- To determine the total tax base add adjusted taxable gifts after 1976 (excluding those included in the gross estate).
- Compute the tentative estate tax on the total tax base.
- Subtract gift tax payable on post 1976 adjusted taxable gifts.
- Subtract all allowable credits.
- The result is the total estate tax payable.

The Federal Generation-Skipping Transfer Tax

Before enactment of the generation-skipping transfer tax in Code Chapter 13, it was possible to avoid federal wealth transfer taxation of property enjoyed by successive generations of beneficiaries by placing the property in a properly drafted trust that created a succession of life estates. For example, a trust might "pay the income in equal shares to such of my children as are living from time to time, and after the death of my last child to die to such of my grandchildren as are living from time to time, and after the death of my last grandchild to die to such of my great grandchildren," and so on, until expiration of the permissible period of the Rule Against Perpetuities. Prior to 1976 such a trust would avoid the estate tax at each younger generation. So would a trust that permitted the trustee to distribute income or principal to descendants as the trustee deemed appropriate in its sole discretion, or any variety of similar trusts.

In addition to being granted income interests and the right to receive principal in the discretion of an independent trustee, beneficiaries in each generation could be given powers to withdraw up to $5,000 or 5% of the trust principal each year, powers to withdraw principal pursuant to an ascertainable standard, or both. Beneficiaries also could be given nongeneral testamentary powers to appoint the trust assets outright or in further trust, permitting redirection of the trust property within a designated class of appointees. Beneficiaries could even serve as trustee of the trust, if their powers were properly limited to avoid characterization as a general power of appointment. In sum, beneficiaries in multiple generations could be given the various rights and powers permissible in a bypass trust (see Chapter 5), all without corrupting the tax minimization or tax avoidance possibilities of the trust.

No part of the trust property would be includible in a beneficiary's estate for federal estate tax purposes as each beneficiary (child, grandchild, great grandchild and so forth) died, because no beneficiary possessed more than a life estate and nontaxable powers of appointment. Thus, after the transferor's[18] payment of gift or estate tax when the trust was created, no

18. The GST refers to a "transferor" who creates a generation-skipping trust. Although it is not the common lingo used by trust law or most planners, this Chapter uses that term also. It is synonymous with "grantor" or "settlor" in most cases, although on occasion the GST transferor will be deemed to change for purposes of applying these rules.

additional tax was imposed on the successive economic enjoyment of the trust property by one generation after another. Instead, the transfer tax was avoided or "skipped" by successive generations of beneficiaries who nevertheless enjoyed substantial benefits from the property.

Some states have modified their laws to permit various forms of perpetual generation-skipping trusts that may benefit successive generations and last literally forever. In every state, it usually is possible for a generation-skipping trust to continue for at least 90 or 100 years through the use of a carefully drafted perpetuities saving clause.[19] In effect then, before enactment of the GST, trust property that was taxed when a trust was established could be removed from the transfer tax rolls until it passed into the outright ownership of beneficiaries when the trust terminated, maybe a century (or more) later. By one estimate, through the use of dynastic trusts and other sophisticated planning arrangements, prior to 1976 the duPont family lost only 5% of its aggregate wealth to the transfer tax system since its inception. Cooper, A VOLUNTARY TAX? NEW PERSPECTIVES ON SOPHISTICATED ESTATE TAX AVOIDANCE 1 (1979). All of this finally prompted Harvard Professor A. James Casner to testify in 1976 regarding the proposed GST: "We haven't got an estate tax; what we have, you pay an estate tax if you want to; if you don't want to, you don't have to." Estate and Gift Taxes: Hearings Before the House Ways and Means Committee, 94th Cong., 2d Sess., part 2, 1335 (1976).

Congress was convinced in 1976 that significant abuse of the wealth transfer tax system was possible through the use of these generation-skipping trusts. It also concluded that these dispositions frustrated the policies and purposes of the wealth transfer tax system because the estate tax fell on most families every generation while wealthier families (who received proper advice and had enough property to employ the requisite devices) incurred wealth transfer taxes only after several generations of beneficiaries had enjoyed and controlled the family wealth. According to Congress, this perceived gap in the coverage of the transfer taxes had to be plugged to make the system work properly.

The GST was enacted to assess dispositions that provided economic benefits to several generations of beneficiaries. Thus, it applies only to trusts and "trust equivalents"[20] with beneficiaries assigned to more than one generation below the transferor. The classic example would be a trust for the benefit of the transferor's child for life, remainder to the child's descendants (or an equivalent life estate and remainder, not in trust). A "beneficiary" is any person with a present or future right to receive distributions from the trust, either absolutely or in the trustee's discretion.

19. See the sample saving clauses in Chapter 19 at page 30.

20. These are legal arrangements (other than estates) that have the same effect as a trust. §2652(b)(1). Examples include a legal life estate (that is, a life estate not in a trust) with a remainder or a life insurance policy settlement option or an annuity arrangement for successive beneficiaries.

The original rules governing who had an interest or a power and when it terminated in a taxable manner were so complicated that eventually everyone (the Treasury Department and Congress too) agreed that the 1976 version of the GST was a failure. In 1986 Congress corrected major deficiencies while simplifying the law through several fundamental changes. First and foremost, every taxpayer now is granted an exemption from the tax that can be applied to transfers during life or at death. It began at $1 million per taxpayer and many people still refer to it as such, but today it is tied to the applicable exclusion amount for estate tax purposes. With proper planning, a married couple may transfer double the amount of the applicable exclusion amount/GST exemption without ever incurring a GST. If it is properly employed this exemption insulates most estate plans from Chapter 13.

A caution is in order, however. At first blush the exemption might suggest that only the truly wealthy and their counselors must be concerned about the GST. Unfortunately even smaller estates, as to which the estate and gift taxes are not a problem and as to which the GST *should* be no problem, will require competent planning to properly allocate and use the exemption. You must ensure that generation-skipping transfers that could be protected by the exemption are protected under the not-always-simple exemption allocation rules. Moreover, generation-skipping has become more popular than before attention was drawn to the subject, now that the tax excepts smaller estates from its reach. Ironically, the exemption encourages the creation of more trusts designed to run for the full period of the Rule Against Perpetuities.

Skip Persons

The key to understanding the GST is to remember the abuses that the tax is meant to prevent: enjoyment of property followed by its movement down the generations without being subjected to estate or gift tax. All of Chapter 13 is related in some way to such planning. Thus, for example, to invoke the tax, there must be either a non-exempt "direct skip" transfer or a trust with a "skip person" as beneficiary. Under §2612(c), a direct skip essentially is any transfer made to or in trust for the benefit of a skip person. As defined in §2613(a)(1), a skip person is any one assigned to a generation more than one below the transferor (such as a grandchild).

Individuals are assigned to generations under §2651 in one of three ways, depending on the individual's relation to the transferor. First, all lineal descendants of the transferor's grandparents ("relatives" of the transferor) are assigned to generations on the basis of consanguinity, and relatives by adoption or by the half blood are treated as natural relatives by the whole blood. Thus, a child is in the first generation below the transferor, an adopted grandchild is in the second generation below the transferor, and a nephew or niece by the half blood (a half sibling's child) is in the first generation, all as illustrated in the diagram at page 28.

Second, any person who was at any time married to any lineal descendant of the transferor's grandparents (including the transferor's own spouse or former spouse) automatically is assigned to the lineal descendant's generation, regardless of the spouse's age. Moreover, the consanguinity rules apply to relatives of the transferor's spouse (or any former spouse) as if the transferor and the spouse were one person. Thus, for example, a child's spouse is assigned to the first generation below the transferor, even if young enough to be the transferor's grandchild, and even if subsequently divorced from the child. If the transferor's spouse had a child by a former marriage, the child would be in the first generation below the transferor even if the transferor never adopted that child, and the same treatment would equally apply to the spouse of the child.

All other non-relatives (beneficiaries who are not related by blood, adoption, or by marriage) are assigned on the basis of age, with spouses of non-relatives *not* automatically receiving the same generation assignment. Beware: many students assume that spouses always are assigned to the same generation, which is not true if neither spouse is a descendant of the transferor's grandparents.

In assigning generations on the basis of age, the fundamental assumption is that each generation is 25 years in length, and that the transferor is exactly in the middle of his or her generation. Thus, someone within 12.5 years above or below the transferor is deemed to be in the same generation as the transferor. Thereafter, every 25 years is a new generation. So, someone more than 12.5 years but not more than 37.5 years younger than the transferor is in the first generation below the transferor, while someone more than 37.5 years but not more than 62.5 years younger than the transferor is in the second generation below the transferor, and so on.

Same Generation	*Grantor and Spouse*	Sibling and Spouse	Cousin and Spouse	Non-Relatives within 12.5 years of age
First Level Below: Non-Skip Persons	Child and Spouse	Niece or Nephew and Spouse	Cousin. Once Removed and Spouse	Non-Relatives 12.5 to 37.5 years younger
Second Level Below: Skip Persons	Grandchild and Spouse	Grandniece or Grandnephew and Spouse	Cousin Twice Removed and Spouse	Non-Relatives 37.5 to 62.5 years younger

If a person is assigned to two generations by virtue of these rules (for example, the transferor adopts a grandchild as a child), the general rule under §2651(e)(1) is that the younger generation assignment governs (making the adopted grandchild a skip person) and preventing efforts to move up a generation to avoid the tax.

Taxable Transfers

To incur a generation-skipping tax there must be a §2611(a) "generation-skipping transfer," of which there are three types: direct skips, taxable distributions, and taxable terminations.

Direct Skips

"Direct skips" are defined in §2612(c) as transfers that are subject to the estate or gift tax, made directly to or in trust for the benefit of a skip person. Applying a vision of property moving down the generations, the direct skip tax is imposed because no interest exists at the first level below the transferor. In essence, this is Congress' way of saying that it wants to tax property as it moves past every younger generation.[21] Thus, a tax should be paid if the property passes immediately to the second or a more remote generation. A direct skip will incur an estate or gift tax and then an immediate GST as well.

A transfer might be made to or in trust for the benefit of a grandchild whose parent was the child of the transferor (or of the transferor's spouse) but who is deceased. Because that direct transfer is not regarded as made for tax minimization reasons, a "predeceased child" exception in §2612(c)(2) precludes application of the direct skip tax in such a case. It provides that the grandchild is treated as a child (and all lineal descendants of the grandchild similarly are "moved up" a generation). For example, assume Transferor died leaving a will that bequeaths Transferor's residuary estate "to my descendants, per stirpes." Transferor is survived by two children, A and B, and grandchild X, the child of Transferor's deceased child C. One third of the residuary estate passes to grandchild X and is not taxed as a direct skip because C was not alive to be "skipped." If, instead, C had survived Transferor but disclaimed all interests under the will, the interest passing to X by reason of the disclaimer would be taxable as a direct skip transfer.

Taxable Distributions

A "taxable distribution" is any distribution from a trust (or trust equivalent) to a skip person. §2612(b). For example, in a trust for the transferor's descendants, a distribution to a child would not be a taxable distribution because the child is not a skip person. In the same trust, however, a distribution of either income or principal to a grandchild would be a taxable distribution because grandchildren normally are skip persons.

---

21. This analysis breaks down a bit because, if the property were left to the great grandchild level (skipping both the child and grandchild levels), a true once-per-generation tax would impose the direct skip tax twice, in addition to the estate or gift tax incurred on the initial transfer. Congress chose not to extend the direct skip treatment in this respect, probably because triple taxation would rarely be incurred and, if imposed, would virtually wipe out the subject wealth.

Taxable Terminations

A "taxable termination" is the termination (by death, passage of time, release or lapse of a power, or otherwise) of any present interest[22] in a generation-skipping trust. §2612(a). There are several exceptions to this definition. Under the first, a taxable termination occurs only if, after the termination, the remaining beneficiaries all are skip persons. This means that the GST is not meant to apply until all present interests at the first generation below the transferor have terminated, and then not again until all present interests at the next generation have terminated, and so on. Thus, no taxable termination occurs if "immediately after such termination, a non-skip person has an interest in such property." §2612(a)(1)(A).

This "postponed termination" exception serves to defer imposition of the GST until termination of the present interests of all beneficiaries in non-skip generations. To illustrate, assume Transferor creates a trust to pay income to children for life, remainder to grandchildren in equal shares. Transferor has two children, A and B. A dies, which constitutes the termination of A's present interest. Nevertheless, this is not a taxable termination because B is a non-skip person and has an interest in the trust. The taxable termination will occur on B's death (unless another non-skip person acquires an interest in the trust, such as by B's exercise of a power of appointment). Similarly, in this example if grandchild X were to die while either A or B were alive, X's death would not be a taxable termination for two reasons: (1) a non-skip person (A or B) still has an interest in the trust, and (2) X's interest was a future interest, not a present interest, making the definition of a taxable termination inapplicable.

Under a second exception, termination of a present interest is not taxable if "at no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person." §2612(a)(1)(B). This "no interest passing to a skip person" exception is consistent with the purpose of the statute, which is to impose a tax only if a generation-skipping transfer actually occurs. This will not happen if the property does not move down the generational ladder by passing to a more remote generation.

For example, assume in the prior illustration that the trust specifies that the trust property passes to the Red Cross if no grandchild is living when the last child dies. In this event, no taxable transfer occurs if the last surviving child outlives all the grandchildren, even though that child's death is the termination of a present interest. This result illustrates that the primary focus of the GST is not on the child's enjoyment but, instead, on

22. An interest is a present right to receive either income or principal, either in the trustee's discretion, as an absolute entitlement, or pursuant to a power of withdrawal. §2652(c)(1). It does not matter how limited an interest is. If the interest exists, the holder is a skip person (if assigned to an appropriate generation) as to the entire trust or that segregable portion from which the interest may be satisfied.

whether the trust property moved down a generation after the child's interest terminated.

Imagine in this last case that the last surviving child and grandchild die together under such circumstances that the order of their deaths cannot be proven. Under state law or the terms of the document, the grandchild might be deemed to have predeceased the child and the property would pass to the Red Cross. Thus, no taxable termination would occur. The GST would be imposed, however, by reason of the child's death if the child died and the grandchild died shortly thereafter. In that case the trust property would be taxed again under the estate tax in the grandchild's estate. For this reason, it would be appropriate to insert a provision requiring that remainder beneficiaries survive the prior income beneficiaries by a specified period (such as 60 days) as a condition to taking.[23]

A third exception involves terminations that also are direct skips. Without elaborating here on the complex ordering scheme, suffice it to say that the Code establishes a priority for treatment of transfers that meet more than one of the taxable event definitions: first direct skips, then taxable terminations, and finally taxable distributions. These ordering rules can have consequences relating to who pays the tax, deferral of the tax, and especially the method of computing the tax on direct skips as compared to taxable terminations and taxable distributions.

Amount and Payment of the Tax

The GST is a flat tax computed at the maximum stated estate tax rate. §2641(a)(1). The estate tax also is a flat tax (under phase-in changes enacted in 2001 and complete after 2005), so the historic disfavor for the GST no longer is a concern. Indeed, unlike prior times, today it may not be cheaper to expose property to estate or gift tax to take advantage of lower rates than the GST.[24] Moreover, some planning is available for GST purposes that is not possible under either the estate or gift taxes.

One example of such planning is the ability to defer the GST under the provisions of §2612(a)(1), as discussed at page 30. Thus, in a trust for child for life, remainder to grandchild, child could appoint the property to child's sibling for life, deferring the GST until the sibling's death. There is no comparable estate tax deferral opportunity.

Another illustration is the ability of a younger generation beneficiary to "layer" property to a more remote generation beneficiary through exercise of a nongeneral power of appointment. If the trust property were includible in the beneficiary's estate for estate tax purposes, such layering would be subject to the direct skip tax, yielding a double tax. But this form

23. This would not be a problem if Chapter 13 contained a counterpart to the §2013 estate tax credit for previously taxed property, but it does not.

24. As an aside, it may be worth considering whether sheltering a beneficiary's applicable exclusion amount and GST exemption would be appropriate, by causing estate tax inclusion to that beneficiary, instead of incurring the GST. Let's leave that topic for a later discussion.

of planning can escape the second tax if made within the GST system. So, for example, in a trust for child for life, remainder to child's descendants, child could appoint the trust property to child's grandchild (the transferor's great grandchild) without incurring an additional tax at the intervening generation, and avoiding the direct skip tax as well. Thus, only the GST at child's death would apply, rather than an estate tax and then an immediate direct skip tax. This layering opportunity also would not be available if the trust property were subject to estate or gift tax at the child level.

Finally, some property may escape both systems of taxation under proper circumstances. For example, in a trust for Child for life, remainder to Child's descendants (if any), otherwise to Child's siblings (if child dies without descendants), the property will pass to the siblings free of GST under §2612(a)(1)(B) if Child dies without descendants. In this situation it would be foolish to cause the trust property to incur estate or gift tax as Child's property, if instead all taxes could be avoided.

Thus, savvy estate plans are drafted to provide sufficient flexibility to determine which system of tax will be most favorable (if any must be imposed). We do this by providing an opportunity to subject trust property either to the GST or to the estate or gift tax, as appears best at the time of the appropriate taxing event.

Amount Subject to the Tax

Under §2621, the amount subject to tax in the case of a taxable distribution is the amount received by the distributee. Because the tax is imposed on the distributee, this system of tax is like the "tax-inclusive" estate tax system discussed in Chapter 12 at page 3. This is because dollars that the distributee uses to pay the tax are themselves subject to the tax. They are included in the tax base. Moreover, if the trust that made the distribution pays the tax on behalf of the distributee, that payment is regarded as an additional taxable distribution that also is subject to the GST, under §2621(b).

In a taxable termination, §2622 provides that the full amount subject to termination is the amount subject to tax. Because the tax is paid out of this fund, the result here also is a tax-inclusive system (like the estate tax), with the dollars used to pay the tax also being subject to the tax.

Direct skips receive a different treatment, under §2623. The amount subject to tax in a direct skip is the value of the property actually received by the beneficiary. Because the beneficiary does not pay the tax on a direct skip, these transfers are cheaper because no rule treats the tax payment (by the transferor in most cases) as an additional generation-skipping taxable transfer. Thus, the direct skip is like the "tax-exclusive" gift tax computation. For example, if a transferor left $1 million of property in a direct skipping transfer at death and directed that the direct skip tax be paid out of the residue of the transferor's estate, the direct skip subject to tax would be the $1 million actually received by the beneficiary. The dollars used to pay the tax would be subject to estate tax but not to the GST.

If the transferor had specified that the beneficiary should pay the tax on this direct skip bequest, then the taxable transfer first would be reduced under §2642(a)(2)(B)(ii) by any federal or state estate or other death tax that is paid out of the bequest. Then the GST would be determined on the fair market value of the bequest remaining after payment of the GST. To determine the tax on the amount left after the tax requires the use of the following algebraic formula:

$$\text{Generation-Skipping Tax} = \text{rate} \times \frac{\text{Fair Market Value}}{1 + \text{rate of tax}}$$

Thus, the amount of the direct skip transfer is the net amount passing to the beneficiary, after payment of all wealth transfer taxes.

An illustration of the relative costs of the various forms of generation-skipping transfer, both inter vivos and at death, would show that an inter vivos direct skip gift is roughly three times cheaper than a testamentary transfer to a trust that will spawn a taxable distribution or taxable termination at a later date.[25] Yet experience shows that the latter alternative is the most common, probably because most clients don't want to incur gift tax during life and cannot afford to cut children out of any portion of their wealth by using direct skip transfers to skip persons. Just as gifting alone is advantageous, so too is direct skipping, but neither is within the reach of less than extremely wealthy taxpayers. Both of these disguised benefits are intentional favors from Congress to the super wealthy.

Source of Payment of the Tax

Under §2603(a), the tax is paid by the distributee in the case of a taxable distribution, by the trustee in a taxable termination or a direct skip from a trust, and by the transferor in a direct skip not from a trust. Further, §2603(b) provides that, "unless otherwise directed pursuant to the governing instrument *by specific reference to the tax imposed by this chapter*," the GST tax is a charge against the property taxed. Collectively, these provisions establish an apparently easy rule that "the person with the generation-skipping property pays the tax, using that property."

Like most simplifications, however, this statement is not entirely accurate in cases involving direct skips. For example, because the transferor (or the transferor's estate) pays the tax in the case of most direct skips, and that tax is computed tax exclusive, the transferor effectively makes the direct skip transfer and then comes up with additional monies to pay the tax. So §2603(b) essentially is a fiction in the case of a direct skip

25. See 2 Casner & Pennell, Estate Planning §11.4.14.1 (6th ed. 1999), for an illustration comparing the inter vivos direct skip taxed under two tax exclusive systems (gift tax and a direct skip) to the testamentary trust subject to two tax inclusive systems (estate tax and either a taxable distribution or taxable termination).

because the tax is not actually paid from the taxable property that constituted the transfer. Otherwise §2603(b) states what should seem obvious: the trustee who holds the property following a taxable termination, or the distributee who just received a taxable distribution, should use the property to pay the tax imposed under §2603(a).

Exceptions to the Tax

Estate and Gift Tax Override

To prevent double taxation the GST effectively provides that Chapter 13 is superseded by Chapters 11 and 12 to the extent a taxable transfer (other than a direct skip) also is subject to either estate or gift taxation. Although nothing in the Internal Revenue Code establishes this priority (that the estate and gift taxes apply before the GST), this in fact is Congress' intent.[26]

Second-Time Around

There is a similar exception under §2611(b)(2) providing that, if property has been generation-skipping taxed once at a given generation (or at a lower generation), it will not be taxed at that level again. As an example, imagine a trust for Child for life (at death there being a taxable termination), then for Grandchild's education and, if Child's spouse is still alive after Grandchild's education is complete, then back up to the spouse for life, finally distributing on the spouse's death to Child's descendants. Having been taxed once at the child level, the trust is insured against being taxed at that level a second time at the death of Child's spouse. This provision also ensures that no taxable termination is deemed to occur when Grandchild's formal education is completed and the interest of Grandchild terminates (at least until death of the spouse), because the spouse's interest prevents the property from moving down a generation.

Nontaxable Gifts

In addition, §2611(b)(1) also grants an overall exemption under Chapter 13 for any transfer *from* a trust that would, if made by an individual, qualify as a gift tax free payment of education or medical expenses under §2503(e). This provision should not be confused with §2642(c), which provides an effective exemption for certain annual exclusion gifts. Like the §2503(b) annual exclusion and the §2503(e) ed/med exclusion, §§2611(b)(2) and 2642(c) are not duplicative. Section 2611(b)(2) gives a nontaxable result to any §2503(e) type transfer *from* a trust. Section 2642(c) deals only with §2503(b) type annual exclusion direct skip transfers made outright or by transfer *into* a trust.

26. See Private Letter Ruling 9123052. This occurs because application of the estate or gift tax will result in the existence of a new transferor (to the extent property is includible in that person's wealth transfer tax base). As such the GST posture of the trust is altered once either tax is incurred. See, e.g., Chapter 12 at page 22 regarding this effect with lapsing withdrawal rights.

Moreover, §2642(c)(2) does not guarantee that all annual exclusion additions to a qualifying trust will be exempt for GST purposes. It provides a zero tax result for direct skipping transfers only if the transfer is outright or into a trust in which a sole beneficiary has exclusive enjoyment of the trust *and* the trust will be includible in the estate of a beneficiary who dies before trust termination. The effect of this provision is most apparent in the context of direct skipping transfers that are made into trusts, as to which the transfer is nontaxable by virtue of a Crummey clause power of withdrawal (see Chapter 9 at pages 51-53). These direct skipping additions to the trust will not escape GST if more than one individual enjoys current benefits in the trust, or if estate tax inclusion of the trust in the beneficiary's estate is not guaranteed.

Stopped Moving Down

The exceptions under §2612(a)(1)(A) and (B) that were discussed at page 30 should be considered again here. They preclude taxable termination treatment if the property has stopped moving down the generations (either permanently or just temporarily) if "(A) immediately after such termination, a non-skip person has an interest in such property or (B) at no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person." To illustrate, consider a trust for Child and Grandchild, with present interests at both generations. If Grandchild dies, no GST will be incurred because Child, a non-skip person, has a continuing interest. §2612(a)(1)(A). When Child later dies §2612(a)(1)(B) would prevent application of the GST if the property does not move down the generational ladder (for example, if the trust goes to the Child's sibling in this event).

As a second example of these exceptions, consider a group trust for children for life, with distribution to grandchildren only on the death of the last child to die. Here the death of any but the last child is not a taxable event because every child is a non-skip person and the exception in §2612(a)(1)(A) will apply while any child remains as a beneficiary. If the trust were held after the last child's death as a group trust for grandchildren until the last grandchild reached a specified age, and a grandchild died before the trust were distributed, the existence of any other living grandchild as a beneficiary similarly would prevent termination of the dying grandchild's interest from being a taxable event.[27]

27. To fully understand how this operates at the grandchild level requires an understanding of the "move down a generation" rule in §2653(a). This provision specifies that, after a generation-skipping taxable transfer occurs in a trust, "the trust will be treated as if the transferor . . . were assigned to the first generation above the highest generation of any person who has an interest in such trust immediately after the transfer." In this example the transferor would be deemed to move down to the child level following the taxable transfer caused by the last child's death, making the grandchildren the first level below the transferor, meaning that they become non-skip persons. Once this occurs, the requirements of §2612(a)(1)(A) would be met when a grandchild later dies.

GST Exemption

The final (and most important) exception to the GST is the §2631(a) "GST exemption" available to all transferors. It is not as easy (or as direct) as it might be, because it is granted in the form of an "inclusion ratio" that is then tied, under §2642, to the rate of tax for computation purposes. The "inclusion ratio" approach specifies that, once determined, the exempt portion does not change with fluctuations in values or distributions that occur. The exemption is incorporated into the rate for computation of the tax with respect to that particular trust so that, once determined for the trust, it can be "retained" in a manner that allows it to be ignored for all other purposes.

As a simple example of the operation of the §2642 "inclusion ratio" approach, assume a trust of $3 million, of which the transferor wishes to exempt $1 million. One way to accomplish this would be to create two trusts, one of $1 million (to be totally exempt) and one of $2 million (to be totally taxable). If, however, the document did not divide the trust into two funds, the inclusion ratio would be determined by subtracting an "applicable fraction" from the number 1. The applicable fraction here would be 1/3, determined by taking the exemption amount as the numerator and the value of the trust as the denominator. The "inclusion ratio" would thus be 2/3, and this fraction then would be multiplied against the rate of tax to determine the applicable rate of tax on all taxable transfers with respect to the trust in the future.

Thus, in this example, if the maximum wealth transfer tax rate was 45%, the applicable rate for this 1/3 exempt trust would be 30% (2/3 times 45%). The result of this incorporation of the exemption into the tax rate is that no transfer from this trust would be totally tax free. Had the full amount of the trust been covered by the exemption, however, the applicable fraction would have been 1/1, producing an inclusion ratio of 0 for multiplication against the applicable rate, producing a 0 rate of tax. For a number of reasons, it is advisable to avoid creation of trusts that are partially exempt. Instead, it is better to create two trusts, one that is totally exempt and another that is totally taxable. To accomplish this requires actual division, accomplished under the authority of state law or specific terms of the trust instrument.

Division is preferable because the exemption will protect appreciation in value, meaning that a separate totally exempt trust could be invested to maximize growth under the umbrella of the exemption while a totally nonexempt trust could be invested to maximize income for non-skip beneficiaries or otherwise without special consideration of the generation-skipping taxability of the trust. Creating separate trusts also is preferable because doing so will permit the fiduciary to decide whether to make distributions from the exempt or from the taxable trust, based on the generation assignment of the beneficiary, the time of distribution, the applicable tax rate at the time, the possibility of further growth in the respective trusts, and so forth. This flexibility is lost if every distribution will be taxable, albeit at a reduced rate.

A great deal of complexity and some inequities may arise by virtue of allocating the exemption badly. Under §§2631 and 2632 the exemption is elective, in the sense that a transferor or the transferor's personal representative may decide how to allocate it (or whether to allocate it at all) among any generation-skipping trusts created. Unfortunately, allocating the exemption proved to be so fraught with error that §2632 now contains automatic allocation rules that apply unless an affirmative alternative allocation (or reservation of the exemption) is selected. Frequently this is the wise approach, because automatic allocation often is not the best use of the exemption.

The automatic allocation rules consume enough exemption to cause the inclusion ratio to be zero, if possible, with allocation first seriatim to lifetime direct skips, then pro rata to direct skips at the transferor's death, and finally pro rata among all other generation-skipping transfers. The important aspect of these rules is that exemption is "wasted" on inter vivos direct skip gifts, which are the cheapest transfers made. This may be appropriate in some cases, because lifetime direct skips, to which automatic allocation is first made, are the earliest transfers to incur the tax.

The balance must be made between deferral of tax (by allowing the exemption to be used on direct skips during life) and maximizing the exemption (by allocation against the more expensive forms of transfer or allocation to those dispositions that will extend the farthest into the future). In this respect, also consider that any allocation of the exemption against any outright transfer is the worst use of it, while allocation to trusts that will last for a long time, to prevent application of the GST on multiple taxable transfers in the future, is the most expeditious use of the exemption (all other factors being equal) in most cases.

There is much more complexity in exemption allocation, which would take us way beyond this introduction to the GST. Please note that failure to allocate exemption properly is fraught with such malpractice concerns that Congress enacted relief provisions in §§2632(d) and 2642 to protect taxpayer advisors who did it badly. You do not want to rely on those, so if you choose not to become expert in this endeavor, then you should refer this element to someone who is. And don't just rely on the return preparer to get it right. Scads of rulings granting relief are proof positive that many get it wrong (even some who purport to be well experienced in return preparation).

State Wealth Transfer Taxes

Every state imposes a tax on the transfer of property at death, although there is some variation in the nature of those taxes.

The oldest variety is the inheritance tax, also known as a legacy or succession tax. These are separate taxes imposed on each benefit conferred on a recipient of property passing from a decedent, the amount of each tax usually being determined by the size of the gift and the degree of consanguinity of the person who receives it. As of 2001 only a handful of states imposed inheritance taxes, and virtually none had their own estate tax any longer. With phase out repeal of the §2011 state death tax credit, some (perhaps most) states will enact or restore prior estate, inheritance, or other succession taxes.

Before repeal of §2011, every state imposed a tax that was a percentage of the federal estate tax as reported on the federal estate tax return (after application of the unified credit). Even those states that imposed their own taxes of the other two varieties collected this pick up or sponge tax to garner the benefit of the §2011 credit for state death taxes. Thus, every state imposed an estate tax that effectively shifted revenue from the federal government to the taxing state without increasing the tax burden on the estate. Indeed, failure to do so merely allowed money that could be diverted to the state to go to the federal government (without reducing the total death taxes payable by a decedent's estate or beneficiaries). Although this credit was repealed, some states continue to base their tax on the credit as it existed in a prior year, meaning that some pick up taxes will continue to apply after full repeal of §2011. See house.leg.state.mn.us/hrd/pubs/stesttax.pdf, prepared by the Minnesota House Research Department, or abanet.org/tax/groups/egt/egt_news.html, prepared by the Estate and Gift Tax Committee of the Tax Section of the American Bar Association, which reflect state death tax changes in response to the amended federal law. Before too long there likely will be even more Balkanization and difficulty in summarizing the various state death tax provisions.

Although most state death taxes follow the federal inclusion rules, not all estates with zero federal estate tax escape state wealth transfer tax. This largely is because not all state death tax laws grant a marital deduction in the same amount or for the same transfers as the federal law. As a result, state death tax may be incurred in some estates that are tax free for federal estate tax purposes.

Many states also adopted their own sponge or pick up tax version of the GST, in all cases equal to the §2604 state GST credit, but no state has yet imposed a GST in excess of that credit amount. This credit also was repealed in 2001, effective after 2004, and it simply is too early to know whether any state will impose a separate state GST in the wake of repeal.

A state may tax the personal estate of a decedent who was domiciled in the state at death and may tax real property and tangible personal property located in the state even if the owner was domiciled elsewhere. Because many wealthy decedents spent parts of the year in various states (snowbirds who went to the sunbelt during the winter or sunbelt residents who went north for the summer), several states may be entitled to tax. Each will determine for itself whether the decedent was domiciled in that state or otherwise was subject to that state's taxing jurisdiction. Occasionally multiple taxation of the same property results.

The most famous example of this may be the estate of John T. Dorrance, of Campbell's Soup fame, who died in 1930 with an estate of $115 million and residences in New Jersey and Pennsylvania. The New Jersey courts ruled that he was domiciled in New Jersey and owed New Jersey tax of $17 million. The Pennsylvania courts ruled that he was domiciled in Pennsylvania and owed Pennsylvania tax of the same amount. Both taxes were collected, as was a federal estate tax. See Worcester County Trust Co. v. Riley, 302 U.S. 292, 297 (1937), for a summary (a substantial part, but not all, of the state taxes was deductible from the federal estate tax as it existed at that time).

More extreme was the case of a Texas decedent whose estate was assessed by Texas, Florida, New York, and Massachusetts, all claiming the decedent as their domiciliary. Collectively they threatened to levy taxes in an amount exceeding the full value of the estate, which was so outrageous that it produced a good result in Texas v. Florida, 306 U.S. 398 (1939), which limited the state excise to only one tax. And the estate of eccentric billionaire Howard Hughes was involved in three United States Supreme Court cases before it was established that a forum even existed to resolve conflicting state tax claims. See California v. Texas, 457 U.S. 164 (1982) (allowing one state to sue another to establish their respective rights to tax the decedent's estate), and cases cited therein. Although the problem generally still exists, many state statutes provide a mechanism to resolve conflicting state claims regarding domicile.

In 2001 only four states still imposed gift taxes. The low number probably reflects the fact that state wealth transfer tax rates are de minimis and probably do not often on their own alter the transfer planning of individual citizens. It may be that a state gift tax will not correlate with the federal gift tax, which could result in imposition of a state gift tax when there is no federal gift tax. Nevertheless, there is no credit against the federal gift tax for gift taxes paid to a state, so there is no incentive for states to enact a gift tax merely to take advantage of the kind of revenue sharing made implicit by §2011 prior to its repeal.