Mastering IRC 2632 GST Exemption Allocation Rules: Identifying GST Trusts and Indirect Skips

THURSDAY, JUNE 22, 2017, 1:00-2:50 pm Eastern

IMPORTANT INFORMATION FOR THE LIVE PROGRAM

This program is approved for 2 CPE credit hours. To earn credit you must:

- **Participate in the program on your own computer connection (no sharing)** - if you need to register additional people, please call customer service at 1-800-926-7926 x10 (or 404-881-1141 x10). Strafford accepts American Express, Visa, MasterCard, Discover.
- **Listen on-line** via your computer speakers.
- **Respond to five prompts during the program plus a single verification code**. You will have to write down only the final verification code on the attestation form, which will be emailed to registered attendees.
- To earn full credit, you must remain connected for the entire program.

WHO TO CONTACT DURING THE LIVE EVENT

For Additional Registrations:
-Call Strafford Customer Service 1-800-926-7926 x10 (or 404-881-1141 x10)

For Assistance During the Live Program:
-On the web, use the chat box at the bottom left of the screen

If you get disconnected during the program, you can simply log in using your original instructions and PIN.

Tricks and Traps of Planning and Reporting Generation-Skipping Transfers

Diana S.C. Zeydel

Greenberg Traurig, P.A.

333 SE 2nd Avenue

Miami, FL 33131

(305) 579-0500

zeydeld@gtlaw.com

© 2013 University of Miami School of Law. This material was initially prepared for the *47th Annual Heckerling Institute on Estate Planning*, published by LexisNexis Matthew Bender. It is reprinted with the permission of the Heckerling Institute and the University of Miami. All Rights Reserved.

CHAPTER **10**

Tricks and Traps of Planning and Reporting Generation-Skipping Transfers*[1]

Diana S.C. Zeydel**

*[1] This outline is taken in part from the following prior publications: Blattmachr & Zeydel, "Adventures in Allocating GST Exemption in Different Scenarios," 35 ESTPLN 3 (April 2008); Zeydel, "Deemed Allocations of GST Exemption to Lifetime Transfers," 34 ESTPLN (March 2007) and Zeydel, "Handling Affirmative and Deemed Allocations of GST Exemption," 34 ESTPLN 12 (February 2007).

** **Diana S.C. Zeydel, Esq.:** Diana S.C. Zeydel is a shareholder of the law firm of Greenberg Traurig, P.A., in Miami, Florida, and a member of the Alaska, Florida and New York Bars. She is a past member of the Board of Regents and past Chair of the Estate & Gift Tax Committee of the American College of Trust and Estate Counsel. Diana is a frequent lecturer on a variety of estate planning topics. She has authored and co-authored numerous articles and publications on a wide variety of tax and estate planning topics. Diana received her LL.M. in Taxation from New York University School of Law (1993), her J.D. from Yale Law School (1986), and her B.A., *summa cum laude*, from Yale University (1982), where she was elected to *Phi Beta Kappa.*

Synopsis

¶ 1000 Introduction to Affirmative and Automatic Allocations of GST Exemption
¶ 1001 Affirmative Timely and Late Allocations of GST Exemption
- **¶ 1001.1 When an Affirmative Allocation Can be Made**
- **¶ 1001.2 Notice of Allocation**
- **¶ 1001.3 When an Affirmative Allocation Takes Effect**
- **¶ 1001.4 Allocations of GST Exemption Precede Taxable Events**
- **¶ 1001.5 First of the Month Rule for Late Allocations**

¶ 1002 Deemed Allocation of GST Exemption to Lifetime Direct Skips
- **¶ 1002.1 When a Deemed Allocation to a Direct Skip Occurs**
- **¶ 1002.2 Electing Out of Deemed Allocation to Direct Skips**
- **¶ 1002.3 No Deemed Allocation to Nontaxable Gifts**

¶ 1003 Deemed Allocation to Certain Lifetime Transfers to GST Trusts
- **¶ 1003.1 When a Deemed Allocation to an Indirect Skip Occurs**
- **¶ 1003.2 Definition of a GST Trust**
- **¶ 1003.3 Examples of GST and Non-GST Trusts**
- **¶ 1003.4 Electing Out of Deemed Allocation to Indirect Skips**
- **¶ 1003.5 Effect of an ETIP**
- **¶ 1003.6 Terminating an Election Out of Deemed Allocation**
- **¶ 1003.7 Effect of Gift Splitting**
- **¶ 1003.8 Electing Into Deemed Allocation**

¶ 1004 Retroactive Allocation of GST Exemption
¶ 1005 Deemed Allocation of GST Exemption at Death
¶ 1006 Conclusions About Affirmative and Automatic Allocations of GST Exemption
¶ 1007 9100 Relief
- **¶ 1007.1 Section 2642(g)**
- **¶ 1007.2 Notice 2001-50**
- **¶ 1007.3 9100 Relief**

¶ 1008 Introduction to More Exotic Allocations of GST Exemption
- **¶ 1008.1 Overview of the Generation-Skipping Transfer Tax Regime**
- **¶ 1008.2 Married Persons and GST Exemption Allocation**
- **¶ 1008.3 Reducing the Number of Trusts**
- **¶ 1008.4 Qualified Severance or No?**
- **¶ 1008.5 Disproportionate Allocation of GST Exemption**
- **¶ 1008.6 Administering GST Exempt and Non-Exempt Trusts**

¶ 1009 Trust Modifications
- **¶ 1009.1 Final Regulations Dealing with Grandfathered Trusts**
- **¶ 1009.2 Principles under the Final Regulations**
- **¶ 1009.3 Framework for Modifications**

¶1010 GST Effects of Decanting
- **¶ 1010.1 IRS Request for Comments**
- **¶ 1010.2 Origins of Decanting Authority**
- **¶ 1010.3 Effective Date Trusts**
- **¶ 1010.4 Decanting Authority Exists at Time Trust is Irrevocable**
- **¶ 1010.5 Trusts Exempt by Reason of an Allocation**

¶ 1010.6 Is Decanting a Severance?
¶ 1010.7 Conclusions About Decanting
¶ 1011 Conclusion
¶ 1012 Exhibits
¶ 1012.1 Exhibit 1: Sample Notice of Allocation
¶ 1012.2 Exhibit 2: Sample Election Out Statement for a Particular Transfer to a Particular Trust
¶ 1012.3 Exhibit 3: Sample Election Out Statement for Any and All Transfers Made in a Particular Year to Particular Trust
¶ 1012.4 Exhibit 4: Sample Election Out Statement for Any and All Current Year and Future Year Transfers to a Particular Trust
¶ 1012.5 Exhibit 5: Sample Election Out Statement for Any and All Transfers Made to a Particular Trust for a Period of Years
¶ 1012.6 Exhibit 6: Sample Election Out Statement for Any Current and Future Year Transfers Taxpayer May Make to Any Trust
¶ 1012.7 Exhibit 7: Election Out Statement for a Prior Transfer to a Trust Subject to an ETIP
¶ 1012.8 Exhibit 8: Sample Termination Statement
¶ 1012.9 Exhibit 9: Sample GST Trust Election
¶ 1012.10 Exhibit 10: Sample Attachment to Schedule R of Form 706

¶ 1000 Introduction to Affirmative and Automatic Allocations of GST Exemption.[2]

Effective allocation of generation-skipping transfer ("GST") tax exemption can be a goldmine and a mine field for estate planners. Early allocation of GST exemption to a trust with appreciating assets can avoid GST tax not only on the value of the property contributed, but on its entire appreciated value. Conversely, a failed allocation could subject substantial property to an onerous tax that effective allocation would have avoided. Due to the possibly significant tax burden that could be caused by an inadvertent failure to allocate GST exemption, the Code[3] provides multiple sets of so-called "deemed" allocation rules, whereby, without any action by the taxpayer,[4] the taxpayer's GST exemption is "deemed" or "automatically" allocated to transfers made by the taxpayer. The deemed allocation rules generally apply in those cases where Congress anticipated that most taxpayers would want to allocate GST exemption to the transfer in question. Inevitably, this approach can result in a deemed allocation of a taxpayer's GST exemption when the taxpayer would not want GST exemption allocated. Estate planners must

---

[2] All sample forms contained in this outline and the Exhibits hereto are provided for illustration purposes only and may not be relied upon. The author disclaims any liability for reliance upon a sample form provided herein. All taxpayers should seek independent advice and all tax practitioners should make an independent determination of the appropriateness of utilizing any sample form.

[3] All References to the "Code" or the Internal Revenue Code" or to a "section" or "§"thereof are to the Internal Revenue Code of 1986, as amended.

[4] See Treas. Reg. §26.2632-1(b)(1)(ii) (except in the case of an election out of automatic allocation, a Form 709 need not be filed to report an automatic allocation of GST exemption to a direct skip); Treas. Reg. §26.2632-1(b)(2)(ii) (automatic allocation to an indirect skip is effective whether or not a Form 709 is filed with respect to the transfer).

therefore be able to assist clients not only to make effective, but to avoid unwanted, and potentially wasted, allocations of GST exemption.

¶ 1001 Affirmative Timely and Late Allocations of GST Exemption.

¶ 1001.1 When an Affirmative Allocation Can be Made.

Section 2632 of the Code provides five methods by which a transferor's GST exemption may be allocated. The first method is by an affirmative allocation by the transferor, or the transferor's executor, at any time on or before the date prescribed for filing the transferor's estate tax return (determined with regard to extensions) and whether or not a return is required.[5] Thus, an affirmative allocation of GST exemption may be made on a gift tax return filed any time prior to the due date of the transferor's estate tax return, or on a timely estate tax return. Depending upon whether the gift tax return is timely or late with respect to the transfer in question, the value of the property to which GST exemption is allocated will be determined either retroactive to the date of the transfer for a timely return, or as of the date of filing for a late return.[6] An allocation of GST exemption becomes irrevocable after the due date of the return.[7]

The regulations clarify that when GST exemption is allocated to a trust, the allocation is made to the entire trust, not to specific assets in the trust.[8] Because it is generally preferable to have trusts that are either entirely exempt from, or entirely subject to, GST tax, it is important to make affirmative allocations that will accomplish that end, and to avoid deemed allocations that will result in partially exempt trusts.

¶ 1001.2 Notice of Allocation.

Section 2632(a)(2) states that the Secretary shall prescribe by forms or regulations the manner in which any allocation of GST exemption is to be made. The regulations state that an allocation of GST exemption must clearly identify the trust to which the allocation is being made, the amount of GST exemption allocated to it, and if the allocation is late or if an inclusion ratio[9] greater than zero is claimed, the value of the trust assets at the effective date of the allocation.[10] The allocation should also state the inclusion ratio of the trust after the allocation.[11]

---

[5] IRC §2632(a)(1).
[6] IRC §2642(b)
[7] Treas. Reg. §26.2632-1(b)(4)
[8] Treas. Reg. §26.2632-1(a)
[9] The term "inclusion ratio" is defined in IRC §2642 and may be conceptually understood as equal to a fraction representing the portion of the property subject to GST tax. *See* IRC §2632(e)(2)(B) defining the term "nonexempt portion" of a trust as the value of the trust multiplied by the inclusion ratio with respect to the trust. The inclusion ratio is technically defined as the excess of 1 over the "applicable fraction." The applicable fraction is a fraction the numerator of which is the amount of GST exemption allocated to the transfer and the denominator of which is value of the entire property transferred reduced by the sum of (i) any Federal or State death tax actually recovered from such property and (ii) any charitable deduction allowed with respect to such property. Thus, the GST exemption does not need to be allocated to the portion of the property that will be used to pay death tax or to the portion of the property eligible for a charitable deduction. If no death tax is payable from the property and no charitable deduction is applicable, then the applicable fraction represents the fraction of the property sheltered by an allocation (either affirmative or automatic) of GST exemption.
[10] Treas. Reg. §26.2632-1(b)(4).
[11] *Id.*

With certain exceptions for charitable lead annuity trusts, an allocation of GST exemption may be made by formula (for example, "the amount necessary to produce an inclusion ratio of zero"). The proper procedure for making an effective allocation of GST exemption is set forth in more detail in the instructions to the gift tax return, Form 709. Unfortunately, the return itself contains only a "hint" by stating in Line 6 of Part 2 of Schedule D that to make an allocation of GST exemption "You must attach a Notice of Allocation."[12] The instructions to Form 709 (currently on page 17) provide the information that a Notice of Allocation must contain for each trust to which the transferor wishes to allocate GST exemption as follows:

A. Clearly identify the trust, including the trust's EIN, if known. This should probably include the name(s) of the trustee(s), the name of the trust and the date of the trust.

B. If this is a late allocation, the year the transfer was reported on Form 709. Of course, it is possible that the transfer was never reported on a gift tax return. In that case, a late or amended return should probably be filed for the year of the transfer to report the gift, make the appropriate GST exemption allocation and start the statute of limitations running on any gift tax consequences of the transfer.

C. The value of the trust assets at the effective date of the allocation. If the return is timely this would mean the value of the assets on the date of transfer. If the taxpayer is making a late allocation, it would be the value of the assets on the date of filing or, if permitted and so elected, the value of the assets on the first day of the month of filing (see discussion below for making a first of the month valuation election for a late allocation).

D. State amount of GST Exemption allocated or use a formula. The amount of GST exemption allocated to each gift (or a statement that you are allocating exemption by means of a formula such as "an amount necessary to produce an inclusion ratio of zero"). It is very helpful that the regulations and the instructions to Form 709 expressly bless a formula allocation, which should probably be used in every case, even for gifts of cash, as there could always be an administrative or clerical error that causes the gift to be more than anticipated. An allocation that exceeds the value of the property transferred would be deemed void under the regulations.[13]

---

[12] This hint is frequently overlooked by return preparers, and has lead to hundreds of requests for relief to make a late, but retroactive, allocation GST exemption under Treas. Reg. §§301.9100-1 through 301.9100-3. IRC §2642(g)(1)(B) expressly provides that for purposes of determining whether to grant an extension of time to make an allocation of GST exemption or to make an election out of the deemed allocation rules, the time for making the allocation or election shall be treated as if not expressly prescribed by statute, thus making so-called 9100 relief available. A simplified procedure for relief is also available under Rev. Proc. 2004-46, 2004-2 C.B. 142 (allocation to transfers to a trust qualifying for the annual exclusion) and Rev. Proc. 2004-47, 2004-2 C.B. 169 (reverse QTIP election for transfer at death). Proposed regulations under section 2642(g)(1) were issued on April 17, 2008, 2008-19, I.R.B. 916 and have not been finalized. When those regulations are finalized, they would replace 9100 relief in the GST area.

[13] Treas. Reg. §26.2632-1(b)(4) ("Except as provided in §26.2642-3 (relating to charitable lead annuity trusts), an allocation of GST exemption to a trust is void to the extent the amount allocated exceeds the amount necessary to obtain an inclusion ratio of zero with respect to the trust. . .. An allocation is also void if the allocation is made with respect to a trust that has no GST potential with respect to the transferor making the allocation, at the time of the allocation. For this purpose, a trust has GST potential even if the possibility of a GST is so remote as to be negligible.")

E. The inclusion ratio of the trust after the allocation. The total GST exemption allocated on the Notice of Allocation must be reported on Line 6 of Part 2 of Schedule D, with the taxpayer's remaining GST exemption reconciled on Line 8. A Notice of Allocation should not be used to report allocations of GST exemption to direct skips made during the taxable year or to report automatic allocations of GST exemption to indirect skips (discussed in section IV). Attached Exhibit 1 contains a sample form of Notice of Allocation.

¶ 1001.3 When an Affirmative Allocation Takes Effect.

The allocation of GST exemption on a timely Form 709 is effective on and after the date of the transfer.[14] The regulations provide that a Form 709 is timely filed if it is filed on or before the date required for reporting the transfer if it were a taxable gift (that is, the date prescribed by section 6075(b)), including extensions to file actually granted.[15] If more than one timely return is filed, the earlier allocation is modified only if the later allocation clearly identifies the transfer and the nature and extent of the modification.[16] If an allocation of GST exemption is made to property transferred by gift on a Form 709 filed after the due date for reporting the transfer (a late allocation), the value of the property is determined at the time the Form 709 allocating GST exemption to the transfer is filed, and is effective on and after the date of filing.[17] The regulations provide that Form 709 is deemed filed on the date it is postmarked to the Internal Revenue Service address as directed in forms or other guidance published by the Service.[18]

¶ 1001.4 Allocations of GST Exemption Precede Taxable Events.

Any allocation of GST exemption is deemed to precede in point of time any taxable event occurring on that date.[19] Thus, a late allocation of GST exemption could be made to mitigate the effect of a taxable event (a taxable termination or a taxable distribution from a trust) provided the taxpayer is able to file a Form 709 on the date the taxable event occurs.

> **Example**: Assume that a trustee contemplates making a distribution to a skip person from a non-exempt trust. The transferor could allocate GST exemption to the trust by filing a late gift tax return on (or before) the date the distribution is made. The allocation would be deemed to precede the taxable distribution, thus mitigating or eliminating the GST consequences of the distribution.[20]

¶ 1001.5 First of the Month Rule for Late Allocations.

---

[14] IRC §2642(b)(1)(B).

[15] Treas. Reg. §26.2632-1(b)(4)(ii). IRC §6075(b) provides that a gift tax return must be filed on or before April 15 following the close of the calendar year. Any extension of time granted the taxpayer for filing his or her income tax return for the calendar year is deemed to also be an extension of time to file the taxpayer's gift tax return for that year. However, in the year of the taxpayer's death, the decedent's final gift tax return may be filed no later than the due date for the decedent's estate tax return. (Including extensions).

[16] Treas. Reg. §26.2632-1(b)(4)(ii). If a timely return is filed on the due date without extension, relief to modify an allocation of GST exemption may be available under Treas. Reg. §301.9100-2 if leave to modify the allocation is sought before the date that would have been the extended due date of the return if an extension of time to file had been sought.

[17] IRC §2642(b)(3).

[18] Treas. Reg. §26.2632-1(b)(4)(ii).

[19] Id.

[20] Treas. Reg. §§26.2632-1(b)(4)(ii) and 26.2632-1(b)(4)(iii) Example 4.

The regulations provide a rule of convenience that permits property that is the subject of a late allocation of GST exemption to be valued as of the first day of the month during which the late allocation is made.[21] The rule does not apply, however, to a life insurance policy or a trust holding a life insurance policy, if the insured has died. Note that the allocation is not effective until the late return is actually filed, notwithstanding the election to use the first of the month as the valuation date. The election is made by stating on the Form 709 on which the allocation is made: (1) That the election is being made; (2) The applicable valuation date; and (3) The fair market value of the trust assets on the valuation date.

> **Example**: Assume that in 2011 a transferor wishes to make an allocation of GST exemption to property transferred in trust in 2009. Transferor proposes to make a late allocation on transferor's timely filed Form 709 (without extensions) for the calendar year 2011. The trust assets have a value of $200,000 on April 15, 2011, the date the transferor files Form 709 making the late allocation, but have a value of $175,000 on April 1, 2011. The transferor may elect to value the assets as of April 1, 2011. Thus, by making the election and allocating $175,000 of GST exemption to the trust, the transferor will achieve a zero inclusion ratio for the trust as of April 15, 2011. Accordingly, a distribution to a skip person occurring on or after April 15, 2011 would not be subject to GST tax.
>
> It does not appear that is it possible to make a "late allocation" of GST exemption unless the return for the year in which the transfer was made is in fact late. Treas. Reg. §26.2632-1(b)(4)(ii)(A)(1) contains the following sentence, "Except as provided in paragraph (d)(1) of this section [relating to allocations by the executor], an allocation to a trust made on a Form 709 filed after the due date for reporting a transfer to the trust (a late allocation) is effective on the date the Form 709 is filed and is deemed to precede in point of time any taxable event occurring on such date." This rules appears more restrictive than necessary and has some unexpected consequences. For example, suppose a transferor make a transfer in trust in 2008, but had no remaining unused GST exemption available to allocate to the transfer. In 2009, the transferor received another $1.5 million of GST exemption (over the maximum of $2 million available in 2008) which she would like to allocate to the trust created in 2008 as of January 1, 2009 But the gift tax return for the year of transfer, 2008, is not yet late and will not be late until April 16, 2009 or possible October 16, 2009, if the due date for filing the transferor's income tax return is extended, thereby causing an automatic extension of the due date for filing the gift tax return for 2008. It therefore appears that the additional GST exemption of $1.5 million available in 2009 may not be allocated to the 2008 transfer until April 16 or possibly October 16, 2009.

¶ 1002 Deemed Allocation of GST Exemption to Lifetime Direct Skips

¶ 1002.1 When a Deemed Allocation to a Direct Skip Occurs.

[21] Treas. Reg. §26.2642-2(a)(2).

The second method by which GST exemption may be allocated is by a deemed allocation to a direct skip transfer made during the transferor's lifetime.[22] The purpose of this deemed allocation rule is to avoid inadvertent GST tax when it is anticipated that the taxpayer would have wished to allocate GST exemption. GST exemption is automatically allocated to the property transferred in a direct skip to the extent necessary to make the inclusion ratio with respect to the property zero. Thus, GST exemption will be deemed allocated to the extent of the fair market value of the property as finally determined for transfer tax purposes. If the transferor's unused GST exemption is insufficient, the entire unused portion is automatically allocated, and the property will have a fractional inclusion ratio, greater than zero and less than one. In that case, GST tax will be due on the value of the property in excess of the transferor's unused GST exemption.

> **Example**: Assume a transferor gives $213,000 to a grandchild in 2011 when she has $100,000 of unused GST exemption. The transferor's entire GST exemption would be deemed allocated to the transfer, and she will owe GST tax on $100,000 (the amount of the transfer in excess of her unused GST exemption and available annual exclusion under section 2503(b)).[23]

For purposes of the deemed allocation to direct skips rule, the unused portion of a transferor's GST exemption is that portion not previously affirmatively allocated by the transferor or deemed allocated under the direct skip rule or the rule applicable to indirect skips to GST trusts discussed in the next section. This would mean that a deemed allocation to a direct skip transfer in a particular calendar year will precede a deemed allocation to an indirect skip transfer made in the same year, and both will precede any affirmative allocation of GST exemption made to other transfers. Thus, to change the order or priority, effective elections out of the deemed allocation rules would be necessary.

> **Example**: Assume a transferor has $5,000,000 of unused GST exemption in 2011. Assume the transferor gives $213,000 to her grandchild on May 1, 2011 and transfers $5,000,000 to a direct skip trust on December 1, 2011. Under the deemed allocation to direct skips rule, the transferor's GST exemption would be allocated chronologically, first to the transfer made on May 1, 2011 to the extent it is not a nontaxable gift (e.g., qualifies for the annual exclusion), and then to the transfer made on December 1, 2011. Thus, only $4,800,000 of GST exemption would be allocated to the $5,000,000 direct skip trust. To change this result, the transferor would need to file a timely Form 709 for the calendar year 2011 electing out of deemed allocation under IRC 2632(b) with respect to the May 1st transfer, and pay the appropriate GST tax. This would cause her entire unused GST exemption to be automatically allocated to the December 1st transfer.

¶ 1002.2 ***Electing Out of Deemed Allocation to Direct Skips***.

---

[22] IRC §2632(b).

[23] See discussion in text below on nontaxable gifts. The technical computation of GST tax would be to multiply the marginal estate tax rate by the inclusion ratio (1/2 in this case) and apply the rate to the entire trust. This will result in the same tax calculation as applying the full GST tax rate to only half the trust.

A transferor may elect to have the deemed allocation to direct skips rule not apply.[24] To prevent deemed allocation, the transferor must file a timely Form 709 for the calendar year in which the direct skip transfer is made describing the transfer and the extent to which deemed allocation should not apply. It is sufficient if the transferor files a timely return and pays the GST tax due with respect to the property transferred in the direct skip. All direct skip gifts made during the calendar year are reported in Part 2 of Schedule A of Form 709. Column C contains a box to elect out of deemed allocation under section 2632(b). But, the instructions to the return provide that checking the box is not sufficient to elect out of deemed allocation. The taxpayer must also attach a separate statement clearly describing the transaction and the extent to which automatic allocation is not to apply. The instructions confirm that reporting the transaction and paying the GST tax on the transfer (presumably on the entire transfer) will qualify as such a statement. It is not clear whether a partial payment of tax would preserve automatic allocation of GST exemption to the balance of the transfer. Therefore, it would seem prudent, in the case of a partial payment, to elect out of deemed allocation, affirmatively allocate GST exemption to the transfer, if desired, and pay tax on the taxable portion of the transfer. A sample form for an election out of deemed allocation to a direct skip is provided in section III.

¶ 1002.3 ***No Deemed Allocation to Nontaxable Gifts***.

It is important to note that electing out of deemed allocation to a direct skip will either result in the payment of GST tax or require an affirmative allocation of GST exemption under the first method. Therefore, the most important aspect of the rule is knowing when a client has made a direct skip transfer that is subject to GST tax. In this regard, a direct skip that is a nontaxable gift has an inclusion ratio of zero.[25] No deemed allocation of GST exemption occurs with respect to a nontaxable gift because section 2632(b) applies only to the extent necessary to reduce the inclusion ratio of the transfer to zero, and nontaxable gifts are automatically assigned an inclusion ratio of zero. A nontaxable gift includes gifts within the annual exclusion under section 2503(b) as well a gifts for medical and educational expenses that are excluded from gift tax under section 2503(e).[26] Thus, if the transferor makes a transfer directly to a skip person, automatic allocation of GST exemption occurs only to the extent of the value of the transfer that does not qualify for the annual exclusion.

> **Example**: Assume the transferor transfers $100,000 to her grandchild A in 2011, and has made no other transfers to A during the calendar year. The first $13,000 of the transfer qualifies for the annual exclusion, is a nontaxable gift, and thus has a zero inclusion ratio; therefore, GST exemption would be automatically allocated only to the balance of the transfer ($87,000).

An important and frequently overlooked rule is that a direct skip transfer in trust will constitute a nontaxable gift only in very limited circumstances. Section 2642(c)(2) provides that the rule applies to a transfer in trust for the benefit of an individual only if, during the individual's life, distributions may be made only to that individual, and if the individual dies before the trust terminates, the trust is includible in the individual's gross estate (a so-called

[24] IRC §2632(b)(3).
[25] IRC §2642(c)(1).
[26] IRC §2642(c)(3).

"2642(c) trust"). Thus, the trust must be exclusively for the benefit of a single skip person during that person's lifetime, and if the trust is not distributed entirely to the skip person during his or her lifetime, it must be includible in the skip person's estate. In addition, the direct skip transfer to the trust must qualify for the annual exclusion, such as by granting the beneficiary a so-called *Crummey* power of withdrawal over transfers to the trust.[27]

If a transfer is made to a trust other than a 2642(c) trust, the nontaxable gift rule simply does not apply, even if skip persons are given *Crummey* powers of withdrawal. This can have at least two consequences. First, transfers to the trust will not be assigned a zero inclusion ratio, even if only skip persons are given *Crummey* powers of withdrawal. Second, if the transferor wishes the trust to have a zero inclusion ratio (and a deemed allocation rule does not apply), she must affirmatively allocate GST exemption to 100 percent of all transfers to the trust, even those that qualify for the annual exclusion. Such an allocation will be effective, however, only if the *Crummey* powers of withdrawal do not cause a shift in the identity of the transferor for GST purposes. The regulations confirm that no shift in the identity of the transferor occurs by reason of the lapse of a power of withdrawal unless the power of withdrawal lapses in a manner that causes the power holder to be deemed to have made a completed transfer to the trust for gift tax purposes.[28] This would occur if a power of withdrawal lapses in an amount greater than $5,000 or 5 percent of the value of the trust corpus in any given taxable year.[29]

¶ 1003 Deemed Allocation to Certain Lifetime Transfers to GST Trusts

¶ 1003.1 *When a Deemed Allocation to an Indirect Skip Occurs*.

The third method by which GST exemption may be allocated is by deemed allocation to an indirect skip within the meaning of section 2632(c).[30] An "indirect skip" is defined as a transfer (other than a direct skip) that is subject to gift tax and made to a GST trust (also a defined term). If an indirect skip occurs, the transferor's unused GST exemption is automatically allocated to the transfer to the extent necessary to make the inclusion ratio of the property zero. A deemed allocation of GST exemption to an indirect skip to a GST trust is effective as of the date the transfer takes place and becomes irrevocable after the due date of the gift tax return for the year of the transfer. The transferor's unused GST exemption is deemed allocated in an amount equal to the fair market value of the property transferred.[31] As in the case of a deemed allocation to direct skips, if the transferor's unused GST exemption is insufficient, the entire unused portion of the transferor's GST exemption is deemed allocated, resulting in a fractional inclusion ratio (greater than zero and less than one) for the GST trust, generally an undesirable result. For purposes of section 2632(c), the unused portion of the transferor's GST exemption is

---

[27] See note 32, *infra*. Note that a transfer to a trust described in IRC §2503(c) qualifies for the gift tax annual exclusion even if the beneficiary is not granted a *Crummey* power of withdrawal. And a section 2503(c) trust is also a 2642(c) trust so that transfers to a section 2503(c) trust for the benefit of a skip person within the limits of the annual exclusion should be treated as nontaxable gifts for GST purposes. *But see* PLR 200633015 in which the IRS did not rule on the application of section 2642(c)(2) to section 2503(c) trusts, and instead ruled that the trusts were direct skip trust to which GST exemption was automatically allocated under section 2632(b)(1).

[28] *See* Treas. Reg. §26.2652-1(a)(5) *Example 5*.

[29] IRC §2514(b) and (e).

[30] The rule automatically allocating GST exemption to indirect skips applies to indirect skips made after December 31, 2000. Treas. Reg. §26.2632-1(b)(2).

[31] Treas. Reg. §26.2632-1(b)(2)(i).

the portion (i) not previously allocated by the transferor, (ii) not deemed allocated to direct skip transfers under section 2632(b) occurring before or during the calendar year in which the indirect skip occurs or (iii) deemed allocated to prior indirect skips. Note that, within a particular calendar year, this means a deemed allocation of the taxpayer's GST exemption would occur first to all direct skips made during the year, even if a direct skip is made after the date of an indirect skip.

> **Example**: Assume a transferor has $5,000,000 of unused GST exemption. She transfers $513,000 to grandchild A on May 1, 2011, $4,500,000 to a GST trust on July 1, 2011 and $513,000 to grandchild B on October 1, 2011. Under sections 2632(b) and (c), her unused GST exemption would be automatically allocated first to the transfer to grandchild A, second to the transfer to grandchild B and last to the transfer to the GST trust, thus producing a fractional inclusion ratio of 1/9 for the trust. To avoid this result, the transferor would have to elect out of the automatic allocation rules under section 2632(b) with respect to the October 1st transfer to grandchild B by filing a timely Form 709, checking the box in Column C of Part 2 of Schedule A reporting the October 1st transfer and attaching the appropriate statement. This would cause her to have $4,500,000 of unused GST exemption, after automatic allocation of $500,000 of her GST exemption to the transfer to grandchild A, all of which would be automatically allocated to the transfer to the GST trust, producing a zero inclusion ratio for the trust. A possible form of statement would be:

ELECTION OUT OF AUTOMATIC ALLOCATION
OF GST EXEMPTION TO DIRECT SKIPS

The taxpayer transferred the sum of $500,000 in cash as a taxable gift not qualifying as a non-taxable gift to her grandchild, B, on October 1, 2011 as reported in Item 2, Part 2, SCHEDULE A. The taxpayer hereby elects that the automatic allocation rule applicable to direct skip transfers will not apply to the $500,000 transferred to B on October 1, 2011.[32]

¶ 1003.2 ***Definition of a GST Trust*** .

A GST trust is a trust that could have a generation-skipping transfer with respect to the transferor. This rule has six exceptions that will exclude a trust with respect to which there could be a generation-skipping transfer from the definition of a GST trust. The six exceptions are as follows:

A. First Exception. The trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons:

1. before the date that the individual attains age 46;

[32] Note that no affirmative allocations of GST exemption to either the May 1, 2012 gift to grandchild A or to the July 1, 2012 transfer to the trust need be made. The automatic allocation rules will effect an allocation of GST exemption to both transfers.

2. on or before one or more dates specified in the trust instrument that will occur before the date such individual attains age 46; or

3. upon the occurrence of an event that, in accordance with regulations prescribed by the Secretary, may reasonably be expected to occur before the date such individual attains age 46 (no such regulations have yet been issued).

B. Second Exception. The trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons and who are living on the date of death of another person identified in the instrument (by name or by class) who is more than 10 years older than such individuals.

C. Third Exception. The trust instrument provides that if one or more individuals who are non-skip persons die before a date or event described in (1) or (2), more than 25 percent of the trust corpus must be distributed either to the estate or estates of one or more such individuals or is subject to a general power of appointment exercisable by one or more of such individuals.

D. Fourth Exception. The trust is a trust any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer.

E. Fifth Exception. The trust is a charitable lead annuity trust or a charitable remainder annuity trust or a charitable remainder unitrust.

F. Sixth Exception. The trust is a charitable lead unitrust which is required to pay principal to a non-skip person if such person is alive when the unitrust interest ends.

A power of withdrawal of no more than the annual exclusion under section 2503(b) held by a non-skip person will not cause the trust to be excluded from the definition of a GST trust, and it is assumed that powers of appointment held by non-skip persons will not be exercised.

¶ 1003.3 *Examples of GST and Non-GST Trusts*.

The regulations do not contain examples of trusts that would be excluded from the definition of a GST trust. But it appears that the following trusts would NOT be GST trusts:

Example 1: A trust for the benefit of descendants that requires a distribution to a child of more than 25 percent of its corpus at age 45.

Example 2: A trust for the benefit of the transferor's sister, age 60, that terminates at the sister's death in favor of the transferor's children, under age 50, if living or, if not living, per stirpes, to their descendants.

Example 3: A QTIP trust for the transferor's spouse that is distributable upon the spouse's death in further lifetime trusts for the transferor's descendants.

Example 4: A trust for the transferor's child and her descendants that provides that if the child dies before age 46, the child has a general power of appointment over more than 25 percent of the trust corpus.

Example 5: A dynasty trust for the transferor's descendants that contains unlapsed *Crummey*[33] powers of withdrawal held by non-skip persons that, in a particular year, exceed the limits of the annual exclusion.

On the other hand, the following trusts would appear to be GST trusts:

Example 6: A trust for spouse and descendants that, upon the spouse's death, is divided, per stirpes, for descendants and held in further trust until each descendant for whom a per stirpital share is set apart reaches age 35.

Example 7: A trust for descendants that requires 50 percent of the trust corpus to be distributed to charity when all the children have attained age 40.

As the foregoing examples demonstrate, there will be instances when a trust is excluded from the definition of a GST trust but the transferor would likely wish GST exemption allocated to transfers to the trust, and other instances when a trust will be defined as a GST trust, yet a transferor would not wish GST exemption allocated. Accordingly, although intended to assist taxpayers in avoiding inadvertent failure to allocate GST exemption, the new rules providing for deemed allocation to indirect skips have greatly increased the burden on estate planners and return preparer carefully to analyze their application, and the desirability of their effects.

¶ 1003.4 ***Electing Out of Deemed Allocation to Indirect Skips***.

As in the case of a deemed allocation of GST exemption to a direct skip, section 2632(c)(5) permits a transferor to elect not to have the automatic allocation rules apply to a particular indirect skip or to any or all transfers made by the transferor to a particular trust, and also to elect to treat any trust as if it is a GST trust, and thus subject to the deemed allocation rules applicable to GST trusts, with respect to any or all transfers made by the transferor to that trust. An election to prevent deemed allocation of GST exemption to an indirect skip that has already occurred must be made on a timely gift tax return with respect to the transfer. The other elections may be made on a timely gift tax return for the calendar year in which the election is to take effect.[34]

---

[33] A so-called Crummey power of withdrawal is a power held by a beneficiary of a trust to withdraw a portion or all of a transfer made to the trust for a limited period of time. During the period that the power is exercisable it constitutes a general power of appointment for purposes of section 2514 and 2041 of the Code, and thus would cause the property subject to the power to be included in the gross estate of the powerholder. The power of withdrawal permits the transfer to the trust to qualify as a present interest (treated for gift tax purposes as a transfer to the powerholder) eligible for annual exclusion treatment under section 2503(b). See Crummey v. Comm'r, 397 F.2d 82 (9th Cir. 1968).

[34] IRC §2632(c)(5)(B).

The final regulations have provided welcome guidance on the manner in which a transferor may elect in and out of deemed allocation to indirect skip transfers.[35] The following actions will constitute an effective election out of automatic allocation to an indirect skip:

A. Making an Affirmative Allocation of a Lesser Amount. An affirmative allocation of GST exemption to the indirect skip on a timely gift tax return of an amount less than (but not equal to) the value of the property transferred.[36] This rule may present a trap for taxpayers.

> **Example**: Assume a transferor transfers property she believes is worth $90,000 to a GST trust. She does not make a formula allocation of GST exemption, but instead allocates exactly $90,000 of her unused exemption to the transfer. The transfer is finally determined to have a value of $100,000. It seems that literally under the regulations, the taxpayer has allocated to the transfer an amount of her GST exemption "less than (but not equal to) the value of the property transferred,"[37] with the consequence that she is deemed to have elected out of the automatic allocation rules. Accordingly, her affirmative allocation of GST exemption in the amount of $90,000 will take effect, and the trust (worth $100,000) will have an inclusion ratio of 1/10.

It is also possible, however, that the taxpayer, by allocating her GST exemption to the full value of the transfer as reported, would be deemed to have allocated to the transfer an amount "equal to the value" of the transfer. In that case, she would not be deemed to have elected out of the automatic allocation rules. Thus, in the above example, her GST exemption would be deemed allocated to the entire transfer, $100,000, producing a zero inclusion ratio for the property. The automatic allocation, in that case, would supersede and render void her affirmative allocation of GST exemption. The better approach, if it is certain that the trust in question is a GST trust, would be for the taxpayer simply to permit the automatic allocation rules to apply. Alternatively, the taxpayer could elect out of the automatic allocation rules by filing the appropriate election out statement (discussed below), and then make an affirmative formula allocation of GST exemption.

B. Options for Election Out of Deemed Allocation. The regulations provide that a transferor may elect out of deemed allocation with respect to:

1. One or more (or all) transfers made in a prior year that are subject to the ETIP rule under section 2642(f) (explained below) to a specified trust or trusts;

2. One or more (or all) transfers made in the current year to a specified trust or trusts;

3. One or more (or all) future transfers made to a specified trust or trusts;

4. All future transfers made by the transferor to all trusts (whether or not in existence at the time of the election out); or

---

[35] Treas. Reg. §26.2632-1(b)(2).
[36] Treas. Reg. §§26.2632-1(b)(2)(ii) and (b)(4)(iii) *Example 6*.
[37] *Id*.

5. Any combination of the above.[38]

In order to make an election out, the transferor must attach a statement (election out statement) to a Form 709 filed on or before the due date for the calendar year in which (i) in the case of a transfer subject to an ETIP, the ETIP period closes, and (ii) for all other elections out, the first transfer to be covered by the election out is made. The election out statement must identify the trust (unless it is an election out under paragraph (d) above), and specifically provide that the transferor is electing out of automatic allocation of GST exemption with respect to the described transfer or transfers. The election out statement, if it is to cover only specific transfers, must specifically describe or otherwise identify the transfers to which it applies.[39]

Column C in Part 3 of Schedule A of Form 709 provides a box to make all elections under section 2632(c) in and out of deemed allocation. Because there is no opportunity on the face of the Form 709 to signify which election you are making, it is critical to attach the required election out statement in order to make an effective election out of deemed allocation. The instructions to the return state that you must attach a statement that describes the election you are making and clearly identifies the trusts and/or transfers to which the election applies. The instructions imply that checking the box in Column C applies only for transfers reported on the return. If no transfer is being reported, then it appears only the explanatory statement must be filed.

The instructions to Form 709 specifically provide that, if a prior election has been made with respect to future transfers, the box in Column C should not be checked and no explanatory statement should be filed. This would seem likely to create confusion.

> **Example**: Assume a transferor files a timely election out of deemed allocation to a particular GST trust for the initial transfer and all future transfers to that trust. Suppose that several years later the transferor transfers additional property to the trust. Without an explanation, the return for the subsequent transfer would not, by itself, indicate why GST exemption is not automatically allocated to the trust equal to the fair market value of the second transfer. To avoid confusion, it would seem appropriate for the transferor to attach a statement to the Form 709 for such later year confirming the prior election out of deemed allocation, perhaps as follows:

NOTICE OF PRIOR ELECTION OUT
OF AUTOMATIC ALLOCATION

The taxpayer has previously elected that the automatic allocation rules will not apply to any and all transfers to the _________ Trust described in Item __, Part 3, SCHEDULE A; accordingly, no portion of the transferor's unused GST exemption should be deemed allocated to the transfer described in Item __, Part 3 of SCHEDULE A.

---

[38] Treas. Reg. §26.2632-1(b)(2)(iii)(A). Hence, a transferor could elect out of the deemed allocation rule with respect to all future transfers by the transferor to some (which are identified) but not all trusts.
[39] Treas. Reg. §26.2632-1(b)(2)(iii)(B).

The regulations contain sample language for various forms of election out statements.[40] Fortunately, unlike the proposed regulations, the final regulations do not require any specific references to any section of the Code or the regulations. References to particular transfers with respect to which an election out is being made may be accomplished by referencing the name of the trust and the date of the transfer. In each case, the example begins "T hereby elects that the automatic allocation rules will not apply to . . ." followed by a description of the transfers or the trusts to which the election out is to apply. Although the GST regulations refer throughout to the transferor, if appears most appropriate to substitute the word "Taxpayer" for "T" in each case. Exhibits 2 through 7 contain sample forms for various types of election out statements as follows:

Exhibit 2: *Election Out Statement for a particular transfer to a particular trust*. The election out of the automatic allocation rules will be effective only for that transfer, and not for any other transfers made to the trust during the same calendar year, or any prior or future calendar year.[41]

Exhibit 3: *Election Out Statement for any and all transfers made in a particular year to a particular trust*. The election out of the automatic allocation rules will be effective for all transfers made to the trust in the particular year.[42]

Exhibit 4: *Election Out Statement for any and all current year and future year transfers to a particular trust*. The election out of the automatic allocation rules will be effective for the taxpayer's transfers to the trust in the current year and all future transfers made by the taxpayer to the trust, unless the taxpayer terminates the election out of automatic allocation.[43]

Exhibit 5: *Election Out Statement for any and all transfers made to a particular trust for a period of years*. The election out of the automatic allocation rules will be effective for all taxpayer's transfers to the trust during the years identified. The election out of the automatic allocation rules will not be effective for any subsequent years, unless the taxpayer elects out of those rules for one or more of those years. The taxpayer may terminate the election out of the automatic allocation rules for future years by filing a timely termination statement (discussed below). The taxpayer may terminate the election out for one or more transfers in the current year by filing a later, but still timely, Form 709 for the year.[44]

Exhibit 6: *Election Out Statement for any current and future year transfers taxpayer may make to any trust.* The election out of the automatic allocation rules will be effective for all of the taxpayer's transfers in the current year and in any future year to any and all trusts (whether the trusts are currently in existence or

---

[40] Treas. Reg. §26.2632-1(b)(4)(iv).
[41] Reg. §26.2632-1(b)(4)(iv) *Example (1)(i).*
[42] Treas. Reg. §26.2632-1(b)(4)(iv) *Example (1)(ii).*
[43] Treas. Reg. §26.2632-1(b)(4)(iv) *Example (1)(iii).*
[44] Treas. Reg. §26.2632-1(b)(4)(iv) *Example (1)(iv).*

created in a later year), unless the taxpayer terminates the election out of the automatic allocation rules.[45]

Exhibit 7: *Election Out Statement for a prior year transfer to a trust subject to an ETIP*. The election out of the automatic allocation rules will be effective for the transfer made to the trust in the prior year, effective at the close of the ETIP period, unless the taxpayer terminates the election out of the automatic allocation rules.[46]

The regulations confirm that an election out of deemed allocation does not affect the automatic allocation of GST exemption to any transfer not covered by the election out statement. Moreover, an election out does not prevent the transferor from making an affirmative allocation of GST exemption to any transfer covered by the election out, either on a timely Form 709, or at a later date to effectuate a late allocation of GST exemption.[47] This rule provides taxpayers with complete flexibility to determine the manner in which GST exemption is allocated to transfers made by the transferor. A transferor can literally elect out of deemed allocation for all transfers that the transferor will ever make to any GST trust the transferor creates by filing an election out statement as set forth in the regulations that says "Taxpayer hereby elects that the automatic allocation rules will not apply to any current or future transfer that Taxpayer may make to any trust."[48] Caution would dictate perhaps modifying the statement to say "any <u>GST</u> trust," otherwise it would appear that the statement could be construed also to cover transfers to a direct skip trust that is within the deemed allocation rules under section 2632(b) (if, as may well be the case, that would be an undesirable result). Thereafter, the taxpayer would be free to make whatever affirmative allocations of GST exemption the taxpayer deems appropriate.

¶ 1003.5 Effect of an ETIP.

Section 2642(f)(3) defines an "estate tax inclusion period" or "ETIP" as any period after the transfer during which the property involved in the transfer would be includible in the gross estate of the transferor or the transferor's spouse for Federal estate tax purposes (other than by reason of the transfer within three years of death rule under section 2035). The ETIP period in no event extends beyond the first to occur of a generation-skipping transfer with respect to the property or the death of the transferor.

Example: Assume a transferor contributes property to a grantor retained annuity trust ("GRAT") (within the meaning of Treas. Reg. §25.2702-3) which is includible in the transferor's estate until the end of the annuity period.[49] Any allocation of GST exemption would appear not take effect until the end of the annuity period. Assume that at the end of the annuity period, the property continues in lifetime trusts for descendants. The GRAT would be a GST trust,

---

[45] Treas. Reg. §26.2632-1(b)(4)(iv) *Example (1)(v).* It seems this later termination of the election out of the automatic allocation rules may be made with respect to one, some or all of the trusts.
[46] Treas. Reg. §26.2632-1(c)(5) *Example (5).*
[47] Treas. Reg. §26.2632-1(b)(2)(iii)(C).
[48] Treas. Reg. §26.2632-1(b)(4)(iv) *Example 1 (v).*
[49] Treas. Reg. 20.2036-1(c)(2) sets forth the manner for computing the includible portion of a trust that is subject to a retainer annuity interest.

and the transferor's GST exemption would be deemed allocated at the close of the ETIP period unless the transferor elects out of deemed allocation. If the transferor dies during the annuity period, the transferor's executor would be permitted to allocate GST exemption to the GRAT as the ETIP period would close as of the transferor's death.

A trust will not be considered subject to an ETIP if the possibility that the property will be included in the gross estate of the transferor or the transferor's spouse is so remote as to be negligible. A possibility is so remote as to be negligible if there is less than a 5 percent actuarial probability that the property will be included in the gross estate.[50] This rule may create a problem for short-term GRATs. In the case of a short term GRAT, the likelihood of death within the term can be very small even with a relatively older grantor. Accordingly, it may be that in the case of a short term GRAT, the 5 percent probability exception to the ETIP rule applies. In that case, the unexpected result is that the deemed allocation rules may also apply depending upon the disposition of the GRAT following the annuity term. Moreover, because the measure of the transfer for GST purposes is more properly viewed as the value of the property contributed to the trust, and not the actuarial value of the GRAT remainder, perhaps the automatic allocation would be to the entire value of the property contributed to the GRAT. This unfortunate result is remedied only by a timely election out of the deemed allocation rules. It may be the best advice always to elect out of the deemed allocation rules, and then make whatever allocations the taxpayer intends to make by an affirmative allocation of GST exemption.[51]

In addition, if a spouse possesses a power of withdrawal of not more than the greater of $5,000 or 5 percent of the trust corpus, and the withdrawal right terminates no later than 60 days after the transfer to the trust, the transfer will not be considered subject to an ETIP.[52] Thus, a transferor may grant her spouse a so-called *Crummey* power of withdrawal over contributions to a trust to the extent of the greater of $5,000 or 5 percent of the value of the corpus for a period not to exceed 60 days, and would nevertheless be permitted to allocate her GST exemption to the contribution.[53] Finally, if a reverse QTIP election under section 2652(a)(3) is made with respect to the transfer, the transfer will not be considered subject to an ETIP.[54] This is a very helpful rule, because it will permit the transferor to allocate her GST exemption to an inter vivos QTIP trust effective on the date of transfer, even though that trust will be included in the donee spouse's gross estate upon the spouse's death under section 2044.

The final regulations confirm that an election out of deemed allocation to a transfer subject to an ETIP may be made on a Form 709 filed for any calendar year up to and including the calendar year in which the ETIP closes.[55]

---

[50] Treas. Reg. §26.2632-1(c)(2)(ii)(A).

[51] For a comprehensive analysis of the GST rules applicable to GRATs see Bramwell, "Generation-Skipping Transfer Tax Consequences of GRATs: Finding the Answers," 114 JTAX 260 (May 2011).

[52] Treas. Reg. §26.2632-1(c)(2)(ii)(B).

[53] Treas. Reg. §26.2652-1(a)(5) confirms that a power of withdrawal held by any person within the so-called "5 and 5" limitation, if limited to 60 days, will not cause the transferor of the trust to shift to the powerholder for GST purposes. This means that the transferor may allocate her GST exemption to the trust, and that the powerholders have not become transferors to the trust for GST purposes.

[54] Treas. Reg. §26.2632-1(c)(2)(ii)(C).

[55] Treas. Reg. §26.2632-1(b)(2)(iii)(C).

> **Example**: Assume a transferor creates a GRAT that provides that upon the termination of the annuity payable to the transferor the property continues in trust for the transferor's descendants until age 50. That makes the GRAT a GST trust to which the automatic allocation rule would apply. Suppose that the transferor does not wish her GST exemption to be automatically allocated to the GRAT at the end of the annuity period (which is when the ETIP will close). The transferor is permitted to elect out of automatic allocation of GST exemption on a Form 709 with the attached election out statement filed on or before the due date of the Form 709 for the calendar year in which the ETIP closes. This includes the Form 709 filed for the calendar year of the transfer to the trust subject to the ETIP, meaning the Form 709 that would report the transfer to the GRAT.[56]

A blanket election out of automatic allocation with respect to all future indirect skips will not constitute an election out of the automatic allocation rules with respect to a transfer subject to an ETIP that occurred in a prior year even though the automatic allocation does not take effect until the close of the ETIP, but will cover a transfer of property subject to an ETIP in a subsequent year.[57] That is because the timeliness of an election out of automatic allocation is determined with reference to date of the transfer, not the date the automatic allocation of GST exemption takes effect.

> **Example**: Assume a transferor transfers property to a 2-year GRAT in 2011, and files an election out statement in 2012 for all future transfers to any trust. The election out statement will not avoid an automatic allocation of GST exemption to the GRAT created in 2011 at the close of its ETIP period in 2014. On the other hand, if a transferor files an election out statement for all future transfers to any trust in 2011 and creates the 2-year GRAT in 2013, the election out statement filed in 2011 will avoid an automatic allocation of GST exemption to the GRAT at the close of its ETIP period in 2015.

An election out of automatic allocation for prior year transfers of property subject to an ETIP must specifically describe or otherwise identify the transfers.[58]

Note that if an affirmative allocation of GST exemption is made to property subject to an ETIP, it is irrevocable after the due date for a timely gift tax return reporting the transfer to the

---

[56] Unfortunately, the wording of Treas. Reg. §26.2632-1(b)(2)(iii)(A)(*1*) might create confusion because it states that a transferor may elect out with respect to "one or more prior-year transfers subject to section 2642(f) (regarding ETIPs) made by the transferor to a specified trust or trusts" raising the question of whether the election out could be done with respect to a "current year transfer" to a trust subject to an ETIP. However, it appears that this language is intended only to confirm that an election out of automatic allocation to property subject to an ETIP can be made at any time up to and including the year the ETIP closes, even though the transfer itself occurred in a prior year and the time for filing a gift tax return with respect to the transfer has passed. This interpretation is confirmed by the preamble to the regulations which expressly states that an election out of automatic allocation to property subject to an ETIP may be made on the gift tax return reporting the transfer subject to the ETIP. 70 FR 37258.

[57] Treas. Reg. §26.2632-1(b)(2)(iii)(D).

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

trust that is subject to the ETIP. The allocation becomes effective at the close of the ETIP and is, therefore, unlikely to cause the trust to be GST exempt.[59]

> **Example**: Assume a transferor contributes property worth $1,000,000 to a 2-year GRAT with a remainder worth $1,000. Assume the GRAT is not a GST trust (so the automatic allocation rule does not apply). The transferor allocates $1,000 of GST exemption to the GRAT. Because the GRAT is subject to an ETIP, the allocation of GST exemption will not take effect until the transferor's annuity has been fully paid so that no portion of the GRAT is included in the transferor's estate.[60] Assume that the trust is then worth $5,000. The trust will have an inclusion ratio of 4/5 (1-($1,000/$5,000)). Accordingly, the transferor would have to allocate an additional $4,000 of GST exemption to the GRAT on a timely Form 709 for the calendar year in which the ETIP closes to cause the trust to be wholly exempt from GST tax. On the other hand, if the value of the trust had declined to zero, the transferor's GST exemption would have been entirely wasted.

It, therefore, seems preferable not to make any affirmative allocation of GST exemption to a trust subject to an ETIP until the ETIP closes. And if the trust is a GST trust, a timely election out of deemed allocation should also be made.

¶ 1003.6 Terminating an Election Out of Deemed Allocation.

An election out of the automatic allocation rules may be terminated on a subsequent Form 709 to the extent the election out applies to future transfers or to a transfer subject to an ETIP.[61] To terminate an election out, the transferor must attach a statement (termination statement) to a timely Form 709 for the year in which the first transfer to which the election out is not to apply is made. A termination of an election out can be made whether or not a transfer is made in the particular calendar year and whether or not a Form 709 is otherwise required to be filed for the year.[62] A termination statement must describe the prior election out that is being terminated, specifically provide that the prior election out is being terminated, and either describe the extent to which the prior election out is being terminated or describe any current-year transfers to which the election out is not to apply.[63] The termination of an election out does not affect any transfer, or any election out, that is not described in the termination statement. The consequence of filing a termination statement is that the deemed allocation rules of section 2632(c)(1) will apply to any transfer in the current year and to all future transfers (as to which the termination statement applies) that otherwise would have been covered by the election out. Exhibit 8 contains a sample form of termination statement.

¶ 1003.7 Effect of Gift Splitting.

---

[59] Treas. Reg. §26.2632-1(c)(1)(ii).
[60] Treas. Reg. §26.2632-1(c)(1)(iii) provides that if any part of a trust is subject to an ETIP, the entire trust is subject to an ETIP.
[61] Treas. Reg. §26.2632-1(b)(2)(iii)(E).
[62] Id.
[63] Id.

In general, as discussed, the deemed allocation rules take effect unless a timely election out of deemed allocation is made. If spouses elect split gift treatment under section 2513 of the Code for a particular calendar year, each spouse's GST exemption will be deemed allocated under the deemed allocation rules to his or her 50 percent portion, as determined under the split gift rules, of all direct and indirect skip transfers made during that year. This rule can cause the deemed allocation rules, in effect, to apply retroactively. Here's why. Section 2513 permits spouses to elect split gift treatment on the first return filed by either spouse for the calendar year for which split gift treatment is sought, even if that return is not timely, so long as the IRS has not issued a notice of deficiency.[64] The regulations provide that upon the filing of the late gift tax return(s) electing split gift treatment, each spouse would be treated as the transferor of 50 percent of the property, and if the transfer is a direct or indirect skip, each spouse's GST exemption would be automatically allocated to his or her portion of the transfer.[65] Moreover, because, in this case, the returns with respect to the transfer are filed late, there is no opportunity to elect out of deemed allocation. Thus, by making an election to split gifts after the due date of the gift tax return for the transfer, the spouses can cause the deemed allocation rules of section 2632(c) to apply the consenting spouse's GST exemption to 50 percent of the transfer irrevocably and retroactive to the date of transfer.

> **Example**: Assume that on December 1, 2011, wife transfers $100,000 to a GST trust. Wife fails to file a timely gift tax return for the transfer. Thus, under 2632(c), $100,000 of wife's GST exemption would be deemed allocated to the transfer. Suppose that on December 1, 2013, husband and wife file late gift tax returns for the calendar year 2011 electing split gift treatment. Thus, wife's $100,000 transfer is deemed made $50,000 by wife and $50,000 by husband. Upon the filing of the late returns, $50,000 of wife's GST exemption is deemed allocated to the transfer, and $50,000 of husband's GST exemption is deemed allocated to the transfer, thus undoing, retroactively $50,000 of the deemed allocation of wife's GST exemption that otherwise would have occurred. This result could be obtained even after the wife's death because section 2513 would permit a posthumous election of split gift treatment by the wife's executor.[66]

A collateral consequence of the gift-splitting rule is that if spouses elect to gift split and wish to elect out of deemed allocation, each spouse must file his or her own timely Form 709 making the appropriate elections. An election out of deemed allocation by the spouse making the transfer will not effectuate an election out of deemed allocation by the consenting spouse.[67]

¶ 1003.8 Electing Into Deemed Allocation.

Section 2632(c)(5) also permits a transferor to elect to treat a trust that is not a GST trust as if it were a GST trust so that the deemed allocation rules of section 2632(c) will apply to transfers to the trust. The manner to elect in to the deemed allocation rules is similar to the

---

[64] IRC §2513(b)(2).

[65] *See* Treas. Reg. §26.2632-1(b)(4)(iii) *Example 5.*

[66] Treas. Reg. §25.2513-2(c).

[67] Treas. Reg. §26.2632-1(b)(2)(iii)(A) ("In the case of a transfer treated under section 2513 as made one-half by the transferor and one-half by the transferor's spouse, each spouse shall be treated as a separate transferor who must satisfy separately the requirements of paragraph (b)(2)(iii)(B) to elect out with respect to the transfer.").

election out rules. The transferor must check the box in Column C of Part 3 of Schedule A for the first transfer to the trust for which the election is to apply and, instead of attaching an election out statement, attach a GST trust election statement. A GST trust election statement may be filed with the same flexible approach as applies to an election out statement. And a GST trust election may be terminated in a manner similar to termination of an election out.[68] See Exhibit 9 for a sample GST trust election statement.

¶ 1004 Retroactive Allocation of GST Exemption

A fourth manner by which GST exemption may be allocated is by a retroactive allocation of GST exemption expressly authorized by section 2632(d) in the case of an unnatural sequence of deaths in the transferor's family. The rule applies if a non-skip person (i) has an interest[69] or a future interest[70] in a trust, (ii) is a lineal descendant of a grandparent of the transferor or the transferor's spouse but assigned to a generation below the generation of the transferor (e.g., a child, a nephew, the child of a cousin) and (iii) predeceases the transferor. In that case, the transferor is permitted to allocate GST exemption to the trust on a Form 709 that would be timely for a gift made in the year of the non-skip person's death and the value of the property transferred to the trust is determined as if the allocation were timely made in the year that such property was transferred to the trust. If more than one transfer has been made to the trust, the allocation must be made on a chronological basis.[71] The allocation is effective immediately before the death of the non-skip person and the amount of GST exemption that may be allocated is the amount of the transferor's unused GST exemption available immediately before the death of the non-skip person.

> **Example**: Assume in 1996 a transferor transfers property worth $500,000 to a discretionary trust for the transferor's child A and A's descendants at a time when the transferor has no unused GST exemption remaining. Ten years later when the trust assets have appreciated to $2,000,000, A dies and the transferor is still living. At that time the transferor has $1 million of unused GST exemption. The transferor is permitted, under section 2632(d), to allocate $500,000 of her unused GST exemption to the trust on a timely Form 709 for the calendar year of A's death, but effectively allocated as of the date of the original transfer to the trust. The allocation will cause the entire trust to be exempt from GST tax immediately before A's death, thus avoiding a taxable termination as to any part of the $2,000,000. Presumably, a formula allocation would also be permitted, although if a timely gift tax return was filed for the year of the transfer to the trust, the value of the property would have been finally determined.

---

[68] Treas. Reg. §26.2632-1(b)(3).

[69] The word "interest" in property held in trust is defined for GST purposes to include a right, other than a future right, to receive income or corpus from the trust, a current discretionary interest in the income or corpus of the trust and certain charitable interests. It does not include a remainder interest held by an individual, and is thus different from what State law would normally define as a beneficial interest in a trust, for example, for purposes of determining to whom a trustee must account.

[70] Defined by IRC §2632(d)(2)(C) to mean that income or corpus is permitted to be paid to such person on a date or dates in the future.

[71] IRC §2632(d)(1)(C).

The requirement that a retroactive allocation of GST exemption must be made on a chronological basis prevents taxpayers from using hindsight to make more effective allocations of GST exemption.

> **Example**: Assume a transferor transfers $100,000 to a discretionary trust for child A and A's descendants. Assume that five years after the initial transfer the value of the trust drops to zero, and the transferor transfers another $100,000 to the trust. Ten years later when the trust assets have appreciated to $400,000, A dies and the transferor is still living. The transferor would like to allocate GST exemption only to the second transfer. But Section 2632(d) does not permit this. Instead, in order to obtain a zero inclusion ratio for the trust, the transferor must retroactively allocate $100,000 of GST exemption to each of the first and second transfers, for a total of $200,000. This is a fair result because presumably if the transferor had intended to create a GST exempt trust, she would have allocated GST exemption to both transfers as she would not have known the allocation to the first transfer would be wasted.

It is not entirely clear how the retroactive allocation rule would work if the transfer of property to the trust was subject to an ETIP. Neither the Code nor any current regulation covers this possibility. If the trust is still subject to an ETIP, presumably no current effective allocation of GST exemption is permitted. The retroactive allocation rule provides that the value of the transfer or transfers for purposes of section 2642(a) shall be determined as if such allocation had been made on a timely filed gift tax return for each calendar year within which each transfer was made. However, in the case of property subject to an ETIP, the value of the transfer, for purposes of determining the inclusion ratio of a trust, is determined at the close of the ETIP period.[72] Therefore, a retroactive allocation of GST exemption equal to the full value of the property on the date of transfer is unlikely to produce a zero inclusion ratio, because the property may appreciate before the close of the ETIP period. And, unfortunately, it appears that the transferor could not increase the allocation of GST exemption because it would be deemed void.[73] It would seem consistent with the intent of the retroactive allocation rule to permit a transferor to make a retroactive allocation of GST exemption to a trust subject to an ETIP that closed during the life of the non-skip person whose death permits a retroactive allocation by determining the value of the transfer or transfers as if the allocation of GST exemption had been made on a timely filed gift tax return for the calendar year in which the ETIP closed. Perhaps, regulations will permit the value of a transfer to a trust subject to an ETIP to be determined either on the date of transfer or on the date the ETIP closes, giving the taxpayer the option as to which value to use.

¶ 1005 Deemed Allocation of GST Exemption at Death

To the extent a transferor's GST exemption is not affirmatively or deemed allocated during her lifetime and is not affirmatively allocated at her death by her executor (either to lifetime transfers or transfers at death), section 2632(e) provides a final set of deemed allocation rules. Under section 2632(e), the decedent's remaining GST exemption is deemed allocated first

[72] IRC §2642(f).
[73] *See* note 12, *supra.*

to direct skips occurring at death and second to trusts of which the decedent is the transferor and from which a taxable distribution or taxable termination might occur at or after the decedent's death. To the extent the decedent's unused GST exemption is insufficient fully to shelter such transfers, it is allocated pro rata, first among direct skips at death and then among trusts having GST potential. The automatic allocation is irrevocable and takes effect on the due date for filing the Federal estate tax return, including extensions.

As a general matter, this automatic allocation rule tends to lead to the wrong result.

> **Example**: Assume a decedent created a lifetime trust that terminates in favor of children upon attaining age 35, and by her testamentary estate planning documents created two trusts for the primary benefit of her spouse, one to be funded with her remaining applicable credit amount[74] at death ("credit shelter trust"), and the other intended to qualify for a marital deduction and funded with the remainder of her estate. Notwithstanding the fact that the lifetime trust is not a GST trust because it terminates in favor of non-skip persons prior to the time they will attain age 46, and thus no deemed allocation of GST exemption would have applied under section 2632(c), upon the transferor's death, the automatic allocation rules of section 2632(e) will apply to allocate the decedent's unused GST exemption proportionately to the date of death value of the lifetime and testamentary trusts. But, it is likely that the most effective allocation of GST exemption would be first to the credit shelter trust and second to any separate marital deduction ("reverse" QTIP) trust set apart for GST purposes. Hence, her executor, on a timely Form 706, should affirmatively allocate GST exemption to the credit shelter trust and the "reverse" QTIP trust created after her death, thus avoiding application of the automatic allocation rules under section 2632(e).[75] Exhibit 10 contains a sample attachment to Schedule R of Form 706 making the allocations of GST exemption to the credit shelter trust and the "reverse" QTIP.

And even if the lifetime trust were a GST trust and the transferor had made an effective election out of the automatic allocation rules with respect to all transfers to the trust, Treas. Reg. §26.2632-1(b)(2)(ii) expressly provides that any election out of the automatic allocation rules has no effect on the application of the automatic allocation rules under section 2632(e) after the transferor's death. Thus, in general, an affirmative allocation of a decedent's unused GST exemption at death to the appropriate transfers or trusts is preferable.

¶ 1006 Conclusions About Affirmative and Automatic Allocations of GST Exemption

Understanding the rules applicable to both affirmative and deemed allocations of GST exemption is critical to effective GST planning. The benefits of proper allocation can be substantial and knowledgeable tax return preparation is critical to obtaining those benefits. The face of the relevant tax returns is unfortunately not sufficient to put return preparers on notice of the steps necessary to make appropriate allocations and elections. Instead, the Code, the

[74] *See* IRC §2010(c).

[75] Note that the automatic allocation rules under section 2632(e), unlike the rules under 2632(b) and 2632(c), are default rules that apply only if the executor fails fully to allocate a decedent's unused GST exemption at death by affirmative allocation on the decedent's estate tax return or any gift tax returns that the executor may file.

regulations and the instructions to the return must all be studied and the requirements scrupulously followed to ensure the desired outcome.

¶ 1007 9100 Relief

Given the complexity of the rules relating to affirmative and deemed allocations of GST exemptions, errors will occur. In the event an error is discovered, the taxpayer may apply for relief, notwithstanding that the deadlines for making effective allocations and elections with respect to GST exemption appear to be statutory. Chapter 13 itself contains specific relief provisions, but proposed regulations relating to those relief provisions, which have been pending since 2008, have not been finalized. Accordingly, so-called "9100 relief" continues to be the available method to remedy the failure to make timely allocations or elections under Chapter 13.

1007.1 Section 2642(g).

A. Relief from Late Elections. Section 2642(g)(1)(A) provides for relief from late elections by stating that the Secretary shall prescribe such circumstances and procedures under which extensions of time will be granted to make:

1. an allocation of GST exemption described in section 2642(b)(1) to gifts for which an allocation is to be made on a timely filed return either at the time of transfer or at the close of an ETIP period or described in section 2642(b)(2) to transfers at death for which an allocation is to be made on a timely filed estate tax return, and

2. elections relating to automatic allocations to direct skips under section 2632(b)(3) or indirect skips under section 2632(c)(5).

The regulations shall include comparable relief with respect to transfers before the effective date of the above provisions which is December 31, 2000. Proposed regulations under section 2642(g)(1) were issued on April 17, 2008[76] and have never been finalized. Once finalized, they would replace 9100 relief in the GST area.

B. Substantial Compliance. An allocation of GST exemption under section 2632 that demonstrates an intent to have the lowest possible inclusion ratio with respect to a transfer or a trust shall be deemed an allocation of so much of the transferor's unused GST exemption as produces the lowest possible inclusion ratio.

C. Standard for Relief. Secretary shall take into account all relevant circumstances in determining whether to grant relief under section 2642(g), including evidence of intent contained in the trust instrument or instrument of transfer and other relevant factors.

D. Link to 9100 Relief. Section 2642(g)(1)(B) contains the following important sentence relating to relief from late elections: "For purposes of determining whether to grant relief under this paragraph, the time for making an allocation (or election) shall be treated as if not expressly prescribed by statute." This permits relief under Treas. Reg. 301.9100-3, which

---

[76] 2008-19 I.R.B. 916.

contains provisions describing the manner in which to apply for a discretionary extension of time to make regulatory elections.

¶ 1007.2 Notice 2001-50.

Notice 2001-50, 2001-34 I.R.B. 189, provides guidance regarding requests for an extension of time to make an allocation of GST exemption under sections 2642(b)(1) and (2) and elections relating to automatic allocation of GST exemption under sections 2632(b)(3) and (c)(5). Notice 2001-50 expressly provides that Treas. Reg. §301.9100-3 applies and that taxpayers should follow the procedures for requesting a private letter ruling under §301.9100 contained in section 5.02 of Rev. Proc. 2001-1 (or its successors).

¶ 1007.3 9100 Relief.

There is no Code Section 9100. The regulations are at section 301.9100 entitled "Extensions of Time for Making Elections."

A. In General. Treasury Regulation 301.9100-1 states that the regulations under that section provide the standards the Commissioner will use to determine whether to grant an extension of time to make a regulatory election. A regulatory election means an election whose due date is prescribed by a regulation published in the Federal Register, or a revenue ruling, revenue procedure, notice or announcement published in the Internal Revenue Bulletin. Thus, the provisions of Code section 2642(g)(1)(B) and Notice 2001-50 are critical to the application of the discretionary relief under the 9100 regulations.

B. Automatic 6-month Extension. Although limited, section 301.9100-2 also provides for an automatic 6-month extension of time to make certain statutory elections and was available prior to January 2001. These provisions provide relief if a return is filed and the mistake is discovered within 6-months of the original due date of the return. Although not well punctuated, so you will need to read it several times, the section grants an automatic 6-month extension of time from the due date of the gift or estate tax return, excluding extensions, if the taxpayer (i) filed a timely return and (ii) takes the prescribed corrective action.

If the election was required to be filed with the return, corrective action includes filing an amended return for the year the election should have been made and attaching the appropriate form or statement making the election. All affected taxpayers must file consistent returns. The top of the amended return should contain the statement "FILED PURSUANT TO §301.9100-2". The amended return must be sent to the same address that the filing to make the election would have been sent had the filing been timely made. No request for letter ruling is required; therefore, user fees do not apply.

C. Discretionary Relief. Section 301.9100-3 permits requests for extensions of time for making regulatory elections. Relief will be granted when the taxpayer provides evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the government.

1. Reasonable and Good Faith Conduct. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer satisfies any of the following:

a. Requests relief before the failure to make the regulatory election is discovered by the IRS;

b. Failed to make the election because of intervening events beyond the taxpayers control;

c. Failed to make the election because, after exercising reasonable diligence (taking into account the taxpayer's experience and the complexity of the return or issue), the taxpayer was unaware of the necessity for the election;

d. Reasonably relied on the written advice of the IRS; or

e. Reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make, the election.

Reasonable reliance on a qualified tax professional is defined in the negative. The taxpayer will not be considered to have reasonably relied on a qualified tax professional if the taxpayer knew or should have known that the professional was either (i) not competent to render advice on the regulatory election or (ii) not aware of all relevant facts.

The taxpayer will not be deemed to have acted reasonably and in good faith, regardless of satisfying one of the above criteria, if the taxpayer was informed in all material respects of the required election and related tax consequences but chose not to file the election, which would seem to require a conscious decision not to elect. The taxpayer will not be deemed to have acted reasonably and in good faith if the taxpayer uses hindsight in requesting relief. If specific facts have changed since the due date for making the election that make the election advantageous, the IRS will ordinarily not grant relief unless the taxpayer provides strong proof that the taxpayer's decisions to seek relief did not involve hindsight. This could be a fairly difficult hurdle in any particular case because it may be the fact that a GST tax is currently due that brings the missed allocation to the taxpayer's attention.

2. The standard for whether the taxpayer acted reasonably and in good faith under the proposed regulation 26.2642-7 is different than the standard set forth in section 301.9100-3. It would seem likely that the IRS would apply the standard in the proposed regulations, that standard being more specifically tailored to the failure timely to make GST exemption allocations or elections. The factors under the proposed regulations are as follows:

a. Intent of the transferor to timely allocate GST exemption to a transfer or to timely make an election under section 2632(b)(3) or (c)(5), as evidenced by the trust instrument, the instrument of transfer or other relevant documentation contemporaneous with the transfer such as Federal gift to estate tax returns and correspondence. This may include evidence of the intended GST tax status of the transfer or trust (for example, exempt, non-exempt, or partially exempt). It would seem prudent for the attorney draftsperson to include a statement of intent in the trust instrument itself, particularly if the attorney will not be the tax return preparer.

b. Intervening events beyond the control of the transferor or executor as the cause of a failure to allocate or make an election.

c. Lack of awareness of the transferor or the executor of the transferor's estate of the need to allocate exemption to the transfer, despite the exercise of reasonable diligence, taking into account the experience of the transferor or executor and the complexity of the GST issue.

d. Consistency of the transferor with regard to the allocation of the transferor's GST exemption (for example, the transferor's consistent election not to have the automatic allocation of GST exemption apply to transfers to one or more trusts or skip persons pursuant to section 2632(b)(3) or (c)(5). Evidence of consistency may be less relevant if there has been a change or circumstances or change of trust beneficiaries that would otherwise explain a deviation from prior GST exemption allocation decisions.

e. Reasonable reliance by the transferor or executor on the advice of a qualified tax professional retained or employed by one or both of the them and, in reliance on or consistent with that advice, the failure of the transferor or executor to allocate GST exemption to the transfer or to make an election described in section 2632(b)(3) or (c)(5). Reliance on a qualified tax professional will not be considered to have been reasonable if the transferor or executor knew or should have known that the professional either --

1. Was not competent to render the advice on GST exemption; or

2. Was not aware of all the relevant facts.

3. Prejudice to the Interests of the Government.

Section 301.9100-3(c) contains the standards for determining when the interests of the government are prejudiced. The interests of the government are prejudiced if granting relief would result in the taxpayer having a lower tax liability, in the aggregate for all taxable years affected by the election, than the taxpayer would have had if the election had been timely made (taking into account the time value of money). Thus, the standard is comparing a properly filed allocation or election with granting relief. This should not be a difficult hurdle in the GST area. In addition, the interests of the government are ordinarily prejudiced if the taxable years in which the regulatory election should have been made or any taxable year that would have been affected by the election had it been timely made is closed by the period of limitations on assessment before the taxpayer's receipt of a ruling granting relief. This second requirement appears not to be strictly followed in connection with granting 9100 relief for missed GST allocations and elections.

Proposed regulation 26.2642-7(d)(3) provides that the interest of the Government would be prejudiced to the extent to which the request for relief is an effort to benefit from hindsight. The test is whether the request for relief would permit an economic advantage or other benefit that would not have been available if the allocation or election were timely made. This would include the ability to select from a number of alternatives that were available at the time the allocation or election could have been timely made, if hindsight makes the selected alternative

more beneficial that the other alternatives. Finally, if there were only choices to make or not make a timely allocation or election, prejudice exists if the transferor failed to make a timely allocation or election in order to wait and see (thus, with the benefit of hindsight) whether or not making the allocation or election would be more beneficial.

a. Timing of the request for relief will be considered. A delay with the intent to deprive the IRS of sufficient time to challenge the claimed identity of the transferor or the transferred property that is the subject of the request for relief, the value of the transferred property for Federal gift or estate tax purposes or any other aspect of the transfer that is relevant for Federal gift or estate tax purposes. The fact that the period of limitations on the assessment or collection of transfer taxes has expired will not by itself prohibit a grant for relief under this section. Significantly, the regulations state that a combination of the expiration of the statute of limitations and the fact that the asset was valued for transfer tax purposes with a valuation discount will not by itself prohibit a grant of relief under this section. This statement in the proposed regulations may have been in response to a policy in effect for a period of time to deny requests for ruling under those facts.

b. The occurrence and effect of an intervening taxable termination or taxable distribution will be considered in determining whether the interests of the Government would be prejudiced by granting relief. The impact of a grant of relief on (and the difficulty of adjusting) the GST tax consequences of intervening taxable terminations or distributions will be considered in determining whether there is prejudice.

c. It is important to note that relief will not be granted to revoke or decrease a timely allocation of GST exemption or to revoke an election under section 2532(b)(3) or (c)(5).

d. Relief also will not be granted if the transferor or executor makes a decision that is the subject of the request for relief with regard to allocation or an election that was reflected or implemented by action or inaction after being accurately informed by a qualified tax professional retained or employed by the taxpayer with respect thereto.

4. Extending the Statute of Limitations.

Relief under 301.9100-3 does not suspend the period of limitations on assessment under section 6501(a); therefore, for relief to be granted, the IRS may require the taxpayer to consent to an extension of the period of limitations on assessment for the taxable year in which the regulatory election should have been made and any taxable years affected by the election had it been timely made. If a return was not filed at all, no period of limitations would have begun to run in any event. If a return was filed, the taxpayer will have to weigh the benefits of relief versus closure on the other issues adequately disclosed by the return, such as valuation of the transfer and so forth. Extending the statute as a practical matter should be viewed as a condition precedent to obtaining relief.

5. Procedural Requirements.

a. Proof of Entitlement to Relief under above Standards.

Taxpayer must provide evidence that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government.

b. Taxpayer's Affidavit.

The taxpayer, or the person individual who acts on the taxpayer's behalf with respect to tax matters, must submit a detailed affidavit describing the events that led to the failure to make a valid regulatory election and the discovery of the failure. When the taxpayer relied on a qualified tax professional for advice, the taxpayer's affidavit must describe the engagement and responsibilities of the professional as well as the extent to which the taxpayer relied on the professional. The affidavit must be accompanied by a dated declaration signed by the taxpayer, which states:

Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and, to the best of my knowledge and belief, the request contains all the relevant facts relating to the request, and such facts are true, correct, and complete.

c. Affidavits from Other Parties.

The taxpayer must submit detailed affidavits from the individuals having knowledge or information about the events that led to the failure to make a valid election and discovery of the failure. These individuals must include the taxpayer's return preparer, any other individual who made a substantial contribution to the preparation of the return, and any accountant or attorney knowledgeable in tax matters who advised the taxpayer with regard to the election. Each affidavit must describe the engagement and responsibilities of the individual as well as the advice the individual provided to the taxpayer. Each affidavit must include the name, current address and taxpayer identification number of the individual and be accompanied by a dated declaration, which states

Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and, to the best of my knowledge and belief, the request contains all the relevant facts relating to the request, and such facts are true, correct and complete.

d. Other Information.

The taxpayer must also supply the following additional information:

1. If a return was filed, whether it is being examined by the district director, or considered by an appeals officer or federal court, or whether the IRS had commenced an examination while the request for relief is pending;

2. When the allocation or election was due, and when it was actually filed;

3. Copies of any documents that refer to the allocation or election (in this connection, the taxpayer may have to consider waiving attorney/client privilege as to the content of certain documents if it is helpful to the application);

4. When requested, a copy of all returns affected by the application for extension of time to make the allocation or election (it would seem helpful to include these with the application as they will certainly be requested); and

5. If applicable, copies of returns of other taxpayers affected by the allocation or election.

6. Revenue Procedure 2017-1.

See Revenue Procedure 2017-1, 2017-I.R.B. 1 for additional procedures with respect to requesting a private letter ruling under §301.9100.

¶ 1008 Introduction to More Exotic Allocations of GST Exemption

Allocations of GST tax exemption are most effective when they produce trusts that are either wholly subject to or wholly exempt from GST tax. There are a variety of methods to accomplish that end, including the creation of separate trusts within an estate plan, discretionary severances of trusts at death pursuant to local law or the governing instrument and qualified severances of existing trusts. This portion of the outline reviews the various methods to create exempt and non-exempt trusts, as well as the effect on GST exempt status of consolidating trusts for administrative purposes. In most circumstances, allocations of GST exemption to a per stirpital estate plan are made pro rata at the highest level of descent. Yet, post death events may cause a per stirpital allocation of GST exemption to accelerate the payment of GST tax. In such a situation, it may be appropriate to consider making a non-pro rata or non-per stirpital allocation of GST exemption even though the decedent has disposed of his or her property in a pro rata or per stirpital manner. This portion of the outline explores the authority to make such a disproportionate allocation and ways to mitigate the after-tax effect on beneficiaries who may pay or whose trusts may pay higher GST tax on account of that allocation.

¶ 1008.1 Overview of the Generation-Skipping Transfer Tax Regime.

Subject to exceptions and limitations, transfers of property to a transferor's grandchildren and more remote descendants and those who are treated as being in the generations of such descendants are subject to the GST tax under section 2601 which imposes a tax on each "generation-skipping transfer." All such persons are known as "skip persons" for GST tax purposes[77]; all others are ingeniously called "non-skip persons." Property may also be exempted from the tax by the allocation of the GST exemption.[78] The GST exemption is equal to the amount of the applicable exclusion amount (also called the "estate tax exemption") for estate tax purposes, currently $5 million indexed for inflation.

A. Specific Exceptions For Medical and Tuition. As indicated, certain transfers, even if not protected from GST tax by an allocation of GST exemption, to or for skip-persons are

[77] See section 2613.
[78] Section 2631(a).

not subject to GST tax. These include transfers for tuition paid directly to the education institution and for medical care paid directly to the healthcare provider.[79]

B. Need to Use Separate Trusts for Effective Planning. Generally, if property may be subject only in part to GST tax (that is, it has an inclusion ratio of greater than zero but less than one), it usually is preferable to have separate trusts,[80] one or more of which would entirely exempt from GST tax (that is, a zero inclusion ratio) and another or others that may be entirely subject to GST tax (an inclusion ratio of one).[81] One of the reasons is that distributions from a trust that would not be subject to GST tax, such as a distribution to a non-skip person or a distribution falling under the medical care or tuition exceptions for a skip person, may be made from a trust that is entirely subject to GST tax, thereby increasing what is available under the trust that is exempt from GST tax. Indeed, this is regarded as so important that the Code was amended in 2001 to allow "qualified severances" under which one trust that is only partially exempt from GST tax by reason of the allocation of GST exemption may be divided into two trusts, one of which is totally exempt (that is, has a zero inclusion ratio) and one that is not exempt at all (that is, has an inclusion ratio of one).[82]

C. Ability to Make Allocations to Distinct Trusts. The taxpayer or the taxpayer's executor may allocate the taxpayers unused GST exemption so that a separate trust created under a decedent's estate plan is entirely exempt from GST tax while another trust is not exempt from GST tax.[83] Indeed, some practitioners direct, by word formula, the disposition of interests among descendants (or others) on the basis that there will be one trust for each beneficiary that is exempt from the tax and one trust that is not. Depending upon whether the individual is married or not, the way that is accomplished may vary.

¶ 1008.2 Married Persons and GST Exemption Allocation.

Transfers to one's spouse are not subject to GST tax because a spouse is not a skip person. Also, transfers in qualifying form[84] to or for one's spouse are not subject to gift or estate tax by reason of the marital deduction.[85] But many, if not most, married persons with appreciable wealth do not transfer all their property at death to their spouses under the protection of the marital deduction. That would "waste" the estate tax exemption of the spouse dying first

---

[79] See, generally, section 2611(b)(1) and section 2642(c)(3) (special rule for direct skip transfers qualifying for the special exclusions from gift tax under section 2503(b) (annual exclusion) and section 2503(e) (transfers for educational and medical expenses).

[80] Substantial separate and independent shares of one trusts are treated as separate trusts for GST tax purposes. Section 2654(b). However, similar or identical shares of a trust for the same beneficiary or beneficiaries are unlikely to constitute such separate shares even if they otherwise would have different inclusion ratios. See, generally, Treas. Reg. §§ 26.2654-1(a)(1)(i) and 1.663(c)-3.

[81] See, generally, Blattmachr, "Getting It Clean and Keeping It Clean (Another Generation-Skipping Adventure)," 8-1 49th Annual Institute on Federal Taxation (1991), reprinted as "Another Generation-Skipping Adventure," ¶472 Macmillan, Inc. - Tax Ideas (July 1991).

[82] Section 2642(a)(3). See, generally, Harrington, Kwon, McCaffrey, Plaine & Schneider, "Breaking Up Is No Longer Hard to Do: Final GST Tax Qualified Severance Regulations" 107 Jl. of Taxn 331 (December 2007).

[83] Under section 2631(a), the allocation is made by the individual taxpayer or his or her executor.

[84] The form of transfer that may qualify for the marital deduction is somewhat different if the transfer is made during lifetime or at death. Compare section 2523(b) with section 2056(b).

[85] Transfers during life to or for one's spouse who is not a US citizen cannot qualify for the gift tax marital deduction. Section 2523(i). Transfers at death may qualify only if to a qualified domestic trust. See section 2056A.

because property sheltered from estate tax by the exemption need not be taxed when the surviving spouse dies but property protected by the marital deduction will be (unless expended during the surviving spouse's lifetime). Hence, married persons at death often provide for the division their estates into at least two shares: one that is protected from estate tax by reason of the estate tax exemption and another qualifying for the marital deduction.[86]

A. Available Shelters for Estate/Gift and GST Purposes may differ. In many cases, the amount of unused GST exemption of a decedent will be different from the amount of his or her unused estate tax exemption. One reason is that lifetime gifts may use a portion of the estate tax exemption but not necessarily GST exemption.[87] In a case where the unused GST exemption exceeds the unused estate tax exemption, a married decedent will waste his or her GST exemption by dividing his or her estate into only two shares, one equal to the estate tax exemption and the balance qualifying for the marital deduction. This is so because a portion of his or her GST exemption will be allocated to property with respect to which the surviving spouse will become the transferor for GST tax purposes.[88] This would happen, for example, if the executor of the Will of the first spouse to die makes an election under section 2056(b)(7) to treat a trust for the surviving spouse as qualified terminable interest property which would cause the trust estate to be included in the surviving spouse's estate under section 2044. But Section 2652(a)(3) allows a taxpayer or the taxpayer's executor who makes an election to treat a transfer that has qualified for the gift or estate tax marital deduction by reason of electing it to constitute qualified terminable interest property (QTIP) to treat the QTIP election, for GST tax purposes, as though never made. In other words, although an election is made for estate tax purposes for the transfer to qualify for the marital deduction as a QTIP, the election is reversed for GST tax purposes. Such a "Reverse QTIP" election permits the taxpayer or his or her executor to treat the taxpayer as the transferor for GST tax purposes so his or her GST exemption may be allocated to the QTIP trust. Hence, when the spouse who is the beneficiary of the Reverse QTIP trust dies, the property will remain exempt from GST tax without further allocation of GST exemption.

B. Need of a Tri-Partite Estate Plan. In fact, to accomplish that result, many married individuals do not direct a two part division of their wealth at death (estate tax exemption part and marital deduction part) but direct a three part division: (1) one part equal to the amount of his or her unused estate tax exemption, usually passing into a trust for the spouse and descendants (sometimes called the "credit shelter trust"[89] or "estate tax exemption trust"); (2) one part equal to the amount by which the unused GST exemption exceeds the unused estate tax exemption, passing into a Reverse QTIP trust, and (3) the balance passing in a form (such as

---

[86] See, generally, Gans & Blattmachr, "Quadpartite Will: - and the Next Generation of Instruments," 32 EST PLN 3 (April 2005).

[87] See section 2001(b).

[88] The executor of the Will of the spouse dying first could allocate GST exemption to the part of the estate qualifying for the marital deduction. But because any subsequent transfer of the property to persons other than the surviving spouse will be treated as transfers by the spouse, he or she will become the transferor of the property for GST tax purposes, effectively resulting in the waste of the exemption of the first spouse to die unless, as explained in the text, the property qualified for a marital deduction by reason of a QTIP election under section 2056(b)(7), and a "reverse" QTIP election is made by the executor of the Will of the first spouse to die.

[89] It is called by some the "credit shelter trust" because the amount passing into the trust is determined by credits, such as the so-called "unified credit" (a/k/a "applicable credit") allowed under section 2010, that shelter the trust from estate tax.

a second QTIP but with respect to which the Reverse QTIP election will not be made) that will qualify for the marital deduction but which will not be exempt from GST tax by reason of the GST exemption of the first spouse to die.[90]

Hence, when the surviving spouse dies, the property remaining in the estate tax exemption trust and the Reverse QTIP trust will be exempt from GST tax by reason of the allocation to those trusts of the GST exemption of the spouse dying first. Of course, the surviving spouse, as with any other decedent, may have unused GST exemption at his or her death. As indicated above, non-married persons often direct the division of their wealth into GST exempt and GST non-exempt shares.

C. Proliferation of Trusts Upon the Death of a Surviving Spouse. In order to minimize applicable estate and GST taxes, the number of trusts following the death of the surviving spouse may be significant. Without any combination of the succeeding trusts, as is discussed next, even if each of the three parts of the estate of the first spouse to die passes into one single trust for all descendants, there may be at least three such trusts created from such property because there were three shares: (1) estate tax exemption trust, (2) Reverse QTIP trust, (3) a second QTIP trust. Again, even if the property of the surviving spouse is to be held in single trusts for all descendants, there will be at least two shares: (1) one equal to the unused GST exemption of the surviving spouse, and (2) the balance of his or her property. Therefore, there could be as many as five trusts for the descendants when the first spouse dies. And, of course, if the couple wishes a per stirpital division of their wealth, as many property owners do, instead of five trusts, there may be fives times the number of per stirpital shares. For instance, if the couple has two children, both of whom survive, there could be ten trusts, five for each child. If a child has predeceased the parents, leaving two children of his or her own, there would be 15 trusts: five for the surviving child and five for each of the two grandchildren (although the trusts for grandchildren would be half of the size of the ones for the surviving child).

¶ 1008.3 Reducing the Number of Trusts.

A. Unlikely that 643(f) Would Apply. Although section 643(f) treats trusts having substantially the same grantor or grantors (and husbands and wives are treated as one grantor for purposes of the section) and substantially the same primary beneficiary or beneficiaries may be treated as one trust for income tax purposes, that does not seem likely to cause the five or so trusts for the same descendant created in the foregoing manner by a married couple to be treated as one trust because the section applies only if a principal purpose of such trusts is the avoidance of income tax. Such tax avoidance is unlikely to be found to be a principal purpose for the creation of the trusts. Rather, it was done efficiently to use the estate and GST exemptions of the first spouse to die and the GST exemption of the surviving spouse. Although each such trust, therefore, is considered a separate taxpayer, the income tax benefit of the $300 or $100 personal

---

[90] Blattmachr, Hastings & Blattmachr, "The Tripartite Will: A New Form of Marital Deduction," 127 Trusts & Estates 47 (April 1988).

exemption for each trust[91] and the modest "bracket ride" likely may not be perceived as sufficiently beneficial to justify keeping separate trusts.[92]

B. Can the Trusts be Consolidated? In any case, where is it not anticipated that separate trusts will produce a significant income tax benefit or produce another benefit that would suggest it would be efficient for separate trusts to be maintained, it seems appropriate to consider consolidating at least some of the trusts.[93] How that may be accomplished may turn on the terms of the governing instrument and state law. For example, many practitioners expressly provide that fiduciaries may combine trusts held under the governing instrument for the same beneficiary or beneficiaries if the terms of the trust are identical. Hence, if, by way of example, the estate tax exempt trust and the Reverse QTIP trust that the first spouse to die creates pass into identical trusts, these trusts presumably could be combined by such an authorization. If the instrument is silent, state law may authorize such a combination. For example, statutes in fourteen states permit a trustee with a power to invade the corpus of a trust to pay the corpus over to another trust for one or more of the person to whom the trustee could make discretionary distributions of corpus.[94] In some cases, however, it will be uncertain whether the power to combine the trusts, even for the same beneficiary or beneficiaries, is available. It may then be considered whether seeking authorization from a court having jurisdiction over the trusts is appropriate and would be successful.[95]

C. Special Rules Relating to Separate Trusts. As indicated above, even if consolidation of the trusts originating with the property of the first spouse to die is permitted, it seems unwise to consolidate any trust that is GST exempt with one that is not. Nevertheless, a special GST tax rule would permit the consolidation of all three trusts, even if the non-Reverse QTIP is not GST exempt without creating a trust with a fractional inclusion ratio. Section 2654(b)(1) provides that, for purposes of the GST tax, the portions of a trust attributable to transfers from different transferors are treated as separate trusts. And the surviving spouse will become the transferor for GST purposes of the non-Reverse QTIP trust because the non-Reverse QTIP trust is includible in the surviving spouse's estate under section 2044.[96] Because the surviving spouse will be treated as the transferor of the third part of the estate of the first spouse to die, it can be consolidated with the other parts (the estate tax exemption trust and Reverse QTIP trust) of the estate of the first spouse to die that are GST exempt and the third part will be treated as a separate trust. Hence, even though the third part may not be exempt from

---

[91] See section 641(b)(2).

[92] Bracket ride refers to the amount of taxable income that is taxed at lower than the highest federal income tax rate. Trusts reach the highest federal income tax rate at $10,450 of taxable income.

[93] One potential benefit of having separate trusts is to isolate the potential liability associated with certain assets from other assets. See, e.g., Matter of Heller, 161 Misc. 2d 369, 613 N.Y.S. 2d 809 (Surr. Ct. 1994). That might also be accomplished by holding assets that might generate liability in separate limited liability entities such as limited liability companies. In any case, separate trusts means the cost of preparation of separate income tax returns, separate estimated payments of tax, maintaining separate financial (e.g., brokerage) accounts and so on. In some situations, having the trusts consolidated but held in separate shares may accomplish some simplification of administration of the property.

[94] See, e.g., Alaska Stat. § 13.36.157; 12 Dela. Code § 3528; Fla. Stat. § 736.04117; NY EPTL 10-6.6; So. Dak. § 55-2-15; Tenn. Stat. § 35.15.816(b)(27).

[95] Cf. Heller, supra, allowing division or severance of one trust into two trusts where it was beneficial to do so. It seems that authority to combine would be granted by many courts if it would be beneficial to do so.

[96] Treas. Reg. § 26.2652-1(a)(1).

GST tax, the trustee of the consolidated trust may specify when a distribution is made whether it is from the property of which the first spouse to die is the transferor or of which the surviving spouse is the transferor for GST tax purposes.[97]

D. Allocating the Surviving Spouse's Exemption. Of course, the surviving spouse may have unused GST exemption of his or her own. Any such exemption could be allocated to the third part of the estate of the first spouse to die of which the surviving spouse will be treated as the transferor. If the GST exemption of the first spouse to die is sufficient to exempt the entire third part from GST tax and it is allocated to that part, that may simplify administration of the consolidated trust because it is likely to be unimportant for GST tax purposes to determine whether a distribution is attributable to property of the spouse dying first is the transferor or is attributable to property of which the survivor is the transferor. In fact, the unused GST exemption the surviving spouse may be sufficient to exempt not just the third part of the estate of the first spouse to die from the tax but also the surviving spouse's own property. In such as case, it may seem simplest to consolidate all of his and her property together into one trust. That might occur under a consolidation authorization under all governing instruments or state law, as discussed above. And it may be that decanting power is present under the common law of states that do have a "decanting" statute.[98]

E. Trusts with Different Termination Dates Should Not be Consolidated. But where the trusts created by the first spouse to die and surviving spouse have different termination terms (such as each such trust having to terminate not later than the maximum term permitted by the applicable rule against perpetuities which began when respective trust's grantor died), it may not be appropriate to consolidate all of them to ensure compliance with the rule. This is true even though, because the husband and wife are treated as different transferors, it seems that there should be no limit in consolidating the trusts from a GST tax perspective. And as long as the trusts are identical, there would not seem to be any adverse income tax effect by such consolidation.[99] To ensure that any consolidation would satisfy the applicable limitation on the duration of trusts, a decanting power could be used to help achieve an appropriate result. The trustee in making the invasion in further trust under a decanting power could specify that the applicable rule against perpetuities with respect to the invaded trust shall apply under the consolidated trust as to the property of the invaded trust. Alternatively, it may be "safer" to have the trust with the longer remaining term paid over to the trust with the shorter term but with a direction that the addition be subject, *to the extent permitted by applicable law*, to the longer remaining term. Depending on the timing of the deaths of husband and wife, subjecting all the property to the shorter term may be satisfactory.

F. Using the "Different Transferors" Rule. If the unused remaining GST exemption of the surviving spouse is insufficient to permit all of property with respect to which the survivor is the transferor for GST tax purposes to be exempted from GST tax, it may not be appropriate to consolidate all the property (that is, property that is GST exempt and property that is not) into one trust. The "different" transferors rule of section 2654(b)(1) discussed above will not apply to

---

[97] Although the rules permit such consolidation, the accounting accuracy needed to maintain the exempt and non-exempt shares may make such a maneuver unwise.

[98] See, e.g., Phipps v. Palm Beach Trust, 142 Fla. 782 (1940).

[99] See, e.g., PLR 200319004. Cf. Treas. Reg. § 1.1001-1(h) (no gain upon certain trust severances). Neither a private letter ruling (PLR) nor a national office technical advice memorandum may be cited or used as precedent.

prevent the consolidated trust with respect to the surviving spouse to be only partly exempt from tax. Similarly, if the GST exempt and GST non-exempt parts of the property which respect to which the surviving spouse is the transferor are similar as they likely would be, the substantially separate and independent shares rule of section 2654(a) will not be available to prevent the consolidated trust from being only partly GST exempt.

G. Practical Solution -- use two trusts. In light of the foregoing discussion, it will not be possible to consolidate down to one trust and maintain GST exemption purity (that is, an inclusion ratio of zero) for part. It may be simplest to consolidate all parts that are GST exempt, regardless of which spouse is the transferor, into one trust, and all parts that are not GST exempt into a second trust.

¶ 1008.4 Qualified Severance or No?

On August 2, 2007, the IRS issued final regulations with respect to making a so-called "qualified severance" of a trust for GST and income tax purposes.[100] There are a number of requirements in order for a severance of a trust to which GST exemption has been allocated to be respected for GST tax purposes. The primary benefit of a qualified severance is that it permits a trust with a fractional inclusion ratio to be divided into a two trusts, one with a zero inclusion ratio, and the other with an inclusion ratio of one.

A. Requirements for a Qualified Severance. Treasury Regulation §26.2642-6 sets forth the requirements for a qualified severance. The severance must be accomplished pursuant to the terms of the governing instrument or applicable local law, and be effective under local law. The valuation date is the date selected by the trustee or the date imposed by court order, with values to be established as of that date and funding to be commenced immediately, and completely no later than 90 days after the valuation date. The original trust must be severed on a fractional basis, which may be established by formula. Funding may be accomplished non-pro rata provided the valuation date values are used without the application of any discounts or premiums. It has been suggested that this requirement is without a statutory basis.[101] The resulting trusts must provide in the aggregate for the same succession of interests. The examples reveal that division of a trust on a per stirpital basis will qualify, but division of a trust based upon the actuarial value of the beneficial interests will not qualify. However, the terms of the resulting trusts must be the same as the original trust. The severance may not shift beneficial interests to lower generations, nor extend the time for vesting of the beneficial interests beyond the period provided in the original trust. If the original trust has an inclusion ratio of either zero or one, each resulting trust will have an inclusion ratio of zero or one. This rule would not appear to be important for an original trust with an inclusion ratio of one so long as the resulting trusts are respected as separate trusts under State law. If the original trust has a fractional inclusion ratio, then the resulting trusts must be divided so that one or more trusts in the aggregate receive that fraction of the original trust equal to the applicable fraction. The regulations also set forth the proper manner to report a qualified severance, which is done on Form 706-GT(T) by writing Qualified Severance across the top and then attaching a Notice of

---

[100] T.D. 9348.

[101] Kwon, "A Hop, Jump & Generation-Skip Away with GST Tax," 46th Annual Heckerling Institute on Estate Planning, Chapter 11 (2012).

Qualified Severance containing the required information. The return with attached Notice are to be filed on April 15th of the year immediately following the year during which the severance occurred, or the last day of the period covered by an extension of time, if an extension of time is granted to file such return.[102]

B. Severances under Section 2654. Following comments to the proposed regulations, the qualified severance regulations clarified that they do not displace the rules applicable in the event of the death of the transferor under section 2654. In general, the Treasury Regulations under section 2654 permit a trust includible in the decedent's estate to be severed or divided into parts on a fractional share basis, for purposes for allocating GST exemption to one of the parts, if the division occurs before the date, including extensions, prescribed for filing the United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706) and is pursuant to an authorization for such severance under local law or the terms of the governing instrument (or is required by it).[103] Under a special rule, if the division will occur pursuant to a local court order, and the court order severing the trust has not been issued at the time the Federal estate tax return is filed, the executor must indicate on a statement attached to the return that a proceeding has been commenced to sever the trust and describe the manner in which the trust is proposed to be severed. A copy of the petition or other instrument used to commence the proceeding must also be attached to the return. On the other hand, if the governing instrument of a trust or local law authorizes the division of the trust, a severance pursuant to that authorization is recognized if the executor indicates on the Federal estate tax return that separate trusts will be created (or funded) and clearly sets forth the manner in which the trust is to be severed and the separate trusts funded even if the severance has not taken place as the time the return is filed. This rule puts a premium on drafting authorization in the governing instrument to ensure maximum flexibility. Example (4) under Treasury Regulation § 26.2654-1(b) confirms that a severance pursuant to authority under applicable state law is valid if accomplished prior to the due date for filing the Federal estate tax return, but does not provide guidance on what would be a sufficient statement by the executor if the severance is delayed until after the return is filed.[104]

C. When Is It Permitted? A trust which has an inclusion ratio of more than zero and less than one may be divided so that one severed trust has an inclusion ratio of zero (totally GST exempt) and the other has an inclusion ratio of one (no part is GST exempt) pursuant to a "qualified severance."[105] A "qualified severance" means the division of a single trust and the creation (by any means available under the governing instrument or under local law) of two or more trusts, if the single trust was divided on a fractional basis, and the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust. However, a qualified severance does not include a severance pursuant to Treas. Reg. § 26.2654-1(b), described in the foregoing paragraph.[106] The reason is that the severance pursuant to that regulation is effective retroactive to the date of the decedent's death; a

[102] Treas. Reg. § 25.264-6(e).
[103] Treas. Reg. § 26.2654-1(b). The regulations also recognizes a pecuniary division as well if required by the terms of the governing instrument.
[104] Treas. Reg. § 26.2654-1(b)(2).
[105] Section 2642(a)(3). Note that an addition or constructive addition to a trust that was irrevocable on September 25, 1985 causes that trust to consist of two portions, a chapter 13 and a non-chapter 13 portion, which may be severed in accordance with Treas. Reg. § 26.2654-1(a)(3). See Treas. Reg. § 26.2642-6(g).
[106] Treas. Reg. § 26.2642-6.

qualified severance is effective only when made. Generally, it may be preferable to effect the severance for property included in a decedent's estate pursuant to Treas. Reg. § 26.2654-1(b) rather than by a qualified severance.

¶ 1008.5 Disproportionate Allocation of GST Exemption.

As indicated, transfers to skip persons may be subject to two taxes: (1) gift or estate tax and (2) a GST tax. When the transfer is a direct skip (essentially one to or at least initially for the exclusive benefit of skip persons), the two taxes are imposed simultaneously.[107] However, where the property subject to gift or estate tax is transferred to a trust in which a non-skip person (such as a child) currently has an interest,[108] the GST tax is postponed until a distribution to a skip person is made or the interests in the trust of the non-skip person or persons terminate.[109]

A. Estate Tax Inclusion in More Than One Estate. Property is often subject to estate tax in the estate of more than one person. For example, property subject to estate tax when it is inherited by child from a parent may be subject to estate tax again when the child dies. However, a credit (subject to limits) in one estate for the estate tax paid in the other estate when one death follows the other within ten years or, in some cases, precedes it by two years.[110] No similar relief is provided when property is subject to estate or gift tax and a generation-skipping skipping event occurs soon thereafter. For example, a parent creates a trust for her child which will end when the child dies in favor of the child's children. The child dies a year after the parent dies. A GST tax will be due except to the extent the trust is included in the child's gross estate for Federal estate tax purposes or allocation of GST exempt has protected the trust from that tax.

B. Exception under 2651(e). A special rule under section 2651(e) provides that if a descendant of the transferor predeceases the transfer that is subject to estate tax or gift tax (which could be at the same time as the GST transfer, in the case of a direct skip, or precede the GST transfer, in the case of a taxable termination or a taxable distribution), then the deceased descendant's own descendants "move up" to the next "higher" generation. For example, a child predeceases her father leaving a son (a grandson of her father). For GST tax purposes, that grandson is treated as the grandfather's child so that no generation-skipping transfer is deemed to occur with respect to transfers to or for the grandson from the grandfather's gross estate (or any gift he makes to or for the grandson) after the daughter has died.[111] (A similar rule applies with respect to certain collateral relatives of the transferor in certain circumstances.)[112] Treasury Regulations provide that any individual who dies no later than 90 days after a transfer occurring by reason of the death of the transferor is treated as having predeceased the transferor.[113] Hence, by way of example, if a child dies within 90 days of his or her parent, he or she will be treated as

[107] Direct skip is defined in section 2612(c).
[108] An "interest" in a trust for GST purposes is defined under section 2652(c) to mean a current right to receive income or corpus, a current discretionary interest in income or corpus and, to prevent acceleration of GST tax, certain interests of charity in charitable remainder trusts and pooled income funds.
[109] Generation-skipping transfers, other than direct skips, are taxable terminations and taxable distributions defined, respectively, in sections 2612(a) and 2612(b).
[110] Section 2013.
[111] Section 2651(e).
[112] Section 2651(e)(2).
[113] Treas. Reg. § 26.2651-1(a)(2)(iii).

predeceasing the parent so that the children of the child "move up" to the child's generation and no GST tax would be imposed on a testamentary transfer to or for the child's children. Similarly, if the parent creates a testamentary trust for the benefit of her son which will continue for the son's children (her grandchildren) when he dies, no generation-skipping transfer would be deemed to occur (and, as a result, no GST tax imposed) if the son dies within 90 days of his mother because his children "move up" to his generation for GST tax purposes.

C. 2651(3) Exception Will Not Always Help. However, if the son survived for more than 90 days, the move-up-a-generation rule would not apply and, unless the GST exemption is allocated to the trust, GST tax will be imposed when the son dies and the trust continues for his children. If the son's death occurs more than 90 days after the parent dies but before the United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706) is required to be filed, the executor of the parent's Will could allocate GST exemption to the trust for the son to reduce or eliminate GST tax. But if a proportionate allocation of GST exemption if not sufficient to reduce the inclusion ratio of the trust for the son to zero, the executor faces the fiduciary dilemma of incurring current GST tax or making a disproportionate allocation.

D. Example. For example, suppose a decedent, with all of her \$2 million GST exemption unused at death, is survived by five children, and has bequeathed her \$3 million estate after estate tax in equal trusts for her children, each such \$600,000 trust to be held until the applicable rule against perpetuities expires. Her oldest daughter dies within 90 days of the decedent and her oldest son dies thereafter but before the estate tax return is due to be filed. If the executor allocates the GST exemption proportionately (that is, \$400,000 to each trust), GST tax would be due on the death of the oldest son on \$200,000.

E. Solve by Disproportionate Allocation? Under section 2631(a), the executor is authorized to allocate GST exemption without limitation. Hence, to avoid the current imposition of GST tax, the executor could allocate \$600,000 of the decedent's \$2 million GST exempt to the trust for the benefit of the oldest son. Under the wise old accountant's adage "a tax dollar delayed may never be paid," that seems sensible.

However, the disproportionate allocation of GST exemption means more GST tax will be payable when a generation-skipping transfer occur with respect with to the other trusts. Indeed, even though the trust for the benefit of the oldest daughter was not subject to GST tax because the daughter died within 90 days of her mother's death, that trust will be subject to the tax when the daughter's children die if the property passes to or for persons who can treated as being the generation of the decedent's grandchildren (which would be the decedent's great grandchildren). Whether that event will, in fact, occur or is likely to occur before or after the other children of the decedent, causing GST tax to be imposed, may be difficult to forecast. It would seem that timing is not the only factor, and it may be appropriate for the executor to consider the probable imposition of GST tax on a generational basis. In other words, as in the case of the decedent's own children, unnatural or early deaths may occur. However, an appropriate manner to determine the allocation of GST exemption and the future administration of the trusts might be to attempt to deliver a comparable level of property to the grandchildren in each line of descent while at the same time avoiding the current imposition of GST tax. Such a determination may be appropriate notwithstanding that a disproportionate allocation of GST exemption may subject all

of the trusts (other than the one for the oldest son) to greater GST tax than if the allocation had been pro rata.

F. Any Fiduciary Liability? Federal law does not appear to require any proportionate or other type of allocation of GST exemption. However, does local law limit the manner in which executor makes the GST exemption allocation? It seems little, if any law, has developed in that regard. Lower court cases,[114] suggest that a fiduciary who would benefit from a disproportionate allocation of tax benefits in his or her favor may be prohibited from making one. On the other hand, no law seems to prohibited a "disinterested" fiduciary from making a disproportionate allocation. That may suggest that a fiduciary would not be liable for making one, at least where there is an apparent reason to do so.

In seems that a decision to make a disproportionate allocation of GST exemption to prevent an "early" imposition of GST tax does not seem unreasonable. The imposition of a current tax otherwise would be a virtual certain. A subsequent imposition of GST tax on the trusts may not occur for several reasons, including a repeal of the tax, distributions that are exempt from the tax, the imposition of gift or estate tax with respect to beneficiaries the termination of whose interests would generate the tax,[115] the distribution of the trust property to the beneficiary the termination of whose interest would generate the tax, or the termination of the trust in favor of non-skip persons.[116]

That may mean an action against the executor who makes a disproportionate allocation of GST exemption to avoid an immediate tax could not be effectively maintained. Indeed, in somewhat analogous circumstances discussed below, it seems no such action has ever been commenced against an executor. But that case law suggests that local law will restore the "lost" tax benefit to the beneficiaries who did not receive a proportionate allocation of the benefit. And this reflects that fiduciaries often have to make decisions with respect to the many tax decisions that fiduciaries make that favor one beneficiary over another.[117]

G. Analogous Guidance for Fiduciaries. One of the most common tax "elections" an executor makes is whether to use estate administration expenses as estate tax deductions[118] or as income tax deductions.[119] Usually, the executor will choose to take the deduction where the greatest amount of tax will be saved. That decision may have two ramifications. If the deduction is used for estate tax purposes, estate tax will be lower than if taken for income tax purposes. Also, in general, an income tax deduction will benefit the current beneficiaries because it will reduce the amount of taxable income of the estate, enhancing the after-tax income available for those beneficiaries. In contrast, the burden of the estate tax may be viewed as falling upon the successor trust beneficiaries (e.g., the remainder persons).

---

[114] See, e.g., Matter of the Estate of Fales, 106 Misc.2d 419, 431 N.Y.S.2d 763 (Surr. Ct. N.Y. Co. 1980).
[115] In some cases, it will be preferable to expose property to gift or estate tax rather than GST tax. See, e.g., Blattmachr & Pennell, "Using 'Delaware Tax Trap' to Avoid Generation-Skipping Taxes," 68 Jl. of Taxn. 242 (April 1988), updated and reprinted in 24 Real Property Probate and Trust Journal 75 (Spring 1989).
[116] For example, the child for whom the trust is created without descendants and, as a result, the trust property passes to another child.
[117] See, e.g., Blattmachr & Slade, "One Hundred Plus Post-Mortem Tax Planning Options," The Chase Review (January 1993), reprinted in revised form in 66 New York State Bar Journal 26 (July/August 1994).
[118] Section 2053(a).
[119] Treas. Reg. § 1.212-1(i).

H. Parallel under Matter of Warms? A somewhat similar consequence occurred in Matter of Warms.[120] In that case, the executor had elected, pursuant to the 1939 Code predecessor of section 642(g), to use estate administration expenses, which under local law were chargeable against the principal account, as income tax deductions rather than as estate tax deductions. The election had two direct ramifications to the estate beneficiaries: (1) it reduced the amount of the estate's taxable income and because income taxes were chargeable under local law to the income account, the value of the income account was enhanced over what it would have been if the expenses had been taken as an estate tax deduction, and (2) the amount of estate taxes, which together with the administration expenses were chargeable to the corpus account, were increased over what they would have been had the administration expenses been used as estate tax deduction, diminishing the corpus account. In the court's view, it was inappropriate for the income account to receive the tax benefit through a deduction of expenses paid by the principal account (when the effect was to increase the tax burden on the corpus account). The court ordered the income account to reimburse the corpus account in the amount of increase in estate tax that resulted from using the expenses as an income tax rather than an estate tax deduction. In other words, the court "equitably adjusted" the interests of the income and remainder beneficiaries to restore the remainder beneficiary to the same position had the expenses been deducted for estate tax purposes. Interestingly, the adjustment was measured by the detriment to the corpus account of the tax election, not by the benefit to the income account. As has been observed, almost all courts who have faced a circumstances where a tax election produced a result that seemed unfair as a matter of local law the court ordered such an "equitable adjustment" with respect to the remaining interests in the estate or trust.[121]

It seems that such an equitable adjustment also may be the appropriate remedy to use where the executor has made a disproportionate allocation of GST exemption for reasonable cause. The court, however, might wait to make any equitable adjustment to see if the disproportionate allocation has resulted in a greater tax than if a proportionate allocation were made. One wonders, however, what the GST tax effect of such an adjustment would be. In Matter of Warms, the adjustment was made within the confines of the same trust. If such an adjustment were to cause property to be paid between trusts, the issue of a constructive addition to the recipient trust arises. If the adjustment causes the movement of property from a GST exempt trust to one that is entirely non-exempt, there may be no issue. But if the recipient trust has a fractional inclusion ratio, one wonders what effect such an adjustment would have on the inclusion ratio of the recipient trust. One might conclude that the recipient trust has a claim for restoration so that the adjustment is in satisfaction of an obligation to the recipient trust (rather than in the nature of a distribution) and therefore cannot be an addition for GST tax purposes. That, of course, raises the other side of the issue if the trustee, or the trust's beneficiaries, of the disadvantaged trust do not seek such an adjustment. It would seem the best way to handle these uncertainties is with appropriate authorization in the governing instrument. Moreover, careful administration of the trusts that did not receive a proportionate allocation of GST exemption may eliminate the loss of benefit from the disproportionate allocation.

¶ 1008.6 Administering GST Exempt and Non-Exempt Trusts.

[120] Matter of Edwin H. Warms, 140 N.Y.S.2d 169 (Surr. Ct. 1955).

[121] See, generally, Dobris, "Equitable Adjustments in Post Mortem Income Tax Planning," 65 Iowa LR 103 (1979).

In the foregoing example, each of the $600,000 trusts, other than the one for the oldest son, would receive an allocation of only $350,000 of the decedent's GST exemption, rather than $400,000 as a result of the allocation of $600,000 in GST exemption to the oldest son's trust to protect it from an immediate GST tax.

A. Solve Financial Detriment of Disproportionate Allocation with Careful Administration. But the detriment of that disproportionate allocation probably can be offset by their careful administration. If each such $600,000 trust is divided pursuant to pursuant to Treas. Reg. § 26.2654-1(b) so there are, initially, one GST exempt trust of $350,000 and one GST non-exempt trust of $250,000, disproportionate distributions may be made from the GST non-exempt trust to non-skip persons as compared to distributions from the GST exempt trust. For example, if the trustee has discretion to accumulate income or to pay income and corpus other than pursuant to a standard that would not permit adequate flexibility to do so, the trustee could accumulate the income in the GST exempt trust and make distributions from the GST non-exempt trust so as to reduce or exhaust it over time. Certainly, such administration of the trusts may not produce exactly the same result that would occur by a proportionate allocation of GST exemption to the trust (as, for example, income accumulated in the trust may be subject to a different level of income tax than if the income were distributed currently to beneficiaries). But it would seem largely to eliminate the detriment of disproportionate allocation of the GST exemption. In fact, even if there had not been a disproportionate allocation of GST exemption, it would seem to make sense to make such a severance and to make disproportionate allocations from the GST non-exempt trust so as to reduce the proportion of property that will be subject to GST tax when the generation-skipping transfer occurs.

B. Need for Flexible Provisions. If the trusts provide little flexibility (e.g., all income must be paid to the child for whom it was created), additional administration steps may produce some benefit from a GST tax perspective. For example, the GST exempt trust might be invested primarily for growth (producing relatively little current accounting income that must be distributed currently) while the GST non-exempt trust invested to produce relatively greater income (perhaps, coupled, with invasions of principal).[122] Overtime, such administration should reduce the proportion of property that otherwise would be subject to GST tax when the generation-skipping transfers occur.

¶ 1009 Trust Modifications

¶ 1009.1 Final Regulations Dealing with Grandfathered Trusts.

On December 20, 2000, final regulations were issued relating to the modification of trusts exempt from generation–skipping transfer ("GST") tax under the effective date rules dealing with trusts that were irrevocable on September 25, 1985. The regulations provide guidance with respect to the types of modifications that will not affect the exempt status of a trust. In addition, the regulations clarify the application of the effective date rules in the case of property transferred pursuant to the exercise of a general power of appointment.

[122] Such higher income might be effected by a conversion to a unitrust or by the exercise of a "power to adjust" if permitted under local law. See, e.g., NY EPTL 11-2.3(b)(5).

A. What about GST Exempt Trusts? Although intended to reduce the number of applications for private letter rulings, taxpayer requests for rulings continue to abound. One reason may be the draconian effect of loss of GST exempt status. Although somewhat mitigated under the current rate structure, a flat tax at the highest marginal estate tax rate on each generation-skipping transfer is substantial. Another reason may be that the regulations by their terms do not apply to trusts that are GST exempt by reason of an allocation of GST exemption, although the IRS appears to analyze both cases in the same manner.[123] Taxpayers contemplating changes to a trust that is either exempt by reason of its effective date, or by reason of an allocation of GST exemption, may not be willing to assume the risk, and trustees, in particular, are unlikely to proceed without certainty as to the GST effects.

B. Final Regulations Do Not Apply. The GST regulations expressly state that its rules are applicable only to determine whether a trust exempt by reason of its effective date retains its exempt status for GST purposes. The rules do not apply to determine whether a modification results in a gift subject to gift tax, causes the trust to become includible in the gross estate of any beneficiary, or results in the realization of a capital gain for purposes of section 1001 of the Code.

¶ 1009.2 Principles under the Final Regulations.

Nevertheless, the GST regulations articulate certain principles that may have general application when analyzing the transfer tax consequences of proposed adjustments to an irrevocable trust after the fact.

A. Distributions from One trust to Another. Treas. Reg. §26.2601-1(b)(4)(i)(A) provides that the distribution of trust principal from an exempt trust to a new trust or retention of trust principal in a continuing trust will not cause the new or continuing trust to be subject to the provisions of Chapter 13 if (a) either (i) the terms of the governing instrument of the exempt trust authorize distributions to the new trust or retention of trust principal in the continuing trust, without the consent or approval of any beneficiary or court, or (ii) at the time the exempt trust became irrevocable, state law authorized distributions to the new trust or retention of principal in the continuing trust, without the consent or approval of any beneficiary or court; and (b) the terms of the governing instrument of the new or continuing trust do not extend the time for vesting of any beneficial interest in the trust in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period measured from the date the original trust became irrevocable, extending beyond any life in being at the date the original trust became irrevocable plus 21 years, plus if necessary, a reasonable period of gestation. An exercise of a trustee's distributive power that postpones or suspends the vesting, absolute ownership, or power of alienation of an interest in property for a term of years that will not exceed 90 years (measured from the date the original trust became irrevocable) will not violate the foregoing rule. The two rules together constitute the so called "GST rule against perpetuities."

[123] *Cf.* PLR 200839025 (rules applicable to a trust exempt by allocation of GST exemption are no less favorable than the rules applicable to a trust exempt by reason of its effective date).

B. Principle Established by the Regulations. The foregoing rule indicates that proceeding under authority contained in the governing trust agreement ought not to have tax consequences, provided the duration of the trust is not extended beyond the common law rule against perpetuities. It is important to note that the need for beneficiary consent or court intervention would fall outside the exception. It seems, though, that a voluntary application to court, by itself, would not have adverse tax consequences. But if court approval or beneficiary consent is required, then the power of distribution would fall outside the safe harbor of the regulation.

C. Example of a Permitted Modification. In PLR 2002-28-007 (April 3, 2002), the decedent created a separate testamentary trust for each of three children. The trust for Child 3 required the payment of income quarterly to Child 3 for life. Child 1 and Child 2 were appointed as trustees with the power of make any distribution of trust principal as they think proper and necessary for the comfort of Child 3 and her children. Upon the death of Child 3, the trust fund would pass on to her children in further trust until the trustees think time is proper to pay the trust fund to the children. Applicable State law permitted the trustees to petition for modification or termination of a trust. The State court determined that the reference in the document to children referred only to natural not adopted children. Child 3 was age 73 and the court determined that the two children of Child 3 had a vested remainder interest in the trust. State court approved a modification whereby the trust was terminated in favor of a new trust with Child 3 as sole trustee. The power of the trustee to distribute principal to herself was limited to an ascertainable standard under State law. Upon Child 3's death, the new trust was required to be distributed equally to her children or their respective estates. The IRS ruled that the modification was within the authority of the original trust instrument, and therefore did not constitute an exchange under Section 1001 nor would it cause the old trust or the new trust to lose its exempt status for purposes of Chapter 13. The IRS further ruled that none of the beneficiaries had made gifts and the new trust would not be included in Child 3's gross estate because the distribution power was not a general power of appointment.[124]

Note that State property law determined the interests of the grandchildren to be vested. And even though the standard of distribution to Child 3 was arguably reduced, the IRS did not find that Child 3 had made a gift to the remainder beneficiaries. This is interesting in light of the IRS's present unwillingness to rule on the gift tax consequences of the surrender of a property interest in a discretionary trust on the basis that the value of the property interest surrendered is a question of fact. Here, Child 3 would appear to have reduced the future opportunity to receive trust distributions by becoming a trustee, with the effect that future distributions would be limited to an ascertainable standard. Yet, perhaps, because that result derived from State law governing the trust since inception, it was considered not to be voluntary, and thus without gift tax consequences. It seems somewhat of a fine line. Becoming trustee was certainly voluntary, but the reduction in the standard of distribution that resulted was not.[125]

---

[124] *Compare* PLR 200917004 (trust agreement that provided words "issue" or "descendants" shall *not* include legally adopted issue modified to include legally adopted infants or minor children had no GST consequences (because no shift to lower generations) but did have gift tax consequences to those whose interests were reduced).

[125] Note that in PLR 200839025, the IRS considered a change of the standard of distribution to one of absolute discretion without limit to be an "increase" in the distributions to non-skip persons and thus not a shift of beneficial

D. Powers of Appointment. A separate rule deals with distributions by the exercise of a power of appointment. The exercise, release or lapse of a power of appointment (other than a general power of appointment within the meaning of Section 2041(b)) will not have adverse GST consequences if the power was contained in the original trust and the power is not exercised in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period beyond the GST rule against perpetuities.[126] There is apparently no other restriction. Accordingly, the GST rules appear to confirm that a power of appointment, or a power that is construed to be akin to a power of appointment (which would appear to mean a power not controlled by any fiduciary obligations under the current draft of the Restatement of Property) if exercised within its scope does not create transfer tax risk, the beneficiaries having no means to object to its effective exercise.

E. Settlement of a Dispute. Treas. Reg. §26.2601-1(b)(4)(i)(B) provides that a court-approved settlement of a bona fide issue regarding the administration of the trust or the construction of the terms of the governing instrument will not cause an exempt trust to be subject to the provisions of chapter 13, if (a) the settlement is the product of arm's length negotiations and (b) the settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. A settlement that results in a compromise between the positions of the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes.

F. Commutation of an Income Interest. In PLR 2002-09-007 (November 15, 2001), the IRS considered the modification of a testamentary trust that owned a concentration of decedent's low-yield, closely-held stock. The trust instrument authorized retention of investments not otherwise authorized by statute so long as the trustee deemed advisable and directed that, if possible, the stock be held until termination of the trust. All the trust's income beneficiaries had died except one who was entitled to a share of the income for life. Upon the death of the surviving income beneficiary, the trust was to be divided into shares for the descendants of four of the deceased income beneficiaries. The surviving income beneficiary and several of the contingent remaindermen brought suit against the trustee to modify the trust under State law permitting modification of a trust if the court finds that the modification will neither materially impair the accomplishment of the trust purposes nor adversely affect the interests of any beneficiary or, if made, materially benefit the trust or any beneficiary. The parties sought commutation of the income beneficiary's life interest. Subsequently, the State enacted a statute authorizing a trustee to make adjustments between principal and income under a prudent investor standard. The income beneficiary filed amended pleadings alleging that the trustee failed to invest the assets in a manner consistent with his interest as a life tenant and to apportion receipts and expenses between income and principal in the manner required by law. The contingent remaindermen opposed the requested relief.

---

interests to a lower generation. Accordingly, a shift to an ascertainable standard might be considered a "decrease" depending on the circumstances.

[126] *See Estate of Timkin,* 2009 WL 1884393 (N.D. Ohio 2009) (lapse of a general power of appointment is a constructive addition); *Estate of Gerson*, 507 F.3d 435, *cert denied*, 128 S.Ct. 2503 (2008) (exercise of a general power of appointment in favor of grandchildren).

In settlement of the dispute, the parties entered into a Modification Agreement whereby (i) the income beneficiary's interest would be commuted for a fair price, (ii) the balance of the trust would be divided into two trusts, one to distribute income to the presumptive remaindermen, determined as of each quarterly distribution and the other to accumulate income, and (iii) the contingent remaindermen who would not receive income distributions would be entitled to a make-up distribution upon the death of the former income beneficiary. The court appointed a special master who found that the modification would not materially impair accomplishment of the trust's purposes. The special master also found that it was not likely that the testator anticipated the deaths of five of the six income beneficiaries so that a large portion of the trust income would be accumulated for possibly more than 41 years.

The IRS opined that there would be no gift tax consequences to a settlement that is based on a compromise of valid claims that reaches an economically fair result. If there are competing claims so that the settlement is different from the result under State law, then an examination is made to determine whether that difference may be justified because of the uncertainty of the result if the question were litigated. The IRS found that the Modification Agreement was a result that is within the range of reasonable settlements based on the expert opinions and the findings of the special master and of the court. Accordingly, the IRS ruled that were no gift tax consequences to the settlement.

The IRS also ruled that the new trusts created by the Modification Agreement would continue to be exempt from GST tax because there was no shifting of any beneficial interest to a beneficiary in a lower generation.

This leaves open the question of whether one needs to satisfy both the settlement test and the "no shifting" test in order to avoid loss of exempt status. The regulations do not require this. It would appear, however, that if the interests of the beneficiaries are changed in a manner that is tantamount to a modification because no reasonable interpretation of the governing instrument would yield the result in the settlement, then both tests must be satisfied. In that case, the importance of the bona fide settlement test has more to do with avoiding taxable gifts and sale or exchanges of beneficial interests having potential income tax consequences than avoiding loss of GST exemption.

Nevertheless, the GST rule on settlements appears to be somewhat in conflict with the *Bosch* standard, which requires that the holding of the State court be consistent with the law of the State as articulated by its highest court. Perhaps what we are seeing here is an unarticulated application of Treas. Reg. §25.2512-8. If the parties to a bona fide dispute determine to settle their differences by compromising their legal positions, its seems that is to be construed as a valid business decision, and not a taxable gift resulting from a voluntary transfer.[127]

G. Bosch Standard. In *Commissioner v. Bosch,*[128] the Supreme Court concluded that federal authorities, including the IRS, are not conclusively bound by a determination of a property interest made by a state trial court in a proceeding to which the United State is not a party. A proceeding to which the IRS is not a party is potentially collusive and should not usurp

[127] See Harris v. Commissioner, 340 U.S. 106 (1950).
[128] 387 U.S. 456 (1967).

a federal interest in collecting tax. In one of the cases consolidated into the *Bosch* decisions, the District Director of the IRS was served but did not appear. The Government advocated for the position that a state trial court adjudication be binding only in such cases when the judgment is the result of an adversary proceeding in the state court. The Supreme Court determined to follow *Erie v. Tompkins*[129] to the effect that the state law as announced by the highest court of the State is to be followed. But "[i]f there is no decision by that court then federal authorities must apply what they find to be the state law after giving 'proper regard' to the relevant rulings of other courts of the State." Note that this standard is different from the standard articulated in the final GST regulations, which would respect a settlement that is in-between the possible outcomes if the case were litigated to conclusion. An exception for the settlement of bona fide dispute seems consistent with the principle set forth in Treas. Reg. §25.2512-8 that a transfer made in the ordinary course of business that is arm's length and free of donative intent is not a gift (and accordingly, also not a GST transfer).

¶ 1009.3 Framework for Modifications.

The GST regulations appear to provide a framework within which to analyze the tax consequences of modifications of trusts after the fact. Changes permitted under the governing instrument or applicable State law generally ought to be respected. Changes to settle a bona fide dispute, even ones failing the *Bosch* standard, may also avoid transfer tax consequences to the extent the result is a reasonable compromise of the competing interests. Any other changes, such a ones agreed to by the interested parties, must be analyzed carefully to determine if beneficial interests are being shifted among the parties.

¶ 1010 GST Effects of Decanting.

¶ 1010.1 IRS Request for Comments .

Notice 2011-101, 2011-52 I.R.B. 932, released on December 21, 2011, requested comments regarding when (and under what circumstances) transfers by a trustee of all or a part of the principal of an irrevocable trust ("Distributing Trust") to another irrevocable trust ("Receiving Trust"), sometimes called "decanting," that result in a change in the beneficial interests in the trust are not subject to income, gift, estate, or generation-skipping transfer ("GST") taxes. The Notice appears focused in part on the significance of the need for court approval or beneficiary consent prior to the exercise of the authority to decant. Although potentially construed as a power to alter or amend a trust, decanting, being a fiduciary power, is probably more properly construed as a subset of the discretionary distribution authority of a trustee. The exercise of discretionary distribution authority by a trustee is controlled by a well developed body of law and, as a general matter, the exercise of discretion by a trustee is not subject to the doctrine of substituted judgment. Rather, a court will not interfere with the exercise of discretion by a trustee unless the trustee has engaged in an abuse of discretion. The broader the discretion the higher the standard to find an abuse. If the discretion is absolute, it would normally require arbitrary or capricious conduct by the trustee to be overturned.

¶ 1010.2 Origins of Decanting Authority .

---

[129] 304 U.S. 64 (1938).

The first recognition by an American court of a trustee decanting power appeared in *Phipps v. Palm Beach Trust Co.*[130] In that case, the Supreme Court of Florida (the highest court of the state) held that a trustee could invade trust property by paying it over to another trust for the beneficiary of the original trust. That decision was based on the Florida Supreme Court's interpretation of the common law, rather than on any specific statutory authority or decanting authority in the trust instrument.

In *Phipps,* the court concluded that a trustee's discretionary distribution authority is comparable to a special power of appointment in favor of the beneficiaries of the trust. The Florida court cited the Restatement of Trusts, section 17, for the proposition that if a trustee has a special power of appointment, that is, a power to appoint among the members of a specified class, then whether the trustee can effectively appoint a trustee for members of the class depends on the terms of the power vested in him. The court concluded that:

> The general rule gleaned from the foregoing and other cases of similar import is that the power vested in a trustee to create an estate in fee includes the power to create or appoint any estate less than a fee unless the donor clearly indicates a contrary intent.[131]

If the reasoning in *Phipps* is sound, there is reason to believe that the common law of every other jurisdiction throughout the United States confers a decanting power on all trustees who have the power to invade trusts for the benefit of their beneficiaries.[132] No court has held to the contrary.

Nevertheless, because of the importance of the decanting power and a reluctance among estate planning counsel to advise their trustees to exercise such a power without specific statutory authority, states began in 1992 to authorize such powers by statute. New York was the first state to enact decanting legislation.[133] The legislative history of the New York act provides that it is consistent with and declaratory of existing common law.[134]

A power held by a trustee to invade the corpus of a trust is analogous to a power of appointment for property law purposes.[135] As a general rule, the holder of a power of

---

[130] 142 Fla. 782, 196 So. 299 (1940).
[131] *Id.* at 786.
[132] See also Wiedenmayer v. Johnson, 106 N.J. Super. 161, 254 A.2d 534 (App. Div., 1968). Wiedenmayer concerned an indirect decanting, however, in that the trustees exercised their power of invasion in favor of the beneficiary contingent on the beneficiary's agreeing to transfer the property in further trust. The court concluded that the transfer was in the beneficiary's best interests, describing "best interests" as follows: "The expression is not limited to a finding that distribution must be to the son's best 'pecuniary' interests. His best interests might be served without regard to his personal financial gain. They may be served by the peace of mind, already much disturbed by matrimonial problems, divorce, and the consequences thereof, which the new trust, rather than the old contingencies provided for in his father's trust indenture, will engender. Of what avail is it to rest one's 'best interests' on a purely financial basis, and without regard to the effect upon a man's mind, heart and soul, if the end result would produce a wealthier man, but a sufferer from mental anguish?"
[133] See N.Y.E.P.T.L. section 10-6.6. See also Halperin and O'Donnell, supra note 2.
[134] See Scott on Trusts §3.1.2 at 143-44 (Aspen 5th ed. 2008). Memorandum in Support of Legislation, Governor's Bill Jacket, 1992 Chapter 591, page 4.
[135] See Restatement (Third) of Property (Wills & Don. Trans.) §17.1 (2011) *Comment g* ("A fiduciary distributive power is a power of appointment (a nongeneral power), but it is not a discretionary power of appointment").If the trustee can invade for his or her own benefit, then the power of invasion may constitute a general (estate taxable)

appointment may appoint the property in further trust.[136] If the power to decant is held by a trustee, however, it is by definition a fiduciary power. The *Comments* to Restatement (Third) of Trusts, section 75, draw a distinction between powers held in a fiduciary capacity and those that are held for the power holder's personal benefit (meaning without regard to any fiduciary obligation to the beneficiaries of the trust or the permissible appointees). The discussion echoes the Reporter's Notes on section 64, which also draw a distinction between a personal power that may be exercised for the personal benefit of the donee of the power and a fiduciary power that must be exercised for the purpose for which the settlor created it. The Reporter's Notes on section 64 indicate that if the power holder's power is personal, then the trustee's only duty is to ascertain whether the attempted exercise is or is not within the terms of the trust.

The donee of a personal power of appointment seems to have no affirmative duty to act in good faith, and appears to be able to exercise a power of appointment to exclude a person from beneficial enjoyment for personal reasons.[137] A fiduciary, on the other hand, would be precluded by fiduciary duties from acting in a similar manner. Instead, a fiduciary will always be held to a minimum standard of good faith, with an obligation to act consistently with the terms of the trust and the interests of the beneficiaries.[138]

¶ 1010.3 Effective Date Trusts.

The final GST tax regulations provide that grandparenting from the GST tax may be forfeited if the trustee decants other than by a state law in effect when the trust became irrevocable or a power contain in the governing instrument. The exercise by the trustee of a state conferred decanting power that extends the term of the trust created before the effective date of the generation-skipping transfer tax could cause "grandparenting" of the trust from the tax to be lost.[139] The regulations indicate that the distribution of trust principal in a grandparented trust to a "new" or "continuing" trust will not cause the property to lose its exemption from taxation if either the terms of the exempt trust instrument authorize such distribution or state law, in effect

---

power of appointment under Code sections 2514(c) and 2041(b). The power to invade for one's own benefit (that is, to withdraw property from the trust) may cause the power holder to be the owner of the trust for purposes of Code section 671 so that the income, deductions, and credits against tax of the trust are attributed to the power holder. See Code section 678(a). If the power is held in a fiduciary capacity, however, Code section 678 may not apply. See Blattmachr, Gans, and Lo, "A Beneficiary as Trust Owner: Decoding Section 678," ACTEC Journal (2009).

[136] See, generally, Scott on Trusts, supra note 6 §3.1.2 at pages 144-45 (the trend is to construe the language conferring a power of appointment with increasing liberality, and to hold that the donee of the power has broad discretion as to the manner in which the power may be exercised). See, e.g., Restatement (Third) of Property: Wills & Other Transfers (Tentative Draft No. 5), §19.14 (except to the extent the donor has manifested a contrary intention, the donee of a nongeneral power is authorized to make an appointment, including an appointment in trust and an appointment that creates a power of appointment in another, that solely benefits permissible appointees of the power).

[137] See Restatement (Third) of Trusts, section 50 (2003), Comment a ("A trustee's discretionary power with respect to trust benefits is to be distinguished from a power of appointment. The latter is not subject to fiduciary obligations and may be exercised arbitrarily within the scope of the power").

[138] See section 105 of the Uniform Trust Code, adopted in 2003 by the National Conference of Commissioners on Uniform State Laws, which prohibits a trust instrument from waiving a trustee's duty to act in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.

[139] Treas. Reg. § 26.2601-1(b)(4)(A). *But see* PLR 200520023 (inclusion of a spendthrift clause in the appointed trust would not affect GST exempt status).

when the trust became irrevocable, authorized the distribution without the consent of a court or any beneficiary.[140]

A. Can You Decant to Florida? However, it may be that, if under the law at the time the trust was created, the trust could have been "moved" to Florida, where under the *Phipps* case a trustee may invade in further trust, then, in essence, the decanting power did exist at the time the trust was created. More important, perhaps, it seems, is that the powers of a trustee (of which decanting would appear to be one) are determined by the law of the jurisdiction where the trust is located.[141] For example, if a pre-September 26, 1985 trust, the validity, construction and effect of which, by its terms, was governed by the law of New York, began to be administered in Florida (perhaps, by an appointment of a majority of trustees resident in that state), the trustees would have the decanting power provided under *Phipps*. Hence, it may be that the safest move if the trustee wishes to decant and postpone vesting of interests in the grandparented trust to move the administration, if not also the governing law, to Florida.

B. Avoid In Cases Where Grandparenting is Critical. However, it seems that should be done only if the effect of losing grandparenting would not be adverse. For example, assume a trust created in 1980 provided for the trust to end when the beneficiary reaches age 50 and for the entire trust to be paid to the beneficiary at that time or, if the beneficiary died before age 50, to be paid upon the beneficiary's death to his or her then living descendants. Hence, if the beneficiary dies before age 50, the wealth taxation of the property will bypass the beneficiary's generation but, if grandparenting were lost, might be imposed if the beneficiary died before age 50 and the trust property were distributed to his or her descendants. It is even possible that the IRS would contend that the loss of grandparenting means that a GST tax is due if the beneficiary survives to age 50 and receives the property at that time assuming the grantor of the trust were the beneficiary's grandparent or someone assign to that or an older generation. Assuming the trustee had a power to invade corpus, and if the administration of the trust were moved to Florida, the trustee could invade the corpus just before the beneficiary turned 50 relying on the *Phipps* case. If that causes grandparenting to be lost, there should be no immediate adverse effect it seems at least if the beneficiary receives a special testamentary power of appointment to avoid a completed gift by the beneficiary.

C. Postpone Vesting with a Power of Appointment. As to a grandparented trust, at least, even if vesting may be postponed, for example by the exercise of a beneficiary's special power of appointment, it seems that the duration of the trust may not be extended beyond the so-called GST rule against perpetuities. If the trust is not a grandparented one, but rather a trust that is exempt by reason of an allocation of GST exemption, the IRS appears to agree that a change to a trust that would not affect the GST exempt status of a grandparented trust should likewise not affect the GST exempt status of a trust exempt by reason of an allocation of GST exemption.[142] The regulations deal with discretionary powers, which decanting should be, differently that a modification, stating that a distribution of trust principal from an exempt trust to a new trust will

---

[140] Certain trusts created after the initial effective date of the generation-skipping transfer tax are exempted (*e.g.*, where the settlor was incompetent). *See* Treas. Reg. § 26.2601-1(b)(3). Hence, one of the applicable state decanting statutes might have been enacted for such special date "grandparented" trusts by the time such a trust became irrevocable.

[141] Scott on Trusts sec. 615.

[142] *See, e.g.,* PLR 200919009.

not cause loss of exempt status if the terms of the governing instrument or applicable state law at the time the trust became irrevocable authorizes the distribution to the new trust without the consent or approval of any beneficiary or court and the terms of the governing instrument of the new trust will not extend the time for vesting beyond any life in being at the date the original trust became irrevocable plus a period of 21 years. Treas. Reg. §26.2601-1(b)(4)(i)(A).

D. Administrative changes should be fine. If the vesting of interests is not postponed, then other changes that do not shift beneficial interests to lower generations will not cause loss of exempt status, even if done pursuant to a statute enacted after the trust became irrevocable.[143]

¶ 1010.4 Decanting Authority Exists at Time Trust is Irrevocable.

There seem, however, to be at least three issues with respect to the question of whether the trustee may exercise the power to invade in trust without negative GST effects. The first issue is whether the applicable state's common law permitted decanting. As discussed above, under Florida law, it seems a decanting power was present, and it is at least arguable that it existed under the common law of all states. Second, the IRS has not construed the regulation strictly. For example, it has allowed trustees under EPTL 10-6.6 to exercise the power of a grandparented trust to make the trust a spendthrift one and to change the situs of the trust.[144] Hence, it may well be that, as long as the trustee does not extend the term of the trust or shift beneficial interests to a lower generation, grandparenting is not lost by the exercise of a decanting power, even one conferred under state law enacted after the trust became irrevocable. This may mean that the trustee could grant a beneficiary a special power of appointment which, perhaps, could be exercised without loss of grandparenting. Third, it seems that the trustee could exercise the power for the shorter of (1) a standard lives in being when the original trust became irrevocable plus 21 year term and (2) the maximum period so that the trust would not lose grandparenting protection.[145] The challenge in this approach is that the trustee will not know when the trust in fact terminates, and thus when payments of GST tax are due.[146]

¶ 1010.5 Trusts Exempt by Reason of an Allocation.

The effects of decanting on a trust that is not grandparented from GST tax but is not subject in its entirety to the tax by reason of allocation of GST exemption is not covered by the

---

[143] *See* PLR 9737024 (not precedent) (no loss of grandparenting where no change in quality, value, or timing of any beneficiary's interest or power pursuant to decanting under EPTL 10-6.6; PLR 9804046 (not precedent) (no loss of grandparenting where spendthrift provision changed by decanting under EPTL 10-6.6); PLR 200227020 (not precedent) (no loss of grandparenting where situs of trust changed from New York pursuant to decanting under EPTL 10-6.6 where the trust would end at the same time); PLR 9438023 (same).

[144] See, e.g., PLR 199942013 and PLR 200227020.

[145] In PLR 200227020, the IRS ruled that grandparenting would not be lost in decanting a trust and explicitly noted that the new trust "will provide that, notwithstanding any other provision, no exercise of a power of appointment granted in the trust shall result in a termination date for a trust or a share thereunder or created pursuant to a power of appointment granted thereunder which is later than the date twenty-one years after the death of the survivor of all of Sister's descendants living at Decedent's death."

[146] See PLR 201218002 (not precedent) (power of appointment over grandfathered trusts were exercised to extend the duration by expanding the class of measuring lives for purposes of applying the rule against perpetuities to include descendants of the powerholder's great grandparents).

regulations or other authority. Many of the rulings addressing trust exempt by reason of an allocation of GST exemption should receive similar treatment. Many of the rulings including the following language, "No guidance has been issued concerning changes that may affect the status of trusts that are exempt from GST tax because sufficient GST exemption was allocated to the trust to result in an inclusion ratio of zero. At a minimum, a change that would not affect the GST status of a trust that was irrevocable on September 25, 1985, should similarly not affect the exempt status of such a trust." Indeed, because a trust exempt, in whole or in part, by reason of allocation of GST exemption could have postponed vesting for whatever period was permitted under applicable law, it seems decanting to garner that result should not result in the loss of that exemption. Moreover, at least in some states (e.g., New York), the decanting statutes have been in place for a sufficiently long enough period of time that the decanting law may well have been in effect when the trust was created, suggesting that using it should not result in loss of exemption effected through the allocation of GST exemption.

¶ 1010.6 Is Decanting a Severance?

It is also possible that the decanting of a trust pursuant to applicable state law might be construed as a severance that does not meet the requirements of a qualified severance.[147] In that case, even though the severance is not qualified, after the date of severance, the trusts will be treated as separate trusts for purposes of GST tax, provided the trusts resulting from such severance are recognized as separate trusts under applicable state law. Assuming the trusts are treated as separate trusts, GST tax exemption may be effectively allocated to only one or more of the trusts without being treated as having been allocated ratably to all the trusts. This would permit, for example, a trust to be divided in order to permit a late allocation of GST exemption to only part of the trust estate, with the result that one or more trusts will have an inclusion ratio of zero and one or more trusts will have an inclusion ratio of one. In addition, if the severance results in a taxable termination as to a portion of the trust, for example because one of the trusts is a skip person, the taxable termination will be deemed to occur only with regard to that particular resulting trust, with no GST tax impact on any other trust resulting from the severance. Each trust resulting from such a severance (prior to the allocation of any additional GST exemption) will have the same inclusion ratio as the original trust. It would seem that changes to the governance of the trust permitted under state law or by judicial reformation should all be respected, particularly if these occur prior to the time GST exemption is allocated to the trust.

¶ 1010.7 Conclusions About Decanting.

Although the GST rules on the decanting of GST exempt trusts have yet to be clearly defined. It would appear that most decanting of exempt trusts do not present GST issues because they are done for reasons other than to extend the duration of the trust. If extending the duration of the trust is desired, the preferable manner to accomplish this would be by means of a power of appointment conferred on one of the beneficiaries, perhaps even a power of appointment that is conferred by means of decanting. If the purpose of decanting is to permit an effective allocation of GST exemption to a portion of an existing trust that is not otherwise exempt, it would appear that those rules are far better defined. So long as the separate trusts created by decanting are

[147] See Treas. Reg. §26.2642-6(h).

respected for State law purposes, an effective late allocation to one, but not the other, of the severed trusts should be respected for GST purposes.

¶ 1011 Conclusion

Handling allocations of GST exemption effectively is not an easy task. The rules are complicated and the "help" provided by the deemed allocation rules can have unanticipated consequences. Fortunately, the IRS continues to appear willing to issue rulings in the GST area not only granting prospective guidance but retroactive relief. The qualified severance rules also provide welcome assistance when the automatic allocation rules result in partial inclusion ratio trusts. A trust exempt from GST tax by reason of the effective date rules or an allocation of GST exemption is a precious thing. State laws permitting virtually perpetual trusts have enhanced the transfer tax effectiveness of exempt trusts. Preserving GST exempt status is critical. Therefore, any attempt to modify or decant such trusts must be undertaken with caution and, in a close case, with the protection of an advance ruling.

¶ 1012 Exhibits

¶ 1012.1 Exhibit 1: Sample Notice of Allocation

Taxpayer: JOHN DOE Taxpayer's ID No: XXX-XX-XXXX

Attachment to and Made a Part of
United States Gift (and Generation-Skipping Transfer) Tax Return, Form 709
Calendar Year 2011

SCHEDULE D, Part 2, Line 6

NOTICE OF ALLOCATION OF GST EXEMPTION

1. SCHEDULE A, Part 3, Item 1

Name of Trust: The Doe Family 2011 Trust
EIN of Trust: XX-XXXXXXX
Name(s) of Trustee(s): Jane Doe
Date of Trust: December 1, 2011
Date of Transfer of Assets: December 15, 2011

Value of Assets on Date of Transfer $100,000.00

Amount of GST Exemption
Allocated to the Transfer: The taxpayer hereby allocates to the assets transferred to The Doe Family 2011 Trust so much of the taxpayer's unused GST exemption as shall be necessary so that The Doe Family 2011 Trust shall have an inclusion ratio of zero for GST purposes or, if that is not possible, the taxpayer's entire unused GST exemption.

Inclusion Ratio: Zero (0)

2. Late Allocation of GST Exemption and Election to Value Assets on First Day of Month

Name of Trust: The Doe Family 2009 Trust
EIN of Trust: XX-XXXXXXX
Name(s) of Trustee(s): Jane Doe
Date of Trust: December 1, 2009

Year Transfer of Assets Reported: 2009

Election to Value Assets on First Day of the Month

Election: For purposes of the late allocation of GST exemption hereby made to The Doe Family 2009 Trust, the taxpayer elects under the Treasury Regulations to value the assets of The Doe Family 2009 Trust as of the first day of the month on which this return, Form 709 for the calendar year 2011, is filed

Applicable Valuation Date: April 1, 2011

Fair Market Value of Trust Assets
of The Doe Family 2010 Trust
on the Valuation Date: $125,000.00

Amount of GST Exemption
Allocated to the Transfer: The taxpayer hereby makes a late allocation of the taxpayer's unused GST exemption to The Doe Family 2009 Trust as of the date of filing of this return, Form 709 for the calendar year 2011, and allocates to The Doe Family 2009 Trust so much of the taxpayer's unused GST exemption remaining (after the allocation of GST exemption made to The Doe Family 2011 Trust by paragraph 1 of this Notice of Allocation) as shall be necessary so that The Doe Family 2009 Trust shall have an inclusion ratio of zero for GST purposes or, if that is not possible, the taxpayer's entire unused GST exemption.

Inclusion Ratio: Zero (0)

¶ 1012.2 Exhibit 2: Sample Election Out Statement for a Particular Transfer to a Particular Trust

Taxpayer: JOHN DOE Taxpayer's ID No: XXX-XX-XXXX

Attachment to and Made a Part of
United States Gift (and Generation-Skipping Transfer) Tax Return, Form 709
Calendar Year 2011

SCHEDULE A, Part 3, Item 1

ELECTION OUT STATEMENT

1. SCHEDULE A, Part 3, Item 1

Name of Trust: The Doe Family 2011 Trust
EIN of Trust: XX-XXXXXXX
Name(s) of Trustee(s): Jane Doe
Date of Trust: December 1, 2011
Date of Transfer of Assets: December 15, 2011

Value of Assets on Date of Transfer: $100,000.00

Inclusion Ratio: One (1)

Election: The taxpayer hereby elects that the automatic allocation rules will not apply to the $100,000.00 transferred to The Doe Family 2011 Trust on December 15, 2011.

¶ 1012.3 Exhibit 3: Sample Election Out Statement for Any and All Transfers Made in a Particular Year to Particular Trust

Taxpayer: JOHN DOE | Taxpayer's ID No: XXX-XX-XXXX

Attachment to and Made a Part of
United States Gift (and Generation-Skipping Transfer) Tax Return, Form 709
Calendar Year 2011

SCHEDULE A, Part 3, Items 1 and 2

ELECTION OUT STATEMENT

1. SCHEDULE A, Part 3, Items 1 and 2

Name of Trust: The Doe Family 2011 Trust
EIN of Trust: XX-XXXXXXX
Name(s) of Trustee(s): Jane Doe
Date of Trust: December 1, 2011

Dates of Transfer of Assets: December 15, 2011 and December 20, 2011

Value of Assets on Date of Transfer: $100,000.00 on December 15, 2011 and $100,000 on December 20, 2011

Inclusion Ratio: One (1)

Election: The taxpayer hereby elects that the automatic allocation rules will not apply to any transfers to The Doe Family 2011 Trust in 2011.

¶ 1012.4 Exhibit 4: Sample Election Out Statement for Any and All Current Year and Future Year Transfers to a Particular Trust

Taxpayer: JOHN DOE | Taxpayer's ID No: XXX-XX-XXXX

Attachment to and Made a Part of
United States Gift (and Generation-Skipping Transfer) Tax Return, Form 709
Calendar Year 2011

SCHEDULE A, Part 3, Item 1

ELECTION OUT STATEMENT

1. SCHEDULE A, Part 3, Item 1

Name of Trust: The Doe Family 2011 Trust
EIN of Trust: XX-XXXXXXX
Name(s) of Trustee(s): Jane Doe
Date of Trust: December 1, 2011

Date of Initial Transfer of Assets: December 15, 2011

Value of Assets on Date of Initial Transfer: $100,000.00

Inclusion Ratio: One (1)

Election: The taxpayer hereby elects that the automatic allocation rules will not apply to the transfer to The Doe Family 2011 Trust made by the taxpayer in 2011 or to any additional transfers taxpayer may make to The Doe Family 2011 Trust in subsequent years.

¶ 1012.5 Exhibit 5: Sample Election Out Statement for Any and All Transfers Made to a Particular Trust for a Period of Years

Taxpayer: JOHN DOE   Taxpayer's ID No: XXX-XX-XXXX

Attachment to and Made a Part of
United States Gift (and Generation-Skipping Transfer) Tax Return, Form 709
Calendar Year 2011

SCHEDULE A, Part 3, Item 1

ELECTION OUT STATEMENT

1. SCHEDULE A, Part 3, Item 1

Name of Trust: The Doe Family 2011 Trust
EIN of Trust: XX-XXXXXXX
Name(s) of Trustee(s): Jane Doe
Date of Trust: December 1, 2011

Date of Initial Transfer of Assets: December 15, 2011

Value of Assets on Date of Initial Transfer: $ 100,000.00

Inclusion Ratio: One (1)

Election: The taxpayer hereby elects that the automatic allocation rules will not apply to any transfers the taxpayer has made or will make to The Doe Family 2011 Trust in the years 2011 through 2013.

¶ 1012.6 Exhibit 6: Sample Election Out Statement for Any Current and Future Year Transfers Taxpayer May Make to Any Trust

Taxpayer: JOHN DOE Taxpayer's ID No: XXX-XX-XXXX

Attachment to and Made a Part of
United States Gift (and Generation-Skipping Transfer) Tax Return, Form 709
Calendar Year 2011

SCHEDULE A, Part 3

ELECTION OUT STATEMENT

1. Current Year Transfer

SCHEDULE A, Part 3

Name of Trust: The Doe Family 2011 Trust
EIN of Trust: XX-XXXXXXX
Name(s) of Trustee(s): Jane Doe
Date of Trust: December 1, 2011

Date of Transfer of Assets in Current Year: December 15, 2011

Value of Assets on Date of Transfer in Current Year: $100,000.00

Inclusion Ratio: One (1)

2. Election Out for All Current and Future Year Transfers to Any Trust

The taxpayer hereby elects that the automatic allocation rules will not apply to any current or future transfer that taxpayer may make to any GST trust, including, but not limited to, The Doe Family 2011 Trust.

¶ 1012.7 Exhibit 7: Election Out Statement for a Prior Transfer to a Trust Subject to an ETIP

Taxpayer: JOHN DOE   Taxpayer's ID No: XXX-XX-XXXX

Attachment to and Made a Part of
United States Gift (and Generation-Skipping Transfer) Tax Return, Form 709
Calendar Year 2011

SCHEDULE A, Part 3

ELECTION OUT STATEMENT

1. SCHEDULE A, Part 3

Name of Trust:	The Doe Family 2009 Trust
EIN of Trust:	XX-XXXXXXX
Name(s) of Trustee(s):	Jane Doe
Date of Trust:	December 1, 2009
Inclusion Ratio:	One (1)
Election:	The Doe Family 2009 Trust is subject to an ETIP. The taxpayer hereby elects that the automatic allocation rules will not apply to any of the following: (i) any and all prior year transfers to The Doe Family 2010 Trust, (ii) any and all transfers in 2011 to The Doe Family 2009 Trust, and (iii) any and all future transfers that taxpayer may make to The Doe Family 2009 Trust.

¶ 1012.8 Exhibit 8: Sample Termination Statement

Taxpayer: JOHN DOE Taxpayer's ID No: XXX-XX-XXXX

Attachment to and Made a Part of
United States Gift (and Generation-Skipping Transfer) Tax Return, Form 709
Calendar Year 2011

SCHEDULE A, Part 3, Item 1

TERMINATION STATEMENT

1. SCHEDULE A, Part 3, Item 1

Name of Trust: The Doe Family 2009 Trust
EIN of Trust: XX-XXXXXXX
Name(s) of Trustee(s): Jane Doe
Date of Trust: December 1, 2009

Current Year Transfer: $100,000.00

Value of Trust Immediately Prior to Current Year Transfer: $400,000.00

Date of Prior Election Out: April 15, 2009

Description of Prior Election Out: On the taxpayer's timely filed Form 709 for the calendar year 2009, the taxpayer elected for the automatic allocation rules not to apply to any current or future year transfer to The Doe Family 2009 Trust.

Termination of Prior Election: The taxpayer hereby terminates the prior election out of the automatic allocation rules made by the taxpayer on April 15, 2009 effective for the transfer to The Doe Family 2009 Trust in 2011 and any and all future transfers that taxpayer may make to The Doe Family 2009 Trust.

Inclusion Ratio: 4/5 (1-$100,000/$500,000)

¶ 1012.9 Exhibit 9: Sample GST Trust Election

Taxpayer: JOHN DOE Taxpayer's ID No: XXX-XX-XXXX

Attachment to and Made a Part of
United States Gift (and Generation-Skipping Transfer) Tax Return, Form 709
Calendar Year 2011

SCHEDULE A, Part 3, Item 1

GST TRUST ELECTION STATEMENT

1. SCHEDULE A, Part 3, Item 1

Name of Trust: The Doe Family 2011 Trust
EIN of Trust: XX-XXXXXXX
Name(s) of Trustee(s): Jane Doe
Date of Trust: December 1, 2011

Date of Transfer of Assets: December 15, 2011

Inclusion Ratio Zero (0)

Election: The taxpayer hereby elects that The Doe Family 2011 Trust be treated as a GST trust and that the automatic allocation rules will apply to any transfer to The Doe Family 2011 Trust in 2011 and to any and all future transfers that taxpayer may make to The Doe Family 2011 Trust.

¶ 1012.10 Exhibit 10: Sample Attachment to Schedule R of Form 706

Taxpayer: JOHN DOE Taxpayer's ID No: XXX-XX-XXXX

Attachment to and Made a Part of
United States Estate (and Generation-Skipping Transfer) Tax Return, Form 706

SCHEDULE R, Part 1, Line 9

ALLOCATION OF GST EXEMPTION

1. The executor of the decedent's estate hereby allocates to the Credit Shelter Trust created under Article ___ of the decedent's Will so much of the decedent's unused GST exemption remaining at his death (within the meaning of Section 2631 of the Internal Revenue Code of 1986, as amended (the "Code")) as shall be necessary so that the Credit Shelter Trust, as finally determined for Federal estate tax purposes, shall have an inclusion ratio of zero for generation-skipping transfer tax purposes.

2. Pursuant to Article ___ of the decedent's Will, the executor is authorized to divide the Marital Trust created under Article ___ of the decedent's Will into two or more separate trusts on a fractional basis. The executor hereby exercises her authority to divide and set apart the principal of the Marital Trust in order to create two separate trusts consisting, respectively, of (i) the "GST Exempt Marital Trust," which shall be comprised of a fractional share of such principal the numerator of which is the amount of the decedent's unused GST exemption remaining after the allocation made to the Credit Shelter Trust by the executor pursuant to paragraph 1 of this Attachment, and the denominator of which is the value of such principal (values, deductions and exemptions used for the purpose of establishing the fraction to be as finally determined for Federal estate tax purposes), and (ii) the "Non-Exempt Marital Trust" which shall be comprised of the balance of such principal, each such trust to be governed by all provisions of the decedent's Will applicable to the Marital Trust. The executor hereby makes the special election under Section 2652(a)(3) of the Code with respect to the GST Exempt Marital Trust. The executor hereby allocates to the GST Exempt Marital Trust the remaining balance of the decedent's unused GST exemption so that the GST Exempt Marital Trust shall have an inclusion ratio of zero for generation-skipping transfer tax purposes.

3. The division of the Marital Trust described in this Attachment shall be done on a fractional basis and each trust created by such division shall be funded based upon the fair market value of the assets on the date of funding or in a manner that fairly reflects the net appreciation or depreciation in the assets from the valuation date for Federal estate tax purposes to the date the trusts are funded.