THE EXEMPTION FROM THE GENERATION-SKIPPING TRANSFER TAX ("GST EXEMPTION"): THE BASICS AND BEYOND

ACTEC MID-ATLANTIC FELLOWS INSTITUTE

NOVEMBER 7, 2019, PHILADELPHIA, PA

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THE GST EXEMPTION: THE BASICS AND BEYOND

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THE GST EXEMPTION: THE BASICS AND BEYOND[1]

I. Introduction.

This outline assumes knowledge of basic federal generation-skipping transfer ("GST") tax[2] terminology and rules and reflects provisions enacted in the "Economic Growth and Tax Relief Reconciliation Act of 2001" ("EGTRRA"),[3] the "Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010" (the "2010 Act"),[4] the American Taxpayer Relief Act of 2012 (the "2012 Act")[5] and the "Tax Cuts and Jobs Act of 2017" (the "2017 Act")[6] impacting the GST tax. Appendix A to this outline includes tables showing recent changes since 2010 in estate, gift and generation-skipping transfer tax rates and exemption amounts.

II. GENERAL RULES FOR ALLOCATING GST EXEMPTION.

A. Amount of GST Exemption.

The 2012 Act eliminated the "sunset" of relevant EGTRRA and 2010 Act provisions which would have reduced the GST exemption as of January 1, 2013. Accordingly, each transferor's unified gift, estate and GST tax exemption was $5,120,000 in 2012 and was maintained with inflation adjustments through 2017, and will apply again once the temporary increase in exemption under the 2017 Act expires on December 31, 2025.[7] Under the 2017 Tax Act, the basic exclusion amount for estate tax, gift tax and GST tax exemptions is increased to $10,000,000 adjusted for inflation from 2010 which is $11,400,000 for 2019 after adjusting for inflation.[8] While the estate/gift tax exemption is portable between spouses, the GST exemption is not.

[1] As of March 18, 2019. We wish to thank Julie M. Kwon, of McDermott Will & Emery LLP, who contributed substantial portions of this outline. However, any errors or omissions are entirely ours. Substantial portions of this outline were originally published in the same form by the University of Miami, 46th Annual Heckerling Institute on Estate Planning (2012).

The "IRC" means the Internal Revenue of Code of 1986, as amended. Unless otherwise specified, "Sections" means Sections of the IRC and "Regulations" means Treasury Department Regulations. "Form 706" means federal Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return. "Form 709" means federal Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return. "Form 8939" means federal Form 8939, Allocation of Increase in Basis for Property Acquired From a Decedent.

[2] For comprehensive summaries of GST tax rules, *see* Carol A. Harrington, Lloyd Leva Plaine, Howard M. Zaritsky, Julie K. Kwon, *Generation-Skipping Transfer Tax*, 2nd edition (Warren Gorham & Lamont 2001, with 2019 cumulative supplement); Carol A. Harrington, Tax Management Portfolio No. 850-2nd, *Generation-Skipping Tax* (BNA, Inc. 2018).

[3] P.L. 107-16, 107th Cong., 1st Sess. (June 7, 2001).

[4] P.L. 111-312, 111th Cong., 2nd Sess. (December 17, 2010).

[5] P.L. 112-240, 112th Cong., 1st Sess. (January 2, 2013).

[6] P.L. 115-97, 115th Cong., 2nd Sess. (December 22, 2017), as amended by the Bipartisan Budget Act of 2018, P.L. 115-123 (February 9, 2018) and the Consolidated Appropriations Act, 2018, P.L. 115-141 (March 23, 2018).

[7] *See* Rev. Proc. 2011-52 (describing inflation adjustment to $5 million base amount).

[8] The non-inflation adjusted exclusion amount was doubled from $5,000,000 to $10,000,000. Before the 2017 Tax Act, the basic exclusion amount would have been $5,600,000 after adjusting for inflation using the CPI-U. Because

(continued…)

B. Timely Allocations. Any allocation of GST exemption may be made any time before the due date (including extensions) for the transferor's estate tax return regardless of whether a return is due. IRC §2632(a)(1). This gives the fiduciary at least 9 months, and up to 15 months if the maximum extension of time is granted, before GST exemption is allocated. However, allocating GST exemption to a lifetime gift after the due date for the gift tax return for the transfer gives different results from an allocation on a timely gift tax return. An allocation of GST exemption is irrevocable.

1. Lifetime Allocations. If the allocation is made on a Form 709 filed on or before the due date, including any extensions actually granted, that would apply if the transfer were a taxable gift, or is deemed made under IRC §2632(b)(1), the allocation is timely filed and the values used in determining the applicable fraction and hence the inclusion ratio are the values on the date of the transfer. IRC §2642(b)(1), Treas. Reg. §26.2632-1(b)(2)(ii), 26.2642-2(a). In such case, the allocation is effective as of the date of the transfer. The regulations provide that for an affirmative allocation, the allocation must (i) clearly identify the trust to which the allocation is being made, (ii) disclose the amount of GST exemption allocated to it, and (3) if the allocation is late or if an inclusion other than zero is claimed, list the value of the trust principal at the time of the allocation. The allocation should also state the inclusion ratio of the trust after the allocation. Treas. Reg. §26.2632-1(b)(2)(i).

A timely allocation may be amended only if the amended allocation is also timely and clearly identifies the transfer and the nature and extent of the modification. Late allocations are effective on the date when the Form 709 is filed. If it is unclear whether an allocation on Form 709 is late or timely, the allocation takes place in the following order: (1) to any transfer to the trust disclosed on the return as to which the return is a timely return, (2) as a late allocation, (3) to any transfer to the trust not disclosed on the return as to which the return would be timely. Treas. Reg. §26.2632-1(b)(2)(ii).

2. Allocations at Death. The allocation of GST exemption to transfers at death is made on Schedule R of the Form 706. For nonresident aliens, the corresponding return is Form 706-NA. Allocation of GST exemption to lifetime transfers is reported on the transferor's gift tax return, Form 709. The regulations provide that a late allocation made by the transferor's executor may be made either on Form 706 or Form 709. Treas. Reg. §26.2632-1(d)(1). Nonresident alien transferors also allocate GST exemption on Form 709 for lifetime transfers. Any GST exemption not affirmatively allocated as of the due date for the transferor's federal estate tax return is automatically allocated under IRC §2632(c) as described below.

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of a change in the CPI inflation factor to the Chained Consumer Price Index for All Urban Consumers (C-CPI-U), the basic exclusion amount for 2018 is calculated to be slightly less than 2 x $5,600,000 ($11,200,000), and is $11,400,000 for 2019 and $11,580,000 for 2020.

C. Allocations of Inflation Adjustments to GST Exemption.[9]

The American Taxpayer Relief Act of 2012 provided that the GST exemption equals the basic exclusion amount under Section 2010(c) and, therefore, is similarly indexed for inflation beginning in 2012. For example, the GST exemption was $5,000,000 in 2010, but increased to $5,120,000 in 2012 and increased thereafter due to the indexing requirement. As noted above, the 2017 Act also temporarily increased the GST exemption for the period from January 1, 2018, to December 31, 2025, from $5,000,000 adjusted for inflation to $10,000,000 adjusted for inflation and provides for ongoing increases for inflation indexing. Given the current and ongoing indexing requirement even after the 2017 Act increase expires, the GST exemption is likely to increase periodically.

Generally, if an allocation is made on a Form 709 federal gift tax return filed on or before the due date, including any extensions actually granted, that would apply to the taxable gift, or is deemed made under the automatic allocation rules of IRC §2632(b)(1), the allocation is timely filed. As a result, the allocation is effective as of the date of the transfer and the values used in determining the inclusion ratio are the values on the date of the transfer.[10] If GST exemption is allocated on a gift tax return that is not timely filed, the inclusion ratio is determined at the value of the transfer on the date the late allocation is filed and the allocation is effective from that date forward.[11] Because of the practical difficulty of valuing the trust assets on the same day that the return must be filed, the regulations provide that the transferor can elect, solely for the purposes of determining the fair market value of the trust assets, to treat the allocation as having been made on the first day of the month during which the late allocation is filed.[12]

The GST tax rules in Chapter 13 of the Code and related regulations were adopted before there were periodic increases in GST exemption. Thus, they do not address the case where the taxpayer makes a gift and receives additional GST exemption as of January 1 of the following year before the due date for the gift tax return reporting the gift. Given this silence, if a taxpayer allocates such additional GST exemption to such prior gift on or before the due date for the timely filed gift tax return, it is not clear when the allocation becomes effective or what value should be used to calculate the resulting inclusion ratio. The allocation does not fall within the description of a "late allocation" because it occurs before the due date for the timely filed Form 709. However, the rules adopted to date do not contemplate this situation and thus do not describe whether this allocation is treated the same as a timely allocation of GST exemption the taxpayer had in the year of the gift, effective as of the date of the gift. The Form 709 has not been revised to show how taxpayers should allocate such increases in GST exemption, when the IRS will treat them as becoming effective or what value is used to determine the resulting

[9] The discussion and recommendation in this Section III were developed with generous input from several practitioners, including my partner, Carlyn McCaffrey, and Beth Shapiro Kaufman, of Caplin Drysdale. For a more detailed discussion of this issue and related technical rules, *see* "Allocation of Indexed GST Exemption," by Beth Kaufman, published by Leimberg Information Services, Inc. at LeimbergServices.com on September 11, 2013.

[10] IRC §2642(b)(1), Treas. Reg. §26.2632-1(b)(2)(ii), 26.2642-2(a).

[11] IRC §2642(b)(3).

[12] Treas. Reg. §26.2642-2(a)(2).

inclusion ratio, and the instructions are particularly confusing because of inconsistent and incorrect references to terms like "transfer" and "generation-skipping transfer".

For example, assume T made a taxable gift in 2017 of $7,000,000 to a trust held for T's children and more remote descendants, while T had $5,120,000 of GST exemption. Thus, at the time of T's gift, T did not have sufficient GST exemption and would have needed another $1,510,000 of GST exemption to produce an inclusion ratio of zero for the trust. However, by operation of law, T received another $5,690,000 of GST exemption ($11,180,000 amount of 2018 GST exemption - $5,490,000 amount of 2017 GST exemption) as of January 1, 2018. If T allocates $1,510,000 of this additional $5,690,000 GST exemption amount on a timely filed Form 709 reporting the gift on April 15, 2018, the allocation is on a timely filed return. It seems that the rules governing "late allocations" (which deem the allocation to occur when made) should apply because T should not be able to use GST exemption T did not have in 2017 to make an allocation effective in 2017 using 2017 values. However, technically T is allocating GST exemption on a timely filed return. Under the literal language of the rules governing "timely" allocations, one can argue that T's allocation should be effective as of the date of the gift, although that does not seem consistent with the effective date of the additional exemption granted and the way the rules work generally for timely and late allocations. Because it is a timely return, one possible effective date of the allocation under the existing rules could be January 1, 2018, the first date after the gift when such exemption became available by operation of law. A result more consistent with other allocations that take effect after the date of the gift would be to treat the allocation as late as of April 15, 2018, and make it effective, and determine the inclusion ratio using values, at that date. The gift tax return instructions have consistently not used helpful examples or language to address these issues.

If T desires to take the position that the allocation in this case is effective as of January 1, T could file a separate Notice of Allocation[13] to the timely filed Form 709 solely for the purpose of allocating the additional indexed GST exemption available as of January 1 of the filing year (in this example, $1,510,000 of the $5,690,000 increase). This Notice of Allocation would explain that T is allocating the additional amount of GST exemption available as of January 1 by operation of law. Most allocations of GST exemption are described by formula as the smallest amount necessary to produce an inclusion ratio that is closest to, or, if possible, equal to zero. In this case, it may be helpful to specify that the formula is intended to produce an inclusion ratio of zero "as of the earliest date on which this allocation is effective, which the taxpayer believes to be January 1, [year of indexed increase]." A separate Notice of Allocation included in the single timely filed Form 709 is preferable to a separate, second Form 709 filed solely to use the indexed increase in GST exemption, to avoid treatment of one Form 709 as superseding the other.

Alternatively, the taxpayer could sever the trust with a qualified severance based on the inclusion ratio resulting from allocation of the taxpayer's GST exemption available when the gift occurred, and make a true late allocation of the indexed increase afterwards. In this example, T

[13] This Notice of Allocation would be separate from the initial Notice of Allocation affirmatively allocating the amount of GST exemption the taxpayer had at the time of the gift ($5,120,000 in this example) as of the transfer date, or the election into treatment as a "GST trust" under Section 2632 subjecting the trust to automatic allocation of GST exemption as of the transfer date.

would allocate T's full $5,490,000 GST exemption available when T made the $7,000,000 gift on a timely filed Form 709, and the trust would have an applicable fraction of .784 (5,490,000/7,000,000) and inclusion ratio of .216 (1-.784). A qualified severance of the trust would produce two separate trusts, one with an inclusion ratio of zero holding 78.4% of the trust property, and the other with an inclusion ratio of one holding 21.6% of the trust property. If the nonexempt trust is funded with cash or another asset unlikely to change in value before the due date of the Form 709, then T could make a late allocation of part or all of the new increase of $5,690,000 in GST exemption to that trust immediately after the due date. If T's late allocation results in an inclusion ratio of zero for that trust, it could be merged back together with the other trust that has an inclusion ratio of zero (assuming the instrument or local law allows the merger).

D. <u>Extension of Time for Timely Allocation and Elections</u>. Until EGTRRA, the failure to allocate on a timely filed gift tax return was irrevocable. Assuming that no automatic allocation had occurred, which before EGTRRA was limited to direct skips, the only option available for a transferor who for any reason failed to timely allocate was to make a late allocation of GST exemption. Because the trust may have appreciated from the date the gift was first made until the failure to allocate GST exemption was discovered, making a late allocation would not put the transferor in the same position had a timely allocation been made. In contrast, if the transferor makes a timely allocation of GST exemption to a transfer, the original gift or estate tax value of the transfer to the trust is used to determine the amount necessary to produce an inclusion ratio of zero instead of the value of the trust as of the date of the late allocation. This resulted in tax return preparers being sued, sometimes for significant amounts of damages.

Relief for certain tax elections is available pursuant to Regulations §§301.9100-1 through 301.9100-3 ("Section 9100 relief"). Section 9100 relief allows the government to grant an extension of time to make certain elections late as if they were made timely. However, the IRS formerly maintained that allocations of GST exemption were statutory elections and thus ineligible for the discretionary extension of time to make regulatory elections under Regulations §301.9100-3. *See* PLRs 9840011, 9835025, 9827032, 9813013, 9226014. Regulations §301.9100-2(b) provides an automatic 6-month extension for regulatory or statutory elections whose due dates are the due date of the return (including extensions) if the return was timely filed by the due date (including extensions). However, in many cases when an error concerning the allocation of GST exemption has occurred, no gift tax returns have been filed or the errors are not discovered within 6 months of the due date of the return.

EGTRRA added IRC §2642(g)(1), which directs the Secretary by regulation to prescribe circumstances and procedures under which extensions of time will be granted to make an allocation of GST exemption for lifetime gifts or gifts at death, elections under IRC §2632(b)(3) (elections out of deemed allocations to direct skips), elections under IRC §2632(c)(5)(A)(i)-(ii) (elections in and out of automatic allocations to indirect skips). In determining whether to grant relief, the IRS is to consider all relevant circumstances including evidence of intent to be exempt from the GST tax in the trust instrument and such other factors as the Secretary deems relevant. IRC §2642(g)(1)(B). When relief is granted, the original gift or estate tax value of the transfer to the trust is used in determining the allocation of GST exemption instead of the value of the trust at the time a late allocation would be made. The effective date provides that the section applies to requests pending on, or filed after, December 31, 2000.

This legislative history of IRC §2642(g)(1) indicates Congress's intent that the IRS should disregard the expiration of any statute of limitations in considering requests for Section 9100 relief under that statute. The Joint Committee on Taxation's discussion of IRC §2642(g)(1) explains:[14]

> [Under EGTRRA], the Treasury Secretary is authorized <u>and directed</u> to grant extensions of time to make the election to allocate generation-skipping transfer tax exemption and to grant exceptions to the time requirement, <u>without regard to whether any period of limitations has expired</u>. If such relief is granted, then the gift tax or estate tax value of the transfer to trust would be used for determining generation-skipping transfer tax exemption allocation.

As a result, IRC §2642(g)(1) does not restrict the availability of relief based on the type of assets transferred or on whether the period of limitations for assessment of gift tax has expired with respect to the original transfer. Instead, IRC §2642(g)(1) and its legislative history reflect Congress's clear intent to provide liberal relief to taxpayers and their tax advisors who inadvertently failed to allocate GST exemption despite their good faith efforts to comply with the GST tax rules.

1. <u>Section 9100 relief</u>. IRS Notice 2001-50[15] provides that the procedures for seeking an extension of time under the new section will be those that generally apply under Regulations §301.9100-3:

> [R]elief will be granted if the taxpayer establishes to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice the interests of the government. Taxpayers requesting relief should follow the procedures for requesting a private letter ruling under §301.9100 contained in Section 5.02 of Rev. Proc. 2001-1 (or its successor), 2001-1 I.R.B. 1, 13.

Regulations §301.9100-3 requires that the taxpayer show that the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice the interests of the government. Under the regulations for Section 9100 relief, the taxpayer is deemed not to have acted reasonably or in good faith if the taxpayer was fully informed of the required election and chose not to make the election. Also, the taxpayer is considered not to have acted reasonably and in good faith if the taxpayer uses hindsight in requesting relief, which is the case if specific facts have changed since the original election would have been made that make an election later to be more advantageous. Finally, prejudice to the government arises if granting relief results in a lower tax liability in the aggregate for all taxable years affected by the election compared to the liability had the election been timely made. Prejudice to the government also will arise if the statute of limitations is closed before the taxpayer's receipt of a ruling granting the relief requested.

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[14] Joint Committee on Taxation's General Explanation of Tax Legislation Enacted in the 107th Congress, at p. 81 (emphasis added).

[15] 2001-34 IRB 189, issued on August 1, 2001.

Thus, taxpayers seeking Section 9100 relief to obtain the extension of time to allocate GST exemption must independently satisfy the criteria of Regulations §301.9100-3. These regulations are designed to preclude exactly the abuse that the IRS fears and, consequently, satisfying these requirements should suffice to obtain relief under IRC §2642(g)(1). Under Regulations §301.9100-3(b)(1) the taxpayer will not be considered to have acted reasonably and in good faith if the taxpayer "uses hindsight" in requesting relief.[16] Similarly, the IRS should not use hindsight to deny relief because the taxpayer would have achieved a beneficial result if the taxpayer had properly implemented her intention to allocate GST exemption. Hindsight is particularly inappropriate when the only "abuse" is that the IRS failed to audit the return despite adequate disclosure sufficient to trigger the running of the statute of limitations. The IRS's failure to challenge the valuation of the gift in time to assess gift tax should not prejudice taxpayers who otherwise have complied fully with the tax laws and are entitled to seek relief pursuant to IRC §2642(g)(1).

Regulations §301.9100-3(c)(1) notes that the interests of the government will ordinarily be prejudiced when the tax year in which the regulatory election should have been made, or any tax year affected by the election had it been made timely, are closed by the statute of limitations before the taxpayer's receipt of a ruling granting Section 9100 relief.[17] However, the statute of limitations for GST tax purposes almost never will have expired before the taxpayer seeks Section 9100 relief under IRC §2642(g)(1), because a GST subject to GST tax typically will not occur for many years after the initial transfer. The expiration of the separate statute of limitations for assessment of gift tax should not be relevant when the taxpayer seeks Section 9100 relief to allocate GST exemption for GST tax purposes because the IRS has not been prejudiced with regard to the election by the expiration of the statute. Further, the legislative history of IRC §2642(g)(1) specifically states that extensions of time to allocate GST exemption are to be granted "without regard to whether any period of limitations has expired."[18]

Many requests for relief under IRC §2642(g)(1) have already been granted. However, the IRS recently may have changed informally the factors that it considers in evaluating requests for relief under IRC §2642(g)(1), which could undermine the effectiveness of this remedy. The IRS apparently is concerned that a taxpayer who made a gift of property valued at a discount may wait for the statute of limitations to expire on the gift tax return reporting the gift before applying for relief under Regulations §301.9100-3 to allocate GST exemption. Commentators urged the IRS, if adopting a new policy, to articulate its new criteria in formal guidance available for public review and comment before it begins to apply those criteria.[19] On April 17, 2008, the

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[16] The regulations make clear that when specific facts have changed since the original due date of the election that make a later election advantageous to a taxpayer, the IRS will not ordinarily grant relief absent strong proof that the decision to seek Section 9100 relief did not involve hindsight.

[17] *See* Reg. §301.9100-3(c)(1)(ii).

[18] *See* the Conference Report to H.R. 1836, H. Rept. 107-84 (May 26, 2001) ("Conference Report") at p. 202.

[19] *See* July 16, 2007, Letter to Donald Korb, Chief Counsel, IRS, from Daniel H. Markstein, III, on behalf of the American College of Trust & Estate Counsel. The principal drafters of those comments were Carol A. Harrington, Lloyd Leva Plaine, Carlyn S. McCaffrey, and Pam H. Schneider, all of whom are fellows of the College, and Julie K. Kwon.

Treasury Department issued new proposed regulations under IRC §2642(g)(1) regarding extensions of time to allocate GST exemption, discussed below. REG-147775-06.

2. Proposed Regulations. On April 17, 2008, the Treasury Department issued new proposed regulations under IRC §2642(g)(1) describing the circumstances and procedures under which an extension of time to allocate GST exemption will be granted. REG-147775-06. The regulations will be effective as to requests for relief filed on or after the date of publication of the final regulations. Once finalized, these regulations will replace Regulations §301.9100-3 as the authority governing requests for an extension of time to allocate GST exemption under §2942(g)(1). Relief will continue to be granted by private letter ruling. Prop. Treas. Reg. §26.2642-7(a). Revenue Procedure 2004-46, which provides a simplified procedure to obtain an extension of time to allocate GST exemption for certain annual exclusion transfers, discussed below, will remain in effect.

The proposed regulations under IRC §2642(g)(1) adopt standards that echo the standards for obtaining Section 9100 relief. The proposed regulations provide that requests for an extension of time to allocate GST exemption under IRC §2642(g)(1) will be granted if the evidence establishes that "the transferor or the executor of the transferor's estate acted reasonably and in good faith, and that the grant of relief will not prejudice the interests of the Government." Prop. Treas. Reg. §26.2642-7(d)(1). In addition, they clarify that the amount of GST exemption that may be allocated to a transfer upon grant of such relief is limited to the amount of the transferor's unused GST exemption as of the date of the transfer. Prop. Treas. Reg. §26.2642-7(c).

However, these proposed regulations reflect a focus on taxpayers who are using hindsight to achieve a GST tax result better than the result the taxpayers could have obtained with a timely allocation. In particular, they indicate a concern that taxpayers may deliberately delay requests for relief "with the intent to deprive the IRS of sufficient time to challenge the claimed identity of the transferor of the transferred property that is the subject of the request for relief, the value of that property for Federal gift or estate tax purposes, or any other aspect of the transfer that is relevant for Federal gift or estate tax purposes." Prop. Treas. Reg. §26.2642-7(d)(3)(ii). The proposed regulations broaden the IRS's discretion in determining whether to grant relief and impose imposing additional criteria to the existing requirements of Regulations §301.9100-3 that the IRS may consider in the determination.[20] Thus, the scope of circumstances in which relief may be available under this proposed regulation is narrower than the scope of circumstances in which Section 9100 relief is available.

In particular, the proposed regulations recite that the expiration of a period of limitations on the assessment or collection of transfer taxes prior to the request for IRC §2642 relief or the application of a discount in valuation of the property for transfer tax purposes, separately or in combination together, will not, "by itself," prohibit a grant of relief. *See* Prop. Treas. Reg.

[20] For an extremely detailed review of these proposed regulations, please see the Comments of the American Bar Association Section of Real Property, Trust and Estate Law and the American Bar Association Section of Taxation submitted to the Treasury Department on July 16, 2008, co-authored by Carol A. Harrington and representatives of both said Sections.

§26.2642-7(d)(3)(ii). However, the proposed regulations do not clarify further how these two factors are relevant to the determination of whether to grant IRC §2642 relief. Instead, the identification of these factors, even not sufficient "by itself" to disqualify a request for relief, suggests that these factors could be considered as relevant when determining whether to grant relief. The legislative history of IRC §2642(g)(1), however, is clear that the expiration of a period of limitations should be irrelevant when determining whether relief should be granted under IRC §2642(g)(1). In addition, courts have routinely held that valuation discounts are appropriate when applied according to established methods of valuation. Thus, the application of a valuation discount does not demonstrate a taxpayer's bad faith or prejudice the Government. As a result, neither factor should be considered relevant to this determination.

Given Congress's clear intent to provide expansive relief, the regulations under IRC §2642(g)(1) should provide relief that is, at least, no more restrictive than the currently available Section 9100 relief for regulatory elections. The reduction of the availability of IRC §2642 relief under the proposed regulations is inconsistent with the statutory clarification that the allocation of GST exemption or related elections are to be non-statutory, clarifying that Section 9100 relief is available to provide IRC §2642 relief.

3. Simplified Method for Annual Exclusion Gifts: Rev. Proc. 2004-46. No doubt due to the volume of requests for Section 9100 relief under IRC §2642(g)(1), the IRS has provided a simplified alternate method for obtaining Section 9100 relief for certain annual gift tax exclusion gifts made before 2001, to be used in place of the formal process for obtaining a letter ruling. *See* Rev. Proc. 2004-46, 2004-31 I.R.B. 142 (August 2, 2004). The significant user fee required for letter ruling requests is not charged for requests filed under Revenue Procedure 2004-46.[21] However, taxpayers unable to obtain an extension of time using this alternate method described in this Revenue Procedure still may request a letter ruling to obtain such relief. This Revenue Procedure applies only if:

(1) On or before December 31, 2000, the taxpayer made or was deemed to have made a transfer by gift to a trust from which a GST may be made;

(2) At the time the taxpayer files the request for relief, no taxable distributions have been made and no taxable terminations have occurred;

(3) The transfer qualified for the annual exclusion under §2503(b), and the amount of the transfer, when added to the value of all other gifts by the transferor to that donee in the same year, was equal to or less than the amount of the applicable annual exclusion for the year of the transfer;

(4) No GST exemption was allocated to the transfer, whether or not a Form 709 was filed; and

[21] The first Revenue Procedure issued each year describes the procedural requirements for obtaining a letter ruling under Regulations Section 301.9100-3.

(5) At the time the taxpayer files a request for relief, the taxpayer has unused GST exemption available to allocate to the transfer.

Note that the transferor may not have sufficient exemption remaining at the time she requests relief under IRC §2642(g)(1) to produce an inclusion ratio of zero for the trust.

E. Lifetime Automatic Allocations: Direct Skips. The statute automatically allocates GST exemption to lifetime direct skips to the extent necessary to make the inclusion ratio zero for each direct skip, or to make the inclusion ratio as small as possible if zero is not possible. IRC §2632(b)(2). The transferor can elect out of an automatic allocation on Form 709. In addition, a timely-filed Form 709 along with payment of GST tax as shown on the return with respect to a direct skip is sufficient to elect out. IRC §2632(b)(3); Treas. Reg. §26.2632-1(b)(1)(i). Before EGTRRA, for lifetime transfers, the automatic allocation of GST exemption applied only to direct skip transfers. Thus for a lifetime transfer to a trust that was a non-skip person, such as a trust that included a child or spouse as a current beneficiary, the only way to allocate GST exemption to a trust was to file a gift tax return and affirmatively allocated GST exemption.

F. Lifetime Automatic Allocations: Indirect Skips.

1. In General. For lifetime transfers in 2001 and thereafter, the automatic allocation of GST exemption was expanded to apply to each "indirect skip," unless the transferor elects out of the automatic allocation rule. The automatic allocation of GST exemption to indirect skips applies to the extent necessary to make the inclusion ratio zero for each indirect skip, or to make the inclusion ratio as small as possible if zero is not possible. IRC §2632(c)(1).

An indirect skip is defined as a lifetime transfer (other than a direct skip) to a "GST trust" as defined in IRC §2632(c)(3)(B). A GST trust is any trust that could have a generation-skipping transfer occur with respect to the transferor other than a trust that falls into one or more of six categories of trusts listed in IRC §2632(c)(3)(B). Indirect skips subject to the ETIP rule of IRC §2642(f) are treated as if made at the end of the ETIP. A GST trust also is any trust that the transferor has elected to be treated as a GST trust, even if it falls within one or more of the six categories. Thus the transferor may elect in or out of the automatic allocation of GST exemption for lifetime transfers in 2001 and thereafter. The automatic allocation to direct skips continues to apply as before.

The expanded automatic allocation rules in IRC §2632(c) apply only to lifetime transfers. The election to be treated as a GST trust so that GST exemption is automatically allocated, or to elect out of the automatic allocation rules, must be made on a timely-filed gift tax return for the year in which the transfer was made (or treated as made when the ETIP ends). The regulations provide that a transferor may elect out of the automatic allocation of GST exemption for an indirect skip making an election as described, but also by making an affirmative allocation of GST exemption that is less than (but not equal to) the value of the property transferred as reported on that return. Regs. IRC §2632-1(b)(2)(ii). Elections out of the automatic allocation rules for lifetime transfers to a trust have no effect on the automatic allocation rules applicable at the transferor's death.

2. Definition of GST Trust. The definition of a GST trust in IRC §2632(c)(3)(B) is complex and ambiguous in several common situations. For that reason, relying on the definitions is not generally recommended when instead a transferor can achieve certainty by merely electing in or out of the automatic allocation rule on the first return reporting the creation of the trust. If, however, a return preparer fails to elect in or out, the definition of GST trust should be examined to see if it has resulted in a default classification consistent with the transferor's desire to allocate or not allocate.

The problem with trying to define trusts to which GST exemption should be automatically allocated is that one cannot necessarily determine merely from the trust terms whether the trust is the best candidate for use of the transferor's GST exemption. The definition of "GST trust" is a somewhat crude attempt to group trusts that appear to be likely to result in a GST tax, but is not a substitute for considering this issue in the planning for the creation of the trust or a discussion of the pros and cons of allocation GST exemption when the gift tax return is filed.

A GST trust is defined as any trust that could have a generation-skipping transfer occur with respect to the transferor unless it falls within one of six exceptions. In other words, GST exemption will be automatically allocated to a trust unless the trust is described as any one or more of the following types of trusts:

(a) A trust is not a GST trust if the trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more non-skip persons before that non-skip person reaches 46 years of age, or on or before one or more dates specified in the trust instrument that will occur before that non-skip person attains 46 years of age, or on the occurrence of an event that, in accordance with regulations, may reasonably be expected to occur before that non-skip person attains age 46. IRC §2632(c)(3)(B)(i). For example, a trust that distributes outright to a beneficiary half at 30 and half at 35 is not a GST trust. However, if the trust provides for the spouse of the transferor, and then continues in trust after the spouse's death for the children, with distribution when the youngest child reaches age 25, the trust does not fall within this exception when it is created because the death of the spouse would not normally be reasonably expected to occur before the youngest child reaches age 46. A trust that fits this common trust pattern, such as many irrevocable insurance trusts, will be a GST trust unless it falls within one or more of the other five exceptions, and GST exemption will be automatically allocated unless the transferor elects out of the automatic allocation of GST exemption. If no other use of GST exemption will be made, automatic allocation of GST exemption is acceptable because there could be a GST transfer if a child dies before the spouse leaving children surviving. However, if the transferor might use GST exemption to create longer term trusts for the children, or wants to make direct transfers to grandchildren, this may be a poor use of GST exemption.

(b) A trust is not a GST trust if the trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more non-skip persons who are living on the date of death of another person identified in the instrument (by name or by class) who is more than ten years older than such non-skip persons. IRC §2632(c)(3)(B)(ii). For example, a trust that distributes outright per stripes to the transferor's descendants on the death of the transferor's spouse who is the parent of the transferor's children normally would fall within this exception. However, the exception would not apply if the spouse were a second spouse who was less than 10 years older than the transferor's children or if the trust will distribute to the transferor's grandchildren even if the transferor's children are living. Such trusts would be GST trusts, unless they fall within another exception, and the automatic allocation rules would apply. This exception would not apply to a trust that provides for the spouse of the transferor, and then continues in trust after the spouse's death for the children, with distribution when the youngest child reaches age 25, unless the youngest child was over age 25 when the transfer is made to the trust. Thus where transfers are being made annually to such a trust, the trust would be a GST trust while the youngest child is under age 25, then change to a non-GST trust after the youngest reaches age 25. In general, it is unfortunate if GST exemption is automatically allocated for several years and then the allocation stops, because the trust would have an inclusion ratio greater than zero and less than one thereafter. While the trust could be divided into two trusts with inclusion ratios of zero and one, determining the inclusion ratio may be an administrative headache because it would be recomputed each time a transfer is made to the trust after the automatic allocation stops.

(c) A trust is not a GST trust if the trust instrument provides that on the death of one or more non-skip persons on or before a date or event described in (i) or (ii) above, more than 25% of the trust principal is distributed to the estate or estates of such non-skip persons, or the trust principal is subject to a general power of appointment exercisable by one or more of such non-skip persons. IRC §2632(c)(3)(B)(iii). For example, assume that the trust provides for the spouse of the transferor, and then continues in trust after the spouse's death for a child, with distribution when the child reaches age 35, and that the child is under age 35 when the transfers are being made. If the trust further provides that if the child dies before the spouse, the child will have a general testamentary power of appointment over the trust, the trust will not be a GST trust, even though it does not meet the exceptions described under (i) or (ii).

(d) A trust is not a GST trust if any portion of it would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer. IRC §2632(c)(3)(B)(iv). On its face, this exception would apply to trusts that contain a lapsing power to withdraw ("Crummey power") held by a spouse, child or other non-skip person. However, to prevent all Crummey trusts from falling outside the definition of a GST trust, on the theory that the automatic allocation rules should apply based on the actual dispositive provisions, an "exception to the exception" provides that the value of transferred property is not considered to be includible in the gross estate of a non-skip person or subject to a right of withdrawal by reason of such person holding a right to withdraw so much of such property as does not exceed the annual exclusion amount referred to in IRC §2503(b) with respect to any transferor. Flush language at the end of IRC §2632(c)(3)(B). Thus a Crummey trust with withdrawal rights within the annual exclusion or less that does not fall within any of the other exceptions will be a GST trust and the automatic allocation will occur.

This exception to the exception, however, does not seem to apply to non-lapsing powers ("hanging powers"). Hanging powers typically lapse each year only to the extent that the lapse will not cause the power holder to be treated as having made a taxable gift. For any transfers made at a time when the total amount that may be withdrawn is greater than the annual exclusion amount with respect to any transferor, the trust will meet exception (4) above and thus will not be a GST trust for those transfers. For example, in the first year that transfers are made, if the amounts subject to withdrawal are less than the annual exclusion amount, the trust will be a GST trust and the automatic allocation rule will apply to allocate GST exemption to the trust. In the second year, assuming the transferor makes an additional annual exclusion gift to the trust, the continuing right to withdraw part of the prior year's gift in addition to the year two gift results in a right to withdraw more than the annual exclusion amount. At that time, the trust is not a GST trust and the automatic allocation rule will not apply. Thus for trusts with hanging powers, an election should be made to elect in or out of the automatic allocation of GST exemption when the trust is created to avoid the allocation occurring in the first year but not for subsequent transfers.

(e) A trust is not a GST trust if it is a charitable lead annuity trust, charitable remainder annuity trust, or a charitable remainder unitrust. IRC §2632(c)(3)(B)(v).

(f) A trust is not a GST trust if it is a charitable lead unitrust with a non-skip person as the remainder beneficiary if living at the end of the lead period. IRC §2632(c)(3)(B)(vi).

3. Elections In or Out of Automatic Allocation. Regulations issued in 2005 clarify that a transferor may elect to opt in or out of the automatic allocation rules in any combination desired. In fact, the transferor can elect out of the automatic allocation rules for all future transfers for all trusts, even trusts not yet in existence. Treas. Reg. §26.2632-1(b)(2)(iii)(A). Elections in, however, relate only to a particular trust. Treas. Reg. §26.2632-1(b)(3)(i). For example, a transferor can opt in for certain transfers or all future transfers, then terminate the election going forward at any time with respect to any transfers. Similarly, a transferor could opt out of the automatic allocation rules, and then at any later time either affirmatively allocate GST exemption or opt in for the automatic allocation to apply to current and/or future transfers. Treas. Reg. §26.2632-1(b), (c). These elections must be made on a timely filed gift tax return for the calendar year for which the election is to become effective. IRC §2632(f)(5). However, any allocation actually stated on a return, is irrevocable after the due date of the 709 for the calendar year in which the transfer was made. Similarly, any election to opt in to the automatic allocation rules will also be irrevocable because that will result in an allocation of GST exemption. In contrast, 9100 relief is available to make the election to opt in or out of the automatic allocation rules late, or to actually allocate GST exemption late.

To elect out of the automatic allocation rule, the transferor must attach a statement to the Form 709 for the year for which the election is to be effective. The statement must identify the trust (unless the election out is for all transfers to all trusts) and that the transferor is electing out of the automatic allocation with respect to the described transfers. Prior year transfers subject to the ETIP rule must be specifically described or identified. Unless the election out is made for all transfers made to the trust in the current year and/or in all future years, the current year transfers or future transfers to which the election out is to apply must be specifically described or otherwise identified in the election out statement. Treas. Reg. §26.2632-1(b)(2)(iii)(B).

To terminate an election out, the transferor must identify the trust, describe the prior election out that is being terminated and describe the extent to which the prior election out is being terminated or describe any current year transfers to which the election out is not to apply. The transferor can elect out again later. Treas. Reg. §26.2632-1(b)(2)(iii)(E).

To elect in (be treated as a GST trust), the transferor must attach a statement ("GST trust election statement") to Form 709 filed on or before the due date for timely filing for the calendar year in which the first transfer to be covered by the GST trust election is made. The GST trust election statement must identify the trust, specifically describe or otherwise clearly identify the transfers to be covered by the election, and specifically provide that the transferor is electing to have the trust treated as a GST trust with respect to the covered transfers. The transferor may prevent automatic allocation of GST exemption by terminating the GST trust election or by electing out of the automatic allocation of GST exemption. Treas. Reg. §26.2632-1(b)(3). Terminating the opt-in election alone is not advisable unless it is absolutely clear that the trust is not otherwise a GST trust. Instead, an election out is safer.

In general, the return preparer should either make the election to opt in to the automatic allocation rules or make the election to opt out. In general, the preparer should not opt out and then actually allocate. If the taxpayer is allocating GST exemption, the trust is intended to have an inclusion ratio of zero, and opt into the automatic allocation rules will cover any subsequent gifts. The only exception would be where there is a specific plan to use unallocated GST exemption elsewhere rather than keep the inclusion ratio zero for the trust at issue if further gifts are made to it. The opt in election protects the trust from inadvertent failures to allocate if additional gifts are made. GST trust definitions should not be relied on because there are ambiguities and inconsistencies in the definition, and the terms alone do not accurately determine the intent of the use of the trust funds. The GST trust definition merely is a backstop when a thoughtful election in or out has not been made and often will not achieve the result desired.

G. Late Allocations. If the allocation of GST exemption is made on a gift tax return that is not timely filed, the statute provides that the applicable fraction and inclusion ratio are determined at the value of the transfer on the date the late allocation is filed and the allocation is effective from that date forward. IRC §2642(b)(3).

Because of the practical difficulty of valuing the trust assets on the same day that the return must be filed, the regulations provide that the transferor can elect, solely for the purposes of determining the fair market value of the trust assets, to treat the allocation as having been made on the first day of the month during which the late allocation is filed. However, the election cannot be made for valuing life insurance or a trust holding life insurance if the insured has died. The late allocation is not effective until actually filed. Treas. Reg. §26.2642-2(a)(2). This election is made by stating on Form 709 on which the allocation is made that the election is being made, the applicable valuation date, and the fair market value of the trust assets on the valuation date. IRC §2642(d)(4) provides for recomputation of the applicable fraction on the late allocation of GST exemption.

If GST exemption will be allocated to a trust to which a transfer has been made, the value of the trust should be reviewed before the due date for the gift tax return reporting the transfer. If on the due date (or on the first day of the month in which the return is due for assets other than life insurance) the property has depreciated from the value on the date of the transfer, the timely allocation of GST exemption could be by-passed and instead the allocation could take place immediately thereafter or whenever the value has dropped to or near the anticipated low for the assets in the trust. Treas. Reg. §26.2642-2(a)(2). The allocation in such case would be effective at the lower value on the date of the late allocation (or on the first of the month if the election to value assets on the first day of the month is made pursuant to the regulations) instead of at the higher value on the date of the transfer because the allocation is not made on a timely filed return. Of course, the transferor must file a gift tax return by its due date and pay any gift tax due or face penalties even if no allocation of GST exemption will be made on that return. In addition, the transferor should opt out of the automatic allocation rules for the trust or transfer involved because if the trust is a GST trust, which is not always clear, a late allocation will be impossible. A significant risk with allocating after the gift tax return due date is that the value of the trust could unexpectedly jump higher before the allocation is made, even beyond the value at the date of the transfer, thereby causing more GST exemption to be used than would have been necessary had the allocation been timely. If the trust holds life insurance on the donor, the insured could die before the late allocation is made, causing the value of the trust on the day of the late allocation to increase many times over what the value was on the date of the transfer.

An intentional late allocation is useful only for transfers to trusts that are not direct skips or, for transfers made after December 31, 2000, that are not GST trusts. The failure to allocate GST exemption on a timely gift tax return where an automatic allocation will occur will be meaningless. Also, if the transfer is a direct skip, opting out of the automatic allocation would cause a direct skip tax to be due immediately. The late allocation of GST exemption applies prospectively only and would not result in a refund of any GST tax owing before the late allocation. IRC §2642(b)(3)(B).

If the transferor wants to have the option to make late allocations of GST exemption because the trust property may decline in value after the transfer occurs, the transferor can either elect each year not to have the automatic allocation rules apply or opt out for all transfers to a trust. After electing out of the automatic allocation rule for that year, the transferor would either then make a timely or late GST exemption allocation to the trust depending on whether the value of the property transferred has increased or decreased after the transfer occurred until the due date for the return. After that, the only choice is when to make the late allocation.

> **EXAMPLE:** Assume that T creates an irrevocable insurance trust funded with term insurance on T's life, the premium for which is $15,000 paid on January 15 each year. T transfers $15,000 to the trustee on January 14 of each year. No GST exemption has been previously allocated to the trust at the time that T is hit by a car and dies on August 1, 2019. T's executor could allocate GST exemption to the transfer that took place on January 14, 2019, on or before the deadline for T's gift tax return on April 15, 2020. (Note that the executor must allocate T's GST exemption by the due date for T's federal estate tax return and that T's final gift tax return is due no later than the same time under §6075(b)(3).) If the value of the trust property (the term policy value immediately before the premium payment is due) is zero, the trust will have an inclusion ratio of zero while using only $15,000 of GST exemption.

However, the term policy immediately before the last premium payment may have some value, which may mean that the trust would not have an inclusion ratio of zero if GST exemption is allocated only to the last premium payment. A late allocation could be made annually to the trust on the day before the premium payment to keep the inclusion ratio at zero. The amount of GST exemption allocated would be the value of the trust at the time of the late allocation. A significant risk in this regard is that the insured could die unexpectedly after the timely allocation is by-passed and before the late allocation is made, causing the value for purposes of the late allocation to increase many times over.

The inclusion ratio is final at different times depending on various circumstances. This is discussed below in II, N, Valuation: Finality of Inclusion Ratio.

H. Automatic Allocations at Death. The statute also automatically allocates GST exemption at the transferor's death to the extent not actually allocated before the due date for the transferor's estate tax return. The unused GST exemption is first automatically allocated to direct skips occurring at the transferor's death. IRC §2632(c)(1)(A). Any remaining GST exemption is automatically allocated pro rata to trusts from which a taxable termination or taxable distribution may occur at or after the transferor's death. IRC §2632(c)(1)(B). The proration is made on the basis of the value of the property as finally determined for chapter 11 purposes of the nonexempt portion of the transferred property, or in the case of property not included in the gross estate, on the basis of the date of death value of the property. Treas. Reg. §26.2632-1(d)(2).

Automatic allocations at death are irrevocable and cannot be amended. Treas. Reg. §26.2632-1(d)(2). No automatic allocation of GST exemption will occur with respect to a trust that will have a new transferor prior to the occurrence of any generation-skipping transfer with respect to the trust. In addition, no automatic allocation of GST exemption will be made to a trust if during the nine month period immediately following the death of the transferor, no generation-skipping transfer has occurred and no future generation-skipping transfer can occur with respect to the trust. Treas. Reg. §26.2632-1(d)(2). For example, a beneficiary could disclaim an interest, or a condition could occur, during the nine month period after the transferor's death so that thereafter no generation-skipping transfer could occur with respect to the trust, in which case no GST exemption would be automatically allocated to the trust.

The allocation of GST exemption under the automatic allocation rules at death appears to be retroactive to the date of death, whether or not the property to which it applies is included in the transferor's gross estate.

I. "Retroactive Allocations" - Death of a Non-Skip Beneficiary While Transferor is Living. Transferors typically do not allocate GST exemption to trusts that primarily benefit non-skip persons. However, a non-skip person/beneficiary could unexpectedly predecease the transferor, thereby causing a taxable termination or increasing the likelihood of future GSTs from the trust. A compelling argument was made to allow a transferor who did not allocate GST exemption to address this situation by using the transferor's GST exemption in these circumstances. EGTRRA introduced new IRC §2632(d) to allow a living transferor to make a late allocation of GST exemption effective as if the allocation had been made on a timely filed gift tax return reporting the transfer where certain non-skip beneficiaries predecease the transferor.

1. In General. IRC §2632(d) provides that if (1) a non-skip person has an interest or future interest in a trust, (2) the non-skip person is a lineal descendant of a grandparent of the transferor or a grandparent of the transferor's spouse or former spouse, and is assigned to a

generation below the generation assignment of the transferor, and (3) the non-skip person predeceases the transferor, the transferor may make an allocation of GST exemption to any previous transfer to the trust on a "chronological basis." The section further provides that if the allocation is made on a gift tax return filed on or before the due date for gifts made in the calendar year in which the death occurred, the value of the transfers for purposes of determining the inclusion ratio are determined as if the allocation had been made on a timely filed gift tax return for each calendar year for which the transfer was made.

2. Effective Date. IRC §2632(d)(2)(B) provides that the allocation will be effective immediately before the death of the deceased non-skip person. Thus, the allocation does not eliminate GST tax otherwise payable due to a generation-skipping transfer that occurred in the past, even though the inclusion ratio resulting from the retroactive allocation is calculated using past values.

3. Amount of GST Exemption. IRC §2632(d)(2)(C) specifies that the amount of the transferor's unused GST exemption available to be allocated retroactively will be determined immediately before the non-skip person's death. This section does not limit the amount of GST exemption the transferor may use in a retroactive allocation to the amount available at the time of the original transfer. This is an extremely valuable benefit as the transferor can allocate more GST exemption than actually was available at the original time of the transfer, especially given the recent large increase under the 2017 Act. This is the only circumstance where a transferor can choose to allocate with the benefit of hindsight. While this result may seem "too good to be true," the plain wording of the statute is not ambiguous in stating that the amount of available GST exemption is determined immediately before the non-skip person's death rather than the date of the prior transfer. The drafters considered and expressly specified the date when the available amount of GST exemption would be determined instead of relying on default rules.[22]

The policy rationale underlying Code §2632(d) to limit this relief to unusually tragic circumstances, a child's untimely death, makes the generosity of this provision understandable.[23] The legislative history of Code §2632(d) also includes this explanation regarding the law prior to its enactment:

> A transferor likely w[ould] not allocate generation-skipping transfer tax exemption to a trust that the transferor expects will benefit only non-skip persons. However, if a taxable termination occurs because, for example, the transferor's child unexpectedly dies such that the trust terminates in favor of the transferor's grandchild, and generation-skipping transfer tax exemption had not been allocated

[22] Moreover, Code §2632(d) was enacted as part of EGTRRA which contemplated increases in GST exemption over time due to inflation indexing which could give the transferor more GST exemption after the date of a transfer.

[23] When a bill including Code §2632(d) language was introduced by Senator Connie Mack, III, he explained that under that bill "the GST exemption may be allocated retroactively when there is an *unnatural order of death*," noting the unexpected circumstances warranting this relief. 145 Cong. Rec. S15,090-092 (daily ed. November 19, 1999) (emphasis added); commenting on Generation-Skipping Transfer Tax Amendments Act of 1999, S. 1975, 106th Cong. (1999).

> to the trust, then generation-skipping transfer tax would be due *even if the transferor had unused generation-skipping transfer tax exemption*.[24]

This language indicates that the unambiguous language of IRC §2632(d) describing the transferor's unused GST exemption at the time of the non-skip person's death was intended to promote this relief provision's purpose.

4. Effect of Retroactive Allocation: Avoidance of GST Tax.

Thus, in the unfortunate circumstances of a beneficiary predeceasing the transferor, the transferor has an opportunity to allocate retroactively if the transferor acts within the time period specified. This could avoid the imposition of an immediate GST tax under certain circumstances.

For example, assume that in 1995 T transfer $1,000,000 to a trust for T's child, C, that pays income and principal to C in the trustee's discretion, with distribution to C half at 30 and half at 40. Assume that T does not allocate GST exemption because T expects C to eventually receive all of the trust principal. Assume further that C dies in 2007 at age 35 with children surviving. On C's death, the trust will distribute outright to C's children. T has until April 15, 2008, (or until the extended due date for T's gift tax return) to make an allocation to the trust that will be effective immediately before C's death at the value of the transfer to the trust as if timely made for the 1995 transfer to the trust. Assume that the trust is worth $5 million in 2007 when C dies. In the absence of any allocation of GST exemption, GST tax would be imposed at 45% on the entire $5 million in the trust for a GST tax of $2,250,000. In contrast, if T allocates $1 million of GST exemption to the trust by the due date for his gift tax return for 2005, no GST tax will be due on distribution to C's children.

Assume a similar trust except that the trust is for the benefit T's three children, C1, C2, and C3. The trust distributes per stirpes to T's descendants when the youngest child reaches age 25. Assume that while the youngest child, C3, is under age 25, the oldest child, C1, dies in 2007 leaving children surviving. T can retroactively allocate $333,333 of GST exemption to the trust. This will be effective immediately before C1's death, with the inclusion ratio computed as if allocated when the trust was created. Thus the applicable fraction would be 333,333/1,000,000, or .333. The trust would have an inclusion ratio of .667. The trust thereafter can be divided in a qualified severance to result in a trust that is funded with the fraction of the trust equal to the applicable fraction, which would be .333, which trust would have an inclusion ratio of zero. The trust receiving the remaining fraction of the assets equal to .667 would have an inclusion ratio of one. The terms of the trust would be rearranged so that the trust funded with .333 of the assets with an inclusion ratio of zero at termination would pass to C1's descendants. The trust with .667 of the assets and an inclusion ratio of one would be distributed at termination to C2 and C3. In this way, the GST exemption can be directed to the share for the predeceased child's descendants without wasting GST exemption on the shares passing to living children.

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[24] H.R. Rep. No. 107-73, at 36-37 (emphasis added); commenting on Death Tax Elimination Bill of 2001, H.R. 8, 107th Cong. (2001).

However, the ability to retroactively allocate is not confined to a trust where the predeceased child is a current beneficiary or where the allocation is necessary to avoid a taxable event due to the child's untimely death. The transferor may allocate to any trust of which the deceased descendant is a current or future beneficiary, even if it is unlikely that the deceased beneficiary would ever have become a current beneficiary. Because T knows exactly how the trusts have performed to that point, T may use this hindsight to maximize the benefit of T's allocation of GST exemption due to the death of T's child.

For example, assume that in 2001, T creates two trusts, one for each of T's two children, C1 and C2, that T does not allocate GST exemption to either trust because T assumes that each trust will be used to make liberal distributions to C1 and C2. The trusts do not provide for any mandatory distribution to a child and that on the death of a child, the trust continues on for the child's descendant, or if none, is added to the other child's trust. Assume that C1 dies with no children while T is living but after unusually large appreciation has occurred in the trusts of both children, so that it is likely that the trusts will continue to have substantial assets that will pass to or in trust for T's grandchildren. No taxable termination occurs on C1's death because the trust for C1 is added to the trust for C2. T may make a retroactive allocation to either or both trusts for C1 and C2. If one trust has appreciated and the other has not, T could chose to allocate to the one that has appreciated and not to the other.

Assume instead that C1 had children and C1's death was a taxable termination, but C1's trust was quite small because liberal distributions had been made to C1 during life. Assume further that T has sufficient GST exemption to allocate to only one of the two trusts at 2001 values. T could allocate only to C2's trust and C1's trust would owe a taxable termination tax. This maximizes the benefit of T's allocation of GST exemption at the price of a small GST tax. Of course, if the GST tax were to be repealed before C2's death, the GST tax, although small, would have been incurred unnecessarily.

J. <u>Time From Which Allocation of GST Exemption Is Effective</u>. Any allocation of GST exemption to property transferred as a result of the death of the transferor is effective as of the date of the transferor's death, even though the actual allocation is not accomplished until a timely return is filed (or until automatically allocated under IRC §2632(c) if no timely 706 is filed). IRC §2642(b)(2)(B). Because the allocation of GST exemption relates back to the date of death, Regulations §26.2654-1 contains detailed rules regarding when trusts must be separate for GST tax purposes and to what extent severing a trust is effective for purposes of allocating GST exemption, discussed below. This is important because formula gifts are used to separate assets into exempt and nonexempt trusts at death, and the allocation of GST exemption and actual division of assets will not be made for many months after death. These regulations allow a formula division to be treated as if effective as of the date of death if certain requirements are satisfied.

Allocations on a gift tax return filed before the due date and automatic allocations are effective as of the date of the transfer. IRC §2642(b)(1)(B). Late allocations (not on a timely filed gift tax return) are effective on and after the date on which the late allocation is filed. IRC §2642(b)(3)(B). Retroactive allocations under IRC §2632(d) are effective "immediately before" the untimely death of the non-skip person. IRC §2632(d)(2)(B).

A transferor creating a lifetime irrevocable trust often also desires to use a formula division because of possible uncertainty about how much GST exemption is remaining and also because the value of the property transferred to the trust is uncertain. Because a timely allocation of GST exemption relates back to the date of the gift, the same issues arise as with transfers at death, because the amount of GST exemption allocated is not known until months after the gift. Unfortunately, there are no parallel regulations that allow a formula division to be treated as if effective as of the date of the gift based on the allocation of GST exemption that necessarily occurs much later. One solution is to use a formula that directs the division to be made based on the amount of GST exemption the transferor has remaining at the time of the gift rather than the amount of GST exemption actually allocated. The other approach is to forgo a formula division in the trust instrument and merely do a qualified severance occur after the allocation of GST exemption is known. This is discussed further below regarding separate shares and trusts.

K. Estate Tax Inclusion Period (ETIP) Rules. A transfer to a trust can be a completed gift for gift tax purposes but also included in the donor's gross estate because of retained rights or powers. IRC §2642(f) provides that an estate tax inclusion period ("ETIP") is the period during which should death occur the value of the transferred property would be includible (other than by reason of §2035) in the gross estate of: (i) the transferor, or (ii) the transferor's spouse, if the death of either one were to occur immediately after the transfer. Treas. Reg. §26.2632-1(c)(2)(i). If any part of a trust is subject to an ETIP, the entire trust is subject to the ETIP. Treas. Reg. §26.2632-1(c)(1). For example, a qualified personal residence trust (QPRT) or a grantor retained annuity trust (GRAT) is subject to an ETIP until the term of the retained use ends, unless certain exceptions apply. In particular, the Remoteness Exception is important and discussed further below.

1. Special Allocation Rule for ETIPs. Any allocation of GST exemption to property subject to an ETIP is effective no earlier than the termination of the ETIP. IRC §2642(f). An allocation of GST exemption at the termination of an ETIP is effective at termination if made by the Form 709 due date that would apply for a taxable gift made at the time the ETIP terminates. Treas. Reg. §26.2632-1(c)(1).

The only possible advantage to allocating before the end of the ETIP is to prevent an inadvertent failure to allocate at the end of the ETIP. However, an allocation is irrevocable, making formula allocations risky when the ETIP trust is created. The better approach is to elect to opt in or out of the automatic allocation depending on which result is planned when the transfer to the trust is reported on a timely filed gift tax return. The regulations allow the election to opt in or out of the automatic allocation rules for the ETIP to be changed any time before the allocation is actually effective, which is the due date for a gift tax return for the calendar year in which the ETIP ends. Treas. Reg. §26.2632-1(b)(2) and (3), and (c). Thus the termination of the ETIP should be docketed so that a decision may be made at that time whether to allocate GST exemption and in what amounts through either using the opt in or out elections or affirmatively allocating GST exemption.

2. ETIP Exceptions.

(a) Reverse QTIP Trusts. The ETIP rules do not apply to reverse

QTIP trusts. Treas. Reg. §26.2632-1(c)(2)(ii)(C).

(b) Remoteness Exception. The regulations provide an important exception for purposes of determining whether an ETIP exists. Transferred property is not considered as being includible in the gross estate of the transferor or of the spouse of the transferor if the possibility that the property will be included is so remote as to be negligible. A possibility is so remote as to be negligible if it can be ascertained by actuarial standards that there is less than a 5% probability that the property will be included in the gross estate (the "Remoteness Exception). Treas. Reg. §26.2632-1(c)(2)(ii)(A). (This language is similar to that used in the definition of direct skips and taxable terminations.)

The regulations provide that if the probability of inclusion is less than 5% at the time of the transfer, the ETIP would not arise. This exception takes many common trusts that would be subject to an ETIP out of the rule but with surprising distinctions. For example, assume that T creates a five year GRAT. The probability that T will die within the five years, assuming that T is not too old, is likely to be less than 5%. The regulation exception removes such a GRAT from the ETIP rules. However, if T is older so that there is a greater than 5% probability of T's death within the five year period of the GRAT, there would be an ETIP. It is not clear what was intended by this exception.

No legislative history explains the Remoteness Exception as it was never enacted as a statutory provision and only exists in the Regulations. The preamble to the Treasury Decision introducing the Final Regulations states that the Remoteness Exception was added "to provide that the ETIP rules do not apply when the possibility that the property will be included in the gross estate of the transferor's (or the transferor's spouse) is so remote as to be negligible."[25] The preamble in the Final Regulations gives no further explanation of the exception's purpose.[26] Without a statement of the purpose of the ETIP rule or of the reason or purpose of the Remoteness Exception, the propriety of its application can only be based on the words in the Remoteness Exception itself.

Similarly, the Regulations do not provide any other clues as to the purpose of the Remoteness Exception or its application. Regulation §26.2632-1(c)(5), Example 1 describes a trust providing for income payments to T for 9 years or until T's prior death, and payment of the remainder to T's grandchild at the termination of T's income interest. The example states: "If T dies within the 9-year period, the value of the trust principal is includible in T's gross estate under Code §2036(a). Thus, the trust is subject to an ETIP." This statement illustrates the ETIP rule without addressing the Remoteness Exception or the probability of T's death during the 9-year term.[27] There are several other examples in this regulation that assume the same facts or use

[25] T.D. 8644 (12/27/1995) (*See* preamble).

[26] T.D. 8644.

[27] We note that this Example 1 preserves the exact same wording as the example included in the proposed Regulations, which did not propose any exceptions to the ETIP rule. The Final Regulations do not provide any example referencing or illustrating application of the Remoteness Exception. Given that Example 1 does not refer to the Remoteness Exception, that it does not provide facts that would clarify whether the exception applies, and that the Example was unchanged from the proposed Regulations, two conclusions are possible. We could conclude that this Example was not closely reviewed after the Remoteness Exception was added and, therefore, does not consider

(continued…)

parallel facts to illustrate other issues regarding the allocation of GST exemption to ETIPs. None of the examples refer to the Remoteness Exception.

One can speculate that it would make more sense to have adopted an exception for remote interests or reversions where the value of the included property would be less than 5% of the total value of the trust, given that if any part of a trust is subject to an ETIP the entire trust is subject to the ETIP. However, this regulation has been in existence for more than 20 years unchanged and taxpayers have little choice but to apply it as it stands. Thus it also excepts powers to withdraw held by a spouse from the ETIP rules because in many cases of withdrawal rights limited in time, the actuarial probability of the property being included in the spouse's gross estate will be less than 5%. This seems to not have been thoroughly considered, given the specific, limited exception for a spouse's withdrawal right, discussed below.

The legislative history of the ETIP rule itself does not explain its purpose, so that speculating on the purpose of an exception to a rule, the purpose of which itself is only speculative, may seem pointless. However, the ETIP rule results in matching the timing of allocation of GST exemption with the gift or estate tax event when the final transfer tax is imposed. If that is a purpose of the ETIP rule, this exception is logical for transfers where the probability of inclusion is possible but unlikely, because it does not make sense to subject a trust to this complicated rule if inclusion in the gross estate is so remote as to be negligible. The Remoteness Exception applies to achieve that result.

Regardless of what we might imagine the purpose of the ETIP rule is or of this exception, the law is well-established that taxpayers may rely on final or temporary Regulations in tax planning in the same manner in which they may rely upon a Code section. In fact, one important purpose for issuing Regulations is to give the public knowledge of the IRS position with respect to particular Code sections.[28] Accordingly, the IRS has instructed its attorneys that they may not argue contrary to final guidance, including final or temporary regulations in force regarding an issue.[29] The meaning of the probability of inclusion during the retained interest period seems clear and the obvious condition for inclusion is the transferor's death. Accordingly, the IRS should follow, and taxpayers should be able to rely on, the Remoteness Exception applied by its plain terms until such time, if ever, when the Regulation containing the Remoteness Exception is changed.

The Remoteness Exception is likely to be detrimental to the taxpayer more often than it helpful. When the Remoteness Exception applies to a transfer, which it often will with a short term GRAT, an automatic allocation of GST exemption to the transfer would be effective immediately as of the date of the transfer as the allocation is not suspended for an ETIP. IRC

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or address whether the Remoteness Exception applies. Alternatively, we could conclude that the Remoteness Exception never applies in this case and, thus, must apply to something other than the transferor's death during the term because it does not state whether the probability of T's death within 9 years is greater or less than 5%. The Regulations do not provide further guidance regarding the Remoteness Exception in any other way.

[28] *See* H.R. Rep. No. 70-1882, at 22 (1928) (Conf. Rep.), reprinted in 1928 U.S.C.C.A.N. ("[I]t is believed that sound administration properly places upon the Government the responsibility and burden of interpreting the law and of prescribing Regulations upon which taxpayers may rely . . . .").

[29] CC-2003-014 (May 8, 2003).

§2642(b)(1)(B). If the transferor did not intend for an automatic allocation to apply effective from the original transfer, then the transferor should be careful to make a timely election out of the automatic allocation to avoid unexpected use of the transferor's GST exemption. Failing to do so could result is wasting the GST exemption allocated to the GRAT.

As for application, when the ETIP rules do not apply to a GRAT, it is not clear what amount of GST exemption must be allocated to result in a zero inclusion ratio. The amount of GST exemption necessary is equal to the "value of the property transferred to the trust." It is unclear whether this amount is the entire amount transferred to the GRAT or whether the retained annuity value is subtracted, so that the GST exemption necessary is only the value of the remainder for gift tax purposes. Even if the amount of GST exemption allocated is only the taxable value of the gift, the GRAT must outperform the rate that applied to determine the gift to produce an efficient use of the GST exemption allocated. Many GRATs underperform the tables, but since little gift tax if any is paid, the GRAT is almost always positive or neutral for gift tax purposes regardless of performance. Allocating GST exemption changes that result so that there is GST exemption that can be lost. If the amount of the allocation would be to the gross amount of the transfer, which many commentators believe is likely, very few GRATs will not waste most of the GST exemption allocated because the amount of appreciation necessary to overcome the distributions to the transferor is unlikely to occur.

Given this uncertainty of how much GST exemption must be allocated to achieve a zero inclusion ratio, planners should be cautious in advising clients to rely on the Remoteness Exception regarding significant transfers. Opting out of the automatic allocation rules should be done for GRATs because of the risk that the automatic rules will result in an allocation to the entire value of the gross transfer to the trust. Some planners opt out of the automatic allocation rules and then affirmatively allocate GST exemption in the amount of the taxable remainder value only. If that amount allocated is relatively small, the risk of having the inclusion ratio determined using the gross value of the transfer may be acceptable.

(c) Spouse's Power to Withdraw. An ETIP will not arise due to a power of withdrawal held by the spouse of the transferor that is limited to the greater of $5,000 or 5% of the corpus and that lapses within 60 days after the transfer to the trust. Treas. Reg. §26.2632-1(c)(2)(ii)(B). This exception will remove from the ETIP rule trusts over which the spouse has a withdrawal right within these limits.

Unfortunately, many irrevocable trusts exist over which the spouse has a withdrawal right that is not limited to the greater of $5,000 or 5% of the corpus or which may last for longer than 60 days. Under the definition of ETIP, if the spouse were to die immediately after the transfer a portion of the trust would be included in the spouse's gross estate while the withdrawal right is outstanding. Thus such trusts would seem to be subject to an ETIP, because this exception would not apply. However, the Remoteness Exception often will apply to a spouse's lapsing withdrawal right in any event and take the trust out of the ETIP rule. The exception for spouse's withdrawal powers alone is illogical because without the Remoteness Exception, it penalizes transfers subject to withdrawal rights that are longer than 60 days and that are thus less illusory than powers that lapse within 60 days, at least if the withdrawal right lapses annually.

Most powers to withdraw in a spouse will fall within the Remoteness Exception because the probability of death during the withdrawal period will not be greater than 5%. For a withdrawal right that does not meet that exception, and where the ETIP is caused by a spouse's withdraw power that is not within the $5,000 and 5%, 60–day exception, the ETIP will end at the time the withdrawal power lapses. At that time, the allocation of GST exemption will be effective if a timely allocation takes place. At the least, this results in the administrative inconvenience of having to revalue the trust property at the end of the ETIP. More important, if the trust holds life insurance and the insured dies during the withdrawal period, the value of the trust will be increased by the life insurance proceeds.

For new trusts, the simpler approach is to draft withdrawal rights in a spouse to fall within the 60-day exception to avoid any issue of an ETIP from arising if GST exemption will be allocated. For existing trusts that do not meet the exception, to avoid any issue, one could condition the transfer to the trust itself so that the spouse's power to withdraw fits within the exception. This does not affect the terms of the trust except to the extent of the current transfer. The spouse should not waive his or her withdrawal rights in an attempt to terminate the ETIP earlier than the date of lapse because a waiver does not qualify for the gift tax exclusion for taxable lapses to the extent of the greater of $5,000 or 5%. The exclusion applies only to a lapse, and not a release. IRC §2514(b) and (e). Thus a waiver will be treated as a gift to the trust by the spouse of the entire amount subject to withdrawal.

If existing trusts provide withdrawal rights that lapse within the greater of $5,000 and 5% but do not lapse within 60 days, and if the withdrawal lapses in all events by year end, the contribution could be made in November (after November 1). Timing the contribution in this way would result in the power lapsing within the 60 day limit.

3. Termination of an ETIP. The regulations provide that an ETIP terminates on the first to occur of:

(a) The death of the transferor;

(b) The time at which no portion of the property is includible in the transferor's gross estate (other than by reason of §2035) or, in the case of an individual who is transferor solely by reason of an election under §2513, the time at which no portion would be includible in the gross estate of the individual's spouse (other than by reason of §2035);

(c) The time of a generation-skipping transfer, but only with respect to the property involved in the generation-skipping transfer; or

(d) For an ETIP arising by reason of an interest or power held by the transferor's spouse, on the first to occur of (a) the death of the spouse; or (b) the time at which no portion of the property would be includible in the spouse's gross estate (other than by reason of §2035). Treas. Reg. §26.2632-1(c)(3).

4. Split Gifts Subject to an ETIP. Most taxpayers do not split gifts for a year that they make a transfer subject to an ETIP due to the disadvantages of the potential inclusion of property in the transferor's gross estate where gift splitting has been elected. Nonetheless, an example in the regulations clarifies the effect of gift splitting for an ETIP transfer. In such case,

if the consenting spouse dies prior to the termination of the trust, the consenting spouse's executor may allocate his or her GST exemption to the trust, but only to the portion for which the consenting spouse is treated as the transferor. However, the allocation does not become effective until the expiration of the ETIP as to the donor spouse. Treas. Reg. §26.2632-1(c)(5), Ex. 3.

Withdrawal rights in the spouse are discussed further below.

L. Trusts Subject to Lapsing Powers of Withdrawal (Crummey Trusts).

1. Transfers Before 4/1/88. Under IRC §2642(c) as originally enacted, all nontaxable transfers for gift tax purposes were ignored in computing the GST tax and the inclusion ratio for a trust. Thus the inclusion ratio for a trust would be zero if all transfers to the trust were nontaxable. This rule still applies for all transfers before April 1, 1988.

2. TAMRA Changes. TAMRA deleted old IRC §2642(c) for transfers to a trust after March 31, 1988, and replaced it with a new section. TAMRA modified IRC §2642(c), effective March 31, 1988, to provide that transfers to a trust that are nontaxable for gift tax purposes are no longer ignored for GST tax purposes. Transfers to a trust that are nontaxable for gift tax purposes do not have an inclusion ratio of zero, absent allocation of GST exemption, and thus will be taxable for GST tax purposes unless the transfer is a direct skip and the trust qualifies under IRC §2642(c)(2). A qualified trust is a trust (1) exclusively for one skip person beneficiary, and (2) includible in that beneficiary's gross estate if death occurs before the trust terminates. Unlike the trust qualifying for the grandchild exclusion ("Gallo", now expired), the income of the trust need not be paid out currently to qualify. Thus the annual gift tax exclusion for transfers for trusts is no longer fully coordinated with the GST tax "annual exclusion."

Transfers to any other type of trust or transfers that are not direct skips do not have an inclusion ratio of zero, absent allocation of GST exemption, even though qualifying for the annual exclusion for gift tax purposes. A transfer to a trust with multiple beneficiaries, or to a trust not includible in the beneficiary's gross estate on death before termination will not qualify. Thus most trusts subject to powers of withdrawal that were executed before the enactment of the current GST tax do not meet the requirements of IRC §2642(c)(2). For existing trusts that do not meet the IRC §2642(c)(2) requirements, the choices are to allocate GST exemption, have the trust subject to GST tax to the extent of the transfers made to the trust after March 31, 1988, or forego further transfers to the trust.

For example, assume that T created an irrevocable insurance trust in 1980 that pays income and principal in the trustee's discretion among T's descendants, that all transfers to the trust are subject to powers of withdrawal within the annual exclusion limits, and that the lapse of each withdrawal power is less than the greater of $5,000 and 5% of the property to which the lapse applies at the time of the lapse. Transfers are made to the trust each year. All transfers after March 31, 1988, are additions to what was an exempt effective date trust. If sufficient GST exemption is not allocated to the trust to give the portion attributable to the additions after March 31, 1988, an inclusion ratio of zero, the additions subject a pro rata portion of each generation-skipping transfer to tax thereafter.

3. Skip Persons with Withdrawal Rights. A transfer to a trust subject to a withdrawal right in a skip person is not a direct skip unless the trust itself is a skip person. For example, assume that T transfers property to a trust in which T's child, C, and T's grandchild, GC, have withdrawal rights. The trustee may pay income and principal to C and GC as the trustee decides. C is a non-skip person and has an interest in the trust. Although the withdrawal right in GC is a present interest for gift tax annual exclusion purposes, the transfer to the trust by T is not a direct skip as to any portion because the trust is not a skip person. Treas. Reg. §26.2612-1(f), Ex. 3. (The preamble to the proposed regulations stated that this was the case, but the added example in the final regulations clarifies this important issue. This result is consistent with IRC §2612(c)(3) and contrary to TAM 8901004.) Thus the transfer to a trust subject to a right of withdrawal in a skip person is not a direct skip if the trust has non-skip persons as current permissible beneficiaries.

4. Spouse's Withdrawal Power that does not Qualify for the Exception. See the discussion above for ETIPs caused by a spouse's withdrawal power that is not within the 60-day, 5 or 5 exception.

5. Identifying the Transferor. Only the transferor can effectively allocate his or her GST exemption. Any GST exemption allocated to property is ignored after a new transferor is determined. Identifying the transferor and knowing if and when a new transferor may exist is crucial in deciding whether to allocate GST exemption.

IRC §2652(a)(1)(B) provides that the transferor is the donor "in the case of any property subject to the tax imposed by chapter 12." The phrase "subject to the tax" means the transfer is a completed gift regardless of whether a gift tax is imposed. Treas. Reg. §26.2652-1(a)(6), Ex. 1. The nontaxable lapse of a power of withdrawal is not "subject to tax" for this purpose. Treas. Reg. §26.2652-1(a)(6), Ex. 5.

If the lapse of a withdrawal right is partly taxable, the trust will have different transferors for the different portions attributable to the nontaxable and taxable portions. Treas. Reg. § 26.2652-1(a)(6), Ex. 5. Portions of a trust attributable to transfers from different transferors are treated as separate trusts. IRC §2654(b)(1). Thus after a taxable lapse has occurred, the trust will have different transferors and the trustee may segregate the portions attributable to each transferor into separate trusts. Treas. Reg. §26.2654-1(a)(3). The tax adviser should consider the identity of the transferor and the events that change the transferor when drafting trusts subject to withdrawal rights and allocating GST exemption.

6. Type of Lapse. The transferor will be affected by the type of lapse of any withdrawal rights.

(a) All Transfers Less Than $5,000 or 5% Per Person. If all transfers to the trust are less than the greater of $5,000 or 5% ("5 or 5 exception") of the value of the trust at the time of the lapse for each person with a withdrawal right, GST exemption can be allocated by the person making the transfer in the amount of the transfer each year so that the entire trust is exempt from GST tax. This is the most common type of trust and the easiest to analyze. Whether the allocation is the best use of GST exemption must be analyzed in the context of the other factors detailed above. (The power holder should never release a power that otherwise will lapse within the 5 or 5 exception because the exception applies only to a lapse and not to a release. *See* IRC §2514(b) and (e)).

(b) Trusts with Hanging Powers. In TAM 8901004, the IRS ruled that the particular provision used in that trust that limited the lapse of the withdrawal right to the amount that would be a nontaxable lapse was void for public policy reasons. The result in that ruling was that the withdrawal right lapsed as to the entire amount over which the withdrawal applied, which was in excess of the 5 or 5 exception. *See* the discussion below regarding lapses in excess of the 5 or 5 exception. The result in that ruling request appears to be due to the particular language in the trust and may not be applicable to other types of hanging powers.

If transfers made to the trust are subject to a hanging power of withdrawal that only lapses to the extent of the 5 or 5 exception, no taxable transfer occurs as to the lapses and thus the person making the transfer to the trust can allocate GST exemption in the amount of the transfer each year if desired. The risk, however, is that the power holder could die before the hanging powers have all lapsed, in which case the part of the trust subject to withdrawal will be included in the gross estate of the power holder. Such inclusion will result in the power holder becoming the new transferor, wiping out some portion of the benefit of the GST exemption allocated to the trust by the original grantor. The transferor often is willing to take this risk because the GST exemption wasted may be small if the power holder predeceases him or her relative to the potential benefit if the power holder does not.

Several alternatives exist for dealing with the unlapsed withdrawal right on the death of the power holder. One option is provide that the amount hanging at the power holder's death is distributed to the power holder's estate. Another possibility is to have the right to withdraw lapse at the power holder's death so that the amount subject to withdrawal and thus to federal estate tax in the power holder's estate remains in the trust. If the power holder's executor allocates the power holder's GST exemption to the trust, the trust will maintain its inclusion ratio of zero. If not, the portion of the trust attributable to the power holder's taxable lapse is treated as a separate trust with an inclusion ratio of one. Distributions or terminations with respect to the trust will thereafter will be treated as occurring pro rata as to the two portions. Alternatively, if the trustee has the authority under applicable local law or the governing instrument, the trustee may separate the portions into two separate trusts.

(c) Trusts with Lapses in Excess of 5 or 5 Exception. Some trusts subject to powers of withdrawal lapse in an amount in excess of the 5 or 5 exception each year. Such trusts either result in a lapse taxable as to the power holder or avoid a taxable lapse by giving the power holder a power of appointment, resulting in an incomplete gift by the power holder. A third alternative may be to grant a successive withdrawal right to allow another beneficiary to withdraw any amount that has lapsed in excess of the 5 or 5 exception.

> (i) Nontaxable Lapses. The power of appointment over the property subject to the withdrawal right in excess of the 5 or 5 exception may be general or limited, but in either case, that portion of the trust is included in the gross estate of the power holder on death because the lapse of the power in excess of the 5 or 5 exception is a transfer with a retained power of disposition as to the power holder. Thus this type of trust does not seem to be a good choice for

GST allocation purposes because much of the GST exemption allocated by the grantor will be wasted to the extent that the power holder becomes the transferor at a later time.

For example, assume that T creates an irrevocable trust and gives C the power to withdraw up to $20,000, which power lapses as to $5,000 if not exercised after 60 days. C has a limited testamentary power over the trust at death. Assume that no further contributions are made to the trust and that the trust distributes to C's children at C's death. On C's death, three fourths of the trust will be includible in C's gross estate and thus C will become the transferor at that time of that portion. However, if T timely allocates GST exemption, the allocation is effective as of the time of the initial transfer. Thus T must allocate $20,000 of GST exemption in a timely allocation to result in an inclusion ratio of zero because C does not become the new transferor until the inclusion of the trust in the power holder's gross estate at death. Three fourths of any GST exemption T allocates will be wasted on this trust in this event.

(ii) Taxable Lapses. Some lapses of withdrawal powers may be taxable to the power holder. In such case, the power holder will become the transferor as to the taxable portion and the original transferor will remain the transferor for the nontaxable portion. Under the separate share rule of IRC §2654(b)(1), the portions of the trust attributable to different transferors will be treated as separate trusts for GST tax purposes. The power holder becomes the new transferor when the power lapses and not at the time of the original transfer to the trust.

For example, assume that on June 1, T transfers $20,000 to an irrevocable trust subject to a power of withdrawal in C that lapses at the end of 60 days. Assume that C does not have any power or beneficial interest that will prevent the lapse from being treated as a completed gift to the extent in excess of the 5 or 5 exception and that the trust is distributed to C's children at C's death.

C becomes the transferor when the power lapses as to $15,000 and T remains the transferor as to the $5,000 that is nontaxable. Treas. Reg. §26.2652-1(a)(6), Ex. 5. At the time of the lapse of the power, the portions attributable to different transferors are treated as if separate trusts for GST purposes. When the GST exemption is allocated on April 15 of the following year, the trusts are separate, but IRC §2642(b)(1)(B) states that the allocation is effective on and after the date of the transfer, which for T is June 1, at which time the trust is a single trust for GST tax purposes. If the allocation is treated as made to a single trust on June 1, T is the transferor of the entire $20,000. If T allocates only $5,000 of GST exemption on a timely filed return, the result would be an inclusion ratio of .25 for the entire trust, of which C becomes the transferor as to .75 of the trust 60 days later. To maintain an inclusion ratio of zero, C will also have to allocate GST exemption. If allocated on a timely filed gift tax return, the allocation will take place at the value of the portion of the trust attributable to the portion over which C's lapse was taxable at the time of the lapse. If allocated late, the allocation would apply to the same portion calculated at the time of the lapse, but valued as of the date of the late allocation.

In this case T may wish to forgo allocating GST exemption on a timely filed gift tax return to avoid wasting GST exemption. It does not appear possible to allocate as of a later date (in this case, 60 days later) on a timely filed gift tax return. In this case, however, T could allocate late, at which time the portions clearly would be treated as separate. However, T will have to allocate to whatever value exists at the time of the late allocation, which involves some risk, especially that the insured might die in the meantime if the trust holds life insurance policies.

If a lapse greater than the 5 or 5 exception is immediately subject to another beneficiary's withdrawal right as to the taxable portion, the taxable portion may qualify for the annual exclusion. Nonetheless, the first power holder would still become the new transferor as to the amount in excess of the 5 or 5 exception when the power lapses because the definition of transferor would apply to a lapse in excess of the 5 or 5 exception that qualifies for the annual exclusion. In addition, the regulations state that an interest in property held in trust is treated as having been distributed to an individual to the extent that the value of the interest is subject to federal estate or gift tax with respect to the individual. Treas. Reg. §26.2612-1(c)(1).

M. <u>Substantial Compliance</u>. Under pre-EGTRRA law, even the best efforts in good faith often failed to allocate GST exemption as the transferor intended, due to the complicated procedural requirements for proper allocation. EGTRRA introduced IRC §2642(g)(2) expressly providing that a transferor's allocation of GST exemption that demonstrates an intent to have the lowest possible inclusion ratio will suffice to accomplish the allocation that produces the lowest possible inclusion ratio. In all events, the substantial compliance doctrine pre-dates and exists even in the absence of IRC §2642(g)(2). Elections may be effective where the taxpayer complied with the essential requirements of a regulation even though the taxpayer failed to comply with exact procedural requirements.[30] In particular, the IRS has granted taxpayers relief based on their substantial compliance with the procedural requirements to allocate GST exemption.[31] Thus, the substantial compliance doctrine should remain applicable regardless of IRC §2642(g)(2).

N. <u>Valuation: Finality of Inclusion Ratio</u>. For direct skips, the inclusion ratio is final when no additional GST tax may be assessed with respect to the direct skip. That of course will be the same time that the statute of limitations has expired for the gift or estate tax applicable to the transfer that is the direct skip.

For taxable terminations and taxable distributions, finality is more complicated. If all transfers to the trust have been lifetime gifts, and all allocations of GST exemption are made only on timely filed gift tax returns, the inclusion ratio generally will be final when the statute of limitations has expired with respect to all of the gifts made to the trust. That is the result because the values of the transferred assets as finally determined for gift tax purposes will be used to determine the inclusion ratio. If the only transfer to the trust is at death using assets that were included in the transferor's gross estate, the inclusion ratio will be final when the statute of

[30] *See* Hewlett-Packard Co. v. Commissioner, 67 T.C. 736, 748 (1977) and cases cited therein.

[31] *See* PLRs 200040013, 200027009, 200017013, 99919027, 9721009.

limitations has expired for estate tax purposes because estate tax values are used to determine the inclusion ratio.

However, if any late allocations are made to a trust, no chapter 12 values exist for any late allocation. In that case, Treas. Reg. §26.2642-5(b) provides that the inclusion ratio is final as of the later of the expiration of the period of assessment with respect to the first GST tax computed using the inclusion ratio and the expiration of the period for the assessment of the federal estate tax with respect to the transferor's estate.[32]

III. SEPARATE SHARES & TRUSTS; MANDATORY SEVERANCES; NON-QUALIFIED SEVERANCES; QUALIFIED SEVERANCES.

Prior to EGTRRA, the "multiple trust rule" denied for GST tax purposes recognition of separate trusts resulting from most severances even if they were effective under state law.[33] Until the enactment of IRC §2642(a)(3) under EGTRRA allowing qualified severances, the regulations recognized for GST tax purposes only the severances of trusts treated as separate under IRC §2654(b) (dealing with trusts that have more than one transferor and trusts that establish substantially separate and independent shares of different beneficiaries) and certain severances of trusts included in the gross estates of transferors. Moreover, Regulations §26.2654-1(a) stated that a separate share of a trust will not be recognized for GST tax purposes unless the share exists from, and at all times after, the creation of the trust. Thus, the uncertainty of whether separate trusts would be recognized as separate for GST tax purposes impeded planning to achieve inclusion ratios of zero or one.

These rules are less important after the enactment of EGTRRA because if a trust has an inclusion ratio between zero and one, it can be divided into two trusts, with inclusion ratios of zero and one. However, advisers need to know when a qualified severance is necessary and how to comply with the regulations to achieve inclusion ratios of zero and one.

These rules are complex and difficult. They are explained below in some detail.

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[32] Prior to EGTRRA, §2642(b) stated that the inclusion ratios for timely and automatic allocations of GST exemption are determined using the "value for purposes of [federal gift tax]" for lifetime transfers, and "value for purposes of [federal estate tax]" for transfers at death. Regulations §26.2642-2 indicates, though IRC §2642(b) did not specify, that these references mean the values as finally determined for gift or estate tax purposes. Thus, these various rules apparently conflicted to the extent they overlapped. EGTRRA amended IRC §§2642(b)(1) and 2642(b)(2)(A) to clarify the valuation provisions relating to timely and automatic allocations. The changes clarified that the inclusion ratio with respect to a timely or automatic allocation is determined using (i) the value as finally determined for gift tax or estate tax purposes (depending on whether the transfer occurs during lifetime or at death) or (ii) for ETIPs, the value at the close of the ETIP. In all events, the amendments presumably clarified, but did not change, the preexisting rules and principles used in determinations of the final inclusion ratio.

[33] Commentators have long argued that the government's general failure to recognize trusts that are separate under state law as separate for GST tax purposes is not authorized by the GST tax statutes and contradicts clear legislative history stating that IRC §2654 does not affect the treatment of trusts that are separate under state law. *See* H.R. Rep. No. 795, 100th Cong., 2d Sess. (1988), p. 354.

A. Formula Divisions to Achieve Zero and One Inclusion Ratios. In practice, the rules in the regulations described below for formula transfers of assets included in the gross estate are relatively easy to meet so that the allocation of GST exemption on the transferor's estate tax return are effective to what are treated for GST tax purposes as separate trusts as of the date of death, even though no division of assets occurs until much later. However, the rules for transfers of assets included in the gross estate essentially are an exception from the rules generally regarding separate trusts.

In contrast, there are no helpful regulations that apply to a gift made during life to a trust with a formula division that allow the trusts to be treated as if separate effective as of the date of the gift based on the allocation of GST exemption that necessarily occurs much later. In fact, before the 2001 enactment of EGTRAA, the regulations were overtly hostile to lifetime transfers in this respect. Those regulations have only been changed to reflect the reality of the qualified severance rules, and not to liberalize the recognition of separate trusts for lifetime gifts in general.

Formula divisions are desirable for transfers to a lifetime irrevocable trust because of uncertainty about how much GST exemption is remaining and also because the value of the property transferred to the trust is uncertain. A timely allocation of GST exemption on a gift tax return is made in the year following the year of the gift, and can be made on an extended gift tax return as late as October 15 of the following year. If made on a timely filed gift tax return, the allocation relates back to the date of the gift. However, no division can be effective immediately on the date of the gift based on the amount of GST exemption actually allocated because the trustee will not know if any GST exemption will be allocated or how much. Thus a division that directs the trustee to divide a trust that otherwise would have an inclusion ratio greater than zero does not seem to be effective as a matter of state law as of the date of the gift and thus there will be no separate trust equal to the amount of GST exemption that is actually allocated. Even when state law recognizes the trusts as separate from a particular point, the IRS will not recognize the separate trusts as having inclusion ratios of zero and one unless the requirements in the regulations are met.

A direction to the trustee to divide a trust that otherwise will have an inclusion ratio greater than zero can be effective, but only from the time that the IRS will recognize the divided trusts as separate with zero and one inclusion ratios under the qualified severance rules. This requires an actual division and funding in accordance with those rules.[34] Thus a lifetime trust with a direction to the trustee to divide the assets into two separate trusts to produce inclusion ratios of zero or one can be effective but only if the mechanics of a qualified severance are met, described below. Such a direction is not self-effectuating—the trustee must actually do the division and the funding in compliance with the qualified severance rules to have separate trusts with inclusion ratios of zero and one.[35]

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[34] See Treas. Reg. §26.2654-1(a)(iii) that recognizes as separate trusts certain mandatory divisions, but treats the inclusion ratios of each as the same unless the qualified severance rules are met.

[35] A qualified severance cannot have retroactive effect because IRC §2642(a)(3)(A) states that trusts resulting from a qualified severance will be treated as separate trusts "thereafter" for GST tax purposes. Treas. Reg. §26.2642-6(f)

(continued…)

To avoid a qualified severance the document can use a formula that directs the division to be made based on the amount of GST exemption the transferor has remaining at the time of the gift rather than the amount of GST exemption actually allocated. The problem with that approach is that the drafter needs to make a number of assumptions regarding gifts made in the prior and current year and whether a split gift election will be made so that the division could be immediately determined and does not depend on the actual returns filed. The gift tax returns filed later may or may not be consistent with those assumptions. In that case, a qualified severance may still be required to clean up any discrepancy or if no GST exemption is allocated do to a change in plans, the separate trusts can be merged because each would have an inclusion ratio of one. The other approach is to forgo a formula division in the trust instrument completely and merely do a qualified severance occur after the allocation of GST exemption is known. As discussed below, the qualified severance can be done through a formula after the gift tax returns have been filed.

Gift tax return preparers need to understand the mechanics of the formulas to know to which trust GST exemption must be allocated. For example, if the document merely directs the trustee to divide the main recipient trust into two new trusts to produce inclusion ratios of zero and one, the preparer must understand what trust is the recipient of the assets and allocate to it. That main trust may then have an inclusion ratio of greater than zero, so that the trustee then would create separate trusts from that main trust. This can be confusing because the trust to which GST exemption is allocated in that case will not necessarily be the trust that eventually has an inclusion ratio of zero.

B. Substantially Separate and Independent Shares, Mandatory Severances. If a single trust consists solely of separate and independent shares for different beneficiaries, the share attributable to each beneficiary or group of beneficiaries is treated as a separate trust for purposes of the GST tax. The phrase "substantially separate and independent shares" generally has the same meaning as provided in Regulations §1.663(c)-3. Treatment of a single trust as separate trusts under this section does not permit separate trust treatment for income tax or any other purposes under the IRC. Additions and distributions from such trusts are allocated pro rata among the separate trusts unless otherwise expressly provided in the governing instrument. Treas. Reg. §26.2654-1(a)(1)(i).

The regulations state that a portion of a trust is not a separate share unless such share exists from and at all times after the creation of the trust. Treas. Reg. §26.2654-1(a)(1)(i). For this purpose, a trust is treated as created at the date of death of the grantor if the trust is includible in its entirety in the grantor's gross estate. Trusts that would not be included in the grantor's gross estate would apparently be considered created when irrevocable. It is not clear whether a new trust is created to the extent property is added to the trust when the addition occurs.

The final regulations relating to severances of trusts that were issued on July 31, 2008, included changes to Regulations §26.2654-1 which will apply to severances occurring on or after

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also specifies that a qualified severance of a trust may occur at any time before the trust terminates, but the resulting trusts will be recognized as separate only from the effective date of the severance.

September 2, 2008.[36] This regulation now notes an exception under new Regulations §26.2654-1(a)(1)(iii) for certain mandatory severances described below. Regulations §26.2654-1(a)(1)(i) also maintains that the shares or trusts recognized as separate under that regulation will not be treated as separate trusts for purposes of filing income tax returns or calculating any other taxes, but now acknowledges an exception for shares or trusts that are recognized as separate trusts under local law.

Regulations §26.2654-1(a)(1)(iii) addresses severances into separate trusts as well as the creation of separate shares within a single trust. According to the Preamble, Regulations §26.2654-1(a)(1)(iii) is intended to address only mandatory severances that, "as with the other types of severances covered by [Regulation] 26.2654-1(a), are dictated by the terms of the trust." In contrast, the Preamble notes that Regulations §26.2642-6(h) is intended only to address discretionary severances "that are elective and within the discretion of the trustee." Thus, Regulations §26.2642-6(h) expressly excludes from its application the trusts resulting from a severance under Regulations §26.2654-1.

Regulations §26.2654-1(a)(1)(iii) provides that the separate trusts or shares resulting from certain mandatory severances upon the occurrence of an event not within any person's discretion will be recognized as separate for GST tax purposes. To be recognized as separate for GST tax purposes, such shares or trusts must be recognized as separate under applicable local law and, apparently, must satisfy the funding rules under Regulations §26.2654-1(b)(1)(ii)(C) which require either a fractional severance or certain types of pecuniary severances. As is the case with non-qualified severances under Regulations §26.2642-6(h), the resulting trusts or shares will have the same inclusion ratio as the original trust. Accordingly, the mandatory severance of any such trust with an inclusion ratio between zero and one still must meet the requirements of a qualified severance to result in separate trusts with inclusion ratios of zero or one.

Regulations §26.2654-1(a)(5) also amends Example 8 to illustrate the recognition of separate shares that do not exist from the creation of the trust but result from the mandatory severance of a single trust. Example 8 describes the creation of an irrevocable trust with the discretionary power in the trustee to distribute income or principal among T's children and grandchildren. The trust provides that when T's youngest child reaches age 21, the trust will be divided into separate shares, one share for each child of T. Thereafter, the income from the child's share will be paid to that child for life with the remainder to that child's children at the child's death. Formerly, Example 8 denied recognition of the separate shares resulting from the division when the youngest child reaches age 21 because they do not exist at all times from the creation of the trust. However, Example 8 now recognizes those shares as separate for GST tax purposes.[37] The example further clarifies that T may allocate GST exemption to any one or more of the separate shares, instead of requiring an allocation that applies to the entire trust and all three separate shares after the severance. The example confirms that same conclusions would

[36] T.D. 9421.

[37] Although Example 8 does not expressly recite that the separate shares or trusts are recognized as separate under applicable state law, this fact is assumed as it is a requirement for recognition as separate for GST tax purposes.

apply if the trust instrument required division of the original trust into separate trusts, rather than separate shares of a single trust.

C. Pecuniary Payment from Trust at Death of Transferor. If a person holds the current right to receive a mandatory pecuniary payment at the death of the transferor from a trust the pecuniary amount is a separate and independent share if (i) the trustee is required to pay appropriate interest and (ii) the pecuniary amount is payable in kind on the basis of date of distribution values or the trustee is required to fund the pecuniary payment in a manner that fairly reflects net appreciation or depreciation in value of the assets available to pay the pecuniary amount measured from the date of death to the date of payment. Treas. Reg. §26.2654-1(a)(1)(ii).

This draconian provision is unnecessary in light of the valuation rules that specifically provide for a discount from the pecuniary amount and for allocation of GST exemption based on date of distribution values if similar requirements are not met. *See* Treas. Reg. §26.2642-2(b). The valuation rules solve the potential abuse problems with pecuniary payments and a separate share rule for mandatory pecuniary payment is unnecessary. In addition, the separate share rule is a much harsher penalty than the penalty under the valuation rules in that the pecuniary payment is not treated as separate from the trust from which it is paid while the valuation rules either discount the value or use distribution values to determine the inclusion ratio. This means that for purposes of GST exemption allocation, and apparently other GST tax purposes, the pecuniary payment is not separate from the trust from which it is made.

For example, assume that T has $1,500,000 of GST exemption remaining, that T's revocable trust holds $7,500,000 after estate taxes are paid and the trust instrument provides for a $1,500,000 gift at T's death to T's grandchildren with the balance of $5,000,000 after taxes passing elsewhere to non-skip persons. If the pecuniary payment for any reason does not meet the separate share rules, it will be impossible to allocate GST exemption to result in a zero inclusion ratio for the gift to the grandchildren. This is because the allocation under this rule must apply to all of the assets, including the balance of the trust of $5,000,000. Thus an allocation of $1,500,000 can only be made to the entire trust resulting in an inclusion ratio of .8 (1 - 1,500,000/7,500,000).

This problem exists only for pecuniary gifts made from a revocable trust at death where no election is made to treat the trust as a part of the estate under IRC §645. This problem does not exist for pecuniary bequests made pursuant to a will or revocable trusts treated as an estate. This is due to the express provision in IRC §2652(b)(1) that an estate is not a trust arrangement, and that the flush language of IRC §2654(b) provides that for purposes of that subsection, a trust making the IRC §645 election is treated as part of the estate. Because an estate or revocable trust treated as an estate is not a trust for purposes of the separate share rules, a pecuniary gift pursuant to a will or such a trust is not part of trust to which the separate share rule can apply. This is an unjustified trap for the unwary.

D. Multiple Transferors to a Single Trust. Portions of a trust attributable to different transferors are treated as separate trusts for purposes of the GST tax. Additions to and distributions from such trusts are allocated pro rata among the separate trusts unless otherwise expressly provided in the governing instrument. If the separate portions are actually divided into separate trusts pursuant to Regulations §26.2654-1(a)(3), presumably the pro rata treatment would not apply, even if no express provision exists in the governing instrument. Treas. Reg. §26.2654-1(a)(2)(i). The portion of a single trust attributable to one of several transferors is determined by multiplying the fair market value of the single trust immediately after the contribution by a fraction. The numerator of the fraction is the value of the separate trust immediately after the contribution. The denominator of the fraction is the fair market value of the property in the trust immediately after the transfer. Treas. Reg. §26.2654-1(a)(2)(ii).

E. Severance of a Single Trust — Separate Shares or Multiple Transferors. A trust with separate shares or multiple transferors may be divided to reflect separate trusts for the separate portions at any time. The rules regarding severance in funding of separate trusts in Regulations §26.2654-1(b)(1)(ii)(C) apply to such a division. Treas. Reg. §26.2654-1(a)(3).

F. Allocation of GST Exemption to Separate Shares. When separate shares are treated as separate trusts, an individual's GST exemption may be allocated to the separate trust. In addition, the regulations clarify that where the automatic allocation rules apply to trusts treated as separate under the regulations, the transferor's GST exemption not previously allocated is automatically allocated on a pro rata basis among the separate trusts, except to the extent the transferor opts out of the automatic allocation rules. The transferor can elect out of the automatic allocation as to any share. Treas. Reg. §26.2654-1(a)(4).

G. Divisions of Trusts Included in the Gross Estate. These rules apply only to trusts included in the gross estate and do not apply to irrevocable lifetime trusts not includible in the transferor's gross estate at death. Treas. Reg. §26.2654-1(b)(1).

1. Mandatory Severances. The regulations provide that if a trust is severed pursuant to a direction in the governing instrument it will be treated as a separate trust for GST purposes. No further requirements are stated for a mandatory severance. Thus, as currently written, the regulations do not require that a mandatory severance on a pecuniary basis meet the appropriate interest or funding requirements. Treas. Reg. §26.2654-1(b)(1)(i). This is inconsistent with the requirements for separate share treatment for pecuniary gifts to individuals. *See* Treas. Reg. §26.2654-1(a)(1)(ii).

2. Discretionary Severances. The severance rules for discretionary splits require either that the split be fractional or, if the severance is required by the terms of the governing instrument to be made on the basis of a pecuniary amount, that the pecuniary split satisfies the requirements for separate share treatment if made to an individual. Thus, both the appropriate interest and funding requirements must be met in this case. Treas. Reg. §26.2654-1(b)(1)(ii)(C).

3. Non Pro Rata Funding Allowed. For a fractional severance, the fractional funding may be done on a pro rata or non pro rata basis. Treas. Reg. §26.2654-1(b)(1)(ii)(C)(*1*).

4. Terms of Severed Trusts. The final regulations state that the terms of the severed trusts may differ from each other as long as in total they provide for the "same succession of interests" and beneficiaries as in the original trust. Treas. Reg. §26.2654-1(b)(1)(ii)(A). The Preamble indicates that the language in the regulation was intended to

preclude splits with differing terms where the new terms create new interests not contemplated in the trust before the split. For example, a trust that provides income for a child for life, remainder to grandchild, could not be split into two trusts consisting of the actuarial value of the child's income interest in one trust, with the value of the remainder interest for the grandchild in the other trust. Preamble p. 66902. (Although the Preamble states that the proposed regulations did not allow differing terms in the severed trusts, apparently relying on the language of Prop. Treas. Reg. §26.2654-1(c)(2)(i)(C)(*1*), this statement does not appear to cause any problems in light of the effective date rules that allow taxpayers to rely on the final regulations for trusts irrevocable after December 23, 1992. Preamble, p. 66902; Treas. Reg. §26.2601-1(c).)

5. Other Requirements. A discretionary severance must take place pursuant to discretionary authority granted either under the governing instrument or local law and the severance occurs or a reformation proceeding must be commenced prior to the due date for filing the federal estate tax return. Treas. Reg. §26.2654-1(b)(1)(ii). If a court order severing the trust has not been issued at the time Form 706 is filed, or no court order is necessary, the executor must indicate on a statement attached to a timely filed estate tax return that a proceeding has been commenced to sever the trust, if that is the case, and in any event clearly set forth the manner in which the trust is to be severed and the separate trusts funded. A copy of the petition or other instrument used to commence the proceeding, if any, also must be attached to the return. Treas. Reg. §26.2654-1(b)(2).

The regulations specifically state that an individual's GST exemption may be allocated to the separate trusts created pursuant to this section. Treas. Reg. §26.2654-1(b)(3).

H. Non-Qualified Severances. On July 31, 2008, the IRS finalized proposed regulations issued in 2007 addressing severances of trusts for GST tax (discussed further below).[38] New Regulations §26.2642-6 addresses "qualified severances" under IRC §2642(a)(3) as well as non-qualified severances, and applies in most respects to severances occurring on or after August 1, 2007.[39]

Prior to the issuance of Regulations §26.2642-6(h), the "multiple trust rule" denied for GST tax purposes recognition of separate trusts resulting from a non-qualified severance that is effective under state law.[40] Consequently, a taxpayer with more than one child had incentive to create a multigenerational single trust for all of his or her children and more remote issue rather than separate trusts for each child's family branch. If separate trusts are created, each child's death is likely to be a taxable termination as to the trust for his or her family line. In contrast, if a single trust is created, even if the trust is divided later into separate trusts for each child's family,

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[38] T.D. 9421.

[39] Reg. §26.2642-6(d)(7)(iii) and (h), and Examples 9, 12 and 13 of Reg. §26.2642-6(j) apply to severances occurring on or after September 2, 2008.

[40] The government's failure to recognize trusts that are separate under state law as separate for GST tax purposes was nowhere authorized in the GST tax statutory provisions and was, in fact, directly contrary to clear legislative history stating that §2654 does not affect the treatment of trusts that are separate under state law. *See* H.R. Rep. No. 795, 100th Cong., 2d Sess. (1988), p. 354.

a taxable termination arguably would not occur with respect to any of the trusts until the death of the last child to die under the multiple trust rule.

New Regulation §26.2642-6(h) now provides that separate trusts resulting from a non-qualified severance (other than a severance described in Regulations §26.2654-1) that are treated as separate under applicable state law will be respected as separate from the date of the severance for all GST tax purposes. However, the inclusion ratio of the resulting trusts will remain the same as the inclusion ratio of the original trust immediately before the severance. Thus, the non-qualified severance of a trust with an inclusion ratio between zero and one will not produce separate trusts with the most efficient inclusion ratios of zero and one. However, recognition of the separate resulting trusts means that allocations of GST exemption, GST tax elections, additions of property and generation-skipping transfers with respect to one such trust will not impact any other such trust for GST tax purposes. Such recognition of non-qualified severances would increase the alternatives for taxpayers to improve the configuration of trusts creating adverse GST tax consequences. Thus, compliance with the requirements for a "qualified severance" will be unnecessary in cases where a change in the inclusion ratio from the original trust is unnecessary.

Regulations §26.2642-6(j) includes new example 12 to illustrate the new recognition of non-qualified severances. Example 12 describes the division of a single trust into trusts that are separate under applicable state law, but is not a qualified severance due to the failure to preserve contingent survivor income interests existing under the original trust. Because the contingent survivor income interests were not preserved, the "same succession of interests" requirement of a qualified severance was not met. Example 12 concludes that the non-qualified severance results in trusts that are recognized as separate for GST tax purposes because they are separate under applicable state law, though the inclusion ratio of those trusts remains the same as the inclusion ratio of the original trust.

Example 12 specifies that the transferor elected to prevent automatic allocations of GST exemption to the original trust and did not otherwise affirmatively allocate GST exemption to the trust. Thus, the conclusion at the end of Example 12 that each severed trust has the same inclusion ratio of the original trust is not particularly significant. Treasury has not yet issued any guidance concerning changes to a trust that may cause the loss of GST exemption that has previously been allocated to a trust. The IRS, however, has issued a number of private letter rulings in which it has stated that "[a]t a minimum, a change that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status of such a trust."[41] Presumably, the severance described in Example 12 would have satisfied the standards described in Regulations §26.2601-1(b)(4), the regulations that establish safe harbors for amendments to grandfathered trusts (i.e., those trusts that were irrevocable on September 24, 1985). To be more specific, it seems to fit within Regulations §26.2601-1(b)(4)(A), which describes a trustee power to distribute to a new trust that is permitted under state law as in effect when the trust became irrevocable. If, however, the distribution had been made pursuant to a state law that became effective after the trust became irrevocable, the IRS may take the position that the GST exemption allocated has been lost.

[41] *See, e.g.*, PLR 200740328, PLR 200615001, and 200536018.

Example 13 confirms that a trust resulting from a non-qualified severance may be divided further with a qualified severance to produce separate trusts with inclusion ratios of one and zero.

I. Qualified Severances. Shortly after the GST tax was enacted, informal discussions with government personnel consistently indicated that once an allocation of GST exemption was made to a trust that results in an inclusion ratio of between zero and one, the trust could not be split into two trusts with different inclusion ratios (the "no downstream split" rule). This rule was applied in PLR 9226014, citing the flush language in IRC §2654(b) as precluding this tactic. If a division of a single trust is not recognized for GST tax purposes as of the effective date of allocation of GST exemption, the new trusts created maintain the same inclusion ratio as the original trust as long as the trusts are in existence (assuming no other event occurs that would require a change in inclusion ratio). *See* Treas. Reg. §26.2642-4.

For example, if a trust were created in the amount of $1,000,000 and GST exemption of $600,000 allocated to it, the trust would have an inclusion ratio of .400. The government maintained that the trust could not be divided thereafter into a trust of 60% of the trust's assets that would have a zero inclusion ratio and a trust of 40% with an inclusion ratio of one, even though it was clear that if the division had occurred before the effective date of the allocation that would be the result. This placed a heavy penalty on the taxpayer who failed to divide a trust properly as of the time the GST exemption allocation would be effective.

IRC §2642(a)(3) was enacted as part of a broad "fix up" initiative of EGTRRA regarding the GST tax. EGTRRA added IRC §2642(a)(3), which provides that if a trust is severed in a "qualified severance" the trusts resulting from the severance are treated as separate trusts thereafter for purposes of the GST tax. The new provision overruled the no downstream split rule by allowing in certain circumstances for a trust that already had an inclusion ratio greater than zero to be divided to result in two trusts, one with an inclusion ratio of zero and the other with an inclusion ratio of one. The Conference Committee Report states: "The Committee believes it is appropriate to make the rules regarding severances less burdensome and less complex."

A "qualified severance" is defined as the division of a single trust (by any means available under the governing instrument or under local law) in two or more trusts if the division is done on a fractional basis and the terms of the new trusts in the aggregate provide for the "same succession of interests" of beneficiaries as provided for in the original trust. IRC §2642(a)(3)(B). However, if a trust has an inclusion ratio of between zero and one, a severance is a qualified severance only if the single trust is divided into two trusts, one of which receives a fractional share of the total value of all trust assets equal to the applicable fraction immediately before the severance. That trust will have an inclusion ratio of zero and the other trust shall have an inclusion ratio of one. IRC §2642(a)(3)(B)(ii). A qualified severance also includes any other severance permitted under regulations prescribed by the Secretary. A severance can be made at any time and the Secretary shall prescribe by forms or regulations the manner in which the qualified severance shall be reported to the Secretary. This new provision is effective for the division of a trust that occurs after December 31, 2000.

On August 2, 2007, the Internal Revenue Service issued final regulations addressing qualified severances of trusts for GST tax and income tax purposes.[42] In these final regulations, the IRS made important changes to the proposed regulations that were issued in 2004. On the same day, August 2, 2007, the IRS also issued new proposed regulations regarding severances to address additional changes meriting further consideration.[43] On July 31, 2008, the IRS finalized those 2007 proposed regulations by issuing additional final regulations addressing severances of trusts for GST tax purposes.[44] New Regulations §26.2642-6 addresses qualified severances and applies in most respects to severances occurring on or after August 1, 2007.[45]

1. General Requirements for a Qualified Severance. The regulations provide a number of requirements for a qualified severance. Treas. Reg. §26.2642-6(d). The severance must be made pursuant to the terms of the governing instrument or under applicable local law. The severance must be effective under local law.

The date of the severance must be either the date selected by the trustee as of which the trust assets are to be valued to determine the funding of the resulting trusts or the court-imposed date of funding in the case of an order of the local court with jurisdiction over the trust ordering the funding as of a specific date. However, the funding must begin immediately and funding must occur within a reasonable time (but in no event more than 90 days after the selected valuation date). Treas. Reg. §26.2642-6(d)(3).

The single trust must be severed on a fractional basis, but a formula may be used. The terms of the new trusts must provide in the aggregate for the "same succession of interests" of beneficiaries as are provided in the original trust.

2. Same Succession of Interests. The "succession of interests" language appears in IRC §2642(a)(3)(B)(i)(II), and is the same language that is used in Treas. Reg. §26.2654-1(b)(1)(ii)(A). The preamble to the final regulations regarding IRC §2654 states as follows:

> The final regulations provide that the trusts resulting from the severance of a single testamentary trust need not be identical. Thus, if the trust provides income to spouse, remainder to child and grandchild, the trust may be severed to create two trusts, one with income to spouse, remainder to child and a second with income to spouse remainder to grandchild. This result could be achieved through proper estate planning in any event. However, the regulations make it clear that the resulting trust must provide for the same succession of interests as provided for under the original trusts. Thus, a trust providing for an income interest to a

[42] T.D. 9348.

[43] Notice of Proposed Rulemaking REG-128843-05, 72 Fed. Regulation 48249 (August 2, 2007, as corrected on August 22, 2007).

[44] T.D. 9421.

[45] Reg. §26.2642-6(d)(7)(iii) and (h), and Examples 9, 12 and 13 of Reg. §26.2642-6(j) apply to severances occurring on or after September 2, 2008.

child, with remainder to a grandchild, could not be divided into one trust for the child (equal in value to the child's income interest) and another for the grandchild.

The regulations provide that the requirement is satisfied if the beneficiaries of the separate resulting trusts and the interests of the beneficiaries with respect to the separate trusts, when viewed collectively, are the same as the beneficiaries and their respective beneficial interests with the respect to the original trust before severance. Treas. Reg. §26.2642-6(d)(5).

(a) No "Horizontal" Severances. Example 3 of the regulations illustrates a trust severance based on the actuarial value of the respective beneficiaries' interests that does not meet the "same succession of interests" test.[46] Example 3 describes a trust with an inclusion ratio of one that provides for distribution of all trust income to T's child C for life with distribution of the remainder to T's grandchild GC (or GC's estate if GC is deceased). The trust is severed to create two trusts, Trust 1 for C's benefit funded with an amount equal to the actuarial value of C's interest in the original trust and Trust 2 for GC's benefit funded with an amount equal to the actuarial value of GC's interest in the original trust. Example 3 concludes that the division is not a qualified severance because the resulting trusts do not provide the same succession of interests. The Example acknowledges that a taxable termination occurs upon distribution to the separate trust for GC, due to the recognition of the separate trusts resulting from non-qualified severances for GST tax purposes. Treas. Reg. §26.2642-6(h). Thus, the transferor may be required to allocate GST exemption to the entire original trust to protect the GST occurring upon severance. Although the final regulations specify that a qualified severance is deemed to occur before a taxable termination or a taxable distribution that occurs due to the qualified severance, that rule does not address non-qualified severances.[47]

(b) Discretionary Trusts. The regulations provide a special rule for the "succession of interests" requirement. Trusts from which discretionary distributions may be made on a non-pro rata basis can be divided without violating the same succession of interests requirement if the terms of the new trusts are the same as the terms of the original trust and the severance does not shift the beneficial interest to any beneficiary in a lower generation than the persons who held the interest in the original trust and further that the severance does not extend the time for vesting of any beneficial interest beyond the period provided for in the original trust. Treas. Reg. §26.2642-6(d)(5) and 26.2642-6 (j), Ex. 2.

The regulation provides an example of a severance of a wholly discretionary trust that maintains the "same succession of beneficial interests." A discretionary trust for the benefit of A, B, and C and their descendants with the remainder to be divided equally among those three families is severed into three separate trusts of equal value: one for the benefit of A and A's descendants, one for the benefit of B and B's descendants, and one trust for the benefit of C and C's descendants. This example for severances of discretionary trusts parallels Example 5 under Treas. Reg. §26.2601-1(b)(4)(E) addressing permissible modifications of trusts grandfathered from application of the GST tax that will not subject the trusts to such tax.

[46] Reg. §26.2642-6(j), Ex. 3.

[47] "A qualified severance shall be deemed to occur before a taxable termination or a taxable distribution that occurs by reason of the qualified severance." Reg. §26.2642-6(f)(2).

This provision authorizing certain severances of discretionary trusts facilitates divisions of trusts along family lines, which are often important means of resolving family disputes. However, several aspects of this rule require additional clarification. Under the example, the meaning of "per capita" for purposes of this rule is unclear if A, B, and C are not all children of the transferor. Experience suggests that transferors and parties negotiating resolutions to disputes regarding the division of trust property typically prefer a "per stirpes" division of property that preserves the shares of property allocated to each family line, beginning with a per capita division at the children's generation. If such per stirpes division was actually contemplated in this provision, then a technical correction might revise the reference to clarify that a per stirpes measure of the beneficiaries' interests after the severance is appropriate.

The example concludes that severances of discretionary trusts meeting certain criteria satisfy the succession of interests requirement. This conclusion is logical because the trustee in the example has the broadest possible discretion to distribute among multiple beneficiaries on a non-*pro rata* basis. This discretion probably precludes any beneficiary from asserting an interest in a particular or identifiable portion of the trust that could be affected by a severance. For the same reason, this example may indicate that the requirement is met even if beneficiaries of one trust do not have a cross-remainder interest in the other trusts, either as discretionary beneficiaries if their trusts are exhausted or as contingent remainder beneficiaries if one family line terminates. This example does not appear to require that each of A, B, and C and their respective descendants maintain interests in all of the trusts resulting from the severance to the extent that any single trust is exhausted. This conclusion seems to be confirmed by the statement that "each permissible beneficiary of the original trust is not a beneficiary of all of the resulting trusts."[48] In contrast, Examples 2 and 7 of the final regulations illustrating qualified severances recite facts showing that the beneficiaries retain their interests in the remainders of both trusts resulting from the severance in the event a single trust is exhausted. However, without specific discussion, the final regulations remain unclear as to whether the preservation of the original beneficiaries' interests in all of the post-severance trusts is required for a qualified severance.

In addition, the final regulations do not provide extensive guidance regarding the standards for the exercise of discretion that would meet the definition of a discretionary trust for purposes of this exception. Example 2 addressing this exception merely states that the trustee may distribute "as the trustee deems advisable." Hopefully, this absolute discretion without qualification is not the only type that satisfies this exception and other discretionary standards considered similarly non-ascertainable for transfer tax purposes (i.e., "best interests and welfare," "comfort" or "happiness") will suffice.

3. Valuation of Assets for Purposes of Non-Pro Rata Funding. Although Treas. Reg. §26.2642-6(d)(4) initially states that non-*pro rata* funding must be based on the "fair market value" of assets, the regulation then adds a new valuation requirement that:

> [E]ach asset received by a resulting trust must be valued, solely for funding purposes, by multiplying the fair market value of the asset held in the original trust as of the date of severance by the fraction or percentage of that asset

[48] Reg. §26.2642-6(d)(5)(i).

received by that resulting trust. Thus, the assets must be valued without taking into account any discount or premium arising from the severance, for example, any valuation discounts that might arise because the resulting trust receives less than the entire interest held by the original trust.

This Regulation denies any valuation discount attributable to the division of an asset. This denial of discounts otherwise required in proper valuation of trust assets is troubling as it lacks any basis in IRC §2642(a)(3) or its legislative history. In fact, this Regulation contravenes the express statutory requirements of IRC §2642(a)(3) for funding the trusts resulting from a qualified severance. IRC §2642(a)(3)(B)(ii) states that "a severance [of a trust with an inclusion ratio between one and zero] is a qualified severance <u>only</u> if the single trust is divided into two trusts, one of which receives a <u>fractional share of the total value of all trust assets equal to the applicable fraction</u> of the single trust immediately before the severance." (Emphasis added.) As discussed further below, this requirement may not be satisfied in some circumstances if trusts are funded pursuant to the Regulation.

The "total value" of trust assets in the statutory formula, as is the norm for transfer tax purposes, should be fair market value. Fair market value has the generally accepted meaning throughout the Code as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of the relevant facts.[49] Such valuation of property requires consideration of appropriate discounts for lack of marketability, minority interest, illiquidity or other relevant factors, as courts presiding over decades of case law have acknowledged when addressing the determination of fair market value.[50] In adopting a special rule for funding trusts resulting from qualified severances, this Regulation departs from the traditional definition of value solely for this purpose. This method of valuation, being contrary to judicial precedent and applicable state law, will require funding that is contrary to IRC §2642(a)(3) to the extent it denies legitimate discounts required for valuation of trust assets. Moreover, funding pursuant to this Regulation may shift beneficial interests between the resulting trusts from the allocation that would result from funding based on values determined under state law. This shift in beneficial interests in the trust property could violate the trustee's duty of impartiality under applicable state law to fund the resulting trusts based on the trust assets' fair market values.

Example 6 of Treas. Reg. §26.2642-6(j) illustrates the effect of this proposed new rule ignoring valuation discounts. Example 6 describes the severance of a trust with an inclusion ratio of .40 into two separate trusts as of August 3, 2008, intended to be a qualified severance funded on a non-*pro rata* basis. Trust 1 will have an inclusion ratio of one and be funded with assets having a fair market value on the date of severance equal to 40% of the value of Trust's assets on that date. Trust 2 will have an inclusion ratio of zero and be funded with assets having a fair market value equal to 60% of the value of Trust's assets on that date. On August 3, 2008, the fair market value of the Trust assets totals $4,000,000. These assets include 52% of the

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[49] Reg. §§1.170 A-1(c)(2), 20.2031-1(b) and 25.2512-1.

[50] Estate of Andrews v. Commissioner, 79 T.C. 938 (1979); Estate of Bright v. United States, 81-2 U.S.T.C. 13,436 (5th Cir. 1981); Propstra v. U.S., 680 F.2d 1248 (9th Cir.1982).

outstanding common stock in Company, a closely-held corporation, valued at $3,000,000 and $1,000,000 in cash and marketable securities. The example does not specify the value of 100% of the Company stock, and so any control premium that may have applied to value the 52% interest at $3,000,000 remains unknown.

Trustee proposes to divide the Company stock equally between Trust 1 and Trust 2, to fund each with 26% of the Company stock. Example 6 explains that, for funding purposes, the Company stock distributed to each trust is valued as a *pro rata* portion of the value of the controlling 52% interest in Company held in the original Trust. No discount that otherwise would apply in valuing the non-controlling 26% interest transferred to each resulting trust will be considered in funding. Accordingly, each 26% interest in Company stock distributed to Trust 1 and Trust 2 is valued for funding purposes at $1,500,000 (.5 x $3,000,000). Therefore, Trust 1 which is to be funded with $1,600,000 total (.40 x $4,000,000), also receives $100,000 in cash and marketable securities valued as of August 3, 2008. Trust 2, which is to be funded with $2,400,000 total (.60 x $4,000,000) receives the balance of $900,000 in cash and marketable securities. The example concludes that if all other requirements are satisfied, then the severance based on this non-*pro rata* funding allocation is a qualified severance.

However, Example 6 reveals how allocations pursuant to Treas. Reg. §26.2642-6(d)(4) may violate the statutory requirements for qualified severance. IRC §2642(a)(3) requires that one trust resulting from the qualified severance must receive "a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance." (Emphasis added.) According to IRC §2642(a)(3), Trust 2 in Example 6 must be funded with assets with a total value equal to the applicable fraction of .60 or $2,400,000 (.60 applicable fraction x $4,000,000 value of the single trust immediately before the severance). However, if any discount properly applies in valuing a 26% interest in the Company, then ignoring the discount in funding the trusts will violate the statute. For example, assume that a court would find that a 26% interest in Company stock would be valued at a 30% discount from the value of one half of a 52% interest. (In fact, the difference in value probably would be even greater than 30% if the 52% interest were valued with a control premium.) Trust 2 ultimately receives assets with an actual total fair market value of only $1,950,000 ($1,500,000 undiscounted value of 26% interest x .7 (to reflect 30% discount) + $900,000 cash). Thus, Treas. Reg. §26.2642-6(d)(4) requires Trust 2 to be funded with assets having a total fair market value of $1,950,000 insufficient to fully fund Trust 2 with the $2,400,000 amount required under IRC §2642(a)(3). This example demonstrates why the Regulation may be invalid as contrary to the plain terms of the statute, as well as the trustee's potential liability for breach of fiduciary duties to beneficiaries for inadequately funding Trust 2.

In fact, this Example 6 demonstrates that, as applied, the Regulation also accommodates a greater potential shift in value to Trust 2 than should be allowed. This result is illustrated if the trustee of Trust 2 buys the 26% interest in Company from Trust 1 at fair market value, which we have assumed is $1,050,000, for $900,000 in cash and a note for the balance of $150,000. Trust 2 now has a 52% interest valued at $3,000,000, with a debt of $150,000, for a net value of $2,850,000, rather than the $2,400,000 it should have had after the division. After the sale, Trust 1 has the $100,000 cash it received originally, the $900,000 paid for the 26% Company interest, and a note receivable for $150,000, for a net asset value of $1,150,000, rather than the $1,600,000 it should have received.

Overall, application of this Regulation may produce inconsistent results or be subject to manipulation, and could radically skew the actual values of resulting trusts from their proper allocations under state law.[51]

4. Reporting the Qualified Severance. The regulations specify how a qualified severance should be reported. However, the regulations provide that reporting to the IRS is not required for a qualified severance to be recognized, although the preamble states that each severance should be reported to ensure that the provisions of the GST tax may be properly applied. Treas. Reg. §26.2642-6(d), (e), Preamble to final regulations.

The regulations provide that while not required, a qualified severance should be reported to the IRS by filing form 706-GS(T) by April 15 of the year immediately following the year in which the severance occurred (or by the extended due date if an extension of time is granted). The regulations request that the words "Qualified Severance" be written at the top of the return and a Notice of Qualified Severance be attached to the return.

The Notice should identify the name of the transferor, the date the trust was created, the taxpayer identification number for the original trust, and the inclusion ratio of the trust before the severance. As to the new trusts, the regulations provide that the Notice should include the name and tax identification number for each new trust that was created, the date of the severance, the fraction of the total assets of the original trust received by the new trust, other details explaining the basis for the funding of the new trust, such as whether the funding is a fraction of each asset or a fraction of the total fair market value of the assets at the date of severance, and the inclusion ratio. A statement that the trust terms will be the same, or if not, a description of how they will differ, also should be included, although the regulations do not require this.

5. Coordination with Treas. Reg. §26.2654-1(b). The regulations clarify that IRC §2642(a)(3) does not replace Treas. Reg. §26.2654-1(b), which applies for trusts included the gross estate. Treas. Reg. §26.2654-1(b) is necessary to address issues regarding establishing an inclusion ratio when trusts are created at death, particularly where the amounts in various trusts may be or are affected by the exercise of discretion by a trustee that can only occur after death, to which the inclusion ratio relates back. For example, a severance of a trust based on a pecuniary amount is not a qualified severance under IRC §2642(a)(3), although it is clearly permissible under Treas. Reg. §26.2654-1(b) for transfers at death. (The 2004 proposed regulations regarding qualified severances would have repealed Treas. Reg. §26.2654-1(b), which would have been unfortunate.) The regulations clarify that a qualified severance is effective only going forward.

6. Timing of Qualified Severances: No Retroactive Effect. A qualified severance cannot have retroactive effect because IRC §2642(a)(3)(A) states that trusts resulting from a qualified severance will be treated as separate trusts "thereafter" for GST tax purposes.

[51] The Treasury Department considered and declined to accept the suggestion that the Regulations could be revised to require that the "total value of all trust assets" will be determined by using traditional fair market values, but by valuing all trust assets *after* any proposed division of assets to be used in funding. This revision would have maintained consistency between the Regulation and the statutory language of §2642(a)(3), while addressing the IRS's concerns. Preamble to the final issuance of Reg. §26.2642-6(d)(4).

Treas. Reg. §26.2642-6(f) also specifies that a qualified severance of a trust may occur at any time before the trust terminates, but the resulting trusts will be recognized as separate only from the effective date of the severance. Accordingly, a qualified severance cannot prevent or otherwise affect taxable transfers that occur prior to the date of the severance. Treas. Reg. §26.2642-6(d)(3).

Practitioners considering qualified severances of existing trusts with inclusion ratios other than zero should consider whether the severance, itself, will create a GST. The final regulations helpfully provide that "[a] qualified severance shall be deemed to occur before a taxable termination or a taxable distribution that occurs by reason of the qualified severance." Treas. Reg. §26.2642-6(f)(2). However, this rule will not eliminate a GST that occurs prior to, and not by reason of, the qualified severance.[52]

Thus, note that the benefits of planning with qualified severances may be lost if a GST occurs before the severance is accomplished or if the severance, itself, creates a GST. Accordingly, trusts drafted to undergo a qualified severance in the future should incorporate provisions postponing potential GSTs until a severance can be accomplished. The easiest way to prevent such GSTs is to include non-skip beneficiaries with interests recognized for GST purposes.[53] A trust that merely prohibits distributions for a period will not be sufficient to avoid a GST if skip persons remain the only beneficiaries entitled to distributions at the end of that period. Treas. Reg. §26.2612-1(d) and (e).

J. Income Tax Consequences of Severances.

1. Safe Harbor. The final regulations issued on August 2, 2007, added a new paragraph (h) to Regulations §1.1001-1, which addresses severances generally and is not limited to qualified severances under IRC §2642(a)(3). The new paragraph provides that a severance does not constitute an exchange of property that would trigger income tax consequences if the severance is authorized by applicable state statute or the governing instrument and, if the separate trusts are funded on a non-*pro rata* basis, only if the funding is authorized by applicable state statute or the governing instrument.

Regulations § 1.1001-1(h)(1) is narrower in scope than the definition of a "qualified severance" under IRC §2642(a)(3), which includes a severance that occurs pursuant to "any

[52] Note that if a late allocation of GST exemption and severance of a trust resulting in a GST occur on the same day, the allocation of exemption should be deemed to have occurred prior to the severance. *See* Treas. Reg. §26.2632-1(b)(2)(ii).

[53] *See* Treas. Reg. §26.2612-1(e). However, planners must consider the anti-abuse rule of IRC §2652(c)(2) which provides that "an interest which is used primarily to postpone or avoid any tax imposed by this chapter shall be disregarded." Neither the statute nor the related regulation provides any guidance regarding the amount that may be sufficient to deflect the anti-abuse rule. In fact, IRC §2652(c)(2) bases its criterion purely on the intention motivating inclusion of the interest and does not indicate that the magnitude of the interest is relevant. Interestingly, the related regulation further elaborates: "An interest is considered as used primarily to postpone or avoid the GST tax if a significant purpose for the creation of the interest is to postpone or avoid the tax." Thus, the regulation appears to provide more leniency than does the statute in determining that an interest should be ignored for GST tax purposes.

means available under" local law (not only by state statute).[54] Accordingly, even in the absence of the specific power to sever in the trust instrument or state statute, a severance by judicial order or other means available under local law should suffice for purposes of the qualified severance statute. However, Regulations § 1.1001-1(h)(1) requires authorization by "state statute" if the trust instrument does not expressly direct or authorize the severance. Thus, this express limitation to statutory authority potentially excludes severances that do not fit squarely within any statute but are effective under broader "state law." However, the regulation also may be broader than the qualified severance rules in that a division that is allowed under state law but does not meet the qualified severance rules may still not be taxable for income tax purposes. For example, a division that does not have the same succession of interests if authorized under state law may not trigger income tax even though it would not be a qualified severance.

2. <u>Cottage Savings Test</u>. The Preamble to Regulations §1.1001-1 notes that "[n]o inference is to be drawn with respect to the income tax consequences under section 1001 of any severance that is not described in Section 1.1001-1(h)(1)." Where a severance is not described in the new safe harbor, the severance must be reviewed for the two elements of a taxable event for income tax purposes under Regulations § 1.1001-1: whether an exchange of property has occurred, and if so, whether the exchange was "for other property differing materially either in kind or in extent." *See Cottage Savings Ass'n. v. Comm'r.*, 499 U.S. 554 (1991).[55]

The IRS has ruled favorably for taxpayers that severances of trusts will not result in a taxable exchange under IRC §1001 after applying the *Cottage Savings* test.[56] However, the IRS also has declined to rule on at least one request for a ruling on this issue, based on "the factual nature of the problem or in the interest of sound tax administration" without offering further explanation.[57] Given the IRS's reliance on *Cottage Savings*, taxpayers must analyze whether beneficiaries may obtain interests in the trust after a severance that are "materially different" from their original interests to avoid unexpected recognition of taxable gain under IRC §1001. In particular, a severance that results in separate trusts governed by terms that are not identical to the original trust may warrant close scrutiny to ensure that resulting beneficial interests are not

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[54] IRC §2642(a)(3).

[55] In *Cottage Savings*, the Court held that a realization event under §1001(a) occurs upon an exchange of properties that are "materially different." 499 U.S. at 560-61. The Court further stated that properties are "materially different" for purposes of §1001(a) to the extent their respective possessors enjoy legal entitlements that are different in kind or extent. *Id*. at 564-65.

[56] PLR 200010037 (trustee had discretionary power to divide trust and IRS concluded trustee's division of trust was not an exchange and no gain realization). Similarly, in PLRs 200116016 and 200210056 trustee's power in trust instrument to divide trusts and the subsequent division of trust was not an exchange and no gain realization. In PLR 200128035, the IRS determined the beneficiaries interests in proposed trusts resulting from a division of a trust were not materially different from their interests in the original trust, and, therefore, no gain realization.

[57] PLR 9831023.

"materially different" under the *Cottage Savings* test -- even though the severance may retain the "same succession of interests" for GST tax purposes.[58]

No exchange should result from a severance pursuant to the trustee's authority, because the trustee's ongoing power generally prevented the beneficiaries from acquiring a fixed and identifiable interest in the trust that would be altered by the severance. The trustee's exercise of a severance power should be treated the same as any other exercise of a trustee's discretion, such as the discretion to make distributions. For example, a severance of a trust providing for wholly discretionary spray distributions of income and principal to beneficiaries does not create interests differing from the beneficiaries' interests in the original trust because those were always subject to change through the exercise of the trustee's discretion. Thus, the beneficiaries do not receive any new interest different from the original interest to which they were entitled and the severance should not incur gain or loss for income tax purposes. However, a severance that results from any means other than pursuant to the trustee's authority must be reviewed for an exchange of property differing materially in kind or in extent.

K. Authorization in Documents to Split Trusts. The trust instrument should expressly allow the trustee to split trusts to minimize adverse GST tax consequences. The trustee power should expressly authorize the terms of the new trusts to differ from the original trust as long as the total effect of the two trusts when evaluated in the aggregate is the same. In addition, the language could expressly authorize the trustee to make disproportionate distributions from the new trusts created. Without this language in the governing instrument, it may not be possible to have the trusts terms differ in the two new trusts after a division occurs without going to court, because state statutes that authorize dividing trusts without a court order may not specifically authorize changing the trust terms after the division.

IV. SPECIAL RULES APPLICABLE TO CHARITIES.

A number of special rules apply to trusts that involve charities. Charities described in IRC §§511(a)(2) and 511(b)(2) and governmental entities are non-skip persons, assigned to the transferor's generation.

A. Definition of Interest in a Charity. A charity has an interest in a trust under two circumstances. First, a charity has an interest in a trust if it has a present nondiscretionary right to receive income or corpus from the trust. For example, the named charitable beneficiary of a qualified charitable lead trust is presently entitled to income and corpus from the trust and so has an interest. A charity entitled to a mandatory payment from any trust also has an interest. Second, a charity has an interest in the trust if the charity is described in IRC §2055(a) and is the remainder beneficiary of a qualified charitable remainder annuity trust or unitrust or pooled income fund.

[58] For a detailed discussion of *Cottage Savings* and its application to planning with trusts for GST tax purposes, *see* Lloyd Leva Plaine, "How Cottage Savings and Recognition of Gain Relate to Trusts," 38th Annual Heckerling Institute on Estate Planning, Chapter 4 (2004).

A charity who is only a permissible current recipient of income or principal in the trustee's discretion does not have an interest even though an individual with the same beneficial rights would have an interest. IRC §2652(c)(1). Thus, if the trustee has discretion to select charitable income beneficiaries, no charity has an interest in the trust even if all trust income must be distributed currently to charity.

B. Charitable Remainder Trusts. Where a charity is the remainder beneficiary of a qualified charitable remainder annuity trust or unitrust or pooled income fund, no taxable termination can occur with respect to the trust because charity has an interest and is defined as a non-skip person. IRC §2651(d)(3). Thus the only potential generation-skipping transfers with respect to a qualified split interest charitable remainder trust are taxable distributions because a non-skip person will always have an interest.

C. Pooled Income Funds. A pooled income fund is a fund managed by charity to which several donors contribute. The donors split the trust income. After the death of a donor, his or her share of the fund passes to charity. A pooled income fund has the same GST tax characteristics as a charitable remainder trust.

D. Charitable Lead Unitrusts. A charitable lead unitrust is subject to GST tax if the property distributes to a skip person at the end of the lead period, unless the predeceased ancestor exception applies. For example, assume that T creates a charitable lead unitrust interest in charity for ten years, and at the end of the ten years the trust distributes per stirpes to T's descendants. Assume further that T has a child, C1, who was alive when the trust was created but who dies before the end of the term leaving descendants and that therefore C1's share passes to C1's descendants, per stirpes, at that time. The distribution at the end of the term to C1's descendants is a taxable termination subject to GST tax. T can obtain an inclusion ratio of zero for the trust by allocating GST exemption in the exact amount of the noncharitable remainder. To the extent that the trust outperforms the IRC §7520 rate that was used to determine the charitable deduction, charity will share in the benefit because the unitrust interest will be increased. To the extent that the trust underperforms the IRC §7520 rate, charity will share in the decrease of the trust. If C1 was deceased when the trust was created, the predeceased ancestor exception will apply.

E. Inclusion Ratio for Charitable Lead Annuity Trusts. IRC §2642(e) applies only to charitable lead annuity trusts and provides that the denominator of the applicable fraction for charitable lead annuity trusts is not determined until after the termination of the charitable lead annuity. For property transferred after October 13, 1987, the applicable fraction is a fraction, the numerator of which is equal to the adjusted GST exemption, and the denominator of which is the value of all property in the trust immediately after the termination of the charitable lead annuity. IRC §2642(e)(2) defines the adjusted GST exemption as the amount of GST exemption allocated to the trust increased by interest which is determined at the interest rate used to determine the amount of the IRC §2055 or IRC §2522 deduction for the charitable lead annuity and for the actual period of the charitable lead annuity. This concept can be expressed as a formula as follows:

$$\text{Applicable Fraction for certain CLATS} = \frac{\text{Adjusted GST Exemption}}{\text{Value of Property in Trust after Termination of Charitable Lead Annuity}}$$

Thus, to compensate for the potential increase in the value of the trust during the lead period, the GST exemption allocated to the trust at its inception will increase over the annuity term at the same interest rate applicable in determining the estate or gift tax charitable deduction for the annuity interest. Whether a GST tax is imposed at the termination of the annuity will depend on whether the trust has had a net increase in value in excess of the applicable table rate for the charitable lead period.

For example, assume T transfers $1,000,000 to a charitable lead annuity trust providing an annuity for 10 years of $100,000 per year when all of T's children were living. At the end of the 10 years, the property passes to T's grandchild, GC. The gift tax deduction for the annuity at a 10% rate is $614,460. The remainder to GC is valued at $385,540. Assume T allocates GST exemption in the same amount as the value of the remainder. Under the statute as originally enacted, the applicable fraction would be computed as follows:

$$\frac{\$385{,}540}{\$1{,}000{,}000 - \$614{,}460} = \frac{\$385{,}540}{\$385{,}540} = 1$$

The inclusion ratio would be zero and the property would have passed to GC without a GST tax regardless of the value of the trust at the time the charitable lead annuity terminated.

However, under IRC §2642(e) the result is different. If in addition to paying the annuity each year, appreciation plus income accumulations during the 10 year period results in a value of the trust of $1,500,000 at the end of the period, the applicable fraction would be $999,991 ($385,540 x 1.110) (rounding errors prevent this number from being exactly $1,000,000) divided by $1,500,000 or .667. The inclusion ratio would be .333. If the charitable lead annuity trust had performed at precisely a 10% per year after tax net rate of increase, the applicable fraction would have been $999,991/$1,000,000 = 1, or an inclusion ratio of 0.

If the lead trust had appreciated at less than the 10% rate, the applicable fraction would be greater than one and the resulting inclusion ratio would be a negative number. A negative inclusion ratio means that more exemption than was necessary was allocated to the trust. If the trust has a negative inclusion ratio, it could be added to another trust with a positive inclusion ratio at a later time. In PLR 9109028, the IRS ruled that if the applicable fraction would be greater than one, the inclusion ratio will be zero and not a negative number.

For late allocations to a charitable lead annuity trust, the regulations provide that adjusted GST exemption is the same except that the increase is limited to the interest that would accrue if invested for the period beginning on the date of the late allocation at the same interest rate as if a timely allocation had been made. (This different treatment for late allocation appears to be in conflict with the statutory provision.) The GST exemption allocated is not reduced even if the adjusted GST exemption is greater than the denominator. Treas. Reg. §26.2642-3(b).

While formula allocations of GST exemption are allowed in general, the regulations specifically provide that formula allocations made with respect to charitable lead annuity trusts are not valid except to the extent that they are dependent on values as finally determined for federal estate or gift tax purposes. This statement appears to preclude a formula allocation to a charitable lead annuity trust that would result in a zero inclusion ratio at the end of the charitable lead period. Treas. Reg. §26.2632-1(b)(2)(i).

If the child of T who is the parent of GC in the above example is deceased when the trust is created, the predeceased ancestor exception will apply. In such case, no taxable termination will occur at the end of the term when the trust distributes to GC.

In summary, if a charitable lead annuity trust outperforms the rate applicable in computing the deduction, the applicable fraction will be less than it would have been under the original version of the statute. If it performs exactly at the rate, the applicable fraction will be the same as it would have been under the original version of the statute. If the trust underperforms the rate, the benefit of the GST exemption allocated may be partially lost.

Charitable lead unitrusts are not affected by this technical correction. This change is effective for property transferred after October 13, 1987. TAMRA §1014(g)(3)(B). Thus the provision is retroactive, and some tax returns may already have been filed for transfers after October 13, 1987, to which the new rule applies.

F. Separate Trusts for Charitable Gifts. For nonqualified charitable gifts, shares for charity should usually be placed into a separate trust to maximize the benefit of any GST exemption allocated. For example, assume that T creates a QTIP trust for T's spouse, S, which provides that on the death of S, the trust property passes half to a trust for T's descendants and the other half to charity. If T's executor makes a reverse QTIP election for the trust and allocates GST exemption, T cannot avoid allocating exemption to the half of the trust that will pass to charity. This wastes GST exemption attributable to the one-half charitable interest. Instead, T should provide for two separate QTIP trusts, one of which would pass to T's descendants and the other to charity. This allows T's executor to allocate GST exemption only to the share that passes to descendants and to use any remaining GST exemption elsewhere.

V. MISCELLANEOUS ISSUES.

A. Health and Education Exclusion Trusts ("HEET").

The concept of the health and education exclusion trust ("HEET") appears to have existed for at least a decade.[59] They attracted enough attention that the President's fiscal year 2014 budget included a proposal to curtail their use.

The HEET typically is an irrevocable, long-term trust that provides for distributions for the benefit grantor's descendants that qualify for the Section 2503(e) gift tax exclusion for tuition

[59] *See* discussion of HEETs in H. Zaritsky, Tax Planning for Family Wealth Transfers, Section 4.11[3][d][iv] (Thomson Reuters/WG&L, 5th ed. 2013); Goffe, "Oddball Trusts and the Lawyers Who Love Them or Trusts for Politicians and Other Animals," 46 Real Prop., Trust, Est. L.J. 543, 548-551 (Winter, 2012); Goffe, "An Introduction to Lesser-Known But Useful Trusts—Part 1," 37 Est. Plan. 13 (July, 2010); Delgass & Gordon, "HEET Wave," 144 Tr. & Est. 20 (Mar. 2005); Adams, Handler & Dunn, "A New Twist on Sec. 2503(e); Health and Education Exclusion Trust (HEET)," 139 Tr. & Est. 18 (July 2000); K. Henkel, Estate Planning and Wealth Preservation: Strategies and Solutions, Section 36.11 (Thomson Reuters/WG&L 1997).

and medical care paid directly to the provider. Such distributions are not "generation-skipping transfers" for purposes of the GST tax.[60] The HEET is designed to avoid all GST taxes by including a perpetual non-skip charitable beneficiary which purportedly prevents any transfers from constituting direct skips and precludes any taxable distributions or taxable terminations from occurring.

Proponents of the HEET typically acknowledge the anti-abuse rule of Section 2652(c)(2) providing that "an interest which is used primarily to postpone or avoid any tax imposed by this chapter shall be disregarded." Accordingly, drafters creating HEETs usually include a minimum amount that the charity will be certain to receive annually. A survey of websites, electronic listserv discussions, firm newsletters and articles indicates that there is a wide range of opinion regarding the sufficient minimum interest, from "1/4 – 1/3 of trust income" to "2% unitrust" to "10% of the value of the trust." However, neither the statute nor the related regulation provide any guidance regarding the amount that may be sufficient to deflect the anti-abuse rule. In fact, Section 2652(c)(2) bases its criterion purely on the intention motivating inclusion of the interest and does not indicate that the magnitude of the interest is relevant. Interestingly, the related regulation further elaborates: "An interest is considered as used primarily to postpone or avoid the GST tax if a significant purpose for the creation of the interest is to postpone or avoid the tax." (Italics added.) Thus, the regulation appears to provide more leniency than does the statute in determining that an interest should be ignored for GST tax purposes. This lesser standard encourages the reinforcement of the charity's mandatory interest in the trust.

However, drafters also must consider the "separate share" rule, which treats a single trust's "substantially separate and independent shares for different beneficiaries" existing from and all times after creation as separate trusts.[61] The operation of this rule may effectively segregate a charity's ascertainable interest as a separate trust for GST tax purposes, resulting in two trusts: one trust for a non-skip charity, and one trust potentially subject to GST tax on a direct skip on funding or eventual taxable termination. In the article by Delgass and Gordon, the authors recommend that drafters postpone the charity's identifiable minimum interest to a later date after creation or provide for an indefinite charitable interest for the duration of the trust (though including some minimum amount to attempt to satisfy the current interest requirement at all times).[62]

Finally, regardless of legal technicalities, practitioners must critically review whether the HEET makes economic sense for a particular client. The drain of a charitable interest sufficient to be recognized for GST tax purposes despite Section 2652(c)(2) without an initial charitable income tax deduction, potentially coupled with lower GST tax rates in the future, may reduce the utility of making a taxable gift to fund a HEET. However, if the HEET is legally effective and economically efficient in avoiding GST taxes, then it may constitute an attractive vehicle for transferors who have exhausted their GST exemption or wish to couple it with trusts that

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[60] Section 2611(b)(1).

[61] Treas. Reg. §26.2654-1(a)(1)(i).

[62] Delgass & Gordon, "HEET Wave," 144 Tr. & Est. 20 (Mar. 2005).

otherwise preclude leverage of GST exemption, such as charitable lead annuity trusts or GRATs and other trusts subject to ETIPs.

The Administration's 2014 fiscal year budget proposal would limit the Section statutory exclusion to direct payments by individuals to medical care providers or to schools for tuition payments.[63] If this proposal is enacted, the exclusion would no longer apply to trust distributions made for those same purposes to the service providers and HEETs no longer would be useful to avoid GST tax. The proposal inaccurately describes this change as a "clarification" of existing law. The statute, itself, qualifies trust distributions for this exclusion as it states that a GST transfer does not include "any transfer, which if made *inter vivos* by an individual, would not be treated as a taxable gift by reason of section 2503(e) . . . ." This conditional language ("if made . . . by an individual . . .") makes clear that this exclusion applies to trust distributions because it does not require a transfer by an individual. If the statute was intended to limit the exclusion to transfers by individuals, the statute would read differently and exclude "any transfer made *inter vivos* by an individual which is not treated as a taxable gift by reason of section 2503(e)." The conditional language in the statute describing a potential transfer by an individual reflects that the exclusion currently applies to trust distributions. Thus, the proposal suggests a new change in the law, rather than a "clarification."

Unlike most proposals which only apply to trusts created after enactment of new law, the proposal would apply to trusts created after *introduction of the bill proposing this change*, and to transfers thereafter trusts that are not subject to GST tax due to the effective date of the tax.[64] Given the effective date provisions of this proposal, if enacted, taxpayers who might be considering HEETs should review whether to proceed with their creation as there may be little or no notice of introduction of the bill foreclosing their usefulness. However, given the passage of time, it seems unlikely that if enacted, the effective date of this rule would be retroactive to 2014.

B. <u>Floors and Ceilings on Formula Clauses in Wills and Revocable Trusts</u>.

As Appendix A indicates, the available GST exemption has changed drastically. Drafters should review estate plans and discuss with clients floors and ceilings on various trusts rather than relying on current or anticipated levels of GST exemption. Transfer tax rates and exemptions have not been a model of stability for quite some time. Drafters can address this uncertainty by discussing with clients the appropriate division between exempt and non-exempt trusts or gifts if significant changes in GST exemption occur in the event the documents are not revised before death makes them irrevocable. Powers of appointment granted to a surviving spouse can be exercised to reallocate assets as well if significant changes in exemption levels have occurred.

C. <u>Existing Non-Exempt Trusts</u>. Older irrevocable non-exempt trusts should be reviewed to determine if a taxable termination will occur on the death of a non-skip person who

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[63] *See* Section 2611(b)(1); Dept. of Treasury, General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals, p. 147 (April, 2013).

[64] *Id*.

will have excess estate tax exemption available. It may be possible to cause estate tax inclusion without attracting an estate tax. This would avoid a taxable termination as well as allow a possible increase in basis if the assets have appreciated. If the transferor is still living, additional GST exemption could be allocated before it expires, currently scheduled to occur at the end of 2025

D. Tax Clauses.

Most tax clauses needed revision after the enactment of the GST tax. In particular, specific bequests to skip persons should be considered carefully. The GST tax provides that the property which is the subject of a generation-skipping transfer is the source of the tax, absent a specific reference to the payment of GST tax in the governing instrument. For example, assume that T has previously used all of T's GST exemption and on T's death, T leaves a bequest of $20,000 to his gardener, who is more than 37 1/2 years younger than T, and the balance of the estate to T's child, C. Unless T's governing instrument makes a specific reference to the GST tax or to the chapter 13 tax, a general clause directing the payment of death taxes from the residue will not exonerate the specific bequest from GST tax. To the gardener, this may look like malpractice.

In drafting a tax clause that exonerates direct skips from payment of GST tax, the possibility of disclaimers must be considered. For example, assume that T creates a generation skipping trust in the amount of T's remaining GST exemption for T's two children, C1 and C2, and their descendants, to last for several generations. Assume further that T makes a specific bequest of $500,000 outright to each of C1 and C2, with a gift over per stirpes to their respective surviving descendants, that the balance of the estate passes in trust for C1 and C2 with ultimate distribution per stirpes to C1's and C2's descendants living at their respective deaths, and that C1 disclaims his specific bequest. If T's executor allocates GST exemption to the disclaimed bequest, the generation-skipping trust for descendants will be diminished or will have an inclusion ratio greater than zero, depending upon the formula used to create it. Neither result would be acceptable to C2. T's tax clause should allocate any direct skip GST tax caused by a disclaimer to the property disclaimed in this case. If the GST tax were instead paid from the residue, C2's family would pay a disproportionate amount of GST tax.

Of course, the tax clause must be adjusted to waive reimbursement for taxes on the Reverse QTIP trust.

E. Predeceased Ancestor Exception.

1. Allocation Issues. A problem with the predeceased ancestor exception arises in determining how to allocate the transferor's GST exemption. For example, assume that T creates three separate trusts, one for each of his two living children and one for the descendants of his deceased child, C1. Assume further that the total value of all three trusts is more than T's remaining amount of GST exemption of $5,000,000 and that all trusts are trusts that last for the maximum allowable time under the local perpetuities law. While it is not necessary to allocate GST exemption to the trust for C1's descendants to avoid a direct skip tax at T's death, if T's executor has discretion to allocate and fails to allocate the same amount of exemption to C1's trust, C1's grandchildren or descendants will pay a GST tax greater than that paid by descendants

of C2 and C3 when property is distributed to C1's grandchildren (a taxable distribution) or when a grandchild no longer has an interest (a taxable termination). However, the tax benefit from allocating GST exemption to C2 and C3's trust seems more valuable in theory because it is likely that C2 and C3 will cause a GST tax much sooner since their deaths are likely to occur sooner. This is particularly true if C2 or C3 are elderly or in poor health. Whatever allocation T's executor makes is subject to criticism by some of the beneficiaries in a case like this.

2. Applicable to Certain Collaterals Only if No Descendants Exist. Trusts for nieces and nephews and their descendants or other non-lineals also create problems. For example, a specific bequest to T's niece, with a gift over to the niece's descendants if the niece does not survive is a taxable direct skip if the niece predeceases T unless T has no descendants at the time of the direct skip because the predeceased ancestor exception is so limited. No predeceased ancestor exception applies to other collaterals, such as descendants of a cousin of the transferor. The statute is not clear exactly when the descendants must be deceased for the exception to apply to grandnieces or grandnephews. For example, assume that T has one descendant, C, when T establishes an irrevocable trust for T's sister, A, and that A's child, AC, is deceased when the trust is established. Assume further that C dies before A and that on A's death the trust passes to A's grandchild, AGC, who is T's grandniece. IRC §2651(e)(2) provides that the exception does not apply to collaterals if the transferor has any descendant living "at the time of the transfer." "Transfer" could mean the transfer subject to gift tax that occurred when the trust was established, in which case the exception would not apply, or it could mean the generation-skipping transfer, which would mean the death of AC and the exception would apply. The term "transfer" is ambiguous because it is used in IRC §2651(e) in both contexts.

F. Survivorship Provisions.

1. 90 Day Survivorship for Predeceased Ancestor Exception. For planning purposes, gifts to descendants of a parent of the transferor, or of the transferor's spouse or former spouse, should be subject to a provision that treats the descendants as predeceasing the transfer if he or she dies within 90 days if applicable local law does not otherwise provide to allow for the maximum use of the predeceased ancestor exception. Unfortunately, existing documents without any such provision do not qualify for this special rule. While it may be possible to qualify for this exception through a disclaimer by the deceased descendant's executor, amending the governing instrument will avoid any uncertainty, and will avoid any court approval for a disclaimer by an executor, which is required in some states. Alternatively, states should enact 90 day survival requirements for descendants of a testator, or grantor of revocable trust, and of a spouse and former spouse. (No general survival requirement should be imposed on the transferor's surviving spouse because such a requirement could forfeit the marital deduction where one was otherwise intended.)

2. In General. The statute left the GST tax effect of the use of survivorship provisions unclear. For example, assume that T's will leaves T's estate per stirpes to T's descendants who survive T by six months. T's child, C, survives T but dies before the end of six months. C's child, GC, receives the share C would have received at the end of the six months. Is the distribution to GC a direct skip or was C's death a taxable distribution as to C's share? IRC §2652(b)(1) specifically excepts an estate from treatment as a trust arrangement, which

provision may support the conclusion that the survivorship condition should not affect the type of taxable transfer that has occurred.

The regulations address this problem in the context of the definition of trust. These regulations provide that a transfer as to which the identity of the transferee is contingent upon the occurrence of an event is a transfer in trust. However, a testamentary transfer contingent upon an event which must occur within six months of the transferor's death is not considered a transfer in trust solely by reason of the existence of the contingency. Treas. Reg. §26.2652-1(b)(1), (2), Ex. 2 and Ex. 3. For example, assume that T's will provides a $200,000 to T's child, C, except that if C does not survive T by 18 months, the bequest is payable to T's grandchild, GC. The bequest is a transfer in trust for purposes of the GST tax and if C dies during the 18 month period, the example in the regulations concludes that C's death is a taxable termination. (One must further assume that death occurs after the first 90 days in light of Treas. Reg. §26.2612-1(a)(2)(i) for this example to make sense.) However, T is not a permissible recipient of trust income or corpus during this time period. It is difficult to understand how T's death is the termination of an interest where T has no interest as defined. Instead, the distribution to GC should be described as a taxable distribution. The validity of this regulation is unclear in light of the specific statutory provision that excepts an estate from treatment as a trust arrangement. IRC §2652(b)(1).

Even though the regulations have clarified this matter, the use of survivorship clauses should be considered carefully in the GST tax context, particularly if the condition applies to a person for whom the predeceased ancestor exception would not apply or is longer than 90 days. For example, assume that T's will leaves all property per stirpes to T's descendants who survive T by six months. Assume that T's child, C, survives T then dies after 90 days but before the end of the six month period, and thus C's child, GC, receives the entire estate. The transfer to GC is a direct skip and any excess over T's GST exemption would be taxable. In contrast, if the survivorship requirement were limited to 90 days, C would receive T's property, which would be subject to estate tax in C's estate. If C's will leaves T's property to GC, GC would still receive the same property and C's estate may not be subject to estate tax if C's estate tax exemption available is large enough. Even if C would pay an estate tax, it will qualify for a PPT credit under IRC §2013. Depending on the circumstances, the PPT credit could eliminate any estate tax in C's estate.

G. Choosing Between Transfer Taxes. A trust with an inclusion ratio of one will be subject to GST tax whenever trust assets are distributed to a skip person or when no beneficiary who is a skip person has an interest.

The transferor can give property in excess of his or her GST exemption outright to the transferor's children or other non-skip persons without attracting GST tax. However, these non-skip beneficiaries will pay an estate tax on their respective deaths to the extent the property has not been consumed or will pay a gift tax if the property is given away during life. If the transferor creates a trust for children or other non-skip beneficiaries, the drafter can choose either to attract the estate tax by giving the non-skip beneficiary a general power of appointment over the trust or to subject the trust to the GST tax at the time that the trust passes on to the next generation level by not giving the beneficiary a taxable power of appointment. The general power of appointment may be restricted to exercise only with the consent of a non-adverse party if complete control is undesirable.

Important differences exist in the way the estate and gift tax are computed compared to the GST tax. Which tax is the better choice depends on the facts in each case. For example, assume that T, at death, creates a trust for T's child, C1, with distribution on C1's death per stirpes to C1's then living descendants, or if none, to C1's sibling, C2. In choosing between chapter 11 and 12, or chapter 13, the following are the major tax considerations:

1. Rates. Rates are not an important consideration. The GST tax is a flat rate and is the same as the highest federal estate tax rate. While the estate tax rates on their face are graduated, the increasing exemption amount uses up the lower rates so that the estate tax is essentially flat at this point.

2. Applicable Credit Amount, Annual Exclusion. C1 has an applicable credit amount which, if not otherwise used, could be available against the estate tax on the trust. No such credit is available for GST tax purposes. In addition, the trustee of a trust for C1 could distribute trust property to C1 to allow C1 to make annual exclusion gifts to skip persons relative to T. No annual exclusion applies to taxable distributions or taxable terminations.

3. State Death and GST Taxes. While less than half of all states now impose state death taxes applicable for property subject to federal estate tax, advisors cannot predict if a beneficiary will reside in one of the states who do impose state estate taxes. For a beneficiary residing in a state that imposes death taxes, those taxes are likely to result in making the estate tax more costly than the GST tax.

No state currently imposes a separate GST tax, although a number of states previously did so.

4. Credit for Tax on Prior Transfers. The credit for tax on prior transfers under IRC §2013 applies to the estate tax but is not available against the GST tax for a prior estate tax. Thus, if C1 dies within 10 years after T and the property is included in C1's gross estate, C1's estate may receive a substantial credit against his estate tax. Similarly, if the property is included in C1's gross estate, and C1 bequeaths the property to a child, GC, who dies within 10 years after C1, GC's estate may claim the IRC §2013 credit. In contrast, if the property were not included in C1's gross estate, and instead is subject to a GST tax at C1's death, no IRC §2013 credit would be available in either case.

5. Marital Deduction Benefits. If C1 leaves the property to C1's spouse so as to qualify for the estate tax marital deduction, C1 can delay the estate tax on the property until the spouse's death. If the property's value is greater than its basis at C1's death, the inclusion of the property in C1's estate allows it a step–up in basis, without generating any estate tax.

Although no marital deduction is available for the GST tax, the GST tax can be delayed in the same way in some cases. If an interest exists immediately after C1's death in C1's spouse or any other person in the same or higher generation as C1, or if C1 uses a power of appointment to create an interest in C1's spouse or other person in a generation level the same or higher than C1's, the imposition of the GST tax is delayed until that interest ends. (This would not be true if the succeeding interest would be disregarded under IRC §2652(c)(2) as one used to postpone or avoid the tax.) Thus, the same delaying effect of the marital deduction is available for a much broader class of beneficiaries for GST tax purposes without having to meet the requirements for the marital deduction. However, no step–up in basis for income tax purposes would occur on C1's death under the GST tax where the tax is so delayed.

6. GST Exemption. C1 can allocate the GST exemption to the trust if the trust is included in C1's gross estate. However, C1 cannot allocate the GST exemption to the trust at C1's death if it is not included in C1's gross estate because C1 is not the transferor. If C1 does not have assets net of taxes and expenses (without the trust assets) sufficient to use the GST exemption, C1's GST exemption may be wasted when it could have been allocated to the trust assets if they were included in C1's estate.

7. Transfers to Same or Higher Generations, Double Skips. If C2 receives the property on C1's death because C1 has no children then living, no GST tax would be imposed at C1's death because C2 is not a skip person as to T. In contrast, estate tax would be imposed if the property is included in C1's gross estate, regardless of the recipient's generation. Where a trust includes several generations as beneficiaries, distributions to a beneficiary who is a skip person will incur the same GST tax, regardless of how many generations are skipped.

8. Other Considerations. In some cases, a trust subject to the GST tax will qualify for an IRC §303 redemption where the estate of the beneficiary would not qualify if the transfer were instead subject to estate tax. In addition, if the taxable transfer consists of stock in a closely–held company, the GST tax is treated as an additional estate tax for purposes of IRC §6166, but only if the transfer is a direct skip occurring at the same time as and as a result of the decedent's death. A new time period for disclaiming usually begins on the imposition of an estate or gift tax (other than for the tax imposed on QTIP property) but does not begin because GST tax is imposed. Finally, the preamble to the 1991 proposed regulations to chapter 14 states that IRC §§2701 and 2702 do not apply for purposes of the GST tax. 56 Fed. Reg. 14,322 (1991). *See* McCaffrey and Witkin, "Freezing Values for Grandchildren--Bridging the Gaps Between Chapters 13 and 14," 27 U. Miami Inst. on Est. Pl. Ch. 8 (1993).

9. Making the Choice. It is impossible to predict with certainty which tax would be better because the choice will be affected by later events. Any analysis should also take into account that the rates, exemptions, credits and other tax considerations may change before the death of a beneficiary. The impossibility of predicting which tax would be better is troublesome. One option is to give the beneficiary a general power only to the extent that the GST tax on the trust would greater than the estate tax in the absence of a general power. These kinds of formulas can be difficult to draft because the disposition of the beneficiary's own property could affect how much estate tax would be paid, such because the beneficiary could make gifts of his or her property that qualify for a marital or charitable deduction. Unless assumptions are made that produce a result that is independent of the actual disposition of the beneficiary's property, the beneficiary arguably has some control over the extent of the general power of appointment. However, disposing of one's property at death seems like it should be an act of independent significance. Another option to consider is giving an independent trustee a power to confer on the beneficiary a general power of appointment. *See* Barnett, Carr and Kalik, "Should I Create a Trust for My Child?," 2 Prob. & Prop. No. 1, 23 27 (Jan./Feb. 1988). For

another option, *See* Blattmachr & Pennell, "Adventures in Generation-Skipping or How We Learned to Love the 'Delaware Tax Trap,'" 24 Real Prop. Prob. & Trust 75 (1989).

H. Reverse QTIP Election. All transfers qualifying for the marital deduction result in the property being subject to estate or gift tax for subsequent transfers by the beneficiary–spouse. Thus, under the general rule for determining the transferor for GST tax purposes, the beneficiary–spouse becomes the transferor of any property that qualified for the marital deduction when the property is subject to the estate or gift tax. IRC §2652(a)(1). However, a special election may be made to change this result as to QTIP property.

The creator of QTIP property may elect to treat the property as if no QTIP election had been made for GST tax purposes. IRC §2652(a)(3). This election is usually referred to as the reverse QTIP election. The effect of the election is merely to ignore the existence of the QTIP election in determining the transferor on the death of the beneficiary-spouse. Thus, if the reverse QTIP election is made, and assuming that there is no other reason that the trust would be included in the beneficiary-spouse's estate, the creator of the QTIP property remains the transferor because the property would not have been subject to tax at the beneficiary–spouse's death if no QTIP election had been made.

1. The "No Partial Reverse QTIP" Rule. The reverse QTIP election can be made only as to all or none of the QTIP property (the "no partial reverse QTIP rule"). IRC §2652(a)(3). Thus, if a QTIP election is made as to the entire trust, the reverse QTIP election must be made as to all or none of the trust. Similarly, if a partial QTIP election is made, the reverse QTIP election must be made as to the entire portion for which the QTIP election has been made or none of the trust.

2. The Necessity of a Separate Reverse QTIP Trust. A separate QTIP trust should be created if a reverse QTIP election will be made in the exact amount of the GST exemption to be allocated to it. A single QTIP trust greater than the GST exemption to be allocated to it does not allow full use of both spouses' GST exemptions and may result in other adverse GST tax effects, discussed below.

For example, assume that T exhausted his unified credit during life. At death, T creates a QTIP trust of the residue of T's estate, valued at $3,000,000, for T's spouse, S. T's executor makes the QTIP election as to all of the trust. The QTIP trust becomes a long–term trust for T's descendants at S's subsequent death. T has unallocated GST exemption of $1,500,000. Assume that under applicable state law, the trustee has no authority to sever the QTIP trust into two separate trusts for state law purposes as of T's death. If T's executor makes the reverse QTIP election and allocates $1,500,000 of GST exemption to the trust, the trust will have an inclusion ratio of .500. On S's subsequent death, S is not the transferor and cannot allocate any of S's GST exemption to the trust. If S has no other property to which the GST exemption can be allocated, S's GST exemption will be wasted. If T's executor forgoes the reverse QTIP election, S will be the transferor of the QTIP trust after S's death. S's executor can allocate S's GST exemption to the trust based on the value of the trust at that time. If the trust is more than S's available GST exemption on S's death, the trust will be subject to GST taxes.

In contrast, T could have created two QTIP trusts for S, one in the amount of T's GST exemption and the other in the amount of the excess. If T's executor made the reverse QTIP election as to the trust in the amount of T's unused GST exemption of $1,500,000 and allocated $1,500,000 of GST exemption to it, the inclusion ratio would be zero for that trust. No reverse QTIP election would be made for the other QTIP trust of $1,500,000 for which the inclusion ratio would be 1. On S's subsequent death, the trust with an inclusion ratio of zero would incur no GST tax regardless of its value. S could allocate S's unused GST exemption of $1,500,000 to the trust for which no reverse QTIP election was made.

3. Adverse Effects of Making a Reverse QTIP Election for a Trust with an Inclusion Ratio Greater Than Zero. The reverse QTIP election may have other adverse tax consequences where a single QTIP trust has been created in excess of the GST exemption allocated to it. While the reverse QTIP election is found in IRC §2652(a) where transferor is defined, the actual language in IRC §2652(a)(3) states that the estate of the decedent or the donor spouse, as the case may be, may elect to treat all of the property "for purposes of this chapter" as if the QTIP election had not been made. The regulations and Rev. Rul. 92–26 state that the reverse QTIP election results in the trust being treated for all purposes, including the definition of direct skips, as if the QTIP election had not been made. If no QTIP election had been made (assuming a trust that otherwise would not be includible in the beneficiary–spouse's gross estate), the QTIP trust would not be subject to estate tax on the beneficiary-spouse's subsequent death.

For example, assume that T creates a QTIP trust for T's spouse, S, when T's child, C, is living. Assume that C dies after the trust is created but before S's death, so that the trust passes to C's child, GC, at S's death. On S's death, if no reverse QTIP election was made, a direct skip occurs because the trust is subject to estate tax and passes to a skip person. However, if the reverse QTIP election had been made, the death of S is a taxable termination when the trust passes to GC because the actual inclusion of the trust in S's gross estate is ignored.

If the inclusion ratio of the trust is zero, whether a taxable termination or a direct skip occurs is irrelevant because the GST tax rate is zero. Thus, with an inclusion ratio of zero, the reverse QTIP election will have no significance other than to maintain the creating spouse as the transferor and thus preserve the GST exemption allocated by the executor of the creating spouse. However, if the trust's inclusion ratio is greater than zero, changing the transfer from a direct skip to a taxable termination creates the following problems:

(a) More Tax Paid. A taxable termination results in more GST tax than a direct skip because the tax base includes the GST tax paid. Assuming an inclusion ratio of one in each case and a trust of $1,000,000 net of federal estate tax, and assuming the direct skip and taxable termination both occur in 2019, the amount of the GST tax due increases from $285,714 ($1,000,000 - $285,714 = $714,286 x .40 = $285,714) on a direct skip to $400,000 on a taxable termination at a 40% maximum estate tax rate.

For example, assume that T creates a QTIP trust of $10,000,000 at death for T's spouse, S. After other allocations, T's executor has $2,000,000 of GST exemption left. On S's death, the trust passes to GC, a grandchild of T whose parent who is T's child is alive. If T's GST exemption of $2,000,000 is to be allocated effectively to the QTIP trust, a reverse QTIP election must be made for the trust. The applicable fraction for the trust would be 2,000,000/10,000,000 or .200 and thus the inclusion ratio for the trust would be .800. On S's death in 2019, the distribution to GC will be a taxable termination instead of a direct skip because the inclusion of the trust in S's gross estate is ignored for GST tax purposes due to the reverse QTIP election. The GST tax due at a 40% maximum rate would be $3,200,000 (.800 ×.40 × $10,000,000), assuming a trust of $10,000,000 net of any estate tax paid from the trust.

In contrast, if no reverse QTIP election were made, T has GST exemption of $2,000,000 remaining unallocated. However, the GST tax on S's death would be lower even if S allocates no GST exemption in this case because the distribution to grandchildren would be a direct skip. The direct skip GST tax due on a trust with an inclusion ratio of 1.000 at a 40% maximum rate would be $2,857,143 (.40 × $7,142,857), assuming a trust of $10,000,000 net of any estate tax paid from the trust. (The direct skip tax is imposed only on the amount actually received by GC net of the GST tax paid, which is $10,000,000 – $2,857,143, or $7,142,857.) Thus forgoing the allocation of some of T's GST exemption in this case, even if S allocates no GST exemption, results in a tax savings of almost $343,000 because no reverse QTIP election is made.

The tax penalty for the reverse QTIP election decreases as the inclusion ratio decreases and breaks even at an inclusion ratio of about .714 at a maximum rate of 40% (.714 inclusion ratio for a taxable termination compared to a zero inclusion ratio for a direct skip). Thus, if the available GST exemption on the death of the first to die is less than about 28.6% of the value of the QTIP trust as of the effective date of the allocation, at a 40% rate the reverse QTIP election will result in more GST tax than if no reverse QTIP election is made if the taxable event occurs at the death of S.

(b) Predeceased Ancestor Exception Unavailable. An additional reason exists that a reverse QTIP election should be made only if the inclusion ratio for the trust is zero. For pre-1998 transfers, the predeceased ancestor exception was generally not available for a QTIP trust for which the reverse QTIP election had been made. If the QTIP trust under any circumstances could pass to a skip person at the death of the beneficiary-spouse, the reverse QTIP election converted what would have been a direct skip eligible for the pre-1998 predeceased ancestor exception in former IRC §2612(c)(2) to a taxable termination not eligible for the exception. In other words, the reverse QTIP election would have caused a GST tax where none otherwise would have been due.

Under the predeceased ancestor exception as revised by the 1997 Act, if C is dead when the trust is created, the predeceased ancestor exception will apply on S's death in 1998 or thereafter, whether or not the reverse QTIP election is made. However, if C is alive when the trust is created but dies before S, and S dies in 1998 or thereafter, application of the revised predeceased ancestor exception still depends on whether or not a reverse QTIP election is made. The exception does not apply if the reverse QTIP election is made because T remains the transferor, and a taxable termination occurs at S's death, resulting in GST tax if the trust's inclusion ratio is greater than zero. In contrast, if no reverse QTIP election is made, the exception will apply on S's death because S becomes the transferor at that time and C predeceased S. IRC §26.2651-1(a)(3), and (c), Ex. 3, 4.

Thus, as stated above, the reverse QTIP election should be made only when the inclusion ratio is zero (even if C in the preceding example is dead when the QTIP trust is created). None of the problems described here exist if the reverse QTIP trust has an inclusion ratio of zero, because no GST tax can be due in any event.

4. Late Reverse QTIP Election. The IRS has provided a simplified alternate method for certain executors and trustees to request relief to make a late reverse QTIP election under IRC §2652, to be used in place of the formal process for obtaining a letter ruling. *See* Rev. Proc. 2004-47, 2004-32 I.R.B. 169 (August 9, 2004). The significant user fee required for letter ruling requests is not charged for requests filed under Revenue Procedure 2004-47.[65] However, taxpayers unable to obtain relief using this alternate method described in this Revenue Procedure still may request a letter ruling to obtain such relief. This Revenue Procedure applies only if:

(1) A valid QTIP election was made for the property or trust on the decedent's federal estate tax return;

(2) The reverse QTIP election was not made on the estate tax return because the taxpayer relied on the advice and counsel of a qualified tax professional who failed to advise the taxpayer of the need, advisability or proper method to make such election;[66]

(3) At the time the taxpayer files a request for relief, the taxpayer has unused GST exemption, after the automatic allocation of GST exemption under IRC §2632(e) and Regulations §26.2632-1(d)(2), to result in a 0-inclusion ratio for the property or trust subject to the reverse QTIP election;

(4) The estate is not eligible for the automatic six-month extension under Regulations §301.9100-2(b);

(5) The surviving spouse has not made a lifetime disposition of all or any part of the qualifying income interest for life in the QTIP property or trust; and

(6) The surviving spouse is alive or no more than six months have passed since the surviving spouse's death.

Revenue Procedure 2004-47 does not apply to *inter vivos* QTIP trusts. In addition, this Revenue Procedure *does not* address how to sever the trust or allocate GST exemption to the trust, which often will be required for a meaningful reverse QTIP election and may require additional requests for relief on those matters.

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[65] The first Revenue Procedure issued each year describes the procedural requirements for obtaining a letter ruling under Regulations §301.9100-3.

[66] The Revenue Procedure actually requires a signed statement from the qualified tax professional on whom the taxpayer relied in preparing the original estate tax return. This may be difficult or impossible to obtain where that professional is unavailable or unwilling to acknowledge providing improper advice to the taxpayer in preparation of the return.

This Revenue Procedure specifies that the amount of the transferor's unused GST exemption available to be allocated is determined at the time when relief is requested – not the exemption that was available at the time of the original transfer. Note that the transferor may not have sufficient exemption remaining at the time she requests relief under IRC §2642(g)(1) to produce an inclusion ratio of zero for the trust.

I. Perpetual Trusts: Delaware Tax Trap. Presently several states allow trusts to last indefinitely, at least under certain circumstances. Some clients are establishing perpetual trusts in these jurisdictions to allow the maximum flexibility for trusts that the grantor believes will have a zero inclusion ratio. The statute provides no time limit on trusts to which GST exemption has been allocated. Although the government has attempted to limit the duration of trusts to which GST exemption has been allocated in some circumstances, to date these attempts have been ill-conceived and only addressed the effect of exercise of powers of appointment. This was first addressed in proposed regulations, then in final regulations, which were later withdrawn. Presently, neither the statute nor any regulation addresses a perpetual trust to which GST exemption has been allocated. Thus currently, no restrictions exist under the GST tax on trusts that exceed the common law perpetuities period and to which GST exemption has been allocated.

An area of concern with perpetual trusts is the possible application of IRC §2041(a)(3) or IRC §2514(d), also known as the Delaware tax trap. This section treats the exercise of a non-general power of appointment as a taxable event if (1) a power is exercised to create another power of appointment and (2) under applicable local law the new power of appointment can be validly exercised to extend the trust beyond a period "ascertainable without regard to the date of the creation of the first power." If this prohibition is violated in a testamentary exercise, the property subject to the non-general power that has been exercised would be includable in the power holder's gross estate. Similarly, if the power is exercised during lifetime, the exercise is treated as a taxable gift. How or even if the second power is exercised is irrelevant to the imposition of estate or gift tax on the exercise of the first power. That the validity of the exercise of the second power is measured without regard to the date of creation of the first power is all that is required to result in transfer tax.

The Delaware tax trap (IRC §2041(a)(3)) was enacted to address the Delaware perpetuities law then in existence. In Delaware at that time, when a non-general power was exercised to create a second power, the validity of the exercise of the second power was measured from the creation of the second power, not from the creation of the first power. This was contrary to the common law rule that the validity of testamentary powers of appointment are generally "read back" into the original document so that the original perpetuities period continues to apply. However, because the Delaware tax trap provisions are so specific, they do not appear to apply in a jurisdiction that has no perpetuities restrictions if the second power can be validly exercised within any period measured from the date of creation of the first power. Thus, read literally, the Delaware tax trap provisions allow a power to be exercised to create a second power if the second power could be exercised, for example, only within 500 years of the date of the creation of the first power. This obvious loop-hole in the Delaware tax trap does not appear to be fixable absent legislation, although concern exists that a court might be tempted to find a way to plug the gap. The penalty for violating these sections is so great that an adviser should consider these issues in exercising powers of appointment over any perpetual trust to which GST exemption has been allocated.

J. Changes to a Trust with a Zero Inclusion Ratio. Requests for rulings have been submitted asking whether a trust with an inclusion ratio of zero will lose that inclusion ratio if changes are made to it. (The IRS has taken the position in private letter rulings that changes to a trust that was in existence on the effective date of the GST tax can forfeit its effective date exemption. This is discussed further below.)

In PLR 201418001, the IRS noted that no guidance had been issued concerning trust modifications to a trust with in inclusion ratio of zero. However, the IRS ruled that, at a minimum, a modification that would not affect the status of a trust exempt from the GST tax under the effective date rules "should similarly not affect the exempt status of such a trust." *See also* PLRs 201320004, 201233008, 201134017, 201032026, 201026018, 201025026, 201024018, 201024014-201024016, 200923016, 200841023, 200743028, 200615001, 200420011, 200314003, 200218023, and 200141024. *See* Treas. Reg. §26.2601-1(b)(4) regarding the safe harbors for the modification of a trust that is exempt from the GST tax under the effective date rules, discussed in detail in VII, below.

VI. GRANDFATHERED TRUSTS: POWERS OF APPOINTMENT.

Although the GST tax was enacted in 1986, many trusts continue today to be exempt from the application of the tax because of the effective date provisions. It is important to recognize when a trust may be exempt because the tax savings may be substantial.

A trust irrevocable on September 25, 1985, is exempt from the GST tax. In addition, a trust created under a will or revocable trust instrument in existence on October 22, 1986, which became irrevocable because of the death of the maker before January 1, 1987, is also exempt from the GST tax. A QTIP trust exempt under either of these rules will continue to be exempt after the death of the beneficiary-spouse even though the trust is included in the gross estate of the surviving spouse after the effective date of the GST tax. Treas. Reg. §26.2601-1(b)(1)(iii) and (2)(iii). Finally, the GST tax does not apply to transfers from a person unable to change the disposition of his or her property on October 22, 1986, because of a mental disability if he or she does not regain competence before death. These trusts are all referred to as "grandfathered" from the GST tax or as effective date exempt trusts.

A. Limited Powers of Appointment.

The legislative history to the Tax Reform Act of 1986 in a footnote states that the tax does not apply "to the exercise of a limited power of appointment under an otherwise grandfathered trust or to trusts to which the trust property is appointed provided such exercise cannot postpone vesting of any estate or interest in the trust property for a period ascertainable without regard to the date of the creation of the trust," citing a colloquy between certain representatives and senators on the House and Senate floor. Staff of Joint Committee on Taxation, General Explanation of Tax Reform Act of 1986, 1267, n.12 (1986).

Regulations specifically provide that the exercise of a non-general power of appointment over an effective date trust is not treated as an addition if the exercise does not postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period, measured from the date of creation of the trust, extending beyond any life in being at the date of creation of the trust plus a period of 21 years ("perpetuities period"). The regulations also provide that an exercise of a power of appointment that validly postpones the vesting, absolute ownership or power of alienation of an interest in property for a term of years that will not exceed 90 years (measured from the date of creation of the trust) is not considered an exercise that extends beyond the perpetuities period. Treas. Reg. §26.2601-1(b)(1)(v)(B)(*2*), (D) Ex. 6, 7.

Thus, a special power of appointment can be exercised over an effective date trust to create or extend the GST tax effect of the trust without loss of its exempt status. Powers of appointment should be exercised to maximize the advantage of the effective date protection.

B. General Powers of Appointment.

The effective date provisions of the GST tax state that a trust is not subject to GST tax if it was "irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income treatable to corpus)." However, these provisions do not define "irrevocable" or "added to the trust" for purposes of determining their applicability, or whether the lapse, release or exercise of a general power of appointment ("GPOA") under an irrevocable trust instrument should subject the trust to GST tax.

1. Split Authorities.

Federal Circuit Courts of Appeals have split in their decisions on whether property of a grandfathered trust included in a taxpayer's taxable estate for estate tax purposes due to a GPOA becomes subject to GST tax. *See Estate of Timken v. U.S.*, 105 AFTR 2d ¶ 2010-702 (6th Cir. 2010), cert. den. 2011 WL 55405 (2011), *Estate of Gerson v. Comm'r.*, 507 F.3d 435 (6th Cir. 2007), *cert. den'd*., 128 S. Ct. 2502 (2008); *E. Norman Peterson Marital Trust v. Comm'r*, 78 F.3d 795 (2d Cir. 1996), *aff'g*. 102 T.C. 790 (1994); *Simpson v. U.S.*, 183 F.3d 812 (8th Cir. 1999), *non-acq.* 2000-9 IRB 711 (2000); *Bachler v. United States*, 281 F.3d 1078 (9th Cir. 2002), *rev'g. and rem'g.*, 126 F. Supp. 2d 1279 (N.D. Ca. 2000).

In *Peterson*, the appellate court concluded that property remaining in the trust after the lapse of a GPOA was a constructive addition that became subject to GST tax, because a GPOA is "essentially identical to outright ownership of the property." 78 F.3d at 800. However, in *Simpson* and *Bachler*, the courts held that a grandfathered trust passing pursuant to the exercise of a taxable GPOA to skip persons did not become subject to GST tax. The courts adhered to the literal terms of the effective date statute, which requires only that the trust was irrevocable on the effective date and that the transfer occurred under the trust. Based on the plain language of the statute, they determined that any transfer pursuant to a power of appointment is a transfer "under" the trust. Accordingly, they denied that the existence or even the exercise of a taxable GPOA subjects a grandfathered trust to GST tax.

In *Simpson* and *Bachler*, the Eighth and Ninth Circuits based their holdings on their conclusion that the plain meaning of the effective date provisions of the GST tax was clear and not ambiguous.[67] Thus, based on the statute's literal terms, both courts found that a transfer pursuant to the exercise of a GPOA granted under a trust that was irrevocable on the effective date was not subject to GST tax.

> Trust A, having been created by Mr. Simpson's will in 1966, was of course irrevocable on September 25, 1985. Was the transfer made by Mrs. Simpson a transfer "under" the trust? We do not see how an affirmative answer can be avoided. The power of appointment that made the transfer possible was created by the trust. Language has to mean something, and the argument that this particular transfer was not "under" trust A is simply untenable.

Simpson, 183 F.3d at 814. Accordingly, the Eighth and Ninth Circuits would not be required to give deference to Regulations §26.2601-1(b)(1)(i) in future challenges, if they adhere to their characterization of the effective date provisions as unambiguous.

In reaction to *Simpson*, the IRS amended Regulations §26.2601-1(b)(1)(i) to specify that property transferred pursuant to a taxable GPOA is treated as a transfer by the power holder subjecting the property to GST tax. Regulations §26.2601-1(b)(1)(i) now provides that the effective date provisions of the statute do not apply to exempt a transfer of property "pursuant to the exercise, release, or lapse of a GPOA that is treated as a taxable transfer under chapter 11 or chapter 12." Instead, "[t]he transfer is made by the person holding the power at the time the exercise, release, or lapse of the power becomes effective, and is not considered a transfer under a trust that was irrevocable on September 25, 1985."[68]

Subsequently, in *Estate of Gerson v. Comm'r.*, 507 F.3d 435 (6th Cir. 2007), *cert. den'd.*, 128 S. Ct. 2502 (2008), the federal Sixth Circuit Court of Appeals affirmed the Tax Court[69] to uphold the validity of Regulations §26.2601-1(b)(1)(i). In *Gerson*, the decedent exercised her testamentary GPOA over a marital trust that had become irrevocable prior to the effective date of the GST tax so that the property passed to a trust benefiting her grandchildren or more remote descendants. The Tax Court held that the regulation is valid as a reasonable interpretation of the effective date provisions of the GST tax and that the marital trust property became subject to

[67] Under *Nat'l Cable & Telecomm. Association v. Brand X Internet Servs.*, 545 U.S. 967 (2005): "A court's prior judicial construction of a statute trumps an agency construction otherwise entitled to Chevron deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion."

[68] In addition, Regulations §26.2601-1(b)(1)(v) provides:

> (A) *Powers of Appointment*. [E]xcept as provided in paragraph (b)(1)(v)(B) of this Section, where any portion of a trust remains in the trust after the post-September 25, 1985, release, exercise, or lapse of a power of appointment over that portion of the trust, and the release, exercise, or lapse is treated to any extent as a taxable transfer under chapter 11 or chapter 12, the value of the entire portion of the trust subject to the power that was released, exercised, or lapsed is treated as if that portion had been withdrawn and immediately retransferred to the trust at the time of the release, exercise, or lapse. The creator of the power will be considered the transferor of the addition except to the extent that the release, exercise, or lapse of the power is treated as a taxable transfer under chapter 11 or chapter 12.

[69] *Gerson v. Comm'r.*, 127 T.C. No. 11 (2006).

GST tax at the decedent's death. On appeal, the Sixth Circuit largely adopted the Tax Court's rationale equating GPOAs with outright ownership. Applying the *Chevron*[70] level of deference to review Regulations §26.2601-1(b)(1)(i), the Sixth Circuit concluded that the effective date provisions of the GST tax are ambiguous and that the regulation reasonably construed the statutory ambiguity. The court reasoned that:

> As the *Peterson* court recognized, "For tax purposes, a [GPOA] has for many, many years been viewed as essentially identical to outright ownership of the property." [Citation omitted.] Thus, the regulation conforms the grandfather clause to other elements of the tax scheme. [Sections 2041 and 2514 citations omitted.] In addition, the other exceptions to the GST tax surrounding the irrevocable trust provision all represent inescapable contingencies that justify grandfathering, while the [Taxpayer's] proposed interpretation protects disproportionately broad reliance on prior tax laws.

More recently, in *Estate of Timken v. U.S.*, 105 AFTR 2d ¶ 2010-702 (6th Cir. 2010), cert. den. 2011 WL 55405 (2011), the federal Sixth Circuit Court of Appeals applied its reasoning from *Gerson* when it upheld former Regulations §26.2601-1(b)(1)(v)(A) treating the exercise, release, or lapse of a power of appointment occurring after September 25, 1985, that is a taxable transfer under chapter 11 or chapter 12 as a withdrawal and re-transfer of property to the trust, subjecting the trust property to GST tax. The *Timken* court concluded, as in *Gerson*, that the exemption for "grandfathered" trusts is ambiguous as to general powers of appointment that are exercised, released or lapse after the effective date of the GST tax. Based on its reasoning in *Gerson*, the court concluded that the former regulation disputed in *Timken* similarly reasonably resolved the statutory ambiguity while that regulation was in effect. The Supreme Court declined to review *Timken*, despite the split in the federal Circuit Courts of Appeals regarding this issue.

The logic of *Peterson* and *Gerson* equating GPOAs with outright ownership for GST tax purposes does not appear to rest on inclusion in the gross estate but rather that a GPOA gives the power holder control that is equivalent to ownership. For example, the GST tax rules expressly provide that a QTIP trust that was irrevocable on the effective date will not become subject to GST tax on the surviving spouse's death, despite inclusion in such spouse's gross estate under IRC §2044. Treas. Reg. §26.2601-1(b)(1)(iii). In addition, a grandfathered trust that is

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[70] In *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), the Supreme Court articulated the following two-step analysis applicable to judicial review of an agency's construction of a statute:

> When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.

Id. at 842-43 (footnote references and citations omitted).

includible in a settlor's gross estate under IRC §2036, but not IRC §2038, does not become subject to GST tax due to such inclusion. Treas. Reg. §26.2601-1(b)(1)(ii)(B). Also, a trust subject to inclusion in the settlor's taxable estate under IRC §2038 on the effective date is subject to GST tax; however, a grandfathered trust that first becomes subject to inclusion under IRC §2038 after the effective date does not become subject to GST tax. *Id*. Thus, inclusion for estate tax purposes is not treated as the basis for subjecting a grandfathered trust to GST tax.

2. Reduction of GPOA to SPOA.

None of *Peterson, Simpson, Bachler, Gerson* or *Timken* limited or otherwise affected the validity of the exception to the constructive addition rules for SPOAs under Regulations §26.2601-1(b)(1)(v)(B).[71]

The IRS also has addressed a special rule under Regulations §26.2601-1(b)(1)(v)(B) for transfers subject to SPOAs resulting from a partial release of a GPOA. *See* PLRs 9125018 and 9229018. In these rulings, the IRS applied Regulations §26.2601-1(b)(1)(v)(B) and concluded that property subject to an SPOA resulting from a partial release of a GPOA does not become subject to GST tax, despite inclusion in the taxable gross estate under IRC §2041.

In PLR 9125018, the taxpayer partially released her GPOA over a marital trust for her benefit that became irrevocable before the effective date, so that she could no longer exercise the power in favor of herself, her estate or her creditors. Her release reduced the GPOA to an SPOA but the trust remained includable in her taxable estate under IRC §2041. The taxpayer proposed to exercise her testamentary SPOA in 1991, after the effective date of the GST tax. The IRS considered the specific issue of whether inclusion in the taxable estate subjects the property to GST tax:

> The question is whether the characterization of the power as a general power of appointment for purposes of [IRC §2041] should control for purposes of [Regulation 26.2601-1(b)(1)(v).] If so, the proposed exercise of the power will constitute an "addition" under IRC §26.2601-1(b)(1)(v)(A). If not, IRC §26.2601-1(b)(1)(v)(B) will control, and the exercise of the power will not constitute an addition to the trust. We conclude that the power is a SPOA for purposes of the GST tax provisions. Therefore, [Regulations §26.2601-1(b)(1)(v)(B)] controls, and the proposed exercise of the power will not constitute an addition to the trust.

The IRS reasoned that the trust was analogous to an irrevocable trust created before the effective date with a retained lifetime income interest, which would not be considered revocable on the effective date based on inclusion under IRC §2036. However, the ruling does not address the fact that the testamentary SPOA would cause inclusion under IRC §2038, which would preclude the trust from qualifying as "irrevocable" under the effective date regulations. Thus,

[71] In fact, a concurring opinion in *Gerson* noted that "the principal architects of the transitional rule understood it to apply to the exercise of a limited power of appointment under an otherwise grandfathered trust, provided that the exercise of the limited power did not unduly extend the time for the vesting of any beneficial interest in the trust." *Gerson*, 127 T.C. No. 11 at 43 (emphasis in original).

the ruling's conclusion is correct only if the treatment of the testamentary power of appointment as special, rather than general, for GST tax purposes is the determinative factor.

In PLR 9229018, the IRS again considered similar facts and concluded that the proposed exercise of a testamentary SPOA resulting from the partial release of a GPOA would not subject the trust to GST tax, relying on the plain terms of Regulations §26.2601-1(b)(1)(v)(B). The IRS noted that if the trust was irrevocable on the effective date and the exercise did not postpone vesting beyond the original perpetuities period, then the exercise would not subject to the GST tax if the power is characterized as an SPOA rather than a GPOA. The IRS recognized that the trust would have been includable in the taxpayer's taxable estate on the effective date under IRC §§2036 and 2038 if he had been the settlor, correcting the misstatement in PLR 9125018. Nonetheless, the IRS concluded that the trust did not become subject to GST tax because taxpayer held an SPOA and Regulations §26.2601-1(b)(1)(v)(B) controls despite estate taxation under IRC §2041.

In both PLR 9229018 and PLR 9125018, the partial release that reduced the GPOA to an SPOA occurred before the effective date of the GST tax. However, neither ruling cites that fact as relevant and this fact does not affect the analysis in either ruling. While these PLRs are not authority and cannot be cited as precedent, a return position reasonably based on a private letter ruling issued after October 31, 1976, generally may satisfy the reasonable basis standard for tax reporting. Regulations §1.6662-3(b)(3). These PLRs reinforce the position that inclusion of a grandfathered trust in a GPOA holder's taxable estate should not necessarily subject the trust to GST tax.

Planners may consider advising clients who hold such GPOAs to release them to the extent necessary to create a non-taxable SPOA as described in PLRs 9229018 and 9125018, to seek the application of Regulations §26.2601-1(b)(1)(v)(B). In addition, planners may consider whether the exercise of any such GPOA should benefit one or more non-skip persons by providing them with genuine and meaningful interests in the property.[72] (In contrast, the taxpayer in each of *Peterson*, *Bachler*, *Simpson* and *Gerson* exercised the GPOA in favor of skip persons which created immediately taxable direct skip GSTs if the transfer is subject to GST tax.) Planners have suggested that a small distribution could be made from a trust created pursuant to such exercise, to be reported on a timely filed return declaring the exempt character of the trust property due to the effective date of the GST tax and achieve finality under the rules governing finality of inclusion ratios. However, those GST tax rules may provide no such benefit in this circumstance, as only trusts subject to GST tax have inclusion ratios – those rules do not apply at all to a trust to which the GST tax does not apply.`

[72] However, planners must consider the anti-abuse rule of §2652(c)(2) which provides that "an interest which is used primarily to postpone or avoid any tax imposed by this chapter shall be disregarded." Neither the statute nor the related regulation provide any guidance regarding the amount that may be sufficient to deflect the anti-abuse rule. In fact, §2652(c)(2) bases its criterion purely on the intention motivating inclusion of the interest and does not indicate that the magnitude of the interest is relevant. Interestingly, the related regulation further elaborates: "An interest is considered as used primarily to postpone or avoid the GST tax if a significant purpose for the creation of the interest is to postpone or avoid the tax." Thus, the regulation appears to provide more leniency than does the statute in determining that an interest should be ignored for GST tax purposes.

APPENDIX A
FEDERAL ESTATE, GIFT AND GST TAX RATES & EXEMPTIONS
(As of March 18, 2019)

Year	Highest Estate Tax Rate	Estate Tax Exemption	GST Tax Rate	GST Exemption	Highest Gift Tax Rate	Gift Tax Exemption	Gift Tax Annual Exclusion
2010	35%	$5M	0%	$5M	35%	$1M	$13,000[3]
2011	35%	$5M	35%	$5M	35%	$5M	$13,000[3]
2012	35%	$5.12M[1]	35%	$5.12M[1]	35%	$5.12M[1]	$13,000[3]
2013	40%	$5.25M[1]	40%	$5.25M[1]	40%	$5.25M[1]	$14,000[3]
2014	40%	$5.34M[1]	40%	$5.34M[1]	40%	$5.34M[1]	$14,000[3]
2015	40%	$5.43M[1]	40%	$5.43M[1]	40%	$5.43M[1]	$14,000[3]
2016	40%	$5.45M[1]	40%	$5.45M[1]	40%	$5.45M[1]	$14,000[3]
2017	40%	$5.49M[1]	40%	$5.49M[1]	40%	$5.49M[1]	$14,000[3]
2018	40%	$11.18M[2]	40%	$11.18M[2]	40%	$11.18M[2]	$15,000[3]
2019	40%	$11.409M[2]	40%	$11.40M[2]	40%	$11.40M[2]	$15,000[3]
2020	40%	$11.580M[2]	40%	$11.58M[2]	40%	$11.58M[2]	$15,000[3]

[1] Inflation adjustment applied to base amount of $5,000,000.

[2] Chained-CPI inflation adjustment applied to base amount of $10,000,000.

[3] Inflation adjustment applied to base amount of $10,000 (using chained-CPI adjustment beginning 1/1/2018).