University of Texas School of Law

2015 Taxation Conference and Estate Planning Workshop

December 2-4, 2015
Austin, Texas

Generation-Skipping Transfer Tax

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GENERATION-SKIPPING TRANSFER TAX PLANNING

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I. INTRODUCTION

The current version of the federal generation-skipping transfer tax was enacted as part of the Tax Reform Act of 1986, with technical corrections being made in subsequent tax acts. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), which was enacted on June 7, 2001, included several changes affecting the generation-skipping transfer tax. Although most of EGTRRA's provisions did not take effect until January 1, 2002, the changes with respect to the generation-skipping transfer tax were generally effective on January 1, 2001. Like all of EGTRRA's other provisions, the generation-skipping transfer tax changes it made had been scheduled to disappear automatically by virtue of EGTRRA's "sunset". This sunset was originally slated to occur on December 31, 2010, but it was extended until December 31, 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Act). The 2010 Tax Act also created specialized tax rules applicable only during 2010 and 2011. The specter of "sunset" was finally eliminated by the passage of the American Taxpayer Relief Act of 2012 (2012 Tax Act), which also made permanent certain temporary changes included in the 2010 Tax Act (such as an indexed $5 million GST exemption).

Section II of this article contains a detailed explanation of the current operational rules of the federal generation-skipping transfer tax. Section III of this article discusses general planning considerations as well as some basic ideas and drafting strategies for generation-skipping transfer tax planning. Section IV discusses the use of formula gifts tied to the GST exemption. Sample language implementing such formula gift planning for both a married couple and a single individual is included at the end of the article, as are sample forms which can be attached to federal gift tax returns to make true late allocations of the GST exemption. In addition, numerous examples of sample language for implementing the strategies or approaches discussed in this article are also found in Sections III and IV. Borders are used to separate this additional sample language from other text when that language is contained in the body of the article.

II. OPERATION OF GENERATION-SKIPPING TRANSFER TAX

A. Basic Definitions

1. <u>TRANSFEROR</u>

"Transferor" means the decedent, in case of property subject to an estate tax; it means the donor, in case of property subject to a gift tax. I.R.C. § 2652(a)(1). An actual transfer of property is not required. An individual will be treated as the transferor of all property (i) that is included in the individual's gross estate for estate tax purposes or (ii) as to which the individual made a gift for gift tax purposes. All such property will be treated as if it had been transferred by that individual whether or not there was a transfer for legal purposes. Treas. Reg. § 26.2652-1(a)(1).

a. <u>Split Gifts</u>

If a married couple elects to have the gifts of each other's separate property made to others treated as being made one-half by each of them, they each will be treated as a transferor as to one-half of the transferred property. I.R.C. § 2652(a)(2).

b. <u>Special "Reverse" QTIP Election</u>

In general, the surviving spouse (or the donee spouse, in the case of an inter vivos transfer) is treated as the transferor with respect to property in which such spouse was given a "qualifying income interest" and for which a QTIP election was made. I.R.C. § 2044(c). This general rule also applies for generation-skipping transfer tax purposes. Id. However, § 2652(a)(3) permits the decedent's estate or donor spouse to elect (solely for purposes of the generation-skipping transfer tax) to treat property that was covered by a QTIP election as though no such election had been made. This special "reverse" QTIP election must be made for the entire portion of the QTIP trust covered by the standard QTIP election. Id. For example, if the standard QTIP election was made for one-half of the property passing to the trust, the reverse QTIP election (if made) can only be made as to one-half of such property, no more or less. Treas. Reg. § 26.2652-2(a). This special QTIP election is irrevocable once made. Id. This election cannot be made with respect to property that would qualify for a marital deduction under § 2056(b)(5). Id. Thus, if the surviving spouse possesses a testamentary general power of appointment over a marital deduction trust, a special QTIP election cannot be made even if a standard QTIP election is made with respect to that trust.

c. Transfers in Trust

A person making a transfer in trust, or a contribution to an existing trust, is the transferor only as to that portion of the trust attributable to the transferred property. This attribution concept is accomplished by treating the portions of a trust that are attributable to different transferors as separate trusts for generation-skipping transfer tax purposes. [See Section II.A.2.c below.]

2. TRUST

"Trust" includes not only express trusts but any arrangement (other than an estate) which has substantially the same effect as a trust. I.R.C. § 2652(b)(1). Expressly listed as examples of such arrangements are i) life estates and remainders, ii) estates for years and iii) insurance and annuity contracts. I.R.C. § 2652(b)(3). Applicable regulations add transfers subject to the Uniform Gifts to Minors Act or similar state legislation to this list of deemed trusts. Treas. Reg. § 26.2652-2(b)(2), Example (1). The Secretary of the Treasury is given authority to issue regulations making any adjustments in the statutory rules that are necessary to properly apply the generation-skipping transfer tax to these deemed trusts. I.R.C. § 2663(3).

a. Trustee

In an arrangement treated as a trust, the person in actual or constructive possession of the property subject to that arrangement is deemed to be the "trustee." I.R.C. § 2652(b)(2).

b. Separate Share Rule

A single trust may be treated as 2 or more separate trusts if the beneficiaries have "substantially separate and independent shares." I.R.C. § 2654(b)(2). The quoted language is identical to that found in section 663(c) of the Code. The regulations confirm this tie to the income tax rules by defining that term by reference to Treas. Reg. § 1.663(c)-3. Treas. Reg. § 26.2654-1(a)(1)(i). However, for generation-skipping transfer tax purposes, the separate shares must have existed since the trust's creation in order for such shares to be considered separate trusts. Id.

c. Multiple Transferors

Where a single trust contains assets attributable to more than one transferor, the trust will be treated as 2 or more separate trusts for generation-skipping transfer tax purposes. I.R.C. § 2654(b)(1). Each portion of that single trust attributable to a different transferor will be a separate trust. Id. The division of the underlying assets between those separate trusts is made on a fractional basis using fair market values. Treas. Reg. § 26.2654-1(a)(2). Since this separate trust treatment applies only for generation-skipping transfer tax purposes, administrative problems could easily be encountered. The regulations permit a trust with multiple transferors to be divided at any time into separate trusts, one for each transferor. Treas. Reg. § 26.2654-1(a)(3). However, unless the trust instrument specifically requires that such a division be made on a pecuniary basis, it must be accomplished on a fractional basis, though the resulting fractional shares can be composed differently as long as a true worth or fairly representative approach is applied. Id.; Treas. Reg. § 26.2654-1(b)(1)(ii)(C). Division of a trust with multiple transferors differs from the