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THE HEART OF DARKNESS: A JOURNEY INTO THE GST JUNGLE

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PUBLICATIONS AND PRESENTATIONS

- THE HEART OF DARKNESS: A JOURNEY INTO THE GST JUNGLE (2017)
- IN GOD WE TRUST; ALL OTHERS MUST PAY CASH: BEST PRACTICES FOR INTRAFAMILY LOANS (2017)
- THE PROPOSED §2704 REGULATIONS: IS THIS GRINCH GOING TO STEAL YOUR CHRISTMAS? (2016)
- THE FAMILY GAME OF THRONES: A PLANNER'S GUIDE TO DRAFTING EFFECTIVE SUCCESSION PLANS (2015)
- TO LOVE, HONOR AND MAINTAIN SEPARATE PROPERTY: AN ESTATE PLANNER'S GUIDE TO PROTECTING A SPOUSE'S PROPERTY RIGHTS (2014)
- YOU CAN'T TAKE IT WITH YOU... BUT YOUR SPOUSE CAN!: HOW PORTABILITY WORKS AND WHAT IT MEANS FOR YOU AND YOUR CLIENTS (2014)
- THE ROLLERCOASTER HAS FINALLY STOPPED!: ESTATE PLANNING IN 2013 AND BEYOND (2013)
- FOCUSING ON WHAT MATTERS: CHANGING LAWS, FAMILY DYNAMICS, AND HOW THEY IMPACT A SUCCESSFUL ESTATE PLAN (2012)
- DIRECT SKIPS, INDIRECT SKIPS AND AUTOMATIC ALLOCATIONS – OH MY!: WHAT EVERY PRACTITIONER NEEDS TO KNOW ABOUT THE GST TAX (2012)
- THE FULL MONTY ON CLOSELY HELD BUSINESS PLANNING: CREATING A PLAN THAT COVERS ALL ANGLES (2011)
- CROSS BORDER TAX ISSUES (2011)
- THE TAX THAT FLEW OVER THE CUCKOO'S NEST – SORTING THROUGH THE INSANITY THAT IS THE FEDERAL ESTATE TAX (2010)
- IS IT TIME TO TRUST YOUR IRA BENEFICIARY DESIGNATION? A DISCUSSION OF THE ISSUES RELATED TO DESIGNATING A TRUST AS THE BENEFICIARY OF YOUR RETIREMENT ACCOUNT (2009)

- AN ESTATE PLANNING POTLUCK! A DISCUSSION OF LEGISLATIVE DEVELOPMENTS, RECENT FLP CASES, RETIREMENT ACCOUNT PLANNING STRATEGIES AND ALTERNATE VALUATION ISSUES (2009)
- SO, YOU LIVE IN MONACO? ASSET PROTECTION PLANNING FOR THE REST OF US (2008)
- PROCRASTINATION – HOW TO GUARANTEE ADVERSE TAX CONSEQUENCES FOR RETIREMENT ASSETS AT DEATH (2007)
- DESPERATE CLIENTS: A SELECTION OF ESTATE, GIFT AND INCOME TAX ISSUES FOR THE RESIDENTS OF WISTERIA LANE (2007)
- WHAT IS IT WORTH? AN OVERVIEW OF VALUATION ISSUES, APPLICABLE STATUTES OF LIMITATION AND ACCURACY RELATED PENALTIES IMPACTING ESTATE AND GIFT RETURNS (2006)

HONORS

- “Top Lawyer” by H Magazine 2012-2017
- Texas Super Lawyer, Rising Star, Estate Planning & Administration, 2011, 2012, 2014 – 2017
- Texas Super Lawyer, Up-And-Coming 100, 2017
- Marvin Key Collie Endowed Presidential Scholar in Tax Law, 2004-2005
- “40 Under 40,” Houston Business Journal 2015

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THE HEART OF DARKNESS: A JOURNEY INTO THE GST JUNGLE

I. INTRODUCTION TO THE GST TAX.

- A. **GST Tax.** The GST tax applies to transfers to persons in lower generations, to the extent that the transfers are not subject to gift tax or estate tax in the intervening generations.
- B. **Governed by Chapter 13 of the IRC.**
- C. **Purpose.** The purpose is to tax transfers that split the benefits of property between generations through the use of trusts and transfers that skip over a younger generation substantially the same as outright transfers from one generation to the next.
- D. **Tax.** No tax is imposed until an interest in property passes to a person two or more generations below the transferor.
- E. **Application of Tax.** The tax applies independently of the federal estate and gift taxes.

II. FUNDAMENTALS OF THE GST TAX.

A. Transferor.

1. For purposes of the GST tax, identifying the “transferor” is of great importance as generation assignments are determined relative to the transferor and it is the transferor’s GST exemption which can be utilized to shelter transfers from taxation.
2. The transferor is generally the person from whom the subject property was transferred, i.e. the decedent for testamentary transfers subject to Chapter 11 or the donor for inter vivos transfers subject to Chapter 12.
3. A transfer may occur even though the property was not actually transferred under local law. The individual will be treated as transferring property if federal estate or gift tax was imposed.¹ For this purpose, a gift tax is imposed without regard to exemptions, exclusions, deductions, and credits.²
4. A person holding a general power of appointment will become the transferor when the property to which the power applies is subject to an estate or gift tax. Until the power is subject to an estate or gift tax, the original transferor will remain the transferor.
 - a. Example: Ross creates a trust for his child, Emma, and gives Emma a power to withdraw half of the principal of the trust at the age of 40. The balance of the principal will remain in trust for Emma’s life. The transfer by Ross to the trust is a completed transfer for gift tax purposes so Ross

¹ Treas. Reg. § 26.2652-1(a)(1).

² Treas. Reg. § 26.2652-1(a)(2), (a)(5), ex. 1.

is the transferor as to the entire property in the trust. Even after Emma reaches age 40, Emma does not become the transferor until a completed gift takes place or the property is subject to estate tax. If Emma exercises the power of appointment, Emma is considered the transferor of the portion of the trust that is a completed gift from Emma because the transferor of the trust for GST tax purposes is the person with respect to whom the property was most recently subject to federal estate or gift tax. Ross will continue to be the transferor of the balance of the assets in the trust.

5. The holder of a *Crummey* power of withdrawal will become a new transferor only to the extent the lapsed power exceeds the greater of \$5,000 or 5% of the value of the trust funds.³ If the lapse of the withdrawal power is partly taxable, the trust will have two different transferors.
6. If property is transferred to a QTIP-able trust for the benefit of the grantor's spouse (and the QTIP election is made), then the recipient spouse/beneficiary will be treated as the transferor of the trust for GST purposes as well as estate tax purposes.
 - a. However, if a so called "reverse QTIP election" is made pursuant to I.R.C. § 2652(a)(3), then the original transferor will continue to be treated as the transferor of the QTIP trust and can allocate his or her GST exemption to that trust.
 - (1) The reverse QTIP election must match the QTIP election that was made. For example, if a QTIP election was made for the entire trust, a reverse QTIP election must be made as to the entire trust or none of the trust.⁴
 - (2) The election is made on the same return as the QTIP election and is irrevocable.⁵
 - (3) Because a partial reverse QTIP election is not allowed, a separate reverse QTIP trust may need to be created in order to fully use both spouses' GST exemption amounts.

B. Skip Persons.

1. A generation-skipping transfer occurs when there is a taxable transfer to a *skip person*.
2. A skip person can either be an individual or a trust.

³ Treas. Reg. § 26.2652(a)(5), ex. 5.

⁴ Treas. Reg. § 26.2652-2(a).

⁵ Treas. Reg. § 26.2652-2(a), (b).

3. Generation Assignments for Individuals.

- a. An individual is a skip person if he or she is assigned to two or more generations below that of the transferor (e.g., a grandchild or great-grandchild).
- b. In most cases, generation assignments are based on family relationships.
 - (1) Lineal descendants of the transferor's grandparents are assigned to generations on the basis of consanguinity.
 - (2) The transferor's spouse or former spouse is assigned to the transferor's generation, regardless of the spouse's age, and the consanguinity rules apply to relatives of the transferor's spouse or former spouse.
 - (3) All other persons are assigned on the basis of age, assuming a 25-year generation.⁶
 - Individuals born within 12.5 years after the transferor are assigned to the transferor's generation.
 - Individuals born 12.5 to 37.5 years after the transferor are assigned to the generation below transferor (non-skip person).
 - Individuals born more than 37.5 years after the transferor are skip persons.

4. Trusts.

- a. A trust is a skip person if all interests in the trust are held by skip persons.⁷
 - (1) A person has an interest in a trust if at that time such person has a present right to or is a permissible recipient of the income or principal of the trust.⁸
 - (2) An interest in a trust will be disregarded if the interest is used primarily to postpone or avoid the imposition of the GST tax.⁹
 - (3) The fact that trust property may be used to discharge a person's legal obligations of support does not create an interest in a trust if such use is discretionary or pursuant to a provision of state law substantially equivalent to the Uniform Gifts to Minors Act.¹⁰

⁶ I.R.C. § 2651(d).

⁷ I.R.C. § 2613(a).

⁸ I.R.C. § 2652(c)(1)(A).

⁹ I.R.C. § 2652(c)(2).

¹⁰ I.R.C. § 2652(c)(3).

- b. A trust is also a skip person if:
 - (1) No person holds an interest in the trust; and
 - (2) At no time after the transfer may a distribution be made to a non-skip person.¹¹
 - According to the Treasury Regulations, a trust will meet this second requirement if it can be actuarially determined that there is less than a 5% probability that a distribution will be made to a non-skip person.¹²

5. Charity: A charity is considered a non-skip person.

- a. A charity may have an interest in a trust in two circumstances: (1) the charity has a mandatory right to receive current distributions of income or corpus from the trust or (2) the charity is described in §2055(a) and is a charitable beneficiary of a charitable remainder annuity trust, a charitable remainder unitrust, or pooled income fund.¹³
- b. A charity who has only a discretionary right to receive distributions or is only a permissible current recipient of income or corpus from the trust does not have an interest in the trust.

C. When is a Generation-Skipping Transfer Taxed?

1. Direct Skip.

- a. A direct skip is a transfer to a skip person that is subject to the federal estate or gift tax.¹⁴
- b. The transfer may be made either outright or to a trust, and it may be by gift during the transferor's life or at death.
- c. If property is transferred to a trust, the transfer is a direct skip only if the trust itself is considered a skip person.
- d. All direct skips are taxed only once, regardless of how many generations are skipped.
- e. Example: Elvis by gift conveys Graceland to his grandchild. Because the transfer is a transfer to a skip person of property subject to federal gift tax, it is a direct skip.

¹¹ *Id.*

¹² Treas. Reg. § 26.2612-1(d)(2)(ii).

¹³ I.R.C. § 2652(c)(1)(A), (C).

¹⁴ I.R.C. § 2612(c).

2. Taxable Termination.

- a. A taxable termination is the termination of an interest in property held in trust unless (a) immediately after such termination, a non-skip person has an interest in such property, or (b) no distributions may be made at any time thereafter to a skip person.¹⁵
- b. “Interest in property held in trust” is a defined term which generally means a present interest.
- c. A taxable termination does not occur if the termination is a transfer subject to estate or gift tax.¹⁶
- d. Exceptions:
 - (1) A termination is not a taxable termination if immediately after such termination, a non-skip person has an interest in such property.
 - (2) A termination is not a taxable termination if at no time after such termination a distribution may be made to a skip person.
- e. The taxable termination rule does not apply to any transfer that is also a direct skip.
- f. Example: Elizabeth establishes an irrevocable trust under which the income is to be paid to her child, Charles, for life. On the death of Charles, the trust principal is to be paid to Elizabeth’s grandchild, William. Since Charles has an interest in the trust, the trust is not a skip person and the transfer to the trust is not a direct skip. If Charles dies survived by William, a taxable termination occurs at Charles’ death because Charles’ interest terminates and thereafter the trust property is distributed to a skip person in a lower generation than Charles.
- g. A taxable termination may occur despite the continuation of the trust, provided that neither exception applies. This can occur when an interest in property held in trust terminates as the result of the death of a lineal descendant of the transferor and a specified portion of the trust’s assets distributes to one or more skip persons. This event would be a taxable termination, not a taxable distribution.¹⁷
- h. Example: Elizabeth creates a trust for her children, Charles and Edward, under which the income is to be paid to Charles and Edward for their lives. On the death of the first of her children to die, one-half of the trust principal is to be paid to Elizabeth’s grandchildren, William and Harry. The balance of the trust principal is to be paid to William and Harry on the death of the survivor of her children. If Edward predeceases Charles, the distribution occurring on the termination of Edward’s interest in the

¹⁵ I.R.C. § 2612(a).

¹⁶ Treas. Reg. §§ 26.2612-1(b)(1)(i), -1(f), ex. 5.

¹⁷ I.R.C. § 2612(a)(2).

trust is a taxable termination, not a taxable distribution. This is the result because the distribution is a distribution of a portion of the trust that occurs as the result of the death of a lineal descendant of Elizabeth and a specified portion of the trust distributes to skip persons.¹⁸

- i. If two beneficiaries in two different younger generations have interests in the trust that terminate at the same time and as the result of one event, only one taxable termination occurs.¹⁹
- j. Example: Elizabeth creates a trust for the benefit of her child, Charles, her grandchild, William, and her great-grandchild, George. The income and principal of the trust may be distributed to any or all of the living beneficiaries in the trustee's sole discretion. Upon the death of Charles, the trust principal is to be distributed to George. If Charles is survived by William and George, both Charles's interest and William's interest in the trust will terminate on the death of Charles. However, due to the fact that both of their respective interests in the trust will terminate at the same time and as the result of one event, the death of Charles, only one taxable termination will occur.
- k. Taxable terminations are reported on Form 706-GS(T), *Generation-Skipping Transfer Tax Return for Terminations*. This form is required to be filed even if no tax is due. See Exhibit 1 attached for a sample Form 706-GS(T).
- l. A trustee of separate share trusts will file a single Form 706-GS(T) but should include a separate Schedule A for each separate share trust.
- m. A trustee is allowed to take a deduction on Form 706-GS(T) for expenses, indebtedness, and taxes (similar to the deduction allowed by Section 2053) incurred in connection with property to which the taxable termination has occurred.²⁰

3. Taxable Distribution.

- a. A taxable distribution is any distribution from a trust to a skip person other than a taxable termination or a direct skip.²¹ Therefore, a distribution from a trust having an inclusion ratio of zero is still a taxable distribution.
- b. It is irrelevant whether distributions are of income or principal.
- c. Example: Homer establishes an irrevocable trust under which income is payable to Homer's child Bart for life and principal may be distributed to Bart or any of Bart's descendants. If the trustee of the trust makes a distribution to any of Bart's children during Bart's lifetime, then such distributions will be treated as taxable distributions.

¹⁸ Treas. Reg. § 26.2612-1(f), ex. 9.

¹⁹ Treas. Reg. § 26.2612-1(f), ex. 8.

²⁰ I.R.C. § 2622(b).

²¹ I.R.C. § 2612(b).

- d. The exercise of a withdrawal power by a skip person is a taxable distribution.²²
- e. An interest in property held in the trust will be a taxable distribution to the extent that the interest is subject to federal estate or gift tax. For example, if a skip person holds a power of withdrawal and the lapse of the withdrawal right is treated as a completed transfer for gift tax purposes, the skip person is treated as having received a taxable distribution from the trust.²³
- f. Taxable distributions are reported by the skip person beneficiary on Form 706-GS(D), *Generation-Skipping Transfer Tax Return for Distributions*, and by the trustee on Form 706-GS(D-1), *Notification of Distribution From a Generation-Skipping Trust*. Form 706-GS(D-1) is required to be filed even if no tax is due. Form 706-GS(D) is not required to be filed if all distributions received by the skip person beneficiary are subject to an inclusion ratio of zero. See Exhibit 2 for sample Form 706-GS(D) and Exhibit 3 for a sample Form 706-GS(D-1).
- g. The trustee files a Form 706-GS(D-1) for each skip person who receives a distribution during the calendar year.
- h. The taxpayer is allowed a deduction on Form 706-GS(D) for adjusted allowable expenses that were incurred in connection with preparing the form or expenses incurred in connection with the determination, collection, or refund of the GST tax.²⁴ The adjusted allowable expenses are equal to the total allowable expenses multiplied by the inclusion ratio of the trust.

4. Move-Up Rule under the Predeceased Ancestor Exception.

- a. If a descendant of the transferor (or of the transferor's spouse or former spouse) is deceased ***at the time of the transfer***, the descendants of such decedent are moved up one generation level.²⁵
 - (1) Example: Jon's father, Ned, is deceased at the time Jon's grandfather creates a trust for Jon's benefit. As such, the move-up rule will apply to treat Jon as a non-skip person as to his grandfather. Jon's descendants are moved up one generation as well.
- b. This exception also applies to descendants of a parent of the transferor, but only if the transferor has no living descendants at the time of the transfer.²⁶

²² Treas. Reg. § 26.2612-1(f), ex. 11.

²³ Treas. Reg. § 26.2652-1(a)(5), ex. 5.

²⁴ I.R.C. § 2621(a)(2).

²⁵ I.R.C. § 2651(e).

²⁶ *Id.*

- c. The move up rule can be applied to move a descendant up more than one generation level. For example, a great-grandchild of the transferor may be treated as a child of the transferor if the great-grandchild's parents and grandparents who are lineal descendants of the transferor are deceased at the time of the transfer.

5. Move-Down Rule.

- a. The move down rule affects the generation assignment of the transferor but not the identity of the transferor. Thus, generation assignments are not redetermined, but persons who were skip persons before the generation-skipping transfer may no longer be skip persons.
- b. The move down rule applies when property held in trust after a generation-skipping transfer has occurred continues to be subject to the GST tax.
- c. In order to minimize multiple generation skipping transfers for the same property, after the generation-skipping transfer, the transferor is treated as if he or she moved down to the first generation above the trust beneficiary in the highest generation after the transfer.²⁷

- (1) Example: Chandler creates a trust to provide income to his child, Joey, for life then to his grandchildren, Rachel and Ross, for their lives. When Joey dies, a taxable termination will occur. Thereafter, Chandler is treated as if he is assigned to Joey's generation. Distributions to Rachel and Ross are not taxable distributions because Chandler's grandchildren are now only one generation younger than Chandler is deemed to be.

6. §2503 Exclusions.

a. Exclusions for taxable distributions.

- (1) Section 2611 grants an exclusion from taxable distribution treatment for any transfer from a trust which would not be treated as a taxable gift by reason of the Section 2503(e) unlimited gift tax exclusion for medical and tuition payments made directly to a service provider if the transfer had been made inter vivos by an individual.
- (2) If GST exemption has not been allocated to a trust, the last surviving non-skip beneficiary may consider appointing the property in the trust, or a portion of the property, to a trust that can be used to pay medical and educational expenses for younger generations prior to a taxable termination. This type of trust is called a Health and Education Exclusion Trust ("HEET").

²⁷ I.R.C. § 2653(a).

- (3) Distributions from the HEET for the benefit of skip persons that are paid directly to medical care providers or educational organizations should not be taxable distributions because of the exclusion in Section 2503(e).
- (4) The key to a HEET is that the trust cannot be considered a skip person. This means that at least one of the beneficiaries of the HEET is not a skip person which may be accomplished by including a charity as a mandatory recipient of income from the trust.

b. Exclusions for transfers to direct skips.

- (1) Outright transfer to a direct skips.
 - Certain outright transfers to direct skips will qualify for an exclusion under the GST tax similar to those under the gift tax:
 - Transfers that qualify for \$14,000 annual exclusion under Section 2503(b); and
 - Transfers that qualify for unlimited exclusion for tuition and medical payments under Section 2503(e).
- (2) Transfer to a trust.
 - A gift made to a trust that qualifies for the gift tax annual exclusion does not automatically qualify for the annual exclusion for the GST tax.
 - A transfer to a trust will qualify for the GST annual exclusion only if:
 - The trust is exclusively for one beneficiary (a skip person) during the beneficiary's lifetime; and
 - Trust corpus is includible in the beneficiary's gross estate if the beneficiary dies before the trust terminates.
 - The consequence is that if the transferor wants the trust to have a zero inclusion ratio and it does not qualify for the GST annual exclusion, the transferor must allocate GST exemption to 100% of all transfers to the trust even if the transfer qualifies for the gift tax annual exclusion.
 - Transfers to a Section 2503(c) trust and custodial gifts under the Uniform Transfers to Minors Act qualify under this exception.
 - Irrevocable life insurance trusts do not qualify, as they usually have more than one beneficiary and are typically structured so as to avoid taxation in the beneficiaries' estates.

7. Estate Tax Inclusion Period.
- a. The estate tax inclusion period (“ETIP”) delays the determination of the inclusion ratio for transfers that are not “complete” for estate tax purposes.
 - b. The ETIP is the period after the transfer during which the property would be includible in the gross estate of the transferor or the transferor’s spouse if either one were to die immediately after making such transfer.²⁸
 - c. The ETIP ends on the first to occur of: (1) the time after which no portion of the property would be included in the estate of the transferor or the transferor’s spouse if the transferor or the transferor’s spouse were to die after such time, (2) the date on which there is a GST transfer of the property, or (3) the transferor’s death.²⁹ For example, if a taxable termination or taxable distribution occurs during the ETIP, the ETIP will end with respect to the property that is subject to the taxable termination or taxable distribution.
 - d. If any part of the trust is subject to an ETIP then the entire trust will be subject to the ETIP. The trust’s inclusion ratio will be determined when the ETIP ends.³⁰
 - e. Exceptions:
 - (1) The possibility that the property will be included in the gross estate of the transferor or the transferor’s spouse is so remote as to be negligible. A possibility is so remote as to be negligible if there is less than a 5% probability that the property will be included in the gross estate.³¹
 - (2) A spouse possesses a power of withdrawal that is limited to the greater of \$5,000 or 5% of the value of the trust and the withdrawal period lapses no later than 60 days after the transfer to the trust.³²
 - f. If an affirmative allocation of GST exemption is made to property which is subject to an ETIP, it becomes irrevocable, but the allocation of GST exemption will be effective no earlier than the termination of the ETIP.³³ Any appreciation with respect to the property between the date of the original transfer and the date of termination of the ETIP may not be covered by the allocation. Thus, the property may be only partially exempt. Conversely, if the value of the trust depreciates during the ETIP, a portion of the transferor’s exemption may be wasted.

²⁸ I.R.C. § 2642(f).

²⁹ I.R.C. § 2642(f)(3).

³⁰ Treas. Reg. § 26.2632-1(c)(1).

³¹ Treas. Reg. § 26.2632-1(c)(2)(ii)(A).

³² Treas. Reg. § 26.2632-1(c)(2)(ii)(B).

³³ See Treas. Reg. § 26.2632-1(c)(5), ex. 1.

- g. GRATs and QPRTs are includible in the gross estate of the transferor if the transferor dies during the retained interest period. Thus, the allocation of GST exemption to a GRAT or QPRT is effective only at the end of the annuity term or on the death of the grantor, whichever occurs earlier.

D. What is the GST Tax?

1. Tax Rate.

- a. Flat rate of tax equal to the maximum estate tax rate at the time of the transfer, multiplied by the “inclusion ratio.”³⁴
- b. Maximum estate tax rate is 40% in 2017.

2. Trust Inclusion Ratio.

- a. A trust’s inclusion ratio represents the pro rata portion of transfers to and from the trust which will be subject to the GST tax, taking into consideration the amount of GST exemption allocated to the trust.
- b. A trust’s inclusion ratio is determined by subtracting the “applicable fraction” from one. The applicable fraction is the amount of GST exemption allocated to the trust or transferred property, over the value of the trust or transferred property. The trust’s inclusion ratio is then multiplied by the tax rate to determine the applicable rate of tax on all taxable transfers made from the trust.

$$\text{Applicable Fraction} = \frac{\text{Allocated exemption amount}}{\text{Total value of trust}}$$

$$\text{Inclusion Ratio} = 1 - \text{Applicable Fraction}$$

$$\text{Applicable Rate} = \text{Inclusion Ratio} \times \text{Maximum Transfer Tax Rate}$$

$$\text{GST Tax} = \text{Applicable Rate} \times \text{GST Transfer}$$

- c. If no GST exemption is allocated to the transfer, the inclusion ratio is one and the effective tax rate is 40% (for 2017 and beyond).
- d. Allocating GST exemption does not exempt any particular assets or portion of a trust from taxation (see discussion of qualified severances at V.A below); rather, allocation of GST exemption lowers the rate of tax applicable to the entire trust.

³⁴ I.R.C. § 2641(a)(1).

- e. The inclusion ratio must be recomputed upon the occurrence of the following events:
- (1) A new transferor is determined because the trust is subject to estate or gift tax (decedent or donor, respectively, is deemed the transferor);
 - (2) A qualified severance occurs;
 - (3) Further transfers are made to the trust requiring a recomputed inclusion ratio under Section 2642(d);
 - (a) The numerator of the recomputed fraction is the sum of the “nontax portion” immediately before the transfer plus the current amount of GST exemption that is being allocated to the trust, if any. The denominator is the sum of (1) the value of the transferred property (reduced by any federal estate tax attributable to the property which is actually recovered from the trust and any charitable deduction allowed with respect to the property), and (2) the value of all property in the trust immediately before the transfer.³⁵ The “nontax portion” is the sum of the value of the trust property multiplied by the applicable fraction for the trust immediately before the transfer.³⁶
 - (b) Example: Jack transfers \$200,000 to a trust under which the income is payable to his child, Kate, for her life. Jack makes a timely allocation of \$100,000 of GST exemption to the trust, resulting in an inclusion ratio of 0.50. Subsequently, Jack transfers an additional \$100,000 to the trust when it has a value of \$300,000 immediately before the new transfer. The nontax portion of the trust is \$150,000 (\$300,000 x 0.50). If Jack allocates no new GST exemption to the trust, the new application fraction will be 0.375 ($\$150,000 / (\$100,000 + \$300,000)$).
 - (4) Additional GST exemption is allocated;
 - (a) The recomputation is similar to the one which takes place for additional transfers.³⁷
 - (5) The inclusion ratio is adjusted under Section 2653(b) due to the payment of a GST tax from the trust; or
 - (6) Recapture tax is imposed under Section 2032A.

³⁵ I.R.C. § 2642(d)(2)(B).

³⁶ I.R.C. § 2642(d)(3).

³⁷ I.R.C. § 2642(d)(4).

- f. If a single trust receives transfers from different transferors, each portion of the trust attributable to a different transferor will be treated as though it is a separate trust and a separate computation will be made for each trust (see discussion of multiple transferors in Section V.A below).³⁸

3. Basis Adjustment.

- a. Generally, the basis of the transferred property is adjusted for the amount of the GST tax paid.³⁹
- b. The adjustment is based on the proportion of the tax that is attributable to the value of the property in excess of the adjusted basis of the property.
- c. Example: Jack creates a trust for his child, Randall. The trustee has the discretion to distribute income and principal to Randall. The trustee makes a distribution from the trust of property to Randall during his lifetime with a value of \$200,000 and an adjusted basis of \$100,000 and a \$40,000 GST tax is imposed. The basis increase would be $\$40,000 \times ((\$200,000 - \$100,000) / \$200,000) = \$20,000$. The new basis in the property would be \$120,000.
- d. The basis adjustment for the GST tax paid is made after the basis adjustment for gift tax under Section 1015 is made.⁴⁰

4. Payment of the GST Tax.

- a. The taxable amount and the person liable for the tax depend on the type of transfer.
- b. Tax-inclusive vs. tax-exclusive.
 - (1) For taxable distributions and taxable terminations, the GST tax is imposed on a tax-inclusive basis in that the taxable amount includes the GST tax (like the federal estate tax). Thus, the tax is intended to be similar to the tax that would have been imposed on the “skipped” generation if the property had been transferred outright to the skipped generation and then subjected to estate tax in the skipped generation at the maximum estate tax rate.
 - (2) The tax on direct skips is tax-exclusive, in that it is imposed only on the amount actually received and does not include the GST tax as part of the tax base (like the gift tax). The transferor is liable for the GST tax on a direct skip but must pay an additional gift tax on the GST tax paid. Thus, the GST tax is intended to be similar to the total transfer taxes that would have been imposed on the “skipped” generation if the property had been transferred outright to the skipped generation and then subjected to the gift tax in the skipped generation at the maximum transfer tax rate.

³⁸ I.R.C. § 2654(b).

³⁹ I.R.C. § 2654(a).

⁴⁰ *Id.*

c. Who pays the GST tax?

(1) Taxable distribution.

- The tax is paid by the transferee.⁴¹
- If the trustee pays the GST tax on behalf of the transferee, it will be treated as an additional taxable distribution, increasing the amount of GST tax.⁴²
- The additional distribution is treated as having been made on the last day of the calendar year that the original distribution is made, even though the actual payment of the GST tax occurs in the next calendar year when the GST tax is due.⁴³

(2) Taxable termination.

- The tax is paid by the trustee out of transferred property.⁴⁴

(3) Direct skip.

- For lifetime direct skips, the transferor is personally liable for the payment of the tax.⁴⁵
- For direct skips from a trust, the trustee is liable for the tax.⁴⁶
- For direct skips at death, the executor is liable for the tax.⁴⁷
- Absent a contrary provision, the tax shall be charged to the property constituting such transfer.⁴⁸
- If the transferor makes a lifetime direct skip, the transferor will pay both a gift tax and a direct skip tax. In addition, the transferor will pay a gift tax on the direct skip tax paid.⁴⁹
- Example: Rebecca transfers \$1,000,000 to her grandchild, Tess, a direct skip transfer, and allocates no GST exemption to the transfer. Assuming a maximum transfer tax rate of 40%, total transfer taxes are computed as follows:

Gift to Skip Person	\$1,000,000
Inclusion ratio	1
Tax Rate	.40
GST Tax on Gift	\$400,000
Taxable Gift Amount	\$1,400,000
Gift Tax	\$560,000
Total Transfer Tax Cost	\$960,000
- The transferor's gross estate will include the gift tax paid on gifts made within three years of the transferor's death, but

⁴¹ I.R.C. § 2603(a).

⁴² I.R.C. § 2621(b).

⁴³ Treas. Reg. § 26.2612-1(c)(1).

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ I.R.C. § 2603(b).

⁴⁹ I.R.C. § 2515.

the gross estate will not include the GST tax paid on such gifts.⁵⁰

III. EXEMPTION.

A. Amount of Exemption.

1. Every taxpayer is granted a GST exemption. The current GST tax exemption is \$5,490,000.

B. Allocation of Exemption.

1. Allocation is elective. The transferor or deceased transferor's executor can allocate the exemption to transfers made during life or at death. Any allocation of GST exemption is irrevocable.
2. Allocations During Lifetime.
 - a. For lifetime transfers, allocation can be made on a timely filed gift tax return (Form 709). The allocation is made on page 5 of the 2016 Form 709. *See attached Exhibit 4.*
 - (1) If allocation is made on timely filed gift tax return, the value of the property for GST purposes is its value for gift tax purposes, and the allocation is effective from the ***date of the transfer.***
 - b. Late allocation rules.
 - (1) If allocation is not made on timely filed return, the value for GST purposes is determined as of the ***date the allocation is made.***
 - (2) Because of the difficulty of valuing trust assets on the same day that the return must be filed, the transferor can, solely for purposes of determining the fair market value of the trust assets, elect to treat the allocation as having been made on the first day of the month during which the late allocation is filed.⁵¹
3. Allocation at Death.
 - a. For transfers at death, GST exemption can be allocated by the executor on or before the date for filing the federal estate tax return, regardless of whether a return is due.
 - b. Allocation is made on Schedule R of Form 706. *See attached Exhibit 5.*

⁵⁰ I.R.C. § 2035.

⁵¹ Treas. Reg. § 26.2642-2(a)(2).

4. Deemed Allocations.

a. Deemed Allocations During Lifetime.

- (1) The Internal Revenue Code (the “Code”) automatically allocates unused GST exemption to lifetime direct skips to the extent necessary to make the inclusion ratio zero, or as small as possible, unless the transferor elects out of the automatic allocation rule.⁵²
- (2) The Code also automatically allocates unused GST exemption to lifetime indirect skips unless the transferor elects out.⁵³
- (3) “Indirect skip” is defined as any transfer of property (other than a direct skip) made to a GST trust and subject to the gift tax.
- (4) “GST trust” is defined as a trust that could have a generation skipping transfer with respect to the transferor unless it falls within one of the exceptions described in Section 2632(c)(3)). The trust will not be automatically allocated GST exemption if it falls within any one or more of the following exceptions:
 - (a) The trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more non-skip persons before the person reaches age 46, on or before one or more dates set out in the trust instrument that will occur before that person will reach age 46, or on the occurrence of an event that, in accordance with the regulations, may reasonably be expected to occur before the person reaches age 46.
 - (b) The trust instrument provides that more than 25% of the corpus must be distributed to or may be withdrawn by one or more non-skip persons who are living on the date of death of another person identified in the trust instrument (either by name or class) who is more than 10 years older than such person.
 - (1) Example: A trust is set up for the benefit of the transferor’s spouse while she is living and at her death the trust distributes outright to the transferor’s descendants per stripes.
 - (c) The trust instrument provides that if one or more non-skip persons die before a date or even described in (1) or (2), more than 25% of the corpus must be distributed to the estate or estates of such non-skip persons or is

⁵² I.R.C. § 2632(b)(1).

⁵³ I.R.C. § 2632(c).

subject to a general power of appointment exercisable by one or more of such non-skip persons.

- (d) Any portion of the trust would be included in the estate of a non-skip person if such person died immediately after the transfer.
 - (1) On its face, this exception would apply to trusts that contain a lapsing power to withdraw held by a non-skip person. To prevent this exception from applying to all *Crummey* trusts, the trust property is not considered includible in the estate of a non-skip person if the right of withdrawal does not exceed the annual exclusion amount.⁵⁴ Thus, a *Crummey* trust with withdrawal rights within the annual exclusion amount will be a GST trust, provided that the trust does not fall within another exception.
 - (2) A remaining issue of the exception to the exception is that it does not seem to apply to nonlapsing powers. If withdrawal rights accumulate over time then at the time of the first transfer of the annual exclusion amount, the trust will be a GST trust and the automatic allocation rules will apply. However, at the time of a subsequent transfer of an additional annual exclusion gift, the amount that the beneficiary may withdraw may exceed the annual exclusion amount because of the beneficiary's continuing right to withdraw part of the prior year's gift in addition to the gift in the subsequent year. In such a case, the trust may not be a GST trust at the time of the subsequent transfer so the automatic allocation rules would not currently apply. Thus, an election should be made when the trust is created to avoid inconsistent automatic allocations from year to year.
 - (e) The trust is a charitable lead annuity trust, charitable remainder annuity trust, or charitable remainder unitrust.
 - (f) The trust is a charitable lead unitrust with a non-skip person as the remainder beneficiary if such person is alive at the end of the lead period.
- (5) A deemed allocation of GST exemption to an indirect skip is effective on the date of the transfer and becomes irrevocable

⁵⁴ I.R.C. § 2632(c)(3)(B) (flush language).

after the due date for the gift tax return for the year of the transfer.⁵⁵

- (6) Indirect skips that are subject to an ETIP will be deemed allocated at the end of the period.⁵⁶
- (7) The transferor may elect out of automatic allocation on a timely filed gift tax return (Form 709).
- (8) In addition, a timely filed Form 709 accompanied by payment of the GST tax is sufficient to prevent automatic allocation.
- (9) The transferor may also elect out of the automatic allocation rules to an indirect skip by making an affirmative allocation of GST exemption on a Form 709 of an amount less than (but not equal to) the value of the property transferred as reported on that return.⁵⁷
- (10) The transferor may elect in or out of automatic allocation rules in any combination desired. The transferor can elect to have the deemed allocation rules not apply to a particular indirect skip, any or all transfers made to a particular trust, or all future transfers to all trusts.⁵⁸

b. Deemed Allocations at Death.

- (1) At the transferor's death, the Code automatically allocates any remaining unused GST exemption to the extent not actually allocated before the due date for the transferor's estate tax return, in the following order:⁵⁹
 - (a) First, to direct skips occurring at the transferor's death; and then
 - (b) Pro rata to trusts from which a taxable termination or taxable distribution might occur at or after the transferor's death.
 - (c) The proration is made on the basis of the chapter 11 value of the nonexempt portion of the transferred property, or in the case of trusts that are not included in the gross estate, on the basis of the date of death value of the trust.⁶⁰

⁵⁵ Treas. Reg. § 26.2632-1(b)(2)(i).

⁵⁶ I.R.C. § 2632(c)(4).

⁵⁷ Treas. Reg. § 26.2632-1(b)(2)(ii).

⁵⁸ Treas. Reg. § 26.2632-1(b)(2)(iii).

⁵⁹ I.R.C. § 2632(e).

⁶⁰ Treas. Reg. § 26.2632-1(d)(2).

- (d) Example: During her lifetime, Rebecca transfers property worth \$400,000 to two trusts, Trust A and Trust B, and allocates \$200,000 of GST exemption to each trust. Trust A is for the benefit of her son, Randall, and is determined to have a value of \$600,000. Trust B is for the benefit of her daughter, Kate, and is determined to have a value of \$600,000. At her death, Rebecca only has \$200,000 of GST exemption remaining. The nonexempt portion of Trust A is \$300,000 and the nonexempt portion of Trust B is \$300,000. Therefore, \$100,000 of GST exemption is allocated to Trust A ($\$200,000 \times (\$300,000 / \$600,000)$) and \$100,000 of GST exemption is allocated to Trust B.
- (e) No automatic allocation of GST exemption will occur if during the nine month period following the transferor's death, no generation-skipping transfer has occurred or will occur in the future with respect to that trust.⁶¹

Example: Randall creates a trust under his Will for the benefit of his daughter, Tess, during her lifetime and the remainder to her living children, if she has any on the date of Randall's death. If Tess has no living children on the date of Randall's death, the remainder of the trust will pass outright to Tess's sister, Annie. When Randall dies, Tess has one living child, Jenny. During the nine months following Randall's death, Jenny disclaims any interest in the trust. Because no generation-skipping transfer will occur as a result of the disclaimer, the trust will not receive an automatic allocation of GST exemption.

c. Retroactive Allocations.

- (1) Section 2632(d) allows a transferor to retroactively allocate unused GST exemption to previous transfers to a trust or trusts, on a chronological basis, when a lineal descendant of a grandparent of the transferor or the transferor's spouse, who is a non-skip person with an interest in the trust and who is assigned to a generation below the transferor's generation, predeceases the transferor.
- (2) If the retroactive allocation is made on a gift tax return filed on or before the date prescribed in Section 6075(b) for gifts made within the calendar year in which the non-skip person's death occurred then:
- (a) The value of such transfer or transfers for purposes of Section 2642(a) is determined as if the allocation had

⁶¹ Treas. Reg. § 26.2632-1(d)(2).

been made on a timely filed gift tax return for each calendar year within which each transfer was made;

- (b) The allocation is effective immediately before the non-skip person's death; and
- (c) The amount of the transferor's unused GST exemption available to be allocated is determined immediately before the non-skip person's death.

5. Formula Allocations of GST Exemption.

- a. If the property constituting a decedent's estate or the subject of a gift transaction is susceptible to arguments regarding its valuation or if the practitioner is concerned about unknown transfers, then consideration should be given to describe the allocation of GST exemption as a formula as opposed to a specific dollar amount.

6. Split Gift Treatment for Spouses.

- a. If a husband and wife elect to split gifts under Section 2513, each spouse is treated as the transferor of one half of the gift for GST purposes.⁶² An election cannot be made to split gifts for gift tax purposes without the election having the same effect for GST tax purposes. Similarly, a gift cannot be split for GST tax purposes without splitting the gift for gift tax purposes.
- b. Once the gift is split, each spouse is free to allocate his or her GST exemption to his or her part of the gift.
- c. If the spouses elect to split the gift, each spouse is treated as the transferor of one-half of the entire value of the transferred property regardless of the interest the electing spouse is deemed to have transferred under Section 2513.⁶³
- d. Thus, the amount that an electing spouse is treated as transferring for GST tax purposes may be different from the amount that is split for gift tax purposes. When a gift is made in part to the donor's spouse and in part to a third party, the amount of the gift that can be split for gift tax purposes is the portion of the gift to the third party that is ascertainable and severable from the portion of the gift to the donor's spouse. For GST tax purposes, as long as some portion of the gift qualifies for gift-splitting treatment, the donor spouse is treated as the transferor of one-half of the entire value of the gift.

⁶² I.R.C. § 2652(a)(2).

⁶³ Treas. Reg. § 26.2652-1(a)(4).

IV. TRUSTS NOT SUBJECT TO CHAPTER 13.

A. Three Types of “Grandfathered” Trusts.

1. The GST tax first came into existence in 1976, but the scheme proved to be so complicated and cumbersome that it was scrapped and replaced by the Internal Revenue Code of 1986. The 1986 legislation provided that three types of trusts would be completely exempt, or “grandfathered,” from the application of Chapter 13:
 - a. A trust that was irrevocable on September 25, 1985.⁶⁴
 - b. A trust executed (or testamentary trust established under a Will) before October 22, 1986 and not amended thereafter if the decedent died before January 1, 1987.⁶⁵
 - c. A trust made by a person who on October 22, 1986, and at all times thereafter, was mentally incompetent and the trust was includable in the incompetent person’s gross estate.⁶⁶

B. Loss of Grandfathered Status.

1. Additions – If property is added to a grandfathered trust, then a pro rata portion of the trust will be subject to GST tax when taxable distributions or taxable terminations occur.
 - a. An addition to a grandfathered trust from another grandfathered trust is not a transfer that will taint the trust.
2. Constructive Additions – The regulations will treat the release, exercise or lapse of any power of appointment as a constructive addition to the trust.
 - a. This rule does not apply if the release, exercise or lapse of the power is a nontaxable event.
 - b. Thus, the lapsing of a “five or five” withdrawal right will not be treated as a constructive addition. Nor will the exercise of a special power of appointment be treated as a constructive addition unless the exercise postpones or suspend the “vesting, absolute ownership or power of alienation of an interest in property” beyond the rule against perpetuities period for such trust or for a term of 90 years from the date of creation of the trust.
3. Modifications – Final regulations were issued in 2000 which relaxed the IRS’s historical position on modifications to grandfathered trusts and now provide for

⁶⁴ Treas. Reg. § 26.2601-1(b)(1).

⁶⁵ Treas. Reg. § 26.2601-1(b)(2).

⁶⁶ Treas. Reg. § 26.2601-1(b)(3).

four safe harbor situations in which a modification will not affect the grandfathered status.⁶⁷

- a. Two of the safe harbors relate to settlement agreements and judicial constructions and generally require that the matter at hand be the product of a bona fide dispute and that the result be within the range of reasonable outcomes.
- b. The other two safe harbors would allow for continued grandfathered status so long as the modification does not shift any benefits in the trust to lower generations and that the modification must not extend the time for “vesting” of any beneficial interest in the trust beyond the period provided in the trust.

C. Taxation of Tainted Grandfathered Trust.

1. After an addition has been made to a grandfathered trust, it is treated as though it has two portions – a taxable portion and a nontaxable portion.
2. The taxable portion is treated as having an inclusion ratio of 1.
3. The taxable portion is determined by reference to the “allocation fraction” which is defined as the FMV of the addition to the trust over the FMV of the entire trust immediately after the addition.

V. SPECIAL RULES.

A. Separate Share Rule and Separate Trusts.

1. Separate Share Rule.
 - a. A single trust that consists of separate and independent shares for different beneficiaries may be treated as two or more separate trusts for purposes of the GST tax.⁶⁸
 - b. The regulations state that the phrase “substantially separate and independent shares” for chapter 13 purposes generally has the rules as those found in Section 663 of the Code.⁶⁹
 - c. However, in contrast to the income tax rules, a portion of the trust will not be a separate share unless the share exists from the date of creation of the trust and at all times after.⁷⁰
2. Multiple Transferors.
 - a. When a single trust consists of assets attributable to different transferors, the trust is treated as separate trusts for GST tax purposes.⁷¹

⁶⁷ Treas. Reg. § 26.2601-1(b)(4).

⁶⁸ I.R.C. § 2654(b)(2).

⁶⁹ Treas. Reg. § 26.2654-1(a)(1).

⁷⁰ Treas. Reg. § 26.2654-1(a)(1)(i).

- b. Example: Jack transfers \$300,000 to a trust and Rebecca simultaneously transfers \$100,000 to the same trust. The single trust would be treated as two trusts for purposes of the GST tax. Jack contributed 3/4 of the value of the initial trust so 3/4 of the single trust principal is treated as a separate trust created by Jack. Rebecca contributed 1/4 of the value of the initial trust so 1/4 of the single trust principal is treated as a separate trust created by Rebecca. Jack or Rebecca may allocate GST exemption to each of their separate trusts.
- c. The regulations permit a trustee with multiple transferors to divide the trust into actual separate trusts at any time.⁷²
- d. Unless the trust instrument specifically requires the division be made on a pecuniary basis, the division must be accomplished on a fractional basis.⁷³

B. Qualified Severance.

- 1. If a trust is severed in a qualified severance, the trusts resulting from the severance are treated as separate trusts for purposes of the GST tax and the inclusion ratio of each new resulting trust may differ from the inclusion ratio of the original trust.⁷⁴
- 2. Requirements for a qualified severance:
 - a. Trust must be severed pursuant to the terms of the governing instrument or applicable local law;
 - (1) The Texas Trust Code contains a section that expressly authorizes the trustee to make divisions of trusts.⁷⁵
 - b. The severance must be effective under local law;
 - c. The single trust must be severed on a fractional basis;
 - d. The terms of the resulting trusts must provide, in the aggregate, for the same succession of interests of beneficiaries as are provided in the original trust;
 - e. If a trust has an inclusion ratio between zero and one and is divided into two trusts, a severance is a qualified severance only if one of the resulting trusts receives a fractional share of the total value of all trust assets equal to the applicable fraction immediately before the severance.

⁷¹ Treas. Reg. § 26.2654-1(a)(2).

⁷² Treas. Reg. § 26.2654-1(a)(3).

⁷³ Treas. Reg. § 26.2654-1(b)(1)(ii)(C).

⁷⁴ Treas. Reg. § 26.2642-6(d)(4).

⁷⁵ Tex. Prop. Code Ann. § 112.057.

That trust will have an inclusion ratio of zero and the other trust will have an inclusion ratio of one.⁷⁶

3. Reporting a Qualified Severance.
 - a. A qualified severance is reported by filing a Form 706-GS(T) Generation-Skipping Transfer Tax Return for Terminations.
 - b. “Qualified Severance” should be written at the top of the form.
 - c. A Notice of Qualified Severance must be attached.
 - d. The Form and Notice should be filed by April 15 of the year immediately following the year during which the severance occurred or by the last day of the period covered by an extension of time, if an extension of time is granted.
4. Time for Making a Qualified Severance. A qualified severance may occur at any time prior to the termination of the trust.

C. Section 9100 Relief and Substantial Compliance.

1. Section 9100 Relief.
 - a. Automatic Six-Month Extension for Statutory Elections. The automatic 12-month extension for regulatory elections under Regs. § 301.9100-2 does not apply for any GST tax election. However, the automatic six-month extension applies to both statutory and regulatory elections.
 - b. The automatic six-month extension applies only if the original return was timely filed, including extensions.
 - c. The six-month period is measured from the original due date, excluding extensions.
 - d. This allows a practitioner who promptly discovers that a return was timely filed but failed to make a GST election to correct the error.
 - e. No application for relief is necessary since the extension is automatic.
 - f. The regulations provide merely that the amended return contain a statement at the top of the document as follows: “FILED PURSUANT TO §301.9100-2.”
2. 9100 Relief for Allocating GST Exemption.
 - a. The enactment of Section 2642(g)(1) under the 2001 TRA made it possible to request an extension of time to make a timely allocation of GST exemption under Treasury Regulations § 301.9100-3 (“9100-3 relief”).

⁷⁶ I.R.C. § 2642(a)(3)(B)(ii).

- b. When Section 9100-3 relief is granted, the taxpayer is allowed to allocate exemption late, but have it treated as if the allocation were timely made.
 - c. Relief may be granted for allocating GST exemption, for making a reverse QTIP election for transfers after death and for electing out of the automatic allocation of GST exemption.
 - d. Relief is requested in the form of a private letter ruling.
 - e. The taxpayer must show that the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice the interests of the government.
 - f. In 2008, the IRS issued proposed regulations providing guidance on the circumstances in which the IRS would grant extensions. The regulations provide nonexclusive lists of factors that the IRS will consider when deciding if the taxpayer has satisfied these standards.
 - g. Some of the factors indicating that the taxpayer acted reasonably and in good faith include: intervening events beyond the transferor's control that caused the failure, the transferor's lack of awareness of the need to allocate exemption to the transfer despite the exercise of reasonable diligence (taking into account the transferor's experience and the complexity of the GST tax issue), and reasonable reliance by the transferor on the advice of a qualified tax professional.
 - h. The interests of the government would be prejudiced if granting the relief will permit the taxpayer to have a lower tax liability, in the aggregate for all taxable years affected by the election, than the taxpayer would have had if the election had been timely made. Essentially, the taxpayer will not be permitted to use hindsight to gain a tax advantage, but will be permitted relief when the taxpayer is merely achieving the intended tax result.
3. Substantial Compliance. Section 2642(g)(2) of the Code provides some breathing room in the allocation of GST exemption. Any allocation that demonstrates an intent to have the lowest possible inclusion ratio with respect to a transfer or trust will be deemed an allocation of so much of the transferor's unused GST exemption as produces the lowest possible inclusion ratio.⁷⁷

D. Applicability to Nonresident Aliens.

- 1. The regulations provide that an individual is a resident or citizen of the United States for GST tax purposes if the individual is a resident or citizen of the United States under the rules for Chapters 11 or 12.
 - a. Estate Tax. The gross estate of a non-resident alien is that part of his gross estate which at the time of his death is situated in the United States. Property situated in the U.S. includes U.S. real estate, tangible personalty

⁷⁷ I.R.C. § 2642(g)(2).

physically located in the U.S., and stock in a U.S. corporation regardless of the location of the certificates.

- b. Gift Tax. Nonresident aliens are subject to gift tax on property situated in the United States, which is real estate and tangible property located in the United States.
2. A nonresident alien has the same amount of GST tax exemption as a U.S. citizen.
 3. Direct Skips.
 - a. A direct skip transfer by a non-resident alien transferor is subject to GST tax only to the extent that the transfer is subject to the federal estate or gift tax within the meaning of Regs. § 26.2652-1(a)(2).
 4. Taxable Distributions and Taxable Terminations.
 - a. The GST tax applies to a taxable distribution or taxable termination to the extent that the initial transfer of property to the trust by a non-resident alien transferor, whether during life or at death, was subject to federal estate or gift tax within the meaning of Regs. § 26.2652-1(a)(2)..
 - b. This is the case regardless of the situs of the property at the time of the actual distribution or termination and regardless of the residency or citizenship of the skip persons receiving the property.
 5. Trusts Funded with U.S. and non-U.S. property.
 - a. For trusts funded with both U.S. and foreign situs property, the non-U.S. property is treated as exempt.⁷⁸

⁷⁸ Treas. Reg. § 26.2663-2(d), ex. 2, 3, 4.

Exhibit 1: Sample Form 706-GS(T)

Form **706-GS(T)** **Generation-Skipping Transfer Tax Return For Terminations**

(Rev. November 2013)

Department of the Treasury
Internal Revenue Service

► Use for terminations made after December 31, 2012.

► For calendar year 2016

► Information about Form 706-GS(T) and its separate instructions is at www.irs.gov/form706gst.

OMB No. 1545-1145

Part I General Information

1a Name of trust
Elizabeth Dynasty Trust

1b Trust's employer identification number (see instructions)
12-1234567

2a Name of trustee
Edward

2b Trustee's address (number and street or P.O. box; apt. or suite no.; city, town or post office; state and ZIP code) If you have a foreign address, also complete the spaces below (see instructions).

1234 Royal Drive, Houston, Texas 77002

Foreign country name	Foreign province/county	Foreign postal code
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Part II Trust Information (see the instructions)

	Yes	No	Sch. A number(s)
3 Has any exemption been allocated to this trust by reason of the deemed allocation rules of section 2632? If "Yes," describe the allocation on the line 7, Schedule A, attachment showing how the inclusion ratio was calculated		✓	N/A
4 Has property been contributed to this trust since the last Form 706-GS(T) or 706-GS(D-1) was filed? If "Yes," attach a schedule showing how the inclusion ratio was calculated		✓	
5 Have any terminations occurred that are not reported on this return because of the exceptions in section 2611(b)(1) or (2) relating to medical and educational exclusions and prior payment of Generation-Skipping Transfer (GST) tax? If "Yes," attach a statement describing the termination		✓	
6 Have any contributions been made to this trust that were not included in calculating the trust's inclusion ratio? If "Yes," attach a statement explaining why the contribution was not included		✓	N/A
7 Has the special QTIP election in section 2652(a)(3) been made for this trust?		✓	N/A
8 If this is not an explicit trust (see the instructions under <i>Who Must File</i>), check here and attach a statement describing the trust arrangement that makes its effect substantially similar to an explicit trust			

Part III Tax Computation

9a Summary of attached Schedules A (see instructions for line 9b)

Schedule A No.	GST tax (from Sch. A, line 10)
1	9a1 408,000.00
2	9a2
3	9a3
4	9a4
5	9a5
6	9a6
9b Total from all additional Schedules A, in excess of six, attached to this form	9b
10 Total GST tax (add lines 9a1 through 9b)	10 408,000.00
11 Payment, if any, made with Form 7004	11
12 Tax due. If line 10 is larger than line 11, enter the amount owed	12 408,000.00
13 Overpayment. If line 11 is larger than line 10, enter amount to be refunded	13 0.00

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

Signature of fiduciary or officer representing fiduciary: _____ Date: _____

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check <input type="checkbox"/> if self-employed	PTIN
Firm's name ► <u>Chamberlain Hrdlicka</u>	Firm's EIN ►			
Firm's address ► <u>1200 Smith Street, Houston, Texas 77002</u>	Phone no.			

Exhibit 2: Sample Form 706-GS(D)

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

Part I General Information

1a Name of skip person distributee <u>Dan Simpson</u>	1b Social security number of individual distributee (see instructions) <u>111-11-1111</u>
2a Name and title of person filing return (if different from 1a, see instructions)	1c Employer identification number of trust distributee (see instructions)

2b Address of distributee or person filing return (see instructions) (number and street or P.O. box; city, town, or post office; state; and ZIP code) If you have a foreign address, also complete the spaces below.

4445 First Avenue, Springfield, Texas 77000

Foreign country name	Foreign province/county	Foreign postal code
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Part II Distributions

a Trust EIN (from Form 706-GS(D-1), line 2a)	b Item no. (from Form 706-GS(D-1), line 3, column a)	c Amount of transfer (from Form 706-GS(D-1), line 3, column f (Tentative transfer))
<u>23-3456789</u>	<u>1</u>	<u>50,000.00</u>

3 Total transfers (add amounts in column **c**) **3** 50,000.00

Part III Tax Computation

4 Adjusted allowable expenses (see instructions)	4	<u>2,000.00</u>
5 Taxable amount (subtract line 4 from line 3)	5	<u>48,000.00</u>
6 Maximum federal estate tax rate (see instructions)	6	<u>40%</u>
7 Generation-skipping transfer tax (Multiply line 5 by line 6)	7	<u>19,200.00</u>
8 Payment, if any, made with Form 7004	8	
9 Tax due ▶	9	<u>19,200.00</u>
10 Overpayment. If line 8 is larger than line 7, enter amount to be refunded ▶	10	<u>0.00</u>

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

Sign Here	Signature of taxpayer or person filing on behalf of taxpayer		Date	
	Print/Type preparer's name	Preparer's signature	Date	Check <input type="checkbox"/> if self-employed PTIN
Paid Preparer Use Only	Firm's name ▶ <u>Chamberlain Hrdlicka</u>		Firm's EIN ▶	
	Firm's address ▶ <u>1200 Smith Street, Houston, Texas 77002</u>		Phone no.	

Exhibit 3: Sample Form 706-GS(D-1)

**Notification of Distribution From a
 Generation-Skipping Trust**
 Complete for each skip person distributee. See separate instructions.
 For calendar year 2016.

Copy A: Send to IRS

Part I General Information

1a Skip person distributee's identifying number (see instructions) <u>111-11-1111</u>	2a Trust's employer identification number (see instructions) <u>23</u> <u>3456789</u>
1b Skip person distributee's name, address, and ZIP code <u>Dan Simpson</u> <u>4445 First Avenue, Springfield, Texas 77000</u>	2b Trust's name, address, and ZIP code <u>Homer Family Trust</u> <u>Marge Trust Company, Trustee</u> <u>999 Elementary Street</u> <u>Springfield, Texas 77000</u>

Part II Distributions

3 Describe each distribution below. (see instructions)

a Item no.	b Description of property	c Date of distribution	d Inclusion ratio	e Value (see instructions)	f Tentative transfer (multiply col. e by col. d)
1	<u>500 shares of stock in XYZ Corporation traded on the NASDAQ, CUSIP R123456-01</u> <u>The shares are valued at the sales price of \$100 per share.</u>	<u>8/1/16</u>	<u>.50</u>	<u>\$100,000.00</u>	<u>\$50,000.00</u>

Part III Trust Information (see instructions)

- 4** If this is not an explicit trust, check here and attach a statement describing the arrangement that makes its effect substantially similar to an explicit trust.
- 5** Has any property been contributed to this trust since the last Form 706-GS(T) or (D-1) was filed? If "Yes," attach a schedule showing how the trust's inclusion ratio has been refigured
- 6** Have any contributions been made to this trust since the last Form 706-GS(T) or (D-1) was filed that were not included in calculating the trust's inclusion ratio? If "Yes," attach a statement explaining why the contributions were not included.
- 7** Has any exemption been allocated to this trust by reason of the deemed allocation rules?

Yes	No
<input type="checkbox"/>	<input checked="" type="checkbox"/>
<input type="checkbox"/>	<input checked="" type="checkbox"/>
<input type="checkbox"/>	<input checked="" type="checkbox"/>

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

Signature of trustee ► Date ►

Signature of preparer other than trustee ► Date ►

Address ►

**Notification of Distribution From a
Generation-Skipping Trust**

Complete for each skip person distributee. See separate instructions.
For calendar year 2016.

**Copy B: For
Distributee**

Part I General Information

<p>1a Skip person distributee's identifying number (see instructions) 111-11-1111</p>	<p>2a Trust's employer identification number (see instructions) 23 3456789</p>
<p>1b Skip person distributee's name, address, and ZIP code Dan Simpson 4445 First Avenue, Springfield, Texas 77000</p>	<p>2b Trust's name, address, and ZIP code Homer Family Trust Marge Trust Company, Trustee 999 Elementary Street Springfield, Texas 77000</p>

Part II Distributions

3 Describe each distribution below (see instructions).

a Item no.	b Description of property	c Date of distribution	d Inclusion ratio	e Value (see instructions)	f Tentative transfer (multiply col. e by col. d)
1	500 shares of stock in XYZ Corporation traded on the NASDAQ, CUSIP R123456-01 The shares are valued at the sales price of \$100 per share.	8/1/16	.50	\$100,000.00	\$50,000.00

Skip person distributee. To report this distribution, you must file Form 706-GS(D), Generation-Skipping Transfer Tax Return for Distributions, at the following address: Department of the Treasury, Internal Revenue Service Center, Cincinnati, OH 45999.

Exhibit 4: 2016 Form 709, Page 5

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

Check here if you are making a section 2652(a)(3) (special QTIP) election (see instructions)

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

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

Part 3—Tax Computation

A Item No. (from Schedule D, Part 1)	B Net Transfer (from Schedule D, Part 1, col. D)	C GST Exemption Allocated	D Divide col. C by col. B	E Inclusion Ratio (Subtract col. D from 1.000)	F Maximum Estate Tax Rate	G Applicable Rate (multiply col. E by col. F)	H Generation-Skipping Transfer Tax (multiply col. B by col. G)
1					40% (.40)		
					40% (.40)		
					40% (.40)		
					40% (.40)		
					40% (.40)		
					40% (.40)		
Gifts made by spouse (for gift splitting only)							
					40% (.40)		
					40% (.40)		
					40% (.40)		
					40% (.40)		
					40% (.40)		
Total exemption claimed. Enter here and on Part 2, line 4, above. May not exceed Part 2, line 3, above		Total generation-skipping transfer tax. Enter here; on page 3, Schedule A, Part 4, line 10; and on page 1, Part 2—Tax Computation, line 16					

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

Exhibit 5: Form 706, Schedule R

SCHEDULE R—Generation-Skipping Transfer Tax

Note. To avoid application of the deemed allocation rules, Form 706 and Schedule R should be filed to allocate the GST exemption to trusts that may later have taxable terminations or distributions under section 2612 even if the form is not required to be filed to report estate or GST tax.

The GST tax is imposed on taxable transfers of interests in property located outside the United States as well as property located inside the United States. (see instructions)

Part 1. GST Exemption Reconciliation (Section 2631) and Special QTIP Election (Section 2652(a)(3))

You no longer need to check a box to make a section 2652(a)(3) (special QTIP) election. If you list qualifying property in Part 1, line 9 below, you will be considered to have made this election. See instructions for details.

1 Maximum allowable GST exemption	1	
2 Total GST exemption allocated by the decedent against decedent's lifetime transfers	2	
3 Total GST exemption allocated by the executor, using Form 709, against decedent's lifetime transfers	3	
4 GST exemption allocated on line 6 of Schedule R, Part 2	4	
5 GST exemption allocated on line 6 of Schedule R, Part 3	5	
6 Total GST exemption allocated on line 4 of Schedule(s) R-1	6	
7 Total GST exemption allocated to <i>inter vivos</i> transfers and direct skips (add lines 2–6)	7	
8 GST exemption available to allocate to trusts and section 2032A interests (subtract line 7 from line 1)	8	
9 Allocation of GST exemption to trusts (as defined for GST tax purposes):		

A Name of trust	B Trust's EIN (if any)	C GST exemption allocated on lines 2–6, above (see instructions)	D Additional GST exemption allocated (see instructions)	E Trust's inclusion ratio (optional—see instructions)

9D Total. May not exceed line 8, above	9D	
10 GST exemption available to allocate to section 2032A interests received by individual beneficiaries (subtract line 9D from line 8). You must attach special-use allocation statement (see instructions) .	10	

Decedent's social security number

Estate of:

Part 2. Direct Skips Where the Property Interests Transferred Bear the GST Tax on the Direct Skips

Name of skip person	Description of property interest transferred	Estate tax value

1 Total estate tax values of all property interests listed above	1	
2 Estate taxes, state death taxes, and other charges borne by the property interests listed above	2	
3 GST taxes borne by the property interests listed above but imposed on direct skips other than those shown on this Part 2 (see instructions)	3	
4 Total fixed taxes and other charges (add lines 2 and 3)	4	
5 Total tentative maximum direct skips (subtract line 4 from line 1)	5	
6 GST exemption allocated	6	
7 Subtract line 6 from line 5	7	
8 GST tax due (divide line 7 by 3.5)	8	
9 Enter the amount from line 8 of Schedule R, Part 3	9	
10 Total GST taxes payable by the estate (add lines 8 and 9). Enter here and on line 17 of Part 2—Tax Computation	10	

Decedent's social security number

Estate of:

Part 3. Direct Skips Where the Property Interests Transferred Do Not Bear the GST Tax on the Direct Skips

Name of skip person	Description of property interest transferred	Estate tax value

1 Total estate tax values of all property interests listed above	1	
2 Estate taxes, state death taxes, and other charges borne by the property interests listed above	2	
3 GST taxes borne by the property interests listed above but imposed on direct skips other than those shown on this Part 3 (see instructions)	3	
4 Total fixed taxes and other charges (add lines 2 and 3)	4	
5 Total tentative maximum direct skips (subtract line 4 from line 1)	5	
6 GST exemption allocated	6	
7 Subtract line 6 from line 5	7	
8 GST tax due (multiply line 7 by .40). Enter here and on Schedule R, Part 2, line 9	8	

**SCHEDULE R-1
(Form 706)**

(Rev. August 2013)
Department of the Treasury
Internal Revenue Service

Generation-Skipping Transfer Tax

Direct Skips From a Trust
Payment Voucher

OMB No. 1545-0015

Executor: File one copy with Form 706 and send two copies to the fiduciary. Do not pay the tax shown. See instructions for details.
Fiduciary: See instructions for details. Pay the tax shown on line 6.

Name of trust		Trust's EIN
Name and title of fiduciary	Name of decedent	
Address of fiduciary (number and street)	Decedent's SSN	Service Center where Form 706 was filed
City, state, and ZIP or postal code	Name of executor	
Address of executor (number and street)	City, state, and ZIP or postal code	
Date of decedent's death	Filing due date of Schedule R, Form 706 (with extensions)	

Part 1. Computation of the GST Tax on the Direct Skip

Description of property interests subject to the direct skip	Estate tax value
1 Total estate tax value of all property interests listed above	1
2 Estate taxes, state death taxes, and other charges borne by the property interests listed above	2
3 Tentative maximum direct skip from trust (subtract line 2 from line 1)	3
4 GST exemption allocated	4
5 Subtract line 4 from line 3	5
6 GST tax due from fiduciary (divide line 5 by 3.5). (See instructions if property will not bear the GST tax.)	6

Under penalties of perjury, I declare that I have examined this document, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature(s) of executor(s) _____
Date

Date

Signature of fiduciary or officer representing fiduciary _____
Date

Instructions for the Trustee

Introduction

Schedule R-1 (Form 706) serves as a payment voucher for the Generation-Skipping Transfer (GST) tax imposed on a direct skip from a trust, which you, the trustee of the trust, must pay. The executor completes the Schedule R-1 (Form 706) and gives you two copies. File one copy and keep one for your records.

How to pay

You can pay by check or money order or by electronic funds transfer.

To pay by check or money order:

- Make it payable to "United States Treasury."
- The amount of the check or money order should be the amount on line 6 of Schedule R-1.
- Write "GST Tax" and the trust's EIN on the check or money order.

To pay by electronic funds transfer:

- Funds must be submitted through the Electronic Federal Tax Payment System (EFTPS).
 - Establish an EFTPS account by visiting www.eftps.gov or calling 1-800-555-4477.
 - To be considered timely, payments made through EFTPS must be completed no later than 8 p.m. Eastern time the day **before** the due date.
-

Signature

You must sign the Schedule R-1 in the space provided.

What to mail

Mail your check or money order, if applicable, and the copy of Schedule R-1 that you signed.

Where to mail

Mail to the Department of the Treasury, Internal Revenue Service Center, Cincinnati, OH 45999.

When to pay

The GST tax is due and payable 9 months after the decedent's date of death (shown on the Schedule R-1). You will owe interest on any GST tax not paid by that date.

Automatic extension

You have an automatic extension of time to file Schedule R-1 and pay the GST tax. The automatic extension allows you to file and pay by 2 months after the due date (with extensions) for filing the decedent's Schedule R (shown on the Schedule R-1).

If you pay the GST tax under the automatic extension, you will be charged interest (but no penalties).

Additional information

For more information, see section 2603(a)(2) and the Instructions for Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return.
