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Estate Planning and the Generation-Skipping Transfer Tax

Harold G. Wren*

Although the generation-skipping transfer tax (GSTT) survived the Economic Recovery Tax Act of 1981, many changes have resulted for the estate planner. In his Article, Professor Wren examines the GSTT and analyzes the effect of these new changes on that tax. Utilizing the new rules and the GSTT, Professor Wren concludes with useful examples for the estate planner on how to obtain maximum tax and nontax benefits.

INTRODUCTION

The Economic Recovery Tax Act of 1981 (ERTA)\(^1\) introduced several new concepts in estate planning. Although the act expanded the unified credit to provide for a $600,000 exemption equivalent by 1987,\(^2\) increased the annual gift tax exclusion from $3,000 to $10,000,\(^3\) and introduced the unlimited marital deduction,\(^4\) it did not repeal the generation-skipping transfer tax.

<table>
<thead>
<tr>
<th>Year</th>
<th>Unified Credit</th>
<th>Exemption Equivalent</th>
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</thead>
<tbody>
<tr>
<td>1981</td>
<td>$47,000</td>
<td>$175,800</td>
</tr>
<tr>
<td>1982</td>
<td>62,800</td>
<td>225,000</td>
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<td>1983</td>
<td>79,300</td>
<td>275,000</td>
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<tr>
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<td>1985</td>
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<tr>
<td>1986</td>
<td>155,800</td>
<td>500,000</td>
</tr>
<tr>
<td>1987 and all</td>
<td>192,800</td>
<td>600,000</td>
</tr>
</tbody>
</table>

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2. ERTA § 401 (amending I.R.C. §§ 2010 (a), (b) (relating to unified credit against estate tax after Dec. 31, 1976), 2505(a), (b) (relating to unified credit against gift tax after Dec. 31, 1976), and 6810(a) (relating to estate tax returns by executors after Dec. 31, 1976)). The unified credit and the corresponding exemption equivalents for 1981 through 1987 are:

3. ERTA § 441 (amending I.R.C. § 2503 (relating to taxable gifts)).

4. ERTA § 403 (amending I.R.C. §§ 2056 (relating to estate tax deduction), 2523 (relating to gift tax deduction)).
Today's estate planner must be prepared, therefore, to create an estate plan that takes advantage of the new rules and simultaneously plans for the ultimate incidence of the GSTT. 6

While only three out of one thousand estates may be subject to the federal estate tax under the new law, 7 planning is still essential to obtain the maximum tax and nontax benefits for clients. Indeed, ERTA has created an unprecedented degree of flexibility in estate planning. This Article reviews the GSTT as developed in the Internal Revenue Code (the Code) and the Proposed Treasury Regulations (the regulations) and offers the estate planner tools to aid in integrating the new rules into an overall estate plan. To achieve this objective, this Article examines the GSTT in detail,8 explores the new tools provided to the planner,9 and suggests methods that best integrate these tools into the optimal estate plan. 10
I. THE POLICY BEHIND TRANSFER TAXATION

The concepts of the GSTT and the unlimited marital deduction provided by ERTA originated in the basic principle governing all transfer taxation: that accumulations of wealth within a family unit should be taxed only once in each generation. Since husband and wife are deemed to be of the same generation, there should be no tax on any transfers between them. As property passes from their generation to each succeeding one, however, the transfer tax should be imposed, with such specific exemptions as legislative policy may dictate. If the principle of transfer taxation with respect to accumulations of wealth is to be retained, the continued existence of both the GSTT and the unlimited marital deduction are essential. Alternatively, the entire system of transfer taxation could be abolished and the relatively small loss in revenue offset by a minor change in the income tax rates or even through institution of a new tax, such as the value-added tax.

The purpose of this Article is not to debate the policies underlying transfer taxation, but to aid estate planners in their efforts to accommodate the new rules of ERTA to the existing GSTT.

11. "The proposal [for an unlimited marital deduction] is designed to provide that property of a married couple will be taxed once as it passes to the next generation, not twice." U.S. DEP'T OF TREASURY, TAX REFORM STUDIES AND PROPOSALS 360 (1969). "The basic objective of the proposal [for a GSTT] is to obtain a transfer tax with respect to each generation regardless of whether that generation receives the property or is skipped in favor of a succeeding generation." Id. at 389.


13. See, e.g., id. § 2613(b)(6) which provides for a $250,000 exemption per deemed transferor (as defined in id. § 2612 (1976)) for transfers to the grandchildren of the grantor. See infra notes 144–51 and accompanying text.

14. Legislation to repeal the GSTT has been introduced by Senator Steve Symms (R. Idaho). Hearings on the bill (S. 1695) are being scheduled before a subcommittee of the Senate Finance Committee. Senator Symms describes the GSTT as "so complex that even the most knowledgeable individuals or corporate fiduciaries, insurance people, accountants, and attorneys, all of whom are affected by this tax, are finding it extremely difficult to interpret and apply." American Bankers Association, Trust Division, Trust Letter No. 185, at 4 (Oct. 26, 1981) [hereinafter cited as Trust Letter].

15. The GSTT, with some modifications, might become the basis for a single transfer tax system, making the estate and gift taxes unnecessary. Another alternative would be the adoption of an accessions tax in lieu of the present transfer tax system.

16. Lester C. Thurow has suggested that a seven and one-half percent value-added tax, with a $1,000 income credit, would raise about $95 billion in additional revenue. NEWSWEEK, Sept. 21, 1981, at 38. This amount is approximately 13 times the estimated $7 billion received in estate taxes each year. N.Y. Times, Sept. 21, 1981, at 20 (editorial). The N.Y. Times notes that, "by 1987, only three estates in a thousand will pay Federal [transfer] taxes, vastly fewer than before," and urges that "defects [in the system] could have been repaired without abandoning the principle of wealth taxation altogether." Id. § A, at 24, col. 1.
II. PLANNING UNDER THE GSTT AND ERTA

Under existing law, the GSTT does not guarantee that every estate otherwise taxable will be taxed in every generation. It is possible for the settlor to transfer property in trust for beneficiaries of the same generation. A settlor, for example, can create one trust for children, another for grandchildren, and another for greatgrandchildren. Although the tax is avoided under this scheme, such an estate plan may ignore the totally the client's nontax objectives. ERTA, however, provides the planner with many more options than under the old Code, thereby allowing for the development of estate plans to serve such nontax objectives. Prior to the unlimited marital deduction, for example, the planner typically would give the surviving spouse complete control of fifty percent of the adjusted gross estate to assure the greatest possible marital deduction.  

Under ERTA, the planner can provide for the complete retention or complete transfer of control by $S_1$, depending on the nontax objectives $S_1$ and $S_2$ seek.

Many questions arise in the preparation of a family's estate plan under the present law. The estate planner must determine whether one basic trust for all members of the settlor's family should be established, or whether it is preferable to establish separate trusts for each descendant or succeeding generation. The planner also must decide how to relate the unlimited marital deduction to the trust or trusts established under the GSTT. One alternative is that the familiar marital and nonmarital trusts can be used to absorb one-half of the federal estate tax upon $S_1$'s death and the balance upon $S_2$'s death. Another alternative is that the executor can be given the opportunity to elect to have the tax deferred under the new "qualified terminable interest rules." A third alternative lies in giving the entire estate to $S_2$, thereby qualifying it for deferring the estate tax until $S_2$'s death. If a family trust is already in existence, the planner must decide whether to

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18. Throughout this Article, "$S_1$" will designate the spouse who is the first to die, and also the one who has the bulk of the family's wealth.

19. "$S_2$" will designate the surviving spouse, who owns little or no property individually. In community property states, of course, $S_1$ and $S_2$ normally own 50% percent each of the family's wealth, and for purposes of the marital deduction it would be immaterial who died first.

20. See ERTA § 403(d)(1) (adding § 2056(b)(7) to the code and introducing Qualified Terminable Interest Trusts (Q-TIP's)). Q-TIP's allow a grantor to maintain greater control over the disposition of property without adverse tax consequences. The acronym, Q-TIP, is derived from "qualified terminable interest in property."
create a new trust, or whether to merely add property to an existing trust. If a new trust is favored, it must be determined whether both $S_1$ and $S_2$ should participate in its creation. The estate planner also must determine whether a trust should be created at all, or whether some "trust equivalent" should be utilized instead.

Regarding taxation, the planner must decide how the transfer tax should be planned in light of the increased unified credit at both $S_1$'s death and, subsequently, at $S_2$'s death; how the increased gift exclusion of $10,000$ per year per donee can best be coordinated with the GSTT; the extent to which joint interests should be used; and whether, if faced with imminent dissolution of the family, the typical pre-1981 divorce and property settlement should be used, or whether the plan should center around the unlimited marital deduction. These are just a few questions planners must consider while developing an estate plan that will accommodate present planning for the GSTT to the more familiar estate planning concepts of the past. Before addressing these questions, an analysis of the GSTT is necessary to identify new considerations in developing estate plans.

III. THE BASIC STRUCTURE OF THE GSTT

To better understand the structure of the GSTT, several important terms must be defined. The GSTT is imposed on taxable distributions and taxable terminations of a generation-skipping trust (GST) or trust equivalent. A generation-skipping trust is an instrument which assigns younger generation beneficiaries (YGB's) to more than one generation.\(^{21}\) A YGB is a beneficiary assigned to a generation younger than the grantor's generation.\(^{22}\) A beneficiary is a person having a present or future interest or power in a trust.\(^{23}\) An interest in a trust is the right to receive income or corpus or the permissible receipt of the income or corpus from the trust.\(^{24}\) A power in a trust is any power to establish or alter the beneficial enjoyment of the income or corpus of the trust.\(^{25}\)

The statute provides several exceptions which prevent some of these definitions from operating in special situations. A cautious

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22. Id. § 2613(c)(1).
23. Id. § 2613(c)(3).
24. Id. § 2613(d).
25. Id. § 2613(d)(2).
planner, therefore, must retrace each of these definitions through each section of the Code. An example illustrates the point.

Grantor, G, transfers property in trust to child, C, for life, remainder to G's grandchild, GC. This transfer is a GST. The trust has two YGB's assigned to more than one generation younger than G's. C and GC are both beneficiaries, since they each have an interest in the trust. The fact that S's interest is a present interest and GC's interest is a future interest is irrelevant in determining whether the trust is a GST. The difference in interests is relevant in determining the existence of a taxable distribution or taxable termination.\(^{26}\)

Whether a trust is a GST is determined immediately before the transfer.\(^{27}\) In this respect, the GSTT is similar to the common law rule against perpetuities.\(^{28}\) The planner should be concerned with what may happen in the future and not only with what actually occurs.

A. Assignment of Generations

Since a GST is defined in terms of YGB's assigned to more than one generation younger than the grantor's generation, the method of ascertaining generations is critical. The proposed regulations\(^{29}\) state the rules in terms of related and unrelated persons. In addition, these rules state special rules dealing with: (1) the effect of marriage or adoption; (2) multiple generation assignments; (3) treatment of half-bloods; and (4) entities as beneficiaries.

1. Related Persons

The lineal descendants of a grantor's grandparent\(^{30}\) are assigned to a generation based on the difference between the number of generations between the grandparent and the individual to be assigned and the number of generations between the

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26. See infra notes 118–31 and accompanying text.
29. The proposed regulations for the GSTT were promulgated by the Commissioner of Internal Revenue in the last days of President Carter's administration. 46 Fed. Reg. 120 (1981).
30. This group includes the lineal descendants of the grantor, plus his or her parents and collateral relatives within the grandparent's parentela, such as first cousins and grandnephews. The Uniform Probate Code uses the same standard to determine the extent of an intestate's heirs. See Unif. Probate Code § 2–103 (1977).
grandparent and the grantor, the latter number always being two.\textsuperscript{31} A grandnephew, for example, would be four generations removed from the grandparent of the grantor and would be assigned to two generations (4−2=2) younger than that of the grantor.

2. Unrelated Persons

Calculating the generation of one who is neither married nor related to the grantor is a simpler process. The proposed regulations track the statute and calculate the relationship to the grantor mathematically. An individual born not more than twelve and one-half years after the birth of the grantor is assigned to the grantor's generation. An individual born more than twelve and one-half years but less than thirty-seven and one-half years after the birth of the grantor is assigned to the first generation younger than the grantor. Similar rules apply for a new generation every 25 years.\textsuperscript{32}

3. Effect of Marriage or Adoption

A person who has at any time been married to the grantor or to a beneficiary is assigned automatically to that grantor's or beneficiary's generation.\textsuperscript{33} In addition, a relationship created by legal adoption is treated as a blood relationship.\textsuperscript{34} Since marriage and adoption are legal relationships that can be entered into voluntarily by either the grantor or any beneficiary, these rules effectively give the planner some control over changes in generations, provided the marriages or adoptions involve unrelated persons.\textsuperscript{35}

4. Multiple Generation Assignment

The proposed regulations repeat the statutory rule that an individual assignable to more than one generation shall be assigned to the youngest generation.\textsuperscript{36} These regulations then add that

\textsuperscript{31} I.R.C. § 2611(c)(1) (1976).
\textsuperscript{35} Although the statute does not specifically preclude marriage to, or adoption of, a related person, the determination of generations in these cases is subject to different rules from those involving unrelated persons in order to prevent tax avoidance. Prop. Treas. Reg. § 26.2611-3(c), 46 Fed. Reg. at 122. \textit{See infra} note 37 and accompanying text.
"[t]his rule does not apply to the adoption of an unrelated person by the grantor or any beneficiary, or the marriage of an unrelated person to the grantor or any beneficiary." 37 This language suggests three corollary rules. First, multiple generation assignment will apply when the parties are related. Otherwise, the grantor or beneficiary could, by marriage or adoption, move a YGB up one or more generations. Second, multiple generation assignment applies when the grantor or beneficiary, or two beneficiaries, are unrelated. Absent marriage or adoption which causes the parties to be related, however, the mathematical rule for unrelated persons 38 makes it difficult to see how a person could be assigned to more than one generation. Third, when the parties are not related, one party may change the generation assignment of another through marriage or adoption.

A person also can be related to another in more than one fashion. Every grantor has at least four grandparents. Since the statute is based on lineal descent from any one of these four grandparents, there will be times when a beneficiary may be related to the grantor through two different grandparents' parentelas. An example illustrates the point:

G, grantor, had a father, F, and a mother, M. F's father (G's grandfather), GF, had two children, G's father, F, and U, G's uncle. U had one child, C, G's first cousin. M's mother (G's grandmother), GM, had two children, G's mother, M, and G's aunt, A. A had a child (first cousin of G), X, who had a child, X-1. X-1 is related to G as a first cousin, once removed. C married X-1, and the couple had a child, X-2. X-2 would be related to G through G's maternal grandmother as a first cousin, twice removed, but through G's parental grandfather as a first cousin, once removed. 39 In this case, the Code 40 indicates that X-2 is treated as

38. See supra note 32 and accompanying text.
39. The relationship may be diagrammed as follows:

```
1st Generation
GF
  /\   \\
  U   F + M
  |    |
2nd Generation
  |    |
  C   G
  |    |
3rd Generation
  |    |
X-1 X
  |    |
4th Generation
  |    |
  X-2
```

being in the fourth generation from GM and second from G, rather than the third generation from GF and first from G.

If husband and wife join in the creation of a trust, as is the norm in community property states, at least eight grandparents may be involved. If the grantor's grandparents and parents remarry, the number of lineal descendants from a single grandparent of the grantor or grantors may become legion. The possibility of the grantor's being related to a YGB through more than one grandparent, therefore, is not so unusual.

5. Treatment of Half Bloods

Both the proposed regulations and the Code contain the rule that "[a] relationship by the half blood shall be treated as a relationship by the whole blood." Since such a relationship hardly can be controlled by a grantor or beneficiary, the rule does little to affect the incidence of the tax.

6. Entity as Beneficiary

The proposed regulations do not add much to the Code rule that the law looks through the entity beneficiary to determine the actual beneficiaries and assigns them to generations according to the rules governing individuals. The regulations state that an "entity is not assigned to a generation," and that a legatee or heir of an estate, trust beneficiary, partner in a partnership, or corporate shareholder will be deemed to have an "indirect interest or power." The regulations also provide guidelines to determine who has a present interest or power and who is a transferee under the rules governing taxable distributions and taxable terminations.

The regulations list three examples demonstrating the operation of the ascertainment of generations. The first two examples concern lineal descendants and unrelated persons, and add lit-

41. Id. § 2611(c)(3); Prop. Treas. Reg. § 26.2611-3(a), 46 Fed. Reg. at 122.
44. Id.
47. Id. § 26.2611-3(f), example (1), 46 Fed. Reg. at 122.
48. Id., example (2).
tle to the Code definitions previously discussed. The third example involves the separation of short term trust income from a reversion retained by the grantor:

Assume A creates a short term trust for his child B for 11 years, and that during the term of the trust A dies and leaves his entire estate to B's grandchild D. Since the estate has the unrestricted right to receive the income or corpus of the trust upon the expiration of the 11 years, D is treated as a beneficiary of the short term trust and is assigned to the third generation below the grantor.

The example is troublesome because A dies during the term of the trust. Had A lived beyond 11 years, the property would have reverted to him in fee. Upon reversion, A might have made a gift of the fee or bequeathed his entire estate to D. Obviously, such a gift would not involve a GST. Although it seems that the grantor's death during the term of the trust should not cause an amalgamation of B's income interest with D's interest under A's will, so as to create a GST, the regulations appear to extend the scope of the GSTT to cover this situation.

B. GST Equivalent

The GSTT is imposed on GST's and their "equivalents." The statute defines a GST equivalent as any nontrust arrangement which has "substantially the same effect" as a GST. Examples of this concept include "life estates and remainders, estates for years, insurance and annuities, and split interests." The regulations repeat these examples and add "direct and indirect transfers to a minor." More importantly, the regulations provide a comprehensive definition to cover any possible arrangements that might have the effect of a GST. The regulations define a GST equivalent as:

any legally enforceable arrangement whether effectuated by contract, deed, will, agreement, understanding, plan or by any other means (including any combination of the preceding at the same or different times) which splits the beneficial enjoyment of assets among two or more younger generation beneficiaries.

49. See supra notes 29-32 and accompanying text.
52. Id. § 2611(d)(2).
who are assigned to more than one generation. The characterization of any arrangement as a generation-skipping trust equivalent depends on the effect of the arrangement and not on the settlor's motives.\textsuperscript{54}

The Commissioner illustrates the GST equivalent rule with a series of examples which reflect the commissioner's preventive approach to tax avoidance. The first example outlines the familiar situation where an insured directs that the proceeds of a life insurance policy be left with the insurance company to pay the income to child, C, for life, remainder to grandchild, GC.\textsuperscript{55} Such an arrangement is the equivalent of a GST. Suppose, however, C has the option to take the entire proceeds at the insured's death, but irrevocably elects to have the proceeds retained by the company with the income going to C for life, remainder to GC. By exercising this option, C becomes the grantor, and since there is only one YGB, the arrangement is not a GST.\textsuperscript{56} Perhaps the most important example in the regulations involves a grantor who, by will, assigns the beneficiaries of the estate to two different generations. Although this assignment is a GST equivalent, there is no GSTT, provided the separate share rule applies.\textsuperscript{57}

Example seven illustrates the peril of using the custodian relationship under the Uniform Gift to Minors Act:\textsuperscript{58}

A transfers $300,000 to his grandchild C under the Uniform Gift to Minors Act naming A's sister as a custodian. The arrangement is a [GST] equivalent because C's parent is treated as a beneficiary under § 26.2613-4(c)(3) and the arrangement splits the beneficial enjoyment of the gift among two [YGBs] who are assigned to two different generations.\textsuperscript{59}

This example presents an unwarranted expansion of fiduciary

\textsuperscript{54} Id. § 26.2611-4(a), 46 Fed. Reg. at 123.

\textsuperscript{55} Id. § 26.2611-4(b), example (1).

\textsuperscript{56} Id. C, of course, by electing the arrangement, may make a taxable gift of the remainder interest under § 2501, causing the value of the proceeds to be includable in his or her gross estate under § 2036. In that event, the transaction, even if construed to be a GST equivalent, still would be excluded from the GSTT. \textit{Cf.} I.R.C. § 2613(a)(4)(B) (1976) ("taxable distribution" does not include transfers subject to tax imposed by chapter 11 or 12) and (b)(5)(B) ("taxable termination" does not include transfers subject to a tax imposed by chapter 11 or 12). It should be noted, however, that a combination life insurance policy and annuity may be a GST equivalent. Prop. Treas. Reg. § 26.2611-4(b), example (3), 46 Fed. Reg. at 123. The same is true for a legal life estate with remainder over. \textit{Id.} § 26.2611-4(b), example (4).

\textsuperscript{57} Id. example (5) (citing examples (3) and (4) under the separate share rule of § 26.2613-5(c)). \textit{See infra} notes 130-41 and accompanying text.

\textsuperscript{58} UNIF. GIFT TO MINORS ACT, 8 U.L.A. 181 (1972).

\textsuperscript{59} Prop. Treas. Reg. § 26.2611-4(b), example (7), 46 Fed. Reg. at 123 (emphasis added). To determine whether C has a present interest or power, see \textit{id.} § 26.2613-4(d).
power. The example correctly assumes C's parent is under a legal obligation to support C. By analogy to cases decided under sections 2036 and 2038 of the Code, however, this example assumes that the custodian has the equivalent of a beneficial power which can be used to satisfy the legal support obligation. Under the proposed regulations, C, the minor, has a present interest or power due to the "unrestricted right to receive income or corpus." The difficulty with the Commissioner's assumption is that the custodian has more than a true fiduciary interest. If C has an "unrestricted right to receive income or corpus," it is difficult to see how the custodian could have anything other than a fiduciary power.

C. Taxable Distributions

1. Defining a Taxable Distribution

Once a trust is found to be a GST, those situations which may be classified as "taxable distributions" must be determined. The proposed regulations define a taxable distribution as "any distribution which exceeds the amount of trust income . . . from a [GST] to any [YGB] who is assigned to a generation younger than the generation assignment of any other person who is or was a [YGB]." The distribution, therefore, must be both from a GST and in excess of trust income, and the distributee must be assigned

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62. Id. § 26.2613-4(d), 46 Fed. Reg. at 128. Although C's parent and C both may be deemed to hold an interest or power, this designation resolves only the question of whether the custodianship is a GST equivalent. Whether a taxable distribution or taxable termination exists depends on other considerations. See infra notes 194-98 and accompanying text.

63. Id.

64. Id. § 26.2613-1(a), 46 Fed. Reg. at 123. The regulation follows the Code except that it discusses an amount "which exceeds" income, rather than an amount "which is not out of income." Id. The regulation also inserts the language "or was" into the definition so as to broaden the time for the ascertainment of a YGB. Id. For the code treatment, see I.R.C. § 2613(a)(1) (1976).
to a generation younger than any other YGB.\textsuperscript{65} One important exception made by the Code and the regulations is that an individual who always had a future interest or power is not a YGB under the taxable distribution rule.\textsuperscript{66}

After defining a taxable distribution and stating its principal exception, the Code then mandates the source of distributions from the GST. Any distribution \textit{out of income} is deemed to be made in descending order of generations, beginning with beneficiaries assigned to the generation that is least remote from the grantor.\textsuperscript{67} The proposed regulations restate this rule and give several examples of taxable distributions involving distributions of corpus and income to more than one generation or beneficiary within a generation.\textsuperscript{68}

Taxable distributions may be contrasted with the normal income tax rule on taxability of income to a beneficiary or trustee.\textsuperscript{69} In the simple trust, when the trustee distributes all current income to an income beneficiary, the trustee receives a deduction\textsuperscript{70} and the beneficiary is taxed on the distributed income.\textsuperscript{71} In contrast, there is no taxable distribution for purposes of the GSTT when the trustee distributes current income.

Most trusts, however, are complex trusts. Drafters often provide that the trustee shall pay or accumulate the trust income depending on the beneficiary's needs. These drafters also may give the trustee power to distribute accumulated income or a portion of principal to the income or principal beneficiary or beneficiaries. Under income tax rules, the trustee's accumulated income is sub-

\textsuperscript{65} I.R.C. § 2613(a)(1) (1976) uses more complicated phraseology than the proposed regulations. The Code requires that there be at least one other YGB assigned to an older (higher) generation than that of the distributee.

\textsuperscript{66} Id. Prop. Treas. Reg. § 26.2613-1(a)(1), 46 Fed. Reg. at 123. The Commissioner does not provide an example of this exception's operation. It is conceivable that a planner might create a discretionary trust in which a distribution to a YGB would not be taxable even though an older YGB had an interest in the trust confined to a future interest or power. If, for example, grantor, G, creates a trust to pay the income to his or her grandchild, GC, for life, then to G's child, C, for life, remainder to the greatgrandchild, GGC, a distribution of corpus to GC would not be a taxable distribution, since for purposes of the first sentence of I.R.C. § 2613(a)(1) (1976), C would not be regarded as a YGB, and the distribution would not be to a YGB assigned to a generation younger than another person who was a YGB.

\textsuperscript{67} I.R.C. § 2613(a)(2) (1976).


\textsuperscript{69} See I.R.C. §§ 641–663 (1976).

\textsuperscript{70} Id. § 651.

\textsuperscript{71} Id. § 652.
ject to income tax. If the trustee makes a distribution of accumulated income in a later tax year, the beneficiary pays an additional tax equal to the difference between the amount the beneficiary would have paid if properly taxed and the amount the trustee actually paid. The accumulated income distribution is exempt from the taxable distribution rule because, although such distribution is income, the rule defines income as fiduciary accounting income.

For income tax purposes, the concept of distributable net income determines the extent to which a distribution is taxable to the beneficiary. Distributions, to the extent covered by distributable net income, are taxed to the beneficiary. If the distribution is not covered, it constitutes an "other amount" not subject to income tax. Because fiduciary accounting income, rather than distributable net income, is the talisman for nontaxability of a taxable distribution under the GSTT, there are situations when a particular taxable distribution is subject to both the income tax and the GSTT. If, for example, the trustee distributes an item of principal covered by distributable net income, the beneficiary may have to pay income tax. If the item is also considered to be "not out of income of the trust (within the meaning of section 643(b))," it could be a taxable distribution under the GSTT. The Commissioner has synchronized the operation of the income tax and GSTT in one area. For income tax purposes, the trustee may elect to have distributions made during the first sixty-five days of the taxable year treated as having been made on the last day of the preceding tax year. If the trustee makes such an elec-

72. Id. §§ 661-663.
73. Id. §§ 665-667.
74. Id. § 2613(a)(1). See Staff of Joint Comm. on Taxation, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976, at 571 (1976) [hereinafter cited as Staff Explanation]. The information returns which the trustee prepares (Forms 706-B(1) and (2)) and the tax return (Form 706-B) which the distributee must file indicate that fiduciary accounting income is the key to the taxation of taxable distributions. The trustee files Form 706-B(1) with the Internal Revenue Service and sends Form 706-B(2) to the distributee. The information returns identify the deemed transferor, the trustee, the grantor, and the beneficiary. These returns also describe the distribution and state the trustee's fiduciary accounting income for the year. See infra note 243.
76. Id. § 662(a)(2).
77. Id. § 2613(a)(1).
78. Id. § 663(b). It is arguable that the commissioner's synchronization of the sixty-five day rule with fiduciary accounting income is erroneous since id. § 2613(a)(1) refers only to § 643(b) (fiduciary accounting income) and does not adopt all of subchapter J, including § 663(b). The commissioner's interpretation, however, does seem to be well
tion, the distribution also is considered to have been made out of
the previous year's fiduciary accounting income for purposes of
the GSTT.\textsuperscript{79}

The proposed regulations illustrate the normal operation of
the taxable distribution rule: "Assume that a discretionary trust is
established for the benefit of the grantor's child and great-
grandchild. The trustee exercises his discretion by distribut-
ing fiduciary accounting income to the child and also makes a dis-
tribution out of corpus to the great-grandchild."\textsuperscript{80} This distribution
is a taxable distribution because there is a distribution of corpus to
a YGB, and there is at least one YGB (the child) assigned to a
generation older than that of the distributee.\textsuperscript{81}

2. Attribution of Taxable Distributions

The Code requires that a taxable distribution be deemed to be
made first out of fiduciary accounting income and then out of
corpus. To the extent that a taxable distribution is made out of
income, it is deemed to be made "in descending order of genera-
tions, beginning with the beneficiaries assigned to the oldest gen-
eration."\textsuperscript{82} The proposed regulations amplify this basic rule by
establishing a proration device for distributions of both corpus
and income to more than one YGB.\textsuperscript{83} In one example,\textsuperscript{84} the gran-
tor, G, creates a discretionary trust for the benefit of child, C, for
life, remainder to G's greatgrandchild, GGC. G gives the trustee
power to make distributions of income and principal in any man-
ner the trustee deems appropriate. In the tax year, the trustee dis-
tributes $100 of principal to C. In addition, $200 of income and
$100 of principal are distributed to GGC. Fiduciary accounting
income for the tax year is $300. What are the GSTT conse-
quences? C, having received income, is not subject to the
GSTT.\textsuperscript{85} GGC is deemed to have received $200 of nontaxable

\begin{itemize}
\item \textsuperscript{80} Id. § 26.2613-1(a)(3), example (1), 46 Fed. Reg. at 123–24.
\item \textsuperscript{81} The example emphasizes that the YGB in the older generation "has a present
interest or power in the trust." This emphasis is superfluous, since a "beneficiary," by
definition, must have a present or future interest or power in the trust. I.R.C.
\item \textsuperscript{82} Id. § 2613(a)(2).
\item \textsuperscript{84} Id. § 26.2613-1(c), example (1).
\item \textsuperscript{85} Even if C were given a distribution in excess of income, there would be no GSTT
\end{itemize}
income and a $100 taxable distribution. Assuming that distributable net income and fiduciary accounting income are the same and that the trustee had complete discretion as to both principal and income, the distribution of income and principal would be prorated on the ratio of distributable net income ($300) to total distributions ($400). For income tax purposes, therefore, C is deemed to have realized $75 and GGC, $225.86

The second illustration provides a similar proration method for purposes of the GSTT:

A establishes a trust for his nephew B, and B's children, C and D. The trustee is given full power to distribute income and/or corpus among B, C, and D, in his discretion. Fiduciary accounting income for the tax year is $4,000. The trustee distributes $2,000 to B, $1,000 to C, and $2,000 to D. How are these distributions taxed under the GSTT?

The $2,000 to B is not subject to tax. The remaining $2,000 is prorated between C and D based on the distributions to them. Hence, one-third of $2,000 ($667) is attributed to C and two-thirds of $2,000 ($1,333) to D. C, therefore, pays a GSTT on $1,000 minus $667 ($333), and D pays a GSTT on $2,000 minus $1,333 ($667). Furthermore, assuming that fiduciary accounting income and distributable net income are equal, it is necessary to prorate the distributable net income of $4,000 among the three beneficiaries based on the ratio of distributable net income to total distributions ($5,000).88

A third example in the proposed regulations illustrates that a distribution which might be tax-free for income tax purposes may still be subject to the GSTT; that if property other than money is distributed, the fair market value of the property will be subject to the tax; and that the rules under the GSTT will take precedence over local law for determining the character of the distribution. The example is as follows:

since C is a YGB assigned to a generation that is not younger than the generation assignment of any other YGB. I.R.C. § 2613(a)(1) (1976).

86. See Treas. Reg. § 1.662(a)-3(d) (1973) (for other amounts distributed, there shall be included in the gross income of the beneficiary an amount which bears the same ratio to distributable net income as the amounts distributed to all beneficiaries).


88. The taxable income to distributees under I.R.C. § 662 would be:

B: 4/5ths of $2000 = $1,600
C: 4/5ths of $1000 = 800
D: 4/5ths of $2000 = $1,600
$4,000

Assume a [GST] received stock dividends during the year with a fair market value of $100,000. The dividends are treated as corpus under local law. The trust's [fiduciary accounting income] for the year was $60,000. At the end of the year the trustee distributes the stock dividend in equal shares to the grantor's child and grandchild. Even though local law treats the stock as corpus, for purposes of the [GSTT] the $50,000 stock distributed to the child is treated as a distribution of income, and the $50,000 in stock distributed to the grandchild is treated as a $10,000 distribution of income and a $40,000 distribution of corpus.  

Although the Commissioner does not expressly say so, the $40,000 would be subject to the GSTT, since it is a distribution to a YGB, the grandchild, who is assigned to a generation younger than that of another YGB, the child.

3. Other Rules Affecting Taxable Distributions

Two important exceptions to the normal taxable distribution rules include the $250,000 exclusion for transfers to the grantor's grandchildren and the exclusion of any transfer which is "included in the federal gross estate or is subject to gift tax without regard to section 2503(b)." The phrase "without regard to section 2503(b)" reveals that under ERTA, the $10,000 exclusions are not considered in determining whether the transfer is "subject to gift tax."

The proposed regulations track the Code by noting that the GSTT payment by the trustee will result in an additional taxable distribution to the beneficiary. Such a route might be appropriate for gift tax purposes, but would be disastrous for purposes of the GSTT, since the additional taxable distribution would cause tax escalation for the beneficiary. Finally, the Commissioner
has included a warning in the proposed regulations that a taxable distribution will occur if "either the loan or ([loan] renewal) or the security arrangement [by the trustee] is not bona fide." The trustee, therefore, must disclose: "[1] Whether the debt is evidenced by a note signed by the beneficiary, and if there is a note, a copy of the note, [2] The amount of the loan and stated interest, and [3] Whether the loan is secured." The Commissioner's directives are not based on the Code, but on the prevention of tax avoidance.

D. Taxable Terminations

The GSTT is imposed on generation-skipping transfers. These transfers normally occur when the interests or powers of one or more YGB's terminate and new interests and powers arise in the next succeeding generation. It is necessary to determine, therefore, how the GSTT is measured and who must pay it.

If the GSTT were imposed only on the termination of a beneficiary's interest, the tax could be avoided easily by a series of distributions prior to the ultimate termination of the beneficiary's interest. The taxation of taxable distributions serves as a backstop for the taxation of taxable terminations in much the same way as the gift tax serves as a backstop for the estate tax.

1. Defining Taxable Termination

The Code defines a taxable termination as "[t]he termination (by death, lapse of time, exercise or non-exercise, or otherwise) of the interest or power in a [GST] of any [YGB] who is assigned to any generation older than the generation assignment of any other person who is a [YGB]." The Code excludes from a "taxable termination" the termination of any interest or power of a person having only a future interest or power. The proposed regulations will result in the generation-skipping transfer being grossed-up by the amount of taxes attributable to that generation-skipping transfer.

See also Taxable Distribution and Taxable Terminations, 46 Fed. Reg. 120, 120.
96. Id. § 26.2613-(f)(2).
97. H.R. REP. No. 1380, 94th Cong., 2d Sess. 52 (1976) [hereinafter referred to as House REPORT].
99. Id. § 2613(b)(1). Conceivably, drafters may attempt to convert what might otherwise be a present interest or power into a future interest or power by providing for the giving of notice before the beneficiary would be deemed to have an interest. See McCaffrey, Planning for Generation-Skipping Transfers, 14 REAL PROP., PROB. & TR. J. 722, 730 (1979). The Commissioner has said that an interest or power shall be treated as a present...
tions also exclude the assignment of a beneficiary’s interest in a GST, regardless of whether it is for a valuable consideration.\(^{100}\)

2. *Postponement of Taxable Terminations*

Since the GSTT is meant to fall precisely when the interest or power of a beneficiary assigned to an *older* generation occurs, isolating this point in time becomes crucial. The Code and the proposed regulations must prevent indefinite postponement of the tax.

Taxable termination will be deferred in four situations: when there are two or more YGB’s of the same generation;\(^{101}\) when a YGB has more than one interest or power;\(^{102}\) when the interest of a YGB assigned to a younger generation is terminated, but there is still an interest outstanding in another YGB assigned to an older generation;\(^{103}\) and when the termination of an interest assigned to a YGB assigned to a younger generation causes an interest to arise in another YGB assigned to the same or older generation.\(^{104}\) All four of these situations are corollaries to the basic principle that no taxable termination occurs until the older generation is no longer involved with the trust.

Two important caveats, however, must be added to these corollaries. First, the rules apply only if the beneficiaries’ interests are *substantial*.\(^{105}\) Second, the rules apply separately when the trust instrument creates *separate shares* or separate trusts.\(^{106}\)

**a. Two or More YGB’s.** When there are two or more YGB’s

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\(^{100}\) See infra notes 107–08 and accompanying text.

\(^{101}\) See infra note 109 and accompanying text.

\(^{102}\) See infra 110–17 and accompanying text.

\(^{103}\) See infra notes 118–31 and accompanying text.

\(^{104}\) See infra notes 132–43 and accompanying text.
of the same generation, all their interests terminate when the interest of the generation's last YGB terminates. If, for example, B, C, and D, children of the settlor, are beneficiaries of the same discretionary trust, and the trust is to continue for their joint lives and the life of the survivor, the taxable termination occurs when the last of the three children dies.\textsuperscript{107}

The House Ways and Means Committee explained that the "tax is postponed in the case of a discretionary (or sprinkling) trust because it is difficult to value the terminated interest until all members of the intervening generation have terminated their interests. . . . "\textsuperscript{108}

b. Same Beneficiary Having More Than One Interest or Power. The proposed regulations reiterate the statutory rule that if a YGB has more than one present interest or power in the trust, the taxable termination occurs when the last present interest or power terminates.\textsuperscript{109}

c. Unusual Order of Termination. The interest or power of a YGB assigned to an older generation usually will terminate prior to that of a YGB assigned to a younger generation. If, however, the reverse situation occurs, the Code and proposed regulations dictate that the taxable termination be deferred until the interest or power of the older beneficiary terminates.\textsuperscript{110} At this time, the GSTT is applied first to the termination of the interest or power of the older YGB, "[a]s if such termination occurred before the termination . . . of the younger beneficiary, [and] the value of the property taken into account for purposes of determining the tax . . . with respect to the termination . . . of the younger beneficiary shall be reduced by the [GSTT] with respect to the termination . . . of the older beneficiary."\textsuperscript{111} The Commissioner illustrates the rule with the following example:

Assume A creates a generation-skipping trust with the income payable in the sole discretion of the trustee to A's child B and A's grandchildren C and D, for the life of B. Upon the death of B the corpus of the trust is to be distributed to A's then living

\textsuperscript{108} House Report, supra note 97, at 50.
issue per stirpes. Further, assume that C predeceases B leaving one child E.  

Using these facts, the death of C is not a taxable termination. Upon B’s death, one-half of the property is distributed to D, and a GSTT is imposed on that one-half. The other one-half of the property passes to E and is treated as having passed through two generation-skipping transfers, one from B to C and a second from C to E. The value of the property taxed on the second transfer from C to E is reduced by the amount of the tax on the transfer from B to C.  

If the present interest or power of a YGB assigned to a younger generation terminates, and immediately after such termination, another YGB assigned to the same or higher generation has a present interest or power arising from such termination, the taxable termination for each YGB is deemed to occur with the termination of the YGB assigned to the older generation. For example, A creates a generation-skipping trust for A’s grandchild, B, who has cancer. On B’s death, A’s child, C, will become the life beneficiary of the trust. At the death of C, the corpus of the trust will be distributed to A’s greatgrandchild, D. In this situation, assuming C survives B, there is a taxable termination of each interest at the death of C. The GSTT will be applied in the same manner as in the case of an unusual order of termination.  

d. The Caveats. Having considered the principal situations when taxable terminations are postponed, the Commissioner then articulates two situations where the prevention of tax avoidance requires additional regulations. The first, the separate share rule, is familiar to estate planners from the income taxation of trusts. The second, dealing with nominal interests, is designed to prevent the planner from unduly postponing the incidence of tax through the creation of many interests in beneficiaries who have no real interest in the trust.  

The Code defines a beneficiary for purposes of the GSTT as “any person who has a present or future interest or power in the trust.” A person has a trust interest if such person has “a right
to receive income or corpus from the trust, or is a permissible recipient of such income or corpus."\textsuperscript{119}

A power is "any power to establish or alter beneficial enjoyment of the corpus or income of the trust."\textsuperscript{120} For purposes of postponement of the incidence of the GSTT, the proposed regulations require that a beneficiary's interest or power be \textit{substantial}.\textsuperscript{121} Without this requirement, drafters of trust instruments could postpone the GSTT incidence simply by naming many unrelated trust beneficiaries of the same or higher generation as those whom the settlor intends to benefit.\textsuperscript{122}

To prevent this situation, the proposed regulations state that if the beneficiary is not a lineal descendant of the grantor's grandparent, the interest will be deemed substantial only "if at least 5 percent of the value of the trust . . . is distributed to the nonlineal descendant[s] . . . annually."\textsuperscript{123} If less than five percent is distributed to nonlineal descendants, the interest is nominal "unless unusual facts and circumstances indicate that it is substantial."\textsuperscript{124} By definition, the interest of a lineal descendant of the grantor's grandparent is substantial.\textsuperscript{125} If a beneficiary's interest is not substantial, it is "nominal." For tax purposes, the value of a nominal interest does not reduce the value of the terminated interest, and its termination is not a taxable event.\textsuperscript{126}

The application of the five percent rule for determining whether a beneficiary has a substantial interest may prove difficult in future years. With interests, the five percent determination is easier, since it is based on the relative values of the trust and property distributed annually. As applied to a power, the valuation becomes difficult because the five percent rule is based on the rela-

\textsuperscript{119} Id. § 2613(d)(1).
\textsuperscript{120} Id. § 2613(d)(2)
\textsuperscript{122} This approach is reminiscent of similar efforts to postpone vesting by using ascertainable groupings as "all lineal descendants of Queen Victoria living at . . . [my] death" as the measuring lives for purposes of the rule against perpetuities. T. BERGIN & P. HASKELL, supra note 28, at 188 (citing In re Villar, 1 Ch. 243 (1929)).
\textsuperscript{124} Id. It is difficult to determine what might be considered unusual facts and circumstances. If it were shown that the settlor had a close relationship with the unrelated beneficiary, this evidence might be sufficient to make the five percent test immaterial.
\textsuperscript{125} Id. Whether this definition is realistic depends on the particular case. The grantor conceivably could list many first cousins who have little contact with the grantor. Conversely, the grantor might have a very close relationship with a daughter-in-law, who is "unrelated" for purposes of the regulation, even though she is in the same generation as the grantor's son, regardless of her age.
tive values of the trust and the right to withdraw corpus or income. The rule attempts to alleviate the problem of determining the value of a right to receive income by only applying to powers with an ascertainable external standard.

Although the five percent rule is the primary method for determining the substantiality of a beneficiary's interest, an interest or power still is treated as nominal "if under all the facts and circumstances the holder of that interest or power was never intended to exercise or benefit from the power or interest." The Commissioner illustrates the rule with the following examples:

(A) Assume a GST is established with the income payable to the settlor's grandchildren A and B for their joint lives and for the life of the survivor and upon the death of the last survivor the income is payable to C and D for their joint lives or accumulated and upon the death of C and D, the corpus is thereafter to be distributed to the great-grandchildren of the settlor. Both C and D are unrelated members of A and B's generation. If the sum of the annual distributions to C and D is at least 5 percent of the value of the trust, no taxable termination will occur until the death of the survivor of C and D or the sum or the distribution in a given year is less than 5 percent of the value of the trust.

(B) Assume the same facts except that the trustee distributed 5 percent of the income to C and D the first year their interests became a present interest. Unless unusual facts indicate otherwise, C and D have a nominal interest because less than 5 percent of the value of the trust was distributed.

Assuming the planner is willing to pay for the privilege, the regulations establish a method for deferring a taxable termination for a group of beneficiaries for a long period of time.

A drafter can create a discretionary trust for the testator's grandchildren, with gifts over to the settlor's great-grandchildren.

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127. *Id.* § 26.2613-2(b)(3)(ii) provides that "[i]f a beneficiary possesses the right to withdraw income or receive income or corpus (or both), the present value of which at the time of the termination is at least 5 percent of the trust, then the beneficiary's interest is substantial." *Id.* (emphasis added).

128. *Id.* When the beneficiary's needs are so remote as to be negligible, the power will be excluded from the five percent rule. *Id.* This acknowledged distinction between different powers is contrary to the policy of the income, estate, and gift taxes. Historically, a transfer subject to the retention of such a power was deemed complete for purposes of all three taxes. *Cf.* Leopold v. United States, 510 F.2d 617 (9th Cir. 1975) (estate tax); Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947) (estate tax); I.R.C. § 674(b)(5)(A) (1976) (income tax); Treas. Reg. § 26.2511-2(c) (gift tax).


130. *Id.* § 26.2613-2(b)(5), example (3).

131. *Id.*, example (4) (emphasis added).
upon the termination of the trust. The drafter next prepares a list of persons unrelated to the grandchildren but of their generation (not younger than twelve and one-half years younger than the youngest grandchild). These persons and the grandchildren are made beneficiaries of a discretionary trust in which the trustee has the power to distribute corpus or income to beneficiaries. Upon the death of the last grandchild, the trust is continued until the death of the last unrelated beneficiary. During this period, the trustee distributes each year a minimum of five percent of the trust value (valued as of the first day of the trust’s tax year) to the unrelated beneficiaries as a group and accumulates any income exceeding this amount for the principal beneficiaries’ benefit. There is no taxable termination until the last unrelated beneficiary dies.

The obvious difficulty of such a draft is that its necessary complexity may not be warranted by the testator’s estate planning objectives. Like the involved efforts of some drafters to postpone vesting for purposes of the rule against perpetuities, however, such a draft defers taxable termination for a long time.

The Code states the general rule that “in the case of a single trust having more than one beneficiary, substantially separate and independent shares of different beneficiaries in the trust shall be treated as separate trusts.” The following proposed regulation illustrates this rule:

Assume that A establishes a trust for the benefit of his two children, B and C. Under the terms of the trust 50 percent of the income must be paid annually to each child and upon the death of either child, 50 percent of the corpus of the trust is to be distributed to that child’s grandchildren. On these facts, the separate share rule applies, and a taxable termination occurs at the death of either B or C with respect to that child’s share.

The separate share rule governing the income taxation of trusts is equally applicable to the GSTT. Even if shares are not considered separate for income taxation purposes, they still may be separate for GSTT purposes. In the past, planners used the separate shares principle to gain income tax advantages.

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134. Id.
135. Id. § 26.2613–5(b)(1).
136. Id. § 26.2613–5(b)(2), (c), example (4).
137. The principal advantage of creating separate shares for income tax purposes is that the additional taxable entities cut the effective income tax brackets of the beneficiaries.
the GSTT, however, drafters normally seek to avoid the separate share rule.\footnote{138} It, of course, is possible to have a GST when only a portion of the trust is subject to the separate share rule. The Commissioner illustrates this possibility with the following example:

Assume a trust is created by A with 50 percent of the income payable in the sole discretion of the trustee to A's children B and C for their lives and for the life of the survivor, and upon the death of the survivor 50 percent of the corpus is to be distributed to the children of B and C per stirpes. The remaining 50 percent of the income is payable to the grantor's nephew D for life and upon the death of D the remaining 50 percent of the corpus is to be distributed to D's children.\footnote{139}

The separate share rule applies to the relationship between D, as an individual, and B and C, as a group. The mutual interests of B and C are not subject to the separate share rule.

While the planner often will want to avoid the separate share rule to postpone a taxable termination as long as possible, there are times when using the rule can be beneficial. The planner may use separate shares when only one YGB (or one generation of YGB's) for each share (or trust) is desired. The Commissioner illustrates this situation thus: "Assume that A dies leaving A's entire estate in equal shares to A's child B, B's child C and C's child D. Under A's will, B has the right to receive all the income from the entire estate during the period of administration."\footnote{140} On these facts, the Commissioner reaches the surprising conclusion that "[t]he separate share rules do not apply," and when the estate is closed, a taxable termination will occur as to two-thirds of the estate value.\footnote{141} Interestingly, if the drafter provides that during the

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\footnote{138}{This advantage is limited by the special rules governing the income taxation of accumulation distributions. \textit{See} I.R.C. \S\S 665–667 (1976). Separate shares (or separate trusts) still may be used, however, with appropriate discretion in the trustee to create greater flexibility in the handling of distributable net income. \textit{See id.} \S\S 661–662.}

\footnote{139}{Prop. Treas. Reg. \S 26.2613–5(c), example (2), 46 Fed. Reg. at 128.}

\footnote{140}{\textit{Id.}, example (3). This example is troublesome since it seems to assume, in contrast with example (4), that the administration of the estate in which B is entitled to all the income is a trust equivalent. This assumption is inconsistent with the distinction between the income taxation of estates and the income taxation of trusts, as outlined in subchapter J. \textit{See} Treas. Reg. \S 1.661(a)–1 (1959). Example (3) notwithstanding, the rights of C and D are nothing more than a right to a one-third interest in A's estate. B, likewise, has a right to one-third of A's estate, but also is entitled to \textit{all} the income during the estate's administration. This arrangement is \textit{not} the same as a trust in which the income is to be paid to B for a period certain, or for life, with remainders over to B, or B's estate, and to C and D, or their estates.}

administration period, B, C, and D each shall have the right to the income from their respective shares, there is no taxable termination when the estate is closed.142 All beneficiaries receive their estate shares, and there is only one YGB as to each share.143

E. Exclusions from Taxable Distributions and Taxable Terminations

The Code provides for two major exclusions from taxable distributions and taxable terminations: an exclusion of $250,000 as to any deemed transferor for transfers to the grantor's grandchildren;144 and an exclusion of any transfer which is "subject to" federal estate or gift taxes.145

1. The $250,000 Exclusion

Of primary importance to estate planners is the $250,000 exclusion allowed deemed transferors for transfers to the grandchildren of the grantor. If grantor, G, establishes a testamentary trust to pay the income to grandchild, GC, for life, then to GC's child, GGC, for life, remainder to the children of GGC, there is no exclusion at the death of GC or GGC. The taxable termination at the death of GC is on a transfer from G's grandchild. If the trust is changed so that income goes to G's child for life, then to GC for life, remainder to such persons as GC appoints, or to GC's estate, the $250,000 exclusion is available for the taxable termination on the death of the grantor's child. Note that the limitation is worded so that the property must be included in GC's gross estate for federal estate tax purposes. This requirement stems from the regulations which state that "[i]t will be available only if the property would be includable in all events in the grandchild's federal gross estate if the grandchild died at any time after the generation-skipping transfer."146

The $250,000 exclusion is typically available for each deemed

142. Id., example (4).
143. Id.
144. I.R.C. § 2613(b)(6) (1976). Section 2613(a)(4)(A) provides the basis for this exclusion by providing that "[t]he term 'taxable distribution' does not include . . . any transfer to the extent such transfer is to a grandchild of the grantor of the trust and does not exceed" the $250,000 limitation. Id. See id. § 2612(a) (deemed transferor defined).
145. Id. § 2613(a)(4)(B). See infra notes 152–53 and accompanying text.
146. Prop. Treas. Reg. § 26.2614-4(a), 46 Fed. Reg. at 128. The precise origin of this limitation is unclear. There is no reason why a joint and survivor annuity in C and GC should not qualify for the exclusion on the death of C, GC surviving, even though nothing is included in GC's estate. But see infra note 148.
transferor. The number of exclusions, therefore, is multiplied by the number of the grantor's children expected to become deemed transferors. If, for example, grantor has four children, A, B, C, and D, up to one million dollars can be transferred without incidence of tax on the termination of the interests of A, B, C, and D. To obtain the maximum tax advantage in this situation, the planner might choose to establish two discretionary trusts. The first would involve the transfer of $1 million to trustees for the joint lives of A, B, C, and D, and for the life of the survivor, remainder to the grantor's grandchildren. In the second trust, all property exceeding that amount would be transferred to the grandchildren for their joint lives and life of the survivor, remainder to the grantor's greatgrandchildren.

The Code offers no clear basis for the requirement that property "be includable in all events in the grandchild's federal gross estate," although it is mentioned in the staff explanation. If grantor, G, transfers property to child, C, for life, then to grandchild, GC, for life, remainder to the children of GC, there are two taxable terminations, one at the death of C, and another at the death of GC. Since the imposition of the GSTT upon the death of GC would produce the same transfer tax revenue as the estate tax if property were includable in GC's gross estate, there is no reason why the $250,000 exclusion should be denied at C's death, because the gift over following GC's life estate is a remainder interest, rather than a transfer to the estate of GC or to GC's appointees.

When several taxable distributions or taxable terminations are subject to the $250,000 exclusion, it "is to be applied against the first distribution or termination that occurs, then the second, and so forth, until the exclusion has been fully utilized." In addition, "[i]f there are simultaneous transfers which are attributable to the same deemed transferor and which benefit more than one grandchild of the grantor of the trust, the $250,000 exclusion is to

147. Alternatively, the grantor might provide for life estates in the children with remainders to such persons as each child might appoint from among his or her lineal descendants. Although such a draft would necessitate the application of the separate share rule, the $250,000 exclusion would eradicate any adverse effect.


149. "This $250,000 exclusion is to be available in any case where the property vests in the grandchild (i.e. the property interests will be taxable in the grandchild's estate) . . . ." STAFF EXPLANATION, supra note 74, at 572.

be allocated between the transfers in accordance with their fair market values."\textsuperscript{151}

2. \textit{The Estate and Gift Tax Exclusion}

In the absence of an express provision excluding transfers from the GSTT which are either subject to the estate and gift tax or contrary to congressional intent, some taxable distributions or taxable terminations could be subject to more than one transfer tax per generation. Assume that grantor, G, transfers property in trust to a grandchild, GC, for life, remainder to such persons as GC appoints by will, with a gift over to G's great-grandchild, GGC, in default of appointment. Upon GC's death, there is a taxable termination when both GC's interest and power in the GST terminate. But since the property also is included in GC's gross estate under section 2041 of the Code, it is proper to exclude that property from the GSTT.\textsuperscript{152} If GC exercises the power of appointment in favor of GGGC (GC's grandchild and G's great-great-grandchild) rather than GGC, the exclusion presumably still applies even though GGC's generation is effectively skipped.

The proposed regulations added little to the exclusion provided by the Code. These regulations, however, expressly provide that the $10,000 exclusion for gift tax purposes is to be disregarded in determining whether a particular transfer is "subject to gift tax."\textsuperscript{153} Thus, the exemption from application of the GSTT applies to the whole transfer.

F. \textit{The Role of the Deemed Transferor}

Under the GSTT statutory plan, the deemed transferor's \textit{tax position} determines the \textit{measure} of the tax. The tax is paid by the recipient in a taxable distribution and the trustee in a taxable termination. Assume, for example, that G transfers property to trustees to pay the income to a GC for life, remainder to GGC. All the requirements of a GST are satisfied: (1) There are two generations of YGB's; (2) they are assigned to more than one generation; and (3) both generations are younger than G's. At GC's death there is a taxable termination, and GC is the "deemed


transferor,” “[t]he parent of the transferee [i.e., GGC] of the property who is more closely related to the grantor . . . than the other parent of such transferee.”

If during GC's life, the trustee distributes only income, GC will pay income tax on the money received. If, however, the trustee delivers a portion of principal to GC, there is no taxable distribution, since GC is assigned to the oldest generation of YGB's under the trust. Upon GC's death, the tax issues become critical. The amount of the GSTT on the taxable termination is based on the fair market value of the trust property as of GC's death. To insure that GC's tax bracket determines the amount of tax on this value, the tax is first computed based on the total fair market values of all prior transfers, plus the present transfer. From this amount, the tax on all prior transfers, whether by gift, estate, or GST, is subtracted. The difference is the amount of the GSTT on this particular transfer at the appropriate tax rate. This calculation has been used for gift tax purposes since 1932, and for both federal estate and gift tax purposes since 1976.

The proposed regulations mirror the statute in defining the deemed transferor as the transferee's parent more closely related to the grantor. If neither parent is related to the grantor, then the deemed transferor will be the parent “having a closer affinity to the grantor.” This situation is illustrated by the following example: Assume, in the previous example, that GGC was the child of $S_1$ and $S_2$. After $S_1$'s death, GC married $S_2$, so that GGC became GC's stepchild. Neither $S_1$ nor $S_2$, the parents of GGC, is related to grantor. $S_2$, however, is the deemed transferor since, as the spouse of GC, $S_2$ is “the parent having a closer affinity to the

155. A taxable distribution is defined as a distribution “not out of . . . income . . . to any [YGB] assigned to a generation younger than . . . any other [YGB].” Id. Hence, a distribution to a YGB assigned to the oldest generation of YGB's is not a taxable distribution.
156. Id. § 2602(a).
157. Id. § 2602(a)(1)(A), (B), (C), (D).
158. Id. § 2602(a).
159. Id.
163. Id.
grantor."164 If, in the first example, C, rather than GC, were the life beneficiary of the trust, C, not GC, would be the deemed transferor. The Code and regulations provide for this result by stating that if the parent (GC) of the transferee (GGC) is not a YGB, "but 1 or more ancestors of the transferee is a . . . [YGB] related by blood or adoption to the grantor of the trust, the youngest of such ancestors"165 will be the deemed transferor. Although adoption and marriage are equally significant in the determination of generation assignment, a parental relationship to the grantor by blood or adoption takes precedence over a relationship by marriage in determining the deemed transferor.166 Thus, if the spouse of GC, S2, were the life beneficiary in the original example, GC is still the deemed transferor, being more closely related to the grantor than S2.

The rules stated in the Code for identification of the deemed transferor are incomplete. Suppose, for example, that grantor, G, transfers property in trust to a child, C, for life, remainder to GC's spouse, A. Which of the two parents of A has the "closer affinity" to G?167 The Commissioner states that the older parent of A is the deemed transferor.168

The Code defines "deemed transferor"169 but says nothing about the transferee.170 The proposed regulations list several persons or groups of persons as transferees: in a taxable distribution, the transferee is the person who receives money or property or has it applied for his or her benefit;171 in a taxable termination which terminates the trust and requires the distribution of the trust corpus to one or more beneficiaries, the transferee is the person

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164. Id. In this example, in the absence of an adoption of GGC by GC, GGC would not be a "lineal descendant of a grandparent of the grantor," and GGC's generation would be ascertained on the basis of the date of his or her birth. I.R.C. § 2611(c)(1), (4), (5) (1976).
167. I.R.C. § 2612(a)(1) (1976). The exception of § 2612(a)(2) is inapplicable, since none of A's ancestors is a YGB.
168. Prop. Treas. Reg. § 26.2612-1(a), 46 Fed. Reg. at 123. This regulation provides that "[i]f the parent is not named in the will or trust instrument, or the lineal descendant of that parent does not have an intervening interest or power in the trust, then the older parent is treated as the deemed transferor with respect to all of the property transferred." Id. (emphasis added).
170. The staff explanation recognized that the term "transferee" was to be "further defined in regulations [to] prevent situations where attempts are made to minimize tax through the use of nominal transferees." STAFF EXPLANATION, supra note 74, at 578.
who receives the property, or has it applied to his or her benefit;\textsuperscript{172} in a taxable termination where the trust continues after termination, the transferee is the person (or persons) with a present interest or power in the trust immediately after the taxable termination;\textsuperscript{173} in a transfer to an entity, the transferees are those persons who are assigned to a generation and are treated as transferees to the extent of the fair market value of their interest in the entity;\textsuperscript{174} and in a charitable organization, charitable trust, or accumulation trust, having a present interest or power in the trust immediately after the taxable termination or having a mandatory accumulation of income for a term of years, the transferee is the person having the next succeeding present interest or present power.\textsuperscript{175}

If, upon taxable termination, the trust assets are not actually distributed to a beneficiary, or if the distribution is to an entity, the property is "deemed transferred pro rata to all beneficiaries with a present interest or present power"\textsuperscript{176} in the following priority order: first, to those assigned to the oldest generation who are lineal descendants of both the grantor and the beneficiary whose interest or power has been terminated;\textsuperscript{177} second, to those assigned to the oldest generation who are lineal descendants of the grantor;\textsuperscript{178} third, to those assigned to the oldest generation who are lineal descendants of the beneficiary whose interest or power has terminated;\textsuperscript{179} fourth, to those assigned to the oldest generation who are lineal descendants of the grantor's grandparents;\textsuperscript{180} and finally, to all beneficiaries holding present interests or present powers \textit{per stirpes}, unless the trust instrument specified \textit{per capita}.\textsuperscript{181}

The Commissioner has illustrated the application of these rules with two examples. In the first example, grantor establishes a discretionary trust with child A as beneficiary. Grantor also names A's children, B and C, and Grantor's greatgrandchildren, D and E, as beneficiaries, and directs that the trustee pay the

\begin{enumerate}
\item[172.] Id.
\item[173.] Id.
\item[174.] Id.
\item[175.] Id.
\item[176.] Id. \textsection 26.2613-3(a)(1), 46 Fed. Reg. at 126.
\item[177.] Id. \textsection 26.2613-3(a)(1)(i).
\item[178.] Id. \textsection 26.2613-3(a)(1)(ii).
\item[179.] Id. \textsection 26.2613-3(a)(1)(iii).
\item[180.] Id. \textsection 26.2613-3(a)(1)(iv).
\item[181.] Id. \textsection 26.2613-3(a)(1)(v).\end{enumerate}
come to the beneficiaries and survivors. Upon the death of the last survivor, the trustee is to distribute the principal to the children of D and E. A dies, causing a taxable termination. Since B and C are members of the oldest generation succeeding A's generation and are lineal descendants of both grantor and the beneficiary whose interest has terminated, they are the transferees at A's death, and the trust property is transferred one-half to each. In the second example, grantor establishes a discretionary trust for the benefit of grantor's child, A, for life, then to A's child, B, and grantor's nephew, C, for their lives and the life of the survivor. At the death of the survivor, the principal of the trust is to be distributed to B's children. Upon A's death, B is assigned to the oldest generation and is the lineal descendant of both grantor and beneficiary, A, whose interest has terminated. B, therefore, is the transferee, and B's parent, A, is the deemed transferor.

G. Interests and Powers

The GSTT is imposed only on taxable distributions or taxable terminations from a GST. A distribution is taxable only if it is made to a YGB assigned to a generation younger than that of at least one other YGB. A termination is taxable only if the interest or power of a YGB assigned to an older generation is terminated, and there is at least one other YGB assigned to a younger generation.

1. The Basic Rules

A YGB must first be a "beneficiary" of a trust or its equivalent. A beneficiary is "any person who has a present or future interest or power in the trust." "A person has an interest in a trust if such person . . . has a right to receive income or corpus from the trust, or . . . is a permissible recipient of such income or corpus."

The Code defines power as [the ability] to establish or alter the

182. Id. § 26.2613-3(a)(2), example (1).
183. Id.
184. Id. § 26.2613-3(a)(2), example (2). The significance of B's being the transferee lies in the fact that it will be B's parent, A, who will be the deemed transferor, even though the taxable termination may be postponed until the death of C, assuming C survives B.
185. Id.
186. See supra notes 64-66 and accompanying text.
188. Id. § 2613(d)(1).
beneficial enjoyment of the corpus or income of the trust."\textsuperscript{189}

The proposed regulations do not elaborate on these definitions. These regulations, however, do distinguish between present and future interests and restricted and unrestricted interests and powers:

A beneficiary’s interest or power is a present interest or power if the beneficiary has an unrestricted right to receive corpus or income from the trust. A right is restricted if it is contingent upon the happening of an event which is wholly outside the beneficiary’s control. A right to receive income or corpus is unrestricted if the right would be enforceable under governing local law, or if the right to receive income or corpus or both is subject only to the giving of notice. If a beneficiary may currently receive income or corpus upon the exercise of a trustee’s or other person’s discretion, the interest may be a nominal interest.\textsuperscript{190}

The Commissioner illustrates the distinction between present and future interests with a simple example. “Assume a grantor creates a . . . [GST]. Under the terms of the trust instrument the current income may be paid to the grantor’s child A for life, or accumulated for the benefit of other [YGB’s] at A’s death.”\textsuperscript{191} On these facts, A has a present interest, and the other YGB’s have future interests.\textsuperscript{192}

A more complicated example illustrates the nature of the interests under the Uniform Gift to Minors Act.\textsuperscript{193} “A transfers $1,000,000 to his grandchild B, a minor, under the Uniform Gift to Minors Act and names C, an unrelated party, the custodian. All the income is accumulated until B reaches the age of majority.”\textsuperscript{194} If no portion of the gift is used to discharge their obligation of support, B’s parents have a future interest.\textsuperscript{195} Thus, when B attains majority, there is no taxable termination.\textsuperscript{196} If any portion of the gift is used to discharge B’s parents’ legal obligation of support, however,\textsuperscript{197} the parents’ have a present interest, and there

\textsuperscript{189} Id. § 2613(d)(2).
\textsuperscript{191} Id. § 26.2613–4(e), example (1).
\textsuperscript{192} Id.
\textsuperscript{193} UNIF. GIFT TO MINORS ACT, 8 U.L.A. 181 (1972).
\textsuperscript{194} Prop. Treas. Reg. § 26.2613–4(e), example (3).
\textsuperscript{195} Id.
\textsuperscript{196} Id.
\textsuperscript{197} Id. “If upon the exercise of a power by a trustee or custodian, an individual is relieved of any legal obligation, that individual’s interest becomes a present interest.” Id. § 26.2613–4(d).
will be a taxable termination when B becomes an adult.\textsuperscript{198}

The remaining example in the regulations illustrates how a beneficiary may have both an interest and a power. "G creates a [GST]. Under the terms of the trust instrument, the income is payable to G's children for their joint lives with the last surviving child having a nongeneral testamentary power of appointment over the trust assets. The last surviving child has a present interest and a future power."\textsuperscript{199} The persons who could benefit from the exercise of the power are all beneficiaries having no present interest.\textsuperscript{200}

The test for determining when a power is a present power causing a taxable termination on its lapse or exercise is whether "the property subject to the power would have been included in the estate of the power holder under section 2036 or 2038 had the power holder been settlor of the trust."\textsuperscript{201} This regulation imports the extensive case law regarding a trustee's powers under sections 2036 and 2038 into the law of generation-skipping transfers.\textsuperscript{202} The statute, however, is concerned only with beneficial, and not

\textsuperscript{198} Id. § 26.2613-4(e), example 3. The commissioner's example appears to be an unwarranted extension of the law. First, an accumulation during the minor's minority is treated as a gift of a future interest \textit{to the parent}. Under traditional federal gift tax analysis, this accumulation has been treated as a gift of a future interest \textit{to the minor}, and it would fail to qualify for the $10,000 gift tax exclusion, unless expressly made to qualify under I.R.C. § 2503(c) or possibly a \textit{Crummey} trust under I.R.C. § 2503(b). \textit{See infra} note 286 and accompanying text. Planners choosing this route risk the Commissioner's treating the entire arrangement as the equivalent of a trust for the parent's benefit during the minor's minority.


\textsuperscript{200} Id.

\textsuperscript{201} Id. § 26.2613-4(d).

\textsuperscript{202} \textit{See}, e.g., Helvering v. City Bank Farmers Trust Co., 296 U.S. 85, 92, \textit{reh'g}\textit{denied}, 296 U.S. 664 (1935), where the Supreme Court held that property transferred subject to a power of revocation exercisable by one of the beneficiaries required inclusion in gross estate under § 302 of the Revenue Act of 1926 (I.R.C. § 2038(a)(1) (1976)). Section 2038 applies to powers over enjoyment of the transferred property, and § 2036(a)(2) applies to powers of possession or enjoyment of the property and income.

The introduction of §§ 2036 and 2038 into the GSTT substantially broadens the scope of the statute. Under these concepts, the \textit{retention by the settlor} of the power to alter the time or manner of enjoyment of the trust property or income would cause the assets of an \textit{inter vivos} trust to be included in the settlor's gross estate. The commissioner would extend the effects of these powers, for purposes of the GSTT, to trustees generally. The taxpayer would have the burden of showing that the trustee was independent and not "related or subordinate." I.R.C. § 2613(e)(2)(ii) (1976). \textit{See} Prop. Treas. Reg. § 26.2613-7(a)(2), 46 Fed. Reg. at 129.

This definition is more extensive than the similar definition for income tax purposes. \textit{Compare} I.R.C. § 2613(e)(2)(B) (1976) (defining "related or subordinate trustee" for purposes of the GSTT) \textit{with} id. § 672(c) (defining "related or subordinate party" for purposes of the income tax on trust income).
fiduciary, powers. 203

The value of a power for purposes of a taxable termination is the value of the trust property subject to the power, determined as of the termination date. 204 This valuation is proper, even though the power is subject to an ascertainable external standard. 205 The valuation also is proper when the beneficiary holds a “five-and-five” power. Assume the value of the principal of a trust is $100,000 and the beneficiary may withdraw annually five percent of the trust corpus206 or five thousand dollars, whichever is greater. The value both of the property and the power is still $100,000 “regardless of the number of years for which the power was held, exercised or allowed to lapse and regardless of the average value of the trust during the period the power was held.”207

The annual lapse of a general power that is not taxable under the federal estate and gift taxes is not a taxable event under the GSTT. 208 The release, final lapse, or exercise of the power, however, may be a taxable termination. 209 When a power is exercisable only over a portion of the trust property, just that portion is considered in valuing the property.210

2. The Exceptions

The Code provides two specific exceptions for certain powers held by third parties having no beneficial interest in the trust. The first exception concerns those having no present future power in the trust “other than a power to dispose of the corpus of the trust or the income therefrom to a beneficiary or a class of beneficiaries who are lineal descendants of the grantor assigned to a generation younger than the generation assignment of such individual.”211 This power provides a degree of flexibility for the estate planner.

203. Cf. Old Colony Trust Co. v. United States, 423 F.2d 601 (1st Cir. 1970) (estate of settlor-trustee charged with value of principal where inter vivos trust instrument gave trustee the discretion to decrease or cease income payments to life beneficiary, a son of settlor-trustee).


205. Id. § 26.2613-2(b)(3)(ii), 46 Fed. Reg. at 125. It is assumed that the beneficiary's needs are “not so remote as to be negligible . . . .” Id.; see also STAFF EXPLANATION, supra note 74, at 574.


207. Id. See also STAFF EXPLANATION, supra note 74, at 574.


209. Id.

210. Id. § 26.2613-3(b)(2).

desiring to place a power in a person having no other interest in the trust. This provision is illustrated in the following example. Grantor, G, establishes a GST with the income payable to a GC for life. At the death of GC, the trustee is to distribute the principal to such persons as G's child, C, appoints from among the lineal descendants of G who are assigned to the generation of GC or any younger generation. C appoints the remainder interest to GGC. C dies. There is no taxable termination at C's death by virtue of C's power over the trust property. When GC dies, there is a taxable termination due to the termination of GC's interest in the trust. If the drafter provides that C can appoint the right to receive principal to the lineal descendants of G, there is a taxable termination at C's death since C could have appointed to his or her own generation.

When the GSTT was first enacted, there was no provision affording independent trustees an exception from the rules. Such trustees often have a sprinkling or spray power to distribute trust income and principal to beneficiaries. This omission was corrected with the addition of section 2613(e)(2) to the Code.212

Under the Code and regulations, a trustee is deemed to have no power in the trust if such individual has no interest in the trust,213 is not "related or subordinate" to the grantor or any beneficiary of the trust,214 and possesses no present or future power in the trust other than a spray or sprinkling power to dispose of the corpus or income of the trust for the benefit of beneficiaries designated in the instrument.215

A number of relationships, similar to those in the "related or subordinate party" classification for purposes of taxation of trust income to the settlor,216 cause a trustee to be deemed "related or subordinate." Among these relationships are those of spouse,217 father, mother, lineal descendant, brother, or sister,218 employee

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216. See I.R.C. § 672(c) (1976). A related or subordinate party is presumed to be subservient to the grantor unless otherwise shown not to be by a preponderance of the evidence. Id.
of a corporation "in which the stockholdings of the grantor, the
trust, and the beneficiaries of the trust are significant from the
viewpoint of voting control";\textsuperscript{219} employee of a corporation "in
which the grantor or any beneficiary of the trust is an executive";\textsuperscript{220} partner of a partnership "in which the interest of the
gantor, the trust, and the beneficiaries of the trust are [sic] signifi-
cant from the viewpoint of operating control or distributive share
of partnership income";\textsuperscript{221} or employee of a partnership "in which
the grantor or any beneficiary of the trust is a partner."\textsuperscript{222}

A trustee is not deemed to have a power in a trust "merely
because one or more of the potential appointees under a power of
appointment held by another is the trustee's spouse, father,
mother, brother or sister."\textsuperscript{223} The Commissioner illustrates this
rule with the following example:

Assume grantor A creates a trust for the benefit of A's chil-
dren B and C for their joint lives and for the life of the survi-
vor. Upon the death of the survivor, the corpus is payable to
A's great-grandchildren if B fails to exercise his nongeneral
power of appointment. . . . A appointed A's close friend G as
trustee.\textsuperscript{224}

On these facts, G has no power, although the trustee's spouse is a
potential appointee.\textsuperscript{225}

\section*{H. Calculation and Administration of the GSTT}

The proposed regulations issued under section 2611 through
2613 of the Code constitute the substantive law of the GSTT. The
procedural law is articulated in temporary regulations.\textsuperscript{226} These
regulations are based on Code sections concerning the imposi-

\textsuperscript{221} Id. § 2613(e)(2)(B)(v). A partnership interest is considered significant if at least
five percent of the partnership is owned by the grantor, the trust, or beneficiaries of
\textsuperscript{224} Id. § 26.2613-7(c).
\textsuperscript{225} Id.
\textsuperscript{226} Temporary Generation-Skipping Transfer Tax Regulations under the Tax Re-
form Act, 26 C.F.R. § 26a.2621 (1981). Throughout this Article, all cites to the temporary
regulations will be designated Temp. Reg.
tion and administration of the tax.\textsuperscript{228}

1. \textit{Method of Calculation}

Section 2601 is a structural statute imposing the GSTT on "every generation-skipping transfer in the amount determined under Section 2602."\textsuperscript{229} According to its legislative history, the GSTT:

would be substantially equivalent to the estate or gift tax which would have been imposed if the property had actually been transferred outright to each generation. This is achieved by adding the amount subject to tax as the result of the generation-skipping transfer to the other taxable transfers of the "deemed transferor." The net effect is that the generation-skipping transfer is taxed at the marginal rate of the deemed transferor.\textsuperscript{230}

A tentative tax is computed on the total of the deemed transferor's (1) taxable gifts made previously,\textsuperscript{231} (2) taxable estate,\textsuperscript{232} (3) prior generation-skipping transfers,\textsuperscript{233} and (4) current transfer.\textsuperscript{234} Subtracted from the total is a tentative tax on the first three of these items.\textsuperscript{235}

The result is the GSTT at the deemed transferor's marginal tax rate.

2. \textit{Payment of the Tax}

In the GSTT statutory scheme, the taxation of taxable distributions is analogous to the imposition of the gift tax. The recipient, however, pays the GSTT, while the donor pays the gift tax.\textsuperscript{236} If the transferor pays the tax on behalf of the transferee, the latter receives an additional taxable distribution.\textsuperscript{237} Funds used by the grantor to pay the gift tax are never subject to any transfer tax.\textsuperscript{238}

The analogy of the taxation of taxable terminations to the estate

\textsuperscript{227} I.R.C. §§ 2601–2603 (1976).
\textsuperscript{228} Id. §§ 2621–2622.
\textsuperscript{229} Id. § 2601.
\textsuperscript{230} STAFF EXPLANATION, supra note 74, at 575.
\textsuperscript{231} I.R.C. § 2602(a)(1)(C) (1976).
\textsuperscript{232} Id. § 2602(a)(1)(D).
\textsuperscript{233} Id. § 2602(a)(1)(B).
\textsuperscript{234} Id. § 2602(a)(1)(A).
\textsuperscript{235} Id. § 2602(a)(2).
\textsuperscript{236} Id. § 2603(a)(1)(B).
\textsuperscript{238} With \textit{inter vivos} transfers includable in the gross estate under §§ 2036, 2037, 2038, 2041, and 2042 occurring within three years of death, the gift tax is "grossed up," resulting in the inclusion of both the transfer and gift tax in the gross estate. I.R.C. § 2035(c) (1976)
tax is even closer. Both taxes are paid out of the property, and the tax is imposed on the transferor. One difference is that under the estate tax, the transferor is either the owner or his or her near equivalent of the property, while the deemed transferor of the GSTT does not purport to be the owner of any of the property.

The distributee remains personally liable up to the fair market value of the property transferred “until the tax is paid in full or becomes unenforceable by reason of lapse of time.” This potential liability exists whether the property received by the distributee results from a taxable distribution or taxable termination. To file a proper return and pay the tax on taxable terminations, the trustee needs certain information regarding the deemed transferor’s tax history. If the taxable termination occurs on the deemed transferor’s death, the trustee may obtain the necessary information from the deemed transferor’s personal representative. The distributee also needs the tax history of the deemed transferor to file a proper GSTT return on any taxable distribution. The trustee obtains the necessary information from the Internal Revenue Service and is exempted from personal liability if the service furnishes erroneous tax rates. The staff explanation acknowledges the right of any person required to file a GSTT return to obtain all information from the Internal Revenue Service necessary “to properly prepare the return (or any refund claim).”

The distributee(s) and trustee must file the GSTT return on
taxable distributions and taxable terminations for any trust.\textsuperscript{247} Since a GST equivalent has no trustee, the distributee must file the return.\textsuperscript{248} When an entity is the distributee, the duty to file the GSTT return falls on those individuals deemed the beneficiaries for purposes of the ascertainment of generations.\textsuperscript{249} A fiduciary or agent must file the return for a minor,\textsuperscript{250} an incompetent,\textsuperscript{251} a disabled person,\textsuperscript{252} or deceased distributees.\textsuperscript{253}

When there are two or more distributees, the GSTT is prorated among them in proportion to the fair market values of their respective interests.\textsuperscript{254} If one or more distributees fail to join in the filing of the return, the remaining distributee(s) must file for the whole transfer and recover any tax attributable to the nonfiling distributees.\textsuperscript{255} For taxable terminations, only one trustee files the return,\textsuperscript{256} but all trustees must be notified.\textsuperscript{257}

\begin{itemize}
  \item[(v)] The amount of generation-skipping transfer tax imposed before the allowance of any credits with respect to prior generation-skipping transfers,
  \item[(vi)] The amount of State death tax credit allowed on the deemed transferor’s estate tax return and the amount of State death tax credit allowed on prior generation-skipping transfer tax returns,
  \item[(vii)] The amounts necessary to complete Schedule F, Credit for Tax on Prior Transfers,
  \item[(viii)] The amount of the grandchild exclusion that has been used for transfers to a grandchild of the grantor,
  \item[(ix)] The amount of any taxable distributions or taxable terminations that occurred during the same taxable year and that were made from other trusts having the same deemed transferor, and
  \item[(x)] Any other data that may be needed to complete Form 706-B, Generation-Skipping Transfers Tax Return.
\end{itemize}

\textsuperscript{248} Id. § 26a.2621-1(b)(1)(iii).
\textsuperscript{249} Id. § 26a.2621-1(b)(2). \textit{See} I.R.C. § 2611(c)(7) (1976) (determination of deemed beneficiaries where entity is distributee).
\textsuperscript{250} Temp. Reg., 26 C.F.R. § 26a.2621-1(b)(3)(i) (1981). The fiduciary is the minor’s guardian or other person charged with the care of the minor’s person or property. Id.
\textsuperscript{251} Id. § 26a.2621-1(b)(3)(ii). The fiduciary is “the guardian or committee of an insane person.” Id.
\textsuperscript{252} Id. § 26a.2621-1(b)(3)(ii). An agent may file a return for those unable to do so due to disease, injury, illness, or absence from the country. “[T]he return must be ratified by the principal within a reasonable time after such person becomes able to do so.” Id.
\textsuperscript{253} Id. § 26a.2621-b(3)(ii). The fiduciary is “the executor or other person in possession of the decedent’s [the distributee’s] assets . . . .” Id.
\textsuperscript{254} Id. § 26a.2621-1(b)(4)(i), (b)(i).
\textsuperscript{255} Id. § 26a.2621-1(b)(4)(i).
\textsuperscript{256} Id. § 26a.2621-1(b)(4)(ii).
\textsuperscript{257} Id. The trustee or trustees are “personally liable for the tax imposed on the transfer if the tax is not paid when due.” Id. § 26a.2621-1(b)(2).

For purposes of filing a return, the trustee is required to prepare two forms for taxable distributions: (1) Form 706-B(1) (Information Return by Trustee for a Taxable Distribution or Termination from a Generation-Skipping Trust); and (2) Form 706-B(2) (Beneficiary’s Share of a Taxable Distribution from a Generation-Skipping Trust). Id. § 26a.
I. Certain Transfers Within Three Years of Death

Section 2035 provides that certain transfers during the three-year period prior to a decedent's death are included in the gross estate.\(^2\) In addition, the amount of gift tax paid on these transfers is "grossed up" and included in the decedent's gross estate.\(^3\) The GSTT follows these principles by imposing a tax "determined as if the transfer occurred after the death of the deemed transferee."\(^4\) As a result of taxing the GST at the deemed transferee's death, the amount of tax imposed is increased. This increase exists especially in an inflationary period since the appreciation between time of transfer and time of death, plus the amount of transfer tax paid are all subject to the transfer tax. The temporary regulations solve this problem and provide a method for handling the problem of amending a GSTT return when the deemed transferee has made a generation-skipping transfer falling within section 2602(e). In such a case, "[t]he due date for the return is determined as if the prior transfer occurred at the same time as the deemed transferee's death and the tax must be recomputed as if the transfer had occurred immediately after the deemed transferee's death."\(^5\)

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2621-1(f)(1). The first form is filed with the Internal Revenue Service Center, where the distributee will later file Form 706-B. \(\text{Id.}\) Form 706-B(2) must be sent by the trustee to the beneficiary within the time that the trustee is required to file Form 706-B(1). \(\text{Id.}\) The distributee(s) then prepares his or her Form 706-B based on the information received from the trustee. Only one Form 706-B is required to be filed by two or more YGB's having the same deemed transferee. \(\text{Id.}\)

When the deemed transferee is living, the filing date for Form 706-B(1) is the "fifteenth day of the third month following the close of the taxable year of the trust," or March 15 for a trust on the calendar year. \(\text{Id.}\) § 26a.2621-1(f)(2). Six months after the close of the trust's tax year, June 30, for a trust on the calendar year, the distributee(s) or the trustee must file Form 706-B for any taxable distributions or terminations that occurred during the tax year. \(\text{Id.}\) § 26a.2621-1(c)(1). "In the case of a taxable distribution or termination that occurs within the same taxable year as the death of the deemed transferee, or any time after the death of the deemed transferee," the due date for Form 706-B is the later of six months after the close of the trustee's taxable year or six months after the federal estate tax return of the deemed transferee is due. \(\text{Id.}\) If there is a postponement of a taxable termination, the due date for filing the returns is measured "from the date on which the transfer is deemed to occur," rather than the date of the actual transfer. \(\text{Id.}\)

258. I.R.C. § 2035(a) (1976). \(\text{See supra}\) note 238.

259. \(\text{Id.}\) § 2035(e).

260. \(\text{Id.}\) § 2602(c). Additional adjustments for any prior GST or taxable gifts of the deemed transferee must be made. \(\text{See id.}\) § 2602(a)(10)(B), (C). \(\text{See also supra}\) note 231 and accompanying text.

IV. ESTATE PLANNING AND THE GSTT

With the enactment of ERTA, questions arise as to the extent to which estate planning principles have been modified and, more particularly, how the planner should integrate the GSTT with respect to these principles. Three estate and gift tax changes are especially interesting to the estate planner: the unlimited marital deduction,262 the new gift tax exclusions,263 and the new treatment of gifts made within three years of death.264 The greatest single change is that the planner no longer is required to limit the size of the deduction to the greater of $250,000 or one-half of the adjusted gross estate.265 In addition, community property now qualifies for the deduction,266 and the planner is free to depart from the familiar pattern of giving $2, the surviving spouse, a general power of appointment to qualify for the marital trust deduction.267 As a result, the planner has much flexibility in developing plans, and the distinction between estate plans in community property and common law states is all but eliminated.268

Effective estate planning requires the planner to coordinate both tax and nontax objectives. To effect these dual goals, the planner must make several inquiries. The planner must determine whether $2 already has substantial property and must formulate the plans to be made in the event that $2 predeceases $1, the spouse owning the bulk of the family's wealth. The planner also must decide whether an attempt should be made to equalize the size of the estates of both $1 and $2. Regarding control over the estate plan, the planner must exercise judgment about the importance of $1's retention of control and should ask whether $2 is to maintain as much control as possible after $1's death. With reference to taxation, the planner must ask whether the primary tax objective of $1 and $2 is to defer payment of transfer taxes as long as possible, regardless of the amount.

262. See supra note 11.
263. See supra notes 91–92 & 144–53 and accompanying text.
264. See supra notes 258–61 and accompanying text.
266. ERTA § 403(c).
268. The planner in a common law state, for example, may make a tax-free interspousal transfer from $1 to $2, so that the two estates are equalized. See I.R.C. § 2523 (1976). Alternatively, the planner may elect to use the new "qualified terminable interest" election under Code § 2056(b)(7). ERTA § 403(d)(1). The planner in the community property state has similar options and can adjust differences between the estates of $1 and $2, or use the qualified terminable interest election.
Other questions for the planner include whether a charitable remainder plan\textsuperscript{269} in $S_2$ is desirable if $S_1$ and $S_2$ are childless; whether $S_1$ and $S_2$ have a plan to make \textit{inter vivos} gifts, or whether a gift program should be established; whether property should be retained until death to take advantage of a stepped-up basis; and, the way in which the estate plan should be coordinated to obtain optimal advantage from both $S_1$'s and $S_2$'s unified credits.

In planning the disposition of $S_1$'s estate to obtain the most favorable transfer tax situation, the planner has three basic choices. The first choice (plan A) transfers $S_1$'s entire estate to $S_2$ through outright gift to $S_2$, gift of life estate with general power of appointment to $S_2$, or gift of life estate to $S_2$, remainder to $S_2$'s estate (the so-called "estate trust"). The second choice (plan B) establishes a "Q-TIP" trust\textsuperscript{270} for $S_2$ under new section 2056(b)(7) and elects to defer the taxation of the family's wealth accumulation until the death of $S_2$, or until $S_2$ disposes of the life interest, whichever event occurs first. The third choice (plan C) provides that a portion of $S_2$'s estate go to the next generation and that the balance go to $S_2$, under plan A or B. This portion is measured by the amount necessary to gain optimal benefit of the unified credit (plan C-1); or, alternatively, $S_2$ is given roughly one-half of $S_1$'s property to equalize the two estates (plan C-2).

Under plan A, there is no tax upon $S_1$'s death, but $S_1$ will have to pay a substantial tax to pass the property to the next generation, thereby leaving less for the next generation. Historically, Plan B was considered "under-qualification." Prior to the introduction of the marital deduction, a large tax would be paid at $S_1$'s death but there would be no tax at $S_2$'s later death when the remainder vested in the next generation. $S_1$, however, could control the ultimate disposition of the property.\textsuperscript{271} By allowing $S_1$'s personal representative to defer the tax until $S_2$'s later death, the new law allows $S_1$ to retain control without the former adverse tax consequence. Plan C is a combination of the other two plans and seeks to obtain the maximum tax benefit. Plan C necessarily will involve the drafting of a residuary clause in accordance with the

\textsuperscript{269} Under the new law, $S_1$ may give $S_2$ a terminable interest followed by a remainder to charity under a qualified charitable remainder trust, and both interests will be fully deductible. See ERTA § 403(d)(1).

\textsuperscript{270} See supra note 20.

\textsuperscript{271} 2 H. Wren, Creative Estate Planning § 12.01 (1970).
To appreciate the tax effects of these various estate plans, assume three different taxable estates of $1 million, $2 million, and $5 million, respectively. Under Plan A, there is no tax upon S₁'s death. At S₂'s later death, the taxes would be as follows:

- At the $1 million level: $153,000
- At the $2 million level: $588,000
- At the $5 million level: $2,083,000

Under plan B, if S₁'s estate should elect to treat S₂'s life estate as a "qualified terminable interest," the results would be the same. If S₁'s executor does not elect to treat S₂'s life interest as a "qualified terminable interest" under section 2056(b)(7), however, S₁'s estate will have to pay estate tax at S₁'s death.

Both plans A and B fall short of the optimum estate plan. The principal advantage of these plans is that no tax is paid on S₁'s death. All taxes in the generation of S₁ and S₂ may be deferred until the second death. The two plans, however, suggest some deficiencies: (1) no effort is made to take advantage of S₁'s unified credit; (2) no effort is made to reduce the taxation levels of S₁ and S₂ by taxing two estates at lower rates; and (3) any transfer tax paid at S₁'s death will reduce correspondingly the amount available to be taxed at S₂'s later death. These deficiencies may be corrected by passing some of S₁'s estate to the next generation, but a question remains as to the quantity of the estate property to be passed.

One solution (plan C-1) is to give the next generation the equivalent of S₁'s exemption through the unified credit. Following this approach, by 1987, $600,000 could be passed to the next generation at S₁'s death tax free. At S₂'s death the transfer tax then would be:

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272. An example of such a clause is:

I give to S₂ an amount equal to the smallest amount that, if allowed as a deduction in computing the federal estate tax liability of my estate, would reduce such liability (after taking into account all credits allowed against such tax) to zero, diminished by the value for such purposes of all other items in said gross estate qualifying for said deduction and passing to my wife under other provisions of this will or otherwise, all such values to be as finally determined for federal estate tax purposes.

If the drafter uses a fractional share formula, the first portion of the above clause will read:

I give to S₂ that fraction of my residuary estate of which the numerator is the smallest amount that, . . . [balance of the clause as above].

See generally D. Westfall, ESTATE PLANNING 491 (1982).
ESTATE PLANNING

<table>
<thead>
<tr>
<th>Taxable Estate</th>
<th>$1 million level</th>
<th>$2 million level</th>
<th>$5 million level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable Estate Tax</td>
<td>121,800</td>
<td>512,800</td>
<td>1,975,800</td>
</tr>
<tr>
<td>Minus Unified Credit</td>
<td>192,800</td>
<td>192,800</td>
<td>192,800</td>
</tr>
<tr>
<td>Tax Payable</td>
<td>$ -0-</td>
<td>$320,000</td>
<td>$1,783,000</td>
</tr>
</tbody>
</table>

This solution does not take advantage of the elimination of some tax from $S_2$’s estate by paying some estate tax at $S_1$’s prior death, but it does provide tax deferral. If $S_2$’s needs could be met at the $2$ and the $5$ million levels by a gift of fifty percent of these amounts at $S_1$’s death, the total transfer tax cost to $S_1$ and $S_2$ could be reduced further:

| Gift to $S_2$ (upon $S_1$’s death) | $1,000,000 | $2,500,000 |
| Gift to Next Generation (upon $S_1$’s death) | $847,000 | $1,667,000 |
| Tax upon $S_1$’s Death | $153,000 | $833,000 |
| Tax upon $S_2$’s Death | $153,000 | $833,000 |
| Total Transfer Taxes | $306,000 | $1,666,000 |

In short, by paying some of the transfer taxes on the family unit upon $S_1$’s prior death, the planner may save substantial amounts:

<table>
<thead>
<tr>
<th>Plans A-B</th>
<th>Plan C-1 ($600,000 to next generation)</th>
<th>Plan C-2 (50% to $S_2$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1 million level</td>
<td>$153,000</td>
<td>$ -0-</td>
</tr>
<tr>
<td>$2 million level</td>
<td>588,000</td>
<td>320,000</td>
</tr>
<tr>
<td>$5 million level</td>
<td>2,083,000</td>
<td>1,783,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Tax Savings Between Plans A &amp; B and Plan C-1</th>
<th>Tax Savings Between Plans A &amp; B and Plan C-2</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1 million level</td>
<td>$153,000</td>
</tr>
<tr>
<td>$2 million level</td>
<td>268,000</td>
</tr>
<tr>
<td>$5 million level</td>
<td>300,000</td>
</tr>
</tbody>
</table>

These solutions have not necessarily resolved all problems facing the planner. If, for example, $S_2$ predeceases $S_1$, and $S_1$ owns all the family property, the potential savings will disappear. An alternative plan would provide for a tax-free interspousal transfer from $S_1$ to $S_2$ of approximately one-half of $S_1$’s adjusted gross estate. The estates would then be roughly equal and the results described above would follow regardless of who dies first.
Moreover, since the estate of the first spouse to die could elect to treat a transfer to the other for life as a “qualified terminable interest,” the advantage of splitting the transfer tax between two estates is still available.

Another method for reducing the transfer tax burden on S₁ and S₂ is to establish a lifetime gift program to reduce the size of their holdings and transfer portions of their estate for several years preceding their deaths. If, for example, S₁ and S₂ have three children and establish a gift program transferring $20,000²⁷³ to each child each year for a ten-year period, the results will be as follows:

<table>
<thead>
<tr>
<th>Original Total Estate</th>
<th>$1 million level ($1,000,000)</th>
<th>$2 million level ($2,000,000)</th>
<th>$5 million level ($5,000,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minus Gifts Over Ten Years ($60,000 per year)</td>
<td>600,000</td>
<td>600,000</td>
<td>600,000</td>
</tr>
<tr>
<td>$ 400,000</td>
<td>$1,400,000</td>
<td>$4,400,000</td>
<td></td>
</tr>
</tbody>
</table>

Under this program, there are no federal transfer taxes at all at the $1,000,000 level. At the $2 and $5 million levels, the results will be:

| Gift to S₂ at S₁’s Death | $700,000 | $2,200,000 |
| Gift to Next Generation upon S₁’s Death | $663,000 | $1,514,000 |
| Tax upon S₁’s Death | 37,000 | 686,000 |
| Tax upon S₂’s Death | 37,000 | 686,000 |
| Total Transfer Taxes | $ 74,000 | $1,372,000 |

Tax savings at the $2 and $5 million levels are $514,000 and $711,000, respectively.

Prior to 1982, any transfer by S₁ within three years of his or her death was included in the gross estate.²⁷⁴ Such a transfer was subject to both gift and estate taxes, and a credit for any gift tax paid was applied against the estate tax. The result was to tax the gift's value at the time of transfer, plus any appreciation in value between time of transfer and death. In addition, any gift tax paid was "grossed up," so that this additional sum was subject to estate tax.

²⁷³ I.R.C. § 2503(b) (1976). The transfers, of course, must not be gifts of future interests. Moreover, the general transfer of $20,000 to each donee presupposes that S₂ will consent to the appropriate gift splitting.

²⁷⁴ Id. § 2035(a), (d)(1).
The net effect of the two transfer taxes was to place the transferor in the same transfer tax position as a transferor who retained the property until death.

ERTA retains the "gross up" feature for transfers within three years of death, but limits the three-years-of-death rule to situations in which property would be includable under the inter vivos transfer sections, the exercise of a general power of appointment, or the transfer of life insurance. While the appreciation between time of transfer and death is not subject to the transfer tax system as to all other transfers, this appreciation is subject to income tax in the hands of the transferee upon ultimate disposition of the property. As a result, the planner will seek to use "high basis" property for any transfer by gift.

To illustrate the problems of coordinating the GSTT with the new ERTA rules, assume that (1) S₁ and S₂ make no inter vivos gifts; (2) the bulk of the family's wealth is approximately $2,000,000 and owned by S₁; (3) S₁ and S₂ have three children; (4) each child has two children; and (5) there is a likelihood that S₁ will predecease S₂. Assume further, that S₁ desires to retain control over the estate and obtain maximum tax advantages. The planner might suggest that approximately $600,000 be transferred to the three children at S₁'s death, and that the tax burden be borne entirely by this portion of the estate, so to relieve S₂ from all transfer tax responsibility. The planner also might recommend the use of a Q-TIP trust to defer estate taxation until S₂'s death, such trust giving S₂ a life estate, with remainder over to the grandchildren. The estate planner also might want to take advantage of the $250,000 exclusion upon the deaths of each of the three children, with remainders over the grandchildren of S₁ and S₂. Assuming S₁ is the husband, his will might read:

I give my estate to my trustee, the X Trust Company, in trust, on the following conditions: (1) My trustee shall hold in trust for the lives of my three children, A, B, and C, and the life of the survivor, property of a fair market value, as determined for federal estate tax purposes, equal to the exemption equivalent for purposes of the unified credit of the federal estate tax in force at the time of my death; and at the date of the death of the

275. Id. § 2035(c).
276. Id. §§ 2036–2038.
277. Id. § 2041.
278. Id. § 2042.
279. The transferee's basis normally will equal the basis of the transferor, increased by any gift tax paid with respect to the transfer. Id. § 1015.
last survivor of my three children, my trustee shall distribute the principal and any accumulated income from the said trust to the children of A, B, and C, living at the death of the last survivor thereof. This trust shall be known as the “Husband Family Trust.”

(2) My trustee shall hold the balance of my residuary estate in trust for my wife for her natural life, and at her death distribute the principal of this portion of my estate to my grandchildren, per capita, living at the death of my wife, in equal shares. If any one or more of my grandchildren shall be under age eighteen at the death of my wife, I direct that his or her share shall be held in trust until he or she shall reach age eighteen, at which time my trustee shall distribute the principal and any accumulated income for his or her share to him or her. This trust shall be known as the “Wife Grandchildren Trust.”

(3) I authorize my executor to elect to treat the life interest in my estate which I have given to my wife as a qualified terminable interest under the Internal Revenue Code.

Assuming the husband S₁ dies in 1987, or thereafter, this estate plan eliminates the transfer tax at S₁’s death since the Husband Family Trust is covered by the unified credit. At the wife’s death, the gross estate equals $1,400,000 with an estate tax of $320,000, leaving a balance of $1,080,000 for distribution to the grandchildren at that time. Since S₁ and S₂ are of the same generation, S₁ is not a younger generation beneficiary (YGB), and the Wife Grandchildren Trust is not a GST. The “Husband Family Trust” is a GST. On the death of the last survivor, there is a $250,000 exemption each for A, B, and C as deemed transferors for as much as a twenty-five percent increase in the value of the trust prior to its being distributed to the grandchildren.

Moreover, through this estate plan, S₁ accomplishes several objectives. S₁ transfers an estate of $2,000,000 to his children and grandchildren at a cost of $320,000, or a net transfer of $1,680,000. At an annual return of six percent on $1,400,000, S₁ provides S₂ with an annual income for life of $84,000, and provides the children an income of $12,000 per year for their lives. In addition, S₁ makes it possible for his grandchildren to assume an inheritance of $280,000.

S₁ can vary these results, depending on family needs. If, for

280. See supra note 2.
282. This problem assumes constant values. The planner, however, may plan deliberately for appreciation or depreciation values.
283. This assumes a rate of return on the Wife Grandchildren Trust of six percent per annum.
example, the income amounts provided A, B, and C ($12,000 each per year) are insufficient, S1 can give more to the children and less to S2. This procedure increases the size of the Husband Family Trust without increasing the GSTT on the death of the survivor of A, B, and C. S1 can increase the trust for A, B, and C to a total of $750,000. This addition would allow an increase in the children’s annual income to approximately $15,000 at a federal estate tax cost of $94,500. S1 would have to consider whether this immediate tax cost is worth the relatively small increase in annual income to his children.

Under ERTA, S1 may make a tax-free inter vivos transfer of one-half of the estate to S2. The principal advantage of such a move is its protection against the possibility of losing the marital deduction in the event S1 should predecease S2. S1 and S2 now may establish separate GST’s, for A, B, and C, utilizing the $250,000 exclusions for both of them with respect to each of their three children.

The planner may want to recommend one or more tax-free interspousal transfers. If S1 is willing to give S2 control of one-half of the estate, both S1’s and S2’s will can be drawn to take advantage of the qualified terminable interest rule, thereby eliminating the risk of failure of the estate plan due to S1’s unforeseen death. At the $2,000,000 level, one-half or $1,000,000 is transferred tax-free to S1. S1’s will provides that if S2 survives, the $1,000,000 estate shall be placed in trust to pay the income to S2 for life with remainders over to the children and grandchildren. If S1 predeceases S2, the property is to be placed in trust for the children and grandchildren.

S2’s will is similar to S1’s in that it provides that if S1 survives S2, S2 will take a life estate in S1, with remainders over to the children and grandchildren. If S1 should fail to survive S2, S2’s estate passes directly to the children and grandchildren. The ef-
fect of this plan is to transfer a net of $1,694,000 on a $2,000,000 estate to succeeding generations. Of this amount, $750,000 can pass from the children to the grandchildren through a GST utilizing three $250,000 exemptions, and the balance ($944,000) can be transferred directly to the grandchildren, thereby avoiding the GSTT.

This plan, however, does not involve the establishment of separate trusts by both $S_1$ and $S_2$. There is no reason why both cannot be grantors of their separate estates. $S_1$ and $S_2$ may want to act separately and have each of their estates pass into a GST for the children and grandchildren. Under such a plan, $S_1$ and $S_2$ give their estates in trust to $A$, $B$, and $C$ for their lives, with remainders over to the grandchildren. The planner also might utilize separate shares in lieu of the Husband Family Trust discussed above. The planner also might choose a per stirpes distribution to grandchildren in lieu of the per capita distribution. In this event, the total tax cost and the value of the trusts created would be as follows:

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$S_1$'s Estate</td>
<td>$1,000,000</td>
<td></td>
</tr>
<tr>
<td>Tax Thereon</td>
<td>345,000</td>
<td></td>
</tr>
<tr>
<td>Minus Unified Credit</td>
<td>192,800</td>
<td></td>
</tr>
<tr>
<td>$S_1$'s Federal Estate Tax</td>
<td>153,000</td>
<td></td>
</tr>
<tr>
<td>Add $S_2$'s Federal Estate Tax</td>
<td>153,000</td>
<td></td>
</tr>
<tr>
<td>Total Tax Cost</td>
<td>$306,000</td>
<td></td>
</tr>
<tr>
<td>$S_1$'s Trust for $A$, $B$, &amp; $C$ ($1,000,000 - $153,000)</td>
<td>$847,000</td>
<td></td>
</tr>
<tr>
<td>$S_2$'s Trust for $A$, $B$, &amp; $C$ ($847,000 + $1,000,000 - $153,000)</td>
<td>$1,694,000</td>
<td></td>
</tr>
</tbody>
</table>

At the death of the survivor of $A$, $B$, and $C$ (or on their respective deaths, if the separate share rule is utilized), there would be little or no additional tax since the deemed transferor could utilize both the $250,000 exclusions and their respective unified credits.

From the estate planning perspective, one of the most important changes in the ERTA is the increase in the section 2503 gift exclusion from $3,000 to $10,000. The planner now can arrange for the transmission of substantial amounts of property over a period of time, free of any transfer taxation, through the establishment of effective gift programs.

For most programs, the key to success lies in ascertaining that any transfer to a donee is a transfer of a present interest. To the extent that the interest transferred to the transferee is a future interest, the deduction will be lost. In planning gifts to minors, planners may elect to use the more flexible Crummey (section
2503(b)) trusts in preference to section 2503(c) trusts. If the minor beneficiary has the right to demand the income from the trust, the planner is assured that the gift is a present interest.

"Trust equivalents" are rarely more desirable from a planning standpoint. More often than not, the "trust equivalent" is used without the drafters' awareness of the GSTT problems. The Uniform Gifts to Minors Act inadventently may cause some arrangements to become subject to the GSTT. If the plan is not used to discharge a parent's support obligation, however, the GSTT should not be involved. Many life insurance arrangements or life insurance and annuity combinations may be considered "trust equivalents." To the extent that these equivalents are favored over the more usual living trust, the planner must be prepared to meet any adverse consequences which the GSTT might present in future years.

V. Conclusion

The purpose of this Article is to alert the estate planner to the planning possibilities and tax traps of the GSTT, rather than to explore the various tax policies underlying the transfer tax. The GSTT has been criticized as being overly complex. Such a criticism can be made of much, if not all, of the Internal Revenue Code. The fundamental philosophy underlying the GSTT remains sound. The primary purpose of transfer taxes in the United States never has been to raise revenue. Instead, the purpose of such taxes has been to prevent the unwarranted accumulation of

287. Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968). See also Rev. Rul. 73-405, 1973-2 C.B. 321. The Service allows a § 2503(b) exclusion, even though no guardian has been appointed, if neither the trust nor local law precludes a minor donee from demanding distribution of the trust income. See Stifel v. Commissioner, 197 F.2d 107, 110 (2d Cir. 1952) (court disallowed exclusion where trust created for child gave trustee discretion to make payments of income to child's guardian).


289. Testifying before the Senate Finance Committee, Donald W. Thurmond, former Chairman of the Trust Division, American Bankers Association, stated that the GSTT has been described as "impossibly complex... a trap for the unwary... extremely costly to administer and yet will raise little revenue." TRUST LETTER, Nov. 10, 1981, at 3. Mr. Thurmond noted that the proposed regulations fail to provide guidance on several issues, the answers to which are required before even common types of trusts can be drafted properly. The unworkability of the tax is illustrated by the failure of the Internal Revenue Service to provide "a simple, relevant and timely set of forms." Id. The costs of administering the tax would be monumental, since the IRS will become a national clearinghouse for transfer tax information. Information will have to be stored for at least seventy-five years. In contrast with these costs, the GSTT will produce negligible revenue in its early years and only $250 million annually in the long term. Id.
wealth. If the United States is to retain dynamism in its economy, it is important that this policy be continued.

For the most part, the transfer tax system has worked well. The original federal estate tax in 1916 sought to reach property in which the decedent had an interest at death and *inter vivos* transfers "in contemplation of or intended to take effect in possession or enjoyment at or after his death . . ."290 From the beginning, Congress guarded against evasions of the fundamental policy of the statute. Judicial interpretation of these phrases and their statutory successors, along with the addition of the gift tax in 1932, combined to create a reasonably effective, but far from perfect, transfer tax system.

In the post-War period, the American Law Institute and the Treasury Department strove to perfect the system, with their efforts culminating in the Tax Reform Act of 1976.291 The GSTT and carryover basis were the two principal changes introduced into the overall tax system. Although Congress chose not to unify the estate and gift taxes into a single transfer tax, certain aspects of unification were introduced. Carryover basis eventually was repealed and the GSTT may now suffer the same fate. Before Congress repeals the tax, it should give serious thought to the entire transfer tax system. Some think that the system should be abandoned entirely.292 Others would strengthen the entire transfer tax structure by providing for a single transfer tax at each generation.293

Presently, the GSTT does not pose a threat to the knowledgeable estate planner. The planner can lessen the tax's impact by using separate shares to avoid putting more than one generation of YGB's in any trust, by deferring the tax for long periods, or by skipping generations by making direct gifts to much younger generations.

Although those who are aware of the tax can protect themselves through careful planning, the GSTT remains a trap for the unwary. The proposed regulations on the substantive aspects of the law are not only inadequate, but misleading. One example of the Commissioner's effort to expand the statute's scope is the ex-

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290. Revenue Act of 1916, ch. 463, § 202(b), 39 Stat. 773, 778 (repealed 1919). Although this provision has been revealed, its interpretation remains alive.
292. Canada repealed the transfer tax system seven years ago. See also supra note 6.
tension of the role of the custodian under the Uniform Gifts to Minors Act. The Commissioner has not sought to differentiate the fundamental distinction between fiduciary and beneficial powers in this context. The Commissioner also has not related taxability in this area to the legal obligation of support. Another example of the Commissioner's effort to expand the statute's scope is the suggestion that the case law under sections 2036 and 2038 should be imported into the interpretation of the GSTT. Like the custodian rules, the case law under sections 2036 and 2038 developed around the concept of the retention of powers by the settlor. To draw an analogy between the settlor of a trust who retains economic dominion and control, and a deemed transferor under the GSTT, is patently erroneous.

By seeking to stretch the GSTT beyond its normal statutory bounds, the Commissioner has placed the GSTT in jeopardy, particularly among those in Congress who would like to see the statute repealed. The Commissioner should have provided credible examples of the operation of the tax well within its statutory limits. Perhaps the Treasury Department will be able to persuade Congress that the fundamental concept of the generation-skipping transfer tax—that accumulations of wealth should be taxed once a generation—is too important to be abandoned totally. With some modifications, the tax may well be retained as part of a complete transfer tax system. With adequate knowledge of the system, the estate planner then will be able to serve clients more effectively.

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