject to gift tax. T's GST tax liability is $225,000. The gift tax is imposed on $4,000,000 plus the $225,000 GST tax paid for a total taxable gift of $4,225,000. Assuming a gift tax rate of 45%, the gift tax is $1,782,050. Total taxes for the transfer of $4,000,000 are $2,007,050.

2. Related Income Tax Provisions

There are several income tax provisions related to the GST tax:

a. **Income Tax Deduction For GST Taxes Paid on Income Distributions**. IRC § 164(a)(4) grants an income tax deduction for GST taxes paid on income distributions. The deductible amount is the GST tax plus any state GST tax described in IRC § 2604. IRC § 164(b)(4)(A). If the GST tax is paid on or before the due date, it is treated as being paid on the last day of the taxable year in which the transfer was made. IRC § 164(b)(4)(B).

b. **Income in Respect of a Decedent**. With respect to a taxable termination or a direct skip as a result of the death of the transferor, IRC § 691(c)(3) allows an income tax deduction for that portion of the GST taxes attributable to items of gross income of the trust which were not properly includible in the gross income of the trust for periods before the due date of such termination.

c. Basis Adjustment for GST Tax Purposes.

(1) Basis Adjustment Generally. The basis of property transferred in a generation-skipping transfer is increased (but not above fair market value) by the GST tax that is attributable to the excess of the fair market value of the property over its adjusted basis immediately before transfer. The basis adjustment for GST tax is made after the basis adjustment under IRC § 1015. IRC § 2654(a)(1).

(2) Taxable Terminations At Death. The basis of property transferred in a taxable termination which occurs at the same time as and as a result of the death of an individual is adjusted in a manner similar to the adjustment in IRC § 1014(a) (*i.e.*, the basis is the federal estate tax value of the property), except that if the inclusion ratio is less than 1, any increase or decrease in basis will be limited by multiplying the increase or decrease by the inclusion ratio. IRC § 2654(a)(2).

> **EXAMPLE:** At T's death, T gave $3,500,000 to a trust for the lifetime benefit of T's child, C. At C's death, the trust will be held for the benefit of T's children. T's executor allocated $1,750,000 of T's GST exemption to the trust. Therefore, the trust's inclusion ratio is 50% (1 - $1,750,000/$3,500,000). At C's death, the basis of the trust property was $3,500,000, and the fair market value of the trust property was $5,500,000. The basis increase is $2,000,000 ($5,500,000 - $3,500,000), but this increase is limited by multiplying the increase ($2,000,000) by the inclusion ratio (.5), resulting in a basis increase of $1,000,000.

K. Benefits of GST Tax Planning

1. Leveraging GST Tax Exclusions During Life

As discussed earlier, a planned giving program that takes advantage of the gift tax and GST tax exclusions can significantly reduce an individual's total transfer tax liability. Such transfers do not generate any gift tax or GST tax, do not use up the transferor's GST exemption or applicable credit amount, or remove the transferred property (and any post-transfer income from and appreciation) from the transferor's estate. The exclusions for tuition expenses and medical expenses are especially valuable since there is no limitation on the amounts that can be excluded for gift and GST tax purposes.

2. Leveraging GST exemption During Life

The GST exemption allows an individual to transfer a significant amount of property without incurring any GST tax. A transferor's lifetime use of his or her GST exemption removes the transferred property (and any post-transfer income from and appreciation) from the transferor's estate.

➔ **Planning Point:** Clients who wish to make lifetime gifts using his or her

GST exemption should consider giving property likely to appreciate or generate significant income.

> **EXAMPLE:** On January 1, 2009, T gives $1,100,000 to T's grandchild, G. No GST tax is due because $1,100,000 of T's GST exemption is allocated to the gift. Assuming the $1,100,000 grows to $4,000,000 at T's death four years later, not only has T removed the initial gift of $1,100,000 from his estate, T has also removed the appreciation ($2,900,000) from his estate. In addition, by T's lifetime gift, G has received more than G would have received if T had left $1,100,000 to G at T's death.

3. Dynasty Trusts

An even more effective use of an individual's GST exemption is to allocate GST exemption to a dynasty trust for the benefit of multiple generations. A dynasty trust is designed to perpetuate for the maximum period of time permitted under applicable law. States differ with respect to the maximum allowable period. In some states, the common law rule against perpetuities allows the trust to exist for a period of time measured by lives in being at the creation of the trust, plus 21 years. Other states have abolished the rule against perpetuities or allowed a trust to opt out of the application of the rule against perpetuities, allowing a trust to exist perpetually.

Even if the estate tax and the GST tax are repealed, dynasty trusts will still be useful. A dynasty trust can be used to benefit multiple generations without gift tax.

> **EXAMPLE:** After T's death, T wants to pass down $5,000,000 to T's son, then to T's grandson, and then to T's great-grandson. If the property is left outright at each generation, the $5,000,000 would be subject to estate tax at each generation before reaching T's great-grandson, reducing the amount left to T's great-grandson to only $625,000.

EVENT	TRANSFER TAX PAID (ASSUME 50% RATE)	PROPERTY LEFT FOR NEXT GENERATION
T's death	$2,500,000	$2,500,000
T's son's death	$1,250,000	$1,250,000
T's grandson's death	$625,000	$625,000

> If T had instead established a dynasty trust for the lifetime benefit of T's son and grandson with the remainder passing to T's great- grandson, only one transfer tax would be paid when T created the trust, and T's great-grandson would receive $2,500,000 (plus any appreciation of or income thereon and less any amounts distributed for T's son and grandson).

EVENT	TRANSFER TAX PAID (ASSUME 50% RATE)	PROPERTY LEFT FOR NEXT GENERATION
T’s death	$2,500,000	$2,500,000
T’s son’s death	$0	$2,500,000
T’s grandson’s death	$0	$2,500,000