CHAPTER 2

Estate, Gift, and Generation-Skipping Transfer Taxes

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CHAPTER 2

Estate, Gift, and Generation-Skipping Transfer Taxes*

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Scope Note

This chapter begins with a discussion of the federal estate tax, including the unified credit and the marital deduction, and continues with a discussion of the Rhode Island estate tax. It then turns to the federal gift tax and the generation-skipping transfer (GST) tax, with practical tips for will and trust drafting for clients who do not intend to skip generations. Exhibits include several hypothetical situations that can trigger the GST tax.

§ 2.1 FEDERAL ESTATE TAX

§ 2.1.1 In General

The federal estate tax is set forth in Chapter 11 of the Internal Revenue Code, beginning with Section 2001. It imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

In 2001, the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001) became law. This 2001 Act provided for an increase in the estate tax exemption (or unified credit amount) to $3.5 million in 2009, and eliminated the estate tax for decedents dying in 2010. The gift tax exemption rose over the same time period to $1 million, and the GST exemption was increased to $3.5 million as well.

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On December 17, 2010, the passage of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 again changed the transfer tax regime for 2010 through 2012, but promised a return to 2001 exemption and tax rates if no further legislation is enacted by January 1, 2013. An exemption amount of $5 million applies to estate taxes, gift taxes, and generation-skipping taxes. Estates of decedents dying in 2010 can choose between two possible tax regimes—a $5 million exemption, with a flat tax of 35 percent for taxable assets in excess of the exemption and a carryover basis for all assets; or no estate taxes, but with carryover basis (with some adjustments) for all assets included in the taxable estate.

These legislative changes have made it difficult for a practitioner to predict the estate tax exemption and rates that might be applicable to a particular client, and have made flexibility in the drafting of estate plans particularly important. Fortunately, the basic rules for determining the taxable estate and the resultant estate tax have remained largely consistent.

§ 2.1.2 Determining the Tax

Where there is an estate tax, determining the tax generally involves taking the following steps.

(a) *Add Up Value of Decedent's Gross Estate*

Add up the value of the decedent's gross estate (I.R.C. § 2031), which includes, among other things, the following:

- all interests in property the decedent owned at his or her death (I.R.C. § 2033);
- property the decedent gave away during life but in which he or she retained an income interest, the use and enjoyment of the property, or the right to control someone else's use and enjoyment of the property (I.R.C. § 2036);
- property the decedent gave away during life but over which he or she retained the right to revoke the transfer or change the transferee (I.R.C. § 2038);
- annuities and retirement plans (I.R.C. § 2039);
- property owned jointly with right of survivorship (I.R.C. § 2040);

- property over which the decedent had a general power of appointment (power to appoint to himself or herself, his or her estate, his or her creditors, or creditors of his or her estate) (I.R.C. § 2041); and

- proceeds of life insurance on his or her life if the decedent owned the policy (I.R.C. § 2042), or if he or she transferred ownership of the policy within three years of death (I.R.C. § 2035).

For valuation of property, the general rule is that property must be valued at its fair market value as of the date of death. An executor may elect to use an "alternate valuation date" of six months after the date of death if, by doing so, the value of the gross estate and the resulting estate tax will be lower. I.R.C. § 2032. Section 2032 requires that if alternate valuation is to be elected, it must be elected for all estate assets.

(b) *Determine Taxable Estate*

Determine the taxable estate (I.R.C. § 2051) by subtracting from the gross estate the following deductions:

- funeral expenses, estate administration expenses, and debts of the decedent (I.R.C. § 2053);

- value of property passing to charities (I.R.C. § 2055);

- value of property passing to the surviving spouse (I.R.C. § 2056);

- value of certain interests in family-owned businesses (I.R.C. § 2057). (This deduction is limited to $675,000 if the value of the business represents at least half of the estate. Generally, the decedent's family must own at least 50 percent of the business or only 30 percent of the business if only one or two other families own most of the rest of the business. Family members must generally remain active in the business for ten years after the owner dies to avoid recapture of the estate tax savings. However, under the 2001 Act, this deduction expired as of January 1, 2004, i.e., for decedents dying after December 31, 2003.); and

- the amount of any state death taxes paid by the estate (I.R.C. § 2058). This replaced the limited credit for state death taxes paid by the estate that was provided for in I.R.C. § 2011. See § 2.1.5, State Death Tax Credit, below.

(c) *Determine Initial Tax*

Determine the initial tax by applying the graduated tax rates to the taxable estate (I.R.C. § 2001). See § 2.1.4, Tax Rates, below.

(d) *Subtract Initial Tax-by-Tax Credits*

Subtract the initial tax-by-tax credits, which include the following:

- the unified credit (I.R.C. § 2010) (see § 2.1.3, Unified Credit, below);
- the state death tax credit for estate taxes paid to a state, up to a limit that is based on the size of the taxable estate (I.R.C. § 2011; see § 2.1.5, State Death Tax Credit, below. As indicated above, under the 2001 Act, beginning in 2005, this *credit* was repealed and replaced with a *deduction* for state death taxes paid by the estate.); and
- the credit for estate tax paid in someone else's estate with respect to property transferred to the decedent within ten years of the decedent's death (I.R.C. § 2013).

(e) *File Return and Pay Tax*

If the gross estate does not exceed the applicable exclusion amount from the table set forth in § 2.1.3, below, file the tax return and pay any tax that may be due. Form 706 (federal estate tax return) and payment of federal estate taxes are due nine months from the date of death. An executor may request and receive an automatic six-month extension on the time for filing the return, but this will not extend the deadline for paying the tax. An executor may request an extension of the time to pay the tax for reasonable cause or undue hardship. Treas. Reg. § 20.6081-1(c). Form 4768 is used for both the automatic and discretionary extension application. In cases where the estate consists largely of an interest in a closely held business, payment of the tax may be deferred for five years and then paid in installments over ten years under I.R.C. § 6166, Treas. Reg. § 20.6166-1.

(f) *File Return Even if No Estate Tax Is Due*

For estates of decedents dying in 2010 that elect out of the estate tax, filing of Form 8939 is required to show the carryover basis of assets included in the estate.

The 2010 Act introduced the concept of portability. The exemption that is not used by the first spouse to die is available to the surviving spouse. However, the

first spouse's estate is required to file an estate tax return to elect portability, even if the first spouse's assets would not otherwise require a return to be filed.

§ 2.1.3 Unified Credit

Every individual may exempt up to a certain amount (according to the schedule below) of lifetime transfers from the federal gift tax, and to the extent that an individual does not use the exemption during life, it is available as an exemption from federal estate tax at death. Under the 2001 Act, this exemption from gift and estate tax was increased to $1 million in 2002. For estate tax purposes only, the exemption was gradually increased until it reached $3.5 million in 2009 (I.R.C. § 2010), while the gift tax exemption has remained frozen at $1 million. The following schedule summarizes the estate and gift tax exemptions:

For transfer in year:	Applicable exclusion amount sheltered from estate tax:	Applicable exclusion amount sheltered from gift tax:
2000 and 2001	$ 675,000	$ 675,000
2002 and 2003	$1,000,000	$1,000,000
2004 and 2005	$1,500,000	$1,000,000
2006, 2007, and 2008	$2,000,000	$1,000,000
2009	$3,500,000	$1,000,000
2010	Estate tax repealed	$1,000,000
2011–2012	$5,000,000	$5,000,000

This exemption is given in the form of a credit against gift and estate taxes (hence the term "unified credit"). In other words, lifetime transfers and transfers at the time of death up to the applicable exclusion amount will be subject to a gift or estate tax at specified rates, but the available credit will eliminate that tax.

Example

A decedent who died in 2002 and who never used any of her unified credit during her lifetime could leave a $1 million estate to her children, and the federal estate tax would be calculated as follows:

Taxable estate	$1,000,000
Initial tax at graduated rates	$345,800
Unified credit	(345,800)
Tax due	$0

Under I.R.C. § 2010, the estate tax unified credit for every decedent dying in a specific year is sufficient to "shelter" the transfer of the applicable exclusion amount for that year. However, gifts made during life that used up some of the credit must also be factored in. This is discussed in the next section.

§ 2.1.4 Tax Rates

Prior to 2002, the estate and gift tax rates ranged from 18 to 55 percent, with fifteen brackets in between. Under the 2001 Act, the maximum rates are reduced according to the following schedule:

For transfer in year:	Highest estate and gift tax rate:
2002	50%
2003	49%
2004	48%
2005	47%
2006	46%
2007, 2008, and 2009	45%
2010	35%, for gift tax only
2011 and 2012	35%

An aggressive taxpayer might hope to divide the transfer of his or her estate into many gifts during his or her lifetime, and one last transfer at death, to make use of the "bracket ride" each time a gift tax or estate tax is computed. Therefore, I.R.C. § 2001 requires that for the purposes of computing the estate tax, all taxable gifts made by the decedent after 1976, other than gifts already included in the gross estate (for example, a gift in which the decedent retained an interest), must be added to the taxable estate. Gifts that qualified for the annual gift tax exclusion (discussed in § 2.3.12(a), below) are not added back. However, gifts that gave rise to gift tax, or gifts that would have given rise to gift tax but were sheltered by use of the unified credit, are added back. After the taxable estate and these "adjusted taxable gifts" are added together, a "tentative tax" is computed on the total, which pushes the taxable estate up into the highest brackets that would have applied had the adjusted taxable gifts not been made until the decedent's death. Finally, so as not to overcharge the estate, the tentative tax is reduced by gift taxes payable on all gifts made after 1976, and the full unified credit is "restored" under I.R.C. § 2010.

Example

In 2002, Barbara makes a $500,000 gift to a trust for her children and pays no federal gift tax by using her unified credit on the gift tax return. At her subsequent death in 2003, she has a taxable estate of $1 million. Her federal estate tax is computed as follows:

Taxable estate	$1,000,000
Adjusted taxable gifts	$500,000
Tentative tax at graduated rates	$555,800
Credit for gift taxes payable since 1976	(0)
Unified credit	(345,800)
Tax due	$210,000

For decedents dying before January 1, 2002, the benefits of the bracket ride (and for decedents dying before 1998, the benefits of the unified credit as well) were phased out in estates that exceeded $10 million. Section 2001(c)(2) of the Internal Revenue Code (the Code) accomplished this by imposing an extra 5 percent surtax until such benefits were recaptured. Prior to 1998, the benefits that were being phased out totaled $552,000 ($359,200 savings from the lower estate brackets and $192,800 from the unified credit), and the surtax fully eliminated such benefits when an estate reached $21,040,000. Thus for estates of that size the federal estate tax rate would reach 60 percent. Beginning in 1998, the purpose of the 5 percent surtax was solely to phase out the benefits of the lower estate tax brackets, worth $359,200, which was eliminated fully when an estate reached $17,184,000. Beginning in 2002, the 2001 Act eliminated the 5 percent surtax on estates that exceed $10 million.

§ 2.1.5 State Death Tax Credit

As discussed above, under the 2001 Act, beginning in 2005, the state death tax credit was repealed and replaced with a deduction for state death taxes paid by the estate. In years 2002 through 2004, the state death tax credit was phased out as follows:

- in 2002, only 75 percent of the credit as computed is allowed;
- in 2003, only 50 percent of the credit as computed is allowed; and
- in 2004, only 25 percent of the credit as computed is allowed.

An understanding of how the state death tax credit is computed after 2004 is important because future federal tax law changes could reinstate it (and the sunset provisions of the 2010 Act would reinstate the credit in 2013) and also because many states, including Rhode Island, have structured their state death tax

laws to require a computation of the federal state death tax credit (with certain adjustments), whether or not the federal estate tax recognizes such a credit. See the discussion of the Rhode Island estate tax in § 2.2.5, Planning for the Rhode Island Estate Tax in 2002 and Beyond, below.

Section 2011 of the Code provides a credit for some, but not necessarily all, of the state death taxes paid by the estate. Computing the potential size of the maximum credit depends on the size of the federal taxable estate and has nothing to do with the amount of state death taxes. The credit applies only to the extent the estate actually pays state death taxes.

Example

If Sam's taxable estate (Sam having died in 1997) were $600,000, the maximum state death tax credit would be $14,000. So if the estate actually paid at least $14,000 in state death taxes, the federal estate tax could be credited by that amount. Of course, if Sam still has his whole unified credit, no federal estate tax will be due after applying the unified credit, and the state death tax credit will not apply.

§ 2.1.6 Marital Deduction

Section 2056 of the Code provides a deduction for the value of property passing to the surviving spouse. The marital deduction is merely a tool for deferring the estate tax until the death of the surviving spouse. Before 1981, the marital deduction was limited to only a fraction of the total estate, which is why the current, more generous deduction is referred to as a "100 percent marital deduction." The marital deduction is available for property passing outright from a decedent to the surviving spouse. In addition, although Section 2056(b) generally denies the marital deduction if the surviving spouse's interest in the property might terminate at some future time, such as through a trust that terminates at the surviving spouse's death ("terminable interest"), there are major exceptions to this general rule in that the marital deduction is available, and the terminable interest rule does not apply, for property passing to any of the following trusts:

- *QTIP trust.* A qualified terminable interest property (QTIP) trust is described in I.R.C. § 2056(b)(7) as a trust that receives "qualified terminable interest property," which means that the trust must meet all of the following requirements:
  - The property passes to the trust from the decedent, meaning that the estate plan must contain directions to get the property to the trust. Generally, neither the surviving spouse nor the

executor can unilaterally place property in the trust and expect to qualify the trust as a QTIP trust.

- The surviving spouse has a "qualifying income interest" for his or her life in the property, meaning that the spouse is entitled to all the income from the property, payable annually or at more frequent intervals, and that principal can never be paid to anyone other than the surviving spouse.

- The decedent's executor makes a QTIP election on the estate tax return, which on the most current Form 706 can be done by simply listing the trust property under Item A1 on Schedule M.

Property in which the surviving spouse has a legal life estate can also qualify for QTIP treatment.

Property for which a QTIP marital deduction is allowed will be included in the surviving spouse's estate under I.R.C. § 2044.

- *General power of appointment trust*. If the surviving spouse is entitled for life to all the income of a trust, payable annually or at more frequent intervals, and if the surviving spouse has the power, exercisable during his or her life or by will, to appoint the trust property to himself or herself, his or her estate, his or her creditors, or the creditors of his or her estate, and if trust property cannot otherwise be distributed to anyone other than the surviving spouse, then I.R.C. § 2056(b)(5) provides that the property passing to the trust qualifies for the marital deduction. The general power of appointment trust will be included in the surviving spouse's estate under I.R.C. § 2041.

- *Estate trust.* A trust that is not for the benefit of anyone other than the surviving spouse, whether it requires any income distributions to the spouse or permits the income to be accumulated, and which pays to the surviving spouse's estate all property remaining in the trust at the spouse's subsequent death, does not constitute a terminable interest, and thus property passing to such an estate trust qualifies for the marital deduction. Treas. Reg. § 20.2056(c)-2(b)(1)(iii). The estate trust will be included in the surviving spouse's estate under I.R.C. § 2033. (The estate trust is much rarer than outright gifts, QTIP trusts, or general power of appointment trusts.)

In cases where the surviving spouse is not a U.S. citizen, Congress was concerned that the Internal Revenue Service (IRS) may be unable to collect the deferred

estate tax when the surviving spouse dies. The solution is I.R.C. §§ 2056(d) and 2056A, which deny the marital deduction for any transfer to a surviving spouse who is not a U.S. citizen unless the transfer is to a qualified domestic trust (QDOT). The regulations set forth the requirements for a QDOT, which are much like those for a QTIP, with added rules about a U.S. citizen being a trustee and—in cases where the QDOT owns substantial real property located outside the United States or where the value of the QDOT exceeds $2 million—provision of security to ensure future collection of the deferred tax. Treas. Reg. § 20.2056A. See *A Practical Guide to Estate Planning in Rhode Island* ch. 4 (MCLE, Inc. 2011).

§ 2.1.7 Tax-Inefficient Estate Plan

If a decedent leaves his or her entire estate to his or her spouse, no tax will be due because of the marital deduction. Instead, the estate tax on the decedent's property will be deferred until the spouse's subsequent death. But at that later death, the spouse's estate will have only the spouse's estate tax credits available, and the couple will have lost the use of the testator's estate tax credits.

Example

Sam and Danielle each have $1,500,000 of assets in his and her own name. Sam dies in 2002, leaving everything to Danielle by beneficiary designation or by joint ownership with rights of survivorship and/or under a will or a living trust. Assuming for simplicity's sake that his estate had no deductions other than the marital deduction, his federal estate tax computation would look like this:

Gross estate	$1,500,000
Marital deduction	(1,500,000)
Taxable estate	$0
Tax due	$0

At Danielle's subsequent death in 2003, because her estate includes her own property plus what she received from her husband, the federal estate tax computation (without any further change in values) would look as follows:

Gross estate	$3,000,000
Marital deduction	0
Taxable estate	$3,000,000
Initial tax at graduated rates	$1,270,800
Unified credit	(345,800)
State death tax credit	(91,000)
Tax due	$834,800

If Sam died in 2011 or 2012, the concept of portability would permit Danielle to use Sam's unused estate tax credits upon her later death. However, portability may not be available after 2012. Also, Rhode Island law does not incorporate the portability concept, and the same notions of tax-efficient or inefficient planning are applicable when planning to minimize Rhode Island estate taxes.

§ 2.1.8 Tax-Efficient Estate Plan

A tax-efficient estate plan would make use of the unified credit of the first spouse to die, and then use the marital deduction to defer any federal estate tax until the surviving spouse's death. The will or living trust of the first spouse to die would place the amount that can be sheltered by the deceased spouse's federal unified credit in further trust for the benefit of the surviving spouse, or for the benefit of the surviving spouse and the couple's descendants. This "credit shelter trust" need not qualify for the marital deduction because it will be sheltered by the deceased spouse's unified credit. The balance of the estate would be designated to pass to the surviving spouse in a manner that qualifies for the marital deduction. See § 2.1.6, above, for a discussion of the federal estate tax marital deduction.

Example

Sam's federal estate tax computation (for death in 2002) with a tax-efficient estate plan would look as follows:

Gross estate	$1,500,000
Marital deduction	(500,000)
Taxable estate	$1,000,000
Initial tax at graduated rates	$345,800
Unified credit	(345,800)
State death tax credit	(0)
Tax due	$0

At Danielle's death in 2003, the federal tax computation (without any further change in values) would look as follows:

Gross estate	$2,000,000
Marital deduction	0
Taxable estate	$2,000,000
Initial tax at graduated rates	$780,800
Unified credit	(345,800)
State death tax credit	(49,800)
Tax due	$385,200

Note that Sam's taxable estate will be even higher if part of the marital deduction is lost because part of the $500,000 is used for a nondeductible purpose. Therefore, the estate plan should ensure that at the first death all nondeductible expenses (such as state death taxes or administration expenses that are deducted for income tax purposes rather than for estate tax purposes) are paid out of the credit shelter trust.

As previously noted, portability may make the first spouse's unused unified credit available to the second spouse to die. However, tax-efficient tax planning is still required to minimize Rhode Island estate taxes.

§ 2.1.9 Alternative Tax-Efficient Plan Using Partial QTIP Election

If a decedent leaves his or her entire estate to a QTIP trust for the benefit of the surviving spouse, will the decedent's unified credit be wasted? Not if the decedent's executor decides to make only a partial QTIP election. Remember, a trust for the sole benefit of the surviving spouse that pays the surviving spouse all of the income is merely "QTIP-able." It is not a QTIP trust until the QTIP election is made on the estate tax return. Conceivably, no election might be made, in which case all the property passing to the trust is subject to tax in the first estate and the decedent's estate tax credits will be used. Or, the legal representative could make a partial QTIP election, qualifying for the marital deduction only the smallest portion of the trust needed to reduce the federal estate tax to zero after taking into account the available unified credit. The fraction of the whole trust that represents the portion for which the partial QTIP election is made is the fraction that is to be applied to the whole trust at the surviving spouse's subsequent death in order to determine how much of the trust must then be included in the spouse's estate. See the final regulations under Treas. Reg. § 20.2056(b)-7 for important rules for making a partial QTIP election and for guidance on when a trustee may then create separate trusts for the elected portion and the nonelected portion.

The partial QTIP election can be extremely helpful in states such as Rhode Island that have "decoupled" their state estate tax from the federal estate tax and permit different QTIP elections for state and federal purposes. See § 2.2.5, below, for planning ideas.

Practice Note

A downside of using a partial QTIP election rather than a separate credit shelter trust is that all of the income of the QTIP trust, both from the elected portion and the nonelected portion, must be paid to

the surviving spouse, since such income will serve to build up his or her taxable estate if not spent by the surviving spouse. On the other hand, income distributed to the surviving spouse may incur a smaller income tax burden than income accumulated in a separate credit shelter trust, because the income tax brackets for trusts are more compressed than the brackets for individuals. To avoid this result, the marital trust may be drafted so that the nonelected portion passes to a trust that does not mandate income distribution to the surviving spouse. *See Clayton Estate v. Comm'r*, 97 T.C. 327 (1991).

§ 2.1.10 Alternative Tax-Efficient Plan Using Disclaimer

The same efficient tax results described above can be achieved if the will or living trust leaves everything outright to the surviving spouse, with a further provision that if the surviving spouse were to disclaim any portion of the bequest, the disclaimed property would then pass to the credit shelter trust. The surviving spouse might have the tax incentive to disclaim the amount sheltered by the decedent's federal unified credit. In this plan, the decision of whether the proposed future tax savings are worth the imposition of a trust can be made by the surviving spouse. The disclaimer by the surviving spouse must be a "qualified disclaimer" under the requirements of I.R.C. § 2518 in order to avoid having the resulting transfer treated as a gift.

Practice Note

In some circumstances it may be advisable for the practitioner to convey to the client the pros and cons of a mandatory credit shelter versus a disclaimer plan. The mandatory plan has the nontax advantages of the testator controlling the disposition of the remainder and protecting the property from the spouse's creditors. The disclaimer plan gives the property protection from the spouse's creditors only if the spouse in fact disclaims, and even then, due to its broad definitions of "transfer" and "fraudulent transfer," Rhode Island's fraudulent transfer law (R.I. Gen. Laws § 6-16-1 et seq.) may very well cause the disclaimer to be defeatable by present and future creditors if it would render the spouse insolvent. In the mandatory plan, the spouse can have a testamentary special power of appointment. In a disclaimer plan, because of qualified disclaimer requirements, the spouse cannot retain any testamentary power of appointment.

Practice Note

Rather than even considering the alternative of a "disclaimer plan" and be left with the uncertainty as to whether the surviving spouse will actually disclaim even in the case where it makes tax planning

sense to do so, instead the surviving spouse can be named as sole trustee of the credit shelter trust and will not be considered the owner of the trust for estate tax purposes if his or her discretionary power to consume, invade, or appropriate trust property for himself or herself is limited by an "ascertainable standard" relating to "health, education, support or maintenance."

§ 2.1.11 Establishing the Marital and Credit Shelter Shares

If a testator or trustmaker wants to create separate marital and credit shelter shares, a formula usually is drafted into the governing instrument to divide the estate because it cannot be predicted how much of the credit shelter will remain at death or be used up in the estate by nondeductible items. Some of the common formula choices (with a few pros and cons) are set out in the following sections. The formulas discussed in these subsections are generally used when the assets at the time of death exceed the available unified credit. If the federal unified credit remains at the $3.5 to $5 million range, many clients' assets will be below the federal unified credit. For these clients, formulas referring to the Rhode Island exemption amount rather than the unified credit share should be used.

Practice Note

Where this chapter refers to a "testator" making a provision in the governing instrument, it is referring to a provision under a will. Often, for purposes of avoiding Probate Court proceedings or otherwise, a decedent's dispositive provisions will have been made under a living trust (which has a companion will, one of the primary purposes of which is to "pour over" any probate assets to the living trust at death); and therefore the term "testator" when used in the context of making a provision under a governing instrument applies equally to a trustmaker (often instead referred to as a grantor, settlor, or trustor) making a provision under a living trust.

(a) *Pecuniary Marital Amount with Residuary Credit Shelter Share*

A pecuniary (fixed-dollar) marital bequest typically describes the minimum amount of property necessary to eliminate any federal estate tax after allowing for any available unified credit. The residue after this bequest represents the credit shelter share.

(b) *Pecuniary Credit Shelter Amount with Residuary Marital Share*

A pecuniary credit shelter bequest typically describes the maximum amount by which the federal taxable estate can be increased without causing an increase in the federal estate tax payable after taking into account the unified credit available against such tax. The residue after this bequest represents the marital share. In other words, the formula allocates to the credit shelter trust only that amount sheltered from tax by the available unified credit.

(c) *Fractional Credit Shelter and Marital Shares*

The fixed dollar pecuniary amounts described above can become fractional shares of the estate if the same language is used to describe the numerator of the fraction, the denominator of which is the value of the estate or living trust. The residue after such a fractional bequest is also a fractional share.

(d) *A Few Pros and Cons*

A pecuniary marital amount is often employed because it freezes the marital share at its date-of-death value. If property values in the estate appreciate during estate administration and before the two shares are fully funded, the appreciation inures to the benefit of the residuary credit shelter share, which, unlike the marital share, will not be subject to estate tax in the surviving spouse's estate.

Alternatively, many practitioners drafting for large estates find that the credit shelter amount is relatively small (especially if the unified credit has been used during life, or if there are significant state death taxes and other nondeductible items that will reduce the credit shelter trust), and that it is administratively easier to set aside the credit shelter as a pecuniary amount. Also, a decrease in values during administration could wipe out a residuary credit shelter disposition.

Note also that the funding of a pecuniary amount with appreciated property gives rise to the realization of gain. *See* Treas. Reg. § 1.1014-4(a)(3). So even with a step up in basis to the estate tax value, assets that appreciate thereafter, to the extent possible, should not be used to fund the pecuniary amount unless funding occurs promptly after death and before significant appreciation. It may be easier to find sufficient assets that have not appreciated during administration if the pecuniary amount is the smaller credit shelter disposition rather than the larger marital disposition.

As discussed in § 2.1.11(e), Valuation of Assets When Funding Shares, below, the funding of a pecuniary share is generally done with property valued as of the

date of funding. If an estate consists mostly of closely held business interests or other property that is difficult to value (and an effort has already been made to arrive at a value for estate tax purposes), using such interests to fund the pecuniary share will require revaluation of the interests on the date of funding. In large estates, this usually means that the smaller credit shelter share should be pecuniary, funded with other assets that are not difficult to value. On the other hand, a business interest likely to appreciate is a good choice for placement in the credit shelter trust (which is not subject to estate tax at the surviving spouse's death). If the interest is difficult to value, simply fund the trust very near the relevant estate tax valuation date.

The funding of a pecuniary amount with "income in respect of a decedent" (IRD)—such as funds from the decedent's qualified retirement plan, other types of deferred compensation, or installment notes, that have not yet been subjected to income tax—gives rise to acceleration of the deferred income. *See* I.R.C. § 691(a)(2). In an estate plan where IRD will comprise a large portion of the estate, fractional credit shelter and marital shares may be more appropriate.

Administration of an estate involving fractional credit shelter and marital shares can be burdensome if a partial distribution to one or the other of the two shares becomes desirable. Unless both shares are partially funded simultaneously in proportion to the relevant fraction, the fraction for future division of property must be recalculated.

(e) *Valuation of Assets When Funding Shares*

If a fiduciary were free to pick assets that have depreciated in value during estate administration and use them to fund the pecuniary marital amount at their higher estate tax value, then it would be possible to underfund the amount that actually passes to the surviving spouse, and thus reduce the estate tax due at the surviving spouse's subsequent death. To prevent this result, Rev. Proc. 64-19, 1964-1 C.B. 682 provides that in order for a marital deduction to be allowed with respect to a pecuniary amount, the fiduciary must be required (under state law or by the governing instrument) to fund that amount with assets that meet one of the following standards:

- the assets used to satisfy the pecuniary amount must have a value on the date of funding that is not less than the pecuniary amount, as that amount is determined for federal estate tax purposes. For example, in a tax-efficient estate tax plan calling for a pecuniary marital amount with a residuary credit shelter share, if the estate of a decedent dying in 2003 is valued at $1.5 million using values as determined for federal estate tax purposes, then the pecuniary

marital amount is $500,000, and the initial residuary credit shelter share (before values may change during estate administration) is $1 million. Staying with this example, the fair market value of the property used to fund the pecuniary marital amount must be at least $500,000 on the date of the funding of the pecuniary amount; or

- the assets used to satisfy the pecuniary amount must be fairly representative of the appreciation or depreciation in the value of all property available for distribution in satisfaction of the pecuniary amount.

Most governing instruments require that the pecuniary amount be funded at date of funding values, in order to avoid the complexity of the fairly representative test. Several technical advice memoranda, and, more recently Rev. Rul. 90-3, 1990-1 C.B. 174, have confirmed that the same rules will apply when funding under a plan calling for a pecuniary credit shelter amount with a residuary marital share.

§ 2.2 RHODE ISLAND ESTATE TAX

The Rhode Island estate tax law as set forth in R.I. Gen. Laws § 44-22-1.1 has different provisions for

- deaths occurring in years 1992 through 2001,
- deaths occurring in years 2002 through 2009, and
- deaths occurring in or after 2010.

The Rhode Island estate tax law for each of these three time frames is discussed below. Note that the following concepts apply:

- For Rhode Island residents who die owning real property or tangible personal property with an actual situs in another jurisdiction, and for residents of other states who died owning real property or tangible personal property with an actual situs in Rhode Island, the Rhode Island estate tax is in effect a pro rata tax on the Rhode Island situs property. R.I. Gen. Laws § 44-22-1.1(b), (e).
- The terms “gross taxable estate,” “net taxable estate,” and “federal gross estate,” when used in the Rhode Island estate tax law, are to have the same meaning as they do in the Internal Revenue Code

as in effect for the year of death with respect to deaths occurring before 2002, and as in effect on January 1, 2001 for deaths occurring in or after 2002. R.I. Gen. Laws § 44-22-1.1(c).

- The concept of "value" for Rhode Island estate tax purposes is the same as for federal estate tax purposes. R.I. Gen. Laws § 44-22-1.1(d).

Rhode Island had an estate tax for deaths occurring prior to 1992, but those provisions are not treated here.

§ 2.2.1 Deaths in Years 1992 Through 2001

For decedents whose death occurs on or after January 1, 1992, but prior to January 1, 2002, R.I. Gen. Laws § 44-22-1.1(a)(1) imposes a tax on the transfer of the net estate of every resident or nonresident decedent equal to the maximum credit for state death taxes allowed by I.R.C. § 2011. Thus, in effect, for those years the Rhode Island estate tax system was "coupled" with the federal estate tax system.

This system, used not only in Rhode Island but in many other states prior to 2002, was often referred to as "sponge tax" or "pick-up tax." Estates of residents of sponge tax states simply calculated their federal estate tax and paid the portion equal to the state death tax credit to their state and the rest to the IRS. But the 2001 Act phased out the state death tax credit over four years (2002 through 2005), and so in order to avoid having federal law effectively repeal their estate tax, many states, including Rhode Island, "decoupled" from the federal estate tax.

§ 2.2.2 Deaths in Years 2002 Through 2009

For decedents whose death occurs on or after January 1, 2002, but prior to January 1, 2002, R.I. Gen. Laws § 44-22-1.1(a)(2) imposes a tax on the transfer of the net estate of every resident or nonresident decedent equal to the maximum credit for state death taxes allowed by I.R.C. § 2011 as it was in effect on January 1, 2001. The tax was only imposed on net taxable estates exceeding $675,000. Thus, in effect, the Rhode Island estate tax system, having been coupled with the federal system for years and 1992 through 2001, has been "de-coupled" from the federal system ever since.

§ 2.2.3 Deaths on or After January 1, 2010

For decedents whose death occurs on or after January 1, 2010, R.I. Gen. Laws § 44-22-1.1(a)(3) continues to be decoupled from the federal system in the same manner as under § 2.2.2 above, except that the tax is only imposed on net taxable estates exceeding $850,000, and beginning on January 1, 2011, and each January 1 thereafter, the $850,000 amount is to be adjusted by the percentage of increase in the Consumer Price Index for all Urban Consumers (CPI-U) as published by the U.S. Department of Labor Statistics determined as of September 30 of the prior calendar year, compounded annually and rounded up to the nearest $5 increment.

Practice Note

An examination of the tax tables on the last page of the Rhode Island Estate Tax Form 100A for estates of decedents who die after 2001 with a gross estate exceeding the Rhode Island exemption reveals that for the first $75,000 of taxable estate, the effective Rhode Island estate tax rate is nearly 39 percent.

§ 2.2.4 The Rhode Island QTIP Election

As discussed in § 2.1.6, above, a decedent's estate must make an election on the federal estate tax return to make "qualified terminable interest property" as described in § 2.1.6 eligible for the federal estate tax marital deduction. But many estate plans prepared for married Rhode Island clients since the enactment of the 2001 tax law changes (and for that matter, estate plans of couples residing in or owning property with a situs in any "decoupled" state), in order to avoid imposition of unnecessary state death taxes, provide for limiting the exemption-sheltering trust to *the lesser of* the federal estate tax exemption and the state estate tax exemption, with the result that all property in excess of the state-death-tax-exempt amount will wind up in a QTIP trust. Since Rhode Island follows federal law and therefore requires an election on the Rhode Island estate tax return to treat that excess as QTIP property that qualifies for the Rhode Island unlimited marital deduction, it became apparent immediately after the enactment of the 2001 federal tax law that unless an estate of the first to die in such cases was able to make a different election (as to amount) for federal and state estate tax purposes, many estates would be forced to pay state death taxes in order to fully shelter the (larger) federal exemption from being part of the surviving spouse's taxable estate. Fortunately, in early 2003, the Rhode Island Division of Taxation issued Declaratory Ruling 2003-3, which provided that estates of individuals dying on or after January 1, 2002, may make a QTIP election on the Rhode Island estate tax return that was different in amount from the federal QTIP election. See the example in § 2.2.5, below.

§ 2.2.5 Planning for the Rhode Island Estate Tax in 2002 and Beyond

Beginning in 2002, Rhode Island requires estates that exceed the value of a so-called Rhode Island exemption to file a return and compute a Rhode Island estate tax equal to the sponge tax to which Rhode Island would have been entitled under federal estate tax law as the federal estate tax laws existed on January 1, 2001. This means ignoring the 2001 Act's increases in the applicable exclusion amount that can be sheltered by the unified credit, ignoring the decreases in the top marginal estate tax rate, and ignoring the phaseout of the state death tax credit.

The following is a comparison of the federal exemption under the 2001 Act with the Rhode Island exemption that sets the new threshold for filing a Rhode Island estate tax return:

Year of death	Federal exemption	RI exemption
2002 and 2003	$1,000,000	$675,000
2004	$1,500,000	$675,000
2005	$1,500,000	$675,000
2006, 2007, and 2008	$2,000,000	$675,000
2009	$3,500,000	$675,000
2010	Unlimited	$850,000
2011–2012	$5,000,000	$850,000 adjusted for inflation

As a result, estates that are exempt from paying federal estate tax because they are below the federal exemption may still be required to file a Rhode Island estate tax return and pay estate tax to Rhode Island.

In the case of married couples, planning continues to be possible to defer all estate tax until the surviving spouse's death, a valuable tool because by the time of the second death the estate may have been spent down, or the estate tax will have been repealed altogether. The challenge will be to qualify for the marital deduction that portion of the deceased spouse's estate that exceeds the Massachusetts exemption. One way to do this is to use the tax-efficient estate plan methods—discussed in § 2.1.8, § 2.1.9, and § 2.1.10, above—but also, taking advantage of the authority to make separate QTIP elections for state and federal purposes as discussed in § 2.2.4, above, limit the amount of the estate tax sheltered amount to the amount that can qualify for the estate tax exemption under both federal and state estate tax law.

Example

Maria's will and revocable trust are amended to provide a credit shelter trust for the benefit of her husband and children to be funded with the largest amount that can pass free of the estate tax under both federal and state tax law. If Maria dies in 2008, the credit shelter trust will be funded with $675,000. Because Maria does not want to waste the balance of $1,375,000 of the federal estate tax exemption to which her estate would be entitled if she were to die in 2008, her amended will and trust further provide that the balance of any federal estate tax exemption will be held in a QTIP-able marital deduction trust. Her executors will elect to treat such trust as a QTIP trust for state estate tax purposes in order to defer the state tax on such amount until the death of the surviving spouse, but no such election will be made for federal purposes, in order to use the balance of Maria's federal estate tax exemption.

§ 2.3 THE FEDERAL GIFT TAX: THE BASIC RULES

§ 2.3.1 Gifting Advantages and Disadvantages in General

Making lifetime gifts has significant advantages and disadvantages. Due to available annual exclusions and lifetime exemptions, lifetime gifts can result in estate and generation-skipping tax savings even where little or no gift tax is paid. And contrary to popular belief, the donee incurs no income tax liability upon receipt of the gifted property. Gifting also may allow clients to shift income from their higher income tax brackets to the lower tax brackets of a child or other relative.

When a client gifts, he or she gets to see the donees enjoy the client's wealth during the client's lifetime. Also, by observing how the donees handle the gifted funds, the client will be in a better position to judge, for example, whether he or she should make additional outright lifetime gifts, or whether future lifetime gifts, and for that matter death transfers, are more appropriately made in trust rather than outright, or whether some wealth should be diverted to charity. Gifting to family members can also serve an asset protection purpose, provided that such transfers do not constitute transfers in defraud of creditors under the state's fraudulent conveyance laws. *See* R.I. Gen. Laws tit. 6, c. 16.

Gifting during the client's lifetime can also have disadvantages. The most obvious disadvantage is that the client would be irrevocably giving up the gifted property. The potential donor and his or her advisors should inventory all of his or her resources and satisfy themselves that the client will not need the gifted property in the future. In making this determination, the client and his or her advisors should consider inflation, the potential for investment losses or lower investment yields, possible uninsured medical expenses, and other possible emergencies or reversals of fortune.

Gifting may also prove to be a disincentive to the donee's leading a productive life.

Disadvantages also exist for the donee. Once the gift is in the donee's hands, it is the property of the donee and may be reached by his or her creditors including, unless clearly traceable to a gift or inheritance and not commingled with the donee's spouse's assets, in a divorce. Also, the donee takes over the donor's income tax basis on any gifted property, whereas if such property were instead gifted at death, with certain possible exceptions for carryover basis property inherited in 2010 as discussed in the practice note in § 2.1.1, above, there would be "stepped-up basis" equal to the value of the gifted property at death. Thus, the advantages to the donor of using annual per-donee gift tax exclusions and of getting future appreciation and income on the gifted property out of his or her estate must be balanced against the disadvantage of losing stepped-up basis at death.

Practice Note

If a client's assets are less than the unified credit amount and there is no estate tax due, it is preferable to hold the property until death so that the recipient will receive the stepped-up basis. Otherwise, the donee will incur unnecessary income taxes if the property is sold during the donee's lifetime.

§ 2.3.2 Additional Factors to Consider When Gifting

Assuming that a lifetime gift-giving program is in keeping with the client's means and philosophy, the tax savings can be significant. When making a determination as to whether or not to gift, the advisor should review the following factors with the client:

- Except as to gifts made within three years prior to death, any gift taxes paid on the transfer will be excluded from the decedent's estate. I.R.C. § 2035(b).

- If the gifted property appreciates or generates income between the date of the gift and the date of death, the appreciation and income will be removed from the donor's estate for tax purposes.
- Administration expenses, such as costs of probate, will not be incurred with respect to the gift taxes that are paid, or on the gifted property itself.
- If the gift is to a family member who is in a lower tax bracket, and if the gift is of income-producing property, then there will be an overall reduction in the family's income taxes.

There are significant tax savings to be realized for a donor in making a gift during his or her lifetime rather than a bequest at death, because of the way in which the gift tax ("tax exclusive") as opposed to the estate tax ("tax inclusive") is calculated.

Example

Assume that in the year 2009, Father has already used his unified credit and is now in the 45 percent transfer tax bracket. Father wants to get another $100,000 to his child. For Father to get the $100,000 to the child during the father's lifetime, it takes $145,000 in assets—the $100,000 he actually gifts to his child and the $45,000 in gift tax that Father pays on a gift tax return filed for the calendar year in which the gift is made. If, instead, Father waits and allows his asset to pass to his child as part of his estate plan at death, it will take $181,818 in assets in order for the child to realize a net distribution of $100,000. On that $181,818, there is an estate tax of $81,818, leaving the net amount of $100,000 for actual distribution to the child. The tax on the gifted assets is calculated on a "tax base" that is exclusive of the tax owed (tax-exclusive), while the estate tax is calculated on a tax base that includes the tax owed (tax-inclusive).

Further, lifetime gifts can be structured so the federal gift tax applies to the net value of the gift. *See* Rev. Rul. 75-72, 1975-1 C.B. 310; *see also* Rev. Rul. 71-232, 1971-1 C.B. 275.

Example

Assume that in the year 2009, Father has already used his unified credit and is now in the 45 percent transfer tax bracket. Father wants to gift another $100,000 to his child, but wants the gift taxes paid from the $100,000. The value of the gift is $68,966. The 45 percent gift tax rate for the gift is $31,034. If instead Father had left the $100,000 to his child through the estate plan, then, assuming

Father was still at the 45 percent transfer tax rate at his death, the estate taxes on the $100,000 would be $45,000, and his child would receive the remaining $55,000, an amount $13,966 less than the child would receive through gifted property. And if the value of the gifted property appreciates between the date of the gift and the date of Father's death, the savings will be even more significant. This example again illustrates that the gift tax is a tax-exclusive system, whereas the estate tax is a tax-inclusive system. Under the estate tax system, unlike the gift tax system, the tax is subject to tax.

§ 2.3.3 Introduction to the Federal Gift Tax

A gift tax is imposed "on the transfer of property by gift" during the calendar year "by any individual resident or nonresident." I.R.C. § 2501(a). A transfer is considered a gift and is taxable whether the transfer is direct or indirect, in trust, or otherwise, and whether the property is real or personal, tangible or intangible. I.R.C. § 2511. For gifts made during 2010, I.R.C. § 2511(c) provides that "a transfer in trust shall be treated as a transfer of property by gift" unless the trust is a grantor trust. However, this provision is scheduled to be repealed on January 1, 2011.

For federal gift tax purposes, the gift tax applies to any transfer made without consideration (or an equivalent value received in return) and without regard to intent. Thus, the common law requirement of donative intent is not necessary to make a gift for federal gift tax purposes, although the presence or absence of any donative intent may be relevant in determining whether a transaction is a gift. Treasury Regulation § 25.2511-1(g)(1) specifically states that donative intent on the part of the transferor is not an essential element in the application of the gift tax. *See also Comm'r v. Wemyss*, 324 U.S. 303 (1945), holding that a transfer was a taxable gift even though there was no donative intent. Gifts may occur in disguised or subtle forms. Special statutory rules apply to some of these special forms. For example, subject to I.R.C. § 2514, the exercise of a power of appointment may constitute the making of a taxable gift. In addition, according to I.R.C. § 2518, a disclaimer or renunciation of an interest in property can sometimes constitute a gift.

Practice Note

Underlying the definition of a gift for gift tax purposes is the effect that the transfer will have on estate taxes. Therefore, a transfer that depletes the estate of the transferor is likely to be regarded as a taxable gift. However, that notion does not rise to the level of a rule, because many consumption expenditures and other disbursements that do in fact deplete the wealth and hence the taxable estate of a person are not gift transfers for purposes of the gift tax. For example,

> support given to someone that the taxpayer is obligated to support, such as a minor child or a spouse, is not a taxable gift. Thus, while not every estate-depleting expenditure will be treated as a gift, any transfer that confers a net benefit on the recipient and is not given in exchange for consideration of the type that will show up in the transferor's gross estate at death, is likely to be taxable as a gift unless it falls within the exemption for transfers made in the ordinary course of business, or for medical expenses, tuition, or some other excepted reason.

The federal gift tax has a structure that resembles that of the federal estate tax. The gift tax begins with net transfers. Transfers are valued according to I.R.C. § 2512 (property valued at the date of the gift). Taxable gifts are determined using this value, minus the annual per donee exclusion ($13,000 for 2012, *see* I.R.C. § 2503(b)), with a deduction for gifts that qualify under I.R.C. § 2522 (charitable and similar gifts) and I.R.C. § 2523 (gifts to spouses). The only credit available against the gift tax is the post-1976 gift unified credit of I.R.C. § 2505. This is a cumulative credit, not an annual credit. In any given year, only the amount of remaining unused credit may be taken. Moreover, the use (and consequent exhaustion) of this credit is not elective. Section 2505(a)(2) of the Code specifies that the credit is reduced each year by any amounts "allowable" (as opposed to "allowed") in previous years. Thus, the donor does not have a choice as to whether to apply the unified credit against a taxable gift; it is mandatory. Rev. Rul. 79-398, 1979-2 C.B. 338. No gift tax can be paid until the credit is exhausted.

Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (2001 Act), Pub. L. No. 107-16, 115 Stat. 38 (2001), the unity between the estate tax exemption and the gift tax lifetime exemption was eliminated. From January 1, 2002, donors have been able to gift a maximum of $1 million tax-free during their lives. The maximum gift tax rate dropped to 50 percent on January 1, 2002, and there is no longer a 5 percent surtax on larger gifts. The maximum gift tax rate decreases along with the decrease in the maximum estate tax rates, until both are at 45 percent. When the estate tax was repealed in 2010, the maximum gift tax rate was further reduced to 35 percent.

The 2010 Act restored the unity between the estate tax exemption and the gift tax lifetime exemption, setting each at $5 million. The rate on all transfers in excess of the exemption is 35 percent. On January 1, 2013, the $1 million gift tax exemption and the 50 percent maximum rate will be restored.

Computation of the gift tax can be complicated because it is the cumulative total over the lifetime of the taxpayer coupled with progressive rates. The following steps will determine the gift tax on a current year's gifts:

1. Total all taxable gifts made since the enactment of the gift tax to the end of the taxable year of the gift in question.

2. Using this aggregated figure, compute the tax using the current rates.

3. Once arriving at this tax, the tax (also computed at current rates) on the total taxable gifts made up to the end of the immediately prior year must be subtracted. The difference is the amount of tax that must be paid on gifts made in the year in question. I.R.C. § 2502.

The progressive rates, along with this cumulative computation of the gift tax required by statute, result in higher and higher tax rates, up to the maximum federal rate.

(a) *Indirect Transfers*

Indirect transfers are subject to gift tax. I.R.C. § 2511. Indirect transfers can come in several forms. For example, a forgiveness of indebtedness or a reimbursement of someone else's expenses will be a taxable gift if the other requirements of the gift tax are met. A gratuitous transfer to a corporation is sometimes regarded as a taxable transfer by a donor to the shareholders of the corporation. Treas. Reg. § 25.2511-1(h)(1). Transfers in trust are another example of an indirect transfer to which the gift tax applies. A disclaimer or a renunciation of a bequest may be an indirect gift. Treas. Reg. § 25.2511-1(c).

(b) *Net Gifts and Gifts on the Condition that the Donee Pay the Gift Tax*

As indicated in § 2.3.2, above, a donor may make a gratuitous transfer of money or other property and condition or may require that the donee pay any gift tax that is levied on the transfer. This is a "net gift," which implies that the value of the property or cash equal to the gift tax liability was not part of the gift itself, and that the donor made a net gift equal to the value of the transferred property less the gift tax liability.

A "net gift" may generate income tax consequences to the donor. In *Diedrich v. Commissioner*, 457 U.S. 191 (1982), the U.S. Supreme Court ruled that the donor realized income when the donee paid the gift tax and that tax exceeded the donor's basis in the "gifted" property. The net gift rule and a formula to determine the amount of gift tax due on the net gift are set out in Rev. Rul. 75-72, 1975-1 C.B. 310 and Rev. Rul. 71-232, 1971-1 C.B. 275.

Practice Note

The *Diedrich* rule does not apply to gifts made before March 4, 1981. *See* Tax Reform Act of 1984, Pub. L. No. 98-369, § 1026(a), 98 Stat. 494, 1031 (1984).

(c) *Interest-Free Loans*

Prior to 1985, it was possible to make interest-free loans without incurring gift tax liability. Interest-free loans were an effective and simple technique to transfer wealth tax-free. A typical example of such a transfer is the following. An individual needs a loan of $200,000 to start a business. He or she could go to a bank, which would require annual interest payments, or obtain an interest-free loan from a wealthy parent without having to pay a gift tax.

Effective January 1, 1985, Congress, in an effort to forestall the use of interest-free loans and below-market interest rate loans as an income-shifting device, enacted I.R.C. § 7872, which treats the foregone interest on any such loan as both a gift from the lender to the borrower and interest income to the lender. I.R.C. § 7872(a)(1). Section 7872 applies to both term and demand loans. Interest is imputed at an "applicable federal rate" in effect under I.R.C. § 1274(d). *See* I.R.C. § 7872(f)(2).

There is a general de minimis exception to the foregoing rules for interest-free loans between individuals that do not exceed $10,000 outstanding at any time. I.R.C. § 7872(c)(2). However, this exception does not shelter an income-shifting gift loan. Section 7872(c)(2)(B) of the Code disallows the exception whenever loan assets are invested by the borrower in income-producing assets.

§ 2.3.4 Gifts Made and Gift Taxes Paid Within Three Years of Death (I.R.C. § 2035)

Because a transfer tax solely on property owned at death is easily avoided by making gifts shortly before dying, the Internal Revenue Code, ever since its enactment in 1916, has contained a provision to draw certain gifts back into the estate tax base.

The relevant provisions are in I.R.C. § 2035. Section 2035(a) provides that any transfer of an interest or relinquishment of a power over property within three years of death that, had there been no transfer or relinquishment, would have been includible in the gross estate under I.R.C. § 2036 (Transfers With Retained Life Interest), I.R.C. § 2037 (Transfers Taking Effect at Death), I.R.C. § 2038

(Revocable Transfers), or I.R.C. § 2042 (Life Insurance), will be drawn back into the gross estate.

In addition, Section 2035(b) provides that the amount of gift taxes paid by a decedent on all gifts made within three years of death is drawn back into the decedent's gross estate, whether or not the gifts themselves are drawn back into the estate.

Also, I.R.C. § 2035(c)(1) requires all transfers within three years of death (other than those made in a bona fide sale for adequate and full consideration) to be included in the gross estate for purposes of applying Section 303(b) (relating to stock redemptions), Section 2032A (relating to special-use valuation), and Sections 6321 through 6326 (relating to liens for taxes).

Also, I.R.C. § 2035(c)(1) provides that an estate shall be treated as meeting the 35 percent of adjusted gross estate requirement of Section 6166(a)(1) (relating to installment payment of estate taxes on certain closely held business interests) only if the estate meets such requirement both with and without the application of Section 2035(a).

Practice Note

In reviewing what assets to recommend that the client gift, gifts of property other than stock may be useful in enabling the estate of an owner of a close corporation to qualify for Section 303 stock redemptions. Gifts of property other than special use property may help an estate that holds an interest in a farm or business qualify for special use election under I.R.C. § 2032A. Lifetime gifts made more than three years before death may help an estate that holds interests in a closely held business qualify for installment payment of the estate taxes attributable under I.R.C. § 6166. On the other hand, gifts made within three years of death may prevent the estate from qualifying for Section 6166 deferral treatment.

Section 2035(a) and (c) do not apply to a transfer that is a bona fide sale for adequate and full consideration, nor does I.R.C. § 2035(c) apply to a gift with respect to which the decedent was not obliged by I.R.C. § 6019 to file a gift tax return, such as gifts of less than the annual exclusion. I.R.C. § 2035(d); I.R.C. § 2035(c)(3).

§ 2.3.5 Gift Tax Credit for Pre-1976 Gifts

With respect to pre-1976 transfers only, I.R.C. § 2012 provides a credit against estate taxes for gift taxes that are paid on the transfers. The amount of the credit

is limited so that it cannot exceed the amount of the gift tax deemed to have been paid on the transfer of property later brought into the estate and also so that it cannot exceed that part of the estate tax that is paid with respect to the gift property when it is later included in the gross estate. For gifts made after 1976, the credit is no longer available, because the calculation of the estate tax automatically provides for a credit for any gift tax payable on post-1976 gifts. The separate credit for gift taxes paid on pre-1976 transfers applies due to the fact that, prior to 1977, gift tax rates were 75 percent of estate tax rates, and taking into account the credit for gift taxes paid on pre-1977 gifts in the same manner as for gift taxes paid on post-1976 gifts would result in taxing such pre-1977 gifts at 100 percent, rather than 75 percent, of the estate tax rates.

§ 2.3.6 Gifts and Income Tax Basis

As to gifts of property during life, the income tax basis of the gifted property in the hands of the donee is the same as its basis in the hands of the donor, except that if such basis is greater than fair market value at the time of the gift, then the basis, for purposes of determining loss only, shall be such fair market value. I.R.C. § 1015. This effectively means that if the donee later sells the gifted property for a price somewhere between the donor's basis and the lower fair market value at the time of the gift, there will be no gain or loss to the donee. Illustrating this concept, Treas. Reg. § 1.1015-1(a)(2) provides as follows:

> Example. A acquires by gift income-producing property which has an adjusted basis of $100,000 at the date of gift. The fair market value of the property at the date of gift is $90,000. A later sells the property for $95,000. In such case there is neither gain nor loss. The basis for determining loss is $90,000; therefore, there is no loss. Furthermore, there is no gain, since the basis for determining gain is $100,000.

Practice Note

If there is a loss, the donor should examine the possible benefits of selling the property first, incurring the loss, and giving the net amount to the donee.

The Section 1015(a) income tax basis in the gifted property is also increased by the amount of gift tax paid with respect to the gift. I.R.C. § 1015(d).

Under I.R.C. § 1041, a special basis rule applies in the case of a transfer to a spousal donee, including a former spouse receiving property incident to a divorce but excluding transfers to a nonresident alien. Any such transfer is treated

as a gift, and the donee will use the donor's basis for purposes of determining gain or loss on a subsequent sale. Under this section, a transfer of property is deemed incident to a divorce if such transfer occurs within one year after the date on which the marriage ceases, or is related to the cessation of the marriage. Transfers in trust also qualify for this treatment except where the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred. A detailed discussion of the estate, gift, and income tax consequences of divorce is beyond the scope of this chapter. For an excellent discussion of this topic, see Robert E. Madden, *Tax Planning for Highly Compensated Individuals* § 2.05 (Warren, Gorham & Lamont 3d ed. 1996).

If, instead of gifting the property, the donor retains it until death so that it passes through his or her estate, then the estate beneficiaries will receive a stepped-up basis in the property equal to the fair market value of the property at the date of death (or six months later if the alternate valuation date is elected by the executor). I.R.C. § 1014(a).

However, stepped-up basis does not apply to all types of property acquired from a decedent. For example, there is no stepped-up basis for property that constitutes a right to receive an item of income in respect of a decedent under I.R.C. § 691. I.R.C. § 1014(e). Also, see the special basis rules that apply with respect to I.R.C. §§ 2031, 2032, and 2032A special use property, referred to in I.R.C. § 1014(a)(2)–(4).

For a detailed definition of what types of property constitute "property acquired from a decedent" for purposes of I.R.C. § 1014, see I.R.C. § 1014(b).

Section 1014(b) of the Code contains another special basis rule regarding property transferred within one year of death. Prior to 1982, a gift of appreciated property could be made to a dying person, then retransferred back to the donor or the donor's spouse upon the donee's death. The basis in the property would be stepped up to the fair market value at the donee's death. Pursuant to the Economic Recovery Tax Act of 1981, I.R.C. § 1014(e) provides that with respect to transfers after 1981, if a donor makes a gift to a donee who is dying, and the gift was made within one year of the donee's death, and as a result of the donee's death the gifted property is transferred back to the donor or his or her spouse, then there will be no step up in basis with respect to the transferred property, i.e., the resulting basis will be the basis in the hands of the donee-decedent immediately prior to his or her death. Section 1014(e) applies only to property transferred back to the original donor and spouse, not property transferred to the donor's children or other family members. For example, if a wife is dying and her husband transfers property with a low basis to her, and she dies and through her

estate plan she bequeaths the property to her children, they will receive stepped-up basis in the property.

Section 1014 is inapplicable to estates of persons dying in 2010. I.R.C. § 1014(f).

(a) *Incomplete Transfers (I.R.C. §§ 2036–38)*

Sections 2036 through 2038 of the Code apply to inter vivos transfers (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), made by trust or otherwise, and whether or not complete for gift tax purposes, that are regarded as incomplete for estate tax purposes. There is no gift with respect to such transfers and, therefore, no gift tax due.

Under I.R.C. § 2036, if a person makes a transfer "under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death . . . the possession or enjoyment of, or the right to the income from, the property, or the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or [its] income," the value of the entire property will be included in the gross estate at death. *See also* Treas. Reg. § 20.2036-1.

Section 2036 applies when there has been a retention of a life estate or a similar interest, but not when there has been an acquisition or reacquisition of such an interest. The life estate or similar interest does not need to be reserved by the instrument of transfer, such as the deed. It is enough if it occurs by the agreement of the parties, or if an agreement can be inferred from objective evidence. *See, e.g.*, Rev. Rul. 78-409, 1978-2 CB 234. If the transferor retains a life estate in only a portion of the transferred property, then only the portion in which the transferor retained the life estate will be included in his or her gross estate.

Under I.R.C. § 2037, if a person makes a transfer (excepting certain pre-October 8, 1949 transfers) under which "possession or enjoyment of the property can, through ownership of such interest, be obtained only by surviving the decedent, and the decedent has retained a reversionary interest in the property, and the value of such reversionary interest immediately before the death of the decedent exceeds 5 percent of the value of such property," the value of the entire property will be included in the gross estate at death. Thus, property is not included in the decedent's gross estate under Section 2037 if, immediately before the decedent's death, possession or enjoyment of the property could have been obtained by a beneficiary either by surviving the decedent or through the occurrence of some other event, such as the expiration of a term of years. Treas. Reg. § 20.2037-1(b).

Under I.R.C. § 2038, if a person makes a transfer (excepting certain pre-June 22, 1936 transfers) "where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate," the value of the entire property will be included in the gross estate at death. *See also* Treas. Reg. § 20.2038.

Also, if the grantor retains any interest under I.R.C. §§ 2036–38 that will be included in the grantor's gross estate under this section and transfers or relinquishes it within three years of his or her death, it will be included in the grantor's estate under I.R.C. § 2035, as discussed in § 2.3.4, above.

§ 2.3.7 Life Insurance—Gift Tax Consequences

Like any other item of property, a policy of life insurance can be the subject of a gift transfer, potentially taxable as such under the gift tax, whether the policy given away is on the life of the donor or on the life of some other person. It is possible for a taxpayer to remove the proceeds of life insurance from his or her gross estate by a transfer of the incidents of ownership before the taxpayer's death. The donor must be careful not to

- make the transfer within three years of death;
- retain any reversionary interest or any power to revest the economic benefits in himself or herself, or his or her estate;
- retain any power to change beneficiaries;
- retain any right to income from the transferred property.

I.R.C. §§ 2035–38.

Also, a gift may take place if the donor pays the premiums on a policy of life insurance owned by another person, whether or not the policy itself was ever transferred. The payment of the premiums itself amounts to a gift when the policy is owned by someone other than the person who is paying the premiums.

If the insured purchases a life insurance policy or pays a premium on a previously issued policy, the proceeds of which are payable to a beneficiary or beneficiaries other than his or her estate, and with respect to which the insured retains no reversionary interest in the insured or his or her estate and no power to revest the economic benefits in the insured or his or her estate or to change the beneficiaries or their proportionate benefits, the insured has made a gift of the value of

the policy, to the extent of the premiums paid, even though the right of the assignee or beneficiary to receive the benefits is conditioned upon surviving the insured. Treas. Reg. § 25.2511-1(h)(8).

The insured may transfer the policy to an individual, such as the insured's spouse or child. In most cases, that transfer will qualify for the annual exclusion. Treas. Reg. § 25.2503-3(a). However, if the policy is gifted to more than one individual, care must be taken to make sure that the transfer qualifies for the annual exclusion. See *Skouras v. Commissioner*, 188 F.2d 831 (2d Cir. 1951), which held that an outright gift of a policy to two or more individuals does not qualify for the annual exclusion because no one donee has the immediate right to use and possess what was given to the donee.

Practice Note

If the client insists on outright ownership of the policy rather than ownership by an irrevocable trust, consider having the children or beneficiaries co-own the policy as tenants in common, which will allow the annual exclusion gifts and make the beneficiaries responsible for their own premium payments. As an alternative, consider splitting the policy into separate policies, each one co-owned by each of the beneficiaries. Their rights are then separate and distinct. If any beneficiary, for example, does not pay the premiums, gets divorced, or has creditor problems, it is that beneficiary's own responsibility.

The insured could transfer the ownership of the life insurance policy to his or her spouse, but especially because Rhode Island now has an unlimited marital deduction, the transfer of ownership of a life insurance policy to a spouse would not seem to accomplish much. The proceeds still will be included in at least one of the spouse's estates. The same result could be obtained (without the insured relinquishing control over the policy) if the proceeds qualified for the marital deduction. Also, the ownership of the policy by the spouse may create problems. The advisor should review the policy and ancillary documents to ascertain who will own the policy if the spouse predeceases the insured. The contingent owner may be the insured; it may be the children. It may be several children, and annual exclusion gifts may be precluded in the future for premium payments. There may be other issues, such as minor children who do not have the capacity to own the policy or an unwillingness by the children to use the proceeds for the payment of estate taxes.

A transfer of a life insurance policy is complete for gift tax purposes when the donor has divested himself or herself of all incidents of ownership, and all dominion and control over the policy. Treas. Reg. §§ 25.2511-2, 25.2511-1(h)(8).

However, see § 2.3.4, above, with respect to inclusion of life insurance policies transferred within three years of death.

> **Practice Note**
> If the taxpayer creates an irrevocable trust in which he or she retains no incidents of ownership and the trustee of the trust (rather than the taxpayer) applies for the insurance, the policy and its death proceeds will not be included in the taxpayer's estate even if he or she dies within three years of issuance of the policy, because he or she would never have owned the policy.

When a gift of a life insurance policy is made, valuation of the insurance policy for the purposes of the gift tax is determined under the principles set forth in the regulations. Treas. Reg. § 25.2512-6(a).

§ 2.3.8 Time of the Gift

The question of when the gift is made can be important. The general rule is that a transfer is deemed to be complete when the donor has fully relinquished dominion and control over the property that is the subject of the gift.

There are some special rules that have been established to govern particular problems, such as the gift of a note or a check. For example, a gift made by check is not complete until the check is paid or negotiated for value to a third party, Rev. Rul. 67-396, 1967-2 C.B. 351, and a gift of the donor's own promissory note is not complete until the note is paid or transferred for value, Rev. Rul. 84-25, 1984-1 C.B. 191. The gift of a check or note of a third party, however, is complete at the time of transfer of the note or check.

A gift is not complete if it is revocable. Because the donor can get the property back at any time by exercising the donor's power of revocation, the occasion for imposing a gift tax has not arisen. Even if the donor cannot exercise the power of revocation, if he or she retains a right to change beneficial interests, even in a way that will not benefit the donor, the gift will be regarded as incomplete. So, if a donor establishes a trust and retains a power to alter the beneficial interest in the trust (though not in the donor's favor), the creation of the trust does not constitute a completed gift at that time. As amounts are paid over to beneficiaries by the trust, the donor will be deemed to have made a completed gift since those amounts are no longer then under the donor's dominion and control. I.R.C. § 2038.

The time of the transfer for tax purposes does not depend on when the donor relinquishes all power to revoke or to get the property back or on when a donee becomes assured of his or her interest, but on whether the donor has relinquished dominion and control over the property. Treas. Reg. § 25.2511-2.

In general, the rules about when a gift is complete for gift tax purposes do not coincide exactly with the rules about when a gift is complete for estate tax purposes. Therefore, a transfer that is complete and thus incurs a gift tax may nevertheless be regarded as incomplete for estate tax purposes, with the result that the estate tax is payable on the same property or interest at the time of the donor's death (with a credit for the gift tax).

§ 2.3.9 Valuation of the Gift

The valuation of the gift is made as of the date of the gift. I.R.C. § 2512. When property is transferred for less than an adequate and full consideration in money or money's worth, the amount of the gift is the amount by which the value of the property transferred exceeds the value of the consideration received.

Generally, for both gift and estate tax purposes, property is valued at its fair market value. Fair market value means "the price at which such property would change hands between a willing buyer and a willing seller, neither under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts." *See* Treas. Reg. §§ 20.2031-1(b), 25.2512-1.

If the asset is a closely held business asset, due to the fact that such interests are seldom traded or sold in the marketplace, determination of fair market value, particularly where the valuation is being used to support a gift tax return or an estate tax return, is a process that generally requires preparation of an appraisal by an independent expert appraiser. The factors the IRS will look at in determining fair market value are set forth in Treas. Reg. § 20.2031-2(f) and in Rev. Rul. 59-60, 1959-1 C.B. 237, *as modified by* Rev. Rul. 65-193, 1965-2 C.B. 370 and Rev. Rul. 77-287, 1977-2 C.B. 319. *See also Eisenberg v. Comm'r*, 82 AFTR 98-5757 (C.A. 2 1998) (held value of gift of closely held stock could be reduced to reflect built-in capital gains tax on corporation's sole asset (improved realty), even though no liquidation or sale was imminent).

When valuing certain assets, such as an interest in a closely held business, an interest in a limited partnership, or real estate owned by individuals jointly or as tenants in common, the value of the gift may be reduced because of the lack of marketability or minority discounts.

Practice Note

Usually, the lack of marketability discount and the minority discount are combined and there is one discount factor. Typically, this can be in the 25 to 60 percent range.

§ 2.3.10 Calculation of the Tax

The method of computing the gift tax for years prior to 2010 is set forth in I.R.C. § 2502. Specifically, for such years, Section 2502 provides for a tentative tax equal to the excess, computed under the estate tax table in I.R.C. § 2001(c), on the aggregate sum of the taxable gifts for the relevant calendar year and for each of the preceding calendar years, over a tentative tax, computed under such table, on the aggregate sum of the taxable gifts for each of the preceding calendar years, such that the tax is calculated cumulatively over the lifetime of the donor.

For 2010, with the federal estate tax having been repealed, there is a separate gift tax table set forth in I.R.C. § 2502. Thus, Section 2502 provides for a tentative tax on year 2010 gifts equal to the excess, computed under the gift tax table in I.R.C. § 2502, on the aggregate sum of the taxable gifts for the relevant calendar year and for each of the preceding calendar years, over a tentative tax, computed under such table, on the aggregate sum of the taxable gifts for each of the preceding calendar years. The rate schedule is as follows:

If the amount with respect to which the tentative taxes to be computed is:	*The tentative tax is:*
Not over $10,000	18% of such amount
Over $10,000 but not over $20,000	$1,800, plus 20% of the excess over $10,000
Over $20,000 but not over $40,000	$3,800, plus 22% of the excess over $20,000
Over $40,000 but not over $60,000	$8,200, plus 24% of the excess over $40,000
Over $60,000 but not over $80,000	$13,000, plus 26% of the excess over $60,000
Over $80,000 but not over $100,000	$18,200, plus 28% of the excess over $80,000
Over $100,000 but not over $150,000	$23,800, plus 30% of the excess over $100,000
Over $150,000 but not over $250,000	$38,800, plus 32% of the excess over $150,000
Over $250,000 but not over $500,000	$70,800, plus 34% of the excess over $250,000
Over $500,000	$155,800, plus 35% of the excess over $500,000

§ 2.3.11 The Gift Tax and the Statute of Limitations

The general statute of limitations for gift tax is three years from the return's due date. It is extended to six years if there is a "substantial omission," which is defined as an omission of gifts valued at more than 25 percent of the reported gifts. Before the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, the IRS ruled that the statute of limitations does not run unless a gift tax is paid or assessed (other than by application of the unified credit), so gifts shielded by the unified credit for which no tax is paid were always subject to revaluation for the purpose of determining the tax on later transfers. The Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 506, amended I.R.C. §§ 2001 and 2504(c) to prohibit the IRS from revaluing an adequately disclosed gift made after the date of the enactment for which the statute of limitations period has passed for the purposes of determining the applicable estate tax bracket and the applicable unified credit bracket. For gifts made after the date of enactment, if the value of a gift is shown on a gift tax return or is disclosed in the return (or in a statement attached to the return) "in a manner adequate to appraise the Secretary of the nature of the gift," the value of such gift for purposes of computing the estate tax is the value of the gift "as finally determined" for gift tax purposes, once the gift tax statute of limitations has expired. This appears to make nontaxable gifts, such as those made within the annual exclusion limits, eligible for the benefits of the statute of limitations even if the taxpayer has not used applicable unified credit and paid any gift taxes. No mention is made of whether the IRS can reopen other issues on "closed gifts" for purposes of calculating the estate tax, such as whether the gift qualified for an annual exclusion claimed on a Form 709, Federal Gift Tax Return.

Technical corrections made to Section 2001(f)(2) in the 1998 Tax and Trade Relief Extension Act, Pub. L. No. 105-277, § 4003(c), clarify that the value of a prior transfer cannot be redetermined if the transfer was disclosed on a gift tax return or in a statement attached to such a return in a manner to adequately apprise the secretary of the treasury of the nature of the transfer even if no gift tax was imposed on that transfer. This correction is retroactive to the enactment of the 1997 Act. Technical corrections made by the 1998 IRS Restructuring and Reform Act clarify that, when determining the amount of taxable gifts made in preceding calendar year periods, the value of prior gifts should be the value of such gifts as finally determined, even if no gift tax was assessed or paid on that gift. For that purpose, final determinations include, for example, the value reported on the gift tax return (if it is not challenged by the IRS before the expiration of the statute of limitations), the value determined by the IRS (if it is not challenged in court by the taxpayer), the value determined by the courts, or the value agreed to by the IRS and the taxpayer. This correction is effective with respect to gifts made after the enactment of the 1997 Act. See Treas. Reg. §§ 20.2001-1, 20.2504-2, and 301.6501(c)-1, which provide a list of information

that must be reported on the gift tax return or an attached statement for the transaction to be considered adequately disclosed for starting the assessment period. According to the regulations, Treas. Reg. § 6501(c)-1(f)(2), a complete and accurate description of the transaction must include the following:

- a description of the transferred property and any consideration received by the transferor;
- the identity of, and relationship between, the transferor and the transferee;
- a detailed description of the method used to determine fair market value, including relevant financial data; and
- a description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property.

If the transfer involves a trust, the trust's taxpayer identification number and a brief description of the trust must be included. A description of any restrictions on the transferred property that were considered in determining its fair market value must be included. A statement describing any position taken on the return that is contrary to any proposed, temporary, or final regulation or Revenue Ruling must also be submitted.

There are enhanced reporting requirements that apply to the gift of any interest in a closely held business.

This regulation is applicable to gifts made in calendar years after December 31, 1996, that are reported on returns filed after December 3, 1999. Treas. Reg. § 6501(c)-1(f)(6).

On the 1996 Form 709, Gift Tax Return, the IRS added a box in Schedule A (Computation of Taxable Gifts) that must be checked if the value of any gift listed on Schedule A reflects a valuation discount. If there is a valuation discount, the taxpayer must attach an explanation giving the factual basis for the claimed discounts and the amount of the discounts taken.

Practice Note

This provision flags for possible audit gifts of units in a closely held business where large discounts have been taken. Where valuation discounts reduce the value of the gift to the annual exclusion (currently $13,000) or less, it appears that these gifts are still exempt from being reported on Form 709. However, if the IRS subsequently

audits the return and determines that the actual value of the gift was over the annual exclusion, the taxpayer would be subject to penalties.

§ 2.3.12 Exclusions and Deductions from the Gift Tax

(a) *Annual Exclusion*

Every donor is allowed an annual exclusion; the amount of the exclusion is $10,000 subject to a cost-of-living adjustment, which is rounded to the next lowest multiple of $1,000. I.R.C. § 2503(b). An annual exclusion amount of $13,000 applies to gifts made in 2011.

To qualify for the annual exclusion, the gift must be one of a present interest. I.R.C. § 2503(b). This future interest limitation on the annual exclusion has been quite heavily litigated. The point of the future interest limitation is that an exclusion should be available only if the donee or donees are known with certainty and only if the values of the interests to be received by each donee can definitely be ascertained. The term "future interest" includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, that are limited to commence in use, possession, or enjoyment at some future date or time. Treas. Reg. § 25.2503-3(a). In attempting to help describe what does constitute a present interest in property, the regulations say that an unrestricted right to the immediate use, possession, or enjoyment of the property or the income from the property is a present interest. Treas. Reg. § 25.2503-3(b).

(b) *Annual Exclusion—Gifts Under the Uniform Transfers to Minors Act*

A gift made to a beneficiary pursuant to the Uniform Transfers to Minors Act qualifies as an annual exclusion gift. The requirements of G.L. c. 201A must be met.

(c) *Annual Exclusion—Section 2503(c) Trusts to Benefit a Minor Beneficiary*

Section 2503(c) of the Internal Revenue Code specifically allows a gift in trust for a donee who is less than age twenty-one to qualify as a present interest for annual exclusion purposes if the gift meets certain conditions.

The first requirement of I.R.C. § 2503(c) is that the property transferred to the trust and the income therefrom may be distributed without restriction to, or for

the benefit of, the donee before the donee reaches age twenty-one. The second requirement of I.R.C. § 2503(c) is that the trust property and accumulated income not previously expended pass to the donee when the donee reaches age twenty-one. Many donors do not want the trust to terminate when the donee is so young; indeed, many donors prefer that the trust continue substantially beyond the date at which the donee attains age twenty-one. Fortunately for estate planners, the IRS has agreed to permit postponement of termination of a Section 2503(c) trust. Rev. Rul. 74-43, 1974-1 C.B. 285. The Section 2503(c) exclusion is permitted if the beneficiary, upon reaching age twenty-one, has either a continuing right to compel distribution or a right during a limited period of time to compel distribution from the trust.

Practice Note
Many Section 2503(c) trust forms provide the donee the right during a sixty-day period of time to compel distribution from the trust. The trust may then continue, assuming that the donee has not withdrawn the funds, until the donee attains a later age. If the trust continues, additional gifts to the trust will not qualify for the annual exclusion unless the beneficiary has a right to immediately withdraw the additional gift.

The third requirement of I.R.C. § 2503(c) is that if the donee dies before attaining age twenty-one, all accumulated income and all principal in the trust must be payable to the estate of the donee or as the donee may appoint under a general power of appointment. I.R.C. § 2503(c)(2)(B).

Practice Note
Under Rhode Island law, a person must be at least age eighteen to make a will. For estate tax purposes, it does not seem to matter that the child may not have the legal capacity to execute a will in which the power of appointment can be exercised. The regulations allow the trust instrument to provide a gift over to remainderpersons if the donee fails to exercise the power of appointment. *See* Treas. Reg. § 25.2503-4(b)(3).

If entitlement to the Section 2503 exclusion is premised on the donee's general power of appointment, the donee's right to exercise that power must not be restricted. A trust will fail to qualify for the exclusion, for example, if the power of appointment cannot be exercised by the donee until he or she reaches a certain age. *See Gall v. United States*, 521 F.2d 878 (5th Cir. 1975).

The donor spouse can also use the other spouse's annual exclusion under the split-gift rules, so that the same total $26,000 exclusion is available using only one spouse's property to fund the gift. I.R.C. § 2513.

(d) *Annual Exclusion—Long-Term* **Crummey** *Trust*

If the client wishes the trust for a person who is under age twenty-one to exist for a relatively longer period of time than the Section 2503(c) trust, the estate planning attorney may establish a long-term *Crummey* trust (named after the taxpayer who obtained the favorable tax court decision, and discussed in § 2.3.12(f), below). This type of trust is irrevocable and permanently transfers the property from the donor. Properly structured, a gift to such a trust will be effective to remove the property from the estate of the donor and, depending on the terms of the trust instrument, the property also may not be included in the estate of the beneficiary. The terms of the trust will control whether the Section 2503 annual per donee exclusion from the gift tax is available. An irrevocable life insurance trust, described below, is typically a long-term *Crummey* trust.

(e) *Annual Exclusion—Irrevocable Life Insurance Trusts*

For most clients, the purpose of an irrevocable life insurance trust is to remove the proceeds of a life insurance policy from the client's gross estate. If the client is married, the client has the ability, if he or she establishes an irrevocable insurance trust, to remove the proceeds of a life insurance policy both from the client's estate and from the estate of his or her spouse.

If, instead, the client owns the life insurance policy on the client's own life, it will be fully included in his or her gross estate at death. If the client's spouse owns the life insurance policy on the client's life, the proceeds will not be taxed at the client's death, but will be fully taxed as an asset of the spouse's estate (assuming that the spouse survives the client). If the policy on the client's life is owned by another person or persons, such as the client's children, the proceeds will be excluded from the client's taxable estate. However, this arrangement raises certain other problems, such as if the cash value in the policies builds up substantially, the cash value is an asset of the children for creditor and divorce purposes. Also, one child may die or may choose not to continue to pay for the policy.

Establishing an irrevocable trust bypasses most of these problems and provides a streamlined mechanism for removing the life insurance proceeds from the client's taxable estate. It does have two potential negatives: the client loses the control over the policy and the gift tax exposure.

(f) *Gift Tax Issues Related to Irrevocable Trusts*

When the insured transfers the life insurance policy to the trust, he or she is making a gift. The value of the gift depends on the type of policy. The gift may

qualify for the annual exclusion. As stated above, to qualify as an annual exclusion gift, the gift must be one of a present, not a future, interest. I.R.C. § 2503(b).

When the policy is transferred to the trust, it will qualify for the annual exclusion only if there is a present right to enjoy the property. This is true for the initial transfer of the policy and for subsequent premium payments. The solution to the future interest problem is to give one or more of the beneficiaries the immediate right to withdraw trust assets as gifts are made to the trust. The landmark case in this area is *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968). This case held that the present interest exclusion was available when a trust beneficiary had an immediate right to withdraw corpus. It is available to the extent of the right to withdraw. The IRS acquiesced in this result in Rev. Rul. 73-405, 1973-2 C.B. 321. *See also* Priv. Ltr. Ruls. 7826050, 7902007, 7909031, 8007080, 8118051, 8445004, 8712014.

The power to withdraw must be immediate. The beneficiary should have the right to do so, commencing when the gift is made. Otherwise, it may be construed to be a future, rather than present interest. The withdrawal rights should also be designed to lapse at the end of a certain time, such as thirty or sixty days after the gift. The IRS has ruled that time periods ranging from thirty to ninety days are reasonable. *See* Priv. Ltr. Ruls. 7939061, 8003033, 8004174 (thirty days is reasonable). The beneficiary must be given notice of his or her right to make the withdrawal. *See* Rev. Rul. 81-7, 1981-1 C.B. 474; Rev. Rul. 83-108, 1983-2 C.B. 167, I.R.B. 1983-30. The beneficiary should also be given notice of all additions to the trust and the beneficiary's right to them.

Practice Note

It is good practice for the trustee to send written *Crummey* notices each year and to have the beneficiaries sign the bottom of the notice to acknowledge receipt.

The question of who is to be in the class of permissible withdrawal beneficiaries should be reviewed carefully. It could state that all children or issue living from time to time are to be included. In *Cristofani v. Commissioner*, 97 T.C. 74 (1991), *acq. in result*, 1992-1 C.B. 1, the court held that a gift tax annual exclusion was allowable for trust property subject to a power of withdrawal given to a grandchild of the grantor who had a remote contingent interest in the trust. In an Action on Decision relating to *Cristofani* (A.O.D. 1992-009), the IRS indicated that it will not contest the use of the annual gift tax exclusion for *Crummey* powers held by current income beneficiaries and persons with vested remainder interests, but that it will deny exclusions for individuals who have no property rights in the trust except for *Crummey* powers or who hold only contingent remainder interests.

Practice Note

If a child has special needs or may require governmental assistance, consider specifically omitting that child as a *Crummey* beneficiary. Otherwise, the Department of Public Welfare or the Social Security Administration may be able to assert the right on behalf of the child.

The draftsperson should consider including a clause in the trust that allows the donor to change the permissible withdrawal beneficiaries on an annual basis. In any given year, the donor could omit a child (who, for example, is in a divorce situation or has chosen to exercise the withdrawal right).

If the amount of the annual premium is higher than the available annual exclusion gifts, there are tax consequences to the beneficiary. If a beneficiary fails to make the *Crummey* withdrawal, the beneficiary is considered to have released a general power of appointment. If the beneficiary's power to withdraw exceeds the greater of $5,000 or 5 percent of the value of the trust property, the beneficiary is considered to have made a gift to the other *Crummey* beneficiaries. I.R.C. §§ 2041(b)(2), 2514(e). It is for this reason that many insurance trusts limit the withdrawal right to the so-called 5-and-5 amount.

If the aggregate amount given to the trust exceeds the lapse amount, some attorneys use a "hanging power" in the trust. A hanging power is designed to lapse in any year only to the extent that the power does not exceed the 5-and-5 limitation. This "hanging power" allows the beneficiary to retain the right to withdraw the excess over what would be protected by the 5-and-5 lapse. The power to withdraw continues into the next year. The IRS does not look favorably on hanging powers. *See* Priv. Ltr. Rul. 8901004. But see also discussion in Howard M. Zaritsky & Stephan R. Leimberg, *Tax Planning with Life Insurance: Analysis with Forms* § 5.03(3)(j)(iii) (Warren, Gorham & Lamont 2d ed.) to the effect that the IRS's reasoning in this ruling is incorrect.

(g) *Exclusion for Education and Medical Expenses*

An unlimited exclusion is also allowed for amounts paid on behalf of a donee *directly to* an educational institution for tuition payments or *directly to* a health-care provider for medical expenses, without regard to the relationship between the donor and the donee. I.R.C. § 2503(e). This exception does not include amounts paid for books, supplies, dormitory fees, or other such expenses.

The medical care exclusion is not allowed for amounts reimbursed by insurance. Medical expenses are limited to the amounts defined in I.R.C. § 213 (those incurred for diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body, transportation for

medical care, qualified long-term care services, and medical care insurance). *See also* Rev. Rul. 82-98, 1982-1 C.B. 141. The medical care exclusion can be useful when dealing with an elderly parent's needs.

(h) *Marital Deduction—Gifts to a Citizen Spouse*

The federal gift tax marital deduction is unlimited for transfers to a citizen spouse. I.R.C. § 2523. The gift tax marital deduction closely resembles the estate tax marital deduction, even to the extent of including its own terminable interest rule.

To qualify as a marital deduction gift, the following requirements must be satisfied:

- the parties must be legally married at the time of the gift (premarital gifts do not qualify);
- the donor spouse must be a U.S. citizen; and
- the gift cannot be one of a "nondeductible interest" but a deduction is allowed for qualified terminable interest property (QTIP).

Practice Note

The unlimited gift tax marital deduction enables married couples, assuming they are both of a mind to do so, to equalize their assets in order to make sure that each spouse has sufficient assets in his or her name to take advantage of the unified credit and the generation-skipping tax exemption. In the same vein, the marital deduction can also facilitate asset protection planning.

(i) *Marital Deduction—Gifts to a Noncitizen Spouse*

The federal gift tax marital deduction for transfers to a spouse who is not a U.S. citizen is not unlimited. I.R.C. § 2523(i)(1). There is a $134,000 annual exclusion in 2010 for gifts that would otherwise qualify for the marital deduction. I.R.C. §§ 2523(i)(2), 2503(b). A lifetime QTIP is not permitted for transfers to a non–U.S. citizen spouse.

If a husband and wife, one of whom is not a U.S. citizen, take property or acquire property in joint names, the rule that each would be considered to own one-half of that property for federal estate and gift tax purposes, regardless of who contributed to it, does not apply. Joint property, and additions to it, are not treated as gifts. I.R.C. § 2523(i)(3). The full value of the jointly owned property will be included in the estate of the first spouse to die unless the surviving spouse can prove his or her contribution to the property. I.R.C. § 2040(a).

(j) *Split Gifts Between Husband and Wife*

A gift by husband or wife to a third party may be considered as made one-half by each spouse. I.R.C. § 2513. This is the split-gift provision, which attributes one-half of the gift to the spouse of the donor, if the spouse consents to such treatment. This split-gift provision enables spouses to take advantage of two lifetime unified credits and two annual exclusions, as well as enabling them to use the lowest of two graduated tax brackets for gifts by either or both of them, whether they are giving separate, community, or jointly owned property.

§ 2.3.13 Liability for the Gift Tax

Primary liability for the gift tax rests with the donor. However, the donee is secondarily liable for the tax, to the extent of the value of the gift. In fact, the donee will be liable even if it has not been proven impossible to collect from the donor. The tax may be assessed at any time within one year after the period of limitation for assessment against the transferor. Also, imposition of gift tax creates a lien against the gift for a period of ten years from the date of the gift. Moreover, the recipient of a tax-free gift can be held liable (only to the extent of the value of the gift) for tax unpaid on all other gifts made by the donor during the same taxable year. I.R.C. §§ 6324(b), 6901(a)(1)(A)(iii), 6901(c)(1).

§ 2.3.14 Gift Tax Return

A gift tax return must be filed by any citizen or resident who, within one calendar year, gives to any one donee property that exceeds or does not qualify for the annual exclusion gift, the exclusion for certain transfers for educational or medical expenditures, or the marital deduction.

The gift tax return must be filed before April 15 following the close of the calendar year of the reportable gift. The return must be filed even if no tax is due because of other allowable deductions or exemptions, and must also be filed in order to elect gift splitting under I.R.C. § 2513. In the case of a split gift, a tax return must be filed even if there is no gift tax liability.

An extension to file the return may be given under I.R.C. § 6081. An extension of time to file the donor's federal income tax return also acts to extend the time for filing the donor's gift tax return. I.R.C. § 6075(b)(2).

The tax, if any, is due with the gift tax return. I.R.C. § 6151. Extensions to pay the gift tax itself can sometimes be obtained. I.R.C. § 6161.

On the 1996 Form 709, Gift Tax Return, the IRS added a box in Schedule A (Computation of Taxable Gifts) that must be checked if the value of any gift listed on Schedule A reflects a valuation discount. If there is a valuation discount, the taxpayer must attach an explanation giving the factual basis for the claimed discounts and the amount of the discounts taken.

§ 2.3.15 Gift Tax and Declaratory Judgments

Section 506(c) of the Taxpayer Relief Act of 1997 added I.R.C. § 7477, which provides that a taxpayer may seek a declaratory judgment regarding the value of the gift. The creation of the declaratory judgment remedy was the consequence of changes to the gift tax statute of limitations and was aimed at encouraging the IRS to review gift tax returns even if no gift tax is currently due. Under Section 2001(f), added by the 1997 Act, the IRS is prohibited from revaluing a gift when examining the donor's estate tax return, provided that the gift was disclosed on a gift tax return as to which the statute of limitations had run. The conference report to the act states that Congress anticipated that the IRS will issue a notice of deficiency when it revalues a gift during a gift tax audit, even when the gift comes under the taxpayer's unified credit. Since no tax would be due on a deficiency that was absorbed by the unified credit, the taxpayer who received such a deficiency notice would have no means of challenging the deficiency without the existence of the declaratory judgment action. Section 7477(b) provides that a tax court petition for a declaratory judgment may be filed by the donor after he or she has exhausted his or her administrative remedies. The petition must be filed after the ninety-first day after the IRS has mailed its determination. The declaratory judgment remedy is available for gifts made after August 5, 1997. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 506(e)(1).

§ 2.4 RHODE ISLAND GIFT TAX

Rhode Island has no gift tax.

§ 2.5 GENERATION-SKIPPING TRANSFER TAX: FUNDAMENTAL CONCEPTS

Note: This section was originally prepared by Helen H. Stewart, Esq., for an MCLE program on understanding the transfer tax system. It was reviewed and updated as necessary in 1999 by Meredeth A. Beers, Esq., of Holland & Knight LLP; in 2002 and 2007 by Christopher D. Perry, Esq., of Northern Trust; and it

was edited and reviewed and updated as necessary and adapted to Rhode Island law in 2010 by Stephen T. O'Neill, Esq.

§ 2.5.1 Policy and Nature of the Tax

When the transfer tax system consisted only of the gift tax and the estate tax, wealthy taxpayers could create trusts that provided their children with the income stream from the trust property and ultimately passed trust principal on to grandchildren, the ability to effect such transfers being limited only by the restrictions imposed by any applicable common law rule against perpetual trusts. This legal environment had the effect of avoiding transfer tax when the trust property was transferred to the grandchildren at the time of the children's deaths. Less wealthy taxpayers, whose heirs would need access to principal, generally could not take advantage of this opportunity. This was not only considered unfair, but substantial revenue was lost as great fortunes passed transfer-tax-free down through the generations. A tax to fill in the gap was first enacted in 1976, but was generally ignored because both taxpayers and the IRS found the rules impossibly unwieldy. The Tax Reform Act of 1986 repealed the first attempt and enacted Chapter 13 of the Code, the generation-skipping transfer (GST) tax, to catch intergenerational donative transfers that would otherwise escape tax. The objective of the new law was to ensure the imposition of a transfer tax at each generation.

In 2001, Congress again passed legislation affecting the GST tax. This legislation, the Economic Growth and Tax Relief Reconciliation Act of 2001 (2001 Act), Pub. L. No. 107-16, 115 Stat. 38 (2001), is perhaps best known to estate planners for gradually phasing out the estate and GST taxes between 2001 and 2009, repealing the estate and GST taxes altogether in 2010. The 2010 Act enacted a $5 million GST exemption, but this law sunsets in 2013.

Although this GST tax may inspire confusion even in experienced estate planners, consider the difficulty of developing a workable design for such a tax. The scheme aims to tax property as if it passed through the estates of the children on its way from grandparents to grandchildren. The original 1976 tax attempted to trace the transfer tax history of the grandparent and compute a marginal rate for the generation-skipping gift. In 1986, Congress simplified the design of the tax by providing that all transfers that skip a generation are taxed at the highest estate tax rate. Prior to January 1, 2001, that rate was 55 percent. Under the 2001 Act, the top estate tax rate is gradually reduced and, with it, the GST tax rate, as follows:

Year	GST tax rate
2002	50%
2003	49%
2004	48%
2005	47%
2006	46%
2007	45%
2008	45%
2009	45%

For 2011 and 2012, the top tax rate is 35 percent.

This single-bracket rate table is perhaps the only simple aspect of the tax. All the rules regarding when and how the tax applies involve special definitions and unfamiliar concepts.

The law allows an exemption in order to confine the effect of the tax to the wealthy, with the admirable intent of narrowing the ever-widening gap between rich and poor in this country and hopefully forestalling a revolution of the type that afflicted France in 1789. This "GST exemption" is discussed in more detail under § 2.5.3(e), The GST Exemption, below. In 2009, the GST exemption reached $3.5 million, which meant that each transferor could give up to $3.5 million to skip persons (as such term is defined in § 2.5.3(b), Skip Person, below) or trusts for their benefit free of GST tax. Both the estate and GST taxes are repealed for the year 2010. In 2011 and 2012, the GST exemption is $5 million. In 2013, the GST exemption is scheduled to return to $1 million, adjusted for inflation. The transferor can allocate this GST tax exemption to outright gifts, either during life or at death, and to trusts. The donor of property to an irrevocable trust may also be deemed to have automatically allocated his or her GST tax exemption to the trust for the contributed amount if the transfer qualifies as an "indirect skip" as discussed under § 2.5.3(d), Four Types of Skips, below. Most of the complexities arise in planning to use the exemption in the context of trusts where the ultimate recipients of property cannot be determined at the inception of the trust.

Practice Note

The good news is that by reading the Code and regulations, you can learn all the relevant rules. The bad news is that the regulations are lengthy, sleep-inducing, and diabolically complex. But many of the more difficult concepts regarding valuation and rules for timing of the

allocation of the exemption can be held in abeyance until the student has been thoroughly immersed in the basic design of the tax.

The rest of this overview endeavors to explain in an orderly manner the major features of the tax. Exceptions and rules for unusual fact patterns and sophisticated planning techniques are omitted in the interest of simplicity and brevity. For examples of certain situations in which the GST tax may be inadvertently incurred, see **Exhibit 2A**.

Ethics Commentary

You may have an ethical duty to consult with a practitioner experienced in planning for this tax when generation-skipping is a specific focus of the client's plan.

§ 2.5.2 Effective Dates

Generally, the GST tax applies to generation-skipping transfers that occur after October 22, 1986. Trusts that were irrevocable on or before September 25, 1985 are grandfathered and therefore exempt from the tax. Special transition rules apply if an instrument was signed before October 22, 1986 and the transferor died before January 1, 1987, or if a decedent was incompetent from October 22, 1986, until death.

Caution

An addition to a grandfathered trust will be subject to the GST tax and will require recalculation of the GST tax rate for the trust. A lapse of a general power of appointment is treated as a constructive addition.

Final GST regulations were published on December 27, 1995. Most of the differences between the temporary regulations and the final version are favorable to the taxpayer, but generally they offer the taxpayer a choice as to which version will apply to transfers made and trusts that became irrevocable between December 23, 1992 and December 27, 1995.

§ 2.5.3 Basic Rules and Definitions

(a) *Transferor*

The "transferor" is the donor in the case of a lifetime gift, and the decedent in the case of a transfer at death. (It is immaterial whether the gift or bequest is free of other transfer tax by virtue of the annual gift tax exclusion or the unified

credit.) For example, the holder of a general power of appointment over trust property will be the transferor of that property because it will be included in the powerholder's taxable estate.

Similarly, a surviving spouse who is the donee of a QTIP trust is the transferor, since the property is taxable in the surviving spouse's estate. However, a special election is provided for a QTIP trust so that the executor of the estate of the donor-spouse can choose whether the donor (the first-to-die) or the donee (the surviving spouse) will be treated as the transferor. This is called a "reverse" QTIP election. How to use the QTIP trust in planning for the GST tax is discussed in § 2.5.4(d), Planning Opportunities of the QTIP Trust, below.

(b) *Skip Person*

A grandchild of the transferor is a "skip person." Also, a trust for the exclusive benefit of grandchildren and further descendants is also considered a "skip person." Section 2613 of the Code defines a skip person as an individual assigned to a generation two or more generations below the generation of a transferor. There are interesting rules in I.R.C. § 2651 for assigning generations for stepdescendants, collateral heirs (such as descendants of siblings), and unrelated transferees. A transferee who is not a lineal descendant of the transferor is a "skip person" if he or she is more than thirty-seven and one-half years younger than the transferor.

Caution

The application of the tax to gifts to unrelated persons thirty-seven and one-half years younger than the transferor is a trap for the unwary. For bequests to unrelated persons, you will need to ask the age of the donor and donee to know whether the gift will be a GST.

(c) *Interest*

Rules defining whether a generation-skipping transfer occurs within a trust hinge on whether a skip person has an "interest" in the trust. But "interest" has an unexpectedly narrow definition for Chapter 13 purposes. Only a present right to receive income or principal, whether mandatory or discretionary, is an interest for purposes of the GST tax.

(d) *Four Types of Skips*

There are four types of skips: direct skip, taxable termination, taxable distribution, and indirect skip.

Direct Skip

A "direct skip" is a transfer to a skip person subject to the estate or gift tax. An outright gift or bequest to a grandchild is a direct skip. Also, a gift to a trust for the exclusive benefit of grandchildren and more remote issue is a direct skip. The other three types of skips happen within trusts that benefit both children and their issue.

The donor is liable for the tax on a direct skip. If the tax is paid from the donor's other property (i.e., not deducted from the gifted property), payment of the tax is an additional (although tax-free) generation-skipping transfer. See § 2.5.3(f), Computing the GST Tax, below.

In the case of a direct skip, there is an exception for a transfer to a grandchild whose parent has died. The logic is that the transferor does not have the option of leaving property to the deceased child.

Practice Note

This exception, found in I.R.C. § 2612(c)(2), is referred to in the regulations as the "predeceased ancestor exception," and in some commentaries as the "generation step-up."

The Taxpayer Relief Act of 1997 extended the predeceased ancestor exception in two ways. First, it was extended to collateral heirs (e.g., grandnieces and grandnephews) if, at the time of the transfer, the donor had no living descendants and the donee had no living parent.

Second, while the predeceased ancestor exception does not generally apply to taxable distributions and taxable terminations, it has been extended to include them in a limited manner. If the parent of the donee is deceased at the earliest time the transfer (in which the donee has an interest) was subject to estate or gift tax, a distribution from the trust to the child is not considered a taxable distribution or taxable termination. For example, suppose that a grandfather establishes a trust for his grandchild by the terms of his will, but at the time of the grandfather's death, the grandchild's parents are not alive. The transfer is subject to estate tax as a result of the grandfather's death, but distributions to the grandchild will not be subject to the GST tax.

The rules extending the predeceased ancestor exception apply to generation-skipping transfers occurring after December 31, 1997.

Taxable Termination

A “taxable termination” occurs when all the (present) interests of nonskip persons end and only skip persons are left as beneficiaries of the trust. In a spray trust for the benefit of children and grandchildren, a taxable termination will occur at the death of the child. The trustee is responsible for paying the tax and the tax is payable from the trust property.

Taxable Distribution

A “taxable distribution” is a distribution of either income or principal from a trust to a skip person. The distributee is responsible for payment of the tax, and the tax is deducted from the property being distributed.

By specific provisions in a trust document, the source of payment of the tax can be shifted, but the responsibility for payment of the tax cannot. Some transfers will fit into more than one definition. The Code and regulations contain rules as to which takes precedence.

Indirect Skip

An indirect skip is a transfer (other than a direct skip) to a “GST trust,” provided the transfer is subject to gift tax. A GST trust is defined broadly as a trust that *could* have a GST with respect to the transferor. Most trusts have some potential for GSTs occurring from the trust. Therefore, the definition of a GST trust is largely made by its exceptions, of which there are six, discussed below. An indirect skip will not usually result in the imposition of the GST, but rather is important in terms of the automatic GST exemption allocation rules (discussed under § 2.5.3(e), The GST Exemption, below). **Exhibit 2B** contains examples that illustrate how these exceptions work. Any transfer to a GST trust will trigger a deemed allocation of the transferor’s GST exemption to the trust for the contributed amount. The automatic allocation of the GST exemption to indirect skips does not apply to transfers at death, and it applies only to transfers subject to gift tax made after December 31, 2000, and to transfers, whenever made, that are subject to estate tax inclusion periods (ETIPs) ending after December 31, 2000. (An ETIP is any period following an inter vivos transfer of property during which the property would be included in the donor’s estate if the donor died during the period.)

Practice Note

A donor may elect to have a trust not treated as a GST trust by making an election on a timely filed gift tax return (including extensions). Given the potentially disastrous consequence of wasting a donor’s

GST exemption by making indirect skip transfers to a trust that the donor does not intend to benefit skip persons but that nonetheless qualifies as a GST trust, it may be prudent to advise clients to opt out of the deemed allocation rules under I.R.C. § 2632(c) by making an election on a timely filed gift tax return. **Exhibit 2B** provides sample language for making such an election.

Under I.R.C. § 2632, a trust is *not* a GST trust if the trust instrument includes the following provisions:

- **Exception 1:** More than 25 percent of the trust must be distributed to (or may be withdrawn by) one or more nonskip persons before age forty-six, or at specified dates that will occur before the nonskip person attains age forty-six, or at an event that will reasonably be expected to occur before age forty-six, based on the regulations. I.R.C. § 2632(c)(3)(B)(i).

- **Exception 2:** More than 25 percent of the trust must be distributed to (or may be withdrawn by) one or more nonskip persons living at the death of a person identified by name or class who is more than ten years older than the nonskip persons. I.R.C. § 2632(c)(3)(B)(ii).

- **Exception 3:** This exception is related to Exceptions 1 and 2, in that 25 percent must be distributed to the estate or estates of one or more nonskip persons dying before a date or event described in Exception 1 or 2, or is subject to a general power of appointment in one or more nonskip persons dying on the dates described in Exceptions 1 and 2. I.R.C. § 2632(c)(3)(B)(iii).

- **Exception 4:** Some portion of the trust would be included in the gross estate of a nonskip person (other than the transferor) if the nonskip person died immediately after the transfer. I.R.C. § 2632(c)(3)(B)(iv).

- **Exception 5:** The trust is a charitable remainder annuity trust (CRAT), charitable lead annuity trust (CLAT), or charitable remainder unitrust (CRUT). I.R.C. § 2632(c)(3)(B)(v).

- **Exception 6:** The trust is a charitable lead unitrust (CLUT) and is required to pay principal to a nonskip person at the term's end. I.R.C. § 2632(c)(3)(B)(vi).

Special Rule for Crummey *Powers*

Under I.R.C. § 2632(c)(3)(B), there is a special rule for annual exclusion withdrawal amounts. Amounts that are includible in the nonskip person's estate or subject to a power of withdrawal by a nonskip person that do not exceed the amount of the annual exclusion from gift tax under Section 2503(b) with respect to a transferor are not considered in applying the exceptions to the definition of a GST trust. Therefore, if the amounts transferred to a *Crummey* trust do not exceed the amount of the annual exclusion each year for each *Crummey* beneficiary (for each transferor) and if each beneficiary's demand right lapses annually, the trust will be a GST trust unless it meets the requirements of one of the exceptions.

If a child holds the *Crummey* demand right and the amounts subject to the *Crummey* withdrawal powers do not fully lapse each year but instead "hang" and accumulate to a value in excess of the annual exclusion amount, the amount that hangs that is in excess of the Section 2503(b) annual exclusion amount will be considered to be property over which the child has a general power of appointment. Therefore—perhaps paradoxically—this "excess" general power of appointment property above the Section 2503(b) amount will be considered when applying the GST trust exceptions.

It is assumed for purposes of the foregoing discussion that powers of appointment held by nonskip persons will not be exercised.

ETIP Rule

The indirect skip is deemed to occur at the termination of the ETIP. I.R.C. § 2632(c)(4).

> **Practice Note**
> The kinds of trusts that most commonly qualify as GST trusts triggering the deemed allocation of GST exemption rules are irrevocable life insurance trusts and irrevocable *Crummey* trusts designed to receive inter vivos gifts for beneficiaries in generations lower than that of the transferor. Therefore, if a client is making gifts to either of these kinds of trusts, careful attention should be paid to whether the trust qualifies as a GST trust, assuming preservation of the donor's GST exemption is an important estate planning goal. A Section 2503(c) trust for a single minor beneficiary will not qualify as a GST trust (even if that beneficiary is a grandchild), because a gift to a Section 2503(c) minor's trust qualifies as a direct skip.

For examples of the kinds of trusts that qualify as GST trusts, see **Exhibit 2B**.

(e) *The GST Exemption*

Under the 2001 Act, in years 2002 and later, the amount that each individual could leave to skip persons or trusts for their benefit free of GST tax is equal to the estate tax applicable exclusion amount (discussed in § 2.1, Federal Estate Tax, above) as follows:

Year	GST exemption
2002, 2003	$1 million
2004, 2005	$1.5 million
2006	$2 million
2007	$2 million
2008	$2 million
2009	$3.5 million
2010	Unlimited
2011, 2012	$5 million

The GST exemption operates to reduce the rate of tax by a mechanism described in § 2.5.3(f), Computing the GST Tax, below. The GST tax rate described in § 2.5.1, above, is developed for each trust at the time the GST exemption is allocated and this rate applies to taxable terminations and distributions over the life of the trust, regardless of fluctuations in the trust's value.

Allocation of the GST exemption can be made by the transferor (or his or her executor) at any time up until the due date of the transferor's estate tax return, including extensions. The GST exemption may also be allocated automatically to a "GST trust," as discussed under § 2.5.3(d), Four Types of Skips, above. Early allocation is generally desirable, as the property sheltered by the exemption can appreciate free of GST tax.

The property to which the GST exemption is allocated, whether a direct skip, taxable termination, taxable distribution, or indirect skip, is generally valued at the time the allocation is made. An individual's available GST exemption is applied automatically to lifetime direct and indirect skips, unless the transferor elects out of the automatic allocation on a timely filed gift tax return.

Practice Note

It would be an unusual fact pattern that would make election out and payment of a GST tax an appropriate planning decision, but election out of automatic allocation for indirect skips that will probably be distributed to children is quite common.

Allocation of GST exemption to lifetime transfers to trusts that are not direct skips is also made on a gift tax return, unless there is an "indirect skip" (see § 2.5.3(d), above). If the allocation is made on a timely filed return, the property is valued at the time of transfer; if the allocation is made on a late return, the property is valued at the time of the allocation. This is a useful planning option if the property decreases in value between the date of transfer and the date of filing the gift tax return.

Practice Note

With respect to late allocations, the value of the property transferred is either its fair market value on the effective date of the allocation or the fair market value on the first day of the month during which the transfer occurs. Life insurance policies can be valued as of the first day of the month as long as the insured does not die before the time the allocation is made.

Under the 2001 Act, relief is provided under I.R.C. § 2632(d) when, due to an unnatural-order-of-death trust, property unexpectedly becomes distributable to a skip person because his or her parent has predeceased. Under the "retroactive allocation of GST exemption" rule, the settlor of the trust (grandparent) can allocate the settlor's GST exemption to the trust as if timely allocation of the settlor's GST exemption had been made at the time of transfer and at the original value. The amount of the transferor's unused GST exemption is determined immediately before the predeceased parent's death, and the allocation is made on a gift tax return that would be timely filed for gifts made in the year that the predeceased parent died.

Practice Note

The retroactive allocation of GST exemption rules are helpful in a situation in which there is a taxable termination upon the death of the predeceased parent. In such a situation, a late allocation of GST exemption is not available because the skip will have occurred prior to the filing of a late allocation. The retroactive allocation of GST exemption rules may also be helpful when used in conjunction with the "qualified trust severance" rules (described in § 2.5.4(c), Qualified Trust Severance, below). For example, if one beneficiary in a class of nonskip beneficiaries of a trust (i.e., children of the donor) predeceases the donor survived by children (the donor's grandchildren), the trustee may be able to sever the deceased child's shares and retroactively allocate the donor's GST exemption to the severed share, maximizing the use of the donor's GST exemption.

Allocation of the exemption to property passing at the death of the transferor is made on the estate tax return, and the property is valued as of the date of death.

The regulations contain rather elaborate rules regarding the valuation and funding of trusts includible in the transferor's estate to prevent postmortem leverage of the exemption by using the most highly appreciated property to fund the GST exempt trust.

If there is no allocation of exemption on the estate tax return, there are default provisions in the Code. Exemption is allocated first to direct skips, then pro rata among trusts that have any potential for taxable terminations or distributions under the dispositive scheme of the trust. For example, a trust that delays distribution to children until age thirty (or forty, or whatever age the client selects) and provides that the share of a child who dies before that age leaving issue goes to the child's issue—a very common type of pattern—has the potential for a taxable termination.

(f) *Computing the GST Tax*

As the chart in § 2.5.1, above, illustrates, the GST tax rate has varied over the last decade, and may continue to change. For purposes of the calculations in this section, a GST tax rate of 50 percent is used.

A $100,000 outright gift to a grandchild will incur a GST tax at 50 percent in the amount of $50,000 unless the donor allocates some of his or her GST exemption. If he or she allocates $100,000 of the exemption, there will be no tax. What happens if the donor allocates less than the amount of the gift? Then the tax rate is 50 percent times the part of the gift in excess of the exemption allocated. For example, if $40,000 worth of exemption is allocated to the $100,000 gift, the tax is 50 percent of the balance of $60,000, or $30,000. This is a reasonably straightforward concept: the GST tax at 50 percent is levied on the portion of the trust not covered by allocation of GST exemption. This method of computing the tax for outright gifts and bequests is easier to understand than the governing Code provisions, but reaches the same result.

Understanding the tax rate computation for a trust is more challenging. The value of the trust will fluctuate, the timing and amounts of taxable terminations and distributions cannot be predicted, and property can be added or additional GST exemption allocated in the future. Generally, a GST tax rate applicable to a trust throughout its existence is developed for the trust when any of the GST exemption is allocated, but there are complicated rules regarding how the tax rate must be recalculated when property is added to the trust or when additional GST exemption is allocated to the trust.

Instead of an outright gift, suppose the transferor creates a trust for the benefit of a child and the child's issue, funded with $100,000, to which $40,000 worth of

GST exemption is allocated. The fraction of the trust sheltered from tax is four-tenths (.4 or 40 percent) and the fraction subject to the tax is six-tenths (.6 or 60 percent). The decimal figure quantifying the portion subject to tax is known as the "inclusion ratio" of the trust; it can be any decimal number between zero and one. In this example, the inclusion ratio is 60 percent. The tax rate for that trust will be the portion subject to tax times the tax rate of 50 percent or, in the case of the example, 30 percent.

Suppose that a distribution is made from this trust to a grandchild in the amount of $20,000. The tax will be 30 percent of $20,000, or $6,000. Next, suppose the child dies when the trust is worth $150,000. A taxable termination has occurred and the entire trust corpus is subject to tax at the rate of 30 percent, resulting in a tax of $45,000.

The calculation of an inclusion ratio other than zero can be avoided if GST exemption is allocated in an amount equal to the property transferred to the trust or to the donee. If no exemption is allocated, the tax rate is simply 50 percent (and the inclusion ratio would equal one).

However, the effective tax rate for direct skips is actually much lower. This is because the base amount on which the tax is calculated is the gift, and does not include the tax. For example, for the $100,000 outright gift to a grandchild, the donor will pay $50,000 in tax. The entire transaction has consumed $150,000 of property and the donee receives $100,000. The effective rate is $50,000 divided by $150,000, or 33 1/3 percent. If the equivalent $150,000 were paid to the grandchild from a trust as a taxable distribution, the tax is 50 percent of $150,000, or $75,000. The grandchild would only receive $75,000. For this reason, and also because of the predeceased ancestor exception discussed above, a direct skip is more desirable than either a taxable termination or taxable distribution.

§ 2.5.4 Planning Concepts

(a) *Avoid an Inclusion Ratio Other than Zero or One*

For purposes of the calculations in this section, a GST tax rate of 50 percent is used, although the actual tax rate may vary. See § 2.5.1, above.

A trust with a zero inclusion ratio (such as a trust of $100,000 to which $100,000 worth of GST exemption has been allocated) will have a GST tax rate of zero multiplied by 50 percent, which equals 0 percent. It will be free of GST tax. Taxable terminations and distributions from this trust will not incur a tax no matter how much the trust property might appreciate.

A trust with no GST exemption allocated has an inclusion ratio of one, meaning the tax rate will be one multiplied by 50 percent, which equals 50 percent. Such a trust should be used exclusively for children (i.e., nonskip persons) to avoid this onerous tax. If your documents allow for segregation of trusts so that they are entirely GST taxable or entirely exempt from GST tax, distributions to grandchildren (i.e., skip persons) can be made exclusively from the exempt trust. Distributions to children and payments for the benefit of grandchildren that qualify for a few limited exceptions can be made from the nonexempt trust. If a trust is partly exempt, distributions to children "waste" the GST exemption and distributions to grandchildren incur a tax, albeit at less than the rate of 50 percent. Therefore, trusts should include language allowing for or directing the segregation of trusts into shares that have an inclusion ratio of either one or zero.

In addition, language in a trust or will calling for generation-skipping transfers to be implemented in an amount designed to use up all GST exemption remaining for a transferor at the time of his or her death, and language governing the authority to divide trusts into separate shares to be maintained as separate trusts with inclusion ratios of one and zero, respectively, should always be drafted in terms of a formula rather than a dollar amount so that adjustment for lifetime use of the exemption or changes in the value as the result of audit will automatically adjust the amount of the transfer or the value of the separate trusts, as the case may be.

The rules about when and how to divide property to create exempt and nonexempt trusts are complicated with an abundance of cross-references to other sections of the regulations. Some of these complexities are intended to prevent the use of fluctuations in value between the date of death and the date of funding of the trust in order to get more property sheltered by the GST exemption. Convoluted rules were also developed for special planning techniques, such as trusts where the grantor or the grantor's spouse retains the income interest for a period of years, resulting in an "estate tax inclusion period." These are important rules to understand, but are beyond the scope of this chapter.

(b) *Sample Trust Division Authority*

The following sample clause is designed to be used with any form of revocable trust included as part of the decedent's estate. It should be considered whenever there is potential for a skip if a child dies prematurely as, for example, where distribution of a child's share is delayed and will go to the child's issue if he or she dies before full distribution. Bracketed language offers a choice between mandatory or optional division; either approach is allowed under the final regulations. The sample clause below calls for division on a pecuniary basis, but the regulations allow non-pro-rata funding if a fractional formula is used.

Practice Note

The sample clause is intended for the inadvertent skip in the event of a premature death. For clients who expressly intend to create a separate generation-skipping trust, consider a trust exclusively for grandchildren to be funded with the balance of the GST exemption available at death.

Sample Trust Clause: Separate Trusts for Generation-Skipping Transfer Tax Purposes

If any trust hereunder (the "original trust") would, but for this provision, have an inclusion ratio other than zero or one for purposes of the generation-skipping transfer tax under Chapter 13, the Trustees [may] [shall] create two trusts in place of the original trust: one (the "exempt trust") shall receive and hold property equal in value to a pecuniary amount defined by the GST exemption to be allocated to the original trust and is intended to have an inclusion ratio of zero and the other (the "non-exempt trust") shall receive and hold the balance of the property which would, but for this provision, pass to the original trust. The Trustees shall base their computations upon values finally determined for Federal estate tax purposes.

1. Division Authority. [If separate trusts are created as provided herein,]

(a) Unless the Donor's Executor has indicated on the Federal estate tax return that separate trusts will be created and has clearly set forth the manner in which the original trust is to be divided and the separate trusts funded, the Trustees shall create the exempt and non-exempt trusts prior to the date prescribed for filing the Federal estate tax return, including extensions actually granted.

(b) The Trustees shall allocate to the exempt and nonexempt trusts a pro rata share of income earned by the property between the valuation date and the date the separate trusts are funded.

(c) The Trustees may satisfy the payment of the pecuniary amount by distribution of property in kind using market values current at the time of distribution.

> *2. Terms of Administration. The exempt and nonexempt trusts shall be administered in accordance with the terms of the original trust, except that:*
>
> > *(a) the Trustees may allocate disproportionate amounts of or interests in property from the exempt and nonexempt trusts in any division of property into separate shares or trusts and in satisfaction of the exercise of any power of appointment or power of withdrawal; and*
> >
> > *(b) the Trustees shall make distributions and payments (including payments of taxes and expenses) which are not generation-skipping transfers from the nonexempt trust to the extent possible.*
>
> *3. Survivorship Presumption. A descendant of the Donor who dies within ninety days following the death of the Donor shall be deemed to have predeceased the Donor for purposes of the GST tax.*
>
> *The Trustees shall not be held liable for the good faith exercise of the authority granted by this Article.*

Also consider adding a clause to the tax allocation provisions of the will pursuant to which any GST tax upon the surviving spouse's death is deflected away from the GST-exempt share of a QTIP marital deduction trust, for example:

> *Taxes attributable to a qualified terminable interest property (QTIP) trust which is exempt from the generation-skipping transfer tax shall be allocated to and recovered from a QTIP trust which is not so exempt. If there is insufficient property in a nonexempt QTIP trust or no such trust, such taxes shall be allocated to and paid from the exempt QTIP.*

(c) *Qualified Trust Severance*

Under Section 2642(a)(3) of the Code, if a trust has an inclusion ratio of other than either one or zero, the trustee may sever the trust into two separate trusts—one with an inclusion ratio of one and the other with an inclusion ratio of zero. A "qualified severance" requires that the trust be divided on a fractional basis, that the severance be by any means available under the governing instrument or local law, and that the terms of the severed trust provide for the same succession of interests of beneficiaries as are provided in the original trust.

Practice Note

The trusts resulting from the qualified severance of a single trust need not be identical. Therefore, if the trust provides income to a spouse and remainder to a child and grandchild, the trust may be severed to create two trusts—one with income to the spouse and remainder to the child, and a second with income to the spouse and remainder to the grandchild. 26 C.F.R. § 26.2654-1(b)(ii)(A).

(d) *Planning Opportunities of the QTIP Trust*

A typical plan for a couple sets aside the credit shelter amount on the death of the first spouse to die, and postpones tax on the balance over the credit shelter amount by using the marital deduction. For purposes of this section, "credit shelter amount" is the maximum amount a decedent may transfer to or for the benefit of individuals other than a surviving spouse at death without incurring either a federal or a Rhode Island estate tax. For a decedent who has made no lifetime taxable gifts, the maximum credit shelter amount is equal to the Rhode Island estate tax exemption of $850,000. A spray credit shelter trust for the benefit of a spouse and issue is a suitable trust to absorb the portion of the decedent's GST exemption equal to the maximum credit shelter amount. However, if the GST exemption of the first-to-die is greater than his or her maximum credit shelter amount and if the estate of the first-to-die does not use the remaining GST exemption, it disappears. But how can you have your marital deduction for everything in excess of the credit shelter amount and not waste the GST exemption, assuming the GST exemption is in excess of the credit shelter amount? The QTIP trust is the answer.

Only the QTIP trust lets the planner choose whether the donor spouse or the donee spouse will be the transferor for GST purposes. For estate and gift tax, the donee spouse's estate will incur the tax if a QTIP election is made. But for GST purposes, one can make a "reverse" QTIP election so that the donor spouse is the transferor. Unlike the QTIP election itself, the GST reverse QTIP election is all or nothing—no partial reverse elections are permitted. This is the reason a typical plan provides for one QTIP trust to absorb the excess of the decedent's available GST exemption over the credit shelter amount as to which the reverse QTIP election is made, and a separate QTIP trust for anything in the estate in excess of the decedent's available GST exemption.

(e) *GST Tax and Gift Tax Exclusions*

Payments of medical expenses and tuition in any amount on behalf of a grandchild are free of GST tax. Generally, a gift to a grandchild of a present interest

under the gift tax annual exclusion amount ($13,000 for 2011) in any calendar year will be exempt for GST tax purposes. This is not true for a transfer in trust unless the trust is for the exclusive benefit of one individual (the grandchild) and anything in the trust at that person's death is included in that person's estate. This discrepancy between the gift and GST taxes as applied to present interests in trusts makes use of *Crummey* powers of withdrawal very tricky and a potential trap for the unwary in connection with GST tax planning if skip persons are granted *Crummey* powers.

§ 2.5.5 When Not to Worry About the GST Tax

The estate plan of a single person that gives all property outright to issue by right of representation cannot result in a generation-skipping transfer. (However, that is not to say that such a plan is necessarily the most tax-efficient or the most creditor-protected plan.) Even if a child predeceased and had children of his or her own, the predeceased ancestor exception will cause the grandchildren to be treated as if they were the decedent's children for GST purposes. This is also true for the wills of a couple where all of their estate goes to the survivor on the first death, and then outright by right of representation to their issue on the second death. If the will also contains a specific bequest to a friend, however, be sure to ask the friend's age in case he or she is more than thirty-seven and one-half years younger than the testator, and is thus a skip person.

Trusts that became irrevocable before September 26, 1985, are grandfathered and therefore exempt from the GST tax. Do not create a plan adding property to such a trust unless you also plan to allocate sufficient exemption to preserve the tax-exempt status. You may want to consider the exercise of any powers of appointment to extend the life of such a trust, but you should be very careful to observe the special GST rule against perpetuities (RAP), which means the power cannot be exercised to extend the term of the trust beyond a period measured by the lives of beneficiaries in being at the time the trust became irrevocable, plus an additional twenty-one years.

If you can be quite certain a couple's combined net worth will not exceed the amount of the current GST exemption, you may decide to risk omitting GST language. For example, a couple in their eighties on a fixed income with a current net worth below $500,000 might be a fairly safe bet. However, it is better practice to include trust division authority as part of your standard boilerplate language on the "better safe than sorry" theory. You may reassure clients who are confused by the provisions that they are unlikely to apply.

Regular QTIP trusts—as opposed to QTIP trusts for which a reverse election is made—going outright to issue on the death of the surviving spouse cannot give

rise to a GST tax, because the surviving spouse will be the transferor. The issue of a child who predeceases that surviving parent will qualify for the predeceased ancestor exception. However, you will probably want to build in the flexibility for dividing the QTIP in order to allow a reverse election if the trust could possibly exceed the available exemption.

§ 2.5.6 Conclusion

This is a much abbreviated and simplified explanation of the GST tax. There are exceptions and refinements to many of the blanket statements and definitions included in this chapter, so you will need to study the tax in more depth. The purpose of this explanation is to outline the concepts and provide a very basic framework upon which to build your knowledge of the law from more detailed and expansive sources.

§ 2.6 DEFENSIVE GENERATION-SKIPPING TRANSFER TAX PLANNING: DRAFTING WILLS AND TRUSTS FOR CLIENTS WHO DO NOT INTEND TO SKIP GENERATIONS

Note: This section was originally prepared by Helen H. Stewart, Esq., for an MCLE program on understanding the transfer tax system. It was reviewed and updated as necessary in 1999 by Meredeth A. Beers, Esq., of Holland & Knight LLP; in 2002 and 2007 by Christopher D. Perry, Esq., of Northern Trust; and was adapted to Rhode Island law and reviewed and updated as necessary in 2010 by Stephen T. O'Neill, Esq., of Lahti, Lahti & O'Neill, PLLC.

§ 2.6.1 Introduction

This section focuses on basic estate planning for clients who have no intention of skipping generations. It attempts to give a complete checklist of GST tax-related clauses that should be in almost all your documents. As discussed in more detail in § 2.1.3 and § 2.5.1, above, the 2001 Act gradually increases the estate and GST exemptions in years 2002 through 2009, thereby increasing the amount that any one individual can give away free of estate or GST tax. In 2010, the estate and GST taxes are repealed. In 2011 and 2012, the gift, estate, and GST taxes all have $5 million exemptions. In 2013, the exemptions will revert to $1 million. The gift tax lifetime exemption will remain constant at $1 million, even in 2010 when the estate tax and GST tax are repealed. For purposes of this

section, the amount that a decedent can give away at death free of estate tax will be referred to as the "exemption equivalent."

In a few limited situations, you do not need to include any reference to the GST tax in an estate plan. For example, a single person leaving all of his or her property to issue by right of representation or all to charity cannot give rise to a generation-skipping transfer. A couple whose combined net worth is under the exemption equivalent threshold for the federal estate tax can have fairly simple wills without any likelihood of a GST tax. After 2001, when the GST exemption and federal estate tax exemption equivalent are unified, an estate plan for a couple that takes full advantage of their respective federal estate tax exemption equivalents will probably also be able to take full advantage of their respective GST exemptions.

However, for couples who are making inter vivos gifts in excess of the annual exclusion amount and who have pour-over wills and trusts designed to shelter the exemption equivalent and to hold the balance in the QTIP trust, the estate planning attorney will generally want to recommend that the couple have GST tax planning provisions in their wills and trusts. This is because, in the event that the amount of the available exemption equivalent of the first spouse to die should turn out to be less than the amount of his or her available GST exemption, unless there are specific provisions in the will or trust providing for the "reverse" QTIP election discussed in § 2.5.4(d), Planning Opportunities of the QTIP Trust, above, the first spouse to die will waste the portion of his or her GST exemption that exceeds his or her available exemption equivalent. Without a reverse QTIP election, upon the death of the surviving spouse, the QTIP trust, which is includible in the estate of the surviving spouse and of which the surviving spouse is considered the transferor, will consist of GST nonexempt property. The surviving spouse's GST exemption may not be sufficient to exempt all of the property in his or her estate from GST tax, potentially resulting in a GST tax that may have been avoidable.

The concept of portability introduced by the 2010 Act further complicates GST planning. Portability permits the surviving spouse to use the unused unified credit of the first spouse (if the first spouse's estate files an estate tax return making this election). However, portability does not apply to the GST exemption. Accordingly, using a reverse QTIP trust for the first spouse's plan may be the only way to fully utilize both GST exemptions.

§ 2.6.2 Will Clauses

(a) *Tax Apportionment*

In the absence of directions allocating taxes among the beneficiaries of an estate, federal and Rhode Island apportionment statutes will control. *See* I.R.C. §§ 2205–07, 4980A; R.I. Gen. Laws tit. 44, c. 23.1. The general effect of these laws is to place the tax burden on the recipients of the property generating the tax. An "all taxes from the residue [of the probate estate, or of the living trust]" type of clause will shift to the residue the burden of death taxes on the nonprobate property. Although such clauses are common, they can have disastrous consequences if the residuary beneficiaries are not the same people as the recipients of nonprobate property, or if a marital or charitable deduction is partly lost by allocating tax to an otherwise exempt residuary bequest.

Generation-skipping transfer tax is charged against the property constituting the transfer in accordance with I.R.C. § 2603 unless the governing instrument provides otherwise by specific reference to the GST tax, I.R.C. § 2603(b). Two cases confirm that the statutory requirement of a specific reference means a reference to the GST tax: *Estate of Monroe v. Commissioner*, 104 T.C. 352 (1995), *rev'd in part on other grounds*, 124 F.3d 699 (5th Cir. 1997) and *In re Estate of Tubbs*, 900 P.2d 865 (Kan. Ct. App. 1995).

When your client directs you to include in his or her will or trust a $300,000 bequest to his or her grandchild, he or she probably intends the grandchild to receive the full $300,000, regardless of the GST tax generated by the gift. If so, you must allocate the tax away from the gift by specific reference to the tax, such as:

> *I direct my Executor to charge generation-skipping transfer taxes imposed on direct skips, whether under this will or otherwise, to the residue of my estate without apportionment to the transferee.*

Suppose your clients' estate plan calls for establishment of a credit shelter trust and two QTIP trusts upon the first spouse's death, with one QTIP trust to receive the deceased spouse's GST exemption amount in excess of his or her exemption equivalent (which is to be allocated to the credit shelter trust) and to have a GST inclusion ratio of zero, and with the other QTIP trust to hold the balance of the trust property. Upon the surviving spouse's death, his or her estate will have a right of recovery from the remainder beneficiaries of the QTIP trust for estate taxes attributable to the QTIP property under I.R.C. § 2207A. The clients' documents should provide that if the surviving spouse's will or trust exercises such right of recovery, the tax burden falls on the second nonexempt QTIP,

thereby maximizing use of the GST exemption of the first spouse to die. The final regulations have confirmed that a direction in such instance not to recover tax from the "reverse QTIP" does not result in a constructive addition to the reverse QTIP trust at the survivor's death for GST purposes, which is a good result because if there were a constructive addition, the reverse QTIP could have a GST inclusion ratio of between zero and one rather than the desired inclusion ratio of zero. Treas. Reg. §§ 26.2652-1(a)(3), 26.2652-1(a)(5) exs. 7, 8. This provision is unchanged in substance from the temporary and proposed regulations. What has been added in the final regulations is a similar rule for chronologically exempt QTIP trusts. Treas. Reg. §§ 26.2601-l(b)(1)(iii)(A), 26.2601-l(b)(1)(v)(C). (Whether there may be a taxable gift when the executor of the surviving spouse's estate fails to recover the tax from the remainder beneficiaries in the absence of a waiver in the donee spouse's will or trust is not a GST issue.)

How do you shift taxes away from the exempt QTIP? By a direction in the will of the surviving spouse and/or directions in his or her living trust to the following effect:

> *Taxes attributable to a qualified terminable interest property (QTIP) trust which is exempt from the generation-skipping transfer tax shall be allocated to and recovered from a QTIP trust which is not so exempt. If there is insufficient property in a nonexempt QTIP trust or no such trust, such taxes shall be allocated to and paid from [the residuary estate, waiving the right of recovery under I.R.C. § 2207A] [the exempt QTIP].*

Choice of the language in brackets will depend on whether the QTIP remainderpersons are also the residuary beneficiaries of the surviving spouse's probate estate; if they are not, the surviving spouse may very well want to place the tax burden on the exempt QTIP.

(b) *GST Exemption Allocation*

Section 2631 of the Internal Revenue Code gives the executor authority to allocate the decedent's remaining GST exemption so that no specific grant is needed in the will. However, allocation of exemption where there are worthy competing gifts and trusts is a guessing game, as the tax result depends on future events. To protect the executor from complaints of unhappy skip persons, exculpatory language such as the following is probably wise:

> *I authorize my Executor to allocate my exemption from the generation-skipping transfer tax to such gifts, bequests, devises of real property or to such trusts or separate shares of*

> *trusts as my Executor deems advisable regardless of whether such allocation may benefit some individuals more than or to the exclusion of others, and my Executor shall not be liable for any good faith exercise of this authority.*

(c) *Miscellaneous*

Remember that a survivorship requirement that lasts longer than six months will turn an outright bequest into a trust arrangement, Treas. Reg. § 26.2652-1(b)(1). This can change the character of the skip. For example, a bequest to a grandchild conditioned on the grandchild surviving for seven months will make what would otherwise be a direct skip into a taxable termination.

The characterization of the skip has important consequences. Direct skips have distinct advantages: the predeceased ancestor exception of Treas. Reg. § 26.2612-1(a)(2) (although somewhat less of an advantage as a result of the Taxpayer Relief Act of 1997; see § 2.5.3(d), Four Types of Skips, above) and the tax exclusive nature of the gift, giving direct skips a lower effective rate. So, the bottom line is: do not have a survivorship requirement longer than six months.

A typical Rhode Island estate plan uses a pour-over will that directs the residue to an inter vivos trust. In such a plan, the remaining GST tax defensive planning provisions can be placed in the trust.

§ 2.6.3 Trust Clauses

(a) *All Purpose, Self-Contained Severance Authority*

The final GST regulations tell us that we can divide trusts with multiple transferors or separate shares at any time. The regulations go on to explain how you can divide a trust, such as your garden-variety revocable trust, provided the trust property is included in the transferor's gross estate. The provisions are complicated because most of the requirements offer choices and subchoices and contain many cross-references. The requirements appear to assume there will be dramatic appreciation in assets between the date of death and the date of funding, and that the taxpayer will attempt to leverage the GST exemption by selecting the most highly appreciated assets to fund the exempt share.

The importance of separating exempt and nonexempt property into separate trusts, even if the trusts have the same dispositive terms, is described in § 2.5.4, Planning Concepts, above. In essence, separate trusts will allow the trustee to use exempt assets for payments to skip persons, and thus avoid the GST tax.

The author has attempted to develop a single article that contains all the necessary authority for the trustee to create separate exempt and nonexempt trusts when the trust is included in the grantor's estate. This article can be grafted onto existing forms, whatever your favorite planning approach may be, without having to make changes throughout the instrument. You will need to make sure the provisions in the sample clause are not inconsistent with powers or terms set forth elsewhere in your forms. The suggested language is appropriate only for the standard revocable trust most often used for a married couple to shelter the exemption equivalent of the first to die. Other trusts, such as those with *Crummey* powers, Section 2503(c) trusts for children, and irrevocable inter vivos trusts, such as QTIPs or those for lifetime use of the unified credit, have different considerations and will require different language.

Treasury Regulation § 26.2654-1(a) provides that a revocable trust includible in the estate of the grantor is treated as if it were created on the death of the grantor. Thus, in spite of the retention of the onerous separate-share-from-the-inception rules, the final regulations allow division into exempt and nonexempt trusts at the grantor's death. The division authority can be optional or mandatory. Treas. Reg. § 26.2654-1(b)(1)(i), (ii). You may want to give the trustee discretion not to divide in a modest net-worth plan where the amounts, terms, or duration of a trust with an inclusion ratio between zero and one is unlikely to be of any practical significance.

Some planners have advocated using a clause giving the trustee the power to choose the estate tax over the GST tax by granting a beneficiary of a nonexempt trust share a general power of appointment. It has been suggested that if the power is confined to permission to appoint to the beneficiary's creditors (in effect the narrowest type of general power of appointment), it would be unlikely for the donee of the power to send assets outside the family.

An important pro-taxpayer provision has been added to the final regulations: the predeceased ancestor exception for direct skips will be available for a descendant of the transferor (who is an ancestor of a skip person) who dies within ninety days after the transfer if the instrument so provides. The survivorship presumption in the suggested clause is designed to take advantage of this favorable addition to the final regulations.

The sample self-contained GST severance clause below offers the trustee a choice between fractional share or pecuniary amount funding methods. This should allow flexibility so that the trustee can select the method most appropriate to the assets and economic climate. A caveat is in order: the author does not know of any other commentators who suggest you can give the trustee such an option between funding methods, so you may want to select the funding instructions that track the marital deduction formula you are using in the rest of the document.

Sample All-Purpose GST Clause

Separate Trusts for Generation-Skipping Transfer Tax Purposes:

> *If any trust hereunder (the "original trust") would, but for this provision, have an inclusion ratio other than zero or one for purposes of the generation-skipping transfer tax under Chapter 13, the Trustees may create two trusts in place of the original trust: one (the "exempt trust") shall receive and hold property equal in value to the GST exemption to be allocated to the original trust and is intended to have an inclusion ratio of zero and the other (the "nonexempt trust") shall receive and hold the balance of the property which would, but for this provision, pass to the original trust. The Trustees shall base their computations upon values finally determined for Federal estate tax purposes.*
>
> *1. Severance Authority: If separate trusts are created as provided herein,*
>
> *(a) Unless the Donor's Executor has indicated on the Federal estate tax return that separate trusts will be created and has clearly set forth the manner in which the original trust is to be severed and the separate trusts funded, the Trustees shall create the exempt and nonexempt trusts prior to the date prescribed for filing the Federal estate tax return, including extensions actually granted.*
>
> *(b) The Trustees may elect to make the severance authorized by this Article on either a fractional or a pecuniary basis, taking into account administrative ease and any other considerations they deem appropriate.*
>
> *(i) If the Trustees elect to make the severance on a fractional basis, they may fund the separate trusts on a non pro rata basis, provided the funding is based either on the fair market value of the assets on the date of funding or is made in a manner that fairly reflects the net change in value of the assets between the valuation date and the date of funding.*
>
> *(ii) If the Trustees elect to make the severance on the basis of a pecuniary amount, property distributed to the exempt and nonexempt trusts in kind shall be valued at the date of*

distribution and the Trustees are required to allocate to such pecuniary distributions pro rata shares of the income earned by the fund to be severed between the valuation date and the date of severance.

2. Terms of Administration: The exempt and nonexempt trusts shall be administered in accordance with the terms of the original trust, except that:

(a) the Trustees may allocate disproportionate amounts of or interests in property from the exempt and nonexempt trusts in any division of property into separate shares or trusts and in satisfaction of the exercise of any power of appointment or power of withdrawal;

(b) the Trustees shall make distributions and payments (including payments of taxes and expenses) which are not generation-skipping transfers from the non-exempt trust to the extent possible.

3. Survivorship Presumption. A descendant of a Transferor as defined for GST tax purposes who dies within ninety (90) days following the death of such Transferor shall be deemed to have predeceased the Transferor for purposes of the GST tax.

The Trustees shall not be held liable for the good faith exercise of the authority granted by this Article.

(b) *Administrative Powers*

It may be necessary to combine trusts of both spouses in order to make the best use of exempt property, as, for example, by funding the share of a deceased child from the reverse QTIP of the first estate. It may be necessary or wise to fund shares or trusts with different proportions of cash or property. For these reasons, the author suggests including the following powers in your standard list:

The Trustees shall have the power:

to combine the property of any two (2) or more trusts hereunder, or to combine the property of any trust hereunder with any trust created by the Donor's spouse if such trusts are for the benefit of the same beneficiaries and have substantially the same dispositive terms and conditions, and to hold and administer such combined trust property as a single trust fund (bearing in mind,

> *however, the inclusion ratio of each such trust and other federal and state tax attributes of each such trust);*
>
> *to divide any trust into one or more separate trusts to be held and administered upon the same terms as the original trust for the purpose of segregating property with different tax attributes;*
>
> *to make allocations, divisions, and distributions pro rata or not pro rata, in cash or in kind or in both, provided that property allocated, divided or distributed in kind is valued on the date or dates of allocation, division, or distribution, . . .*

(c) *Rule Against Perpetuities (Repealed in Rhode Island)*

The common law rule against perpetuities provides that no interest is valid unless it is certain to vest within lives in being plus twenty-one years. Scholarly tomes have been written on the meaning of "vest" and other aspects of the rule. A perpetuities savings clause must be included in any trust where there is a possibility an interest generated by the document may extend beyond the permitted period. This is a matter of state property law, and every state has its own approach and body of case law.

Practice Note

Rhode Island has repealed its Rule against Perpetuities, and is one of more than twenty states that have either repealed the rule against perpetuities or extended the period in which an interest must vest to up to 1,000 years. In such states, it is possible to create GST trusts in perpetuity, which are commonly known as "dynasty trusts." Bear in mind, when drafting a Rhode Island trust whose duration either through its own terms or through exercise of a power of appointment conferred thereunder may exceed the period permitted by the common law rule against perpetuities, that any power given to the trustees or beneficiaries to change the trust situs to another jurisdiction should be limited to changing the situs to jurisdictions whose perpetuities law has been repealed.

The rule against perpetuities is relevant in the GST world as the limit to the length of time one can protect exempt property from transfer tax in subsequent generations. A version of the rule appears in the effective date provisions as a limit to the time chronologically exempt trusts can be stretched over future generations. Treas. Reg. § 26.2601-1(b)(1)(v)(B)(2). The exercise of a special power of appointment will be considered a constructive addition to a chronologically exempt trust if it is exercised so as to exceed the perpetuities period.

§ 2.7 RHODE ISLAND GENERATION-SKIPPING TRANSFER TAX

Rhode Island General Laws tit. 44, c. 40 provides for a generation-skipping transfer tax in an amount equal to the credit for state generation-skipping transfer taxes under I.R.C. § 2604. Effective January 1, 2005, the I.R.C. § 2604 credit for state generation-skipping transfer taxes was repealed, effectively voiding the Rhode Island generation-skipping transfer tax. However, repeal of the federal credit for state generation-skipping transfer taxes is scheduled to “sunset” on January 1, 2013, which would apparently revitalize the Rhode Island generation-skipping transfer tax. Although the interaction between the two statutes is not completely clear, since the maximum allowable credit under I.R.C. § 2604 is 5 percent of the federal generation-skipping transfer tax imposed, that would arguably be the amount of the Rhode Island generation-skipping transfer tax on postsunset transfers.

MCLE thanks Professor Charles E. Rounds, Jr., Esq., Ethics Editor, for contributing the Ethics Commentaries included in this chapter.

EXHIBIT 2A—GST Tax: Questions and Answers for Spotting Potential Skips

Note: This exhibit was originally prepared by Meredeth A. Beers, Esq., of Holland & Knight LLP, for the 1999 MCLE program Understanding the Transfer Tax System (MCLE, Inc. 1999-08.22), and was adapted for this chapter. It has been updated by Christopher D. Perry, Esq., of Northern Trust, to incorporate the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16, 115 Stat. 38 (2001).

While mastering the provisions of the GST tax is necessary for sophisticated estate planning, developing a nose for potential GST issues is important when working on all types of estate plans, because the GST tax is easily triggered in a wide variety of situations. The following are typical estate-planning scenarios in which the GST tax may be inadvertently incurred.

1. A husband and a wife have identical estate plans in which they set up a credit shelter trust and a QTIP Trust for the excess over the credit shelter trust. They have young children, so at the death of the second spouse, the QTIP Trust and all of the assets of the second spouse to die pour into the credit shelter trust where they will be held until the youngest child is 25. When the youngest child turns 25 all the trust property goes outright equally to the children, with the children of any deceased child to receive that deceased child's share. Is there a GST tax issue?

   Discussion: If the husband and wife have assets worth more than their combined GST exemptions, it is possible that after both of their deaths, more than the GST exemption amounts will be held in the credit shelter trust. If one child dies and is survived by children before the youngest child turns 25, the distribution to the deceased child's children when the youngest child is 25 will be a taxable termination, subject to the GST tax.

   As an alternative estate plan, consider having the property in the QTIP Trust go directly to trusts for the children, over which they have a general power of appointment. In this way, the amount in the credit shelter trust will never exceed the GST exemption.

2. A widow sets up share trusts for her children. Each child has a general power of appointment at death. If the power is not exercised, the trust property is to stay in separate trusts for each of the deceased child's children (i.e., the grandchildren). The trust for a grandchild terminates when the grandchild turns 25. If the grandchild dies before he or she turns 25, the trust property goes to the grandchild's children. Is there a GST tax issue?

Discussion: If a grandchild were to die before turning 25, and were to be survived by children, the trust property would skip a generation and potentially trigger the GST tax (if insufficient GST exemption has been allocated).

Consider giving the grandchild a general power of appointment or making the trust property payable to the deceased grandchild's estate to provide for a potential premature death.

3. A husband and a wife have identical estate plans; both establish one QTIP Trust for the survivor. At the death of the survivor, all of the property is combined into one set of share trusts for the children. The children may withdraw one-third of the trust property when they turn 25, another third at 30, and the balance at 35. The children have a general power of appointment over the property over which they have a withdrawal power, and a limited power of appointment over the property over which they have no withdrawal power. Is there a GST tax issue?

   Discussion: If a child dies before turning 35, but is survived by children, the portion of the trust over which the child has a limited power of appointment would be subject to the GST tax.

   Consider whether it is necessary to include the limited power of appointment.

4. A widow establishes a QPRT to hold her lovely, extremely valuable seaside property. The QPRT has a ten-year term. At the end of the term, the home is to pass outright to her children, per stirpes. Is there a GST tax issue?

   Discussion: A QPRT is an example of a type of trust to which the "ETIP" rules apply. "ETIP" stands for "estate tax inclusion period." An ETIP is any period following an inter vivos transfer of property, during which the property would be included in the donor's estate if the donor died during the period. The term of the QPRT is an ETIP, because if the donor dies during the term, the trust property is included in the donor's estate.

   Under Section 2642(f) of the Code, GST exemption cannot be allocated until the end of an ETIP. If it is allocated during an ETIP, it is not effective until the termination of the ETIP.

   With respect to the QPRT, if a child were to die during the term of the QPRT, a distribution to children of the deceased child would be a taxable termination. Unfortunately, GST exemption cannot be allocated until the end of the term. Presumably, at that time the property will be considerably more valuable than it is at the time of the initial transfer.

Practitioners employ many different methods to avoid an inadvertent generation skip with a QPRT. One is to leave the property at the end of the term to living children only. In these cases, the donor's other estate-planning documents usually contain a make-up provision for the children of any deceased child. Another method is to leave the property at the end of the term equally to living children and the estate of any deceased child. Because it can often be inconvenient to leave property to an estate, the children are sometimes given general powers of appointment to avoid a generation skip.

5. A widower transfers all his life insurance policies to an irrevocable trust. All the beneficiaries have a right to withdraw their portion of any gift made to the trust for a certain period of time following notice of the gift (in other words, they have *Crummey* powers), so the gifts qualify for the gift tax annual exclusion. His premium payments are quite large, so he makes all his children and grandchildren the beneficiaries. At the death of the widower, the trust breaks down into separate share trusts for each child. Each child has a general power of appointment over his or her share trust. Is there a GST tax issue?

   Discussion: Unfortunately, the annual gift exclusion under the GST tax does not perfectly track the annual exclusion from gift tax. Just because a gift qualifies for the exclusion from gift tax does not mean it will qualify for the exclusion from GST tax. Transfers to a trust are only entitled to qualify for the GST exclusion if the transfer is to a "direct skip trust." A direct skip trust is a trust for a skip person from which principal and income may be distributed only to the skip person, and which will be included in the skip person's estate at his or her death (if it is not terminated before then). Accordingly, gifts to the trust in this example will not qualify for the GST annual exclusion.

   GST exemption should therefore be allocated to every gift, or a late allocation can be made at some point. The next question is, however, who is the transferor of the gift? The GST regulations indicate that the donor of the gift is the transferor with respect to the first $5,000 or 5 percent of assets, but that the donee with the *Crummey* power is the transferor with respect to the excess over the $5,000 or 5 percent amount.

   Hanging powers would eliminate the need to worry about this issue, but they raise issues of their own. If possible, consider whether the insurance trust can be drafted as separate share trusts for each child and his or her issue from inception, with each child having a general power of appointment over his or her share.

EXHIBIT 2B—GST Tax: Examples and Illustrations for the Rules on Automatic Deemed Allocation of GST Tax Exemption to "Indirect Skips"

Note: This exhibit was prepared by Christopher D. Perry, Esq., of Northern Trust.

EXAMPLES

As explained under § 2.5.3(d), above, any transfer to a "GST trust" as defined under Section 2632(c) of the Code will cause an automatic allocation of the donor's GST exemption to the trust in the amount of the gift. A GST trust is any trust that could have a generation-skipping transfer from that trust. The definition is so broad that it is made primarily by its six exceptions, contained in § 2.5.3(d), above. The purpose of the following examples is to illustrate how to determine whether a trust qualifies as a GST trust for purposes of the rules on deemed allocation of GST exemption. As of the date of this material, regulations explaining the exceptions to the definition of GST trust have not yet been promulgated. Therefore, it is unclear when the determination should be made of whether 25 percent of the trust property must be distributed to (or may be withdrawn by) one or more nonskip persons under Exceptions 1 through 3. For the purposes of these examples, it is assumed that the determination should be made based on the facts as they exist at the time of the transfer to the trust.

1. Settlor creates an irrevocable trust for her daughter that provides that the daughter will receive discretionary distributions of income and principal until she is 35, at which time the entire balance of the trust corpus will be distributed to her. If she dies before reaching age 35, the trust will be distributed to her issue who survive her, per stirpes. This is not a GST trust because Exception 1 applies. The trust instrument requires that the trustees distribute all of the trust corpus to the daughter before she attains age 46. Therefore, there will be no indirect skip upon the transfer to the trust.

2. H establishes and funds an irrevocable trust for the benefit of W for life, and at her death, outright to H's issue, per stirpes. W is age 30, and H has 3 children, ages 18, 21 and 25. This is not a GST trust, because Exception 2 applies. W is more than 10 years older than the 18-year-old (who is entitled to more than 25 percent of the trust) on the death of W. If, however, the 18-year-old predeceases W with issue, then Exception 2 would cease to apply.

3. Settlor establishes an irrevocable trust for her three children for life, all of whom are under age 46; provided, however, that each child has a general

power of appointment upon his or her death. This is not a GST trust, even though Exception 1 does not apply, because, under Exception 3, if a child dies prior to attaining age 46, more than 25 percent of the trust property is includible in the child's estate as a result of her general power of appointment.

4. H creates an inter vivos QTIP trust for W, remainder per stirpes to issue. Under Exception 4, this is not a GST trust, because trust property is includible in the estate of W if she dies immediately after the transfer.

5. H establishes an irrevocable trust for the benefit of W for life. At W's death, the property is to be divided among H's issue, per stirpes, and distributed one-half at age 30 and the balance at age 35. If any beneficiary survives W and dies before reaching age 35, the beneficiary has a general power of appointment over that beneficiary's trust. W is age 41, and the children are 21, 25 and 30. Here, one child would be entitled to an outright distribution of 16.7 percent of the trust (one-half of 33.3 percent) if W died immediately. Because the 25 percent rule is not met, Exception 2 does not apply, although Exception 2 will apply in five years when the second child attains age 30. Exception 3 probably does not apply because the children do not have a general power of appointment if they predecease W, but rather only if they survive her. Exception 4 does not apply because no portion of the trust would be included in a nonskip person's estate if the nonskip person died immediately after the transfer. Thus, this is a GST trust for which the election out of the automatic allocation rules should be considered.

6. H establishes an irrevocable life insurance trust (ILIT) and funds it with an insurance policy on his life. Upon his death, the proceeds from the insurance policy are to be held in a spray trust for the benefit of W and H's issue during W's lifetime, and upon W's death, outright to H's issue per stirpes. H has two children who are more than 10 years younger than W, and annual premiums total $10,000. Exception 1 does not apply, because there is no requirement in the ILIT that the nonskip children must receive the property prior to attaining age 46. Exception 2, however, applies, because Exception 2 requires that more than 25 percent of the trust property must be distributed to nonskip persons living at the death of a person (or class of persons) identified in the trust instrument who is more than 10 years older than the nonskip persons. H and W qualify as a "class of persons" identified in the trust instrument. There is a possibility that one of the children could die before the survivor of his or her parents. This possibility of an out of order death should be ignored in determining whether the older person exception applies. Neither Exception 3 nor Exception 4 applies, because no portion of the trust property will be included in the estate of a nonskip person who dies survived by either parent. (The *Crummey* power will not trigger Exception 4,

as discussed in § 2.5.3(d), above, and example 7.) Therefore, this is a GST trust.

7. H establishes an irrevocable life insurance trust for the benefit of all of his descendants. This is intended as a dynasty trust to continue for H's descendants for as long as is allowed under local law. H's child has a *Crummey* right that is limited to the annual exclusion amount. A portion of the child's withdrawal right lapses within 30 days, and the child has a continuing "hanging" right to the extent that lapses would otherwise exceed the greater of $5,000 or 5 percent of the trust. On December 31, 2001, the child has a continuing right to withdraw $18,000 based upon the hanging power. At first blush this appears to be a GST trust, but Exception 4 must be considered, because if the child died immediately after the transfer the amount of the child's withdrawal right would be included in the child's estate. The flush language of Section 2632(c) provides a special rule for *Crummey* rights. This provision states as follows:

> For purposes of this subparagraph, the value of transferred property shall not be considered to be includible in the gross estate of a non-skip person or subject to a right of withdrawal by reason of such person holding a right to withdraw so much of such property as does not exceed the amount referred to in section 2503(b) with respect to any transferor, and it shall be assumed that powers of appointment held by non-skip persons will not be exercised.

Based on the flush language, the child's withdrawal right does not create estate inclusion, but only up to the Section 2503(b) amount. Here, the $18,000 withdrawal right exceeds the Section 2503(b) amount, so the flush language is inapplicable to $8,000 (the amount in excess of the Section 2503(b) amount in 2001). Exception 4 applies, so the trust is not a GST trust even though it may have been intended as one.

SAMPLE LANGUAGE FOR FORM 709 TO ELECT OUT OF THE DEEMED ALLOCATION RULES

Attachment to Schedule C, Part 2 of Form 709

Notice of IRC § 2632(c)(5)(A)(i) Election Out of Automatic Allocation of GST Exemption

The Taxpayer, __________, previously has made a transfer to the __________ Trust, dated __________ (EIN: __________) with __________ as trustee (the "Trust"). These transfers to the Trust generally are not subject to the gift tax, because they are present interests and do not exceed the annual exclusion amount. The Taxpayer made such a transfer to the Trust in 2006 and may continue to do so in the future.

Election

The Taxpayer elects, as contemplated pursuant to IRC § 2632(c)(5)(A)(i), to have the trust described above treated as NOT being a GST trust for purposes of IRC § 2632(c) with respect to any of the transfers (or deemed transfers) made by the Taxpayer to the trust (and therefore to NOT have automatic allocation of GST exemption pursuant to IRC § 2632(c) apply to any or all transfer (or deemed transfers) made by the Taxpayer to the trust described above). This election is intended to be effective with respect to all future transfers to the trust described above until the Taxpayer indicates otherwise on a future Form 709.