Chapter 18

GENERATION-SKIPPING TRANSFER TAX

WHAT IS IT?

This chapter discusses the generation-skipping transfer tax and planning with generation-skipping transfers, including the use of generation-skipping trusts.

A generation-skipping transfer (GST) is any transfer of property by gift or at death, to any person who, under federal tax law, is assigned to a generation that is two or more generations below that of the transferor (i.e., one or more generations below the transferor is skipped). In the case of family members, this means, for example, that transferor’s grandchildren and great nieces and nephews would be assigned two generations below the transferor. Such persons who are two or more generations below that of the transferor are defined as skip persons.

The generation-skipping transfer tax applies to generation-skipping transfers. An annual exclusion ($12,000 in 2006) and an exclusion for certain transfers for educational or medical purposes is available that reduces the amount of a generation-skipping transfer. A transferor has a GST exemption ($2,000,000 in 2006) that can be allocated to generation-skipping transfers. An inclusion ratio is calculated based on allocations of GST exemption to generation-skipping transfers. The GST tax is calculated by multiplying the GST tax rate (46% in 2006) by the amount of the GST transfer property and the inclusion ratio for such property. For GST exemptions and tax rates in other years, see Figure 18.1.

EGTRRA 2001 repeals the generation-skipping transfer tax and the estate tax for one year in 2010.

WHEN IS THE USE OF SUCH A DEVICE INDICATED?

The generation-skipping transfer was traditionally used as a device to save federal gift and estate tax by keeping property out of the taxable estates of the members of the intermediate generation. The beneficiary could be trustee, have all the income, invade the principal for needs, and control the distribution of the property as long as the beneficiary did not have a general power of appointment (i.e., the power to appoint the property to the beneficiary or the beneficiary’s estate, or creditors of either, or to satisfy the beneficiary’s obligations). Now the generation-skipping transfer tax implications of such transfers must also be considered.

There are three levels where generation-skipping transfer techniques are useful. First, where a client stands to inherit a substantial estate from a parent and already has a substantial estate of his own, a generation-skipping trust would be set up to receive the parent’s property for the benefit of the client. A generation-skipping trust would allow the client-beneficiary the use and enjoyment of the inherited property, together with protection against creditors, divorce courts, or bankruptcy. The amount subject to the GST exemption will also be excluded from the beneficiary’s already substantial estate. Although the client’s parent may pay gift or estate tax, the client does not pay estate tax or GST tax on the exempt inherited property at death. Furthermore, no estate tax or GST tax is paid by the client’s children or future issue depending on the term allowed for the trust.

Secondly, a generation-skipping trust may be used where parents wish to minimize transfer taxes in a child’s estate but still give the child the use and benefit of the property, or where the parents wish to protect the property from a spendthrift child, or from being subject to loss through a child’s divorce or bankruptcy. In these situations, a generation-skipping trust would be set up to provide income to the child for life, but with the principal being preserved for subsequent distribution to grandchildren. The trust can continue through the grandchildren’s lives (and for great-grandchildren as well), avoiding transfer tax in each generation, subject only to the limitation on the maximum life of a trust under state law. In the case of many estates, however, the generation skip occurs as a result of the death of a member of the intermediate generation before such member receives full ownership of the gift or inheritance, as when a trust is provided for a child until he attains age 30, and that child dies before attaining age 30 leaving grandchildren surviving.

Thirdly, a client may wish to make direct transfers to a grandchild or other skip person for the beneficiary’s support or enjoyment, or in order to avoid tax in the estate of the intervening generation. Gifts that immediately
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benefit grandchildren will generally be subject to the GST tax unless they qualify for the generation-skipping exemption or the annual exclusion.

EGTRRA 2001 repeals the generation-skipping transfer tax and the estate tax for one year in 2010.

WHAT ARE THE REQUIREMENTS?

There is no special form of generation-skipping transfer. It could simply be a gift or bequest to a skip person, or the establishment of a trust in which distributions will or may be made to a skip person. All that is really required to trigger the device is any gift or transfer of property that will or may benefit a skip person.

HOW IT IS DONE – AN EXAMPLE

A generation-skipping trust can be created as part of an individual’s will or revocable trust, so that it comes into being only upon the transferor’s death. If the transferor intends to make gifts to the generation-skipping transfer trust, the trust will be created as a separate document. In that case, the generation-skipping trust is also usually a receptacle for assets passing from the transferor at his death.

The trust instrument would provide for two trusts. The “exempt” trust would receive gifts or bequests to which the transferor’s generation-skipping transfer tax exemption has or will be allocated, and this is the trust that will pass tax-free at the recipient’s death. Any assets passing to the trust for which no exemption is allocated will pass to a “nonexempt” trust.

For optimal results, planners prefer to fund the exempt trust with assets with the greatest growth potential. This concept allows the maximum amount of assets to pass to future generations without transfer tax because, once the exemption is allocated to the trust, the growth is also exempt.

The exempt and nonexempt trusts are established so that they have GST tax inclusion ratios of zero and one respectively (i.e., no trust is partially exempt and partially nonexempt). When the exempt trust is established with an inclusion ratio of zero, that trust generally maintains its 100% immunity from GST tax as long as there are no later additions of nonexempt property.

In a family intervivos trust with distributions to the survivor’s trusts, a bypass trust and a QTIP trust, assuming that the donors have made no taxable lifetime gifts, the person making the allocation would typically make an allocation of the GST tax exemption of the first grantor to die to the bypass trust. The bypass trust is typically funded with an amount equal to the estate tax unified credit equivalent (or applicable exclusion), $2,000,000 in 2006. Thus, $2,000,000 of the GST exemption would also be allocated to the bypass trust to make it GST exempt.

When the GST exemption was $1,120,000 in 2003, the decedent had $120,000 of exemption remaining after allocating $1,000,000 (the amount protected by the estate tax unified credit in 2003) to the bypass trust. If the remaining assets exceeded $120,000, the trust instrument would instruct the executor to split the QTIP into two separate trusts. $120,000 would be placed in an exempt QTIP trust, to which the remaining $120,000 of GST exemption would be allocated. The rest of the assets would go to the other separate QTIP trust and would be fully nonexempt. On the federal estate tax return, the executor would make a “reverse QTIP election,” so that the $120,000 of property in the exempt QTIP would be treated as passing from the first spouse to die for purposes of the GST tax.) Use of the reverse QTIP election would permit the full use of the GST exemption of the first donor spouse to die without incurring any gift or estate tax at the first death.

In 2004 to 2009, the amount passing to the bypass trust, the estate tax unified credit equivalent, is equal to the GST exemption, so division of the QTIP trust may not be required. However, if the decedent made gifts or transfers during lifetime that made the amounts of estate tax unified credit and GST exemption remaining at death unequal, a reverse QTIP election may still be useful. In 2010, the estate tax and the GST tax are repealed for one year.

The trust instrument would also instruct the trustee to make any distributions of principal to the surviving spouse first from the nonexempt trust. This is because there is no GST tax on distributions to nonskip persons such as the surviving spouse. In addition, the trustee would also be instructed to pay any taxes attributable to the QTIP trusts first from the nonexempt QTIP, upon the death of the surviving grantor. When the surviving spouse dies, that spouse’s executor would allocate the spouse’s GST exemption to other trust property that was not already exempt under the first spouse’s exemption.

After the death of both donors, the exempt bypass and QTIP trusts, together with the amount of assets from the surviving spouse to which that spouse’s
unused GST exemption would be allocated, could be held in trust for the children for their lives, and then held in trust for the grandchildren, and then held for the great grandchildren, subject to the rule against perpetuities. There would be no tax imposed (either estate tax or GST tax) at the death of each successive generation.

The provisions of the trust for the children would provide that the trust for their benefit be divided and maintained in exempt and nonexempt trusts for GST purposes. The children are typically given the income from both the exempt and nonexempt trusts, although many exempt trusts allow income to be “sprinkled” among the child and issue of the child, or even permit income to be accumulated to allow the exempt trust to grow in value. The children are also usually given a nongeneral power of appointment over the assets of the exempt trust.

The nongeneral power of appointment allows the children the flexibility to appoint the principal of the trust in different proportions either to whomever they like or sometimes only to a specified class of beneficiaries, usually their own children or perhaps a life estate to their spouse. Since the power is not a general power of appointment, the property is not included in their estates. In addition, since the original donor’s GST tax exemption was allocated to the exempt trust, when the trust passes to the grandchildren or their issue (all classified as skip persons), it is exempt from generation-skipping tax. Thus, the exempt trust passes through the children’s generation, to future generations free from estate and GST tax.

The trust instrument typically grants the children a general power of appointment over the principal of the nonexempt trust so that the nonexempt trust will be purposely included in their estates for estate tax purposes. This avoids the GST tax that would otherwise be imposed at the maximum estate tax rate (because the nonexempt trust will pass to skip persons). By having the property included in the child’s estate for estate tax purposes, it is possible to take advantage of the child’s estate tax unified credit and graduated tax rates. The nonexempt trust can also be drafted to allow the child to make gifts to the child’s issue (or others) under the gift tax annual exclusion.

The same exempt/nonexempt structure would continue to apply to the trusts as they pass to the grantor’s grandchildren, great-grandchildren, and so on, the object being to preserve the exempt trust from transfer tax at each generation level.

A limited power of appointment is often given to some nonbeneficiary (sometimes called a “trust protector”) to be able to alter the trust to deal with changes in tax law or other circumstances.

WHAT ARE THE TAX IMPLICATIONS?

**Generation-Skipping Transfer Tax**

**General Rules**

A flat rate tax equal to the highest estate tax rate (46 percent in 2006, see Figure 18.1) is imposed on every generation-skipping transfer. EGTRRA 2001 repeals the generation-skipping transfer tax for one year in 2010. Essentially, the generation-skipping transfer (GST) tax will affect transfers to grandchildren or others in the grandchildren’s or younger generations. The tax applies to outright transfers and to transfers in trust or arrangements having substantially the same effect as a trust, such as transfers involving life estates and remainders, estates for years, and insurance and annuity contracts.

Every individual is allowed to make aggregate transfers during lifetime or at death, that will be wholly exempt from the GST tax (the GST exemption is $2,000,000 in 2006, see Figure 18.1).

Essentially, the GST tax rate is equal to the maximum estate tax rate at the time a taxable distribution, taxable termination, or direct skip is made. Technically, the applicable rate is the maximum federal estate tax rate multiplied by a fraction called an inclusion ratio. This inclusion ratio is described below.

The taxable amount, which is the amount to be multiplied by the applicable rate mentioned in the preceding paragraph, depends on whether the transfer is considered a taxable distribution, a taxable termination, or a direct skip.

**Generation Assignment**

For GST tax purposes, all persons are assigned to a generation. In the case of related persons, this is done by reference to the ancestral chain relating back to grandparents of the transferor, except that spouses of the transferor or a descendent are always assigned to the same generation as the transferor or descendant. Unrelated persons are assigned to the transferor’s genera-
tion if such person is not more than 12½ years younger than the transferor, otherwise unrelated persons are assigned to succeeding generations on the basis of 25 years for each generation (i.e., first younger generation – 12½ to 37½ years younger than transferor). Where the transferee is an entity (i.e., estate, trust, partnership, or corporation), individuals who own beneficial interests in the entity are assigned to generations.5

Where persons are initially assigned to generations under the rules just discussed, it is possible that subsequent events will result in generation reassignment. For example, upon a taxable transfer to succeeding generations of skip persons, such as grandchildren and great-grandchildren, each transfer is subject to tax, but upon each successive transfer, the transferor is assigned to a lower generation. This is to prevent the imposition of the GST tax twice on transfers to persons in the same generation.6

If an individual’s parent who is a lineal descendant of the transferor or transferor’s spouse is deceased at the time of a transfer from which the individual’s interest is derived, the individual and all succeeding generations move up one generation. This predeceased parent rule also applies to collateral relatives (e.g., nephews and nieces) if the transferor had no living lineal descendants at the time of the transfer.7

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### Skip Persons

A person assigned two or more generations below the transferor is a “skip person.” A trust may be a skip person if all beneficiaries holding interests in the trust are skip persons, or no person holds an interest in the trust, but no distributions could be made to “nonskip persons.”8 For example, a trust is generally a skip person where a grandfather makes a transfer to a trust benefitting grandchildren and great grandchildren (all trust beneficiaries are skip persons). For purposes of this trust, there is a reassignment of generations after the GST to the trust; the great grandchildren are skip persons, but the grandchildren are no longer skip persons.

Solely for GST tax purposes, a person holds an “interest” in a trust or trust equivalent if the person is entitled to receive current nondiscretionary distributions of income or corpus, or is a permissible current recipient of income or corpus and is not a qualified charity.9

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### Taxable Distribution

A taxable distribution is any distribution of income or corpus from a trust to a skip person that is not otherwise subject to estate or gift tax.10 For instance, a distribution from a trust to a grandson of the grantor would be to a skip person. Likewise, if a mother creates a trust providing distributions of income or principal to her daughter or granddaughter at the discretion of the trustee, a distribution from that trust to the granddaughter is a taxable distribution. A distribution from one trust to a second trust would be considered a transfer to a skip person if all interests in the second trust were held by skip persons.

The taxable amount in the case of a taxable distribution is the net value of the property received by the distributee less any consideration paid by the distributee. In other words, the taxable amount is what the distributee received, reduced by (1) any expenses incurred by the distributee in connection with the determination, collection, or refund of the GST tax, and (2) any consideration paid for the distribution. The transferee is obligated to pay the GST tax in a taxable distribution. If the trust itself pays the tax for the transferees, the payment will be treated as an additional taxable distribution.11

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* Plus increases for indexing for inflation after 2003.
The tax levied upon a taxable distribution is **tax inclusive**. That means the amount subject to tax includes (1) the property and (2) the GST tax itself.

*Example:* If a trustee makes a taxable distribution of $10,000 of trust income to a grandchild in 2006 (assuming a trust inclusion ratio of one), the tax would be $4,600 (if paid by the grandchild). The grandchild will net only $5,400.

**Taxable Termination**

A taxable termination is essentially the termination by death, lapse of time, release of a power, or otherwise of an interest in property held in a trust resulting in skip persons holding all the interests in the trust. For instance, if Alan leaves a life income to his son, Sam, with a remainder to his granddaughter, Gina, the son’s death terminates his life interest in trust property and it then passes to Gina, a skip person. A taxable termination occurs on the date of the son’s death. A taxable termination cannot occur as long as at least one nonskip person has a present interest in the property. However, nominal interests are disregarded in determining whether a person has an interest in a trust if a significant purpose for their creation is to postpone or avoid a GST tax. Furthermore, there is no taxable termination if an estate or gift tax is imposed on the nonskip individual (the son in this example) at termination.

The taxable amount in the case of a taxable termination is the value of all property involved less (1) a deduction for any expenses, debts, and taxes (other than the GST tax) generated by the property, and (2) any consideration paid by the transferee. If one or more taxable terminations with respect to the same trust occur at the same time as a result of the death of an individual, the executor may elect to value all the taxable termination property under federal estate tax alternate valuation rules. The trustee (broadly defined to mean the person in actual or constructive possession of the GST property) is responsible for the payment of the tax in a taxable termination.

The tax payable upon a taxable termination is **tax inclusive** because, as with the taxable distribution, the property subject to the transfer includes the generation-skipping tax itself.

*Example:* Assume $1 million is placed into an irrevocable trust for the benefit of the grantor’s daughter for life with remainder to his granddaughter. At the daughter’s death in 2006, a taxable termination occurs. Assume no exemptions were claimed and the trust has an inclusion ratio of one. The tax is 46 percent of $1 million, or $460,000. It must be paid out of property passing to the granddaughter. Therefore, the granddaughter nets only $540,000.

**Direct Skips**

A direct skip is a transfer subject to an estate or gift tax made to a skip person.

A gift from an individual to his grandchild is a direct skip. A direct skip can also occur when an individual makes a transfer to a trust if all the beneficiaries of the trust are skip persons. Therefore, an individual who creates an irrevocable trust for the benefit of his grandchildren would be making a direct skip upon funding the trust.

The taxable amount in the case of a direct skip is the value of the property or interest in property (including the current right to receive income or corpus or power of appointment) received by the transferee, reduced by any consideration paid by the transferee. The transferor (the decedent in the case of a death time transfer or the donor in the case of a lifetime transfer) is responsible for payment of the GST tax in the case of a direct skip.

The tax in a direct skip is **tax exclusive**. In other words, the tax is paid by the transferor or the estate and the taxable amount does not include the amount of generation-skipping tax.

*Example:* A grandfather makes a lifetime gift of $1 million to his granddaughter in 2006. Assume no exemptions are available and the inclusion ratio is one. The grandparent must pay a generation-skipping tax of $460,000. But the tax is paid, not out of the gift, but out of additional assets of the grandparent. The grandchild will therefore net the full $1 million.

**Exemptions and Exclusions**

An exemption is available from the GST tax ($2,000,000 in 2006, see Figure 18.1). For a married couple, each spouse has a GST exemption. A gift subject to the GST
tax which is “split” by the spouses will be treated as having been made half by each spouse, and each spouse can use some (or all) of his or her GST exemption to avoid the GST tax.13

Certain transfers are excluded from the definition of the term generation-skipping transfer. Transfers excluded from the definition include:

• certain transfers that, if made by gift, would qualify as gift tax free as direct payments made for the donee’s educational or medical expenses.14

• transfers that pass gift tax free under the annual exclusion rules. Transfers in trust will not qualify for this exemption unless (1) no portion of the trust’s income or principal can be distributed to or used for the benefit of anyone other than the grandchild as long as the grandchild is alive, and (2) if the grandchild dies prior to the termination of the trust, the assets of the trust must be includable in the grandchild’s estate.15

• certain transfers that have already been subjected to the GST tax in which the transferee was in the same or lower generation as the present transferee.16

Unless the governing instrument directs otherwise (by specific reference to the GST tax), the GST tax is charged to the property constituting the transfer.17

Property subject to the GST tax must be valued as of the time of the generation-skipping transfer. However, where the tax involves a direct skip (for example, from grandparent to grandchild), if the property is included in the transferor’s estate, its value for GST tax purposes is the same as its value for federal estate tax purposes, including elections for the alternate valuation date or special-use valuation.

Computing the Tax

A GST exemption (see Figure 18.1) is allowed in computing the tax actually payable. Because married individuals making a lifetime transfer can elect to treat the transfer as if made one-half by each, the exemption can be doubled. To understand how this exemption works and how the tax is actually calculated, it is first necessary to examine the “inclusion ratio.”

The inclusion ratio procedure is in two parts. Compute the applicable fraction as follows:

1. State the portion of the GST tax exemption allocated to the trust or direct skip. $_______

2. (a) State the value of the property transferred to the trust (or involved in the direct skip). $_______

   (b) State the total of any federal estate or state death tax actually recovered from the trust attributable to such property. $_______

   (c) State the amount of any charitable deduction allowed under estate or gift tax law with respect to the property. $_______

   (d) Add (b) and (c). $_______

3. Subtract (d) from (a). $_______

4. Divide the line 1 exemption by line 3. This is the “applicable fraction.” $_______

Once the applicable fraction is computed, the inclusion ratio is calculated. The inclusion ratio is 1 minus the applicable fraction (line 4).

An exception to the above computation is for a charitable lead annuity trust (CLAT). The computation for transfers to such a trust after October 13, 1987 is as follows:

GST exemption allocated to the transfer, increased by the interest rate used in computing the lead interest for the number of years of the term

If a person allocates GST exemption equal to the remainder interest and if the trust performs as expected by the government valuation tables, the fraction would be 1/1. However, it is obviously impossible to know in advance how the trust will perform, so allocation of the GST exemption for a charitable lead annuity trust is a guessing game.

After computing the inclusion ratio, that number is multiplied by the maximum federal estate tax rate (see Figure 18.1) to arrive at the applicable rate.

The total GST tax due is determined by multiplying the taxable amount by the applicable rate.18

For decedent’s dying before 2005 or after 2010, a credit for state death taxes is allowed against the GST tax if
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the transfer (other than a direct skip) occurs at the same time and as a result of an individual’s death. The credit is available for the amount of any GST tax actually paid to a state under its laws, up to a maximum of 5 percent of the GST tax payable to the federal government.

The blank worksheet at Figure 18.2 and example worksheet at Figure 18.3 illustrate the entire process.

**Liability for Payment of GST Tax**

If the transfer is a taxable distribution, the GST tax is on the amount received by the transferee, less expenses relating to the determination of the GST tax, and the transferee pays the GST tax. If the transfer is a taxable termination or partial termination, the GST tax is on the value of the property in which the interest terminates, less expenses “attributable” to the property, and the trustee pays the GST tax. In the case of direct skips (other than a direct skip from a trust), the GST tax is on the value of the property received, and the transferor pays the GST tax.19

**Special Provisions**

There are special provisions for the following:

- QTIP property (see below)
- taxation of multiple skips
- basis adjustments (In general, basis is increased by an amount equal to the portion of the GST tax actually imposed which is attributable to the appreciation of the property transferred.20)
- disclaimers (A disclaimer that results in property passing to a person at least two generations below that of the original transferor will result in a GST tax. For instance, assume a daughter disclaimed a bequest from her mother. As a result of that disclaimer, certain property passes to the mother’s granddaughter. The GST tax would be imposed on the transfer – in addition to the federal estate tax.)
- administration
- return requirements (The GST tax return must be filed on or before the due date of the applicable gift or estate tax return. In other cases, the GST tax return must be filed on or before the 15th day of the 4th month after the close of the taxable year in which the transfer occurs.)

Trusts can have multiple generation skips and each skip would be taxed. For example, a trust could be for the benefit of a child, a grandchild, and a great-grandchild. A taxable termination would occur at the death of the child and at the death of the grandchild. But if a direct skip is directly to a great grandchild, two taxes are not imposed.

IRC Section 303 can be used to make protected redemptions of stock to pay a GST tax.

IRC Section 6166, which allows for installment payments of federal estate tax, allows deferral of the tax generated under a GST because of direct skips resulting at death.

**Planning for GST Tax**

The generation-skipping tax may be imposed in addition to any estate or gift tax that may also be due because of the transfer. It appears that in many cases the total cost of making a property transfer can exceed the value of the gift.

**Example 1:** Assume a grandfather in a 46 percent gift tax bracket makes a gift in 2006. Assume the value of his gift is $2 million, and it is made to a trust for his grandchild. Assume he doesn’t allocate any of his generation-skipping transfer tax exemption (or he has already used the exemption) and he has already used his gift tax unified credit. The generation-skipping transfer tax is $920,000 ($2,000,000 x .46). For gift tax purposes, the amount of the gift to the grandson is $2,920,000 ($2,000,000 + $920,000). The gift tax on the total deemed gift is $1,343,200 ($2,920,000 x .46). The total tax therefore is $2,263,200, which exceeds the value of the gift actually made.

**Example 2:** Assume a father in a 46 percent federal estate tax bracket establishes a testamentary trust in 2006 that provides, “to my son for life, then to my grandson.” Assume he has
### GENERATION-SKIPPING TRANSFER (GST) TAX WORKSHEET

#### Part A – GST Direct Skip

1. **Transfer**
2. Federal Estate or State Death Taxes Borne by Transfer
3. Federal Gift or Estate Tax Charitable Deduction
4. Nontaxable Gift Portion (GST Exclusions)
5. Total Reductions \[(2) + (3) + (4)\]
6. Net Transfer (Denominator) \[(1) - (5)\]
7. GST Exemption Allocated (Numerator)
8. Applicable Fraction \[(7) / (6)\]
9. Inclusion Ratio \[1 - (8)\]
10. Maximum Tax Rate
11. Effective Maximum Tax Rate
12. Applicable Rate \[(9) x (11)\]
13. GST Tax \[(6) x (12)\]

* If lifetime transfer, or GST tax is borne by other property, enter (10); otherwise, use formula \[(10) / (1 + (10))\]

#### Part B – GST Inclusion Ratio for Trust

1. Prior Applicable Fraction
2. Prior Value of Trust
3. Nontax Portion \[(1) x (2)\]
4. Current Transfer
5. Federal Estate or State Death Taxes Borne by Transfer
6. Federal Gift or Estate Tax Charitable Deduction
7. Nontaxable Gift Portion (if transfer is direct skip)
8. Total Reductions \[(5) + (6) + (7)\]
9. Net Transfer \[(4) - (8)\]
10. Current GST Exemption Allocation
11. Numerator \[(3) + (10)\]
12. Denominator \[(2) + (9)\]
13. New Applicable Fraction \[(11) / (12)\]
14. New Inclusion Ratio \[1 - (13)\]

* If no prior transfers have been made to this trust, enter 0

#### Part C – GST Taxable Termination/Distribution

1. Transfer
2. Inclusion Ratio
3. Maximum Tax Rate
4. Applicable Rate \[(2) x (3)\]
5. Gross Up Rate
6. Grossed Up Transfer \[(1) x (1 + (5))\]
7. GST Tax \[(6) x (4)\]

* If transfer is taxable distribution and donee pays GST tax, use formula \[1 / (1 - (4)) - 1\]; otherwise enter 0%

Source: Advanced Sales Reference Service (a National Underwriter Company publication).
## Chapter 18 – Generation-Skipping Transfer Tax

### Figure 18.3

### GENERATION-SKIPPING TRANSFER (GST) TAX WORKSHEET

**Part A** – Use to calculate GST tax for direct skips.

**Part B** – Use to calculate the new inclusion ratio for a trust whenever a transfer is made to the trust or GST exemption is allocated to the trust. It is generally preferable to keep the inclusion ratio for a trust at either one (no protection from GST tax) or zero (fully protected from GST tax). Apply ETIP and CLAT rules, if appropriate.

**Part C** – Use to calculate GST tax for taxable distributions and taxable terminations. Generally, use the inclusion ratio from Part B. If there were no other transfers to the trust and no other allocations of GST exemption to the trust, the inclusion ratio from Part A could be used for the trust.

### Part A – GST Direct Skip

1. **Transfer** 4,000,000
2. Federal Estate or State Death Taxes Borne by Transfer 0
3. Federal Gift or Estate Tax Charitable Deduction 0
4. Nontaxable Gift Portion (GST Exclusions) 0
5. Total Reductions \[(2) + (3) + (4)\] 0
6. Net Transfer (Denominator) \[(1) - (5)\] 4,000,000
7. GST Exemption Allocated (Numerator) 1,000,000
8. Applicable Fraction \[(7) / (6)\] 0.250
9. Inclusion Ratio \[1 - (8)\] 0.750
10. Maximum Tax Rate 55%
11. Effective Maximum Tax Rate 0.55%*
12. Applicable Rate \[(9) x (11)\] 0.413
13. GST Tax \[(6) x (12)\] 1,652,000

* If lifetime transfer, or GST tax is borne by other property, enter (10); otherwise, use formula \[(10) / (1 + (10))\]

### Part B – GST Inclusion Ratio for Trust

1. Prior Applicable Fraction 0.250*
2. Prior Value of Trust 6,000,000*
3. Nontax Portion \[(1) x (2)\] 1,500,000*
4. Current Transfer 3,000,000
5. Federal Estate or State Death Taxes Borne by Transfer 0
6. Federal Gift or Estate Tax Charitable Deduction 0
7. Nontaxable Gift Portion (if transfer is direct skip) 0
8. Total Reductions \[(5) + (6) + (7)\] 0
9. Net Transfer \[(4) - (8)\] 3,000,000
10. Current GST Exemption Allocation 1,000,000
11. Numerator \[(3) + (10)\] 2,500,000
12. Denominator \[(2) + (9)\] 9,000,000
13. New Applicable Fraction \[(11) / (12)\] 0.278
14. New Inclusion Ratio \[1 - (13)\] 0.722

*If no prior transfers have been made to this trust, enter 0

### Part C – GST Taxable Termination/Distribution

1. Transfer 100,000
2. Inclusion Ratio 0.722
3. Maximum Tax Rate 46.0%
4. Applicable Rate \[(2) x (3)\] 0.332
5. Gross Up Rate 0.0*
6. Grossed Up Transfer \[(1) x (1 + (5))\] 100,000
7. GST Tax \[(6) x (4)\] 33,200

* If transfer is taxable distribution and donee pays GST tax, use formula \[1 / (1 - (4)) - 1\]; otherwise enter 0%

**Notes.** Lifetime direct skip of $4,000,000 to trust in 1997, with GST exemption allocation of $1,000,000 (see Part A). Lifetime direct skip of $3,000,000 in 2006, with GST exemption allocation of $1,000,000, when trust is worth $6,000,000 (see Part B). [Tax on second direct skip not shown here.] Later, taxable distribution of $100,000 in 2006 (see Part C).

Source: *Advanced Sales Reference Service* (a National Underwriter Company publication).
already used his GST exemption (and the estate tax unified credit is disregarded.) He leaves $5 million, and the federal estate tax is $2,300,000 ($5,000,000 x .46). That leaves $2,700,000 to provide for his son. Assume that during the son’s lifetime there is no appreciation in the trust. At the son’s death in 2011, a generation-skipping transfer tax is levied at 55 percent and amounts to $1,485,000 ($2,700,000 x .55). The total tax on the $5 million is therefore $3,785,000 ($2,300,000 plus $1,485,000).

Trust distributions will be subjected to the tax regardless of whether they are made from income or from corpus. Recipients of income subject to the GST tax may take an income tax deduction (similar to the IRD deduction for estate tax under IRC Section 691) for the GST tax imposed on the distribution.

### Allocation of the GST Exemption

Given the severity of the GST tax, probably the most important planning decision is how to allocate the GST exemption.

When all or a portion of a person’s exemption is allocated to a GST in computing the applicable fraction, this has the effect of exempting from the GST tax all future appreciation on the property designated to be exempt. For example, assume a divorced man transfers $1 million in trust for his children and grandchildren. To eliminate the GST tax, he allocates $1 million of GST exemption to the trust and avoids any GST tax. All the property in that trust will always be exempt from the GST tax, no matter how much it appreciates. (If asset values are rapidly increasing, the more quickly the allocation is made, the better.) But if the individual had allocated only half of his exemption, one-half of all future distributions from the trust to his grandchildren would be subject to the tax as taxable distributions, and one-half of the value of the assets remaining in the trust would be subject to the GST tax when his children die (as taxable terminations).

When selecting assets that will be protected by the GST exemption, assets most likely to appreciate should be used. This is because, once assets are protected by the exemption, any growth in the value of the assets is beyond the scope of the GST tax. Therefore, it would make great sense to include life insurance on the grantor’s life among these assets.

The GST exemption may be allocated by the donor (or the executor) among any property that is transferred. Once made, the election is irrevocable. Regulations specifically permit allocations of the exemption by formula without requiring taxpayers to specify a dollar amount on the gift or estate tax return.

The GST exemption will be automatically allocated to a direct skip during life unless the donor elects otherwise.

Prior to 2001, a lifetime gift that was not a direct skip required the filing of a gift tax return to allocate the donor’s GST exemption. EGTRRA 2001 provides that with respect to a lifetime gift to a generation-skipping trust (an indirect skip), the GST exemption will be automatically allocated to an indirect skip unless the donor elects otherwise. Elections with respect to indirect skips can be made with respect to a transfer or for all transfers to a trust. An election can also be made to treat any trust as a generation-skipping trust.

For this purpose, a generation-skipping trust is generally any trust that could have a generation-skipping transfer with respect to the transferor unless the trust has certain provisions for nonskip persons. Such provisions include (1) more than 25% of the trust must be distributed to, or withdrawn by, nonskip persons prior to reaching age 46 (or a date or event prior to such birthday); (2) more than 25% of the trust must be distributed to, or withdrawn by, nonskip persons if they are living on the date of death of an individual named in the trust who is more than 10 years older than such skip persons; (3) if a nonskip person dies before a date or event described in (1) or (2), more than 25% of the trust must be distributed to such person’s estate or subject to a general power of appointment by such individual; (4) the trust would be includable in the gross estate of a nonskip person (other than the transferor) if the person died immediately after the transfer; or (5) the trust is a CLAT, CLUT, CRAT, or CRUT with a nonskip remainder person.

As a general rule, the allocation of the exemption will be based on the fair market value of the property on the effective date of allocation. The effective date of allocation for direct skips during the transferor’s lifetime is the date of transfer. Where a timely filed gift tax return is filed, the effective date of allocation even for skips other than direct skips is generally the date of transfer as to which the Form 709 relates. An application can be made for an extension of time to make a timely allocation of GST exemption and the Service has been quite lenient in granting such extensions. EGTRRA2001 permits certain retroactive allocations to be made when certain nonskip beneficiaries of a trust die. Also, where late allocations are made during life,
the transferor may, solely for purposes of determining the fair market value, elect to treat the allocation as having been made on the first day of the month during which the late allocation is made. However, such an election is not effective with respect to life insurance if the insured has died.23 Where property is held in trust, the allocation must be made to the entire trust, rather than to specific trust assets.24

Where some GST tax exemption is allocated to gifts to pay premiums through an irrevocable life insurance trust, some practitioners suggest deliberately filing “late” so that the allocation will apply to the then reduced value of the policy rather than to the full amount of the premium. Obviously, this involves the risk of the insured dying and requiring the exemption to be allocated on the basis of the face amount of its policy. It may also require filing a gift tax return to elect out of automatic allocation.

As discussed above, taxable distributions and taxable terminations are tax inclusive, whereas direct skips are tax exclusive. Thus, it makes sense to use the generation-skipping exemption to minimize the tax on taxable distributions and terminations. Perhaps more importantly, many direct skips are gifts made directly to grandchildren, so the exemption shelters only that transfer. If the exemption is allocated to a properly drafted trust, it may allow transfer tax avoidance at the death of two or more generations.

At the transferor’s death, where the executor or other person making the allocation fails to allocate the exemption, it is allocated automatically according to a statutory formula. The statute allocates any unused exemption first to direct skips occurring at the individual’s death on a pro rata basis, and then to any trusts from which a taxable distribution or termination could occur after the transferor’s death.25 Thus, the statutory order of allocation tends to be nonoptimal.

Split–Gifts and the Reverse QTIP Election

If a husband and a wife elect to split a gift pursuant to IRC Section 2513, each is deemed the transferor as to one-half.26 Since each spouse has a GST exemption to allocate, this can be extremely important in planning transfers that could be subject to the tax.

Where one spouse makes a gift to the other, either during lifetime or at death, in a form that qualifies for the marital deduction, there is a danger that all or part of the available GST exemption of the transferor spouse will be lost. For example, if husband died in 2003 and left his entire estate in excess of the amount necessary to offset his available unified credit to his wife, this would have left a taxable estate of no more than $1,000,000 (see Chapter 24). Since his estate could have sheltered up to $1,120,000 in 2003 from GST tax, the result is a loss of up to $120,000 of that exemption.

However, where the transfer had been in the form of a QTIP trust, even though the transferor spouse or estate claimed the full marital deduction, an election could have been made solely for GST purposes to treat the QTIP property as if no QTIP election was made at the date of gift or death.27 This is an “all or nothing election,” i.e., the election to treat the property as if no QTIP election has been made must apply to all qualifying property in the trust. If the total value of the QTIP trust may exceed the available GST exemption, the will or trust should provide for division of the single QTIP trust into two trusts to take advantage of the reverse election.

Example: Wife’s taxable estate is valued at $2 million in 2003. Her estate plan creates three trusts – a bypass trust of the estate tax unified credit equivalent (or applicable exclusion) ($1,000,000 in 2003) to offset the unified credit, one reverse QTIP trust equal in value to any unused GST exemption not otherwise applied by her executor, and a second QTIP trust for the balance of her estate. Assuming the executor applies $1,000,000 of the $1,120,000 (in 2003) GST exemption to the bypass trust, the first QTIP trust can be established with a value of $120,000, and the remaining GST exemption will be applied to it. This will leave a second QTIP trust of $880,000, which may be subject to GST tax on subsequent distributions or termination. (Of course, the husband, at his death, could allocate his GST exemption against the second QTIP trust.)

This problem has become less of a concern for many because the GST exemption equals the estate tax unified credit equivalent (applicable exclusion) amount in 2004 to 2009 and the estate tax and GST tax are repealed for one year in 2010. However, if the decedent makes gifts or transfers during lifetime that make the amounts of estate tax unified credit and GST exemption remaining at death unequal, a reverse QTIP election may still be useful. Also, the GST exemption and estate tax unified credit equivalent (applicable exclusion) amount are scheduled to be different once again in 2011.
Chapter 18 – Generation-Skipping Transfer Tax

Grantor Retained Income, Annuity, and Unitrust ETIP

The GST tax may have an impact on transfers of remainder interests in property where the transferor retains the income, use of, or payment from a trust for a term of years. The subject of grantor retained income trusts, annuity trusts, and unitrusts is covered in Chapter 26. The issue here is the GST tax consequences of such trusts where the remainder interests pass to skip persons.

It is possible to make such a transfer that is complete for gift tax purposes, but which may be includable in the transferor’s taxable estate. The question is whether for GST purposes the transfer is made at the date of transfer or the date of death of the transferor. The grantor retained income trust, grantor retained annuity trust, or grantor retained unitrust is a perfect example.

In such arrangements, the GST rules postpone allocation of the exemption until there is an actual GST transfer, or the transferor dies, or the property would no longer be included in his estate. The law provides that where transferred property would be includable in the transferor’s taxable estate under any statute other than IRC Section 2035 if the transferor were to die immediately after the transfer, allocation of his GST exemption will be postponed during the estate tax inclusion period (ETIP), which runs until the earlier of (1) the date the property would no longer be included in the taxable estate, (2) the date there is an actual generation-skipping transfer, or (3) if neither event occurs during the transferor’s lifetime, the death of the transferor. If the transfer is a direct skip, allocation is deemed to occur at the end of the ETIP. The postponement period is only for purposes of determining the inclusion ratio, and should not affect other rules (e.g., there is no step-up in generation for a child whose parent was alive when the transfer was made, even if the parent dies before the end of ETIP).

Multi-Generational Planning

If the taxable transfer is to succeeding generations of skip persons (i.e., grandchildren and great-grandchildren), each transfer is subject to tax. Upon each successive taxable transfer, the transferor is assigned to a lower generation. However, a transfer to a person more than two generations below the transferor is subject to only one GST tax. This may lead to the establishment of multi-generational trusts that permit distributions at least two generations below the transferor. In the case of older clients, direct skip transfers assigned at least two generations below the transferor should be considered. Compare the result where a trust provides for distributions to children for life, then grandchildren for life, remainder to great-grandchildren. There will be three taxable events – when the trust is created (estate or gift tax), when child dies (taxable termination), and when the last surviving grandchild dies (taxable termination). Allowing distributions directly to great-grandchildren while child is still alive eliminates one level of tax. Also, direct transfers to grandchildren after a child is dead eliminate one level of tax, since the grandchildren move up a generation.

A common approach to multi-generational planning is the establishment of a “dynastic” trust to take advantage of the GST exemptions of a client and spouse that is intended to continue through succeeding generations as long as the law will permit. The actual distribution of these trust assets will be postponed as long as possible, to avoid estate tax as long as possible. Such trusts could last many years, limited only by a legal limitation called the rule against perpetuities, which prohibits the establishment of trusts that last indefinitely. For example, if a trust with a present value of $2,000,000 will continue in existence at least 75 years, and grows at an annual rate of only 4%, it will increase to over $37,000,000. This kind of planning may appeal to clients who have a tradition of preserving wealth in a family through succeeding generations.

Example: Tom and Pam Monson have an estate of $2,200,000 and plan to use life insurance and leveraging to maximize the utilization of their GST tax exemptions for the benefit of their five children and their issue. The transferors make annual gifts to the trust to pay the life insurance premiums. Those annual gifts are exempt from gift tax under the annual exclusion. In addition, GST exemption is allocated to the annual gifts. The premiums are $25,000 per year for 16 years, for a total of $400,000 of premium (assume $200,000 given by each spouse). The insurance is the “survivorship” type that only pays when the survivor dies.

In this situation, although only $400,000 of GST exemption was allocated to the life insurance trust premiums, all of the $1,000,000 of insurance proceeds paid at the second spouse’s death will be sheltered from generation-skipping transfer tax.

At Tom’s death in 2014, his estate is divided $1,000,000 (the unified credit equivalent amount
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in 2014) to the bypass trust and $100,000 to the QTIP trust. Tom’s executor allocates $1,000,000 of his GST exemption to the bypass trust. [GST exemptions, after inflation adjustments, are assumed to be adequate for the allocations described in this example.]

Pam’s executor, at her death in 2014, allocates $1,118,000 GST exemption to the generation-skipping gift trust for the children into which the QTIP trust and the spouse’s property flows ($100,000 QTIP trust plus $1,100,000 spouse’s property, minus estate tax of $82,000). Tom’s $1,000,000 bypass trust also flows into that trust. That trust holds the $1,000,000 life insurance policy. The end result is that $3,118,000 ends up being exempt from GST tax instead of just $2,118,000 because of the leveraging of life insurance, even assuming a zero growth rate.

If the assets were to grow in value after the allocations of exemption, the amounts going to the GST tax exempt trust for the children would be even greater. Furthermore, as the trust continues down to lower generations, assets in the trust avoiding GST and estate tax may compound even further.

Planning to Pay Estate Tax Rather than GST Tax

Almost the reverse of multi-generational planning is planning transfers to trigger federal estate tax in the estates of each succeeding generation. Any transfer from a trust other than a direct skip that is subject to estate or gift tax with respect to a person in the first generation below the grantor is exempt from GST tax. In many situations, since the GST tax is computed at the highest possible federal estate tax rate, it would be preferable to allow the property in a nonexempt trust to pass through the taxable estates of children to grandchildren, since the federal estate tax imposed on the property cannot exceed the GST tax, and in many cases, will be substantially less. This could be accomplished by giving children a general power of appointment over the trust, at least up to the amount needed to put the child in the highest estate tax bracket. While this may result in tax saving, there is always a danger the children will exercise the power and cause the property to pass to someone other than the grandchildren. A possible solution is to give the child only the power to appoint to creditors of his estate, which is a general power of appointment.

Exclusion for Nontaxable Gifts

Gifts that are not taxable by reason of the gift tax annual exclusion are also exempt from GST tax under most circumstances. The inclusion ratio for nontaxable gifts is zero. This includes gifts not subject to tax under IRC Sections 2503(b) and 2503(e), and by inference, 2503(c).

However, in the case of transfers after March 31, 1988, only nontaxable gifts that are direct skips would have a zero inclusion ratio. In addition, nontaxable gifts to trusts would not have a zero inclusion unless:

1. No portion of the trust could be distributed to a person other than a single beneficiary, and
2. If that beneficiary dies before the trust terminates, the trust assets will be included in his estate.

Therefore, for purposes of the generation-skipping transfer tax, annual exclusions are not available for Crummey withdrawal powers (see Chapters 22 and 30).

To Skip or Not to Skip?

Where there is intentional planning to skip generations, the GST tax cost must be compared to the estate or gift tax cost of transferring the property to the first generation (children), who would then transfer to the second generation (grandchildren). Relative tax cost on a tax inclusive basis should be considered. Assuming a 46% (in 2006) transfer tax rate:

1. Since the gift tax is exclusive of the gift, a 46% gift tax rate amounts to a tax inclusive rate of 31.5% \[
\frac{46\%}{(1 + 46\%)}.
\]
2. The estate tax inclusive rate is 46%, since the tax is included in the tax base, i.e., the taxable estate.
3. The GST tax on taxable distributions and terminations is tax inclusive, since it is imposed on the transferee, and the tax inclusive rate is 46%.
4. The GST tax on direct skips is tax exclusive, resulting in a 31.5% tax inclusive rate.
5. However, the GST tax on lifetime gifts is also considered to be a taxable gift, and a gift tax will be paid on the GST tax. The total gift and GST tax could equal 113% \[
\frac{46\% x (1 + (1 + .46))}{(1 + (1 + .46))}
\] of the value of the gift [but see (7) below].
6. Also, if a direct skip is made at death, the GST tax will have to be paid from assets that were also subject to the federal estate tax; but the estate tax and the GST tax reduce the GST. The total estate and GST tax could equal 63% \([\{46\% \times 1\} + (31.5\% \times (1 - .46))\] of the value of the transfer.

7. On the other hand, if a lifetime direct skip gift is made, both the gift tax and GST tax paid will reduce the taxable estate of the donor (in the case of the gift tax, assuming the donor lives at least three years after the transfer). For example, the gift in (5) above would remove 213% \((100\% \text{ gift} + 113\% \text{ tax})\) of the value of the gift from the taxable estate.

**Other Planning Considerations**

As a general rule, the GST tax applies to transfers after October 22, 1986. However, lifetime transfers that were made after September 25, 1985 and were subject to gift tax are also subject to the GST tax. GST tax does not apply to any transfer from a trust that was irrevocable on September 25, 1985, so long as no additions are made after that date. Even if a trust is grandfathered for GST purposes, the trust may become tainted to the extent that there are either actual or constructive additions.

A constructive addition will occur where a general power of appointment is exercised or released, or lapses over a portion of the grandfathered trust. However a constructive addition will not occur where a nongeneral power of appointment is exercised if the exercise will not postpone or suspend the vesting, absolute ownership, or power of alienation of the interest for a period longer than allowed by the rule against perpetuities from the date of the creation of the trust. However, the exercise of a power of appointment that validly postpones or suspends 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 will extend beyond the perpetuities period.30

These rules create the opportunity to change the distribution of grandfathered trusts via exercise of nongeneral powers of appointment without adversely affecting its grandfathered (exempt from GST tax) status.

Since irrevocable trusts created before September 26, 1985, are completely exempt from the GST tax system (but only to the extent no additions are made to the trust from that date), it is important not to taint such trusts by adding new property to them. Not only would this create a tax where none existed, but it would also create an administrative nightmare tracking and allocating pre- and post- September 26 assets and appreciation.

Whenever possible, transfer some assets from a rich spouse to a less wealthy spouse. This is because the GST exemption is not freely transferable between spouses. But a transfer to a less wealthy spouse can double the advantage of the GST exemption, since both spouses can take advantage of it. This is similar to the rationale for making transfers to a spouse in order to achieve the full benefit of both spouses’ unified credits.

Greater emphasis should now be placed on protecting irrevocable life insurance trusts from the GST tax by advising clients to consider allocating a portion of the GST exemption to each transfer made to the trust. Keep in mind that the use of a portion of the GST exemption to shield, say, twenty $50,000 annual premiums protects not only that $1,000,000, but also the future trust corpus generated by the policy proceeds created by those premium payments. Leveraging the GST exemption this way (for as long as this technique lasts) may be the single most effective long run means of keeping wealth within the family.

**ISSUES AND IMPLICATIONS IN COMMUNITY PROPERTY STATES**

Where community property is involved, gift splitting by husbands and wives may not be necessary, nor may it be necessary for one spouse to consider a transfer to the other so that both may use their full GST exemption.

**QUESTIONS AND ANSWERS**

**Question** – The will of a client provides for a family trust that authorizes the trustee to make distributions from the trust to the spouse, children, and grandchildren of client. On the death of the spouse, the trust will be distributed to the then surviving children. However, if no children then survive, the share of such a deceased child will pass to the child’s issue. Under what circumstances will trust distributions be subject to GST tax?

**Answer** – Distributions of trust income or principal to the spouse and children will not be subject to GST tax. The spouse is assigned to the same generation as the client, and the children to the first generation below. Thus, none of these beneficiaries are skip persons.
However, any income or principal distributions to grandchildren will be subject to GST tax, since they are skip persons (unless the client’s GST exemption allocated to the trust was sufficient to give the trust a zero inclusion ratio).

When the spouse dies, distributions of shares of the trust to children will not be subject to GST tax, since the children are not skip persons. However, any distribution of a share of the trust to the issue of a deceased child of the client will be a taxable termination subject to GST tax, since the grandchildren are skip persons.

**Question** – Client’s will directs that his estate be distributed to a trust that will be divided into separate shares, one for each of his children living at his death, and one for the issue of any child who predeceased the client. Under what circumstances will distributions from this trust be subject to GST tax?

**Answer** – Under the GST rules, separate shares in a single trust are treated as separate trusts. Distributions to children from the trusts created for them are not subject to GST tax, since they are not skip persons. Distributions from the shares set aside for the issue of a child who predeceased the client are also not subject to GST tax. The reason is that when a transfer is made to grandchildren of the transferor whose parents are predeceased, those grandchildren move up a generation. As a result, the grandchildren of a predeceased parent are no longer skip persons, and distributions to them should not trigger a GST tax.

**Question** – Under the terms of an irrevocable trust, the trustee is directed to accumulate income until the beneficiary attains age 21, and cannot make corpus distributions to the beneficiary until that time. For GST purposes, does the beneficiary have an “interest” in the trust?

**Answer** – The beneficiary has no interest in the trust until attaining age 21. This is because the beneficiary is not entitled to receive any present distributions of trust income or principal. If that person is the only beneficiary, there is no person with an interest in the trust. If the beneficiary is a skip person, the transfer to trust would be a direct skip.

**Question** – Transferor creates a trust providing for an annuity payable to his granddaughter for life, remainder to charity. Assume this is a qualified charitable remainder trust (see Chapter 33). Who is treated as having an interest in the trust?

**Answer** – Both the granddaughter and the charity have interests in the trust, and the future interest of the charity becomes a present interest for GST tax purposes. This is a special rule that only applies to charities. The transfer to the trust cannot be a direct skip since the charity, which is assigned to the transferor’s generation, has an interest. However, distributions to the granddaughter will be taxable distributions to a skip person.

**Question** – A family trust created under a will is a pot trust for lineal descendants, which will terminate and be distributed to then living lineal descendants when the youngest grandchild attains age 65. Assuming all children of the testator die before the youngest grandchild attains age 65, what are the GST tax consequences?

**Answer** – Upon the death of the last child, there is a taxable termination, since the only remaining beneficiaries of the trust, grandchildren and possibly their descendants, are skip persons. Immediately after the taxable termination, the transferor is treated as being one generation above the grandchildren, so that subsequent distributions to the grandchildren will not be taxed again. But distributions to their descendants will be subject to GST tax.

**Question** – At the date of death, the estate value of assets in decedent’s estate is $2 million. The will provides that the executor is to allocate $1 million in assets to a trust based on date of death value. However, the actual value of the assets transferred to the trust at date of allocation has increased from $1 million to $1.3 million. For purposes of computing the exclusion ratio, is the denominator of the fraction $1,000,000 or $1,300,000?

**Answer** – The denominator of the fraction is the pecuniary amount ($1 million in this example) only if the pecuniary payment of property must be satisfied on a basis that fairly reflects net appreciation or depreciation (between the valuation date and the date of distribution) in all of the assets from which the distribution could have been made. Otherwise the denominator of the fraction would have to be the date of distribution value ($1.3 million in this example).31

**Question** – Transferor conveyed property worth $500,000 to a generation-skipping trust in 2004 and allocated $300,000 of her exemption to it. In 2006, when that property was worth $700,000, she transferred...
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$100,000 cash to the trust, and claimed a $100,000 exemption. What is the inclusion ratio?

Answer – The inclusion ratio is:

\[
1 - \frac{100,000 + (0.600 \times 700,000)}{100,000 + 700,000} = 0.350
\]

The .600 represents the nontax portion of the trust before the second transfer, $300,000 / $500,000.32

Question – Where a preexisting life insurance trust is grandfathered as a pre-September 25, 1985 trust, can gifts to cover premium payments continue without the trust being subject to GST tax?

Answer – No, additional transfers to pay life insurance premiums would be considered additions to the trust. The additions to the trust will result in inclusion of part of the trust for GST tax purposes, unless the lifetime exemption is allocated to cover the portion of the trust that is not grandfathered.

ASRS: Sec. 56.

CHAPTER ENDNOTES

1. IRC Secs. 2601, 2602.
2. IRC Sec. 2652(b).
3. IRC Sec. 2631.
4. IRC Sec. 2641.
5. IRC Sec. 2651.
6. IRC Sec. 2653(a).
7. IRC Sec. 2651(e).
8. IRC Sec. 2613.
9. IRC Sec. 2652(c).
10. IRC Sec. 2612(b).
11. IRC Sec. 2621.
12. IRC Sec. 2652(c)(2); Treas. Reg. §26.2612-1(e)(2)(ii).
13. IRC Sec. 2652(a)(2).
14. IRC Sec. 2611(b).
15. IRC Sec. 2642(c).
16. IRC Sec. 2611(b).
17. IRC Sec. 2603(b).
18. IRC Sec. 2641, 2642.
19. IRC Sec. 2603.
20. IRC Sec. 2654(a).
22. IRC Sec. 2632.
25. IRC Sec. 2632(c).
26. IRC Sec. 2652(a)(2).
27. IRC Sec. 2652(a)(3).
28. IRC Sec. 2642(f).
29. IRC Sec. 2653(a).
32. IRC Sec. 2642(d).