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Personal Planning Strategies Client Alert

A report for clients and friends of the firm

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New "Generation-Skipping" Tax Rules Require Taxpayers to File Gift Tax Returns to Elect Out of Automatic Allocation of Exemption

Last June we sent you a Client Alert in which we discussed some of the significant estate planning provisions of the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA"), enacted on June 7, 2001. While taxpayers continue to grapple with how to plan for the future in light of EGTRRA's one-year repeal of estate and generation-skipping transfer taxes scheduled for 2010, they must pay immediate attention to the manner in which their generation-skipping transfer tax exemptions are allocated, beginning with transfers made in 2001.

A Brief Overview of the Generation-Skipping Transfer Tax

The generation-skipping transfer ("GST") tax applies to direct and indirect transfers taking place during the lifetime, or as a result of the death, of a transferor and are made to a person who is two or more generations younger than the transferor. For example, a grandfather who transfers stock to a trust for the benefit of his grandchildren, having skipped his children, will have made a transfer to which the GST tax applies. Such a transfer is called a "direct skip."

The GST tax also applies to "indirect skips" referred to as "taxable terminations" and "taxable distributions." A "taxable termination" occurs, for example, when, at the death of a son for whom a trust was created by his mother, the remaining principal is distributed to his children (i.e., her grandchildren). If that trust also had permitted the Trustees to make payments to her grandchildren before her son died, those payments would be "taxable distributions."

GST Tax Rates and Exemption Amounts

The GST tax is imposed in addition to any gift or estate tax that also may be imposed when a transfer is made, and is assessed at the highest estate tax rate then in effect. Each taxpayer has a "GST exemption" that may be allocated in order to shield certain transfers from the tax. EGTRRA amended the applicable GST tax rates and GST exemption amounts, which are now:

Calendar Year	Applicable GST Tax Rate	GST Exemption
2002	50%	$1,100,000
2003	49%	$1,100,000 plus an inflation adjustment
2004	48%	$1,500,000
2005	47%	1,500,000
2006	46%	2,000,000
2007	45%	2,000,000
2008	45%	2,000,000
2009	45%	3,500,000
2010	GST Tax Repealed	GST Tax Repealed

If no other change is made, in 2011 the GST tax will be restored with an applicable rate of 55% and an exemption of only $1,060,000 (plus an inflation adjustment for the years since 2001).

Automatic Allocation of GST Exemption

Prior to the enactment of EGTRRA, a taxpayer's GST exemption was automatically allocated to direct transfers only without any requirement to make an election on a gift return. By contrast, a taxpayer who wished to allocate his or her exemption to an indirect transfer was required to do so on a gift tax return filed for the year in which the transfer was made.

In some cases, taxpayers neglected to allocate their GST exemptions to indirect transfers. As a result, trusts that should have been shielded against imposition of the GST tax became fully exposed to it.

EGTRRA attempts to cure the unnecessary imposition of a GST tax by creating a new category of so-called "GST trusts" to which automatic allocation of the GST exemption also applies. EGTRRA so broadly defines a "GST trust" that the term could apply to virtually any trust created for the benefit of family members unless the trust falls into one of a small group of exceptions to these new rules. The language used to create these exceptions poses as great an interpretive challenge as any of the complex provisions of the tax code, but the exceptions are, in essence, crafted to ensure that a transferor's GST exemption will not be allocated automatically if it is doubtful that a person who is at least two generations younger than the transferor will receive assets from the trust.

Wasting of GST Exemption

However, there remain many trusts to which the automatic allocation of GST exemption would, in effect, squander it.

One notable example is an irrevocable life insurance trust ("ILIT"). A typical ILIT is established by a taxpayer for the initial benefit of his or her spouse, upon whose death the trust assets are to be paid to the taxpayer's children, either outright or in further trust. A successful ILIT will fully shield all policy proceeds against estate tax that otherwise would be imposed in the insured party's estate. Policy proceeds paid to a successful ILIT also would likely not be subject to the GST tax. Nevertheless, under the new GST automatic allocation rules, GST exemption would be allocated to the ILIT. And that would be true even though trust assets may never pass to grandchildren.

Electing Out of Automatic Allocation

To avoid that result, taxpayers may "elect out" of an automatic GST exemption allocation on a timely-filed gift tax return for the year in which a given transfer is made. In some cases, even if a transferor would not otherwise be required to file a gift tax return to report the transfer, he or she nevertheless will want to file a gift tax return so that he or she can "elect out" of an automatic GST exemption allocation. Gift tax returns are due on April 15 of the year following a transfer subject to gift tax unless extensions of time to file them apply.

If you created a trust, or made a gift to a pre-existing trust, any time after January 1, 2001, you should give this Client Alert to your accountant or other tax return preparer to determine if you need to "elect out" of an automatic allocation of your GST exemption. If you or your tax return preparer have any questions about how or whether to file a gift tax return to "elect out," call us.

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Client Alert

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