

**NAEPC 46th Annual Conference**  
**Generation Skipping Transfer Tax**  
**November 13, 2009**

Susan R. Schoenfeld, CPA, JD, LL.M. (Taxation), MBA

- I. The generation skipping transfer tax is designed to tax transfers to donees two or more generations below the person making the transfer.
  
- II. Transferor [§2652(a)]
  - A. In general, a transferor is an individual who has transferred property, outright or in trust, subject to either gift or estate tax.
  - B. If a married couple elects to split gifts, each spouse is a transferor of one-half the gift.
  - C. An individual need not be the original disposer of property to be considered the transferor; *e.g.*, holder of general power of appointment.
  - D. Reverse QTIP election – if husband (assumed 1<sup>st</sup> to die) creates testamentary QTIP for wife, the assets will be taxed at wife's second death, causing her to be considered the transferor for estate tax purposes. Husband's executor may elect to have husband treated as transferor with respect to the GST Tax (but not estate tax).
  
- III. Skip Person [§2613(a)]
  - A. An individual assigned to a generation 2 or more generations below the transferor's generation, **or**
  - B. A trust, all of which beneficiaries are skip persons or from which distributions may never be made to non-skip persons.

#### IV. How to Assign Generations

##### A. If the parties are related (including by marriage), look to the family tree:

1. Grandparents and their siblings and spouses belong to one generation.
2. Parents, aunts, uncles and their spouses belong in the next lower generation.
3. Child, brothers, sisters and their spouses belong in the next lower generation.
4. Grandchildren and spouses belong in the next lower generation.
5. Predeceased Ancestor Rule - If transferor's child predeceases the *transfer*, descendants move up a generation. Reg. §26.2651-1(b). An individual's interest in property or a trust is established or derived at the time the transferor is subject to gift or estate tax. Disclaimers don't count.
6. Half-blood and adopted persons treated the same as full blood.
7. A spouse and ex-spouse of the transferor are assigned to the transferor's generation; spouses and ex-spouses of descendants are assigned to the same generation as the descendant. And lineal heirs of ex-spouses are deemed "related" persons for purposes of generation assignment!

##### B. If the parties are not related, look to their age difference:

1. A generation is presumed to last 25 years.
2. An unrelated person aged within 12 ½ years of the transferor belongs to the same generation.
3. An unrelated individual aged more than 12 ½ years but less than 37 ½ years apart from the transferor belongs in the next lower ("child's") generation.
4. An unrelated individual aged more than 37 ½ years apart from the transferor belongs in the next lower ("grandchild's") generation.

#### V. GST Taxable Events

##### A. Direct Skip [§2612(c)]

- 1) A transfer to a skip person, by gift or upon death, outright or in irrevocable trust whose only beneficiaries are skip persons.
- 2) Tax is paid by the transferor on net amount received by transferee (tax-exclusive, like the gift tax).
- 3) Examples: Outright gift by grandparent to grandchild, gift in trust for benefit of grandchildren, bequest in Will to or in trust for grandchildren.

##### B. Taxable Termination [§2612(a)]

- 1) Termination (by death, lapse of time, release of power or otherwise) of an interest in property held in trust, unless either: (i) immediately after the termination, a

nonskip person has an interest in the trust, or (ii) at no time after the termination may a distribution be made to a skip person. In other words: a person's interest in a trust terminates, no non-skip person has an interest, and a skip person could benefit.

- 2) Occurs when the last nonskip beneficiary's interest ends (not necessarily trust termination).
- 3) Example: Trust for benefit of child and grandchild. Upon child's death, a taxable termination occurs, even if property stays in continuing trust for grandchild's benefit.
- 4) If a transfer overlaps direct skip and taxable termination (e.g., transferor retains income interest for life, remainder to grandchild), the transaction is deemed a direct skip.
- 5) The entire trust becomes subject to the GSTT upon a taxable termination.
- 6) Tax is paid by the trust itself on the value of all property with respect to which the termination has occurred, reduced by certain expenses (tax inclusive, like the estate tax).
- 7) Report on Form 706 GS(T).

#### C. Taxable Distribution [§2612(b)]

- 1) A distribution to a skip person that is not a direct skip or taxable termination.
- 2) Example: Trust for benefit of child and grandchild. If during child's lifetime a distribution is made to or for benefit of grandchild, a taxable distribution occurs.
- 3) Only the amount distributed to a skip person is subject to the tax.
- 4) Tax is paid by the recipient on the value received, reduced by certain expenses (tax inclusive, like the estate tax).
- 5) Report on Form 706 GS(D).

### VI. Computation of the GST Tax

- A. Flat tax of maximum Federal estate tax rate in addition to any Federal estate or gift tax on the transfer.
- B. Determine inclusion ratio (% of trust not protected by exemption).

## VII. Exclusions

- A. Transfers excluded from gift tax under §2503(e) for direct payment of medical or tuition expenses [§2611(b)(1)].
- B. Annual exclusion gifts outright to grandchild, or in trust for grandchild *only* if:
  - 1. Trust is for a single beneficiary,
  - 2. During that beneficiary's lifetime, no income or principal may be distributed from the trust to or for any person other than that beneficiary,
  - 3. Trust property will be included in that beneficiary's gross estate if trust still exists at beneficiary's death, and
  - 4. Must otherwise satisfy rules for annual gift tax exclusion [§2642(c)].
- C. Annual transfers to a typical life insurance trust may qualify for annual gift tax exclusion, but will probably not qualify for GST annual exclusion. Think about likely beneficiaries!

## VIII. \$3.5 Million GST Exemption

- A. Every individual is allowed a GST exemption of \$3.5 million, which may be irrevocably allocated to any transfer (during life or at death) with respect to which such individual is the transferor [§2631(a)].
- B. GST Exemption tied to estate tax exemption:

2006-2008	\$2,000,000	
2009	\$3,500,000	
2010	\$0	
2011	\$1,000,000	(tax rate returns to 55%)

\*\*\* Gift Tax Exemption is fixed at \$1 million – does not increase!

- C. Allocation may be made with respect to a direct skip immediately subject to GST tax, or a transfer in trust that may later give rise to a taxable distribution or a taxable termination.

## IX. Allocation Rules

- A. Allocation of exemption is generally made at the time the transfer becomes irrevocable and is discretionary. Transferor may apply available exemption to some, all or none of property being transferred.
- B. If a married couple elects to split gifts, each spouse's GST exemption may be used to exempt half the transfer.

- C. For lifetime transfers, allocation is made on federal gift tax return.
  - 1. May use formula allocation.
  - 2. Value at date of transfer except for late filing, then value at date of filing (within same month).
  - 3. If allocation of GST exemption is desired, must file gift tax return even if not otherwise required for the transfer.
- D. A timely allocation is as of the date of transfer, even if value increased by April 15. Late allocations are based on the value of the property at the time of allocation.
  - possible only if no automatic allocation, or transferor already opted out;
  - may be desirable if assets have depreciated before filing date; e.g., life insurance trust, but if donor dies before allocation, entire insurance proceeds are subject to GST tax.
- E. ETIP Rules (Estate Tax Inclusion Period): May not allocate GST exemption to an inter vivos transfer of property that would be includible in the gross estate of the transferor, generally GRATs and QPRTs. Must wait until end of ETIP to allocate, even if file gift tax return at beginning.
- F. Retroactive allocation if unnatural order of death. §2632(d)

#### X. Deemed Allocation Rules

- A. Lifetime Direct Skips – A transferor’s GST exemption is automatically allocated to lifetime direct skips.
- B. Automatic Allocations After Death – To extent available, GST exemption is automatically allocated first to testamentary direct skips, then pro rata to trusts which could have taxable terminations or taxable distributions. Both the automatic allocation and the election out of the automatic allocation are irrevocable.
- C. Additional Automatic Allocations Situations Under 2001 Tax Act – Any transfer after 2000 is subject to the new automatic allocation rules if the transfer is made to a trust out of which a GST triggering event may occur at a later time, with certain exceptions. Two of the most important exceptions (where automatic allocation does not occur) are described below.
  - 1. Age 46 Exception – Automatic allocation will not apply to transfers to a trust if at least 25% of the trust must be distributed to or may be withdrawn by a child of the transferor (or, technically, by any “non-skip person”) before the beneficiary reaches age 46. §2632(c)(3)(B)(i).
  - 2. Older Person Exception – The trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more children of the donor (technically, by any non-skip person) who are living on the date of death of another person identified in the instrument (by name or by class) who is more

than 10 years older than such children of the donor (or other non-skip persons). §2632(c)(3)(B)(ii). *Example: Trust is created primarily to provide income for client's parents (age 70). Trust assets will pass to client's child (age 40) upon the death of the client's parents. Automatic allocation does not apply, because the assets must be distributed to the child upon the death of a person (the donor's last surviving parent) who is more than 10 years older than the child.*

The other exceptions include situations where the trust would be included in a nonskip person's taxable estate, or for CLATs, CRATs, CRUTs, or CLUTs with a nonskip remainderman.

- D. Automatic Allocations May Waste GST Exemption in Some Situations – An example of a common situation where automatic allocation may apply that would not be desired is an irrevocable life insurance trust, that lasts for the lifetime of the insured's spouse, then remains in further trust for the children until they reach age 30. This situation does not meet any of the exceptions. (It will not necessarily pass to children before they reach age 46 [if the spouse is still alive] and it does not necessarily pass to children when the spouse dies [if the children are then under age 30].) Therefore, the trust is a "GST trust" as to any transfers made to the trust before the children have reached age 30. Automatic allocations would be made to any gifts to the trust – despite the fact that in all likelihood the trust assets will pass to the insured's children (not grandchildren) and any GST exemption allocation would be wasted.

## XI. Review of Transfers to Irrevocable Trusts

- A. The GST automatic allocation rules can be quite complex. Inadvertent automatic allocations may waste the donor's GST exemption. Furthermore, automatic allocations make record keeping more difficult. Because no gift tax returns need be filed to report the automatic allocations, after a number of years of having automatic allocations apply, keeping track of the amount of automatic allocations, and of how much GST exemption that the donor has remaining may be very difficult (and expensive for the accounting work that would be required.)
- B. Accordingly, tax preparers should closely review the situation by April 15 to determine if automatic allocations might occur, whether the donor should elect out of automatic allocations that might possibly occur, and whether the donor should specifically allocate GST exemption to the transfer.
- C. To Avoid Automatic Allocation of the GST Exemption – Transferors may elect not to have the automatic allocation rules apply to an indirect skip on a timely-filed gift tax return for the calendar year in which the transfer was made or deemed to have been made or on such later date or dates as the IRS may prescribe in regulations or instructions to tax forms. §2632(c)(5)(A)(i)(I).

Also, transferors can make a "one-time" election not to have the automatic allocation rules apply to any or all transfers made by such individual to a particular trust.

§2632(c)(5)(A)(i)(II). Such election may be made on a timely filed gift tax return for the calendar year for which the election is to become effective. §2632(c)(5)(B)(ii).

The final regulations provide guidance for electing out of automatic allocation of unused GST exemption to certain transfers to GST trusts. To make an election out of the automatic allocation rules, the transferor must attach an elect-out statement to a timely-filed Form 709 for the first transfer covered by the election out. The election out statement must: (1) identify the trust; (2) specifically state that the transferor is electing out of the automatic GST exemption allocation rules for the described transfer or transfers; and (3) specifically describe or identify the current and/or future transfers to which the election applies (unless the election applies for *all* transfers to the trust in the current and/or future years).

Electing out does not affect the automatic allocation of GST exemption to transfers not covered by the election out statement. Also, electing out does not prevent a later affirmative election in, providing taxpayers (and their advisers) complete flexibility to determine optimal GST allocation. You can also terminate an election out of deemed allocation by filing a termination statement to a timely Form 709 for the first year the election out is not to apply. Form 709, Schedule A, Part 3, Column C provides a box to check to elect in and out of deemed allocation, but you must also attach the required election out statement. **See Regs. §26.2632-1(b)(4)(iv) for sample language.**

- D. Recommend file gift tax returns for all additions to irrevocable trusts, whether or not there is a taxable gift (*i.e.*, whether or not the addition is within the annual exclusion) and whether or not there is any intention to claim GST exemption for the trust. This is because if you don't file the return, the "deemed allocation" rules for GST exemption will apply. They are at best confusing, and if they do apply, you will have no record of the use of the GST exemption and will never be able to keep track of it. Consider opting out of automatic allocation, then affirmatively opting in, if desired. Even if it is determined that the deemed allocation is desirable, still consider filing an allocation to keep track of exemption.
- E. The ETIP period does not extend beyond a GST taxable event or the transferor's death, whichever occurs first. So if for example, upon the termination of a GRAT term the trust continues for descendants, deemed allocation will occur at the end of the annuity period for the continuing trust. A determination of whether to opt out or affirmatively allocate exemption should be made at that time. Election out of deemed allocation to a transfer subject to an ETIP is made on Form 709 for any calendar year up to and including the calendar year in which the ETIP closes.
- F. If spouses elect gift splitting, each spouse's GST exemption will be deemed allocated under the deemed allocation rules for his/her one-half portion of all direct and indirect skip transfers during the year. To opt out of automatic allocation, each spouse should file his/her own Form 709; an election out by the transferor spouse will not count as an election out by the consenting spouse absent a separate Form 709 with appropriate opt-out statements.

- G. If there is an unnatural order of death in the family (e.g., a child dies prematurely after the transfer, leaving issue), the transferor may retroactively allocate GST exemption, as of the date of the original transfer to the trust, filed for the year of the child's death. §2632(d). Must be made on a chronological basis, if multiple transfers to the trust have been made. This works only if the transferor still has exemption available.
- H. EGTRRA provides for 9100 relief for late allocations. The IRS has adopted an internal rule refusing to grant 9100 relief for late GST exemption allocations if (1) the original transfer involved a discounted asset, and (2) the gift tax statute of limitations on additional assessments has run for that transfer. But see Proposed Reg. §26.2642-7.

XII. Proposed Reg. §26.2642-7 – Generation-Skipping Exemption Allocation Regulations (issued April 17, 2008)

- A. After the deadline for a timely allocation/election has passed, provides a mechanism for taxpayers seeking to make an affirmative allocation, elect out of the automatic (default) allocation, or elect to treat a trust as a §2632(c) GST trust.
- B. Overrides the relief provisions of Reg. §301.9100-3.
- C. Contains a list of situations indicating reasonableness and good faith, and identifies several circumstances in which relief will not be granted. Look to taxpayer intent, events beyond taxpayer's control, consistency in allocation, etc.
- D. Proposed Regulation 26.2642-7 provides new features for making late GST exemption allocations pursuant to §2642(g)(1). The new system will replace Notice 2001-50 that allowed relief under Regulation §301.9100-3. There are more factors to be considered under the new proposed regulations than under 9100 relief, which was totally discretionary with the IRS. This guidance project came out partly because of a change recently announced by the IRS in the standards it was using to analyze these requests. By taking the system out of 9100 relief and putting it into regulations, everyone is bound by the regulations. For example, the proposed regulations say that whether or not the statute of limitations has run on the collection of transfer tax on the original transfer will not by itself prohibit a grant of relief. Furthermore, the combination of the expiration of the statute of limitations on additional taxes with the use of the valuation discount will not by itself prohibit a grant of relief. The IRS does not view this as a shift; the provisions in the proposed regulations are very close to how the IRS has been addressing 9100 relief for GST exemption allocation extensions.

### XIII. Qualified Severances. 2007 Final Regulations: Reg. §26.2642-6

- A. Significance. GST exemption must be allocated to the ENTIRE trust, and cannot be allocated only to a portion of the trust that is severed into a separate trust under the terms of the instrument at a later time. However, if a trust severance is recognized, GST exemption can be allocated to one or more of the severed trusts. Reg. §26.2654-1(b)(3).
- B. Severance Requirements. Only severances that are described in the Code or in the GST regulations will be recognized for GST purposes. If the severance of a trust does not meet those requirements, the severed trusts will be treated as a single trust for GST purposes (meaning that GST exemption could be allocated to only the combined separate trusts, collectively, and not to just one of the severed trusts.)

An additional severance procedure was recognized in the 2001 Tax Act. Under that provision, a trust may be severed into separate trusts (and GST exemption could be allocated to just one of the severed trusts) if several procedural requirements are met. In addition, a trust that is only partially exempt from the GST tax may be severed into two trusts, one of which will be exempt and one of which will be non-exempt. (This can be helpful so that distributions to children could be made only from the non-exempt trust, and the exempt trust could be administered for as much future growth as possible.)

- C. Is Court Action Required? Many trust instruments and many state laws allow the trustee to sever trusts without court involvement. If neither the trust instrument nor state law clearly allows a severance by the trustee under the particular fact situation, the trustee should seek authority from a court directing the trustee to make the severance.
- D. There were also proposed regs issued contemporaneously with the final regs, which deal with severances that are not Qualified Severances. Essentially, after severance, both trusts must have the same inclusion ratio as before.

### XIV. Transitional Rules

**MOST COMMON TRANSITION RULES ON APPLICATION OF GST TAX**

<b>Trust Creation Date</b>	<b>Description</b>
9/25/85 or before	<u>Effective Date Rule 1</u> : Trusts irrevocable on or before this date (assumes no post-1985 additions and no general power of appointment)
any date	<u>Effective Date Rule 2</u> : Spin-off trusts from trusts irrevocable on 9/25/85 if spin-off trusts are created after that day by exercise of limited power of appointment that does not extend life of trust past original perpetuities date
12/31/86 or before **	<u>Transition Rule</u> : Trusts established pursuant to Will or Trust executed prior to 10/22/86, if decedent dies on or before 12/31/86
3/31/88 or before	<u>Gift Tax Exclusion</u> : “Direct skip” gifts (in trust or otherwise) that qualify for annual gift tax exclusion. After 3/31/88 direct skip gifts in trust must also satisfy requirements of §2642(c)(2)
12/31/89 or before	<u>Effective Date Rule 3</u> : Grandchild exclusion [“GALLO”] trusts, for trusts established for grandchildren of settlor, up to \$2 MM per grandchild
After 9/25/85	<u>GST Exemption</u> : GST exemption is deemed allocated on direct skips and certain transfers to trusts up to exemption amount; otherwise must be allocated on a timely-filed gift tax return or an estate tax return ( <u>and provable</u> ).
After 9/25/85	All other trusts

\*\*

Also applies regardless of creation date of trust if settlor/decedent executed plan prior to 10/22/86 and was “incompetent” (as certified by a physician) at all times from 10/22/86 to date of creation of trust (e.g., date of death).

**SUSAN R. SCHOENFELD, JD, LL.M. (Taxation), CPA, MBA**

Principal / Associate Fiduciary Counsel  
Bessemer Trust  
630 Fifth Avenue  
New York, NY 10111  
tel (212) 708-9152  
fax (212) 408-9638  
schoenfeld@bessemer.com

is an Attorney and CPA, practicing in the area of estate planning. Susan is Principal and Associate Fiduciary Counsel in the Legacy Planning Department of Bessemer Trust, where she helps high net worth individuals and families develop and implement generational wealth transfer planning strategies.

Susan is a member of the American Bar Association, New York State Bar Association (Estate Planning Committee 2003- ), Association of the Bar of the City of New York (Estate and Gift Taxation Committee 2000-2003), and the Westchester County Bar Association.

She regularly speaks on estate planning matters, including recent presentations at Practising Law Institute, New York University Summer Institute in Taxation, and the Westchester County Bar Association. She has chaired the Foundation for Accounting Education's Estate Planning Conference and its Annual Tax Conference numerous times.

Susan was extensively quoted in the Financial Times, March 25, 2008, *Parents Must Put Children In The Know*, By Ian Driscoll. She has authored numerous tax and estate planning articles published in professional journals, and wrote the Estate Planning column for Small Business Taxation magazine. Her other publications include *Allocation of GST Exemption to Contributions to Life Insurance Trusts*, CPA Journal, May 1999; *Can Your Pet Be Trusted?*, CPA Journal, July 1997; *Post Mortem Estate Planning*, Small Business Taxation, May 1989; reprinted in WG&L Tax News, Fall 1989; and *Rehabilitation Credit*, CPA Journal, May 1986.

She serves on the Estate Planning Committee (Committee Chair 2000-2002) of the New York State Society of Certified Public Accountants, also serves on its Tax Division Oversight Committee (Committee Chair 2006-2008), and previously served as the Society's Vice-President (2005-2006) and on its Strategic Planning Task Force, Committee on Committee Operations and Awards Committee. Susan chaired the Estate Planning Committee of the Westchester Chapter of the NYS Society of CPAs; subsequently, she served as Chapter Officer and Executive Board member, and is past-President of that Chapter.

In addition to her CPA, Susan was awarded an LL.M. (in Taxation) from NYU School of Law, a J.D. from Pace University School of Law, and BBA (*summa cum laude*) and MBA (with distinction) degrees in Accounting from Pace University.

Susan is volunteer Treasurer for the Broadway Training Center of Westchester, a not-for-profit performing arts training center located in Hastings-on-Hudson, NY.