

# **Generation-Skipping Transfer Tax Developments**

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**Generation-Skipping Trust Reformations.** There is extensive authority under §2601 regarding the issue of which forms of amendment or reformation will not alter a chronologically exempt trust's status for generation-skipping transfer tax purposes, but no similar guidance on changes that will not alter the status of a trust with an inclusion ratio of zero. In that regard **Private Letter Rulings 200420011, 200417014, 200410015** and **200410014** are useful for applying the same §2601 authorities for preservation of the inclusion ratio status of a trust as well. Absent any other guidance that seems to be a perfectly reasonable posture.

**Simplified GST Exemption Allocation Extension.** By implication it appears that the government has received numerous requests for relief under Treas. Reg. §301.9100-3 to make a late §2642(b)(1) allocation at date of gift value rather than under §2642(b)(3) at the value when exemption allocation finally is being made. The typical situation involves a request that makes it clear that a tax advisor (a disproportionate number being accountants, probably only because they tend to be the professional filing the gift tax return that failed to make an effective exemption allocation) failed to make the allocation. It would be easy to guess that **Rev. Proc. 2004-46**, 2004-2 C.B. 142, indicates that the government is tired of these requests and is looking for a way to provide "a simplified alternate method for obtaining an extension to make an allocation of . . . exemption under §2642(b)(1)." They didn't ease their workload significantly, because the requirements of this streamlined approach are somewhat rigid: (1) the transfer occurred before 2001 (after 2000 the automatic allocation rule in §2632(c) likely applies), (2) no taxable transfers have been made yet from the trust involved, (3) the gift involved did not exceed the gift tax annual exclusion amount (in combination with all other gifts to the same donee in that year), (4) no GST exemption was allocated to the transfer, and (5) the taxpayer has GST exemption remaining available to allocate. In those cases a multi-step process is detailed that avoids the need to file a Ruling request or pay the normal fee. The most important requirement? Application is required "on or before the date prescribed for filing the federal estate tax return for the transferor's estate (determined with regard to any extensions actually obtained), regardless of whether an estate tax return is required to be filed."

**Simplified Late Reverse QTIP Election.** In addition to providing relief regarding late exemption allocation, new **Rev. Proc. 2004-47**, 2004-2 C.B. 169, provides "a simplified alternate method for . . . relief to make a late reverse QTIP election" under §2652(a)(3) without the need to file a Ruling request or pay the normal fee. Like Rev. Proc. 2004-46 this option is not as extensive as it might be, in several respects. For one, it does not apply to inter vivos transfers to a spouse, nor to marital QDOTs for a noncitizen spouse. Much more importantly, it does not provide authority to make a late severance of a QTIP trust into the reverse elected portion and the balance, nor does it permit late allocation of GST exemption — that typically is covered by the automatic allocation rules in §2632(e). Finally, this streamlined approach requires (among other technical aspects): (1) that a valid QTIP election was made (you can't reverse QTIP the trust if it isn't a QTIP to begin with), (2) the decedent has adequate GST exemption remaining to produce a zero inclusion ratio by the reverse QTIP election, (3) the surviving spouse has not already disposed of all *or any part* of the qualifying income interest in the QTIP, (4) the surviving spouse is alive (or has not been dead more than six months), and the real kicker, that (5) "the reverse QTIP election was not made on the estate tax return as filed

because the taxpayer relied on the advice and counsel of a qualified tax professional . . . [who] failed to advise the taxpayer of the need, advisability, or proper method to make a reverse QTIP election.” Included in the information that must support this request is a signed statement from the qualified tax professional on whom the taxpayer relied when preparing the original estate tax return that establishes that professional’s qualifications and that swears to the accuracy of the representations in the request for relief, presumably including item (5).

### ***Simplified Override to Automatic GST Exemption Allocation.***

By addition of **Prop. Treas. Reg. §26.2632-1(b)(2)** the government also is making it easier to *prevent* automatic allocation of GST exemption to inter vivos indirect skip transfers in trust. The circumstance in which this commonly will be useful is an irrevocable life insurance trust as to which annual premium contributions will be made, with Crummey power of withdrawals in multiple beneficiaries in multiple generations, granted to qualify for the gift tax annual exclusion to avoid gift tax, but failing the inclusion ratio of zero result in §2642(c) because there are multiple beneficiaries and no vesting of shares for tax purposes. These transfers are indirect skips as to which GST exemption normally would apply by the §2632(c) automatic allocation rules, but in some cases that use of the transferor’s exemption is not desirable. To avoid the need to file each and every year to prevent automatic allocation to contributions that will be made in the future, the regulation allows a one time filing that is effective to override future automatic allocations until that election is terminated. A converse election is provided by **Prop. Treas. Reg. §26.2632-1(b)(3)**, all to be effective as of July 13, 2004, but only if these proposals are made final. Which means that reliance on the procedure is allowable immediately, subject to the risk that the proposal will not be finalized.

### ***Predeceased Parent Rule, and an Adoption Kicker.***

The predeceased parent rule in §2651(e) was added in 1997 to expand and replace the rule previously in §2612. It reflects the reality that taxpayers who skip generations by leaving property directly to younger generation beneficiaries more than one generation removed may not be motivated by tax reduction motives. The simple circumstance reflected in the Code is a transferor who leaves property to a grandchild whose parent is the transferor’s child who predeceased the transferor. Had the child lived the transferor would have provided for the child (and relied on the child to provide for the grandchild), but the child died first. Congress adopted the §2651(e) predeceased parent rule to treat the grandchild as a child of the transferor in this case, which prevents application of the GST on the otherwise direct skip bequest to the grandchild. The 1997 change reflected that leaving property to a sibling’s grandchild because the sibling’s child was deceased also is not an abusive transaction. **Prop. Treas. Reg. §26. 2651-1** adds meaning to this rule by determining when the intervening generation parent must be deceased to qualify as “predeceased” under this rule. The general answer is that the parent must predecease the first estate or gift taxable transfer by the transferor (because it is possible for a transfer to be subject to gift tax and then be brought back into the transferor’s gross estate at death, the first of these is the relevant date). An exception to the general rule applies if the taxable transfer is into a QTIP trust. In that case inclusion in the estate of the transferor’s surviving spouse constitutes the relevant taxable event to determine the predeceased parent element. And an exception to that exception applies if a §2652(a)(3) reverse QTIP election was made, to disregard the transferor’s spouse as the transferor with respect to the QTIP trust. As the preamble to the regulation explains, that exception to the exception

likely does not matter, because most reverse QTIP elections make the trust exempt from GST in their entirety.

Not directly addressed by the proposed regulation is whether a surviving spouse who triggers gift tax under §2519 by an inter vivos assignment of any part of the spouse's income interest should be treated the same as §2044 inclusion in the spouse's gross estate at death. In many cases this inter vivos transfer will be followed by §2036(a)(1) inclusion in the spouse's estate at death but the first taxable event rule (with the spouse as the transferor) should apply and the QTIP trust rule will apply (spouse as transferor) as intended. The only difference would be that the time for applying the predeceased parent rule would be accelerated to the time of the §2519 event rather than waiting until death of the spouse. And in a case in which gift tax treatment under §2519 is the last taxable transfer of the property by the surviving spouse, the regulation does not state that it would be regarded as the relevant taxable transfer in determining predeceased parent status but that also seems to be a given.

Most interesting about this regulation project is that the government used it as a vehicle to adopt another, unrelated concept, relevant under §2651(f)(1), dealing with the effect of an adoption. The traditional §2651(f) rule is that a person who is assigned to two generations by virtue of the various generation assignment rules is assigned to the lower of them for GST purposes. This means that adoption as a mechanism to convert a skip person in to a nonskip person will fail. But **Prop. Treas. Reg. §26.2651-2** reflects what the preamble describes as a "reasonable [presumption] that tax avoidance is not a primary motive when a transferor adopts a descendant of a parent of the transferor (or the transferor's spouse or former spouse) who is a minor." Subject to only the limitation that adoption must occur before the adoptee is 18 years old, the proposed regulation appears to authorize a grandparent to adopt a grandchild and move their generation up to the nonskip person level. Quere how often this might occur *purely* for tax purposes (for example, involving a very rich grandparent and grandchildren who still are minors when estate planning is being recommended).

**Prop. Treas. Reg. §26.2651-3** specifies that these regulations will be effective after they become final, but prior to then "any reasonable interpretation" may be relied upon for purposes of the §2651(e) predeceased parent rule and "these proposed regulations are treated as a reasonable interpretation of the statute." Notice, however, that this does *not* apply to the proposed adoption rule.

**Trust Severance.** Under §2642(a)(3) it may be useful to regard a single trust as being two separate trusts for GST exemption allocation purposes, such as to create one subtrust that is totally exempt and a second that is totally taxable. Replacing existing Treas. Reg. §26.2654-1(b), **Prop. Treas. Reg. §26.2642-6** establishes essentially six rules for making a qualified severance. As a predicate, none of this is applicable unless severance is authorized by local statute or the governing instrument. Quere the result if severance is by court order: would that constitute a reformation of the trust and essentially constitute a division that is authorized by the trust instrument? That question is not resolved.

Among the requirements that *are* established, the first is that any qualified severance of a trust that has an inclusion ratio of less than one but greater than zero (meaning that it is "partially" taxable) must produce two trusts, of which one is totally taxable (inclusion ratio of one) and one that is totally exempt (inclusion ratio of zero). A second is that added severances then may be made of either or both of those two trusts, to produce

separate trusts (e.g., for different blood lines in a family). But first the trust must be severed to produce totally exempt and taxable trusts. Third, any severance must be made on a fractional/percentage basis, rather than on a pecuniary basis, meaning that leveraging appreciation into one subtrust or another is prohibited. In this regard a *formula* fractional division is expressly authorized.

Fourth, severance need not be on a pro rata basis with respect to each and every asset in the trust. Rather, the regulation essentially embraces a form of division that mimics the marital deduction funding known as a “pick-and-choose” fractional, by which division is made on a fractional basis (reflecting total appreciation/depreciation in the fund) of the *value* of the trust but the respective portions are funded by selection of assets at their value on the date(s) of distribution, with full trustee discretion to allocate some, all, or none of any particular asset in distributing assets with a date of funding value equal to the value of the respective subtrusts. As an ancillary to this, **Prop. Treas. Reg. §1.1001-1(h)** also provides that severance according to these rules is *not* regarded as an income tax gain/loss realization event. *And* there is no requirement that the selection of assets in the pick-and-choose non-pro-rata funding of the severed trusts must comply with the kind of dictate found in Rev. Proc. 64-19. Pro rata allocation of value but not of built-in capital gain/loss is the only requisite.

Fifth, any severance along different beneficiary lines must provide that, *in the aggregate*, each trust provides for the same succession of beneficial interest as the original trust. This does *not* require, however, that every beneficiary of the original trust must be a beneficiary of each severed trust, provided that there is no shift of beneficial interest to a beneficiary in a lower generation than the original trust. Further, the new trusts must not extend the vesting duration of the original trust. Finally, severance may be made at *any* time, specifically before or after any exemption allocation, before or after a taxable transfer has occurred, or before or after any addition has been made to the trust. With the reservation that no severance can alter the tax consequence of a *previously* complete taxable event.

This regulation again provides that it is a reasonable interpretation of the statute and may be relied upon before it becomes final, at which point it applies to any subsequent severance.