SPECIAL REPORT:
THE IMPORTANCE OF GST EXEMPTION ALLOCATIONS ON GIFT TAX RETURNS FOR LIFE-TIME TRANSFERS TO TRUSTS

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Properly allocating the generation skipping transfer tax ("GST") exemption for lifetime transfers to trusts requires careful attention to the trust document and knowledge of the GST law and regulations. Failing to make timely and proper allocations of the GST exemption for certain lifetime gifts to trusts can often frustrate the client's estate planning goals of maximizing the use of the exemption and minimizing transfer taxes on future distributions from the trust.

GST is an additional tax (imposed at the rate of 55%) for generation skipping transfers that are subject to gift taxes in the case of lifetime transfers and estate taxes in the case of transfers at the time of death. An individual has a current exemption of $1,030,000[1] from GST. This exemption allows assets to pass from grandparents to grandchildren without the requiring the children (the intermediate generation) to pay estate or gift taxes on the transfer.[2] The exemption, when utilized properly by a grandparent, has the potential to save families over $550,000 in estate taxes upon death if a child/parent is in the 55% estate tax bracket.

As explained further below, whether a transfer to a trust requires allocation of the GST exemption on the gift tax return depends upon whether the gift is deemed a *direct skip* or a transfer to a *non-skip person*. Understanding the statutory definitions as interpreted by the Treasury regulations is imperative to making a proper GST allocation. Generally, a trust is a *skip person* if all interests in the trust are held by *skip* persons.[3] An individual is a *skip person* who is two or more generations below the transferor. Transfers to trusts with *skip* and *non-skip* persons are tested at the entity level and therefore are non-skip persons.[4]

Maintaining a zero inclusion ratio is key to allocating the GST exemption for lifetime transfers. The inclusion ratio is defined as the difference between one and the applicable fraction.[5] The applicable fraction is the amount of GST exemption allocated to a transfer to a trust or a direct skip divided by the value of the property transferred.[6] A zero inclusion ratio is obtained if the amount of exemption allocated (the applicable fraction numerator) equals the value of the property transferred (the applicable fraction denominator). For instance, if $100,000 in cash is transferred to a *non-skip* person trust and the transferor has not previously used the GST exemption, then a zero inclusion ratio is reportable on a timely filed gift tax return computed as follows: 1 - ($100,000/$100,000).[7] Generally, so long as timely allocations are made for *non-skip* person trusts, a trust will maintain a zero inclusion ratio provided that the aggregate value of transfers to the trust does not exceed the available exemption. If transfers to a *non-skip* person trust exceed the exemption, then, in the absence of splitting the trust into separate shares, one with an inclusion ratio of zero, and one with an inclusion ratio of one, the inclusion ratio will be greater than zero, resulting in a GST event on distribution to a *skip* person.

Example. A grantor funds a trust for children and grandchildren with $1,530,000 in December, 2000. A timely filed gift tax return is filed in April 2001, which allocates the grantor's entire exemption ($1,030,000) to the trust. The inclusion ratio is .3268 (1-1,030,000/1,530,000). In December 2001, a $100,000 distribution is made from the trust to a skip person.

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1 Section 2631. This amount is adjusted for inflation in $10,000 increments.

2 Frequently, generation skipping transfers are set up with split interest irrevocable trusts, wherein the children are discretionary or mandatory income beneficiaries who also may be entitled to principal subject to an ascertainable standard (for their health, education, support and maintenance), and the grandchildren are permissible principal beneficiaries and the remaindermen. The grandchildren may also be discretionary beneficiaries during their parent's lifetimes. Further, great-grandchildren may also be beneficiaries, creating another generational layer of tax benefits.

3 Section 2613(a)(2).

4 *See* Reg. § 26.2612-1 for further explanation and examples.

5 Section 2642(a)(1). Mathematically stated the inclusion ratio = (1 - applicable fraction).

6 Section 2642(a)(2). If applicable, the denominator of the applicable fraction is reduced by any federal estate tax and state death tax attributable to, and recovered from, the property and any estate or gift tax charitable deduction allowed with respect to the property.

7 Any future appreciation of the trust's assets will not be subject to the GST upon distributions to skip persons, so long as the inclusion ratio remains zero.

There is a GST payable on this distribution (.3268 (inclusion ratio) x $100,000 (distribution) x .55 (tax rate)).

In order to prepare a gift tax return with proper GST exemption allocations for lifetime transfers to irrevocable trusts,[8] practitioners need more than a basic understanding of the GST. What follows explains the reasons for this need and some of the issues involved.

NO PARITY WITH GIFT TAX ANNUAL EXCLUSION

Since 1988, the $10,000 annual exclusion from the GST has been much narrower than the annual gift tax exclusion.[9] The GST annual exclusion for transfers to trusts, found at section 2642(c), is limited to trusts with a sole *skip person* beneficiary. Eligibility for the GST annual exclusion also requires that, during the beneficiary's life, no portion of the corpus or income may be distributed to anyone other than the beneficiary, and that the trust will be included in the beneficiary's estate if the trust does not terminate before his death. Thus, a trust that qualifies for the GST annual exclusion will also qualify for the gift tax annual exclusion, but not vice versa.

A *Crummey* trust with one beneficiary may be drafted to qualify for the GST annual exclusion, but a *Crummey* trust with more than one beneficiary does not satisfy the above requirements (although transfers to it, may, in part, qualify for the gift tax annual exclusion). Accordingly, many transfers to trusts with more than one beneficiary may be excluded from gift taxes, but will not be exempt from GST. Transfers to such trusts require allocating the GST exemption on a gift tax return.

ALLOCATING EXEMPTIONS AND GIFT TAX RETURN REQUIREMENTS

Generally, in the case of *direct skips*, the GST exemption is automatically allocated to transferred property, first to achieve a zero inclusion ratio.[10] In the absence of gift splitting, allocating the GST exemption is not required on a gift tax return.[11] However, most tax preparers allocate for *direct skips* so that there is a clear record of the lifetime exemption used. Importantly, a late filed gift tax return for previous *direct skip* transfers uses the date of transfer values.[12]

Allocation problems most frequently occur with lifetime transfers to trusts that are *non-skip persons*, but have some beneficiaries who are *skip persons*. Regulation section 26.2632-1(b)(2) requires allocation of the exemption on a gift tax return. The return must clearly identify all of the following:[13]

- the trust to which the allocation is made,
- the amount of GST exemption that is allocated, which can be expressed by formula,
- the value of the trust assets at the effective date of the allocation when allocation is late (on a non-timely filed return, including extensions) or an inclusion ration greater than zero is claimed, and
- the inclusion ratio of the trust after the allocation.

With respect to a timely allocation for trusts that are not *skip persons*, an allocation of the GST exemption becomes irrevocable after the due date of the return.[14] Late allocations on non-timely filed returns are irrevocable, upon filing.

Although it would seem reasonable for gifts to a trust with *skip* and *non-skip persons* who have *Crummey* withdrawal rights as beneficiaries to be *direct skips* as to the *skip person* beneficiaries because of the current right to withdraw the money, the December 1995 Treasury Regulations make it clear that these transfers are *not direct skips*. Regulation section 26.2612-1(f), Example 3, provides as follows.

T transfers $50,000 to a new trust providing that trust income is to be paid to T's child, C, for life and, on C's death, the trust principal is to be paid to T's descendants. Under the terms of the trust, T grants four grandchildren the right to withdraw $10,000 from the trust for a 60 day period following the transfer. Since C, who is not a skip person, has an interest in the trust, the trust is not a skip person. T's transfer to the trust is not a *direct skip*.[15]

LATE ALLOCATIONS FOR NON SKIP PERSON TRUSTS

Late allocations (after due date, including extension) for transfers other than *direct skips* must be made at the value of the property at the time of allocation, including any and all post-gift appreciation (or depreciation) after the transfer date.[16] For example, if a marketable security was transferred to a trust for the benefit of

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8 All references to trusts mean irrevocable trusts which receive completed gifts.

9 Section 2503(b).

10 One, however, may elect out of the automatic allocation to direct skips on a timely filed gift tax return specifying that the automatic election does not apply. Reg. § 26.2632-1(b)(1).

11 Reg. § 26.2632-1(b)(1)(ii).

12 Reg. § 26.2632-1(b)(2)(iii).

13 This information is normally set forth on a "Notice of Allocation" attached to the Gift Tax Return and referred to at Schedule C, Part 2, Item 5 of Form 709.

14 Reg § 26.2632-1(b)(2).

15 *See also* Treas. Dec. 8644, 12/26/1995 (enacting temporary and final GST regulations effective December 27, 1995) *But see* PLR 8901004, where the Service ruled that *Crummey* withdrawal rights to grandchildren in a trust where children and grandchild held *Crummey* powers were a direct skip to the grandchild and not a transfer to the trust. This private letter ruling is no longer valid authority for transfers after December 1995, but may be of some help for late allocations for transfers prior to the regulations.

16 Reg. § 26.2632-1(b)(2).

children and grandchildren and its value at the time of transfer was $250,000, then $250,000 of exemption should be allocated on a timely filed gift tax return. Assume that a gift tax return was not timely filed, that three years later, the stock had a value of $1,000,000, and that a gift tax return was filed at that time. At the time of the late filing, $1,000,000[17] of exemption must be allocated. The result is wasting $750,000 of GST exemption.

What if a trustee of a *non-skip* person trust with no prior GST allocations makes a transfer to a *skip* person at the time of a late allocation? Is the GST imposed on that taxable distribution computed before or after the late allocation? The late allocation is *deemed* to occur prior to the distribution, as demonstrated by the example found at regulation section 26.2632-1(b)(2)(iii).

In the example, T transfers $100,000 to a generation-skipping trust on December 1, 1996, in a transfer that is not a direct skip. T does not make an allocation of the GST exemption on a timely-filed Form 709. On July 1, 1997, the trustee makes a taxable distribution from the trust to T's grandchild in the amount of $30,000. Immediately prior to the distribution, the value of the trust assets was $150,000. On the same date, T allocates the GST exemption to the trust in the amount of $50,000. The allocation of GST exemption on the date of the transfer is treated as preceding in point of time the taxable distribution. At the time of the GST, the trust has an inclusion ratio of .6667 (1 - (50,000/150,000)).

The $30,000 distribution to the grandchild resulted in GST of $11,000.55 computed as follows: .6667 (inclusion ratio) x $30,000 (distribution) x .55 (tax rate).[18]

LATE ALLOCATIONS WITH DECREASE IN VALUE SINCE FUNDING

With the recent downward trend in the stock market, trustees may want to make late GST allocations for trusts holding marketable securities that have decreased in value since funding. The late allocation will have the unintended but favorable result of less of the exemption being utilized than was originally contemplated. Assume that X shares of a marketable security worth $1,000,000 were transferred to a trust for the benefit of children and grandchildren. Assume that a gift tax return was not timely filed and that, three years later, the stock had a value of $250,000 at which time a gift tax return was filed. At the time of the late filing, $250,000 of the GST exemption was allocated. Unlike the earlier example, the result here is to preserve $750,000 of GST exemption rather than to waste the same amount.

IRREVOCABLE LIFE INSURANCE TRUSTS ("ILITS")

An ILIT which is not a *skip* person because the beneficiaries are *skip* and *non-skip* persons offers an opportunity to leverage the GST exemption. The reason is that, if timely filed gift tax returns with proper GST allocations are filed for each year of the trust, *then only the premium equivalents gifted to the trust are allocated* to the GST exemption. Upon the death of the insured grantor, the death benefits pass to the ILIT trustee, without further GST allocation or consequences, even if the death benefits are greater than the grantor's remaining GST exemption available at the time of death.

If, for example, there is a $1,000,000 life insurance policy in an ILIT, the premiums are $50,000 per year, the insured dies in year three after "gifting premium equivalents" of $150,000 to the trustee, and timely filed gift tax returns allocated $50,000 per year, then the grantor/insured's GST exemption was reduced only by $150,000, the potential remaining exemption is $880,000, and the $1,000,000 death benefit passes to the trustee free from any present or future GST. Accordingly, there is a 6.6 leverage factor between the $1,000,000 life insurance death benefit passing to the ILIT trustee and the $150,000 GST exemption allocated. However, if gift tax returns were not timely filed, then the entire $1,000,000 is subject to GST and if the exemption were applied at death, then the death benefits would consume almost the entire exemption.

CONCLUSION

Proper and timely allocation of the GST exemption on a gift tax return is very important. Failing to do so may thwart a client's estate plan and could expose the tax preparer to damages for professional negligence. Allocation errors can be very expensive and usually can be avoided if the tax attorney is involved throughout the planning process and establishes clear guidelines for the annual gift tax return filings. The cost of the preparation of a timely and properly prepared gift tax return setting forth the GST exemption allocations is a very small expense when compared to the potential liability for the failure to allocate properly. ■

17 For practical reasons, valuation at the first day of the month of the late allocation may be used. Reg. § 26.2642-2(a)(2) (but this rule does not apply to the value of a life insurance policy held by the trust, if the individual insured died).

18 The tax relief provided by the deemed allocation prior to the taxable distribution is significant. If the rule did not exist, then the inclusion ration would have been 1 and the GST on the taxable distribution would have been $16,5000 computed as follows: 1 (inclusion ratio) x $30,000 (distribution) x .55 (tax rate).