Back to Basics:

The Role of Generation Skipping Transfer Taxes in Everyday Estate Planning

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I. Introduction

The generation-skipping transfer (GST) tax is an enigma to many tax professionals. For most of our clients, the GST tax is both of little consequence yet always present. In many ways, it is a "stealth" tax that arises where it was unintended by both the taxpayer and the taxpayer's adviser.

While the GST tax can arise in a number of situations, let's keep perspective here. The IRS recently posted on its website a statistical summary of estate tax returns filed in 2008. The summary lists 38,373 estate tax returns filed in 2008 reporting $24.9 billion in net estate tax. Of that number, only 197 returns reported a GST tax due (that is 0.5%) totaling $104 million (0.04% of the net estate tax paid). Only 207 gift tax returns were filed in 2008 reporting a GST tax due - a total of $38.5 million (out of 257,500 federal gift tax returns filed in that year). This is not to say that other returns did not show GSTs (the transfers may have been covered by the GST exemption). Still, while the GST tax can loom over every estate, especially larger estates, the tax itself is a very minor part of the federal transfer tax system.

The purpose of this presentation is not to make all of us GST experts. There are many GST tax issues, especially regarding the use of the GST exemption automatic and elective allocations, how to make late allocations, and procedures for granting such extensions, that are beyond the scope of this basic overview. Instead, our goal here is to allow the average estate planner to spot GST tax issues and navigate accordingly, even when the planner's goal is to avoid a GST altogether. For most of us, sailing into GST waters will rarely occur, and when it does, it often will be an unintended incursion.

The original GST tax was enacted in 1976, but it was a cumbersome and complicated tax. A generation-skipping transfer was defined as one which split the enjoyment and ownership of property between generations. The first generation, the children, had a life interest in the property. The second generation, usually grandchildren, received fee simple ownership at the death of the children. Prior to 1976, this arrangement resulted in estate tax on the property to the transferor and the ultimate recipients, but not the intermediate generation that enjoyed a life interest. Complex rules were designed to tax the termination of the life estate at the same estate tax rate which would have been applicable had the property been transferred outright by the donor and then by the holder of the life estate. This made it difficult for tax preparers, since they had to know (or guess) the size of the deemed transferor's estate to determine the tax rate.

Ten years later, the GST system as we know it today (Chapter 13 of the Internal Revenue Code (Sections 2601-2664)) was created, repealing the existing generation-skipping transfer tax retroactive to June 11, 1976, and applying to all GSTs (as defined in IRC 2611(a)) made after October 22, 1986. Instead of a graduated tax, based on estate tax rates, the new GST tax had a flat rate set at the highest estate tax rate in effect at the time. The tax was applicable to all GSTs, including both property interests that the next generation enjoyed for life (but which were not taxable to that generation) and property

interests that directly skipped to the generations below without that first generation enjoying any beneficial interest.

Compared to the estate tax (enacted in 1916), the GST tax is still a young, and sometimes troublesome, relative. Final regulations for Chapter 13 were not even issued until December 27, 1995. Furthermore, changes to the GST tax enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) meant to make the tax more "user friendly" have in many cases confused practitioners even further.

II. GST Basics

To understand the GST tax system, you must first understand the trinity of the GST system: (1) who is a transferor for GST purposes, (2) is the transferee a skip person, and (3) what are the transfers to a skip person that can trigger the GST tax?

a. Transferor

The transferor is the starting point to decide if a transfer is a GST, since the fundamental question is the generational relationship of the transferor and the transferee. If the gap between the transferor and the transferee is two generations or more, the transfer is a GST.

The transferor is the person who has disposed of property (either directly or through a trust) by a transfer that is either subject to gift or estate tax. (IRC 2652). If a transferor splits the gift with a spouse, each spouse is a transferor as to half of the transfer (IRC 2652(a)(2)). Furthermore, if a person has a taxable power of appointment over property, exercising, releasing or letting the power lapse will make the holder of the power the transferor for GST purposes. (IRC 2652(a)). Finally, if a gift is made to a spouse that qualifies for the marital deduction (either outright, or in a marital trust under Section 2056(b)), the transferor is the donor spouse when he or she passes the property on. This result, however, can be reversed by the donor spouse in the case of a gift to a QTIP trust by making a special election under Section 2652(a)(3).

Therefore, if a grandfather makes a gift to his grandson, he is the transferor. If the grandfather makes the gift to a trust, first for the benefit of his son, then for the benefit of his son's children, and the son has no taxable power over the trust (like a general power of appointment), the transferor is the grandfather. If the son had a general power, however, thus including the trust assets in the son's estate for estate tax purposes, the son, and not the grandfather, is the transferor.

b. Skip Persons and Non-Skip Persons

Every GST transfer also needs a skip person. A skip person is (1) a natural person who is assigned to a generation that is two or more generations below the generational assignment of the transferor, or (2) a trust, the interests of which are held only by skip persons, or, if there is no person holding an interest in such trust, a trust that at no time may make a distribution to a non-skip person (IRC 2613(a)). A non-skip person is anyone other than a skip person. If there in no skip person transferee, there is no GST. To determine the skip person, you first must assign everyone to a generation.

i. Generation Assignment

Generation assignment starts with the transferor, who is assigned to a generation (IRC 2651). All other persons in the world are then measured accordingly:

> Transferor's Generation: Transferor, his or her spouse, siblings (whole, half, adopted and in-laws) and their spouses, and first cousins and their spouses. Also, anyone who has a similar relation to the transferor's spouse is assigned to the transferor's generation. Finally, anyone not related to the transferor by blood, adoption or marriage that is not more than 12.5 years older or younger than the transferor.
>
> One Generation Below Transferor: Children of transferor and their spouses, nephews and nieces of transferor, first cousins once removed (children of first cousins) and their spouses, and unrelated persons who are more than 12.5 years but not more than 37.5 years younger than the transferor.
>
> Two Generations Below Transferor: Grandchildren of transferor and the grandchildren's spouses, grandnephews and grandnieces of the transferor and the spouses of them, grandchildren of first cousins and the spouses of them, and unrelated persons who are more than 37.5 years but not more than 62.5 years younger than the transferor.

Therefore, persons put in the last category (two generations below transferor) generally would be skip persons for GST purposes (but see the predeceased ancestor rule).

As you can see, there are underlying rules here. First, to determine a generation, do a family tree and draw horizontal lines – you will find this helps. Second, spouses are assigned to the same generation, regardless of any age difference between them (IRC 2651(b)(2)). This also means that those persons related to the transferor's spouse are also assigned to generations they would have been assigned to if directly related to the transferor. Finally, for persons unrelated to the transferor or the transferor's spouse, generation assignment is in 25-year intervals (IRC 2651(d)).

ii. Predeceased Ancestor Rule

What happens if one of the persons in the family has died before the transfer has occurred? For example, a man leaves his estate at his death to his two children in shares of equal value, per stirpes. His will states that if one of his children should die before he dies, that child's share will pass to the grandchildren by that child. At the man's death, there would be a transfer from grandfather to grandchildren (children of the deceased child), but the grandchildren are not skip persons. Why?

The answer lies in the predeceased ancestor rule of Section 2651(e). If an ancestor is deceased at the time of a transfer, the succeeding generations are bumped up a generation for purposes of determining whether or not there has been a GST. This rule only applies to deceased persons one or more generations lower than the taxpayer. The rule also applies to grandnieces and grandnephews, who are bumped up a generation if a parent (nephew or niece of the transferor) predeceases the transferor, but only if the transferor does not have any living descendants of his or her own.

The death of a parent of the transferor is not relevant, since the GST tax is a tax on transfers to skip persons two or more generations below that of the transferor; therefore, the gap between these generations does not change unless there is a death in an intermediate generation.

This rule is absolute and does not require an intention to leave property to the deceased person. Therefore, if the taxpayer in our previous example bypassed children in any event, leaving them nothing but leaving everything to the grandchildren, at his death the transfers to the children of the deceased child would still not be GSTs, but the transfers to the children of the living child would be GSTs.

Note that the predeceased ancestor rule applies only if the ancestor died before, and not after, the transfer occurred. In the example above, if the decedent sets up a trust for the benefit of children and grandchildren, the death of a child beneficiary after the trust is established does not cause a generation bump up for grandchildren beneficiaries of the same trust.

TIP: Consider the predeceased ancestor rule if your client wants to create one trust to benefit all the client's grandchildren. If there is a predeceased child of the client (who is also the parent of some but not all of the grandchildren), those grandchildren move up a generation, and transfers to them are not GSTs. Therefore, creating one trust for all the grandchildren will waste GST exemption (the trust will have skip and non-skip persons, even though it benefits grandchildren), so the trusts should be segregated in the estate plan.

c. Taxable Transfers

Once you've identified the skip persons to the transferor, the next question is what types of interests are being conveyed that could end up in the hands of the skip persons. Transfers that can be subject to GST tax come in three types: (i) direct skips, (ii) taxable terminations and (iii) taxable distributions. Categorizing the type of transfer is vital in determining when the GST tax will be assessed and against whom.

i. Direct Skips

A direct skip is a transfer to a skip person that is subject to estate or gift tax. (IRC 2612(c)). An inheritance by a grandchild from his maternal grandfather whose mother (the deceased's daughter) is still living is a direct skip. Furthermore, if the grandfather left the inheritance in trust for that grandchild only, that would also be a direct skip, as a transfer to a trust where all current beneficiaries are skip persons is also a direct skip.

A transfer that skips two or more generations is treated as a single skip. (Treas. Reg. 26.2612-1(a)(1), 26.2612-1(f), Ex. 2). Therefore, gifts to great grandchildren (outright or in a trust where all current beneficiaries are skip persons) where the grandchildren and children are still living is treated as one direct skip, and not as one transfer to the grandchildren and a second to the great grandchildren.

> TIP: The problem of direct skips does not come up so much in the context of a gift to a grandchild. When clients want to make gifts to grandchildren or great grandchildren with living parents, they understand that such transfers are GSTs and normally don't make sizable gifts. Difficulty and surprise arises when clients make gifts to neighbors, servants or friends. Remember that anyone not related to the client who is 37.5 years or more younger than the client is a skip person. For clients in their 90s or even past 100, especially those with few or no relatives, this rule means that a good many of the people they have come to know and are close to are skip persons for GST tax purposes, so be sure to consider this when planning in this type of situation.

ii. Taxable Terminations

The rules get trickier on taxable terminations and taxable distributions. A taxable termination is a termination of an interest held in trust unless (A) immediately after the termination a non-skip person has an interest in the trust, or (B) at no time after the termination may a distribution be made from the trust to a skip person. (IRC 2612(a)(1)). Taxable terminations generally occur when a property interest in trust enjoyed by a non-skip person beneficiary terminates (either at a set time period or on the death of the non-skip person) and passes to a skip person or persons without the interest being included in the estate of the non-skip person for estate tax purposes.

For example, if a parent leaves property in trust for her son during his life (income and principal distributed to him as needed by an ascertainable standard), and at the son's death, the property in trust passes to the son's children, the son's death is a taxable termination. The creation and funding of the trust is not itself subject to GST tax, since conceivably the son could use all the property in trust for his care and support.

If the interests of two or more beneficiaries from different generations terminate, only one taxable termination will have occurred.

TIP: <u>As a rule of thumb, ask yourself the following question: will this property interest being enjoyed by a person be subject to estate tax at the person's death? If so, generally the GST tax will not apply to the property interest. Always keep in mind that the purpose of the GST tax is to force the imposition of transfer tax at each generation, so if the estate tax applies to a property interest that terminates at death, the GST tax will not.</u>

iii. Taxable Distributions

A taxable distribution occurs when a distribution of income or principal is made by a trust to a skip person, except when the distribution would be defined as a direct skip or a taxable termination. An example is a trust created by a grandmother for her daughter and grandchildren. When the trust pays out income to one of those grandchildren, that payout is a taxable distribution.

iv. What is the Difference?

It is vital to know whether you are dealing with a direct skip, a taxable termination or a taxable distribution, since the type of transfer determines when the tax is owed, who must report the tax and who must pay the tax.

The timing of the tax depends on the type of transfer. GST tax on a direct skip is reported on Form 706 and paid within nine months of death (plus extensions) in the case of testamentary direct skips, and in the year after the year of the gift on Form 709 in the case of lifetime direct skips. GST tax on a taxable termination is reported and paid at the time the termination occurs, and not when the trust is originally created and funded. GST tax on a taxable distribution is reported and paid at the time the distribution occurs, and not when the trust that is making the distribution was originally created and funded.

Finally, keep in mind that direct skips are tax exclusive, that is, the tax is owed on top of the property transferred, while taxable terminations and taxable distributions are tax inclusive, meaning that the GST tax is paid out of the transfers. This, in turn, shifts the tax burden. GST tax on direct skips is paid by the transferor (or the transferor's estate). (IRC 2603(a)(3)). In the case of taxable terminations and taxable distributions, because the GST tax is paid out of the transfers, the tax is paid, indirectly, by the transferee.

In the case of taxable terminations and taxable distributions, the trustee is liable to report and pay the tax. (IRC 2603(a)(1)-(2)).

III. Calculation of the GST Tax

a. GST Tax Formula

The GST tax formula, found in Section 2602 can be summarized as follows:

GST Tax = Taxable Amount x Applicable Rate

The “applicable rate” is also a formula set forth in Section 2641 as follows:

Applicable Rate = Maximum Federal Estate Tax Rate x Inclusion Ratio

Maximum federal estate tax rate is a set number, so the variable is the inclusion ratio. “Inclusion ratio” is a formula as well set forth in Section 2642 as follows:

Inclusion Ratio = 1 – Applicable Fraction

So to do a GST calculation, you must first know the applicable fraction. To know the applicable fraction, however, you must first gain an understanding of the GST exemption and how it is applied to GST transfers.

b. GST Exemption

The GST tax has an exemption, like the estate and gift tax. For many years, that exemption was $1 million, indexed for inflation. The result was a GST exemption greater than the estate tax exemption.

With the enactment of EGTRRA, the GST exemption was lock step with the estate tax exemption, meaning that in 2009, the exemption was $3.5 million. In 2010, as with the federal estate tax, there is no GST tax. Finally, unless Congress acts to make the EGTRRA provisions permanent or otherwise change the law, in 2011 the GST tax will revert to its pre-2001 days, meaning that the exemption will again be $1 million, indexed for inflation (it was $1.1 million before increasing to the estate tax exemption amount).

The GST exemption is used for both lifetime gifts and transfers at death. Like the gift/estate tax exemption, using the GST exemption for lifetime transfers reduces its availability at death on a dollar-for-dollar basis. If a person makes lifetime GST gifts of $500,000, if this person had died in 2009, the amount of GST exemption available would have been $3 million ($3.5 million exemption - $500,000 used during life).

For most of our clients, even if the GST exemption comes back, the sizeable GST exemption means that GSTs will never exceed the lifetime GST exemption, hence the reason why so few estates will ever pay a GST tax.

c. Allocation of GST Exemption

If the estate exceeds $2 million, then the matter of GST exemption allocation comes up. As a general rule, a person can determine which property will be exempt from GST tax (whether at the time of transfer or in the future, if a transfer into trust), by making certain elections. There are also automatic GST exemption allocations that are made to certain transfers, in which case the person would have to elect out of the automatic allocation in order to use that GST exemption elsewhere. Allocations come in two varieties – automatic and elective.

Elective allocations are made by the transferor on a timely filed gift tax return. If the allocation election is not made, no GST exemption is allocated to the gift. Also, once the election is made, it is irrevocable. (IRC 2631(b)).

i. Automatic Allocations

Automatic allocations of GST exemption are deemed to be made to certain types of transfers regardless of whether or not an estate or gift tax return was filed making the election. If the transferor does not want an automatic allocation to be made, the transferor must make an election on a timely filed gift or estate tax return reporting the gift and opting out of the automatic allocation of GST exemption.

A transferor is deemed to have made a GST exemption allocation on all lifetime direct skips subject to gift tax, which again are direct gifts to skip persons and gifts to trusts in which only skip persons are beneficiaries. (IRC 2632(b)(1)). A transferor also is deemed to have made a GST exemption allocation on lifetime indirect skips subject to gift tax (transfers to GST trusts in which skip persons are beneficiaries) as is necessary to make the inclusion ratio 0. (IRC 2632(c)). Section 2632(c) is an addition to the Code from EGTRRA, and final regulations for it have only recently come out. This automatic allocation rule applies to all indirect skips made after December 31, 2000.

A person can opt out of an automatic allocation by filing a statement expressly opting out of the automatic allocation on a gift tax return filed for the year in which the direct or indirect skip took place.

Finally, Section 2632(e) provides for the automatic allocation of unused GST exemption at death, first to testamentary direct skips, then to trusts from which taxable terminations and distributions could occur, either at or after the transferor's death.

> TIP: <u>Section 2632(e) is useful for estates under the estate tax threshold, because generally no estate tax return will be filed for these estates. Therefore, no GST exemption allocation will be made on a return. By having the allocation automatic, GST transfers at death avoid GST tax in the same way that an estate under the tax threshold avoids estate tax, without any additional tax work required. Still, the attorney or accountant might want to put a memo in the file</u>

when there is a testamentary GST gift in a nontaxable estate that the GST exemption allocation was automatic by virtue of Section 2632(e). If the gift was in trust, the trust over time could grow substantially, in which case none of the terminations or distributions in the future will be subject to GST tax.

ii. Elective Allocations

The GST exemption can be allocated by the transferor to any direct skip, taxable termination or taxable distribution during life by election on a gift tax return, and any unused GST exemption can be used by the transferor's representative at death by election on the estate tax return. (IRC 2632(a)). If such an election is made, the notice attached to the gift tax return must clearly state the trust receiving the GST exemption (including the trust FEIN), the amount of exemption being received, and if the allocation is late or the inclusion ratio will be greater than 0, the value of the assets in the trust on the date of the allocation. (Treas. Reg 26.2632-1(b)(4)).

TIP: I have a hard time seeing how an estate representative would make an elective GST allocation, with the Section 2642(e) automatic allocation of unused GST exemption on testamentary GST transfers, unless the will or trust specifically directs the representative to do so. Making an elective allocation different from the automatic allocation could shift the value of transfers. For example, a representative could elect to apply all of the available GST exemption to a GST trust for the benefit of children and grandchildren and none to outright gifts to friends of the decedent who are more than 37.5 years younger than the decedent (with the automatic allocation the direct skips would first get the GST exemption). This would favor the GST trust beneficiaries (whose trust might have been reduced by GST tax upon termination or distributions) at the expense of the estate remaindermen (since the GST tax on testamentary direct skips is paid by the transferor's estate, which reduces the residuary). Would a representative making such an election be breaching the duty of impartiality?

Section 2632(d) allows for the retroactive allocation of the GST exemption in the event of the death of a non-skip beneficiary of the trust prior to the death of the transferor. In that case, GST exemption can be retroactively allocated after the transfer if the deceased non-skip person is a lineal descendant of a grandparent of the transferor (for example, an uncle, aunt or cousin of the transferor). The retroactive allocation must be made on a gift tax return (even though no gift took place) for the year in which the non-skip person died. (IRC 2632(d)(2)).

Allocations can also be made late (i.e. after the gift tax return, plus extensions, for the year in which the gift was made was due) by filing a subsequent gift tax return. Note that for purposes of calculating the amount of allocation to make the transfer exempt from GST tax, the allocation must equal the value of the property at the time of the allocation, and not at the time of the transfer. (Treas. Reg. 26.2642-2(a)(2)).

iii. Correcting GST Exemption Allocation Mistakes - Section 9100 Relief

As you can imagine, the GST exemption allocation rules are handled erroneously all the time. Taxpayers (and their tax professionals) either fail to make an allocation, or fail to make a timely allocation, or fail to opt out of an automatic allocation, or even make a timely allocation, but make mistakes in the election itself.

Fortunately, EGTRRA added Section 2642(g)(1)(A) which allows the IRS to prescribe regulations allowing for an extension of time to allocate GST exemption, and opt out of automatic GST exemption allocation for lifetime direct skips or indirect lifetime gifts. Relief is sought through the issuance of a private letter ruling, so the rules for obtaining a private letter ruling must also be observed (although in certain circumstances the procedure is streamlined) (Rev. Proc. 2004-46, 2004-31 I.R.B. 142).

Whether or not to grant such an extension is for the IRS to decide, but the statute says that the IRS is "to take into account all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Secretary deems relevant." (IRC 2642(g)(1)(B)).

Treasury Regulation 301.9100-3 now provides the standards used by the IRS in determining whether or not to grant this relief. Five circumstances can, if shown, result in a grant of an extension:

1) Application for relief comes prior to discovery by the IRS of the missing election.
2) The election was not made due to circumstances beyond the taxpayer's control.
3) Although the taxpayer exercised reasonable diligence, the taxpayer was still unaware of the necessity for the election.
4) The taxpayer relied on the written advice of the IRS.
5) That taxpayer reasonably relied on a qualified tax professional, and it was the tax professional who made the mistake.

(Treas. Reg. 301-9100-3(b)(1)). The most common circumstance for which relief has been sought the past few years has been the last, that a tax professional made the error. The IRS has stated that there must be reasonableness on the part of the taxpayer, primarily that a reasonable person would believe that the attorney or accountant was competent to deal with GST exemption allocation issues (i.e. relying on the advice of your neighbor who is a criminal defense attorney and does not hold himself out to be a tax or estate planning attorney will probably not result in the granting of relief).

Finally, the IRS will look to see if facts have changed such that the taxpayer is actually trying to use hindsight in seeking relief. If relief is granted, the taxpayer will be allowed to make the election effective as of the time of the transfer.

d. Applicable Fraction

The entire purpose of determining if there is a GST and applying GST exemption to it is to determine the applicable fraction and thus the inclusion ratio for GST tax purposes. The applicable fraction defines what portion of the transferred property interest (whether in trust or outright) is covered by the GST exemption. If the applicable fraction is 1, all of the property is GST tax exempt. If the applicable fraction is 0, none of the property is GST tax exempt. An applicable fraction of between 0 and 1 means some, but not all, of the property will be exempt from GST tax.

The applicable fraction is a fraction, the numerator of which is the amount of GST exemption allocated to the property in question, and the denominator of which is the fair market value of the property. (IRC 2642(a)(2)). So if a grandfather makes a gift of $1 million to his grandson and applies $1 million in GST exemption, the applicable fraction is 1 ($1,000,000/$1,000,000). If, however, our generous grandfather only had $250,000 in GST exemption available, the applicable fraction is 1/4 ($250,000/$1,000,000).

If more than one transfer is made to the same trust, the applicable fraction is recomputed after each transfer. (IRC 2642(d)).

e. Inclusion Ratio

The inclusion ratio is the proportion of the property subject to GST tax and is equal to 1 minus the applicable fraction. Thus, if the applicable fraction is 1/4, the inclusion ratio is 3/4 (1- 1/4). This, in turn, means that a direct skip gift of $1,000,000 with an inclusion ratio of 3/4 will have the GST tax imposed on $750,000 of that gift ($1,000,000 x 3/4).

The inclusion ratio will be applied to every transfer from a GST trust; therefore, if in the preceding example the $1,000,000 gift was placed in a trust for the benefit of grandchildren, should the trustee later pay $10,000 to the grandchild, $7,500 of that gift will be subject to GST tax. You cannot segregate assets and state the distributions are coming from the exempt portion of the trust, but you may be able to establish separate trusts or segregate existing trusts, all as discussed below.

f. Applicable Rate

The "applicable rate" is the product of (i) the maximum federal estate tax rate at the time of the transfer subject to tax and (ii) the inclusion ratio with respect to the transfer. (IRC 2641). The maximum federal estate tax rate is currently 45% and will remain at that rate until 2011, when it returns to 55%, barring Congressional action to make the EGTRRA tax changes permanent. In some cases, this means that the GST tax can be imposed on a transfer that already has paid an estate tax (so the transfer is taxed twice immediately), meaning an effective combined federal tax rate of 69.75%!

g. Taxable Amount

Once you know the applicable rate, you multiply it by the taxable amount, as defined in Sections 2621-23.

i. Taxable Distribution

For taxable distributions, the taxable amount is the value of the property received by the transferee, less expenses incurred by the transferee in connection with the determination, collection or refund of the GST tax imposed on account of the distribution. (IRC 2621).

ii. Taxable Termination

For taxable terminations, the taxable amount is the value of the property to which the termination has occurred, less certain taxes, expenses of administration and indebtedness attributable to the property that would be deductible for federal estate tax purposes had the property been subject to estate tax. (IRC 2622).

iii. Direct Skip

For direct skips, the taxable amount is the value of the property transferred to the transferee, net of any GST tax on the transfer paid from the property transferred. (IRC 2623).

iv. Value of the Property

Regardless of the type of transfer, in determining the taxable amount, the value of property is that property's fair market value at the time the transfer occurs. (IRC 2624). Alternate valuation and special use valuation can also be elected for GSTs when allowed.

h. Calculation of the GST Tax

Once you know the applicable rate (inclusion ratio x maximum estate tax rate) and the taxable amount, you can make the GST calculation. Below are some examples:

i. **Example 1 (Direct Skip):** Grandfather who dies in 2007 makes an outright gift at death to his grandchildren of $2 million. All the grandchildren have living parents, so all of them are skip persons, making this gift a direct skip. The grandfather, however, had previously allocated $1 million of his GST exemption to lifetime gifts, meaning that there is only $1 million in GST exemption to apply to this gift. The taxable amount is the fair market value of the transferred property on the date of death ($2 million). The

applicable fraction thus is 1/2 ($1 million/$2 million), which in turn means the inclusion ratio is 1/2 (1 – 1/2). The applicable rate is therefore 22.5% (1/2 x 45%), and applying the applicable rate to the $2 million direct skip results in a GST tax of $450,000.

ii. **Example 2 (Taxable Termination):** Grandfather who dies in 2007 makes a $5 million gift to a trust for the benefit of his son for life, with only special powers of appointment for the son. At the son's death a year later, the trust (now worth $5.5 million) terminates and passes to the son's children, the grandchildren. Even though the son has now died, since he was alive at the time the trust was created, the predeceased ancestor rule does not apply, and the trust at termination is a taxable termination. The grandfather's entire $2 million GST exemption is allocated to the trust, meaning that the applicable fraction is 2/5 ($2 million/$5 million), and the inclusion ratio is 3/5 (1 – 2/5). The applicable rate is 27% (3/5 x 45%). The taxable amount is $5.5 million. At the termination of the trust, the GST tax due will be $1,485,000 ($5.5 million x 27%).

iii. **Example 3 (Taxable Distribution):** Assume the same facts as Example 2, except that the trust allows for distributions of income and principal to both the son while living and his children. A $10,000 distribution while the trust is still in existence is made to one of the grandchildren. The taxable amount is $10,000. The GST tax due on this gift is $2,700. Note that if the $10,000 distribution were made to the son, there would be no GST tax since the son is not a skip person.

TIP: The last two examples show the problem with a trust that has an inclusion ratio of between 0 and 1, because transfers to grandchildren, either by termination or distribution, will always be subject to GST tax. The better planning option would have been for the grandfather to create two trusts at death, the first with $2 million and the second with $3 million. All of the grandfather's $2 million exemption could have been applied to the first trust, and none to the second trust. The result would have been a first trust with an inclusion ratio of 0, and a second trust with an inclusion ratio of 1. Distributions out of the first trust would never be subject to GST tax, and thus that trust could be used for the benefit of grandchildren, with the second trust being used primarily for the benefit of the son. It might also have made sense to give the son a testamentary general power over the second trust to avoid a taxable termination at his death, but if the effective estate tax rate would have been 45% in any event, the resulting tax might be the same (it would depend on the size of the son's estate).

One way to fix this problem (if possible) is to engage in a qualified severance of the trust into two trusts, one with an inclusion ratio of 1 and the other with an

inclusion ration of 0. The rules of qualified severances are found in Section 2642(a)(3) but are beyond the scope of this outline.

IV. Other Issues

a. GST Tax Annual Exclusion

Like the estate and gift tax, the GST tax has an annual exclusion that allows for lifetime direct skip GST gifts without drawing down on the GST lifetime exemption. (IRC 2642(c)(3)(A)). The GST annual exclusion rules are for the most part the same as the gift tax annual exclusion rules. The current exclusion is $12,000 per person per year (and will increase over time in increments of $1,000 as it adjusts for inflation). A married couple can split the gift, allowing a gift of $24,000 to be made to a single person in a single year. GST annual exclusion gifts can be made to a custodial account under UTMA or UGMA, and to a Section 2503(c) minor's trust.

The one difference is with gifts to trusts. Typically, to qualify for the gift tax annual exclusion, gifts to trusts are subject to *Crummey* powers that allow for an immediate withdrawal right of the gift by the beneficiary or beneficiaries for a set period of time. Transfers to *Crummey* trusts do not qualify for the GST annual exclusion unless (1) the trust has only one beneficiary, and (2) the trust will be included in the gross estate of that beneficiary for estate tax purposes. (See Treas. Reg. 26.2612-1(a), (f) (Ex. 3)).

b. Estate Tax Inclusion Period (ETIP)

When a transferor makes a gift that, while completed for gift tax purposes, might still be included in the transferor's estate for estate tax purposes, the estate tax inclusion period (ETIP) rule applies. Section 2642(f) states that any allocation of GST tax exemption will not be effective until the expiration of the ETIP. This rule does not apply to gifted assets that are brought back into the estate under Section 2035 (inclusion of certain property given within 3 years of death). (IRC 2642(f)(2)). Examples of ETIPs include the following:

- Qualified personal residence trusts (QPRT) (donor retained term)
- Grantor retained annuity trusts (or unitrusts) (GRAT or GRUT) (donor retained income interest)

The ETIP terminates when (i) the transferor dies, (ii) when no portion of the property is included in the transferor's estate for estate tax purposes, or, in the case of a split gift, when no portion of the property would be included in the spouse's estate other than by reason of Section 2053 (dealing with expenses, indebtedness and taxes), (iii) at the time of a GST, or (iv) if it is an ETIP as a result of a power held by the spouse of the transferor, on the first to occur of the spouse's death or the time when the property would not be included in the spouse's estate other than by reason of Section 2053.

The danger in the ETIP rule is that if a GST exemption allocation is made to a gift subject to an ETIP, the exemption will not be effective until the expiration of the ETIP; yet, the allocation of GST exemption is irrevocable. Therefore, allocation prior to the expiration of the ETIP may cause an inclusion ratio greater than 0 and less than 1 if the value of the assets should change on the date of the termination of the ETIP. For this reason, the practitioner should monitor the ETIP and make a GST exemption allocation at the expiration of the ETIP, not when the gift is made.

One way to solve this problem is to have a formula GST exemption allocation, in which the GST exemption is set at whatever the value of the gifted interest is at the end of the ETIP; however, this again is an irrevocable allocation of GST exemption at the time made and is still not effective until the ETIP expires. The problem with a formula is that if additional GST gifts are made during the ETIP, the planner does not know exactly how much exemption is available until the ETIP expires and the amount determined.

There are a number of exceptions to the ETIP rule: (i) inclusion of a transferred asset in the spouse's estate due to a retained interest or power held by the spouse, (ii) a reverse QTIP trust, (iii) a power or right that is so remote as to be negligible, and (iv) a spouse's 5 and 5 power withdrawal power (greater of $5,000 or 5% of the trust) and the power lapses within 60 days after the transfer to trust.

Pursuant to the automatic allocation rule of Section 2642(c), the indirect skip for purposes of the automatic allocation shall be deemed to have been made at the end of the ETIP, with the value of the gift being the fair market value of the ETIP property at the end of the ETIP.

c. Reverse Qualified Terminable Interest Property (QTIP)

Often, a couple engages in estate planning to utilize both of their estate tax exemptions, thereby passing up to $4 million to children and other loved ones free from estate tax. GST gifts can also be made in this fashion, but if the GST exemption exceeds the estate tax exemption (due to lifetime gifts that reduce the estate tax, but not GST exemption, or due to the current status of the law), what then? Normally, property that exceeds the estate tax exemption amount passes to the surviving spouse, either outright or in the form of a qualified terminable interest property (QTIP) trust in order to avoid estate tax at the first death.

But if the couple has a goal of making GST gifts, there is a problem in this scheme. While the credit shelter trust may be allocated GST exemption at the first death, if there is additional available GST exemption, the only place for it to go is over to the marital share. The problem is that property given to a surviving spouse outright can be passed to skip persons or to trusts that might benefit skip persons, <u>but such transfers will be allocated GST exemption of the surviving spouse, since that person, and not the first spouse to die, is the transferor for GST purposes.</u> The surviving spouse is the transferor because the marital trust is included in the taxable estate of the surviving spouse.

The same is true of QTIP property. A QTIP trust may be created by the first spouse to die that stays in trust for the benefit of the surviving spouse first, then for the children for life and finally passes to grandchildren at the children's death, free from estate tax (thus a GST taxable termination). However, for transfer tax purposes, a QTIP trust is included in the surviving spouse's estate, and that person is also the transferor for GST purposes. The result is a waste of some of the first spouse to die's GST exemption, as the surviving spouse's GST exemption will have to be used to avoid GST tax on a GST QTIP trust established by the predeceased spouse.

Until EGTRRA united the estate and GST tax exemptions, this was a constant problem, because the GST exemption was $1 million (adjusted for inflation) while the estate tax exemption was much lower ($600,000 for most of this period). To allow a couple to maximize the use of both GST exemptions, Section 2652(a)(3) allows the representative of the first spouse to die to make a "reverse" QTIP election, in which the first spouse to die, not the surviving spouse, is treated as the transferor for GST purposes only. The result is to allow for maximum use of the GST exemptions of both spouses, and not limit the GST exemption for the first spouse to the possibly lower estate tax exemption. The election will treat the first spouse to die as the transferor for GST purposes and the second spouse to die as the transferor for estate tax purposes (best of both worlds).

If you expect to utilize the reverse QTIP election, however, beware of the one drawback and draft accordingly. The reverse QTIP election can only be made over an entire QTIP trust, meaning that if the QTIP trust is quite large, the GST gift can be large as well, too large for the available GST exemption. This is where a three-trust structure works well. At the death of the first spouse to die, three trusts are established. The first is a GST credit shelter trust with an amount equal to the lesser of the estate or GST exemption (usually the estate tax exemption amount will be less, if there is any difference at all). Both the estate and GST tax exemptions are applied to this trust, meaning it will escape estate tax and GST tax.

The second trust is a QTIP trust into which is placed the difference between the GST exemption and the estate tax exemption (the excess GST exemption). A reverse QTIP election will be made for this trust on the estate tax return of the first spouse to die, so that this trust is subject to the marital deduction for estate tax purposes (and would be subject to estate tax at the death of the surviving spouse), but it will avoid GST tax in the future and will allow the surviving spouse to apply his or her GST exemption to other GST gifts.

Finally, the third trust will be the marital trust, and a regular QTIP election will be made to this trust. The terms of this last trust will also call for distribution to the children at the death of the surviving spouse, or else a general power for the children, to prevent this last trust from being subject to GST tax at termination.

Carefully written trusts will also allow for a non-GST credit shelter trust in the event there is a greater estate tax exemption than GST exemption, but, unless there is a

change in the law, about the only time this would occur is if a client is making lifetime gifts to a trust, subject to *Crummey* powers, that qualify for the gift tax annual exclusion (no draw on the gift/estate tax exemption) but not the GST tax exemption (thus a draw on that exemption). Also note that the GST exemption can be applied to lifetime GST gifts as well as testamentary GST gifts, while the estate and gift tax have had (and might in the future have) a disconnect, with the gift tax exemption in 2009 being $1 million and the estate tax exemption in the same year being $3.5 million (thus you could conceivably have made a lifetime GST gift of $3.5 million, paid gift tax on the amount over $1 million but still allocate the entire GST exemption to the gift and have no GST tax due on the gift).

A reverse QTIP election is made by listing the qualifying QTIP property on Line 9, Part 1 of Schedule R of IRS Form 706. The election must be made for all properties in a particular trust for which a QTIP election is allowed, and noted on Schedule M. In making the election, you should note on the return itself that a reverse QTIP election is being made.

d. Reporting, Allocation Election and Payment of GST Tax

Lifetime GST gifts are reported by the transferor on Parts 2 and 3 and Schedule C of IRS Form 709, and testamentary GST gifts are reported on Schedule R of IRS Form 706. Unless allocation is automatic, it is also on these returns that the GST exemption is allocated to GST gifts. For those trusts whose distributions are not GST-exempt (i.e. do not have an inclusion ratio of 0), the IRS has released a new version of Form 706-GS(D-1) which is used by trustees to report distributions from trusts that are subject to the GST tax.

Payment of GST tax owed by a transferor or transferor's estate is due at the same time and under the same conditions as the federal gift or estate tax. Tax is assessed against the transferor individually, in the case of a lifetime gift, or against the transferor's estate (of which the executor or trustee is responsible) in the case of an estate. If the transferor is liable but does not pay, the transferee becomes liable for the tax. (IRC 6324(b), 6901(a)(1)(A)(iii)). No separate check for payment is necessary.

e. "Grandfathered" (Pre-September 25, 1985) GST Trusts

As stated at the beginning, the GST tax applies to transfers made after October 22, 1986, except those made from trusts that were irrevocable on September 25, 1985 and to which no additions have been made after that date. Therefore, so-called "grandfathered" GST trusts are exempt from GST tax regardless of their size, terms and the like.

The main issues with grandfathered GST trusts are that (1) they cannot be modified and (2) that property cannot be added to them after September 25, 1985.

i. Modifications

With respect to modification, although a trust is not grandfathered unless it is irrevocable, irrevocable trusts can still be modified under certain circumstances, specifically if there is an express provision in the instrument allowing for modification by a trust protector or some person other than the grantor. Not all modifications are at issue, but those modifications that do the following will, if made, cause the trust to lose its GST grandfathered status:

1) The modification shifts a beneficial interest in the trust to any beneficiary who is a member of a lower generation than the person who held the beneficial interest before the modification; or

2) The modification extends the time for vesting beyond that provided for in the original instrument.

Recently, several states have begun allowing for the conversion of traditional income interests in trusts (interest and dividends) to a unitrust or equitable apportionment scheme (in which capital appreciation can be used to satisfy an income interest). This raised the question of whether such changes to grandfathered GST trusts would cause an impermissible modification of the trust. The IRS has answered that, provided such change, done pursuant to local law, provides for a reasonable apportionment between income and residuary beneficiaries and meets the requirements of Treasury Regulation 1.643(b)-1, such change is an administrative modification that, even if it causes a slight shift in beneficial interests, does not cause the trust to lose its GST grandfathered status. (Treas. Reg. 26.2601-1(b)(4)(i)(D)).

ii. Property Additions

As for property additions, if property is added to a grandfathered GST trust, a portion of the trust is no longer exempt, causing all distributions from that trust to be partially subject to GST tax, unless GST exemption was allocated to the addition to keep the inclusion ratio at 0.

In addition to an actual addition of property, certain constructive additions are also treated as additions that cause part of the trust to be subject to GST tax. For example, if debts, taxes or other liabilities that are chargeable to a grandfathered GST trust are paid out of other sources, a constructive addition will be deemed to have occurred. Also, the exercise, release or lapse of certain powers of appointment after September 25, 1985 that constitute a taxable transfer for gift or estate tax purposes are considered constructive additions in that the power is deemed to have been exercised and the property subject to the power withdrawn and immediately placed back into the trust. (Treas. Reg. 26-2601-1(b)(1)(v)(A)). Likewise a nonqualified disclaimer (thus a taxable gift) is also a constructive addition on the same theory. (PLR 9811044).

Finally, a shifting of interest to lower generations will cause the trust to be deemed to have been reconstituted after September 25, 1985, in which case it loses its grandfathered status. This was of particular concern as it pertained to the recent changes in the trust law of many states allowing for the change of a traditional income interest to a unitrust interest. The IRS has ruled that such a conversion does not affect the grandfathered status of such trusts. The rules here are too comprehensive for a basic overview of the GST tax, but treat grandfathered GST trusts with great care.

> TIP: Be very careful with irrevocable trusts created on or before September 25, 1985 that could benefit multiple generations. Such trusts can result in fantastic wealth transfers to succeeding generations at little or no transfer tax, but getting cute with such trusts can lead to disaster. Never add property to a grandfathered trust. Never extend the life of a GST trust by exercising a power of appointment that creates a new trust. If the otherwise irrevocable trust has a trust protector or other pseudo-amendable power, be very careful in the exercising of any such powers. Unless absolutely necessary, I recommend leaving a grandfathered GST trust alone. The risks far outweigh any planning benefits in most cases.

The reverse QTIP election is not needed for QTIP trusts in existence before September 25, 1985, because, pursuant to the "grandfathered" trust rules, the first spouse to die will be deemed to have made the reverse QTIP election. (Treas. Reg. 26-2601-1(b)(iii)(A)).

f. Illinois GST Tax

There is no Illinois GST tax in 2010, just as there is no Illinois estate tax in this year. Between 2003-2009, there was a question about whether or not we had an Illinois GST tax. The confusion came from the definition of "state tax credit" which stated as follows:

> "State tax credit" means: . . . (b) For persons dying after December 31, 2005 and on or before December 31, 2009, an amount equal to the full credit calculable under **Section 2011 or 2604** of the Internal Revenue Code as the credit would have been computed and allowed under the Internal Revenue Code as in effect on December 31, 2001, without reduction in the State Death Tax Credit as provided in Section 2011(b)(2) or the termination of the State Death Tax Credit as provided in **Section 2011(f)** as enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001, but recognizing the exclusion amount of only $2,000,000. (emphasis added).

(35 ILCS 405/2). Before EGTRRA, there was a state GST tax credit not to exceed 5% of the federal tax imposed, and Illinois picked up this credit with its own GST tax. When EGTRRA phased-out state death tax credits, Illinois decoupled and amended its statutory definition to continue to assess its tax as if there was still a state death tax credit; but, note that while the first part of the statutory definition says an amount equal to the full credit

calculable under Section 2011 (dealing with the state estate tax credit) or 2604 (dealing with the state GST tax credit), reference to Section 2604, particularly Section 2604(c) which terminated the 5% state GST credit, is omitted from the second part of the definition telling the reader to disregard the termination of the credit.

Therefore, on its face the statute does not ignore the termination of the state GST tax credit under Section 2604, so there is no decoupling (at least with respect to the GST tax). Was this just a legislative error, misprint or intentional act? I believe it was probably an error, but the statute is still clear on its face and should be interpreted as such. Still, given that decoupling has been in effect for almost seven years yet this issue is unsettled shows how little, if any, the state GST tax is ever assessed.

Assuming there is no change in the tax law this year, starting on January 1, 2011, the Illinois GST tax will come back, as will the credit for state GST taxes against the federal GST tax for taxes paid upon death, except in the case of a direct skip, with a limit of 5% of the federal tax on the transfer. (IRC 2604).

V. Basic GST Planning

a. Common Situations for GST Planning

Where might GST planning be appropriate for a client? Some might say that GST planning is appropriate in all cases, but I find that to be somewhat unrealistic. If most estates will never come close to paying an estate tax, why should the GST tax be an issue?

Instead, I consider GST planning in the following contexts:

1) **High Net Worth Clients**: Client is going to provide so much wealth to the next generation at death that the estate tax will not only be an issue for the client, but the client's children as well. In this case, either making direct skip gifts to grandchildren or placing assets in trusts that are allocated the GST exemption for the use of the children during life, then succeeding generations might make sense and save on taxes down the road.

2) **Children are Wealthy in Their Own Right**: Sometimes, the parents are of modest means but the children are wealthy. While clients may still feel that children should not be punished for being financially successful, if the children are themselves engaged in estate tax planning to minimize taxes at their deaths, putting an inheritance, even a modest one, in their laps will only exacerbate the problem. In such a case, gifts to grandchildren or to GST trusts might also make sense. In discussing estate planning with clients, I always make a point of

asking about the children and their financial means, and if GST planning is a possibility, I have even had conversations with both the children and their own estate planning attorneys and accountants.

3) **Children Cannot be Trusted**: This comes up when you have a child who cannot be trusted by the clients to do what the clients would want with the inheritance, either during life or at the child's death. The child could squander an inheritance, due to an addiction or spendthrift ways. While such concerns can be addressed by placing an inheritance in trust, to avoid a GST, the child must be given some kind of general power of appointment, usually testamentary, over the trust to make the trust includible in the child's estate.

   If the clients are concerned that the child will misuse even a testamentary general power to disinherit grandchildren (for example, his or her children from a prior marriage) or give the assets at death to someone that the client does not want to see enjoy the fruits of the client's labor, a GST trust may be the only way to avoid this result. The tax tail should never wag the estate planning dog. As long as clients realize a GST tax will be due at the child's death on assets in a trust that provides for the child while avoiding giving that child any control, even testamentary control, so be it.

4) **Grandchild's Needs are Greater**: Occasionally, a grandchild's needs are greater than those of the children. This may come up in the case of a permanently disabled grandchild, in which case a special needs trust may be warranted for the grandchild.

TIP: Remember that the GST tax can be assessed decades after the decision to make such a gift was made. Be sure to always document when a client makes a conscious decision to make a GST taxable gift, since the common initial reaction of children and grandchildren is that an assessed GST tax was a mistake on the part of the planner.

b. Outright Gifts

A client wants to give $100,000 to her granddaughter (whose parents are still alive) to help her with a down payment on a house following the granddaughter's marriage. This is a perfectly acceptable outright gift. It is also a GST gift subject to tax. The client reports the gift on a Form 709 filed by April 15 of the following year (plus timely filed extensions) and allocates both gift tax and GST exemption to the transfer. If our client is married, gift splitting is also available.

I have many clients in this situation – they want to help grandchildren get started in life and do so while they are around to see the fruits of their generosity.

c. GST Annual Exclusion, Qualified Medical and Tuition Gifts

Since gifts subject to the Section 2503(b) annual exclusion (currently $13,000 per person per year) are not taxable gifts, those gifts have an inclusion ratio of 0 and are not subject to GST tax. (IRC 2642(c)(1)). While there are slightly different rules for transfers to trusts that qualify for the gift tax annual exclusion (see below), the application of the GST annual exclusion is the same. If estate taxes are a concern for the client, annual exclusion gifts to children and grandchildren are a good and simple way to chip away at the likely estate tax bill at death.

i. GST Gifts to Section 2503(c) Minor's Trusts

Since gifts to grandchildren many times are gifts to minors, a gifting plan involving grandchildren might also include the creation of minor's trusts under Section 2503(c) of the Code, gifts to Section 529 college savings plans, or both. A Section 2503(c) minor's trust has the benefit of not requiring *Crummey* powers in order to qualify gifts to the trust for the annual exclusion. Since Section 2503(c) requires that when the minor turns age 21 the trust terminates, often a minor's trust will allow for a withdrawal period by the beneficiary at age 21, after which if the beneficiary does not exercise that right, the trust continues, with the difference being that future gifts must have *Crummey* withdrawal rights in order to qualify for the annual exclusion. As long as the trust benefits only one skip person (and a minor's trust typically does), gifts subject to *Crummey* powers should still qualify for the GST annual exclusion.

ii. Gifts to 529 College Savings Plans

Gifts to Section 529 college savings plans are considered completed gifts, even if the transferor has the right to change the beneficiary at his or her discretion. A feature that works well with Section 529 plans is that a transferor can accelerate annual exclusion gifts to these plans for five years. Therefore, a grandparent providing for a grandchild's education can establish a Section 529 college savings plan for the grandchild and fund it in year one with $60,000 ($120,000 if the grandparent is married). No further gifts can be made to the grandchild or the 529 plan for the next five years, and if the grandparent dies during this period, a portion of the gift is brought back into the estate for estate tax purposes; however, accelerating the gift allows the assets to be invested immediately tax deferred (and eventually tax free if used for qualified educational expenses).

iii. Qualified Medical and Tuition Gifts

Qualified medical and tuition gifts under Section 2503(e) of the Code are subject to neither gift nor GST tax. (IRC 2611(b)(1)). This makes them very powerful estate planning tools in your arsenal. In my experience, most medical expenses are covered by insurance, so I have only once or twice seen a qualified medical expense.

Qualified tuition gifts, conversely, offer grandparents the best of all worlds: (1) a chance to benefit grandchildren during life, (2) at no tax cost to the grandparent, and (3) for a specific purpose that is usually the dream of every grandparent – an education for his or her grandchild. The key for most planners advising on qualified tuition gifts is to advise the client, in writing, that the tuition must be directly paid to the educational institution. Writing checks to a parent who then pays the tuition is a regular gift to the parent, and is not a qualified tuition gift on behalf of the grandchild.

In addition to qualified medical and tuition gifts directly by the grandparents, distributions for the benefit of grandchildren from trusts that would also be covered under Section 2503(e) as if made by an individual are also exempt from GST tax. (IRC 2642(c)(3)(B)).

d. GST Trusts

Gifts can also be made to trusts that benefit skip persons. A common method is to allocate the GST exemption (which is currently the same as the estate tax exemption) to the credit shelter trust at the death of the first spouse to die. In that situation, and assuming that no lifetime gifts have made the GST and estate tax exemptions different, the credit shelter trust is also a GST trust, designed to (1) avoid estate tax at the death of the surviving spouse, and (2) avoid estate tax at the deaths of successive beneficiaries (children, grandchildren, etc.). This type of trust requires the planner to consider a number of things:

1) **Should the GST Trust Require Mandatory Income Payments?** Certainly, requiring the trust to pay all income to the beneficiaries is tax inefficient if the beneficiaries are non-skip persons. GST exemption allocated to such a trust is paying income to non-skip persons (surviving spouse, children), wanting GST exemption and decreasing the growth of the trust. At the same time, trusts that require mandatory income payments are simple trusts, which from an accounting point of view are easier to administer. Finally, if someone other than the then current income beneficiary is the trustee, there is always the tension about whether income should be paid to the beneficiary, whereas a mandatory income requirement avoids the possible conflict.

2) **Should the GST Trust be a Marital Trust?** Related to the first question is whether or not the GST exemption should be allocated to a marital trust. A marital trust, to qualify for the marital estate tax deduction, requires, among other things, that all income must be paid to the surviving spouse, and that all principal payouts can only be to the surviving spouse. As the transferor's spouse is assigned to the same generation as the transferor, he or she is a non-skip person for GST purposes. For this reason, it would seem to make more sense for

the GST allocation to go to a non-marital credit shelter or residuary trust.

Furthermore, at the death of the surviving spouse, the spouse's estate generally has a right of contribution from all included marital trusts to reimbursement for the difference in the estate tax owed by the spouse's estate with and without including the marital trusts. As a result, often a marital trust must make a substantial contribution for estate taxes. If that trust is a GST-exempt trust, the result is GST-exempt assets not passing down to skip persons but to the spouse's estate.

Therefore, all wills and living trusts containing testamentary GST trusts should have a requirement that all taxes come first out of non-GST-exempt marital trusts, and all marital trusts before credit shelter trusts (lest you also see estate tax exemption wasted as well).

3) **What Rights Should Beneficiaries Have Over a GST Trust?** Remember that a GST-exempt trust will last at least for the life of the transferor's children, which could be 50 years. If the trust lasts throughout the lives of grandchildren, then another 50 years is not out of the question.

Special Powers of Appointment

For this reason, it is usually best to give those beneficiaries lifetime and testamentary limited powers, allowing for property in the trust to go to persons not even contemplated by the grantor (an example is the spouse of a grandchild, who may have been a toddler when the trust was created). Be sure that the powers are never general powers (a common way to avoid this is to be sure to state in the power it is never to be exercised or interpreted to be exercised "for the beneficiary (holder of the power), the beneficiary's estate, the creditors of the beneficiary, or the creditors of the beneficiary's estate".

If a beneficiary has a general power, then when the power is exercised or lapses, the beneficiary becomes the transferor for GST purposes and the property subject to the power is subject to gift tax (if a lifetime general power is exercised), or estate tax (if either a lifetime general or testamentary power lapses at death or a testamentary general power is exercised).

Trustee Removal/Replacement Powers

In addition to limited powers, I usually put some provisions in GST trusts allowing for the removal and replacement of trustees by those

beneficiaries, including the right to make the beneficiary the trustee. Keep in mind that if the GST trust lasts as long as it is designed to do, it will undoubtedly outlive the first trustee, and maybe several trustees. Furthermore, circumstances arise that require the removal of a trustee. Sometimes individual beneficiaries simply tire of the responsibility, or there is a dispute between the beneficiary and the trustee. In the case of a corporate trustee, the beneficiaries may be dissatisfied with the investment performance or want to move to a new financial institution when a favored trust officer changes employers.

Removal powers do take the trust closer to the estate tax precipice, since under certain circumstances a beneficiary acting as trustee is treated as having a general power in fact for estate tax purposes, but if the trustee's right to distribute income and principal is limited by an ascertainable standard "health, maintenance in reasonable comfort, or education", then the trustee has a fiduciary duty that limits his or her ability to pull out assets, and the fact that the beneficiary is the trustee is not by itself a general power. If the beneficiary does have broader powers over the income and principal, then a trustee removal/replacement power is not a good idea.

Trust Protectors

Since the GST trust is expected to last for many years, during which there is likely to be both changes in circumstances in the family and changes in the law, a trust protector generally is a good idea. A trust protector is a person, with no other interest in the trust (either as a grantor, a beneficiary or a trustee) who has the right to make certain changes to the trust instrument. Typically, the trust will name one or more persons in successive order to act as trust protector, but the trust also should state at no time can an "adverse party" be a trust protector, as that term is defined in Section 672(a). To allow a person who is not an adverse party to be a trust protector can cause the person holding that right, coupled with other interests the person might have in the trust, to be deemed to have a taxable general power.

4) **Should the GST Trust be a Perpetual "Dynasty" Trust?** In recent years, many states have abolished the rule against perpetuities or allowed a grantor to opt a trust out of the rule (like in Illinois). Should your GST trust do this, and be a perpetual trust, also known as a Dynasty trust? Some clients are excited by the idea of a trust surviving for over 100 years to generations unborn yet. Other clients feel that remote descendants are strangers, and that providing for them is the responsibility of subsequent generations.

If your client is interested in a Dynasty trust, be sure that the governing state law provides for it, and, if here in Illinois, that you have opted out of the rule against perpetuities in the governing instrument.

5) **<u>Should the GST Trust be a Grantor Trust</u>?** There has been much talk about the so called "intentionally defective grantor trust" in which the grantor makes a completed gift to a trust for gift and estate tax purposes, but because of certain retained rights over the trust, the grantor is deemed the owner of the trust assets for income tax purposes, and thus is taxed on the income earned by that trust. The grantor trust rules were put into place to stop taxpayers from dividing their sources of income in order to take advantage of the graduated tax brackets; but, these rules offer the estate planner a great wealth transfer opportunity.

If the grantor is paying income tax out of his or her own property (which will be subject to estate tax at death) on assets that are outside of the grantor's estate, then the result is to maximize the growth potential of gifted assets at the expense of the taxable estate. Since the income tax paid is to satisfy the legal obligation of the grantor, this payment of tax on income earned by a grantor trust is not a gift.

Consider making lifetime GST trusts grantor trusts for income tax purposes. Payment of income tax by the grantor is not a gift, and so too it is not a GST. Of course, at the death of the grantor, the retained right over the grantor trust ends, and the trust is no longer a grantor trust, but at least for the life of the grantor, allowing assets to grow tax free in a GST trust gives that trust a good head start for the future.

e. Use of Disclaimers

Disclaimers allow for post-mortem GST planning, and the consideration of them should be on every estate planning attorney's checklist when beginning estate administration, even for non-taxable estates. Often, by the time a person dies, his or her children already are advanced in years and considering their own estate planning, including the reduction of estate taxes. If the children are already financially secure and looking for ways to pass wealth to their children, one or more of those children can disclaim an inheritance, which means, in the typical estate plan, that the share will pass to the children of the disclaiming child. The decedent will be the transferor. Although with a disclaimer, the disclaiming person will be deemed to have predeceased the decedent, the predeceased ancestor rule does not apply to disclaimers (the grandchildren will be skip persons).

Partial disclaimers are also a possibility here. Even though they may not need the money, some children do not want to disclaim an entire inheritance. In addition, if the inheritance is greater than the available GST allocation (either greater than $2 million or the decedent used much of his or her GST allocation already), the child can make a partial disclaimer.

Remember that a disclaiming child cannot put conditions on the disclaimer or direct to whom it will go, as that will be determined by the decedent's will or trust as if the disclaiming child predeceased the decedent. Therefore, a disclaimer will work only if the deceased already addresses the concern in his or her estate plan (i.e. trust for certain grandchildren or expressly excluding certain grandchildren). Also, if you represent the estate but not necessarily the children, be sure to discuss this matter (or have the children discuss this matter) with their own estate planners.

If you plan ahead, you can also provide for a disclaimer trust, whereby any disclaimed amounts pass to a GST trust, rather than outright to skip persons.

f. Life Insurance Planning

If done properly, life insurance in an irrevocable life insurance trust can offer tremendous leveraging of the GST exemption. However, because some life insurance trusts can hold policies that will be worth several million dollars at death, a failure to properly plan for the GST tax can leave these proceeds subject to GST tax, even if they are not subject to estate tax.

The main issue is the *Crummey* power. *Crummey* powers are commonly used in life insurance trusts so that gifts into these trusts (which are then used to pay premiums) are covered by the gift tax annual exclusion. The rules for GST tax are different, however. As previously discussed, gifts to a trust with multiple beneficiaries are not covered by the GST tax annual exclusion. The result is a trust exempt from gift and estate tax, but if later the policy pays out and distributions are made to skip person beneficiaries, the distributions will be subject to GST tax.

The way to avoid this result is to allocate GST exemption to gifts made to an insurance trust. A trust with *Crummey* withdrawal rights is not considered a direct skip to a skip person for purposes of the automatic allocation, so the election must be affirmatively made. (Treas. Reg. 26-2612-1(a)). However, there are two questions that arise. First, should an election be made. If the insurance trust has a number of non-skip person beneficiaries, those beneficiaries could use up all the trust property before any distributions are made to skip persons. Furthermore, most life insurance policies are never paid out. If the policy held by the trust is a term policy, or if you think at some point it might be reduced in value or cashed out altogether (in the case of a whole or variable life policy), using GST exemption now (which is an irrevocable action) could waste the GST exemption. If you plan on making additional GST gifts that will be funded with assets that will more likely pass to the benefit of skip persons, you may want to consider applying the GST exemption to those transfers.

Second, if you do decide to allocate GST exemption to gifts to an insurance trust, remember that (except when 9100 relief is granted), for purposes of determining the inclusion ratio, you look at the value of the property on the date of the election if filed late, not the date of the transfer. In the case of insurance trusts, the value of contributions could actually decline, meaning a late allocation will require less GST exemption. This is a game of Russian roulette, however, since if the insured dies, the trust will appreciate greatly in value, and a late allocation will be too late.

TIP: If you are advising on using life insurance for a GST gift, consider a second-to-die policy, which pays out on the death of both husband and wife. Since the goal of the policy is a gift to subsequent generations, there is no reason to create a single-life policy and name the surviving spouse as a trust beneficiary. Second-to-die policies tend to be much cheaper, since the actuarial life expectancy of two lives is longer than one life. Furthermore, in many cases one of the two spouses might not be insurable, due to age or health.

g. Avoiding GST

Unfortunately, often the GST tax is an unintended tax, and if you are not looking to make GSTs, ask whether any person's interest or enjoyment of property would be included in the person's estate for estate tax purposes prior to full vesting. If not, a potential GST problem exists.

The classic example is a trust for a minor. A trust created by a parent for her child (age 25) says to keep the property in trust for the benefit of the child until the child reaches age 30, at which time the trust terminates. The trust states that if the child dies before age 30, the trust property passes to the child's child (her grandchild). There is no GST here merely upon the creation of the trust. However, if the child dies before attaining age 28 and has no general power over this trust, the trust property will pass to the grandchild, and this will be a taxable termination. Though the intention had not been to engage in a GST, the death of the child beneficiary prior to termination of the trust resulted in a GST all the same.

The best method to avoid GST is to grant children trust beneficiaries a testamentary general power over the property in the trust, thereby causing inclusion of the property in the event of premature death. While it may seem ridiculous to grant a minor child a testamentary general power of appointment (and it fact how could it even be exercised by one who lacks the legal power to create a will in which to exercise the power), the existence of the general power will cause the trust to be included in the child's estate for estate tax purposes and avoid a GST.

VI. Sunset of EGTRRA, 2010 Repeal and the GST Tax

a. The Problem

The problem, for lack of a better word, is uncertainty. More than the gift and estate tax, the future impact of the GST tax depends on decisions and elections made years before any tax is even imposed. There is no GST tax is 2010. That is the good news – the bad news is there is no GST exemption, so gifts, bequests and other transfers in 2010, especially to GST trusts, cannot be allocated GST exemption. Does that mean that in 2011, these trusts will have an inclusion ratio of one? Does it mean that a taxpayer will have to make a late allocation on January 1, 2011 to a trust that is intended to be GST exempt? No one knows the answers to these questions right now.

b. Loss of EGTRRA Benefits

EGTRRA, as it has been pointed out throughout this presentation, brought more benefits to taxpayers than simply reduced tax rates and increased exemptions. In the realm of the GST tax, certain benefits were added to make the GST tax more taxpayer friendly. When EGTRRA "sunsets" on December 31, 2010 and the GST tax comes back in 2011, all of those benefits will be gone. This includes loss of the following:

(1) Automatic Allocation for Certain Lifetime Transfers under Section 2632(c).

(2) Retroactive Allocations Under Section 2632(d).

(3) Late Election 9100 Relief under Section 2642(b)(2)(a).

(4) Severance of Trusts Into Exempt and Nonexempt Trusts Under Section 2642(a)(3).

So even if Congress lets the rate go back to 55% and the exemption go back to $1 million (indexed for inflation), it is hoped that at least legislation can be enacted bringing these benefits back to taxpayers.

c. What to Do in This Year of Uncertainty

If Congress brings back the GST tax for 2010 and makes it retroactive to the beginning of the year, none of this may matter; however, some planners are making the following recommendations for the time being:

(1) <u>Taxable Distribution Holdbacks</u>. For any nonexempt trust already in existence and making a taxable distribution in 2010, the trustee should hold back enough to cover the GST tax, as it would have existed in 2009, just in case the GST tax is brought back retroactively.

(2) <u>Outright Gifts to Skip Persons in 2010 is Preferable to Gifts in Trust (at least from a tax standpoint)</u>. While retroactivity might require allocation of GST exemption, this would have been the case anyway with a gift into a trust. The

benefit of an outright gift is that if the GST tax is not brought back retroactively, there is no further transfer to tax (the direct skip is one and done, the trust will be subject to GST tax at the time of taxes when there are taxable terminations and distributions). Of course, the problem here is loss of control of the asset and the inability of non-skip persons to benefit from the gift. Any direct skips will be subject to gift tax in 2010.

(3) Acceleration of a Taxable Distribution from a Nonexempt Trust. If possible, accelerate distributions now to beat any GST tax, in case there is no retroactivity. If there is, then it does not matter anyway if the distribution was required at some point in the year.

(4) Beware of Gifts to UTMA Accounts. Transfers to UTMA accounts can be subject to the annual exclusion for GST purposes under Section 2642(c); but, if there is no GST tax in 2010, likewise there are no exemptions. Since a UTMA account is treated like a trust substitute by the IRS, it may be possible that such gifts would be subject to GST tax later on when assets are distributed.

(5) Consider Creating New Gift Trusts in 2010 to Protect Existing Gift Trusts That are Wholly Exempt. If we make gifts to trusts that are already wholly exempt, we run the risk that gifts to those trusts in 2010 for which we cannot at present make allocations of GST exemption, could have an inclusion ratio of between 0 and 1 come January 1, 2011. For that reason, in lieu of outright gifts, new parallel trusts could be established into which would go 2010 gifts. If later on GST exemption could be allocated to these new trusts to make them wholly exempt as well, the two trusts might be merged.

VI. Conclusion

The goal of this presentation is to provide the planner with an overview of the GST tax. In that spirit, here is a summary of points to remember:

A. All GST transfers require a skip person, who is a person assigned to a generation two or more generations below that of the transferor, unless there is a predeceased intermediary relative.

B. Every GST is also subject to gift or estate tax and will use those exemptions as well.

C. If a GST gift is also a QTIP, be sure to remember the reverse QTIP election so that a spouse creating the QTIP, and not the spouse benefiting from the QTIP, will be treated as the transferor for GST purposes.

D. A transfer in trust that avoids estate tax at the death of a beneficiary is a GST transfer – the GST tax is designed to force taxation at the death of each generation.

E. If a client chooses to engage in transactions that will result in GST tax, be sure to document this decision for future generations.

F. Remember the importance of making GST allocations on timely filed gift tax returns; but, if you believe an error has been made, consider the possibility of 9100 relief.

G. *Crummey* powers for trusts that benefit multiple beneficiaries will not work for the GST annual exclusion, and GST exclusion may have to be applied to those trusts to make them completely GST exempt.

H. When in doubt, never do anything to an irrevocable trust created before September 25, 1985.

I. Be wary of GST planning in 2010, given the uncertainty about retroactivity and what the GST tax will look like in 2011 and subsequent years. Be sure to advise the clients on the possible outcomes of GST planning decisions.