Tax Symposium: Generation Skipping Transfer Tax

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INTRODUCTION

With the Tax Reform Act of 1976, Congress attempted to complement the estate and gift tax laws by enacting a generation-skipping transfer tax (hereinafter sometimes referred to as a “Chapter 13 tax”), which was aimed at insuring the imposition of a transfer tax at least once every generation. Prior to the enactment of the original generation-skipping transfer tax, a transferor could establish a trust that would last for many years and benefit several generations of beneficiaries, without the imposition of any subsequent estate or gift taxes after the initial transfer into trust.

The law enacted in 1976 imposed a tax on transfers under trusts or similar arrangements having beneficiaries in more than one generation below that of the transferor. The tax was imposed when principal was distributed from a trust to a generation-skipping beneficiary or upon the termination of an intervening interest in a trust. No tax, however, was imposed on income distributions from trusts, nor on outright transfers to generation-skipping beneficiaries. The original generation-skipping transfer tax used the same rate structure as the estate and gift taxes, and each “deemed transferor” was allowed a $250,000 “grandchild exclusion.” The 1976 tax necessitated the definition of several new terms and concepts, the application of which was extremely complex. The intricacy of the original Chapter 13 tax prompted cries for repeal almost immediately upon its enactment. Although one purpose of the 1976 tax had been to eliminate the inequity that existed between the very wealthy, who were able to establish generation-skipping transfers, and the not so

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2. STAFF OF JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, 564-65 (Comm. Print 1976) [hereinafter “GENERAL EXPLANATION 1976”].


7. Id. §§ 2611-2613 (1982) (repealed 1986). For example, one had to determine the identity of the “deemed transferor” with respect to each transfer potentially subject to the tax, as well as the identity of the various “younger generation beneficiaries” that might be involved. See id. § 2611 (1982) (repealed 1986). “Interest” and “powers” had to be assessed to determine whether their termination would give rise to the tax. See id. § 2613 (1982) (repealed 1986). In some circumstances, “deemed transferees” had to be identified as well.
wealthy, who were subject to either estate or gift tax at every generational level, the tax as enacted was woefully inadequate in this regard.

The Tax Reform Act of 1986 ("TRA’86") retroactively repealed the original generation-skipping transfer tax and substituted a somewhat more manageable set of rules. A new exemption of $1 million per transferor was added to eliminate the impact of the tax on a large number of estates. A flat tax rate, equal to the highest marginal estate and gift tax rate, simplifies the calculation of the new tax. Although there appear to be several methods by which one can avoid the full impact of the new generation-skipping transfer tax, the initial impression is that it should be somewhat more effective than the 1976 law, as well as more even-handed. As other commentators have noted, though, "do not be deceived into thinking the new tax is simple. It is not. Its incredible complexity has not yet been fully realized by practitioners. If Congress were truly interested in simplification, it would simply repeal Chapter 13."

Since the new Chapter 13 is likely to survive longer than its predecessor, probate and estate planning practitioners must develop a workable understanding of the new generation-skipping transfer tax. This article is intended to assist in that goal.

REASONS FOR CHANGE — PROBLEM AREAS

The generation-skipping transfer tax of the Tax Reform Act of 1976 had a simple rationale: it was designed to prevent wealthy families from circumventing estate and gift taxes by insuring taxation of each generation deriving a benefit from trust funds. The application of the 1976 generation-skipping transfer tax, though, was extremely complex. Taxpayers had difficulties complying with its provisions, and the Internal Revenue Service found it impossible to administer. Tax scholars, individual attorneys, and organizations such as the American Bar Association ("ABA") widely criticized the original Chapter 13 tax, and several

8. GENERAL EXPLANATION 1976, supra note 2, at 564.
10. Id. § 1433(c).
12. Id. § 2641.
14. GENERAL EXPLANATION 1976, supra note 2, at 565. See also, Hellige & Weinsheimer, Part I, supra note 13, at 8.
15. GENERAL EXPLANATION 1976, supra note 2, at 8. See also Letter from John E. Chapoton, Assistant Treasury Secretary for Tax Policy, to Sen. Steven D. Symms, Chairman, Senate Finance Subcommittee on Estate and Gift Taxation (April 29, 1983), reprinted in DAILY TAX REPORT (No. 84) J-1 Apr. 29, 1983.
amendments to it were made in the late 1970's and early 1980's. Nonetheless, in 1981, the President of the American Bar Association called for the immediate repeal of the generation-skipping transfer tax, stating that "no amount of 'patch-up' [could] expunge the inherent shortcomings of Chapter 13." In April of 1983, the Assistant Secretary of the Treasury for Tax Policy submitted to the Senate Finance Subcommittee on Estate and Gift Taxation a document entitled, "A Proposal to Simplify and Improve the Generation-Skipping Tax," which identified the principal problems with the existing law. Those problems were: (1) scope, (2) complexity, (3) administrability, (4) effectiveness, (5) fairness, and (6) lack of logical consistency.

First, the 1976 law was too broad in scope. Every time there were beneficiaries of a trust or equivalent arrangement in two or more generations below that of the transferor, the tax applied regardless of the size of the trust. Thus, generation-skipping transfers occurred even in simple wills drafted by general practitioners with limited knowledge of the details of the tax. Similarly, the trustees of small trusts often had little sophistication with respect to the law. These factors resulted in a high level of non-compliance and uneven application of the tax.

Second, experts, as well as general practitioners, had difficulty understanding all aspects of the original generation-skipping transfer tax. The 1976 law was too complex. The law had thirteen defined terms and an "intricate pattern of rules and exceptions." This complexity carried with it a real cost to practitioners, taxpayers, and the federal government. The time needed by attorneys to master the law could not be billed directly to clients, and in part was transformed into generally increased fees for estate planning. The federal coffers suffered as well when taxpayers took these increased fees as tax deductions.

Third, the enforcement of the original Chapter 13 tax involved excessive administrative costs. Under the law, any individual alive on June 11, 1976 or thereafter was a potential "deemed transferor." The bur-

20. Id.
23. See Brink, supra note 18.
25. Id.
26. I.R.C. § 2612 (1982) (repealed 1986) described a deemed transfer as:
   (1) except as provided in paragraph (2), the parent of the transferee of the property who is more closely related to the grantor of the trust than
den on the Internal Revenue Service to provide information with respect to each possible deemed transferor was enormous.27 Not only was the storage and retrieval of information costly, but provisions of the law made it difficult for the IRS to determine the amount of unused unified credit28 of the deemed transferor in many cases.29

Fourth, critics of the tax, including the ABA, pointed out its ineffectiveness in achieving the stated goals of Congress.30 The sophisticated attorney could use one or more of the numerous exceptions to Chapter 13 so that the client would avoid paying the tax. For example, the wealthy could “layer” their estates,31 and other well-advised clients could take advantage of both the $250,000 exclusion for transfers to grandchildren32 and the exception for distributions of income.33 In addition, while a relatively small amount of tax revenue was generated by the federal estate and gift tax provisions,34 the cost of administering the generation-skipping transfer tax was high.35 Ultimately, taxpayers adopted more complex estate plans simply to avoid the provisions of the law.36

Fifth, although Congress sought to assure that the tax was applied uniformly,37 in practical terms the tax was unfair. The tax was a trap for those not well versed in the area, while sophisticated taxpayers could easily avoid its application by taking advantage of its numerous exceptions. The very wealthy remained unaffected, while the tax discriminated against families of more modest wealth.38 The old law encouraged individuals to bypass their children’s generation in favor of inter vivos or testamentary gifts to their grandchildren.39 Not only could wealthy families more readily manage the cost of sophisticated legal advice, but they could also better afford to bypass their children’s generation in arranging

\[
\text{the other parent of such transferee (or if neither parent is related to such grantor, the parent having a closer affinity to the grantor), or}
\]

\[
(2) \text{if the parent described in paragraph (1) is not a younger generation beneficiary of the trust but 1 or more ancestors of the transferee is a younger generation beneficiary related by blood or adoption to the grantor of the trust, the youngest of such ancestors.}
\]

27. The deemed transferor’s complete gift and estate tax history was needed to compute the generation-skipping transfer tax under I.R.C. § 2602 (1954) (repealed 1986).
30. Brink, supra note 18.
31. “Layering” involved the creation of one or more trusts, each of which had only one generation of beneficiaries, so that the trust fell outside the definition of I.R.C. § 2611(b) (1982) (repealed 1986).
34. See Chapoton, supra note 15.
35. Id.
36. Id.
38. Chapoton, supra note 15.
39. Id.
their estates. Families of more modest means would usually wish a much larger portion of the estate to be distributed to the children's generation.

Finally, the tax lacked logical consistency. The old generation-skipping transfer tax did not assure imposition of the tax once in every generation, since direct transfers were not within its purview, nor was the tax limited to cases of extreme tax avoidance.

Ultimately, Congress came to a full appreciation of the inadequacies of the old Chapter 13 tax and concluded that it needed replacement in its entirety. It was retroactively repealed by the TRA'86. In enacting a new generation-skipping transfer tax, Congress hoped to fulfill "the goal of simplified administration while ensuring that transfers having a similar substantial effect will be subject to tax in a similar manner."

EXPLANATION OF PROVISIONS

The TRA'86 repeals the old generation-skipping transfer tax retroactively and enacts a completely new Chapter 13 tax. Like the original Chapter 13 tax, the purpose of the new law is to insure that "transfer tax consequences do not vary widely depending on whether property is transferred outright to immediately succeeding generations or is transferred in ways that skip generations."

In general, the new tax applies to transfers made after the date of enactment, October 22, 1986. Inter vivos transfers occurring after September 25, 1985 but before October 22, 1986 are treated as if they were made on the first day after enactment, and are thus subject to the new law. Correspondingly, transfers from trusts which were irrevocable on September 25, 1985 are not subject to the new tax, except to the extent such transfers are made out of principal added to the trust after September 25, 1985. Where a will was executed before October 22, 1986, and

40. Id.
41. Id.
42. Id.
43. Brink, supra note 18.
44. TRA '86 § 1433(c).
45. GENERAL EXPLANATION 1986, supra note 37, at 1263.
46. TRA '86, § 1433(a), (b), (d). An additional year from the date of enactment was granted for the filing of claims for refunds under the prior law, even if the claim would otherwise have been barred by the statute of limitations. Id., § 1433(c).
47. GENERAL EXPLANATION 1986, supra note 37, at 1263.
48. TRA '86 § 1431(a). Transfers subject to the tax are identified in I.R.C. § 2611 (1986), and defined in I.R.C. § 2612 (1986).
49. TRA '86 § 1433(b)(1). One commentator has suggested that the actual date of the transfer (not the deemed date of occurrence) should control for valuation purposes. Generation-Skipping Transfers, PRAC. DRAFTING, July 1987, 1149, 1226 [hereinafter Generation-Skipping Transfers]. The interested reader is encouraged to examine the exhaustive, yet extremely practical discussion of the new Chapter 13 in this article.
50. TRA '86 § 1433(b)(2)(A).
51. Id. See also Priv. Ltr. Rul. 8,726,016 (March 25, 1987), which indicates that princi-
the decedent died before January 1, 1987, any transfers thereunder are not subject to the new tax. 52 Similarly, direct skip transfers which occur by reason of the death of a decedent, where the decedent was incompetent on the date of enactment and until his or her death, are not subject to the tax. 53

The new law expands to bring within it scope "direct" generation-skipping transfers (such as a transfer from a grandparent directly to a grandchild), 54 income distributions from trusts, 55 and transfers in which benefits are shared by more than one younger generation. 56 The new law is simpler than its predecessor in a number of respects. Unlike the former law, under which it was necessary to ascertain the "powers" 57 of family members over trusts, the new law requires only a determination of "whether a member of a particular generation has a beneficial interest." 58 In addition, the new law provides for a flat tax rate, 59 making it unnecessary to use the device of a "deemed transferor" or to research the deemed transferor's transfer tax history. 60 The new tax replaces the old law's complicated grandchild exclusion 61 with an exemption of $1 million per transferor, 62 thus allowing taxpayers with moderate estates to avoid the tax. In addition, there is a $2 million per grandchild exemption for "direct skips" to grandchildren made before 1990. 63

To understand the new law, one must first identify the parties to a generation-skipping transfer. 64 If the transfer is an *inter vivos* gift that would be subject to the gift tax, the donor is the transferor. 65 If the transfer would be subject to estate taxes, the decedent is the transferor. 66

52. TRA '86 § 1433(b)(2)(B).
53. Id. § 1433(b)(2)(C). "Direct skip" transfers are defined in I.R.C. § 2612(c) (1986).
55. Id. § 2612(b).
56. Id. § 2613(a).
61. Use of the old grandchild exclusion in I.R.C. § 2613(b)(6) (1982) (repealed 1986) was complicated, as one had to identify the deemed transferor, as well as all prior taxable distributions or taxable terminations to the grandchild attributable to that deemed transferor.
63. TRA '86 § 1433(b)(3).
64. Generation-skipping transfers are described in I.R.C. § 2611 (West Supp. 1988).
65. Id. § 2652(a)(1)(B).
66. *Id.* § 2652(a)(1)(A). Section 2653 provides a special rule for identification of the transferor where there are multiple skips in a single trust. Other than for generation assignment purposes, if there is a transfer subject to Chapter 13, and immediately thereafter the transferred property is held in trust, the trust will be treated as if the...
If a married couple elects to gift-split, the spouses will be treated similarly for Chapter 13 purposes, i.e., each will be treated as the transferor of one-half of the gift.

Where qualified terminable interest property ("QTIP") marital deduction trusts are involved, a special election may be made to treat the donor spouse or the predeceasing spouse, as the case may be, as the transferor. Without this election, the spouse beneficiary of the QTIP trust would be treated as the transferor. This election can be an effective tax planning tool because the identity of the transferor determines the available exemptions from the generation-skipping transfer tax. The Code itself does not address the mechanics of the section 2652(a)(3) election, but Temporary Regulations indicate that the section 2652(a)(3) election is irrevocable, and provide how and when it is to be signified.

The new law introduces a new term, "skip person," to define potential recipients. A skip person is (1) a person who is assigned to a generation at least two generations below the transferor's generation, or (2) a trust if either (a) all interests in the trust are held by skip persons or (b) there is no person who holds an interest in the trust and at no time after the transfer may the trust make a distribution to a non-skip person. A "non-skip" person is any person who is not a skip person. For purposes of Chapter 13, a trust is defined as including any "arrangement" having "substantially the same effect as a trust." Statutory examples include life estates, estates for years, and insurance and annuity contracts.

The old generation-skipping transfer tax sought to impose the same tax that would have been paid by each generation had the wealth been transferred directly rather than by skipping generations, and thus used the graduated rate structure of the estate and gift tax. The new tax, however, uses a flat rate, equal to the maximum federal estate tax rate, to transferor were assigned to the first generation above the highest generation beneficiary with an interest in the trust immediately after the transfer. Id. § 2653(a).

67. Id. § 2513(a).
68. Id. § 2652(a)(2).
69. Id. § 2056(b)(7)(B).
70. Id. § 2652(a)(3).
71. Id. § 2652(a)(1).
72. Id. § 2631(a).
75. Id. § 2613(b).
76. Id. § 2652(b)(1).
77. Id. § 2552(b)(3). It is not clear whether transfers under the Uniform Gift to Minors Act will be considered trust equivalents; such transfers may be deemed direct transfers to the beneficiary. In the case of an arrangement not a trust but treated as a trust for Chapter 13 purposes, the term "trustee" is defined to be "the person in actual or constructive possession of the property subject to such arrangement." Id. § 2652(b)(2).
tax generation-skipping transfers.\textsuperscript{79} This flat tax rate is intended to simplify the application of Chapter 13 and to ensure that transfers with similar outcomes will be subject to tax in a similar manner.\textsuperscript{80}

The law defines a “generation-skipping transfer” as one of three types of taxable events: a taxable distribution, a taxable termination, or a direct skip.\textsuperscript{81} A taxable distribution is any distribution (other than a taxable termination or a direct skip) from a trust to a skip person.\textsuperscript{82} For example, a distribution of income\textsuperscript{83} or principal (other than on termination) from a trust to a grandchild of the transferor is a taxable distribution. By virtue of the above definition, where a transfer would qualify as a taxable distribution and either a taxable termination or a direct skip, characterization as a taxable termination or a direct skip takes precedence over a taxable distribution.

A taxable termination is a termination of an interest in property held in trust if (1) after the termination all interests in the trust are held by skip persons, and (2) distributions from the trust may be made to a skip person at the termination or sometime thereafter.\textsuperscript{84} An “interest” in property is defined as a current right to receive income or principal,\textsuperscript{85} whether mandatory or permissible;\textsuperscript{86} the term does not include a future interest.\textsuperscript{87} To illustrate, if A creates a trust for her daughter for life with remainder to her granddaughter, the granddaughter does not have an interest in the trust until the daughter’s death. The daughter’s death will constitute a taxable termination. There would also be a taxable termination upon the daughter’s death if the trust were to continue for the granddaughter’s life with remainder to her issue. There would not be, however, a taxable termination, if after the daughter’s death, the trustee


\textsuperscript{80} GENERAL EXPLANATION 1986, supra note 37, at 1263.

\textsuperscript{81} I.R.C. § 2611(a) (1982 & West Supp. 1988).

\textsuperscript{82} Id. § 2612(b) (West Supp. 1988).

\textsuperscript{83} If a taxable distribution includes income, an income tax deduction is allowed under I.R.C. § 164(a)(6) (1982 & West Supp. 1988) for the generation-skipping transfer tax imposed on the income includible by the transferee.

\textsuperscript{84} Id. § 2612(a). Although, in general, there will not be a taxable termination until all interests of non-skip persons in the trust have ceased, the new law provides for a partial termination if a specified portion of the assets of the trust are distributed to skip persons who are lineal descendants of the person who holds the interest that terminates or to trusts that are held for the exclusive benefit of such lineal descendants of the interest holder. Id. § 2612(a)(2).

\textsuperscript{85} Id. § 2652(c). In addition, to prevent efforts to delay unreasonably taxable terminations, interests that are used primarily to avoid or postpone the tax should be disregarded. Id. § 2652(c)(2).

\textsuperscript{86} There is some question whether the discretion of a trustee to make payments which relieve a parent of a support obligation for his children will be deemed to be an interest of the parent. \textit{See} Generation-Skipping Transfers, supra note 49, at 1164-65.

\textsuperscript{87} If a charitable organization has a current right to receive income or principal from a trust, or if it is the remainderman of a charitable remainder annuity trust, charitable remainder unitrust, or pooled income fund, then such charity has an interest in the trust for Chapter 13 purposes. I.R.C. § 2652(c)(1)(C) (West Supp. 1988).
had discretion to distribute income or principal to another child of A, as well as to the granddaughter.

A direct skip is the transfer of an interest in property to a skip person that is subject to the federal estate or gift tax. Thus, a gift of $25,000 from a grandparent to a grandchild is a direct skip.

There are a number of protections from the generation-skipping transfer tax available to taxpayers. Two important exemptions are (1) a $1 million exemption for each transferor, and (2) an exemption of $2 million for direct skips to grandchildren made prior to 1990. Certain inter vivos transfers exempt from the gift tax are excluded from generation-skipping transfers, as are transfers from a trust (other than a direct skip) where either gift or estate taxes are imposed on a person who is only one generation below the transferor. For purposes of direct skips, a grandchild of any one of the transferor, the transferor's spouse, or a former spouse of the transferor is to be treated as a child of the transferor if the grandchild's parent who is a lineal descendant of the transferor is dead at the time of the transfer.

A lifetime exemption of $1 million, the “GST exemption,” is available to each transferor making generation-skipping transfers. The transferor or his personal representative may allocate the $1 million exemption in whole or in part to property which is subject to the tax. There is no statutory requirement that the exemption be used at a particular time or in any particular order. The time of making the allocation, however, may affect the value of the property to which the GST exemption is allocated. With the exception of the special election for QTIP trusts, the exemption can be allocated only to property as to which the

88. Id. § 2612(c). Two exceptions to the general rule defining direct skips are the predeceased child rule of I.R.C. § 2612(c)(2) (1986), and the $2,000,000 per grandchild exemption of TRA '86 § 1433(b)(3), for transfers made before January 1, 1990.
90. TRA '86 § 1433(b)(3). It is interesting to note that the so-called “Gallo exception” appears in the effective date provisions of new Chapter 13, rather than as part of the Internal Revenue Code of 1986.
92. Id. § 2612(c)(2). In addition, all of the lineal descendants of that grandchild are deemed to move up one generation.
93. Id. § 2631.
94. Id.
95. Id. § 2632. Although the statute is silent on the issue, the January 1987 “Instructions for Form 709” require use of the taxpayer’s $2 million grandchild exclusion for gifts to grandchildren made before January 1, 1990, in the chronological order that such gifts were made.
96. Id. § 2642(b)(3). If the allocation is made on a timely filed gift tax return, the value of the property at the date of the gift is used. Id. § 2642(b)(1). If the allocation is made during the transferor’s life, but not on a timely filed gift tax return, the value of the property as of the date of allocation is used. Id. § 2642(b)(3). For property subject to the generation-skipping transfer tax upon the death of the transferor, the federal estate tax value is used. Id. § 2642(b)(2).
97. Id. § 2652(a)(3).
individual is the transferor. For QTIP trusts, the spouse creating the trust may elect to be treated as the transferor of the trust. If such an election is not made, the beneficiary spouse will be treated as the transferor.

If an individual makes a direct skip during his lifetime, any unused portion of his GST exemption is deemed allocated to the property transferred, unless the individual elects out of this deemed allocation. An individual may make the allocation of his GST exemption any time on or before the date his federal estate tax return is due (including extensions). The transferor can allocate part of his GST exemption to specific inter vivos transfers in a timely filed gift tax return. If an individual makes no allocation, the law allocates his GST exemption in the following order: first, to direct skips occurring during the lifetime of the transferor; second, to direct skips occurring on the death of the transferor; and finally, to trusts where the decedent is the transferor and from which a taxable distribution or a taxable termination might occur at or after the decedent’s death. Within these categories of deemed allocation, the law allocates the exemption proportionately to all transfers within that category.

Once the taxpayer allocates some or all of his GST exemption to a transfer, that allocation is irrevocable, and the GST exemption will protect all appreciation on the property or portion thereof to which the GST exemption applies.

The new generation-skipping transfer tax does not apply to inter vivos gifts which qualify for (1) the present interest exclusion provided by Code section 2503(b), or (2) the exclusion afforded by Code section 2612(c)(1). Obviously, the personal representative should be given broad powers in a will to allocate the GST exemption and should make such allocation with care.

98. Id. § 2631(a).
99. Id. § 2652(a)(3).
100. Id. § 2652(a)(1)(A). For married transferors, this election allows full use of each transferor's GST exemption, even in a “reduce-to-zero” estate plan. See infra note 174 and accompanying text discussing this issue.
101. Id. § 2632(b)(1).
104. Id. § 2642(b)(1). In such a situation, the value of the property for purposes of the inclusion ratio is its value for gift tax purposes; accordingly, a determination by the IRS for the purpose of adding adjusted taxable gifts to the tax base for the federal estate tax, or even for the purpose of subsequent gifts, should not affect the value for Chapter 13 purposes.
105. Id. § 2632(b),(c)(1). Obviously, the personal representative should be given broad powers in a will to allocate the GST exemption and should make such allocation with care.
106. Id. § 2632(c)(2)(A).
107. Id. § 2631(b).
2503(e) for certain direct payments of tuition and medical expenses.\textsuperscript{110} The TRA'86 also provides a special exemption for direct skips of up to $2 million to each grandchild of the transferor made before January 1, 1990.\textsuperscript{111} Married individuals may elect to treat these exempt transfers as made one-half by each spouse.\textsuperscript{112}

The new law assigns generations in the same manner as the old law, except for a special rule for purposes of direct skips which treats a grandchild whose deceased parent is a lineal descendant of the transferor or the transferor's spouse or former spouse as a member of the deceased parent's generation.\textsuperscript{113} In the case of a lineal descendant, generation assignment is accomplished by comparing the number of generations between the grandparent of the transferor and the potential skip person to the number of generations between the grandparent and the transferor.\textsuperscript{114} A change from the prior law is that lineal descendants of the grandparents of the transferor's spouse also are assigned to generations in the same manner as lineal descendants of the transferor.\textsuperscript{115} Spouses are assigned to the generation of one another.\textsuperscript{116} For persons not lineal descendants, the law places an individual not more than twelve and one-half years younger than the transferor in the same generation as the transferor.\textsuperscript{117} Each twenty-five year period beyond the transferor's generation defines a new generation.\textsuperscript{118} Consequently, two persons thirty-eight and sixty-two years younger than the transferor would each be assigned to the same generation, two generations below the transferor, assuming they were not lineal descendants of the transferor. If more than one generation assignment applies to an individual, the youngest assignment takes precedence.\textsuperscript{119} Certain charitable organizations and trusts described in Code section 511 are assigned to the generation of the transferor.\textsuperscript{120}

\footnotesize
\textsuperscript{110} The exclusion of § 2503(b) are not "subject to a tax imposed by chapter 11," and thus do not fall within the definition of a direct skip. \textit{Id.}
\textsuperscript{111} \textit{Id.} § 2611(b)(2).
\textsuperscript{112} TRA '86 § 1433(b)(3).
\textsuperscript{113} I.R.C. § 2652(a)(2) (West Supp. 1988). \textit{See infra} notes 187 and accompanying text discussing the intricacies surrounding this election and the GST exemption.
\textsuperscript{114} I.R.C. § 2612(c)(2) (West Supp. 1988). It is important to be aware that this protective provision appears to apply only in the case of a direct skip. \textit{See supra} text accompanying note 92.
\textsuperscript{115} \textit{Id.} § 2651(b)(1). For example, if the transferor wishes to make a transfer to her great-grandson, one would determine that there were two generations between the transferor and her grandmother, five between her grandmother and her great-grandson, and thus three generations between her and her great-grandson.
\textsuperscript{116} \textit{Id.} § 2651(b)(2).
\textsuperscript{117} \textit{Id.} § 2651(c). This assignment occurs even if, at the time of the transfer, the persons are no longer married.
\textsuperscript{118} \textit{Id.} § 2651(d)(1).
\textsuperscript{119} \textit{Id.} § 2651(d)(2),(3).
\textsuperscript{120} \textit{Id.} § 2651(e)(3). Subject to the special treatment of charitable organizations, if an entity such as a trust, partnership, estate, or corporation has an interest in property, the new law provides that each person having a beneficial interest in the entity is to
The rate of tax on a generation-skipping transfer equals the maximum gift and estate tax rate,\(^\text{121}\) and is thus 55% until 1993, and 50% thereafter.\(^\text{122}\) Although the tax is imposed at a flat rate,\(^\text{123}\) the determination of the amount of Chapter 13 tax actually due is somewhat more complicated. First, one must determine the "applicable rate,"\(^\text{124}\) which is obtained by multiplying the maximum federal estate tax rate by the "inclusion ratio"\(^\text{125}\) for the transfer. The inclusion ratio is defined as the excess of one (1) over the "applicable fraction," and is mathematically expressed as follows:

\[
1 - \frac{TE}{VPT - (ET + CD)}
\]

where

- TE = Transferor's GST exemption allocable to the property transferred.
- VPT = value of property transferred.
- ET = estate tax actually recovered from the property transferred.
- CD = charitable deduction allowed with respect to the property transferred.\(^\text{126}\)

The applicable rate is then multiplied by the "taxable amount,"\(^\text{127}\) which for any particular generation-skipping transfer depends on whether the transfer is characterized as a taxable distribution, taxable termination, or direct skip.\(^\text{128}\)

In a taxable distribution, the taxable amount is the value of the property received by the transferee,\(^\text{129}\) and the transferee bears the liability for the tax.\(^\text{130}\) For taxable distributions, then, the tax is imposed on a tax-inclusive basis. If the tax is instead paid out of the trust, that amount

\(^{121}\) Id. § 2641.
\(^{122}\) Id. § 2001(c)(2).
\(^{123}\) Id. § 2641.
\(^{124}\) Id. § 2641(a).
\(^{125}\) Id. § 2642(a).
\(^{126}\) Id. See also Katzenstein, The New Generation Skipping Tax: A Road Map, 65 Taxes 259, 264 (1987). An important change that appears in the Technical Corrections Bill is the deletion of the deduction for qualified charitable transfers that appears in the denominator of the applicable fraction. This change, if enacted, would severely limit a taxpayer's ability to leverage Chapter 13 transfers by combining them with various types of charitable gifts.
\(^{128}\) Id. §§ 2621-23.
\(^{129}\) Id. § 2621(a). The taxable amount is reduced by expenses incurred by the transferee in connection with the determination, collection, or refund of the Chapter 13 tax.
\(^{130}\) Id. § 2603(a)(1).
is also treated as a taxable distribution.\textsuperscript{131} A taxable termination is also taxed on a tax-inclusive basis, and the taxable amount equals the value of the property to which the interest terminates, less deductions such as expenses, indebtedness, and taxes similar to those allowed under Code section 2053 attributable to the property represented by the taxable termination.\textsuperscript{132} For a taxable termination, the trustee pays the tax out of the trust property.\textsuperscript{133} Upon a direct skip, the taxable amount equals the value of the property received by the transferee,\textsuperscript{134} and thus is taxed on a tax-exclusive basis. The transferor bears the liability for the payment of tax in a direct skip.\textsuperscript{135} In the case of a taxable gift which is a direct skip, the tax payment constitutes an additional gift to the transferee and is itself subject to the gift tax,\textsuperscript{136} although this additional gift does not appear to be considered an additional generation-skipping transfer.\textsuperscript{137}

The property which is the subject of a generation-skipping transfer is generally valued at the time of transfer in the same way that the gift and estate tax provisions value property.\textsuperscript{138} If the transferor's GST exemption is allocated to a transfer on a gift tax return not timely filed, however, the value of the property will be determined as of the time the allocation is filed.\textsuperscript{139} If a transferor's estate takes advantage of an alternate valuation date\textsuperscript{140} or special use valuation provision\textsuperscript{141} with respect to direct skip property, these provisions must also apply for generation-skipping transfer tax purposes.\textsuperscript{142}

To illustrate the determination of the amount of Chapter 13 tax due on a transfer, assume that in 1987 grandfather establishes a trust with $1 million principal for his son for life, with the remainder to his granddaughter. Grandfather allocates $400,000 of his GST exemption to the

\begin{itemize}
\item \textsuperscript{131} \textit{Id.} § 2621(b).
\item \textsuperscript{132} \textit{Id.} § 2622.
\item \textsuperscript{133} \textit{Id.} § 2603(a)(2).
\item \textsuperscript{134} \textit{Id.} § 2623. Thus, the tax base for Chapter 13 purposes does not include any federal estate tax or gift tax paid out of the property.
\item \textsuperscript{135} \textit{Id.} § 2603(a)(3). Under § 2603(a)(2), the trustee pays the tax on a direct skip from a trust.
\item \textsuperscript{136} \textit{Id.} § 2515.
\item \textsuperscript{138} \textit{Id.} § 2624. Any consideration for the transfer provided by the transferee will reduce the value subject to tax under Chapter 13. \textit{Id.} § 2624(d). "Flower" bonds, the United States Treasury bonds redeemable at par in payment of the estate tax, are not redeemable at par in payment of the generation-skipping tax, and in some cases this may create a discrepancy with the federal estate tax valuation rules. I.R.C. § 6312 (1954), repealed by § 4(a)(2) of Pub. L. No. 92-5, 85 Stat. 5 (1971); Treas. Reg. § 20.6151-1(c) (1986); 31 C.F.R. § 306.28 (1987); Rev. Rul. 69-489, 1969-2 C.B. 172.
\item \textsuperscript{139} \textit{Id.} § 2642(b)(3). This rule suggests that taxpayers will want to watch closely the increase or decrease in value of transferred property and time the filing of their GST exemption allocation on Form 709 accordingly. See Generation-Skipping Transfers, supra note 49, at 1214.
\item \textsuperscript{140} I.R.C. § 2032 (1982 & West Supp. 1988).
\item \textsuperscript{141} \textit{Id.} § 2032A.
\item \textsuperscript{142} \textit{Id.} § 2624(b).
trust at the time of its creation. On his son's death in 1990, the principal
is worth $1.5 million. The applicable fraction will be $400,000/$1,000,000 or 2/5. The inclusion ratio will be one (1) minus 2/5, or 3/5. The applicable rate will be 3/5 of fifty percent, or thirty percent. The taxable amount is $1.5 million, which when multiplied by the applicable rate of thirty percent results in a tax due of $450,000.

The federal generation-skipping transfer tax incorporates a credit for any state generation-skipping transfer tax actually paid to a state of up to five percent of the federal generation-skipping transfer tax on transfers (other than direct skips) occurring due to death. 143

Tax returns must be filed by the individual liable for the tax, on or before the due date of the federal estate or gift tax return required to be filed with respect to the transfer. 144 In cases other than a direct skip, a return is required to be filed on or before the fifteenth day of the fourth month after the taxable year end for the person required to file the return. 145

As a general rule, Code provisions governing the administration of gift and estate taxes also apply to the generation-skipping transfer tax. 146
In addition to adjustments in basis made under the gift or estate tax provisions, basis also is increased by the portion of paid generation-skipping transfer tax attributable to the excess of the property's fair market value over its basis immediately before the transfer. 147 If a taxable termination occurs as a result of death, a step-up in basis occurs in a manner similar to that in Code section 1014(a), except that if the inclusion ratio is less than one, the law limits the basis adjustment to the product of the increase in basis and the inclusion ratio. 148

Finally, several other provisions of the Code parallel the estate and gift tax rules. Section 303, allowing favorable treatment of redemptions of stock to pay estate taxes, applies to redemptions of stock to pay the generation-skipping tax in case of death. 149 Section 164(a)(6) allows an income tax deduction for Chapter 13 tax on income distributions includible in the gross income of a beneficiary. 150 Under section 691(c)(3), an income tax deduction is allowable for the portion of the generation-skipping transfer tax attributable to trust income which was not properly taxable prior to the termination. Section 6166(i) extends the provisions of that section, relating to the payment of estate tax attributable to a

143. Id. § 2604.
144. Id. § 2662(a)(2)(A).
145. Id. § 2662(a)(2)(B).
146. Id. §§ 2661, 2663.
147. Id. § 2654(a)(1).
148. Id. § 2654(a)(2).
149. Id. § 303(d).
150. Section 164(b)(4) (1982 & West Supp. 1988) limits the amount of the tax to the amount included in the gross income of the distributee and applies only if the throwback rules of § 666 are inapplicable.
closely-held business over a ten-year period, to the Chapter 13 tax due on a direct skip as a result of death.

Several critics of the new generation-skipping transfer tax note that it is not any less complex than the tax it replaced. Attorneys must plan carefully in order to utilize the provisions of the new generation-skipping tax to the client's best advantage. Practical considerations regarding the new tax are discussed below.

DISCUSSION

General Thoughts

When working with clients of reasonably substantial wealth, the attorney should now approach planning for the generation-skipping transfer tax as a routine part of the estate planning process. Like other parts of that process, planning for the generation-skipping transfer tax requires, first, scrupulous effort to ascertain the relevant factual background concerning the client's personal and financial circumstances; second, a thoughtful application of the impact of the governing law upon the client's circumstances; and, third, a dialogue with the client covering the advantages and disadvantages of various approaches toward the generation-skipping transfer tax. Many clients (particularly younger ones) may simply wish to disregard the generation-skipping transfer tax on the grounds that in most instances it will become a factor only upon the death of their children, by which time the entire tax structure may have been changed several times. This attitude is not necessarily wrong, but the lawyer should endeavor to see that a considered decision is made rather than a capricious, reflexive one. Those facts that lead many clients to disregard the generation-skipping transfer tax render particularly difficult the lawyer's task in ascertaining the correct blend of tax and personal elements in formulating an estate plan.

Planning for Use of Grandfathered Vehicles

As discussed above, the new generation-skipping transfer tax generally applies to inter vivos generation-skipping transfers occurring after September 25, 1985, and to other types of transfers occurring after the date of enactment, October 22, 1986. For inter vivos transfers, the effective date rules operate by treating all such transfers made between September 25, 1985 and October 22, 1986 as if they had been made on October 23, 1986. The mechanics of this rule raise a question as to the proper valuation date for inter vivos transfers that occurred during that period.

151. Hellige & Weinsheimer, supra note 13; Katzenstein, supra note 126, at 266.
152. See supra text accompanying notes 48-53.
153. TRA'86 § 1433(b)(1).
154. See Generation-Skipping Transfers, supra note 49, at 1226, where it is suggested that the actual date of the transfer should be the relevant valuation date.
There are a number of exceptions to the general effective date rules, the most important of which is that transfers from trusts that were irrevocable on September 25, 1985 are exempt to the extent that the transfers are not attributable to additions to the trust principal occurring after that date. A recent letter ruling indicates that principal appreciation and income accumulated on pre-September 25, 1985 principal additions will not be considered additions to principal for purposes of the effective date provisions. The Technical Corrections Bill includes an amendment to section 1433(b)(2)(A) of TRA'86 which is intended to clarify the rule that the grandfathered status does not extend to income generated from post-September 25, 1985 principal additions.

Trusts that were irrevocable on September 25, 1985, particularly those with limited powers of appointment, should thus be viewed as wonderful tax planning opportunities. The Joint Committee on Taxation stated in its General Explanation:

The new generation-skipping transfer tax does not apply to the exercise of a limited power of appointment under an otherwise grandfathered trust or to trusts to which the trust property is appointed provided such exercise cannot postpone vesting of any estate or interest in the trust property for a period ascertainable without regard to the date of the creation of the trust.

Using this statement as a point of departure, a number of planning techniques suggest themselves. Grandfathered generation-skipping trusts should be used to make transfers that would otherwise be subject to the new Chapter 13 tax to younger generation beneficiaries, wherever practicable. Where the trustee has discretion to make such distributions, the discretion can be exercised in such a manner as to make transfers that would otherwise be subject to the generation-skipping transfer tax. Similarly, if there is a limited power of appointment to be exercised, it should be used to make distributions to skip persons. To the extent possible, limited powers of appointment granted under grandfathered trusts should be exercised so as to continue the trusts for as long as possible, consistent with the vesting rules cited above. If accumulation of income in such trusts is permissible and the current beneficiaries do not

155. TRA '86 § 1433(b)(2).
156. Id. § 1433(b)(2)(A).
158. Id.
159. JOINT COMMITTEE ON TAXATION, 100TH CONG., 1ST SESS., DESCRIPTION OF THE TECHNICAL CORRECTIONS ACT OF 1987, at 268-69 (Comm. Print 1987) [hereinafter "TECH CORR. ACT"]).
160. GENERAL EXPLANATION 1986, supra note 37, at 1267 n.12 (citing 132 CONG. REC. H 8362 (Sept. 25, 1986) (colloquy between Mr. Rostenkowski and Mr. Andrews) and 132 CONG. REC., S13952 (Sept. 26, 1986) (colloquy between Senator Packwood and Senator Bentsen)).
161. See supra text accompanying notes 152-160.
need the income, income accumulation will help increase the value of the grandfathered assets (although perhaps at the cost of the application of the throwback rules). Disclaimers of interests in certain grandfathered trusts may be worth considering to take maximum advantage of the exemption from Chapter 13. Trustees of such trusts may wish to focus the trust’s investments on growth, rather than income, to maximize the benefit of the grandfathered status. It also may be appropriate to consider the purchase of insurance as an investment for grandfathered trusts. In general, transfers should be made to such trusts only if the present interest exclusion is available to avoid tainting the favorable Chapter 13 treatment otherwise available.

The effective date provisions in TRA'86 regarding grandfathered inter vivos trusts are identical to those under the original generation-skipping tax law, except that the dates have been changed. One would anticipate that the Regulations interpreting the old effective date provisions should thus apply to the new law.

A recent private letter ruling indicates that timely disclaimers may provide an additional, advantageous use of the effective date rules. In the letter ruling, a decedent died before October 22, 1986, survived by two children and several grandchildren. The decedent’s will essentially left his residuary estate to his descendants, per stirpes. The two children proposed to disclaim their interests, after October 22, 1986, but within the limits of Code section 2518. The IRS ruled that since the disclaimer provisions operate to treat properly disclaimed property as passing directly from the decedent to the ultimate recipients as of the date of death, the transfers resulting from the proposed disclaimers would not be subject to the provisions of the new Chapter 13. This ruling suggests that disclaimers may have additional uses in that they may effectively extend the time within which decisions relating to grandfathered vehicles must be made.

The provisions of new Chapter 13 do not apply to decedents who died before January 1, 1987, if their wills were executed prior to October 22, 1986. The Technical Corrections Bill extends this exception to transfers under revocable trusts by reason of a decedent’s death, and moves the document execution date back to September 25, 1985.

163. Treas. Reg. § 25.2503-3(b) (as amended 1983). A present interest in property is an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property. Id.
164. TRA '86 § 1433.
165. TRA '76 § 2006(c).
166. See Generation-Skipping Transfers, supra note 49, at 1228.
168. Id.
169. Id.
170. TRA '86 § 1433(b)(2)(B).
171. TECH. CORR. ACT, supra note 159.
estates of decedents who qualify under these rules, it will be very important to consider disclaimers.

In addition, QTIP elections will assume new dimensions, particularly in light of the election under section 2652(a)(3). For a decedent with a grandfathered will who died on December 31, 1986, and whose personal representative elected QTIP treatment with respect to a testamentary trust, the section 2652(a)(3) election for all or a portion of the QTIP trust should avoid the application of Chapter 13 taxes on the surviving spouse's subsequent death. This results because the predeceasing spouse would be considered the transferor of the portion of the QTIP trust as to which the section 2652(a)(3) election was made, and since he died prior to the effective date of Chapter 13, the transfers from that trust after the surviving spouse's death should not be subject to the generation-skipping transfer tax. An alternative method of avoiding the Chapter 13 tax in this case might be for the personal representative not to make the section 2056(b)(7) election in the predeceasing spouse's estate, although this would generate a federal estate tax.

Planning for Use of Exemptions and Exclusions

The obvious, and frequently the most effective, method of planning to minimize the generation-skipping transfer tax is by careful attention to the $1,000,000 GST exemption. Some basic principles, although essentially self-evident, are helpful both to organize one's thoughts and to act as an informal check list when utilizing the $1,000,000 exemption. These include: (1) insuring that the client uses his available exemption; (2) facilitating use of the exemption available to the client's spouse; (3) using the exemption to protect property that is most likely to appreciate in value; (4) using the exemption at the earliest possible time to permit the assets to appreciate over the longest period; (5) using the exemption in conjunction with various devices that will assist in protecting the greatest value of property; (6) using the exemption to protect some property completely from the generation-skipping transfer tax rather than partially protecting property; (7) avoiding use of the exemption against property that will go in part to non-skip persons, and thus wasting part of the exemption.

The major risk that the client or the client's spouse may not be able to use his or her entire exemption is usually attributable to a discrepancy in the size of their estates. There are several approaches to this problem. A simple one, with significant other ramifications, is to increase the smaller estate through inter-spousal gifts, until it is large enough to use the full exemption. Unless the clients are in a position to make substantial inter vivos gifts and elect gift-splitting, inter-spousal gifts are the only

172. There is some question as to whether the predeceasing spouse's personal representative could make such an election, and whether it could be a partial election.
approach that will guarantee the spouse with the smaller estate the ability to use the full exemption. Other solutions will be effective only if the wealthier spouse dies first, leaving the surviving spouse enough assets to permit him full use of his exemption.

Even if the wealthier spouse were to die first, the attorney must plan for full use of the decedent's $1,000,000 exemption; the majority of wills provide for a bypass (or "family") trust equal to the available unified credit (which even with other available credits would not exceed $642,425) with the balance of the property passing in a way that qualifies for the federal estate tax marital deduction. The bypass trust can be drafted to use part of the testator's $1,000,000 exemption. Ordinarily, however, the property qualifying for the marital deduction, and therefore includable in the surviving spouse's estate, would be treated as passing from the surviving spouse for generation-skipping transfer tax purposes. The surviving spouse could use his or her exemption against such property, but the predeceasing spouse could not. Thus, the typical estate plan in place prior to the enactment of the new Chapter 13 would result in a waste of approximately $400,000 of the predeceasing spouse's generation-skipping tax exemption.

This situation may be addressed through the election offered by section 2652(a)(3), by which the decedent's estate (or, in the case of an inter vivos gift, the donor spouse) may treat the property as if the qualified terminable interest property election had not been made. It is not clear, however, that such an election may be partial. If partial elections are permissible, the election under section 2652(a)(3), to treat that portion of the QTIP property equal to the decedent's otherwise unused $1,000,000 exemption as if no QTIP election had been made, would permit the personal representative to utilize the predeceasing spouse's entire GST exemption. If partial elections are not permissible, it may be possible to achieve the same result by dividing the marital share into two separate trusts, one equal to the unused portion of the testator's $1,000,000 exemption and the other representing the balance of the marital share. The election under section 2652(a)(3) could then be made with respect to the trust equal to the unused portion of the exemption. This approach seems preferable to gambling on the validity of a partial election.

The client can also achieve complete use of his exemption by increasing the bypass trust to $1,000,000, and by voluntarily paying some federal estate tax in his estate even if his spouse should survive him. If the aggregate assets of the client and his spouse are significant and the assets in the trust are expected to appreciate at a reasonable rate, this approach may also ultimately save substantial federal estate as well as generation-skipping transfer taxes. The federal estate taxes paid upon the client's death obviously will not be available to the surviving spouse.

174. Id. § 2652(a).
during the time she survives; hence, increasing the size of the bypass trust is most frequently appropriate only in families of substantial wealth.

If an *inter vivos* transfer is subject to the generation-skipping transfer tax, it is possible to take advantage of gift-splitting for generation-skipping transfer tax purposes. This will permit the spouse with the smaller estate greater use of his $1,000,000 exemption.

Many other considerations concerning the use of the $1,000,000 GST exemption follow logically from its operation. In general, the $1,000,000 exemption is applied at the onset, and, once applied, thereafter protects the property from the operation of the generation-skipping transfer tax.¹⁷⁵ It follows, therefore, that the exemption may be used best to protect (a) assets that are going to appreciate, and (b) trusts (i) all of whose income and principal will pass to skip persons, and (ii) that last for as many generations as possible. Careful planning and thoughtful drafting can greatly facilitate these goals.

The will should permit the personal representative, or, if appropriate, the trustee, wide latitude in funding a generation-skipping trust. Consideration should be given to permitting discretionary accumulation of income by the trustee if this is otherwise suitable; a trust of this type might be combined with another, non-generation-skipping trust directing distribution of income, granting the trustee liberal discretion to invade principal, and giving the children general testamentary powers of appointment. The latter trust would insure adequate protection of the children’s generation while the former could shift as much property as possible to future generations free of either a federal estate tax or the generation-skipping transfer tax.

Under the current law, irrevocable life insurance trusts may be used in conjunction with the $1,000,000 exemption to great advantage. An irrevocable life insurance trust is based, in large part, on excluding substantial appreciation from the testator’s estate. The unification of the gift and estate taxes in 1976 limited the ability of individuals to save taxes by making gifts. Setting aside the possibility of income tax savings (which is much reduced as a result of the TRA’86), gifts save transfer taxes only to the extent that (1) they qualify for the $10,000 annual exclusion, (2) they qualify for the exclusions for direct payment of medical expenses and tuition, or (3) there is post-gift appreciation in the value of the gift. Irrevocable life insurance trusts are usually drawn to capitalize on the $10,000 annual exclusion. They are also attractive, however, because life insurance (particularly term life insurance) typically has an extremely low value for gift tax purposes as compared to its federal estate tax value: life insurance appreciates in value dramatically upon the death of the insured. Consequently, it will usually be advantageous to utilize part of the $1,000,000 GST exemption to the extent necessary to exempt an irrevocable life insurance trust from the generation-skipping transfer tax.

¹⁷⁵. *See supra* note 108.
Since many of the contributions to the trust may be protected by the annual exclusion through the use of a Crummey withdrawal right, the use of a portion of the $1,000,000 GST exemption to protect the balance will be particularly efficient, since the benefit of the annual exclusion protection against the generation-skipping transfer tax will otherwise be lost.

It frequently will be advantageous to use part of the $1,000,000 GST exemption to shelter transfers to a trust if other transfers to the trust qualify for the annual exclusion. *Inter vivos* transfers that qualify for the $10,000 annual exclusion are not subject to the generation-skipping transfer tax.\(^\text{177}\) Thus, if all gifts to a trust that would otherwise be subject to the generation-skipping transfer tax qualify for the annual exclusion under section 2503(b) (presumably through the existence of appropriate Crummey withdrawal rights), the trust would not be subject to the generation-skipping transfer tax. If, on the other hand, over the course of time $1,000,000 were contributed to the trust in ways that qualified for the annual exclusion, and then $10,000 were contributed to the trust and not protected by an allocation of a part of the GST exemption, the entire value of the trust would be subject to the generation-skipping transfer tax.\(^\text{178}\) Yet the entire trust could be protected by use of only $10,000 of the $1,000,000 GST exemption. It is possible that the holder of the Crummey withdrawal power, rather than the original donor, will be considered the grantor of the trust. If this proves to be the case and the relationship between the holder and the beneficiaries is such that the trust would be considered a generation-skipping trust, then it may be necessary to shelter the property subject to the withdrawal right by using the exemption of the holder of the Crummey power.

In general, it will be preferable to have trusts either totally exempt from or totally subject to the generation-skipping transfer tax (i.e., having an inclusion ratio of either zero or one), rather than being partially subject to the tax. Since a trust that is protected by the GST exemption sufficiently to have a zero inclusion ratio will not thereafter be subject to the generation-skipping transfer tax, the recordkeeping and other administrative costs associated with the generation-skipping transfer tax will be diminished. In addition, the trust can be drafted to maximize the generation-skipping possibilities (e.g., it can permit accumulation of income, give few or no beneficial interests to any non-skip person, and last for as long as the applicable rule against perpetuities) and administered to maximize such possibilities (e.g., through investments in property likely to

176. Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968). The Crummey exception allows a demand of a portion of the proceeds of a trust by the beneficiary, or the guardian of a beneficiary who is a minor.

177. I.R.C. § 2612(c)(1) (West Supp. 1988). Such transfers are not "subject to a tax imposed by Chapter 11 or 12" and are consequently not direct skips. Nor are they taxable distributions or terminations as defined in Chapter 13.

178. The applicable fraction (I.R.C. § 2642(a)(2)) would be zero, making the inclusion ratio 1 (I.R.C. § 2642(a)(11)), which would result in all of the trust property being taxed at the maximum federal estate tax rate under I.R.C. §§ 2641, 2612, 2602.
appreciate and avoidance of discretionary distributions to non-skip persons). Trusts that would be subject to the generation-skipping transfer tax could be drafted to insure that children and other non-skip persons are adequately protected and administered to yield enough income to protect such beneficiaries.

Segregation of property qualifying for the $1,000,000 GST exemption can be achieved through the creation of a separate trust to hold such property. For example, if Testator's spouse is alive and Testator wishes to defer any federal estate tax until his surviving spouse's death, Testator's will could create a separate QTIP trust, which by formula would equal the unused balance of the $1,000,000 GST exemption. Testator's personal representative could then make the election under section 2652(a)(3) to treat Testator, rather than his spouse, as the transferor. The remainder of the assets intended to qualify for the marital deduction could be left outright to the wife, to a general power of appointment marital deduction trust, or to a separate QTIP trust. It may also be possible to authorize the personal representative or the trustee to divide the credit shelter or by-pass trust (if that trust exceeds the unused portion of the $1,000,000 GST exemption) or the QTIP trust into separate trusts having inclusion ratios of 0 and 1, respectively.

Any planning for the generation-skipping transfer tax should take into account the many areas in which there are presently no clear answers, and, perhaps even more importantly, the probability of legislative reform. The Technical Corrections Bill of 1987 represented the joint positions of the House and Senate as of June, 1987; since then the House Ways and Means Committee and the Senate Finance Committee have both proposed further changes. The final result is obviously uncertain.

Planning for Direct Skips

Direct skips, by definition, are transfers to a skip person which are subject to either the estate or the gift tax. Because they are taxed on a tax-exclusive basis, direct skips are more tax efficient than other generation-skipping transfers. The taxable amount is the value of the property received by the transferee. The transferor's payment of the Chapter 13 tax, for which he is liable, does not create an additional transfer subject to the generation-skipping tax, although the Chapter 13 tax paid on an inter vivos direct skip is a taxable gift. As between inter vivos and testamentary direct skips, an inter vivos transfer results in the lowest total

179. TECH. CORR. ACT, supra note 159.
180. HOUSE WAYS & MEANS COMM., REVENUE BILL OF 1987, H.R. REP. 3545, 100th Cong., 1st Sess., Title X, Subtitle B, XIV.C.
182. See supra notes 135-37 and accompanying text.
184. Id. § 2603(a)(3).
185. Id. § 2515.
transfer taxes due, although such taxes will be due immediately rather than at the death of the transferor. The operation of these principles can be demonstrated as follows (for simplicity assume a fifty percent tax rate):

<table>
<thead>
<tr>
<th>1988 Testamentary</th>
<th>1988 Inter vivos</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Skip</td>
<td>Direct Skip</td>
</tr>
<tr>
<td>$3,000,000</td>
<td>$2,250,000</td>
</tr>
<tr>
<td>(1,500,000)</td>
<td>(500,000)</td>
</tr>
<tr>
<td>(500,000)</td>
<td>(250,000)</td>
</tr>
<tr>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

A second advantage of an *inter vivos* direct skip is that the basis adjustments allowed in section 1015(d) and section 2654(a)(1) may provide a step-up in basis for the property transferred. The increase in basis is equal to that portion of the generation-skipping transfer tax attributable to the excess of the fair market value of the property transferred over the adjusted basis immediately before the transfer. This would not occur in the case of a taxable distribution or a taxable termination unrelated to the death of an individual.

Careful planning with respect to the rules relating to the identification of the transferor, when used with the principle that direct skips are most tax efficient, can extend the benefits available to a married couple. Gift-splitting and use of the special election for QTIP property will enable a couple to make the most effective use of their GST exemptions. For example, there are several methods by which a couple with assets of between $1 and $2 million can avoid Chapter 13 taxes entirely, without taking into account the $2 million grandchild exclusion. Assuming the husband has $2,000,000 in his name alone, and he predeceases his wife, he can divide his estate into three shares, as follows:

<table>
<thead>
<tr>
<th>Unified Credit Shelter Trust</th>
<th>QTIP Trust</th>
<th>QTIP Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>$600,000</td>
<td>$400,000</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

His personal representative allocates $600,000 of the decedent's GST exemption to the unified credit shelter trust, and his remaining $400,000 GST exemption to the smaller QTIP trust, after making a section 2652(b)(3) election so that the decedent will be considered the transferor of that trust. When his wife dies, her personal representative will allo-

186. *Id.* §§ 1015(d), 2654(a)(1).
187. *Id.* § 2652(a).
cate all of her GST exemption to the larger QTIP trust. Thus they will have effectively used both GST exemptions to shelter their entire estate from the generation-skipping transfer tax.

Another method would be for the husband to establish an *inter vivos* QTIP trust of $1 million for his wife, or transfer to her $1 million outright. Each of their testamentary schemes would then include a $600,000 unified credit shelter trust and a $400,000 QTIP trust for the survivor.

Direct skips to a transferor's great-grandchildren or more remote descendants, although not qualifying for the $2 million grandchild exclusion, will avoid one or more generation levels of taxation. When a transferor is wealthy enough, is old enough to have great-grandchildren or more remote descendants, and has fully used all other available exemptions and exclusions, direct skips to those descendants may ultimately save the family unit some generation-skipping transfer tax.

**Deferring Taxable Events**

The time value of money generally encourages taxpayers to defer, whenever possible, payment of tax that would otherwise be due currently. Planning for deferral of events that give rise to the generation-skipping tax is most appropriate when the transfer will not be exempt from Chapter 13 because all available exemptions and exclusions have been exhausted or are otherwise unavailable.

One technique to be considered when drafting a generation-skipping trust would be to include a number of non-skip persons as discretionary beneficiaries. This will result in the deferral of a taxable termination. Care must be taken, though, to avoid the application of section 2652(c)(2), which provides that nominal interests used to postpone or avoid the Chapter 13 tax shall be disregarded. The Technical Corrections Bill expands section 2652(c)(2) to cover interests greater than nominal,188 which may effectively eliminate the technique of adding additional beneficiaries.

Another method of deferring taxable terminations is to include limited testamentary powers of appointment in trust instruments. For example, if grandmother creates a trust for son for his life, and then to granddaughter, a taxable termination could be avoided at the son's death if he had and exercised the power to appoint the trust property in further trust for his sister or for his wife. The flexibility inherent in the limited power of appointment may be very valuable, particularly if unforeseen circumstances arise.

Similarly, using "pot" trusts for a generation of beneficiaries rather than separate trusts may be preferable. If properly drafted, a taxable termination could be delayed until the death of all individuals (and their spouses) in any given generation level.

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Subjecting Transfers to Gift or Estate Tax

If a transferor has used all of his or her available exemptions and exclusions, subjecting generation-skipping transfers to Chapter 11 or Chapter 12 taxes is another planning possibility. Because the generation-skipping tax is imposed at the highest unified transfer tax rate, if the imposition of an estate or gift tax would avoid the generation-skipping tax, it may be advantageous to use the graduated rate structure of the unified transfer tax. By definition, generation-skipping transfers do not include transfers from trusts (other than direct skips) which are subject to estate or gift tax at the level of the first generation below the transferor. Because direct skips are defined as transfers of property to skip persons which are subject to Chapter 11 or 12 taxes, it is important to keep in mind that using the estate and gift taxes to avoid Chapter 13 taxes can only be accomplished by taxable distributions or taxable terminations.

One method by which the gift tax can be used to avoid the generation-skipping tax is to have the trustee of a discretionary trust make distributions to the transferor's children, and then those children can make a gift to their own children, rather than having the trustee make distributions directly to the transferor's grandchildren.

The estate tax can be used to avoid the Chapter 13 tax by granting a testamentary general power of appointment over trust property to the transferor's child, which will result in the inclusion of the property subject to the power in the child's estate, and the avoidance of generation-skipping tax should the child appoint the property to his children. If the child decides to appoint the property to his grandchildren, his GST exemption may be available to protect the property from Chapter 13 tax.

Finally, it may be appropriate to allow the trustee of a generation-skipping trust to create general powers of appointment in one or more beneficiaries, if such powers would result in the overall reduction of gift, estate, and generation-skipping transfer taxes.

CONCLUSION

One noted estate planning scholar has delivered the following scathing comment on the 1986 generation-skipping transfer tax reform effort:

The gutted version of the generation-skipping transfer tax that is included in the 1986 Code revision may be as much as the Treasury could hope to salvage from the ill-starred Congressional effort to deal with the problem in the 1976 Act. Congress has shown a marked disinclination to impose effective wealth transfer taxes and professional groups have persistently...
urged the repeal of the generation-skipping transfer tax altogether. From a long-range policy perspective, it might have been preferable to allow the tax to die completely, rather than to continue to create the illusion that the 1986 Code deals adequately with the use of generation-skipping transfers to avoid estate and gift taxes. Although the 1986 version may be expected to limit generation-skipping by very wealthy families in the future, it achieves this result at the cost of grandfathering all trusts that were irrevocable on September 25, 1985, and by providing extremely generous exemptions for later generation-skipping transfers.191

Practitioners in the estate planning area may find some comfort in this assessment of the new Chapter 13, but the fact of the matter is that the new tax cannot be ignored. Over a decade of effort in formulating a workable complement to the estate and gift taxes has produced a flawed, although somewhat improved, generation-skipping transfer tax. This time, though, Chapter 13 may be here to stay.