

Adventures in Allocating GST Exemption in Different Scenarios

Dealing with the generation-skipping transfer tax is complex. But properly allocating GST exemption provides an opportunity to reduce or eliminate the tax, as the innovative strategies in this article illustrate.

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Allocations of GST exemption are most effective when they produce trusts that are either wholly subject to or wholly exempt from generation-skipping transfer ("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 article analyzes the various methods to create GST 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 article 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.

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; ¹ all others are ingeniously called "non-skip persons." Property also may be exempted from the tax by the allocation of the GST exemption. ² The GST

exemption is equal to the amount of the applicable exclusion amount (also called the "estate tax exemption") for estate tax purposes, currently \$2 million.

The GST exemption, however, is not a true exemption from GST tax, nor does it operate as a credit against tax as the applicable exclusion amount does. Rather, it

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is a rate reducer. The effective rate of generation-skipping tax (called the "applicable rate"³) is determined by multiplying the "inclusion ratio,"⁴ which essentially is the percentage of the property to which GST exemption has not been allocated, by the maximum federal estate tax rate (currently 45%).⁵

For example, an individual transfers \$750,000 to a trust for her descendants and allocates \$250,000 of GST exemption to the trust.⁶ As a result, \$500,000 of the \$750,000 transferred to the trust (or two-thirds of the trust) is not "protected" from GST tax or, in other words, the inclusion ratio of the trust is two-thirds. Hence, when a generation-skipping transfer from the trust occurs (for instance, a distribution to a grandchild other than for medical needs or education⁷), the effective tax rate is two-thirds of the current highest rate listed for estate and gift tax purposes under Section 2001(c). Under current law, this would produce a tax rate of 30% (2/3 of 45%). A trust all of which is protected from the tax by allocation of GST exemption has an inclusion ratio of zero. A trust none of which is so protected has an inclusion ratio of one.

As indicated, certain transfers, even if not protected from GST tax by an allocation of GST exemption, to or for skip persons are 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.⁸

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,⁹ one or more of which would be 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).¹⁰ 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 GST exempt (that is, has a zero inclusion ratio) and one that is not exempt at all (that is, has an inclusion ratio of one).¹¹

The taxpayer or the taxpayer's executor may allocate the taxpayer's 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.¹² Indeed, some practitioners direct, by word formula,¹³ 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 on whether the individual is married or not, the way that is accomplished may vary.

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 form¹⁴ to or for one's spouse are not subject to gift or estate tax by reason of the marital deduction.¹⁵ 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 because property sheltered from estate tax by the exemption need not be taxed

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when the surviving spouse dies but property protected by the marital deduction will be (unless expended during the surviving spouse's lifetime). Accordingly, married persons at death often provide for the division of 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.¹⁶

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.¹⁷ 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.¹⁸

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 ("QTIP") 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 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 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 that his or her GST exemption may be allocated to the QTIP trust. Thus, 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.

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"¹⁹ 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 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.²⁰

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.

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, and (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. Consequently, 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,

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there may be five 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 the size of the ones for the surviving child).

Reducing the number of trusts

Although Section 643(f) provides that trusts having substantially the same grantor or grantors (and a husband and wife 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 exemption for each trust²¹ and the modest "bracket ride" likely may not be perceived as sufficiently beneficial to justify keeping separate trusts.²²

In any case, where it is 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.²³ How that may be accomplished may turn on the terms of the governing instrument and state law.

For instance, 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 six 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 persons to whom the trustee could make discretionary distributions of corpus.²⁴ In some cases,

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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.²⁵

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 includable in the surviving spouse's estate under Section 2044.²⁶ 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. Therefore, even though the third part may not be exempt from 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.²⁷

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 which 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 of 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 a 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.²⁸

But where the trusts created by the first spouse to die and the 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.²⁹

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.

If the unused remaining GST exemption of the surviving spouse is insufficient to permit all the 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 prevent the

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consolidated trust with respect to the surviving spouse to be only partly exempt from tax. Moreover, if the GST exempt and GST non-exempt parts of the property with 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(b)(2) will not be available to prevent the consolidated trust from being only partly GST exempt.

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.

Qualified severance or no?

In general, the Regulations under Section 2654 permit a trust includable 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).³⁰ 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 at the time the return is filed. This rule puts a premium on drafting authorization in the governing instrument to ensure maximum flexibility. New Example (3) under Reg. 26.2654-1(b) confirms that a severance pursuant to authority under applicable state law is valid if accomplished before 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. ³¹

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." ³² 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 Reg. 26.2654-1(b), described in the foregoing paragraph of this article. ³³ The reason is that the severance pursuant to that Regulation is effective retroactive to the date of the decedent's death; a 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 Reg. 26.2654-1(b) rather than by a qualified severance.

Disproportionate allocation of GST exemption

As indicated, transfers to skip persons may be subject to two taxes: (1) a 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. ³⁴ 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, ³⁵ 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. ³⁶

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 a child from a parent

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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 is available when one death follows the other within ten years or, in some cases, precedes it by two years. ³⁷

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, suppose that 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 ³⁸ or allocation of GST exemption has protected the trust from that tax.

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 could 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, suppose that 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 that grandson from the grandfather's gross estate (or any gift he makes to or for the grandson) after the daughter has died.³⁹ (A similar rule applies with respect to certain collateral relatives of the transferor in certain circumstances.⁴⁰)

The 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.⁴¹ Accordingly, by way of example, if a child dies within 90 days of his or her parent, he or she will be treated as 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.

On the other hand, if the son survived for more than 90 days, the move-up-a-generation rule would not apply and, unless 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 is 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.

For instance, 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 is 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 about \$200,000 (or, if there has been no severance between a GST exempt and GST non-exempt portions, a GST tax on the entire son's trust at a rate of one-third of the highest estate tax rate in effect at the son's death).

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 exemption 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. Another step that could reduce but not eliminate GST tax might be for a disclaimer under Section 2518 to be made on behalf of a child who dies after 90 days but within nine months of the parent's death.⁴²

However, the disproportionate allocation of GST exemption means more GST tax will be payable when a generation-skipping transfer occurs with respect with to the other trusts. Indeed, even though

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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 be treated as being the generation of the decedent's grandchildren (which would be the decedent's great-grandchildren) or more remote descendants. Whether that event will, in fact, occur or is likely to occur before or after the other children of the decedent die, 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 the trusts (other than the one for the oldest son) to greater GST tax than if the allocation had been pro rata.

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 an executor makes the GST exemption allocation? It seems little, if any, law has developed in that regard. Lower court cases⁴³ 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 prohibit 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.

It 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 certainty. A subsequent imposition of GST tax on the trusts may not occur for several reasons, including a repeal of the tax,⁴⁴ distributions that are exempt from the tax,⁴⁵ the imposition of gift or estate tax with respect to beneficiaries the termination of whose interests would generate the tax,⁴⁶ 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.⁴⁷

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.⁴⁸

One of the most common tax "elections" an executor makes is

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whether to use estate administration expenses as estate tax deductions⁴⁹ or as income tax deductions.⁵⁰ 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 the deduction had been 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).

A somewhat similar consequence occurred in *Matter of Warms*.⁵¹ In that case, the executor had elected, pursuant to the 1939 Internal Revenue 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, was increased over what they would have been had the administration expenses been used as an 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 the 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 that have faced circumstances where a tax election produced a result that seemed unfair as a matter of local law, have ordered such an "equitable adjustment" with respect to the remaining interests in the estate or trust.⁵²

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. Whether there could be GST tax consequences if such an equitable adjustment is made is uncertain. In *Matter of Warms*, the adjustment was made within the confines of the same trust although from the interests of one beneficiary to another.

On the other hand, if such an adjustment were to cause property to be paid between trusts, the issue of a constructive addition to the recipient trust arises (which might mean a change in the trust's inclusion ratio or causing the trust to have another transferor). If the adjustment causes the movement of property from a GST exempt trust to one that is entirely non-exempt, there may be no GST tax issue. One might also 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.

It seems there can be no addition to any trust for GST tax purposes unless some individual is treated as making a gift. "If the equitable adjustment is required as a matter of local law, it seems doubtful that making the adjustment is a transfer subject to the gift tax."⁵³ 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. Drafting to afford the executor

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sufficient authority to address these issues seems the best solution.

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.

Administering GST exempt and non-exempt trusts

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. But the detriment to the other trusts of that disproportionate allocation probably can be offset by their careful administration.

If each such \$600,000 trust is divided pursuant to Reg. 26.2654-1(b) so that 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.

If the trusts provide little flexibility (e.g., all income must be paid to the child for whom the trust 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 might be invested to produce relatively greater income (perhaps, coupled, with invasions of principal).⁵⁴ Over time, such administration should reduce the proportion of property that otherwise would be subject to GST tax when the generation-skipping transfers occur.

Summary and conclusions

Dealing with the GST tax is complex. The GST exemption provides an opportunity to reduce or eliminate the tax. However, it is only a rate reducer—not a true exemption. Generally, it is preferable, when property will be placed in trust and the generation-skipping transfer will occur at a later time, to allocate GST exemption to one trust (or group of trusts) so that it (or they) will be entirely exempt from the tax and for the other trust (or trusts) to not be exempt at all, rather than creating partially exempt trusts.

This separation into purely exempt and non-exempt trusts may provide many opportunities to reduce the overall payment of GST tax. Even if the governing instrument does not direct the creation of such separate trusts (or groups of trusts), such purity of exemption may be achieved, at least in some cases, by a qualified severance.

In some cases, it will be preferable to make a disproportionate allocation of GST exemption—such as where a skip person, whose death will constitute a generation-skipping transfer, dies or is expected to die sufficiently early that the tax may be viewed as premature compared to other trusts to which GST exemption could be allocated. That seems reasonable to do. If it develops that the trusts to which a disproportionately small allocation was made are disadvantaged by the allocation, their trustees (or, perhaps, beneficiaries) may seek an equitable adjustment to restore the loss of benefit. Nevertheless, making disproportionate allocations from separate GST non-exempt trusts may eliminate the disadvantage of the disproportionate allocation of GST exemption to them or, in some cases, eliminate the GST tax in its entirety.

PRACTICE NOTES

It seems that an equitable adjustment may be the appropriate remedy to use where the executor has made a disproportionate allocation of GST exemption for reasonable cause.¹

² See Section 2613.

³ Section 2631(a).

⁴ Section 2641.

⁵ See 2642(a).

⁶ Section 2641(a).

⁷ Under Section 2632, GST exemption may be automatically allocated to a transfer (unless an election is made to prevent such allocation) or may be affirmatively allocated. See, generally, Zeydel, "Deemed Allocations of GST Exemption to Lifetime Transfers," 34 ETPL 3 (Mar. 2007); and Zeydel, "Handling Affirmative and Deemed Allocations of GST Exemption," 34 ETPL 12 (Feb. 2007).

⁸ See Section 2611(b)(1) for the exclusion from GST tax for any transfer which if made inter vivos by an individual would not be treated as a taxable gift by reason of Section 2503(e).

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).

[9](#)

Substantially separate and independent shares of different beneficiaries in one trust 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, Reg. 26.2654-1(a)(1)(i) and Reg. 1.663(c)-3.

[10](#)

See, generally, Blattmachr, "Getting It Clean and Keeping It Clean (Another Generation-Skipping Adventure)," 49th *Ann. Inst. on Federal Tax'n* p. 8-1 (1991), reprinted as "Another Generation-Skipping Adventure," ¶472 Macmillan, Inc.—Tax Ideas (July 1991).

[11](#)

Section 2642(a)(3). See, generally, Harrington, Kwon, McCaffrey, Plaine, and Schneider, "Breaking Up Is No Longer Hard to Do: Final GST Tax Qualified Severance Regulations," 107 *J. Tax'n* 331 (Dec. 2007); and Bieber and Hodgman "Trust Severances and Other Planning Under the New Final and Prop. GST Regs.," 35 *ETPL* 3 (Jan. 2008) .

[12](#)

Under Section 2631(a), the allocation is made by the individual taxpayer or his or her executor.

[13](#)

See, e.g., Formula Gift Equal to Available GST Exemption generated by the Wealth Transfer Planning forms for wills and revocable trusts published by Interactive Legal Systems (www.ilsdocs.com).

[14](#)

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).

[15](#)

Transfers during life to or for one's spouse who is not a U.S. 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.

[16](#)

See, generally, Gans and Blattmachr, "Quadpartite Will: Decoupling and the Next Generation of Instruments," 32 *ETPL* 3 (Apr. 2005).

[17](#)

See Section 2001(b).

[18](#)

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.

[19](#)

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.

[20](#)

See J. Blattmachr, D. Hastings, and D. Blattmachr, "The Tripartite Will: A New Form of Marital Deduction," 127 *Tr. & Est.* 47 (Apr. 1988).

[21](#)

See Section 642(b)(2).

[22](#)

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 \$10,700 of taxable income in 2008.

[23](#)

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 NYS2d 809, 1994 WL 270709 (Surr. Ct. N.Y. Co., 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 mean the cost of preparation of separate income tax returns, separate estimated tax payments, 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.

[24](#)

Alaska Stat. §13.36.157; 12 Del. Code §3528; Fla. Stat. §736.04117; N.Y. EPTL 10-6.6; S.D. §55-2-15; Tenn. Stat. §35.15.816(b)(27).

[25](#)

Cf. *Heller*, *supra* note 23, 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.

[26](#)

Reg. 26.2652-1(a)(1).

[27](#)

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

[28](#)

See, e.g., *Phipps v. Palm Beach Trust Co.*, 196 So 299 (1940).

[29](#)

See, e.g., Ltr. Rul. 200319004. *Cf.* Reg. 1.1001-1(h) (no gain upon certain trust severances). Under Section 6110(k)(3), neither a private letter ruling nor an IRS National Office technical advice memorandum may be cited or used as precedent.

[30](#)

Reg. 26.2654-1(b). The Regulations also recognize a pecuniary division if required by the terms of the governing instrument.

[31](#)

Reg. 26.2654-1(b)(2).

[32](#)

Section 2642(a)(3). An addition or constructive addition to a trust that was irrevocable on 9/25/85 causes that trust to consist of two portions, a Chapter 13 and a non-Chapter 13 portion, which may be severed in accordance with Reg. 26.2654-1(a)(3). See Reg. 26.2642-6(g).

[33](#)

Reg. 26.2642-6.

[34](#)

"Direct skip" is defined in Section 2612(c).

[35](#)

An "interest" in a trust for GST tax 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.

[36](#)

Generation-skipping transfers, other than direct skips, are taxable terminations and taxable distributions defined, respectively, in Section 2612(a) and Section 2612(b).

[37](#)

Section 2013.

[38](#)

Blattmachr and Pennell, "Using 'Delaware Tax Trap' to Avoid Generation-Skipping Taxes," 68 J. Tax'n 242 (Apr. 1988), updated and reprinted in 24 Real Prop., Prob. and Tr. J. 75 (Spring 1989), fn. 7 for an explanation.

[39](#)

Section 2651(e).

[40](#)

Section 2651(e)(2).

[41](#)

Reg. 26.2651-1(a)(2)(iii).

[42](#)

Cf. Section 2621 with Section 2622 and Section 2623.

[43](#)

See, e.g., Matter of Estate of Fales, 106 Misc 2d 419, 431 NYS2d 763 (Surr. Ct. N.Y. Co., 1980).

[44](#)

In fact, under current legislation, there will be no GST tax for the year 2010. See the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. No. 107-16) §§901(a)-901(b). Other proposals to repeal the tax have been made.

[45](#)

See footnote 6 and the accompanying text.

[46](#)

In some cases, it will be preferable to expose property to gift or estate tax rather than GST tax. See, e.g., Blattmachr and Pennell, *supra* note 38. Indeed, it may seem better to have the property in the trust included in the beneficiary's gross estate so the credit under Section 2013 would be allowed. But merely invading the trust so the assets are owned by the beneficiary at death or having the beneficiary exercise the Delaware Tax Trap will not cause that credit to be allowed where the trust is a purely discretionary one for the beneficiary who dies within ten years of the death of the decedent who created the trust for the beneficiary. Rather, the beneficiary would need to have a quantifiable interest in the trust, such as an income interest, which may be a negative from the standpoint of the decedent's overall estate planning objectives.

[47](#)

For example, the child for whom the trust is created dies without descendants and, as a result, the trust property passes to another child.

[48](#)

See, e.g., Blattmachr and Slade, "One Hundred Plus Post-Mortem Tax Planning Options," The Chase Review (Jan. 1993), reprinted in revised form in 66 N.Y. State B.J. 26 (July/Aug. 1994).

[49](#)

Section 2053(a).

[50](#)

Reg. 1.212-1(i).

[51](#)

140 NYS2d 169 (Surr. Ct. N.Y. Co., 1955).

[52](#)

See, generally, Dobris, "Equitable Adjustments in Post Mortem Income Tax Planning," 65 Iowa L. Rev. 103 (1979).

[53](#)

Blattmachr, "The Tax Effects of Equitable Adjustments: An Internal Revenue Code Odyssey," 18 *U. Miami Inst. on Est. Plan.* ¶1400, ¶1406.2 (footnote omitted) (1984).

[54](#)

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., N.Y. EPTL 11-2.3(b)(5).