

Generation-Skipping Transfer Tax

By Yahne Miorini, LL.M.

The first Generation-skipping transfer tax was enacted by the 1976 Act. This tax was created in order to prevent the avoidance of transfer taxes over a period of successive generation. The tax was tremendously complex. The 1986 Act repealed it and replaced with a new transfer tax applicable to all generation-skipping transfers whether by way of a trust, trust equivalent, or direct transfer. The Generation-Skipping Transfer (GST) Tax applied to estate tax and gift tax. This tax was created for people dying after October 22, 1986. The tax is imposed only on the value of the interests in property that actually pass to certain transferees, who are referred as “skip persons.”

1.) Generation-Skipping Transfers

The GST tax brings new concepts such as “transferor” and “generation”. Under I.R.C. Section 2652(a) the transferor is

the donor or the decedent. The generation is defined among the family lines. There is the generation of the transferor which includes the transferor, the transferor’s spouse, and the transferor’s siblings. The children are part of the next generation. The grandchildren are part the generation following. If the transfer is made outside the family, generations are determined by ages. A person who was born not more than 12½ year after the decedent is in the same generation of the decedent. A person born more than 12½ years, but not more than 37½ years, after the decedent is in the first generation younger than the decedent. A similar rule applies for a new generation every 25 years. Therefore, a skip person is a natural person who was born more than 37 ½ years after the decedent.

There are three types of generation-skipping transfers:

- (1) taxable terminations,
- (2) taxable distributions, and

(3) direct skips.

A **taxable termination** occurs upon the termination of an interest in a trust. After the termination event the skip person holds all interest in the trusts. For instance, dad created a trust, giving the income for life of his daughter and the remainder to his granddaughter.

A **taxable distribution** exists when there is a distribution of principal or income from the trust to a skip person. For instance, mom created a trust providing payment of income and principal to her children and grandchildren. What is collected by the grandchildren is subject to GST tax.

A **direct skip** is when property is transferred without compensation to a skip person. Among family members, a skip person would be a grandchild. For a non-family member, a skip person is a person of two or more generations below the transferor.

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2.) Married couple special rule.

A married couple may elect to treat generation-skipping transfers as being made one-half by each spouse. The QTIP election used for estate tax purpose is separate and ignored for GTS tax. The fiduciary may allocate part or all of the decedent's GST exemption to the property. Because each person is entitled to a GST exemption, indexed for inflation, the GST election on a QTIP trust allows using two times the GST exemption. This is a reverse QTIP election¹.

3.) Tax Allocation

The amount of tax imposed on any generation-skipping transfer is determined² by multiplying the "taxable amount" by the "applicable rate."

3.1.) Taxable Amount

The taxable amount varies depending on the transfer. For a taxable distribution transfer, the taxable amount is the transfer received by the transferee, reduced by the expenses incurred in the determination, collection, or refund which Chapter 13 tax imposed. For a taxable termination transfer, the taxable amount is the value of property received at the termination reduced by deductions similar to Section 2053. For a direct skip transfer, the taxable amount is the amount received. The taxable distribution transfer and the taxable termination transfer are tax-inclusive transfers while the direct skip transfer is a tax-exclusive transfer. In a tax-inclusive transfer the tax is calculated on the amount of the transfer. The transferee receives the net of the transfer, therefore less than the gross amount of the transfer. For instance, if the transfer amount is \$2 million and the tax rate is 45%, the transferee will receive \$1,100,000 [\$2 million - (\$2 million x 45%)]. In

a tax-exclusive transfer, the transferred amount is what the transferee will receive. If the transferee receives \$1.1 million, the tax to pay out of the gift is \$495,000. The Cost of the gift is \$1,595,000. However, for inter vivos transfers to direct skip, The IRS considers the transfer a tax-inclusive/tax-exclusive transfer. In this situation, the payment of tax is considered to be an additional gift. An additional \$222,750 should be paid. The total cost of the \$1.1 million gift is \$1,817,750.

3.2.) GST exemption

In 2008 the GST exemption is \$3.5 million. Above the exemption amount the tax rate is 45%. The Act of 2001 provides that the GST is repealed in 2010 and reinstated in 2011 with an exemption of \$1 million and a tax rate of 55%. Because the GST exemption is indexed for inflation, the GST exemption presumably will be the 2003 amount of the GST exemption: \$1,120,000. There is currently no

¹ See I.R.C. Section 2652(a)(3).

² See I.R.C. § 2602.

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credit for state tax paid with respect to direct skip generation-skipping transfers.

3.3.) Applicable Rate and Ratio

The applicable rate of tax³ is defined as the maximum transfer tax rate then in effect multiplied by the inclusion ratio.

Each transfer has an inclusion ratio of one if none of the transferor's GST exemption is allocated to the trust or transfer. This exclusion ratio can be reduced by any GST exemption allocated. For instance, John transfers \$4 million to an irrevocable trust which provides that income is to be accumulated for 10 years. At the end of the term, the accumulated income is to be distributed to John's daughter, Mary, and the trust principal is to be paid to John's granddaughter, Suzie. John allocates \$3.5 million of John's GST exemption to the trust on a timely filed gift tax return. The applicable fraction with respect to

the trust is 0.88 [$\$3.5 \text{ million} / \4 million]. The inclusion ratio is 0.12 ($1 - 0.88$). If the maximum federal estate tax rate is 45% at the time the GST, the rate of tax applicable to the transfer will be 0.054.

³ See I.R.S. § 264(1a).