

Trust & Estates

Taxes and Planning

TM Financial Services

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Generation Skipping Taxes

The generation-skipping-transfer tax (GST) was instituted to ensure that there is a tax paid when property is transferred over a generation to an even younger generation. The GST tax rules require every person to be assigned a generation. For individuals who are not lineal descendants of the transferor, generations are assigned as follows

- One who is born 12½ years or less than the transferor is assigned the transferor's generation.
- One born between 12½ and 37½ years less than the transferor is assigned to the first generation younger.
- Every additional 25 years constitutes an additional generation (between 37½ and 62½ would be two generations down or the lineal equivalent of a grandson of the transferor).

Note that a transfer to a grandchild whose parent is dead at the time of the transfer will be treated as if the transfer were made to a child of the transferor.

Creating 2 trusts to minimize the GSTT

As the GST tax is allocated to the entire value of the trust with the tax rate adjusted by the inclusion ratio, it can be advantageous at times to use separate trusts as shown in the following example.

Surviving spouse has an estate of \$20,000,000. The assets are transferred to a trust for the benefit of her child and the remainder to be allocated 25% to grandchild and 75% to charity. After allocating the spouse's \$5,000,000 exemption, the trust has an inclusion ratio of 75%. Upon the child's death there is a taxable termination \$5,000,000 and a GST tax of \$1,312,500 ($5,000,000 \times 35\% \times 75\%$).

If two trusts had been created for \$5,000,000 and \$15,000,000 with the remainders to the grandchild and charity respectively the spouse's entire GST exemption could be allocated to the first trust producing an inclusion ratio of zero and no GST tax due upon the death of the child.

By segregating assets there is a savings of at least \$1,312,500 (greater if the assets had appreciated).

Savings can also be achieved in marital deduction planning by creating two QTIP trusts. The first one is funded with assets equal to the unused GST exemption (exempt QTIP trust). The balance of the assets go into the second trust (nonexempt QTIP trust). A reverse QTIP election will be made on the exempt trust by listing it on Schedule R of Form 706 for the first spouse to die, so that the first spouse will be considered the transferor for GST purposes only.

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GSTT (continued from page 1)

A generation-skipping transfer can be of three types:

- A direct skip
- A taxable termination
- A taxable distribution

A direct skip is a transfer to an individual two generations down (skip person) which is taxable under the gift/estate tax rules. A taxable termination occurs when the death of an individual results in a transfer of a trust interest to a skip beneficiary. A taxable distribution is any kind of distribution from a trust to a skip person other than a taxable termination.

The rate of tax on a generation-skipping transfer is dependent on the inclusion ratio of the transferred property. The inclusion ratio as defined in §2642(a), is the excess of 1 over the applicable fraction which is the amount of GST exemption divided by the value of the property transferred to the trust (reduced by Estate taxes paid which are attributable to the property and any charitable deduction with respect to such property).

$$\text{Inclusion ratio} = 1 - \frac{\text{EA}}{\text{PV} - (\text{ET} + \text{CD})}$$

Where EA = Exemption amount allocated

PV = Value of property transferred

ET = Estate taxes paid &

CD = Charitable deduction

The GST tax paid is equal to the product of the maximum federal estate tax rate (currently 35%) and the inclusion ratio.

For 2011 the GST exemption stands at \$5,000,000 (unlike the estate/gift exemption there is no portability). An election to allocate an individual's exemption may be made at any time on or before the date for filing such individual's estate tax return (regardless of whether a return is required to be filed). Code sections 2632(b)(1) and 2632(C)(1) prescribe an automatic allocation of exemption amounts to both direct and indirect lifetime skips. A timely filed gift tax return is needed to elect out of automatic allocation.

A donor cannot allocate GST exemption to a lifetime transfer if the property would be included in his or her spouse's gross estate (other than under IRC section 2035) if the donor died immediately after the transfer. The period during which the donor is prohibited from allocating GST exemption to the transferred property is called the "estate tax inclusion period" (ETIP).

As such, an allocation of GST exemption to a GRAT or QPRT will not become effective until the grantor's retained interest ends (the ETIP) as the trust property will be included in the gross estate if the donor dies before the term of the trust. The value of such property for determining the inclusion ratio is the value at the close of the ETIP. IRC §2642(b)(1)(B).

Code sections 2632(b) and 2632(c) govern the automatic or deemed allocation of GST exemption to direct and indirect lifetime skips respectively. Both sections call for allocating any unused exemption of an individual to property transferred to the extent necessary to make the inclusion ratio zero. For direct skips this is done on Form 709, Schedule A, Part 2, column c, by checking the 2632(b) election out field. You must also attach a statement describing the transaction and the extent to which the automatic allocation is not to apply.

(continued on page 3)

Where to report GST Taxes

DIRECT SKIPS

INDIRECT SKIPS

	<u>Payable by Transferor</u>	<u>Payable by Estate</u>	<u>Payable by Certain Trusts</u>	<u>to Trusts not currently subject to GSTT</u>	<u>Taxable Distributions</u>	<u>Taxable Terminations</u>
<i>Inter vivos</i>	Form 709 Schedule A Part 2			Form 709 Schedule A Part 3	Form 706- GS(D)	Form 706- GS(T)
<i>Post mortem</i>		Form 706 Schedule R Part 2 *	Form 706 Schedule R-1	Form 706 Schedule R Part 1, Line 9	Form 706- GS(D)	Form 706- GS(T)
<i>Taxes paid by</i>	Transferor	Estate	Trustee	No tax	Beneficiary	Trustee

* Part 3 if will specifies that GST tax is not to be paid from the transferred property interests.

GSTT (continued from page 3)

For indirect skips use Part 3 column c. In this case the field is titled 2632(c) election (rather than election out). Here you have the option of not having the automatic allocation rules apply to the present transfer, both the current transfer and any future transfers to the trust or to treat any trust as a GST trust for purposes of the automatic allocation rules. Again a statement must be attached to Form 709 describing which of the three elections is being made and identifying the trusts or transfers to which the election applies.

Creating 2 trusts (continued from page 1)

Any payments of principal to the surviving spouse should be first made out of the nonexempt QTIP trust as the assets from this trust in excess of the surviving spouse's GST exemption will result in a tax if a transfer is made, for example, to the grandchildren. The reverse QTIP election helps in

that we are able to utilize the first spouse's unused GST exemption on the QTIP property despite the fact that under §2652(a) the surviving spouse is generally considered the transferor for GST purposes of QTIP property included in the estate under §2044. This allows more of the surviving spouse's GST exemption to be allocated to the nonexempt QTIP trust. In effect the reverse QTIP election compensates for the lack of portability of the GST exemption. This strategy is not available for outright dispositions to the surviving spouse.

The character of the distributions on termination of the trust is effected by the reverse QTIP election. After the death of the surviving spouse distributions to the grandchildren will be a taxable termination from the exempt trust as the first spouse remains the transferor but from the nonexempt trust any distributions will be considered direct skips by the surviving spouse.

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IRS	General Information	800-829-1040
	EINs	800-829-4933
	Form 706 & 709	866-699-4083
NJ	General Information	609-826-4400
	Estate & Inheritance	609-292-5033
NY	General Information	518-457-5181
	Estate Tax	518-457-5387
CT	General Information	860-297-5962
PA	General Information	717-787-8201

Creation of joint interests – is there a gift?

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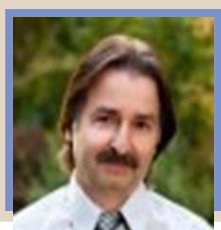
If an individual changes title on property purchased with his own funds to JTWROS, a completed gift of one half of the value of the property has been made if the property is in a form of joint title that may be defeated by either party severing his interest. Examples include real property and stock or bond certificates held by the owner (not in street name). Treas.Reg. 25.2511-1(h)(5)

On the other hand the creation of a joint interest does not result in a completed gift if the property is in a form of ownership by which one can get back the entire funds without the donee's consent. This would include bank accounts, US Savings bonds and mutual funds. Treas. Reg. 25.2511-1(h)(4). For this type of property a completed gift will have been made when the donee draws on the bank account for his own benefit without any obligation to repay or cashes in the savings bonds without any similar obligation.

The creation of a tenancy by the entirety between spouses is not deemed a gift regardless of the proportion of the total consideration furnished by either spouse.

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