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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

* Professor of Law, University of Louisville and Distinguished Visiting Professor of Law, Case Western Reserve University School of Law, 1981-1982. A.B., Columbia University (1942); LL.B., Columbia University (1948); J.S.D., Yale University (1957).

1. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (to be codified at scattered sections of 26 U.S.C.A.).

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:

	Unified Credit	Exemption Equivalent
1981	\$ 47,000	\$175,800
1982	62,800	225,000
1983	79,300	275,000
1984	96,300	325,000
1985	121,800	400,000
1986	155,800	500,000
1987 and all subsequent years	192,800	600,000

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)).

(GSTT).⁵ 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

5. Although the GSTT was not repealed, the effective date for the "grandfathering" of existing trusts was extended from January 1, 1982 until January 1, 1983. ERTA § 428 (amending the Tax Reform Act of 1976 § 2006(c), 26 U.S.C. § 2601 (1976), *as amended by* Revenue Act of 1978, Pub. L. No. 95-600, § 702(n)(1), 92 Stat. 2763, 2935 (1978), and Technical Corrections Act of 1979, Pub. L. No. 96-222, § 107(a)(2)(B), 94 Stat. 194, 223 (1980)). The following trusts are considered to be "grandfathered" and excluded from the GSTT: (1) a trust that was irrevocable on June 11, 1976, to the extent that the transfer is not made out of principal added to the trust after June 11, 1976; (2) any revocable trust created before June 12, 1976, which was not amended by the decedent at any time after that date to create or increase any generation-skipping transfer prior to decedent's death on or before December 31, 1982; and (3) any testamentary trust arising from a will executed prior to June 12, 1976, when the testator dies before January 1, 1983, provided there has been no addition to the trust, due to execution of a codicil or for some other reason which would create or increase any generation-skipping transfer. If a decedent were unable to change the disposition of his or her property on June 11, 1976 due to a mental disability, the period for (2) and (3) above is extended until two years after the decedent has regained competence to dispose of the property. *Id.*

6. The GSTT has been criticized as being "entirely too complex and . . . virtually unworkable from an administrative standpoint." 7 *Am. College of Probate Counsel, Probate Notes No. 4*, at 11 (Summer 1981). Some predict that "Congress won't get rid of the tax entirely, [but] it will be simplified to make it more workable." PRENTICE-HALL, INC., HANDBOOK ON THE ECONOMIC RECOVERY TAX ACT OF 1981 ¶ 179 (1981). The College also has stated that the GSTT "creates other inequalities and injustices" and produces an "administrative nightmare." 8 *Am. College of Probate Counsel, Probate Notes No. 4*, at 34-35 (Winter 1982).

7. *N.Y. Times*, Sept. 21, 1981, § A, at 24, col. 1 (editorial). Congressman Al Ullman, former Chairman of the House Ways and Means Committee, questioned this editorial in a letter to the *N.Y. Times*, emphasizing that there still would be many large estates subject to transfer taxes. *Id.*, Oct. 5, 1981, § A, at 20, col. 6.

8. See *infra* notes 23-50 and accompanying text.

9. See *infra* notes 51-261 and accompanying text.

10. See *infra* notes 17-20 & 267-85 and accompanying text.

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.¹¹ Since husband and wife are deemed to be of the same generation,¹² 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.¹³ If the principle of transfer taxation with respect to accumulations of wealth is to be retained,¹⁴ the continued existence of both the GSTT and the unlimited marital deduction are essential. Alternatively, the entire system of transfer taxation could be abolished¹⁵ 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.¹⁶ 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. "[T]he 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. DEPT 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.

12. I.R.C. § 2611(6)(2) (1976).

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, "[b]y 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 great-grandchildren. 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.¹⁷ Under ERTA, the planner can provide for the complete retention or complete transfer of control by S_1 ,¹⁸ depending on the nontax objectives S_1 and S_2 ¹⁹ seek.²⁰

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

17. I.R.C. § 2056(c)(1)(A)(ii) (1976).

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

21. I.R.C. § 2611(b) (1976).

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 regulations²⁹ 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 grandparent³⁰ 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

26. See *infra* notes 118-31 and accompanying text.

27. I.R.C. § 2613(c)(2) (1976).

28. See, e.g., KY. REV. STAT. ANN. § 381.216 (Baldwin 1969); 20 PA. CONS. STAT. ANN. § 6104 (Purdon 1975 & Supp. 1981). For a brief but excellent description of the rule against perpetuities, see T. BERGIN & P. HASKELL, PREFACE TO ESTATES IN LAND AND FUTURE INTERESTS 183 (1966).

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 grand-nephews. 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.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.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.³³ In addition, a relationship created by legal adoption is treated as a blood relationship.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.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.³⁶ These regulations then add that

31. I.R.C. § 2611(c)(1) (1976).

32. *Id.* Prop. Treas. Reg. § 26.2611-3(b), 46 Fed. Reg. at 122 (1981). Throughout this Article, all cites to the proposed treasury regulations are from the 1981 edition of the Federal Register.

33. I.R.C. § 2611(c)(2) (1976); Prop. Treas. Reg. § 26.2611-3(a), 46 Fed. Reg. at 122.

34. I.R.C. § 2611(c)(4) (1976); Prop. Treas. Reg. § 26.2611-3(a), 46 Fed. Reg. at 122.

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. See *infra* note 37 and accompanying text.

36. I.R.C. § 2611(c)(6) (1976); Prop. Treas. Reg. § 26.2611-3(c), 46 Fed. Reg. at 122.

“[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 persons³⁸ 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.

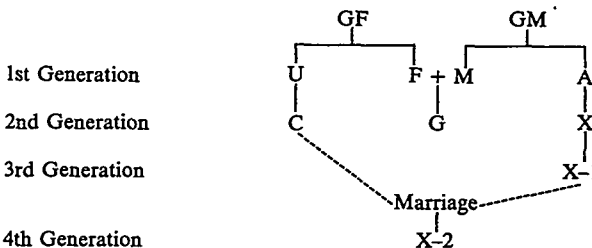
A person also can be related to another in more than one fashion. Every grantor has at least four grandparents. Since the statute is based on lineal descent from any one of these four grandparents, there will be times when a beneficiary may be related to the grantor through two different grandparents' 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 Code⁴⁰ indicates that X-2 is treated as

37. Prop. Treas. Reg. § 26.2611-3(c), 46 Fed. Reg. at 122 (emphasis added).

38. See *supra* note 32 and accompanying text.

39. The relationship may be diagrammed as follows:



40. I.R.C. § 2611(c)(6) (1976).

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."⁴¹ 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.⁴² The regulations state that an "entity is not assigned to a generation,"⁴³ 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."⁴⁴ The regulations also provide guidelines to determine who has a present interest or power⁴⁵ and who is a transferee under the rules governing taxable distributions and taxable terminations.⁴⁶

The regulations list three examples demonstrating the operation of the ascertainment of generations. The first two examples concern lineal descendants⁴⁷ and unrelated persons,⁴⁸ and add lit-

41. *Id.* § 2611(c)(3); Prop. Treas. Reg. § 26.2611-3(a), 46 Fed. Reg. at 122.

42. I.R.C. § 2611(c)(7) (1976); Prop. Treas. Reg. § 26.2611-3(d), (e), 46 Fed. Reg. at 122.

43. Prop. Treas. Reg. § 26.2611-3(d), 46 Fed. Reg. at 122 (excluding charitable corporations and trusts).

44. *Id.*

45. *Id.* § 26.2613-(4)(d), 46 Fed. Reg. at 128. See *infra* notes 186-225 and accompanying text.

46. Prop. Treas. Reg. § 26.2612-1(b), -3(a), 46 Fed. Reg. at 123, 126. See *infra* notes 170-85 and accompanying text.

47. *Id.* § 26.2611-3(f), example (1), 46 Fed. Reg. at 122.

48. *Id.*, example (2).

tle to the Code definitions previously discussed.⁴⁹ 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.⁵⁰

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.⁵¹ Examples of this concept include "life estates and remainders, estates for years, insurance and annuities, and split interests."⁵² The regulations repeat these examples and add "direct and indirect transfers to a minor."⁵³ 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.

50. Prop. Treas. Reg. § 26.2611-3(f), example (3), 46 Fed. Reg. at 122.

The value of A's reversionary interest would be includable in his gross estate under I.R.C. § 2031 (1976).

51. I.R.C. § 2611(d)(1) (1976).

52. *Id.* § 2611(d)(2).

53. Prop. Treas. Reg. § 26.2611-4(a), 46 Fed. Reg. at 122.

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.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.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.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.⁵⁷

Example seven illustrates the peril of using the custodian relationship under the Uniform Gift to Minors Act: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.⁵⁹

This example presents an unwarranted expansion of fiduciary

54. *Id.* § 26.2611-4(a), 46 Fed. Reg. at 123.

55. *Id.* § 26.2611-4(b), example (1).

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. *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. *Id.* § 26.2611-4(b), example (4).

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

58. UNIF. GIFT TO MINORS ACT, § 8 U.L.A. 181 (1972).

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 *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,⁶⁰ however, this example assumes that the custodian has the equivalent of a beneficial power which can be used to satisfy the legal support obligation.⁶¹ Under the proposed regulations, C, the minor, has a present interest or power due to the "unrestricted right to receive income or corpus."⁶² 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,"⁶³ 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]."⁶⁴ The distribution, therefore, must be both from a GST and in excess of trust income, and the distributee must be assigned

60. *See, e.g.*, *Stuit v. Commissioner*, 452 F.2d 190 (7th Cir. 1971); *Eichstedt v. United States*, 354 F. Supp. 484 (N.D. Cal. 1972); *Crocker Citizens Nat'l Bank v. United States*, 1975-2 U.S. Tax Cas. (CCH) ¶ 13,106 (N.D. Cal.); *Estate of Aris Carpousis*, 33 T.C.M. (CCH) 1143 (1974); *Zien v. United States*, 1973-2 U.S. Tax Cas. (CCH) ¶ 12,964 (E.D. Wis.); *Estate of Prudowski*, 55 T.C. 890 (1971), *aff'd per curiam*, 465 F.2d 62 (7th Cir. 1974); *Estate of Charles M. Jacoby*, 29 T.C.M. (CCH) 737 (1970); Rev. Rul. 70-348, 1970-2 C.B. 193; Rev. Rul. 59-357, 1959-2 C.B. 212; Rev. Rul. 57-366, 1957-2 C.B. 618. *But see* *Estate of Chrysler v. Commissioner*, 361 F.2d 508 (2d Cir. 1966); Rev. Rul. 74-556, 1974-2 C.B. 300.

61. Prop. Treas. Reg. § 26.2613-4(c)(3), 46 Fed. Reg. at 127.

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.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.⁶⁶

After defining a taxable distribution and stating its principal exception, the Code then mandates the *source* of distributions from the GST. Any distribution *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.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.⁶⁸

Taxable distributions may be contrasted with the normal income tax rule on taxability of income to a beneficiary or trustee.⁶⁹ In the simple trust, when the trustee distributes all current income to an income beneficiary, the trustee receives a deduction⁷⁰ and the beneficiary is taxed on the distributed income.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-

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.

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.

67. I.R.C. § 2613(a)(2) (1976).

68. Prop. Treas. Reg. § 26.2613-1(b), (c), 46 Fed. Reg. at 124.

69. *See* I.R.C. §§ 641-663 (1976).

70. *Id.* § 651.

71. *Id.* § 652.

ject to income tax.⁷² 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.⁷³ 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.⁷⁴

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.⁷⁵ If the distribution is not covered, it constitutes an "other amount" not subject to income tax.⁷⁶ 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)),⁷⁷" 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.⁷⁸ 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.

75. I.R.C. § 662(a)(1) (1976).

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.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 distributing fiduciary accounting income to the child and also makes a distribution out of corpus to the great-grandchild."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.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 generations, beginning with the beneficiaries assigned to the oldest generation."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.⁸³ In one example,⁸⁴ the grantor, G, creates a discretionary trust for the benefit of child, C, for life, remainder to G's great-grandchild, GGC. G gives the trustee power to make distributions of income and principal in any manner the trustee deems appropriate. In the tax year, the trustee distributes \$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 consequences? C, having received income, is not subject to the GSTT.⁸⁵ GGC is deemed to have received \$200 of nontaxable

within the spirit of the statutory scheme of the GSTT. The emphasis on fiduciary accounting income, as contrasted with distributable net income, undoubtedly will increase the importance of drafting and local law with respect to allocation of principal and income.

79. Prop. Treas. Reg. § 26.2613-1(a)(2), 46 Fed. Reg. at 122.

80. *Id.* § 26.2613-1(a)(3), example (1), 46 Fed. Reg. at 123-24.

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. § 2613(3)(a)(1) (1976).

82. *Id.* § 2613(a)(2).

83. Prop. Treas. Reg. § 26.2613-1(b), 46 Fed. Reg. at 124.

84. *Id.* § 26.2613-1(c), example (1).

85. Even if C were given a distribution in *excess* of income, there would be no GSTT

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 illustration⁸⁷ 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 regulations⁸⁹ 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).

87. Prop. Treas. Reg. § 26.2613-1(c), example (2), 46 Fed. Reg. at 124.

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

89. Prop. Treas. Reg. § 26.2613-1(c), example (3), 46 Fed. Reg. at 124.

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.⁹⁰

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)." ⁹¹ 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." ⁹²

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. ⁹³ 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. ⁹⁴ Finally, the Commissioner

90. *Id.*

91. *Id.* § 26.2613-1(d).

92. It might be argued that this exception language has the effect of treating transfers subject to the \$10,000 exclusion as being subject to the GSTT. This interpretation requires some written record of all prior gifts under \$10,000. Administratively, this requirement would pose very difficult problems for the commissioner.

93. I.R.C. § 2613(a)(3) (1976); Prop. Treas. Reg. § 26.2613-1(e), 46 Fed. Reg. at 124.

94. In the background discussion of taxable distributions, the Commissioner makes this additional comment:

The proposed regulation under § 26.2613-1 defines the term "taxable distribution" and provides, in part, that if any portion of the tax imposed on a generation-skipping transfer is paid by the trust and the amount of the tax is not included in the tax base, then the amount of the taxes paid by the trust is another generation-skipping transfer. This latter transfer is treated as having occurred at the same time as the generation-skipping transfer that caused the imposition of tax. This

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."⁹⁵ 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."⁹⁶ The Commissioner's directives are not based on the Code, but on the prevention of tax avoidance.⁹⁷

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]."⁹⁸ The Code excludes from a "taxable termination" the termination of any interest or power of a person having only a *future* interest or power.⁹⁹ The proposed regula-

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.

95. Prop. Treas. Reg. § 26.2613-1(f)(1), 46 Fed. Reg. at 124.

96. *Id.* § 26.2613-1(f)(2).

97. H.R. REP. NO. 1380, 94th Cong., 2d Sess. 52 (1976) [hereinafter referred to as HOUSE REPORT].

98. I.R.C. § 2613(b)(1) (1976) (emphasis added).

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

interest or power "as long as the interest or power arises annually." Prop. Treas. Reg. § 26.2613-2(c)(2), 46 Fed. Reg. at 126.

100. Prop. Treas. Reg. § 26.2613-2(a), 46 Fed. Reg. at 125. Such an assignment, if for less than adequate consideration, is subject to the gift tax and exempt under I.R.C. § 2613(b)(5)(B) (1976). Conceivably, the GSTT could be avoided by an assignment. If S₁ created a trust with S₂ as life tenant, and child, C, as remainderman, there would be no GST present. C then might assign one-half of the remainder interest to his or her child, GC (S₁'s grandchild), and the other one-half to GC's grandchild, GGC (S₁'s great-grandchild). If there is no amalgamation of S₁'s original trust with C's assignment, there is no GST. For this plan to work, the interests of C must be assignable under local law.

101. I.R.C. § 2613(b)(2)(A) (1976); Prop. Treas. Reg. § 26.2613-2(b)(1), 46 Fed. Reg. at 126. See *infra* notes 107-08 and accompanying text.

102. I.R.C. § 2613(b)(2)(B) (1976); Prop. Treas. Reg. § 26.2613-2(c), 46 Fed. Reg. at 126. See *infra* note 109 and accompanying text.

103. I.R.C. § 2613(b)(2)(C)(1) (1976); Prop. Treas. Reg. § 26.2613-2(d), 46 Fed. Reg. at 126. See *infra* 110-17 and accompanying text.

104. I.R.C. § 2613(b)(2)(D) (1976); Prop. Treas. Reg. § 26.2613-2(b)(2), 46 Fed. Reg. at 125.

105. See *infra* notes 118-31 and accompanying text.

106. 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.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. . . ." 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.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.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."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

107. Prop. Treas. Reg. § 26.2613-2(b)(5), example (1), 46 Fed. Reg. at 125.

108. HOUSE REPORT, *supra* note 97, at 50.

109. Prop. Treas. Reg. § 26.2613-2(c)(1), 46 Fed. Reg. at 126.

110. I.R.C. § 2613(b)(2)(C)(ii) (1976); Prop. Treas. Reg. § 26.2613-2(d)(2), 46 Fed. Reg. at 126.

111. I.R.C. § 2613(b)(2)(C)(ii) (1976); Prop. Treas. Reg. § 26.2613-2(d)(2), 46 Fed. Reg. at 126.

issue per stirpes. Further, assume that C predeceases B leaving one child E.¹¹²

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,¹¹³ 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.¹¹⁴ 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.¹¹⁵

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.¹¹⁶ 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.¹¹⁷

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."¹¹⁸ A person has a trust interest if such person has "a right

112. Prop. Treas. Reg. § 26.2613-2(b)(5), example (5), 46 Fed. Reg. at 125.

113. *Id.* It is assumed that the grandchild exclusion already has been exhausted.

114. *Id.*

115. *See id.* § 26.2613-2(d)(3), example (1), 46 Fed. Reg. at 126.

116. *Id.* § 26.2613-2(b)(2).

117. I.R.C. § 2613(b)(2)(D) (1976).

118. *Id.* § 2613(c)(3).

to receive income or corpus from the trust, or is a permissible recipient of such income or corpus."¹¹⁹

A power is "any power to establish or alter beneficial enjoyment of the corpus or income of the trust."¹²⁰ For purposes of postponement of the incidence of the GSTT, the proposed regulations require that a beneficiary's interest or power be *substantial*.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.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 "[i]f at least 5 percent of the value of the trust . . . is distributed to the nonlineal descendant[s] . . . annually."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."¹²⁴ By definition, the interest of a lineal descendant of the grantor's grandparent is substantial.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.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-

119. *Id.* § 2613(d)(1).

120. *Id.* § 2613(d)(2)

121. Prop. Treas. Reg. § 26.2613-2(b)(3), 46 Fed. Reg. at 125.

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)).

123. Prop. Treas. Reg. § 26.2613-2(b)(3)(iii), 46 Fed. Reg. at 125.

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.

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.

126. Prop. Treas. Reg. § 26.2613-2(b)(3)(i), 46 Fed. Reg. at 125.

tive values of the trust and the right to withdraw corpus or income.¹²⁷ 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.¹²⁸

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."¹²⁹ 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.¹³⁰

(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.¹³¹

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

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).

129. Prop. Treas. Reg. § 26.2613-2(b)(3)(iv), 46 Fed. Reg. at 125.

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."¹³² 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.¹³³

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.¹³⁴

The separate share rule governing the income taxation of trusts is equally applicable to the GSTT.¹³⁵ Even if shares are not considered separate for income taxation purposes, they still may be separate for GSTT purposes.¹³⁶ In the past, planners used the separate shares principle to gain income tax advantages.¹³⁷ Under

132. I.R.C. § 663(1) (1976).

133. Prop. Treas. Reg. § 26.2613-5(c), example (1), 46 Fed. Reg. at 128.

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.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.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."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.¹⁴¹ Interestingly, if the drafter provides that during the

This advantage is limited by the special rules governing the income taxation of accumulation distributions. See I.R.C. §§ 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. See *id.* §§ 661-662.

138. This is assuming that the planner is not seeking to leave separate shares or separate trusts for each succeeding generation.

139. Prop. Treas. Reg. § 26.2613-5(c), example (2), 46 Fed. Reg. at 128.

140. *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. See Treas. Reg. § 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 *all* the income during the estate's administration. This arrangement is *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.

141. Prop. Treas. Reg. § 26.2613-5(c), example (3), 46 Fed. Reg. at 128.

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 "[t]his exclusion is 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.¹⁴⁷ 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,"¹⁴⁸ although it is mentioned in the staff explanation.¹⁴⁹ 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."¹⁵⁰ 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.

148. Prop. Treas. Reg. § 26.2614-4(a), 46 Fed. Reg. at 127.

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.

150. Prop. Treas. Reg. § 26.2613-4(a)(1), 46 Fed. Reg. at 127. See also HOUSE REPORT, *supra* note 97, at 52.

be allocated between the transfers in accordance with their fair market values."¹⁵¹

2. *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 greatgrandchild, 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.¹⁵² If GC exercises the power of appointment in favor of GGC (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."¹⁵³ Thus, the exemption from application of the GSTT applies to the whole transfer.

F. *The Role of the Deemed Transferor*

Under the GSTT statutory plan, the deemed transferor's *tax position* determines the *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

151. Prop. Treas. Reg. § 26.2613-4(a)(2), 46 Fed. Reg. at 127. See also HOUSE REPORT, *supra* note 97, at 53.

152. I.R.C. § 2613(a)(4)(B) (taxable distributions), (b)(5)(B) (1976) (taxable terminations).

153. Prop. Treas. Reg. § 26.2613-1(d) (taxable distributions), -3(c), 46 Fed. Reg. at 124-26 (taxable terminations). See *supra* note 92 and accompanying text.

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."¹⁵⁴

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.¹⁵⁵ 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.¹⁵⁶ 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.¹⁵⁷ From this amount, the tax on all prior transfers, whether by gift, estate, or GST, is subtracted.¹⁵⁸ The difference is the amount of the GSTT on this particular transfer at the appropriate tax rate.¹⁵⁹ This calculation has been used for gift tax purposes since 1932,¹⁶⁰ and for both federal estate and gift tax purposes since 1976.¹⁶¹

The proposed regulations mirror the statute in defining the deemed transferor as the transferee's parent more closely related to the grantor.¹⁶² If neither parent is related to the grantor, then the deemed transferor will be the parent "having a closer affinity to the grantor."¹⁶³ This situation is illustrated by the following example: Assume, in the previous example, that GGC was the child of S₁ and S₂. After S₁'s death, GC married S₂, so that GGC became GC's stepchild. Neither S₁ nor S₂, the parents of GGC, is related to grantor. S₂, however, is the deemed transferor since, as the spouse of GC, S₂ is "the parent having a closer affinity to the

154. I.R.C. § 2612(a)(1) (1976).

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.*

160. Rev. Act of June 6, 1932, Pub. L. No. 72-154, § 502, 47 Stat. 177, 246 (codified at I.R.C. § 2502 (1976)).

161. I.R.C. § 2001(b) (1976).

162. Prop. Treas. Reg. § 26.2612-1(a), 46 Fed. Reg. at 123.

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

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).

165. I.R.C. § 2612(a)(2) (1976); Prop. Treas. Reg. § 26.2612-1(a), 46 Fed. Reg. at 123.

166. I.R.C. § 2612(b) (1976); *see* Prop. Treas. Reg. § 26.2612-1(a), 46 Fed. Reg. at 123.

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).

169. *See* I.R.C. § 2612(a) (1976).

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.

171. Prop. Treas. Reg. § 26.2612-1(b), 46 Fed. Reg. at 123.

who receives the property, or has it applied to his or her benefit;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;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;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.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"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;¹⁷⁷ second, to those assigned to the oldest generation who are lineal descendants of the grantor;¹⁷⁸ third, to those assigned to the oldest generation who are lineal descendants of the beneficiary whose interest or power has been terminated;¹⁷⁹ fourth, to those assigned to the oldest generation who are lineal descendants of the grantor's grandparents;¹⁸⁰ and finally, to all beneficiaries holding present interests or present powers *per stirpes*, unless the trust instrument specified *per capita*.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 in-

172. *Id.*

173. *Id.*

174. *Id.*

175. *Id.*

176. *Id.* § 26.2613-3(a)(1), 46 Fed. Reg. at 126.

177. *Id.* § 26.2613-3(a)(1)(i).

178. *Id.* § 26.2613-3(a)(1)(ii).

179. *Id.* § 26.2613-3(a)(1)(iii).

180. *Id.* § 26.2613-3(a)(1)(iv).

181. *Id.* § 26.2613-3(a)(1)(v).

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.¹⁸² 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.¹⁸³ 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.¹⁸⁴ 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.¹⁸⁵

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.¹⁸⁶

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."¹⁸⁷ "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."¹⁸⁸

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.

187. I.R.C. § 2613(c)(3) (1976).

188. *Id.* § 2613(d)(1).

beneficial enjoyment of the corpus or income of the trust."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. . . .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."¹⁹¹ On these facts, A has a present interest, and the other YGB's have future interests.¹⁹²

A more complicated example illustrates the nature of the interests under the Uniform Gift to Minors Act.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."¹⁹⁴ If no portion of the gift is used to discharge their obligation of support, B's *parents* have a *future* interest.¹⁹⁵ Thus, when B attains majority, there is no taxable termination.¹⁹⁶ If any portion of the gift is used to discharge B's parents' legal obligation of support, however,¹⁹⁷ the parents' have a *present* interest, and there

189. *Id.* § 2613(d)(2).

190. Prop. Treas. Reg. § 26.2613-4(d), 46 Fed. Reg. at 128.

191. *Id.* § 26.2613-4(e), example (1).

192. *Id.*

193. UNIF. GIFT TO MINORS ACT, § 8 U.L.A. 181 (1972).

194. Prop. Treas. Reg. § 26.2613-4(e), example (3).

195. *Id.*

196. *Id.*

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.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."¹⁹⁹ The persons who could benefit from the exercise of the power are all beneficiaries having no *present* interest.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."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.²⁰² The statute, however, is concerned only with beneficial, and not

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 *to the parent*. Under traditional federal gift tax analysis, this accumulation has been treated as a gift of a future interest *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 *Crummey* trust under I.R.C. § 2503(b). 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.

199. Prop. Treas. Reg. § 26.2613-4(e), example (2), 46 Fed. Reg. at 128.

200. *Id.*

201. *Id.* § 26.2613-4(d).

202. See, e.g., *Helvering v. City Bank Farmers Trust Co.*, 296 U.S. 85, 92, *reh'g 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 *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 *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). 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. Compare I.R.C. § 2613(e)(2)(B) (1976) (defining "related or subordinate trustee" for purposes of the GSTT) 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).

204. Prop. Treas. Reg. § 26.2613-3(b)(1), 46 Fed. Reg. at 126-27.

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.

206. Prop. Treas. Reg. § 26.2613-3(b)(1), 46 Fed. Reg. at 126.

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

208. Prop. Treas. Reg. § 26.2613-3(b)(1), 46 Fed. Reg. at 126.

209. *Id.*

210. *Id.* § 26.2613-3(b)(2).

211. I.R.C. § 2613(e)(1) (1976). See also Prop. Treas. Reg. § 26.2613-6(a), 46 Fed. Reg. at 129.

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

212. Revenue Act of 1978, Pub. L. No. 95-600, § 702(n)(3), 92 Stat. 2763, 2935.

213. I.R.C. § 2613(e)(2)(A)(i) (Supp. III 1979). See also Prop. Treas. Reg. § 26.2613-7(a)(1), 46 Fed. Reg. at 129.

214. I.R.C. § 2613(e)(2)(A)(ii) (Supp. III 1979). See also Prop. Treas. Reg. § 26.2613-7(a)(2), 46 Fed. Reg. at 129.

215. I.R.C. § 2613(e)(2)(A)(iii) (Supp. III 1979). See also Prop. Treas. Reg. § 26.2613-7(a)(3), 46 Fed. Reg. at 129.

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.*

217. I.R.C. § 2613(e)(2)(B)(i) (Supp. III 1979).

218. *Id.* § 2613(e)(2)(B)(ii). The regulation has added "employee" of the beneficiary to this list. Prop. Treas. Reg. § 26.2613-7(b)(1), 46 Fed. Reg. at 129.

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";²¹⁹ employee of a corporation "in which the grantor or any beneficiary of the trust is an executive";²²⁰ partner of a partnership "in which the interest of the grantor, the trust, and the beneficiaries of the trust are [sic] significant from the viewpoint of operating control or distributive share of partnership income";²²¹ or employee of a partnership "in which the grantor or any beneficiary of the trust is a partner."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."²²³ The Commissioner illustrates this rule with the following example:

Assume grantor A creates a trust for the benefit of A's children B and C for their joint lives and for the life of the survivor. 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.²²⁴

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

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.²²⁶ These regulations are based on Code sections concerning the imposi-

219. I.R.C. § 2613(e)(2)(B)(iii) (Supp. III 1979).

Stockholdings in a corporation are significant if they provide effective control of the corporation. Prop. Treas. Reg. § 26.2613-7(b)(2), 46 Fed. Reg. at 129. Effective control is defined as "the power to direct or cause the direction of the management and policies of the corporation." *Id.*

220. I.R.C. § 2613(e)(2)(B)(iv), (vi) (Supp. III 1979).

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 the trust. Prop. Treas. Reg. § 26.2613-7(b)(1), 46 Fed. Reg. at 129.

222. I.R.C. § 2613(e)(2)(B)(vii) (Supp. III 1979).

223. Prop. Treas. Reg. § 26.2613-7(b)(3), 46 Fed. Reg. at 129.

224. *Id.* § 26.2613-7(c).

225. *Id.*

226. Temporary Generation-Skipping Transfer Tax Regulations under the Tax Reform Act, 26 C.F.R. § 26a.2621 (1981). Throughout this Article, all cites to the temporary regulations will be designated Temp. Reg.

tion²²⁷ and administration of the tax.²²⁸

1. *Method of Calculation*

Section 2601 is a structural statute imposing the GSTT on "every generation-skipping transfer in the amount determined under Section 2602."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.²³⁰

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

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

2. *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.²³⁶ If the transferor pays the tax on behalf of the transferee, the latter receives an additional taxable distribution.²³⁷ Funds used by the grantor to pay the gift tax are never subject to any transfer tax.²³⁸ The analogy of the taxation of taxable terminations to the estate

227. I.R.C. §§ 2601-2603 (1976).

228. *Id.* §§ 2621-2622.

229. *Id.* § 2601.

230. STAFF EXPLANATION, *supra* note 74, at 575.

231. I.R.C. § 2602(a)(1)(C) (1976).

232. *Id.* § 2602(a)(1)(D).

233. *Id.* § 2602(a)(1)(B).

234. *Id.* § 2602(a)(1)(A).

235. *Id.* § 2602(a)(2).

236. *Id.* § 2603(a)(1)(B).

237. Prop. Treas. Reg. § 26.2613-1(e), 46 Fed. Reg. at 124.

238. With *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.²³⁹ 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 transferred²⁴⁰ "until the tax is paid in full or becomes unenforceable by reason of lapse of time."²⁴¹ This potential liability exists whether the property received by the distributee results from a taxable distribution or taxable termination. To file a proper return²⁴² and pay the tax²⁴³ on taxable terminations, the trustee needs certain information regarding the deemed transferor's tax history.²⁴⁴ 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.²⁴⁵ 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)."²⁴⁶

The distributee(s) and trustee must file the GSTT return on

& Supp. III 1979). In addition, the fair market value of any appreciation between time of transfer and death is subject to the transfer tax system. *Id.* § 2035(a) (1976).

239. *Id.* §§ 2603(a)(1)(A), 2621(c)(1)(A)(ii).

240. *Id.* § 2603(a)(3).

241. *Id.* § 2603(b).

242. *Id.* § 2621(c)(1)(A)(ii).

243. *Id.* § 2603(a)(1)(A).

244. *Id.* § 2603(a)(2)(A). The trustee is not liable for any additional tax attributable to tax rates above those furnished by the Internal Revenue Service, "as . . . the rates at which the transfer may reasonably be expected to be taxed." *Id.*

245. *Id.*

246. STAFF EXPLANATION, *supra* note 74, at 581.

The Temporary Regulations specify the items which a trustee or distributee may request to get the necessary information to complete the tax return, Form 706-B:

- (i) The amount of the deemed transferor's adjusted taxable gifts within the meaning of section 2001(b) as modified by section 2001(e),
- (ii) The amount of the deemed transferor's taxable estate and the estate tax thereon before allowance of any credits,
- (iii) The amount of prior generation-skipping transfers with respect to the deemed transferor,
- (iv) The amount of prior generation-skipping transfers that occurred within three years prior to the deemed transferor's death and the amount of the generation-skipping tax paid with respect to these transfers,

taxable distributions and taxable terminations for any trust.²⁴⁷ Since a GST equivalent has no trustee, the distributee must file the return.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.²⁴⁹ A fiduciary or agent must file the return for a minor,²⁵⁰ an incompetent,²⁵¹ a disabled person,²⁵² or deceased distributees.²⁵³

When there are two or more distributees, the GSTT is pro-rated among them in proportion to the fair market values of their respective interests.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.²⁵⁵ For taxable terminations, only one trustee files the return,²⁵⁶ but all trustees must be notified.²⁵⁷

(v) The amount of generation-skipping transfer tax imposed before the allowance of any credits with respect to prior generation-skipping transfers,

(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,

(vii) The amounts necessary to complete Schedule F, Credit for Tax on Prior Transfers,

(viii) The amount of the grandchild exclusion that has been used for transfers to a grandchild of the grantor,

(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

(x) Any other data that may be needed to complete Form 706-B, *Generation-Skipping Transfers Tax Return*.

Temp. Reg. 26 C.F.R. § 26a.2621-1(J) (1981).

247. Temp. Reg., 26 C.F.R. § 26a.2621-1(b)(1)(i), (ii) (1981).

248. *Id.* § 26a.2621-1(b)(1)(iii).

249. *Id.* § 26a.2621-1(b)(2). See I.R.C. § 2611(c)(7) (1976) (determination of deemed beneficiaries where entity is distributee).

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.*

251. *Id.* § 26a.2621-1(b)(3)(iii). The fiduciary is "the guardian or committee of an insane person." *Id.*

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.*

253. *Id.* § 26a.2621-b(3)(iii). The fiduciary is "the executor or other person in possession of the decedent's [the distributee's] assets . . ." *Id.*

254. *Id.* § 26a.2621-1(b)(4)(i), (h)(i).

255. *Id.* § 26a.2621-1(b)(4)(i).

256. *Id.* § 26a.2621-1(b)(4)(ii).

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(h)(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.²⁵⁸ In addition, the amount of gift tax paid on these transfers is "grossed up" and included in the decedent's gross estate.²⁵⁹ The GSTT follows these principles by imposing a tax "determined as if the transfer occurred after the death of the deemed transferor."²⁶⁰ As a result of taxing the GST at the deemed transferor'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 transferor 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 transferor's death and the tax must be recomputed as if the transfer had occurred immediately after the deemed transferor's death."²⁶¹

2621-1(f)(1). The first form is filed with the Internal Revenue Service Center, where the distributee will later file Form 706-B. *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). *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 transferor. *Id.*

When the deemed transferor 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. *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. *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 transferor, or any time after the death of the deemed transferor," 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 transferor is due. *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. *Id.*

258. I.R.C. § 2035(a) (1976). See *supra* note 238.

259. *Id.* § 2035(c).

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

261. Temp. Reg., 26 C.F.R. § 26a.2621-1(c)(2) (1981).

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 S_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 S_2 already has substantial property and must formulate the plans to be made in the event that S_2 predeceases S_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 S_1 and S_2 . Regarding control over the estate plan, the planner must exercise judgment about the importance of S_1 's retention of control and should ask whether S_2 is to maintain as much control as possible after S_1 's death. With reference to taxation, the planner must ask whether the primary tax objective of S_1 and S_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.

265. Congress achieved this result by repealing I.R.C. § 2056(c) (1976). ERTA § 403(a)(1)(A).

266. ERTA § 403(c).

267. See I.R.C. § 2040(b)(2) (1976).

268. The planner in a common law state, for example, may make a tax-free interspousal transfer from S_1 to S_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 S_1 and S_2 , or use the qualified terminable interest election.

Other questions for the planner include whether a charitable remainder plan²⁶⁹ in S_2 is desirable if S_1 and S_2 are childless; whether S_1 and S_2 have a plan to make *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" trust²⁷⁰ 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.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

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).

270. See *supra* note 20.

271. 2 H. WREN, CREATIVE ESTATE PLANNING § 12.01 (1970).

present law.²⁷²

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 S_1 's death. At S_2 '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 S_1 's estate should elect to treat S_2 's life estate as a "qualified terminable interest," the results would be the same. If S_1 's executor does not elect to treat S_2 's life interest as a "qualified terminable interest" under section 2056(b)(7), however, S_1 's estate will have to pay estate tax at S_1 '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 S_1 's death. All taxes in the generation of S_1 and S_2 may be deferred until the second death. The two plans, however, suggest some deficiencies: (1) no effort is made to take advantage of S_1 's unified credit; (2) no effort is made to reduce the taxation levels of S_1 and S_2 by taxing two estates at lower rates; and (3) any transfer tax paid at S_1 's death will reduce correspondingly the amount available to be taxed at S_2 's later death. These deficiencies may be corrected by passing *some* of S_1 '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 S_1 's exemption through the unified credit. Following this approach, by 1987, \$600,000 could be passed to the next generation at S_1 's death tax free. At S_2 's death the transfer tax then would be:

272. An example of such a clause is:

I give to S_2 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 S_2 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).

	\$1 million level	\$2 million level	\$5 million level
Taxable Estate	\$400,000	\$1,400,000	\$4,400,000
Taxable Estate Tax	121,800	512,800	1,975,800
Minus Unified Credit	192,800	192,800	192,800
Tax Payable	\$ -0-	\$320,000	\$1,783,000

This solution does not take advantage of the elimination of some tax from S₂'s estate by paying *some* estate tax at S₁'s prior death, but it does provide tax deferral. If S₂'s needs could be met at the \$2 and the \$5 million levels by a gift of fifty percent of these amounts at S₁'s death, the total transfer tax cost to S₁ and S₂ could be reduced further:

	\$2 million level	\$5 million level
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 S₁'s prior death, the planner may save substantial amounts:

	Plans A-B	Plan C-1 (\$600,000 to next generation)	Plan C-2 (50% to S ₂)
\$1 million level	\$ 153,000	\$ -0-	\$ -0-
\$2 million level	588,000	320,000	306,000
\$5 million level	2,083,000	1,783,000	1,666,000
	Tax Savings Between Plans A & B and Plan C-1		Tax Savings Between Plans A & B and Plan C-2
\$1 million level	\$153,000		\$153,000
\$2 million level	268,000		282,000
\$5 million level	300,000		417,000

These solutions have not necessarily resolved all problems facing the planner. If, for example, S₂ predeceases S₁, and S₁ owns all the family property, the potential savings will disappear. An alternative plan would provide for a tax-free interspousal transfer from S₁ to S₂ of approximately one-half of S₁'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 S_1 and S_2 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, S_1 and S_2 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:

	\$1 million level	\$2 million level	\$5 million level
Original Total Estate	\$1,000,000	\$2,000,000	\$5,000,000
Minus Gifts Over Ten Years (\$60,000 per year)	600,000	600,000	600,000
	\$ 400,000	\$1,400,000	\$4,400,000

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:

	\$2 million level	\$5 million level
Gift to S_2 at S_1 's Death	\$700,000	\$2,200,000
Gift to Next Generation upon S_1 's Death	\$663,000	\$1,514,000
Tax upon S_1 's Death	37,000	686,000
Tax upon S_2 '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 S_1 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

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 S_2 will consent to the appropriate gift splitting.

274. *Id.* § 2035(a), (d)(1).

tax.²⁷⁵ 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,²⁷⁶ the exercise of a general power of appointment,²⁷⁷ or the transfer of life insurance.²⁷⁸ 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.²⁷⁹ 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) S_1 and S_2 make no *inter vivos* gifts; (2) the bulk of the family's wealth is approximately \$2,000,000 and owned by S_1 ; (3) S_1 and S_2 have three children; (4) each child has two children; and (5) there is a likelihood that S_1 will predecease S_2 . Assume further, that S_1 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 S_1 's death, and that the tax burden be borne entirely by this portion of the estate, so to relieve S_2 from all transfer tax responsibility. The planner also might recommend the use of a Q-TIP trust to defer estate taxation until S_2 's death, such trust giving S_2 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 S_1 and S_2 . Assuming S_1 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 S_1 dies in 1987, or thereafter, this estate plan eliminates the transfer tax at S_1 's death since the Husband Family Trust is covered by the unified credit.²⁸⁰ 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 S_1 and S_2 are of the same generation, S_1 is not a younger generation beneficiary (YGB), and the Wife Grandchildren Trust is not a GST.²⁸¹ 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.²⁸²

Moreover, through this estate plan, S_1 accomplishes several objectives. S_1 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, S_1 provides S_2 with an annual income for life of \$84,000,²⁸³ and provides the children an income of \$12,000 per year for their lives. In addition, S_1 makes it possible for his grandchildren to assume an inheritance of \$280,000.

S_1 can vary these results, depending on family needs. If, for

280. See *supra* note 2.

281. See *supra* notes 21-28 & 36-40.

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.²⁸⁴ 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* transfer²⁸⁵ 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.²⁸⁶

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-

284. If D dies on or after January 1, 1987, the estate has to pay a federal estate tax of \$94,500. Assuming that this tax is borne by the Husband Family Trust, A, B, and C each receive one-third of the balance, \$850,000 minus \$94,500, or \$755,500. This amount is taxed slightly at the death of the survivor of A, B, and C, since it is almost entirely covered by three \$250,000 exclusions for them as deemed transferors.

285. I.R.C. § 2523(a) (1976).

286. Transfers to a grandchild of the grantor are not treated as taxable terminations or taxable distributions except to the extent that the total amount of the transfers from one or more trusts exceeds \$250,000 for each deemed transferor. Since S₁ and S₂ presumably are treated as separate grantors, the effect is to double the exclusions available for A, B, and C. This increase in exclusions, however, is consistent with the fundamental philosophy of community property, the unlimited marital deduction, and the concept of gift splitting.

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* S₁ and S₂. There is no reason why both cannot be grantors of their separate estates. S₁ and S₂ may want to act separately and have each of their estates pass into a GST for the children and grandchildren. Under such a plan, S₁ and S₂ 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:

S ₁ 's Estate	\$1,000,000
Tax Thereon	345,000
Minus Unified Credit	192,800
S ₁ 's Federal Estate Tax	153,000
Add S ₂ 's Federal Estate Tax	153,000
Total Tax Cost	\$ 306,000
S ₁ 's Trust for A,B, & C (\$1,000,000 - \$153,000) ...	\$ 847,000
S ₂ 's Trust for A,B, & C (\$847,000 + \$1,000,000 - \$153,000)	\$1,694,000

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)) trusts²⁸⁷ 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 Act²⁸⁸ inadvertently 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.²⁸⁹ 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).

288. UNIF. GIFT TO MINORS ACT, § 8 U.L.A. 181 (1972).

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-

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.

291. Pub. L. No. 94-455, 90 Stat. 1520 (1976) (codified in scattered sections of 26 U.S.C.).

292. Canada repealed the transfer tax system seven years ago. See also *supra* note 6.

293. See generally E. HALBACH, DEATH, TAXES AND FAMILY PROPERTY 77-100 (1977).

tension of the role of the custodian under the Uniform Gifts to Minors Act.²⁹⁴ 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.

294. UNIF. GIFT TO MINORS ACT, 8 U.L.A. 181 (1972).