

Specialty Law Columns Estate and Trust Forum

The Perilous Federal Gift Tax Return--Part II
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Editor's Note:

This is the second part of a two-part article on the federal gift tax return ("GTR"). Part I, which appeared in the November 1999 issue at page 71, reviewed basic reporting rules and focused on the gift tax statutes of limitation, and the proposed regulations on adequate disclosure of gifts. Part II discusses the generation-skipping transfer ("GST") exemption allocation rules and their practical application to the federal GTR.

Some knowledge of the tax on GSTs under Chapter 13 of the Internal Revenue Code ("Code") is assumed for purposes of this article. As wealth increases, and the population ages, GST planning will loom larger. All lifetime GST planning requires a consideration of the exemption allocation rules and, usually, the Form 709. The goal of this article is to highlight issues and provide limited, practical guidance for allocation of the GST exemption on the Form 709--United States Gift (and Generation-Skipping-Transfer) Tax Return. The Code, the Regulations, and a good treatise are deemed essential.¹

Allocation of GST Exemption

The generation-skipping transfer tax ("GSTT") is in addition to the estate and gift tax, and is imposed every time there is a GST, which includes taxable terminations, taxable distributions, and direct skips (subject to certain exceptions), at the rate of 55 percent. Every donor is allowed a lifetime exemption from GSTT. The current exemption of \$1,010,000 per donor will be indexed annually for inflation.² The donor can apply this exemption to *inter vivos* transfers or to transfers taking effect at death.

If a trust is fully exempt, it has an "inclusion ratio" of zero.³ Future transfers to skip persons from a trust with an inclusion ratio of zero will be exempt from the GSTT. With proper planning, and early allocation, the GST exemption can be leveraged to result in the transfer of substantial amounts of wealth to skip persons (that is, grandchildren and other persons assigned to a generation that is two or more generations below the generation of the transferor).

Gifts That Are Direct Skips

Gifts that are *inter vivos* direct skips made after September 25, 1985, must be reported on Part 2 of Schedule A of Form 709. An *inter vivos* direct skip is a transfer made during the donor's lifetime that is (1) subject to the gift tax, (2) a gift of an interest in property, and (3) made to a skip person.⁴

A transfer is subject to the gift tax if it is required to be reported on Schedule A of Form 709. This may include split gifts.

A skip person can be a natural person or a trust. A donee who is a natural person is a skip person if that donee is assigned to a generation that is two or more generations below the generation assignment of the donor. A donee that is a trust is a skip person if either (1) all the present interests in the property transferred to the trust are held by skip persons, or (2) there are no interests in the property transferred to the trust held by any person, and future distributions or terminations from the trust can be made only to skip persons.⁵ However, gifts in the form of charitable remainder trusts ("CRT") are not treated as direct skips, even if all the life beneficiaries are skip persons, and therefore should always be reported on Part 1 of Schedule A.⁶ The transferor to a CRT may wish to allocate GST exemption to the CRT by Notice of Allocation, as described below, if any of the noncharitable beneficiaries are skip persons.

Exclusion from GSTT

Generally, direct skips that are nontaxable gifts [due to the annual, medical, or educational exclusions of Code §§ 2503(b) and (e)] also are excluded from the GSTT.⁷ Excluded gifts do not require allocation of GST exemption. However, an important exception exists. If an otherwise nontaxable gift is a direct skip to a trust, the gift will be subject to the GSTT unless: (1) during the lifetime of the individual beneficiary of the trust, no corpus or income may be distributed to anyone other than the beneficiary; and (2) if the beneficiary dies before the termination of the trust, the assets of the trust will be included in the gross estate of the beneficiary. These trusts are described in, and commonly referred to as, Code § 2642(c) trusts.

Trusts created for the benefit of a minor pursuant to Code § 2503(c) should qualify for GST exclusion under Code § 2642(c). However, gifts to a trust for the benefit of several of the donor's grandchildren, all of whom are given Crummey withdrawal rights, could be excluded from the gift tax but will not be excluded from the GSTT, unless the trust creates substantially separate shares for each grandchild. These gifts would not meet the requirements of Code § 2642(c) because the trust has more than one beneficiary. The gift also would fail to qualify under Code § 2642(c) if the trust had only one beneficiary but the trust would not be included in the beneficiary's estate if he or she died prior to termination of the trust. If the gift in trust fails to qualify under a Code § 2642(c) trust, GST exemption must be allocated to the trust to yield an inclusion ratio of zero.

Gifts reported on Part 2 of Schedule A must be listed in chronological order, and, for GSTT computation purposes, the gift tax annual exclusion allowed against the GSTT must be allocated to the maximum allowable amount on a gift-by-gift basis in chronological order, beginning with the earliest gift that qualifies for the exclusion.⁸ For any direct skips in excess of the exclusion allocated to such gift, GST exemption must be allocated to produce an inclusion ratio of zero. The automatic allocation rules discussed below will normally operate to allocate sufficient GST exemption to any nonexcluded portion.

Automatic ("Deemed") Allocation

In the case of *inter vivos* direct skips, a portion of the donor's unused GST exemption is automatically allocated to the transferred property to make the inclusion ratio zero, or as close to zero as possible, unless the donor elects otherwise.⁹ In the rare situation where it is desirable, the donor may elect out of the automatic allocation on a timely filed Form 709 with a statement attached describing the transaction and the extent to which the automatic allocation is not to apply. Reporting a direct skip on a timely filed Form 709 and paying the GSTT on the transfer will qualify as such a statement. In general, the automatic allocation of GST exemption becomes irrevocable after the due date for reporting the transfer if it were a taxable gift, including any extensions actually granted. If an election out of the automatic allocation is made, the election becomes irrevocable when made.¹⁰

The practitioner should consider actually allocating GST exemption on a timely filed GTR to reportable direct skips even when the deemed allocation rules would apply. This makes it clear that GST exemption has been allocated and provides a record of the inclusion ratios and amount of the exemption used for later use.

Gifts That Are Not Direct Skips

For gifts which may or may not be subject to the gift tax, but are not direct skips, there is no automatic allocation of GST exemption. For example, a gift to a trust that has the donor's children as present interest beneficiaries and the donor's grandchildren or great-grandchildren as future beneficiaries would not be a direct skip because the present interests in the trust are held by nonskip persons. However, future terminations and distributions made from this trust would be subject to the GSTT.

Whether exemption should be allocated in these cases must be determined on a case-by-case basis. The determination will depend on the likelihood of a future GST from the trust. Often, such trusts are specifically designed to skip generations. If GST exemption is not properly allocated, the planning is for naught. If sufficient GST exemption is allocated to such a trust so that the trust has an inclusion ratio of zero, the trust assets can appreciate well beyond the value of the initial gifts without any distributions from the trust ever being subject to GSTT. Failure to allocate can lead to disastrous results if a highly appreciated asset is ultimately distributed to skip persons. The enormous risk placed on tax advisors for failure to allocate has led the American Institute of Certified Public Accountants ("AICPA") to propose legislation requiring automatic allocation of GST exemption to most transfers with GST potential.

"As wealth increases, and the population ages, GST planning will loom larger. All lifetime GST planning requires a consideration of the exemption allocation rules."

Gifts that are not direct skips but that are subject to gift tax must be reported on Part 1 of Schedule A of Form 709. Allocation of GST exemption to transfers in trust reported on Part 1, or to other gifts not necessarily required to appear on the GTR at all, may be made by attaching a Notice of Allocation to the return. All transfers reported on Part 1 of Schedule A may be consolidated with all transfers not appearing on the Form 709 to which the donor wishes to allocate exemption on one Notice of Allocation.

Notice of Allocation

The Instructions for Form 709 provide that the Notice of Allocation must be entitled "Notice of Allocation" and contain the following information for each trust:

- clear identity of the trust, including the trust's EIN, if known;
- the item number(s) from column A, Schedule A, Part 1, of the gifts to that trust;
- the values shown in column E, Schedule A, Part 1, for the gifts (adjusted to account for split gifts, if any, reported on Schedule A, Part 3, line 2) (or, if the allocation is late, the value of the trust assets at the time of the allocation);
- the amount of GST exemption allocated to each gift (or a statement that the exemption is being allocated by means of a formula such as "an amount necessary to produce an inclusion ratio of zero"); and
- the inclusion ratio of the trust after the allocation.¹¹

If an allocation of GST exemption is made to a trust, it is made to the entire trust, not to specific trust property.¹²

Except in the case of charitable lead annuity trusts, allocations in excess of the amount needed to obtain a zero inclusion ratio are void.¹³ If values are filled in on the return, these values may be followed by an asterisk with a footnote that explains: "This amount is based on the values reported on the return. The actual allocation made on the attached Notice of Allocation is made by a formula."

The use of a formula can be very helpful when assets are involved that are difficult to value, and a formula should be used in most cases because of the possibility of mathematical errors, potential valuation changes on audit, and uncertainty regarding the law. It also is possible that the donor has previously allocated GST exemption that he or she is not aware of, or failed to tell the return preparer about. It also is important to indicate the prioritization of the allocation, so it is clear how GST exemption will be allocated if values are increased on audit, causing the proposed allocation to exceed the available GST exemption. The prioritization could be *pro rata* or all to one trust first, then to another.

Timely Allocations

If the GST allocation is made on a timely filed GTR, including extensions, the allocation is effective as of the date of the transfer.¹⁴ For a timely allocation, the gift tax value is the value used to determine the amount of GST exemption allocation required. Once made, an allocation of GST exemption on a timely return may be modified or revoked up to the due date of the return.

Late Allocations

If the allocation is made on a late-filed gift tax return, it is effective as of the date of its postmark and is irrevocable.¹⁵ A late allocation of the GST exemption made by an executor with respect to an *inter vivos* transfer of property if filed on or before the due date of the estate tax return, is effective as of the date the allocation is filed.¹⁶

Ordinarily, the value of the trust assets for purposes of determining the inclusion ratio is the value on the effective date of the late allocation. However, solely for purposes of determining the fair market value of the trust assets, for late allocations the transferor may elect to treat the allocation as having been made on the first day of the month during which the late allocation is made (the "valuation date"). The transferor makes this election by stating on the gift tax return on which the allocation is made that the election is being made, the applicable valuation date, and the fair market value of the trust assets on the valuation date. This election is unavailable for life insurance or a trust holding a life insurance policy if the insured individual dies prior to the allocation.¹⁷

Late allocations should be made on a current Form 709 with a notation at the top substantially as follows: "SUPPLEMENTAL RETURN--ALLOCATION OF GST EXEMPTION ONLY." Language also could be added to Schedule A, Part 1 as follows: "This is not an amended return but is filed only for the purpose of allocating GST exemption. See Notice of Allocation attached."

If a late allocation is made to a trust from which distributions have been made, the value used to determine the amount of exemption to be allocated is the value of the trust on the effective date of the allocation. Distributions to nonskip persons made prior to a late allocation need not be accounted for and can effectively reduce the amount of the trust and GST exemption required. Distributions to skip persons made prior to allocation are either taxable distributions, for which Form 706GS and Form 706GS(D-1) should have been filed, or taxable terminations, for which Form 706GS(T) should have been filed.¹⁸

Estate Tax Inclusion Period

An estate tax inclusion period ("ETIP") is the period during which, should death occur, the value of the transferred property would be includable (other than by reason of Code § 2035) in the gross estate of the transferor or the spouse of the transferor.¹⁹ A transfer made during an ETIP will not be effective for GST

exemption allocation purposes until the end of the ETIP.²⁰ The result is that the transferor may not effectively leverage the GST exemption where an ETIP applies.

For example, the ETIP rules would apply to preclude effective allocation of GST exemption to a grantor retained annuity trust ("GRAT") or a qualified personal residence trust ("QPRT") until the end of the term of the transferor.

An allocation of GST exemption by the transferor to property subject to an ETIP made prior to the termination of the ETIP is irrevocable, but will not be effective until termination of the ETIP. An allocation of GST exemption made after the termination of the ETIP during the transferor's lifetime is effective as of the termination of the ETIP if made by the due date of a GTR that would apply to a taxable gift occurring at the time the ETIP terminated.

If the ETIP property is includable in the transferor's estate, the value used for purposes of allocating GST exemption is the value for federal estate tax purposes. A timely allocation of the decedent's unused GST exemption by the executor of decedent's estate is made on the decedent's federal estate tax return.²¹ If the ETIP property is not includable in the transferor's estate, the value used for allocating the GST exemption is the value of the property at the close of the ETIP if GST exemption is allocated on a timely filed gift tax return, or its fair market value at the time such allocation is filed for a late allocation.²²

If any part of a trust is subject to an ETIP, the entire trust is subject to an ETIP.²³

Conclusion

The GTR has increased in complexity and risk as its presence has become pervasive in modern estate planning. A basic understanding of GTR reporting requirements is a virtual necessity for all planners. However, the breadth of knowledge and expertise required to complete the GTR for every conceivable transfer is beyond the capacity of most practitioners in the legal or accounting professions. The risk and complexity of the GST allocation rules and requirements has led the AICPA to propose remedial legislation, and many tax preparers to question the advisability of continuing to prepare GTRs.

NOTES

[1.](#) See Harrington *et al.*, *Generation Skipping Transfer Tax* (Warren, Gorham and Lamont, 1999).

[2.](#) IRC § 2631(c).

[3.](#) See IRC § 2642.

[4.](#) See *also* IRC §§ 2611 through 2613 and Treas. Reg. § 26.2612-1; Instructions to Form 709 (Rev. January 1999), at 4-5.

[5.](#) IRC § 2613(a).

[6.](#) Instructions to Form 709 (Rev. January 1999), at 5.

[7.](#) IRC § 2642(c).

[8.](#) Instructions to Form 709 (Rev. January 1999), at 7.

[9.](#) IRC § 2632(b).

- [10.](#) Treas. Reg. § 26.2632-1(b)(1).
- [11.](#) Instructions to Form 709 (Rev. January 1999), at 8.
- [12.](#) Treas. Reg. § 26.2632-1(a).
- [13.](#) Treas. Reg. § 26.2632-1(b)(2).
- [14.](#) Treas. Reg. § 26.2632-1(b)(2).
- [15.](#) Treas. Reg. § 26.2632-1(b)(2)(ii).
- [16.](#) Treas. Reg. § 26.2632-1(d)(i).
- [17.](#) Treas. Reg. § 26-2642-2(a)(2).
- [18.](#) Treas. Reg. § 26.2662-1(b).
- [19.](#) Treas. Reg. § 26.2632-1(c)(2).
- [20.](#) IRC § 2642(f).
- [21.](#) Treas. Reg. § 26.2632-1(d).
- [22.](#) IRC § 2642(f)(2).
- [23.](#) Treas. Reg. § 26.2632-1(c).