

The “Grandparent Tax”

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Summary

GST is imposed on a direct transfer of property to a grandchild that would otherwise be subject to two levels of estate taxation if first taxed as part of the parent’s estate, then transferred from parent to child, taxed as part of the child’s estate, and finally transferred to the grandchild. To ensure that such transfers do not entirely escape two levels of taxation, assets conveyed are subject to GST at the time they are transferred: Direct skip transfers made during lifetime are reported on **Form 709**; direct skips made at death are reported on **Form 706**, thereby ensuring that any tax due cannot be escaped in life or after death.

The information contained herein is for educational use only and should not be construed as tax, financial, or legal advice. Each individual’s situation is unique and may require specialized treatment. It is, therefore, imperative that you consult with tax and legal professionals prior to implementation of any strategies discussed.

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Table of Contents

| | | |
|-------------|--|-----------|
| I. | Introduction | 1 |
| II. | History of the GST | 2 |
| III. | Transfers Subject to GST..... | 4 |
| | A. Skip Persons | |
| | B. Transferor | |
| | C. Subject Transfers | |
| IV. | Tax Computations | 7 |
| | A. Direct Skips | |
| | • Valuation | |
| | • Inclusion Ratio | |
| | B. Indirect Skips | |
| | • Exemption Allocation | |
| | • Estate Tax Inclusion Period | |
| V. | Mechanics..... | 13 |
| | A. Liability | |
| | • Non-citizens | |
| | B. Due Date | |
| VI. | Sample Scenarios..... | 15 |
| | A. Direct Skips | |
| | B. Taxable Terminations | |
| | C. Taxable Distributions | |
| VII. | GST Planning..... | 16 |
| | APPENDIX A: Where to report GST | 21 |
| | APPENDIX B: Form 709, Schedule D..... | 22 |
| | APPENDIX C: Form 706-GS(D)..... | 24 |
| | APPENDIX D: Form 706, Schedule R..... | 25 |

I. Introduction

Often labeled the “Grandparent Tax”, the Generation-Skipping Tax (“GST”) is imposed on a direct transfer of property to an individual two or more generations below the transferor if that transfer would otherwise have been subject to two levels of estate taxation – first taxed as part of the transferor’s estate and then transferred from that heir to a younger beneficiary and taxed once more.¹ A typical example would be a direct transfer from grandparent to grandchild, skipping the parent in the middle generation; thereby avoiding the intermediate level of estate tax that would have been due had the asset passed from grandparent to parent, taxed, and then transferred from parent to grandchild, and taxed again.



Because the GST rate equals the top bracket of the estate tax rate currently in effect, this tax usually exceeds that which would have otherwise been incurred at graduated rates if the property had been transferred and the estates taxed at each successive generation.

Each transferor has an exemption² and the tax is not applied to outright gifts that are excluded by the annual gift tax exclusion or qualified transfers for medical and tuition payments. However, a gift to a trust which qualifies for the gift tax annual exclusion

¹ IRC § 2612.

² The exemption is automatically allocated to lifetime direct skips and indirect skips made to a GST trust (which could have future taxable distributions or taxable terminations). Transferors can elect not to have the automatic rules apply [IRC §2632(b) and §2632(c)].

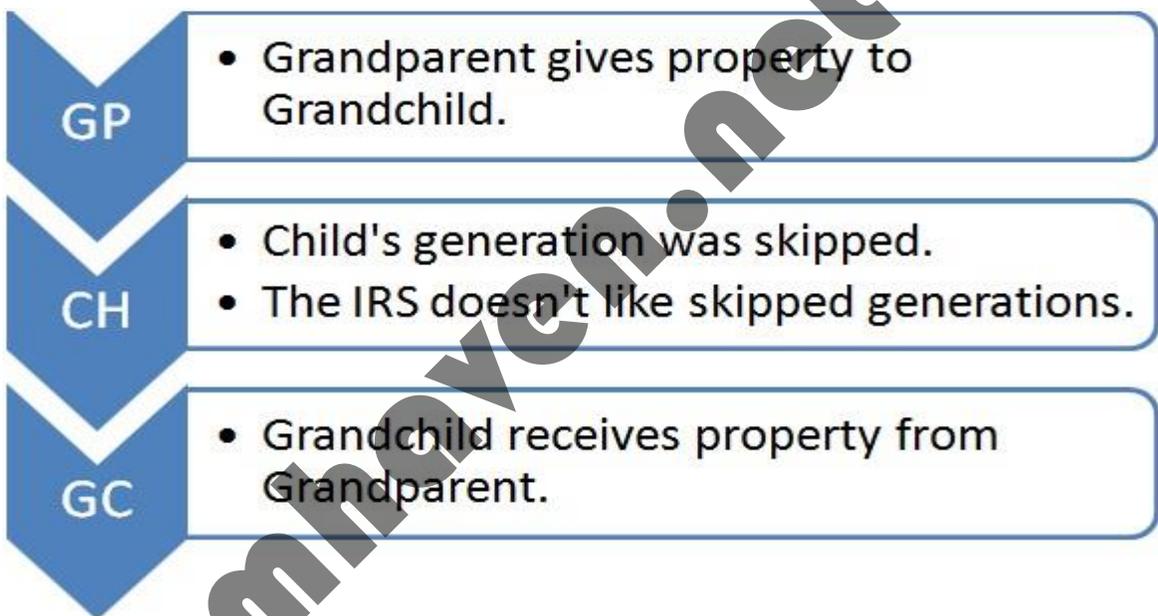
NOTE: Although the estate tax exclusion became permanently portable between husband and wife with the passage of the American Taxpayer Relief Act of 2012, **any unused portion of the GST exclusion is not transferable.**

must meet additional requirements to qualify for the GST annual exclusion – for example, Crummey Trusts³ qualify for the gift tax but not the GST annual exclusion.

Direct skip transfers made during lifetime are reported on **Form 709**; direct skips made at death are reported on **Form 706**.

II. History of the GST

While estate and gift tax regimes had been previously adopted and were used to tax permanent transfers of ownership, neither regime imposed a tax on life estates which only temporarily grant beneficial (but not outright) ownership to a beneficiary. Beneficial (and often outright) ownership generally transfers to another individual or reverts back to the original transferor when the first beneficiary dies. By establishing a series of successive life estates, wealthy families were able to effectively pass assets from one generation to the next without becoming subject to estate taxation.



Congress moved to “remedy the perceived abuse of using a trust to benefit several generations while avoiding the Federal Estate Tax during the term if the trust” by enacting a complex set of generation-skipping rules in 1976.⁴ The generation skipping

³ Crummey Trusts, named for Clifford Crummey, can be used to transform otherwise taxable gifts into tax-free transfers by granting trust beneficiaries an opportunity to withdraw contributed funds for a limited period of time, thereby converting gifts of future interest into gifts of present interest.

⁴ Powel, *The Generation-Skipping Transfer Tax: A Quick Guide*, Journal of Accountancy, October 2009 [available at <http://journalofaccountancy.com/issues/2009/oct/20091804.html>, last accessed April 19, 2015].

transfer tax (“GSTT”) was designed to treat the termination of an intervening life estate as a taxable event, subject to tax at a rate equal to the estate and gift tax rates which would have been applicable had the property been transferred outright first by the donor and then later by the first beneficiary.⁵

But because the GSTT applied only to indirect transfers from trusts and not to direct transfers from grandparents to grandchild, it was retroactively repealed. With the passage of the Tax Reform Act of 1986, the GST was (re-)introduced much in the same format as remains in effect today.

The 1986 Act applied a flat tax equal to the maximum estate tax rate currently in effect to cumulative intergenerational transfers in excess of \$1 million per donor. A \$2 million exemption per donee was briefly in effect during 1989 but was then reset to the pre-1989 donor limit. Along with estate and gift taxes, the GST was temporarily repealed in 2010⁶ but reinstated in 2011 with an exemption amount set to \$5 million.⁷ And, finally, with the passage of the American Taxpayer Relief Act of 2012, the exemption has been “permanently” set to \$5 million, adjusted annually for inflation (in \$10,000 increments).

| Year | GST Exemption | GST Tax Rate |
|-----------|-------------------------------------|--------------|
| 1997 - 98 | \$1,000,000 | 55% |
| 1999 | \$1,010,000 | 55% |
| 2000 | \$1,030,000 | 55% |
| 2001 | \$1,060,000 | 55% |
| 2002 | \$1,100,000 | 50% |
| 2003 | \$1,120,000 | 49% |
| 2004 | \$1,500,000 | 48% |
| 2005 | \$1,500,000 | 47% |
| 2006 | \$2,000,000 | 46% |
| 2007 - 08 | \$2,000,000 | 45% |
| 2009 | \$3,500,000 | 45% |
| 2010 | No generation skipping transfer tax | N/A |
| 2011 | \$5,000,000 | 35% |
| 2012 | \$5,120,000 | 35% |
| 2013 | \$5,250,000 | 40% |
| 2014 | \$5,340,000 | 40% |
| 2015 | \$5,430,000 | 40% |

⁵ Joulfaian. *The Federal Estate Tax: History, Law, and Economic*, Office of Tax Analysis, US Dept. of Treasury, August 2012.

⁶ Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

⁷ Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010 (TRUIAJC).



III. Transfers Subject to GST

GST applies only to transfers made to a “skip person” that would normally be subject to either gift or estate tax. Therefore, transfers that are already exempted from gift taxation under applicable rules such as the annual gift exclusion or direct payments of tuition and medical expenses are also not subject to GST. And if the transfer is made to any individual other than a skip person, it too is exempt from GST.

A. Skip Persons

Relatives

Generally, a skip person is any relative who is at least two generations below the transferor. However, if the transferor’s child is deceased, the grandchildren by that child are not considered skip persons.⁸ If the transferor has no lineal descendants and a niece or nephew of the transferor is deceased, the children of the deceased niece or nephew are not skip persons. Spouses and former spouses are also non-skip persons, regardless of any age difference between the transferee spouse and the transferor.⁹

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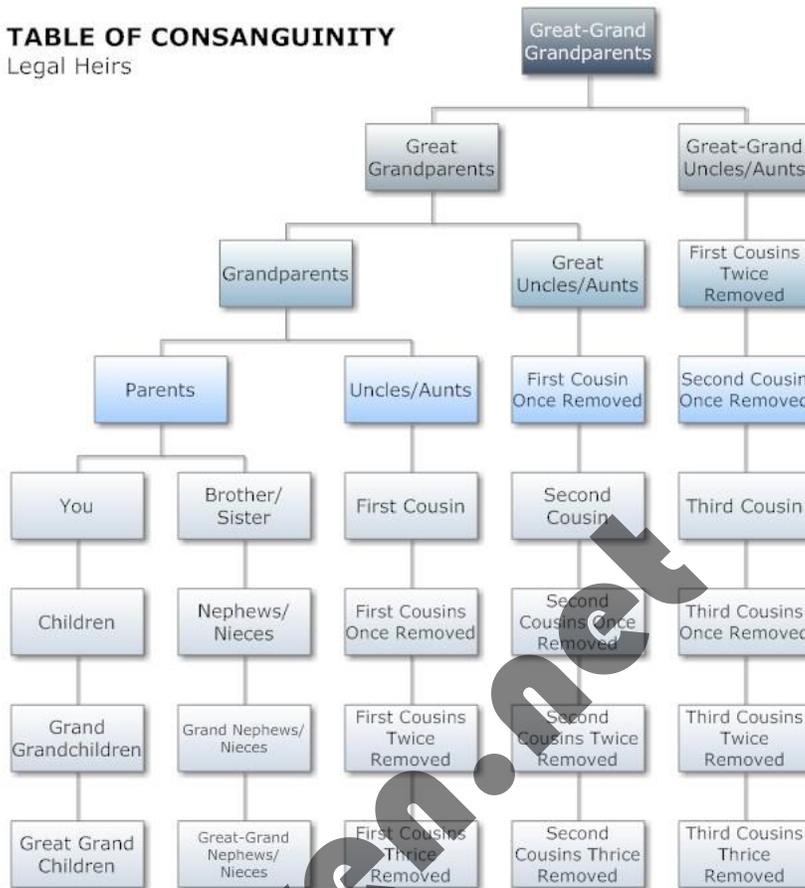
⁸ Ninety-Day Rule for transfers after July 18, 2005 [Treas. Reg. § 26.2651-1(a)(2)(iii)]: If a transferee dies within 90 days after receiving a gift, he will be treated as though he had pre-deceased the transferor.

⁹ IRC § 2651(b)(2).



TABLE OF CONSANGUINITY

Legal Heirs



Unrelated Individuals

Non-family members may also be deemed to be skip persons if:

- They are of the same generation as the transferor but no more than 12½ years older or younger than the transferor
- They are one generation below the transferor and at least 12½ but no more than 37½ years younger than the transferor
- They are two generations below the transferor and at least 37½ years but no more than 62½ younger than the transferor.

NOTE: Senior transferors should beware of gifting to unrelated individuals who are more than 37½ years younger if they want to avoid a potential GST liability.



“Persons” (not Individuals)

A trust may be considered to be a skip “person” if all trust beneficiaries are skip persons or trust distributions can only be made to a skip person. Tax-exempt organizations and charitable trusts are not skip persons.

B. Transferor

The transferor is the individual who has made a gift and may be referred to as “donor” or “trustor”, depending upon the mechanism by which the property is transferred. For example, an individual who makes a non-taxable gift to a spouse using the unlimited marital deductions, will eventually become a transferor when the previously gifted property passes from the donee spouse to another transferee. And, an individual who holds a general power of appointment over property and eventually exercises, releases or allows the power to lapse, will become a transferor for GST purposes.¹⁰ A general power of appointment gives the holder very broad power to give away the decedent’s property.¹¹

Examples of Transferors

- i. *Grandfather* who gifts property to Grandson.
- ii. *Grandfather* who gifts property to a trust for the benefit of Father and later for the benefit of Grandson.
- iii. *Father* who has general power of appointment over Grandfather’s trust established to eventually benefit Grandson.

C. Subject Transfers

GST applies to three types of transfers – Direct Skips, Taxable Terminations and Taxable Distributions – defined below:

1. Direct Skips

Generally direct skips are transfers to individuals, not trusts (unless the trust itself is characterized as a skip person). A transfer that skips two or more generations is treated as a single skip.

¹⁰ IRC § 2652(a).

¹¹ As defined by Legal Information Institute [available at http://www.law.cornell.edu/wex/general_power_of_appointment, last accessed April 19, 2015].



Example

Gifts to great-grandchildren are deemed to be single skips – even if the transferor’s children and grandchildren are still alive – and are not counted as though a transfer was first made to a grandchild followed by a second transfer to a great-grandchild.

2. Taxable Terminations

The termination of a trust becomes a taxable event subject to GST unless:

- Only non-skip persons have an interest in the trust property, or
- Termination distributions are made only to non-skip persons.¹²

Taxable terminations generally occur when a trust terminates – as scheduled or when the non-skip beneficiary dies – and the trust’s corpus passes to a skip person without being included in the non-skip beneficiary’s estate.

NOTE: If assets being transferred are subject to estate taxation, they are not subject to GST; only one or the other tax is imposed.

3. Taxable Distributions

Trust distributions of income or corpus – not already classified as direct skips or taxable terminations – are subject to GST if made to skip persons. For example, income distributions to the trustor’s grandchild from a trust created for the simultaneous benefit of the trustor’s child and grandchild would be subject to GST as long as the trust remains in existence.

IV. Tax Computations

GST is a flat tax assessed at the highest gift and estate tax rate currently in effect on all subject amounts in excess of the applicable exclusion. For 2015, that rate is 40%. It is a punitive tax intended to discourage taxpayers who seek to make an end-run around gift and estate tax regimes by arranging transfers that might otherwise escape taxation.

For example, if Grandfather passed his wealth to Father who in turn passed it on to Son, two levels of gift or estate tax would be applied to the transfer. If, instead, Grandfather had passed his wealth directly to Son (his grandson), the intermediate level of taxation would have been avoided. To dissuade Grandfather from employing this tax-saving tactic, GST is applied to the transferred amount at the highest marginal rate even if the

¹² IRC § 2612(a)(1).



transferred amount is comparatively small and would have been subject to a lesser marginal rate had it been taxed under the gift or estate tax regimes.

The following formula can be applied to compute the GST due:

$$\text{Taxable Amount} \times \text{Tax Rate} \times \text{Inclusion Ratio}$$

The GST is computed on **Form 709**, Schedule D. Part 1 is used to list all generation-skipping transfers. Part 2 is used to reconcile the GST exemption. Part 3 is used to compute the GST liability.

A. Taxation of Direct Skips

Valuation

The taxable amount is equal to the value of property transferred.¹³ Valuation is determined on the date of transfer¹⁴ unless the property is includible in the transferor's gross estate and valued at death or on the alternate valuation date.¹⁵ If the transferee paid for some or all of the property transferred, the valuation is reduced by the amount of consideration given.¹⁶

Inclusion Ratio

The inclusion ratio¹⁷ is used to determine how much of the transferred property will be subject to GST and can range from 0 to 1. An inclusion ratio of 0 means the trust is exempt from GST, while an inclusion ratio of 1 means that all taxable distributions from the trust will be subject to GST.

The inclusion ratio is defined as 1 minus the applicable fraction. The applicable fraction formula is the exemption divided by property value, any charitable deductions and estate taxes.

For example, if someone transfers \$4,000,000 into a generation-skipping trust and allocates \$3,500,000 to the then-effective exemption, the applicable fraction assuming no estate taxes or charitable contributions would be: $\$3,500,000 \div \$4,000,000 = 7/8$. Subtract 7/8 from 1 to get the

¹³ IRC § 2623.

¹⁴ IRC § 2624(a).

¹⁵ IRC § 2624(b).

¹⁶ IRC § 2624(d).

¹⁷ IRC § 2642.

inclusion ratio, which equals 1/8 or 0.125. To find the tax rate on the assets, multiply the inclusion ratio (0.125) by the highest estate tax rate.

NOTE: If the exclusion amount changes or there are additional transfers made, the inclusion ratio must be recalculated.¹⁸

The inclusion ratio is an overly complicated way of making sure that only gifts in excess of each individual transferor's GST exemption will be taxed. Since the exemption is currently set at \$5.43 million [in 2015], a single transferor could generously gift that much to his grandchildren without ever incurring GST; a married couple could gift twice that amount if each partner elected to maximize his/her GST exemption.¹⁹



The inclusion ratio for direct skips will always be zero for cumulative transfers below the applicable exemption and no GST will be due until such time as the transferor makes transfers that exceed the exemption amount. For example, a transferor transfers \$5.43 million in 2015 when the GST exemption is \$5.43 million. The inclusion ratio is calculated as $1 - (\$5.43 \text{ million} \div 5.43 \text{ million})$ which, of course, equals zero!

RULE: No GST will be assessed on transfers equal to or less than the currently applicable GST exemption.

B. Taxation of Indirect Skips

Valuation

Once again, the taxable amount is based on the value of property transferred at the time of transfer. Alternate valuation may be elected if the taxable termination resulted from the death of an individual, even if alternate valuation is not elected for estate tax purposes.²⁰

The taxable amount of a taxable distribution is the value of the property transferred less any expenses incurred by the transferee in connection with the determination and collection of GST.²¹

¹⁸ Clayton, *The Generation-Skipping Tax Inclusion Ratio* [available at http://www.ehow.com/info_10040590_generationskipping-tax-inclusion-ratio.html, last accessed April 19, 2015].

¹⁹ Additionally, each grandparent could gift amounts up to the annual gift tax exemption [\$14,000 in 2015] to each of his/her grandchildren without ever impacting his/her GST exemption amount.

²⁰ IRC § 2624(c).

²¹ IRC § 2621(a).



Inclusion Ratio

GST will generally be due for indirect skips unless an affirmative election is made on **Forms 709** or **706** to allocate a portion of the transferor's available exclusion to the particular indirect transfer that would otherwise be subject to GST.²² By electing to exclude as much as possible at the time of the indirect transfer, the inclusion ratio necessarily becomes as small as possible; maybe even as small as zero if an election is made to exclude the maximum exclusion amount available in the year of a taxable termination or distribution.

Example

In 2015, Father gifts stock worth \$4 million to a trust set up for Son who should receive all of the trust's income for life; at Son's death, the remaining corpus should pass to Son's two children. Father does not allocate his GST exclusion to the gift.

Tax Consequences and Reporting:

- Father does not incur any gift tax at the time of trust funding since the value of the stock is less than the \$5.43 million lifetime exclusion currently in effect. Nevertheless, the gift must be reported by Father on **Form 709**, Schedule A, Part 1 by April 15th of the year following the date of transfer.
- Father does not incur GST at the time of trust funding since current beneficiary of trust is not a skip person. Father must report the skip transfer on **Form 709**, Schedule A, Part 2²³ at the close of the Estate Tax Inclusion Period.²⁴
- At Son's death, trust corpus is worth \$16 million; each of Son's children inherits \$8 million and becomes liable for GST at the then-applicable maximum federal estate tax rate. Each of Father's grandchildren will have to file **Form 706-GS(D)** by April 15th of the year following the date of receipt of trust corpus.

²² To make the election, gift and estate tax returns must be filed even if no GST, gift or estate taxes would otherwise be due. The election is made on **Form 709**, Schedule D, Part 2, Line 6.

²³ **Form 709**, Schedule A, Part 3 would be used to report indirect skips.

²⁴ If Father dies prior to Son, the GST portion of the gift must instead be reported on **Form 706**, Schedule R within 9 months after Father's death.



BUT... if Father had allocated \$4 million of his GST exclusion at the time of the gift, the exclusion ratio would have been 1, the inclusion ratio would have been 0, and no tax would be due when Grandchildren inherit the trust's corpus.

Automatic Rules

With lifetime direct skips²⁵ as well as indirect skips made after December 31, 2000,²⁶ any as-yet unused portion of a transferor's GST exemption will automatically be applied to transfers, in order of occurrence, to produce an inclusion ratio of zero, whether or not a gift or estate tax return is filed.²⁷ Any unused GST exemption upon the transferor's death will be automatically allocated to testamentary direct skips first and then to trusts from which taxable terminations and distributions could occur.²⁸

However, a transferor may affirmatively elect out of the automatic allocation. To do so, the transferor must file **Form 709** or **706**, even if not otherwise required, and attach a statement clearly describing the transaction, providing the employer identification number of the receiving trust, and the extent to which the automatic allocation is not to apply.²⁹

As per the instructions of **Form 709**, a transferor may choose to:

1. not have the automatic allocation rules apply to a current transfer only, or
2. not have the automatic rules apply to both the current transfer and any (all) future transfers, or
3. treat any trust as a GST trust.³⁰

²⁵ IRC § 2632(b).

²⁶ IRC § 2632(c).

²⁷ Smith, *Planning Techniques for the GST Exemption in Generation-Skipping Trusts*, College of William & Mary Law School, 1987 [available at <http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&ved=0CDkQFjAB&url=http%3A%2F%2Fscholarship.law.wm.edu%2Fcgi%2Fviewcontent.cgi%3Farticle%3D1418%26context%3Dtax&ei=AZR1UdPcMsS8iwLG7ICACQ&usq=AFQjCNE0jv7mDMiFojtcPA-9-tKx57gQZA&bvm=bv.45512109.d.cGE&cad=rja>, last accessed April 19,2015].

²⁸ IRC § 2632(e).

²⁹ Treas. Reg. § 26.2632-1(b)(4).

³⁰ Also known as a Dynasty Trust, a GST Trust is an irrevocable trust that may stay in effect for multiple generations without being subject to GST, estate or gift taxes. While such a trust may be funded either during or after the life of a transferor, only an inter vivos trust may serve to remove the assets used to fund the trust from the transferor's taxable estate and shelter any asset appreciation that may occur prior to the transferor's death.



Election

Election 1 to allocate the GST exemption is irrevocable and must be made on a timely filed gift tax return for the year the transfer was made or was deemed to have been made. Elections 2 (future transfers) and 3 (GST trust treatment) may be made on a timely filed gift tax return for the year for which the election is to become effective.³¹



Unused Allocation: Any exemption still unused at transferor's death may be allocated by the transferor's personal representative on the decedent's estate tax return. NOTE: The representative may be liable for breach of impartiality if the exemption is unfairly and non-uniformly allocated to terminations and distributions payable to separate beneficiaries.

Retroactive Allocations: An exemption previously not allocated may be apportioned retroactively if a non-skip beneficiary who is an aunt, uncle or cousin of the transferor predeceases the transferor. The allocation must be affirmatively made on a timely filed **Form 709** for the year in which the non-skip person died.

Late Allocations: A GST exemption allocation may also be made after a gift tax return (plus extensions) was due, simply by filing a subsequent gift tax return. Valuation of the transferred property will occur at the time of allocation, not transfer.³²

Corrections: Relief for failure to make an allocation, failure to make a timely allocation, or failure to opt out of the automatic allocation is granted at the discretion of the IRS which must "take into account all relevant circumstances."³³ Relief may be granted if:

- Request for relief via private letter ruling is made before the IRS discovers the missed election.
- The taxpayer failed to make the election due to circumstances beyond his control.

³¹ Department of Treasury, Internal Revenue Service, *2012 Instructions for Form 709 United States Gift (and Generation-Skipping Transfer) Tax Return*.

³² Treas. Reg. § 26.2642-2(a)(2).

³³ IRC § 2642(g)(1)(B).



- The taxpayer, despite reasonable care and diligence, did not know that it was necessary to make the election.
- The taxpayer relied upon the written advice of the IRS.
- The taxpayer reasonably relied upon a qualified tax professional who made the mistake.³⁴

Estate Tax Inclusion Period (ETIP)

An allocation of the GST exemption does not become effective until such time that the transferor dies or there is certainty that none of the transferred property will be included in the transferor's estate (or the transferor spousal estate if a split gift was made).³⁵ In other words, finality is only achieved when there is no further possibility that additional GST could be assessed.



While the election of GST exemption allocation is irrevocable, the allocation does not in fact become effective until the ETIP has expired. Allocation before ETIP finality is achieved may lead to an inclusion ratio greater than 0 if the value of assets transferred change between the time of transfer and the expiration of the ETIP. As a result, some tax planners make it a practice to only make a GST exemption allocation when the ETIP expires and not at the time a transfer is made.

NOTE: Under the automatic allocation rule, indirect skips are deemed to have been made at the end of the ETIP regardless of when the actual transfer occurred; hence, the gifted property is valued at the close of the ETIP.³⁶

V. Mechanics of the GST

A. Liability for the Tax

GST imposed on a direct skip must be paid by the transferor.³⁷ Transferors become personally liable for any GST due; if the transferor or the transferor's personal representative does not meet his obligation, the liability for any tax due

³⁴ Treas. Reg. § 301.9100-3.

³⁵ IRC § 2642(f).

³⁶ IRC § 2642(c).

³⁷ IRC § 2603(a)(3).

is passed to the transferee.³⁸ If the transfer was made from a trust, the trustee becomes liable for any applicable GST.

Since the source for the payment of any GST due is the transferred property, direct skips are taxed on a tax-exclusive basis. Taxable terminations and distributions, on the other hand, are taxed on a tax-inclusive basis since the taxable amount is not reduced by the GST generated from the transfer. For example, if a trust makes a taxable distribution in 2015 of \$100,000, the skip person who receives the property must pay GST of \$40,000 and will receive a net distribution of \$60,000.³⁹

If, however, the trust instrument provides that the trustee shall pay the tax, the transfer will have been deemed to include the GST paid and therefore total \$140,000, resulting in additional GST of \$16,000. If the transferee pays the additional GST due, he will ultimately net \$84,000 (= \$140,000 deemed distribution - \$40,000 GST paid by trustee - \$16,000 GST paid by transferee); this is exactly equal to the net amount the transferee would have received had he paid the entire GST liability on the deemed distribution (= \$140,000 – 40% GST).

NOTE: In the case of a taxable distribution, it is the transferee (distributee) who becomes liable for the GST and the filing of the requisite tax return.

Non-Citizens

Individuals, who are not US citizens and not US residents, are nevertheless subject to GST and gift tax for gifts of tangible personal but generally not intangible property.⁴⁰ These individuals must file **Form 709** if they made gifts:

- of future interest, or
- of present interest totaling more than \$14,000 [in 2015] to any one donee, or
- to a non-citizen spouse in excess of \$147,000 in 2015.

³⁸ IRC § 6324(b).

³⁹ IRC § 2603(a)(1).

⁴⁰ IRC § 2501(a).



B. Due Date

The GST for a direct skip is generally due at the same time that the associated gift or estate tax is due.⁴¹ Extensions of time to pay may be requested in the same manner as for estate and gift taxes.⁴² If GST is attributable to the transfer of a closely-held business, the tax may be paid on an installment basis.⁴³



The GST for an indirect skip is due on the 15th day of the 4th month following the close of the calendar year in which the termination or distribution occurred. If alternate valuation is elected, GST will be due 10 months after the date of death that triggered the taxable event.⁴⁴

VI. Sample Scenarios⁴⁵

A. Direct Skip

Grandfather, who dies in 2007, makes an outright gift at death of \$2 million to Grandchildren. All Grandchildren have living parents, so all of them are skip persons; therefore, this gift is a testamentary direct skip.

Grandfather had previously allocated \$1 million of his GST exemption to lifetime gifts [set at \$2 million in 2007], meaning that only \$1 million GST exemption remains to apply to this gift. The taxable amount is the fair market value of the transferred property on the date of death (\$2 million). The applicable fraction is $1/2$ ($= \$1 \text{ million} / \2 million), which in turn means the inclusion ratio is $1/2$ ($= 1 - 1/2$). The applicable tax rate is therefore 22.5% ($= 1/2 \times 45\%$ [in 2007]); by applying the applicable rate to the \$2 million direct skip, a GST tax of \$450,000 results.

⁴¹ IRC § 2662(a)(2).

⁴² IRC § 2661.

⁴³ IRC § 6166(l).

⁴⁴ Treas. Reg. § 26.2662-1(d).

⁴⁵ Examples adapted from Ornduff, *Back to Basics: The Role of Generation Skipping Transfer Taxes in Everyday Estate Planning*, presented to The Chicago Estate Planning Council Younger Members Forum, May 25, 2010.



B. Taxable Termination

Grandfather, who dies in 2007, makes a \$5 million gift to a trust for the benefit of Son for life. At the Son's death in 2008, the trust (now worth \$5.5 million) terminates and passes to Son's children (Grandchildren). Even though Son has died in the interim, the predeceased ancestor rule does not apply since Son was alive at the time the trust was created. This is a taxable termination.

Grandfather's entire \$2 million GST exemption is allocated to the trust; the applicable fraction, therefore, is $\frac{2}{5}$ ($= \$2 \text{ million} / \5 million), and the inclusion ratio is $\frac{3}{5}$ ($= 1 - \frac{2}{5}$). The applicable rate is 27% ($= \frac{3}{5} \times 45\%$). The taxable amount is \$5.5 million. At the termination of the trust, the GST tax due is \$1,485,000 ($= \$5.5 \text{ million} \times 27\%$).

C. Taxable Distribution

Assume the same facts as in the taxable termination example [above], except that the trust allows for distributions of income and principal to Son while living and to his children. A \$10,000 distribution while the trust is still in existence is made to one Grandchild.

The taxable amount is \$10,000. The GST tax due on this gift is \$2,700 [see tax rate computation above]. NOTE: If the \$10,000 distribution were made to Son, there would be no GST tax since Son is not a skip person.

TAX STRATEGY: In the case of taxable terminations and distributions from trusts with inclusion ratios between 0 and 1, all transfers to skip persons (here, Grandchildren) will always be subject to GST. However, had Grandfather created two separate trusts at death – Trust 1 for the benefit of Grandchildren (funded with \$2 million) and Trust 2 primarily for the benefit of Son (funded with \$3 million), Grandfather's GST entire \$2 million exemption could have been allocated to Trust 1. Thereafter, all distributions from Trust 1 would be permanently free of GST.

VII. GST Planning Strategies

GST, when applicable, can be an expensive tax but it is a tax that is only rarely imposed and then only if a generation-skipping gift exceeds the rather generous GST exemption now in effect. As a result, GST tax planning is typically only called for when dealing with high net worth taxpayers or clients with children who are themselves wealthy or who cannot be trusted to manage money wisely or whose own children have greater needs.



Types of Generation-skipping Gifts

Intergenerational gifting may take many forms, including:

1. **Outright Gifts** – whereby transferor generously transfers cash or other assets directly to transferee; for example, Grandparent gifts Grandchild cash for down-payment on a house.
2. **Annual Gifting** – used to maximize the currently applicable gift tax exclusion [\$14,000 in 2015]. Such gifts could be made to:
 - **Minor's Trust:** To qualify for the annual gift exclusion, a gift must be of present interest. As a result, gifts made to trusts which often do not terminate until far into the future, must offer a *Crummey* clause that provides for at least a temporary right of withdrawal which converts future to present interests. However, because a Minor's Trust is automatically scheduled to terminate when the child reaches the age of majority (age 21 in most states) and automatically has the choice to withdraw the trust assets or allow the trust to continue, gifts to this type of trust are deemed to be of present interest (even without a *Crummey* Clause) and are eligible for the annual exclusion as long as the child is under-age.⁴⁶ If the trust continues in existence after the child reaches the age of majority, gifts to the trust are generally required to offer *Crummey* withdrawal rights.
 - **College Savings Plan:**⁴⁷ Even though the transferor retains the right to change the plan's beneficiary, a 529 Plan is considered by law to be a completed gift that qualifies for the annual exclusion. In fact, under a special provision, donors have the option to accumulate and accelerate the annual exclusion for five years, allowing them to contribute a lump-sum of up to \$70,000 [in 2015] – of course, no additional tax-free gifts can be made by the same transferor to the same transferee during the ensuing five years. NOTE: If Grandparent dies before five-year term is complete, a pro-rated portion of the gift must be included in Grandparent's estate for estate tax purposes.
 - **Qualified Medical Payments and Tuition:**⁴⁸ Transferor has the option to make payments on a beneficiary's behalf *directly* to



⁴⁶ IRC § 2503(c).

⁴⁷ IRC § 529.

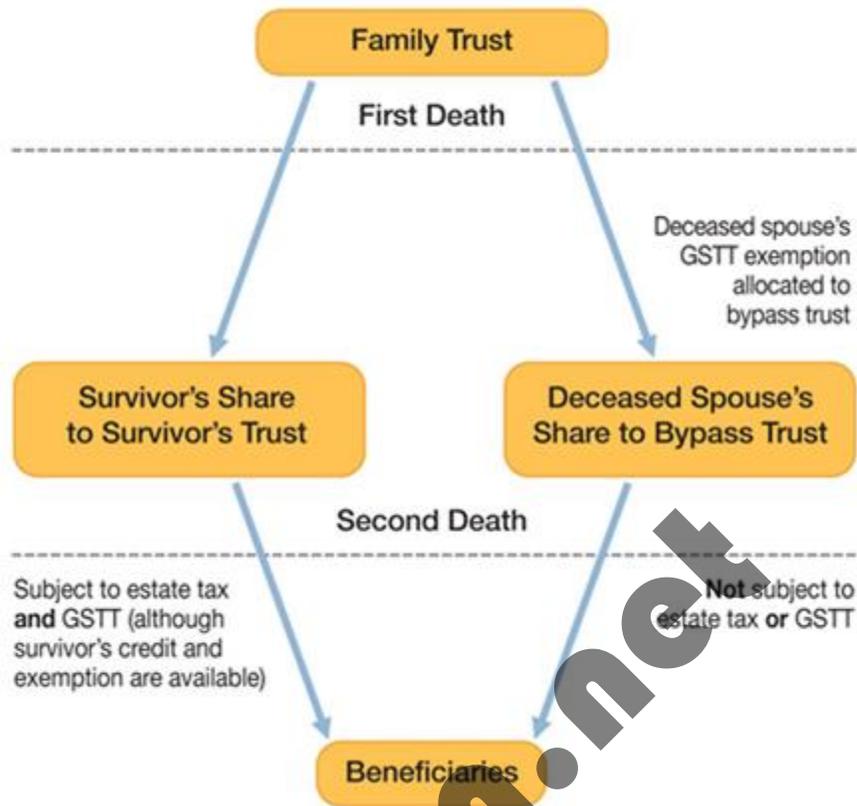
⁴⁸ IRC § 2503(e).

qualified medical and educational providers. No limits apply and no gift tax is due.

- 3. GST Trusts** – in some cases, these trusts may exist into perpetuity (where allowed by state law) and are referred to as “Dynasty Trusts” but other types exist as well.

When appropriate, gifts can be made to specially created trusts to which the GST exemption has been allocated. This method is commonly a feature of A-B Trust planning for estates: Husband and Wife establish a combined family trust that is designed to be split into two trusts upon the death of the first spouse to die. Assets equal to the then-applicable estate tax exemption [which is currently equal to the GST exemption] are used to fund the credit shelter trust (the “B” Trust); the remaining assets stay in the “A” Trust over which the spouse has unfettered control. The credit shelter trust, however, is usually designed to allow the surviving spouse to withdraw the trust’s income while preserving the trust’s corpus for the children or grandchildren of the husband/wife trustors. In this manner, estate tax upon the death of the surviving spouse can be avoided, as well as possibly estate tax upon the death of the trustors’ children, bypassed in favor of the grandchildren.





4. **Disclaimers** – whereby named beneficiaries elect to forego an inheritance. In some cases, wealthy or aging children of decedents may choose to disclaim some or all of the assets due to them in favor of their own children with greater needs and less wealth. These successor beneficiaries will, of course, be deemed skip persons relative to the decedent and GST may apply. NOTE: Disclaimers only work if the decedent provided for alternate beneficiaries or a GST Trust in his will or trust.
5. **Irrevocable Life Insurance Trust (ILIT)** – Often used by transferors to gift money to a trust charged with purchasing life insurance which will be paid to trust beneficiaries upon the transferor's death. Life insurance policies owned by the transferor become part of the transferor's taxable estate, but ILIT policies are separate and distinct and not considered part of the deceased transferor's assets.

To ensure proper funding of an ILIT, the transferor must make gifts to the trust that are sufficient to cover the annual policy premium but must also offer *Crummey* withdrawal rights to the trust beneficiaries to ensure that

the annual gifts are eligible for the gift exclusion. NOTE: Gifts to a trust with multiple beneficiaries qualify for the gift tax exclusion, but not the GST exclusion!

To ensure that future distributions to a skip person from an ILIT are exempt from GST, the GST exemption must be affirmatively allocated to the transferor's gifts. Tax planners should be sure to consider all relevant factors when making the decision to allocate the GST exemption, including:

- Whether the policy will ever be paid out; for example, the benefits of a term life policy may expire long before the ILIT is required to make a distribution.
- Whether the election is even necessary if the trust has sufficient non-skip beneficiaries whose distributions would deplete the trust property even before the skip persons would benefit.
- Whether the transferor expects to make additional gifts outside of the ILIT that would enjoy a greater benefit from GST exemption allocation.
- Whether it would be better to make a late GST exemption allocation since the inclusion ratio is calculated based on the value of property on the date of election rather than on the date of transfer; careful not to make the election too late since the ILIT will automatically jump in value once the insured dies.

6. **GST Avoidance** – Trusts that are created for beneficiaries may nevertheless be included in the transferor's estate if the beneficiary predeceases the transferor. To avoid GST inclusion, the transferor may wish to consider granting a testamentary general power of appointment to the beneficiary so that the trust's assets will be includible in the beneficiary's estate rather than in the transferor's estate, subject to GST if a skip person was named.



**APPENDIX A
Where to Report GST⁴⁹**

| | <u>DIRECT SKIPS</u> | | | <u>INDIRECT SKIPS</u> | | |
|----------------------|----------------------------------|------------------------------------|---------------------------------|---|--------------------------|-------------------------|
| | Payable by Transferor | Payable by Estate | Payable by Certain Trusts | to Trusts not currently subject to GSTT | Taxable Distributions | Taxable Terminations |
| <i>Inter vivos</i> | Form 709 Schedule A Part 2 | | | Form 709 Schedule A Part 3 | Form 706- GS(D) | Form 706- GS(T) |
| <i>Post mortem</i> | | Form 706 Schedule R Part 2 * | Form 706 Schedule R-1 | Form 706 Schedule R Part 1, Line 9 | Form 706- GS(D) | Form 706- GS(T) |
| <i>Taxes paid by</i> | Transferor | Estate | Trustee | No tax | Beneficiary | Trustee |

* Part 3 if will specifies that GST tax is not to be paid from the transferred property interests.

⁴⁹ Mohle, *Generation Skipping Taxes, Trusts & Estates Taxes and Planning*, V. 2, Issue 2, January 2012 [available at <http://www.tmfincialtax.com/newsletters/january-2012.pdf>, last accessed April 19, 2015.]

APPENDIX B
Form 709, Schedule D
(Continued)

Form 709 (2012)

Page **5**

Part 2—GST Exemption Reconciliation (Section 2631) and Section 2652(a)(3) Election

Check here If you are making a section 2652(a)(3) (special QTIP) election (see Instructions)

Enter the item numbers from Schedule A of the gifts for which you are making this election

| | | |
|----------|---|----------|
| 1 | Maximum allowable exemption (see Instructions) | 1 |
| 2 | Total exemption used for periods before filing this return | 2 |
| 3 | Exemption available for this return. Subtract line 2 from line 1 | 3 |
| 4 | Exemption claimed on this return from Part 3, column C total, below | 4 |
| 5 | Automatic allocation of exemption to transfers reported on Schedule A, Part 3 (see Instructions) | 5 |
| 6 | Exemption allocated to transfers not shown on line 4 or 5, above. You must attach a "Notice of Allocation." (see Instructions) | 6 |
| 7 | Add lines 4, 5, and 6 | 7 |
| 8 | Exemption available for future transfers. Subtract line 7 from line 3 | 8 |

Part 3—Tax Computation

| A Item No. (from Schedule D, Part 1) | B Net Transfer (from Schedule D, Part 1, col. D) | C GST Exemption Allocated | D Divide col. C by col. B | E Inclusion Ratio (Subtract col. D from 1.000) | F Maximum Estate Tax Rate | G Applicable Rate (multiply col. E by col. F) | H Generation-Skipping Transfer Tax (multiply col. B by col. G) |
|--|--|--|--|--|--|---|--|
| 1 | | | | | 35% (.35) | | |
| | | | | | 35% (.35) | | |
| | | | | | 35% (.35) | | |
| | | | | | 35% (.35) | | |
| | | | | | 35% (.35) | | |
| | | | | | 35% (.35) | | |
| Gifts made by spouse (for gift splitting only) | | | | | | | |
| | | | | | 35% (.35) | | |
| | | | | | 35% (.35) | | |
| | | | | | 35% (.35) | | |
| | | | | | 35% (.35) | | |
| | | | | | 35% (.35) | | |
| Total exemption claimed. Enter here and on Part 2, line 4, above. May not exceed Part 2, line 3, above | | | | | Total generation-skipping transfer tax. Enter here; on page 3, Schedule A, Part 4, line 10; and on page 1, Part 2—Tax Computation, line 16 | | |

(If more space is needed, attach additional statements.)

Form **709** (2012)



**APPENDIX C
Form 706-GS(D)**

Used by a skip person distributee to calculate and report GST due on distributions from a trust

Form **706-GS(D)**
(Rev. November 2011)
Department of the Treasury
Internal Revenue Service

**Generation-Skipping Transfer Tax
Return For Distributions**
▶ Use for distributions made after December 31, 2010.
For calendar year _____

OMB No. 1545-1144

Attach a copy of all Forms 706-GS(D-1) to this return.

Part I General Information

| | |
|--|--|
| 1a Name of skip person distributee | 1b Social security number of individual distributee (see instructions) |
| 2a Name and title of person filing return (if different from 1a, see instructions) | 1c Employer identification number of trust distributee (see instructions) |
| 2b Address of distributee or person filing return (see instructions) (number and street or P.O. box; city, town, or post office; state; and ZIP code) | |

Part II Distributions

| a Trust EIN (from Form 706-GS(D-1), line 2a) | b Item no. (from Form 706-GS(D-1), line 3, column a) | c Amount of transfer (from Form 706-GS(D-1), line 3, column f (Tentative transfer)) |
|--|--|---|
| | | |
| | | |
| | | |
| | | |
| 3 Total transfers (add amounts in column c) | | 3 |

Part III Tax Computation

| | |
|---|------------|
| 4 Adjusted allowable expenses (see instructions) | 4 |
| 5 Taxable amount (subtract line 4 from line 3) | 5 |
| 6 Maximum federal estate tax rate (see instructions) | 6 % |
| 7 Generation-skipping transfer tax (Multiply line 5 by line 6) | 7 |
| 8 Payment, if any, made with Form 7004 | 8 |
| 9 Tax due | 9 |
| 10 Overpayment. If line 8 is larger than line 7, enter amount to be refunded | 10 |

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer other than taxpayer is based on all information of which preparer has any knowledge.

| | | | |
|-------------------------------|--|---|------|
| Sign Here | Signature of taxpayer or person filing on behalf of taxpayer | | Date |
| | Preparer's signature | | Date |
| Paid Preparer Use Only | Print/Type preparer's name | Check <input type="checkbox"/> if self-employed | PTIN |
| | Firm's name | Firm's EIN | |
| | Firm's address | Phone no. | |

For Privacy Act and Paperwork Reduction Act Notice, see instructions.

Cat. No. 10327Q

Form **706-GS(D)** (Rev. 11-2011)



