Estate and Gift Tax Provisions and Income Taxation of Trusts

W. Birch Douglass III
I. Income Taxation of Trusts and Estates

A. New rate schedules for trusts and estates [Act § 101 amending § 1]

1. Trusts and estates continue to be treated as conduits with respect to income distributed currently and are only taxed on retained income.

2. Starting with taxable years beginning in 1987, new rate schedules are provided for trusts and estates. The existing rates continue to apply to trusts and estates with fiscal years beginning in 1986 and ending in 1987.

   a. The rate schedule for taxable years beginning in 1987 has 5 brackets.

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 - $ 500</td>
<td>1.1%</td>
</tr>
<tr>
<td>$ 501 - $ 4,700</td>
<td>15%</td>
</tr>
<tr>
<td>$4,701 - $ 7,550</td>
<td>28%</td>
</tr>
<tr>
<td>$7,551 - $15,150</td>
<td>35%</td>
</tr>
<tr>
<td>Over $15,150</td>
<td>38.5%</td>
</tr>
</tbody>
</table>

   b. For taxable years beginning in 1988, taxable income up to $5,000 will be taxed at a rate of 15% and taxable income in excess of $5,000 will be taxed at a rate of 28%. The benefit of the 15% bracket is phased out by imposing a 5% surcharge on retained taxable income between $13,000 and $26,000. The surcharge results in an effective marginal tax rate of 33% in this range, and subjects trusts and estates to a 28% flat rate of tax when their income subject to tax exceeds $26,000.

3. The "compression" of the income tax brackets will reduce the income tax savings available by creating trusts. Multiple trusts will not be as
advantageous, and there will be less incentive to accumulate income in a trust or estate, as the maximum tax benefit will be less than $1,000 per trust when only the first $5,000 of taxable income is taxed at a rate of 15% and the trust or estate will reach the 28% bracket before its beneficiaries.

B. Capital gains [Act §§ 301 and 302 repealing § 1202 and amending § 1]

1. The capital gains rules that apply to individuals also generally apply to trusts and estates.

2. The maximum capital gains rate is 28% for taxable years beginning after 1986, although starting in 1988 capital gains may be taxed at higher marginal rates because of the phase out of the 15% rate.

3. In the case of trusts and estates with fiscal years beginning in 1986 and ending in 1987, the 20% maximum capital gains rate applies to sales made during that fiscal year, even though the sale is made after January 1, 1987. Such trusts and estates may find it advantageous to sell appreciated assets during this fiscal year before the increased rates take effect.

C. Trusts required to adopt calendar year [Act § 1403 adding § 645]

1. All new and existing trusts are required to have taxable years ending on December 31 (thus reducing the ability to defer tax on trust income) for trust taxable years beginning after December 31, 1986.

   a. An exception is provided for tax-exempt trusts described in § 501(a) and wholly charitable trusts described in § 4947(a)(1). These trusts may continue to select any fiscal year.

   b. Charitable remainder trusts exempt from tax under § 664 must switch to the calendar year.

   c. These new rules do not affect estates. Executors may continue to defer income by selecting fiscal years.
2. Existing trusts that are not already on the calendar year must convert to the calendar year in 1987 and will have short taxable years ending December 31, 1987. Beneficiaries must report trust income from that short taxable year ratably over a 4-year spread-forward period beginning with their 1987 income tax returns.

a. The spread-forward applies only to distributions of the trust's distributable net income. Accumulation distributions and amounts accumulated by complex trusts during the short taxable year are taxed in full in that year.

b. The spread-forward rule will allow many fiscal year trusts to reduce fiduciary taxable income by making large distributions in late 1987 to beneficiaries who will defer paying taxes on a portion of that income until April 15, 1991. Some trustees may wish to take steps during 1987 to increase distributable net income to take advantage of this opportunity.

c. Virginia income taxes must be considered because the General Assembly may not amend Virginia's income tax rules to permit spread-forward reporting.

d. The spread-forward rules may cause difficulties in the case of tiered fiscal year entities such as a fiscal year trust that is a partner in a fiscal year partnership, since multiple applications of the spread-forward rules will be required.

D. Estimated tax payments required of trusts and certain estates [Act §§ 1404 and 1542 amending §§ 643, 6154, and 6654]

1. Trusts must make estimated income tax payments for trust taxable years beginning in 1987 and thereafter. Most trusts will pay estimated taxes under the same rules as apply to individuals (90% of taxes for the current year or 100% of the prior year's tax liability must be paid in quarterly installments during the year).

a. Because the underpayment penalty exception for payment of 100% of the prior year's tax only applies if the preceding taxable year is a full 12 months, there is a possibility
a new trust may not use this exception until its third taxable year. Existing fiscal year trusts forced to short years for 1987 may be required to pay estimated taxes for 1988 based on 90% of actual 1988 tax liability.

b. A trust (but not an estate) may elect to treat all or a portion of its estimated tax payments as having been made by a beneficiary to the extent its estimated tax payments exceed its taxes due.

i. The election must be made on the trust's income tax return and only may be made if the return is filed by the 65th day after the close of the taxable year.

ii. The amount assigned to a beneficiary is considered as a trust distribution received by the beneficiary on the last day of the trust's taxable year and an estimated tax payment made by the beneficiary on the following January 15.

2. For taxable years beginning after 1986, estates must make estimated tax payments under the same rules as apply to individuals starting with the estate's third taxable year.

3. Tax-exempt organizations subject to tax on unrelated business taxable income under § 511 and private foundations subject to the 2% tax on net investment income under § 4940 must make estimated tax payments for taxable years beginning after 1986 as if those taxes were corporate taxes.

E. Grantor trusts -- general [§§ 671-678]

1. Under the grantor trust rules, a grantor who transfers property to a trust and retains certain powers or interests in the trust is treated as the owner of the trust for federal income tax purposes. The income and deductions attributable to the trust are taken into account by the grantor directly.

2. Previously, an exception to grantor trust treatment existed for a reversionary trust having
a term of more than 10 years (the so-called Clifford trusts).

3. In recent years, practitioners avoided the requirement of keeping the property in trust for more than 10 years by using a spousal remainder trust having a term shorter than 10 years and under which the grantor gave the remainder to the spouse instead of retaining the reversionary interest for himself.

F. Elimination of Clifford trusts [Act § 1402 amending § 673]

1. Beginning with transfers made to trusts after March 1, 1986, the grantor is treated as the owner of all transfers with respect to which the grantor (or the grantor’s spouse) has a reversionary interest (in the corpus transferred or the income therefrom) in excess of 5% of the value of the amount transferred. The possibility that an interest may revert under intestacy laws is to be ignored.

2. There is no longer any exemption to grantor trust treatment for transfers of at least 10 years and one day, although existing Clifford trusts continue to be exempt from the grantor trust rules for transfers made on or before March 1, 1986.

3. A transitional rule grandfathers transfers to Clifford trusts created pursuant to certain binding property settlements entered into before March 1, 1986.

4. There is no proscribed reversionary interest with respect to a reversion that will occur only after the death of an income beneficiary before attaining age 21, if the beneficiary is a lineal descendant of the grantor and has an entire present interest in that portion of the trust.

G. Elimination of spousal remainder trusts [Act § 1401 amending § 672]

1. Beginning with transfers made to trusts after March 1, 1986, the grantor is treated as holding powers or interests in a trust held by his spouse if the spouse was living with the grantor at the time the interest or power was created.
2. This rule applies to persons eligible to file a joint return in the year of the transfer and who were spouses at the time the property was transferred in trust.

H. Deduction of administration expenses  [Act § 132 adding § 671]

1. Legal and accounting fees, fiduciary commissions, and other estate and trust administration expenses that would not have been incurred if the property were not held in the trust or estate are deductible in full to estates and non-grantor trusts (that is, they are not subject to the 2% of adjusted gross income floor).

2. Expenditures (such as investment advisory fees) that would have been incurred had the property not been held in trust are subject to the 2% floor on deductibility.

3. The 2% floor will apply to beneficiaries succeeding to the property of a trust or estate on its termination and having excess deductions over its gross income for its final year.

I. Installment payments  [Act § 1404 repealing § 6152]

1. For taxable years beginning after 1986, estates may no longer pay fiduciary income taxes in quarterly installments.

J. Alternative minimum tax  [Act § 701 adding § 59]

1. Beginning in 1987, a modified version of the alternative minimum tax applicable to individuals will apply to trusts and estates.

2. The minimum tax will apply by determining distributable net income on an alternative minimum taxable income basis, with the minimum tax exemption amount treated in the same manner as the deduction for personal exemptions under § 643(a)(2). Items treated differently for regular tax and minimum tax are not to be apportioned between the estate or trust and the beneficiaries as they are currently.

K. Accrual method of accounting  [Act § 801 adding § 448]

1. Charitable and other tax-exempt trusts subject to the tax on unrelated trade or business taxable
income are required to use the accrual method of accounting with respect to the activities constituting an unrelated trade or business.

2. Such trusts may continue to use the cash method of accounting for other tax purposes such as the 2% tax on the net investment income of a private foundation.

L. **Trust distributions** [Act § 1806 amending § 643]

1. The election provided under the Tax Reform Act of 1984 to recognize gain or loss on the distribution of property from a trust or estate applies to all distributions made during the taxable year.

M. **Multiple trusts** [Act § 1806 amending § 643]

1. The changes made by the Tax Reform Act of 1984, treating multiple trusts as one trust for income tax purposes if their grantors and beneficiaries are substantially the same and their principal purpose is tax avoidance, do not apply to trusts irrevocable on March 1, 1984, except to the extent property is transferred in trust after that date.

II. **Miscellaneous Changes Affecting Gift and Estate Taxes**

A. **Estate tax special-use valuation elections** [Act § 1421]

1. Under § 2032A, an executor may elect to value for estate purposes certain real property used in farming or other closely held business operations based upon its current use value rather than its full fair market value.

2. If an estate made a defective current use valuation election on a timely filed estate tax return providing substantially all the information requested by the return form then in use, the election is valid provided the estate supplies any missing information within 90 days after being notified by the IRS that there is missing information. This provision applies to estates of persons dying after 1976 and before 1986, if the statute of limitations has not run.

B. **Deductions for conservation easement donations** [Act § 1423 amending §§ 2055(f) and 2522]
1. Taxpayers may claim deductions for contributions of certain interests in real property to charitable and governmental organizations for income tax and gift and estate tax purposes. If the contributions do not meet the requirements for deductibility for income tax purposes, the income tax deduction is lost.

2. The taxpayer will be permitted to claim an estate or gift tax deduction for the contribution notwithstanding the disallowance of the income tax deduction, effective for contributions made after December 31, 1986.

C. Pension benefits [Act § 1133 adding § 4981]

1. In conjunction with the new excise tax on excess distributions from tax-favored retirement savings arrangements, an additional estate tax is imposed at a rate of 15% on the value of a decedent's interests in all qualified retirement plans, tax-sheltered annuities, and IRAs to the extent the value exceeds the amount that would be required to produce a life income of $112,500 per year.

2. The unified credit, marital deduction, and charitable deduction may not be used to reduce this tax.

3. No income tax deduction under § 691(c) is available with respect to the payment of this estate tax.

D. Estate tax deduction for sales of employer securities to ESOP [Act § 1172 adding § 2057]

1. An executor of an estate may exclude from the gross estate 50% of the proceeds from the sale of employer securities to an ESOP before the due date (including extensions) of the estate's tax return. This rule does not apply with respect to certain employer securities acquired in a distribution from a tax-exempt plan or acquired under a § 83 or ISO transfer.

2. The executor must file a statement with the IRS.

3. This provision applies to sales occurring after the date of enactment of the Act and before January 1, 1992.
III. Income of Children

A. Personal exemption and standard deduction [Act §§ 102 and 103 amending §§ 63 and 151]

1. When computing income tax liability, an individual generally may claim a personal exemption and a standard deduction (formerly, the zero bracket amount).

   a. Personal exemption amount (phased out for high-income taxpayers)

      
      
      | Year  | Amount  |
      |-------|---------|
      | 1986  | $1,080  |
      | 1987  | $1,900  |
      | 1988  | $1,950  |
      | 1989 and thereafter | $2,000 |

   b. Standard deduction amount (single taxpayers)

      
      
      | Year  | Amount  |
      |-------|---------|
      | 1986  | $2,300  |
      | 1987  | $2,570  |
      | 1988 and thereafter | $3,000 |

2. An individual who may be claimed as a dependent on another person's return may not claim a personal exemption and may claim a standard deduction equal only to the sum of the individual's earned income plus up to $500 of unearned income.

B. Tax rates applicable to unearned income of children under 14 [Act § 1411 adding § 1(i)]

1. Beginning in 1987, all of the net unearned income in excess of $500 of a child under age 14 is taxed to the child at his parent's top marginal tax rate if the tax would be greater than the regular tax computed on the child's income.

   a. Whether or not a child has attained age 14 is determined as of the end of the year. Either of the child's parents must also be alive as of the close of the year for the rule to apply.

   b. The tax on the child's unearned income subject to tax at the parent's marginal tax rate is the tax the parent would have paid had the parent's taxable income actually included that unearned income less the tax
actually imposed on the parent's taxable income. Thus, in determining the tax, the unearned income of the children is deemed to shift the parent into a higher tax bracket or into a taxable income level where the 5% surcharge is imposed. If the parent has more than one child, the tax is allocated among the children based on proportionate unearned income subject to tax at the parent's rate.

2. Because a child under age 14 (who may be claimed as a dependent by another taxpayer) may allocate up to $500 of his standard deduction to unearned income, only unearned income in excess of $1,000 would normally be taxed at the parent's top marginal rate. The $500 attributable to the child's standard deduction will not be subject to tax and the remaining $500 will be taxed at the child's rate.

3. If the parents file separate returns, the tax will be determined using the return of the parent with the greater taxable income. If the parents are divorced, the tax will be computed using the return of the parent with custody.

4. Unearned income includes unearned income from all property regardless of the source of the property producing the unearned income. There is no relief for property previously transferred to children by grandparents or others.

5. Unearned income includes a trust's unearned income reportable by the child. Thus, income from grandfathered Clifford trusts and income distributions of irrevocable trusts is taxable at the parent's rate if the beneficiary child is under age 14.

6. Complications may exist in circumstances where either the child or the parent is subject to the alternative minimum tax.

IV. Income Shifting After the Tax Reform Act of 1986

A. Children under age 14

1. Children may be given property producing unearned income not to exceed $1,000 without adverse tax consequences since the child has a $500 exemption amount and may allocate up to $500 of the standard deduction to unearned income. At
current interest rates, a child could have a savings account in excess of $11,000 and still not pay tax at the parent's rates.

2. Children may be put on the payroll of a business, so that they have earned income subject to tax at their own (and not their parent's) rates.
   a. Care should be taken that the child actually performs services comparable in value to the amount of compensation.

3. It may be desirable to make gifts to children of investments that do not produce income until the child reaches age 14, for example, tax-exempt bonds, Treasury Series EE Bonds, and life insurance products such as a universal life policy.
   a. It may make sense to have children under age 14 with large current investments switch out of taxable investments to tax-deferred or tax-free investments.

4. Transfers to irrevocable trusts that do not pay out income may be useful since the first $5,000 of trust income will be taxable at the 15% rate.

B. Children age 14 and older

1. Transfers to irrevocable trusts will continue to be viable, although not as beneficial.

2. Charitable remainder trusts, particularly for college age children, may be more attractive.

3. Wealthy individuals will want to consider the transfer of income-producing property to a grantor trust under the terms of which the beneficiary (for example, a child) is to be paid annually the trust's income and to receive the trust corpus upon reaching a specified age. The grantor is taxed on the income produced by the trust, with the effect that he has transferred the gross amount of the income to the beneficiary (perhaps without incurring a gift tax) and has avoided including either the appreciated value of the trust property or the income taxes paid in his estate.

4. When a child reaches age 14, his unearned income in excess of $1,000 is subject to tax at his own
rates, thus making current income-shifting transfers viable again.

V. Year-End Tax Planning for 1986

A. Use of grantor charitable lead trusts

1. Before the end of 1986, the grantor contributes income-producing property to a trust, the terms of which provide that a specified charity is to receive the income from the trust assets for a period of years and then the trust corpus reverts to the grantor (or passes to descendants if the grantor trust rules are brought into play by a retained power or other technique that does not cause inclusion in the gross estate). The grantor claims a charitable deduction in 1986, presumably when it would be of most benefit, equal to the present value of the income stream to be paid to the charity throughout the term of the trust. The grantor would be required to include in income and pay tax on the amounts earned each year by the trust that are being paid to the charity. Taxation to the grantor may be avoided by investing the trust assets in assets producing income not subject to tax (for example, tax-free municipal bonds).

2. Example -- In 1986, a grantor lead trust is funded with $100,000, which is invested in municipal bonds producing $10,000 annually. Under the terms of the trust, the income is to be paid to X charity for a period of 5 years, at which time the trust is to terminate and revert to the grantor. The grantor would have a current deduction of $37,908 in 1986 (assuming that is the present value of the income stream), and the corpus would revert to the grantor at the end of 5 years. Assuming a 50% marginal tax rate, the grantor would obtain a federal tax benefit of $18,954. If, instead of investing in tax-free bonds, the funds had been invested in investments producing taxable income, the grantor would have a lesser net tax savings but would still obtain the benefit of tax deferral.

B. Use of charitable remainder trusts

1. Establish a charitable remainder trust in 1986 that would pay a fixed percentage of trust assets at least annually for a specified period to one or more persons who are not charitable organizations and then terminate and pass the
trust assets to one or more charitable organizations.

2. Unless the trust has unrelated business taxable income, the trust is exempt from taxation under § 664. The beneficiaries are taxed on the income received from the trust. The grantor obtains a charitable deduction for the value of the charitable remainder interest at the time the trust is established. The value of the interest given to the non-charitable beneficiary is subject to gift and estate tax, but the donor is entitled to the gift tax annual exclusion.

3. Example -- In 1986, an individual creates a charitable remainder annuity trust funded with $100,000 of marketable securities with these terms: 8% annuity payment to his mother, age 65, for her lifetime payable on the last day of each year, and then to a qualified public charity. The value of the mother's interest in the trust is $54,375, which qualified for $20,000 of gift tax annual exclusions. The balance of the mother's gift may be sheltered by any unused unified credit. The value of the charitable remainder is $45,625, which qualifies for a current income tax charitable deduction for 1986, the year the trust is created.

C. Liquidation of existing corporations with appreciated assets

1. The Act repeals the General Utilities doctrine, thus subjecting certain corporate liquidations to tax at both the corporate and shareholder levels. Liquidations completed before 1987 continue to be subject to the pre-Act law exempting liquidating distributions from tax at the corporate level. As a result, liquidations completed before 1987 would be subject to tax at a rate of 20% to individual shareholders, whereas, in the case of those accomplished after 1986, gain would be taxed 34% at the corporate level and 28% at the individual level on the remaining 66%.

a. Shareholders of closely held corporations with appreciated assets should consider whether it is advantageous to liquidate their corporation this year or convert to S corporation status.
2. The repeal of General Utilities will affect many traditional estate planning opportunities such as holding companies and recapitalizations.

VI. Generation-Skipping Transfer Tax

A. Repeal of prior law

1. The Act retroactively repeals the generation-skipping transfer tax (the "GST tax") enacted in 1976.

2. The repeal also applies to interest, additions to tax and other additional amounts. The GST taxes that were collected may be credited or refunded (with interest) as an overpayment.

3. Refunds or credits barred by the statute of limitations will be allowed if a claim is filed within one year after the date of enactment of the Act.

B. Imposition of new tax [Act §§ 1431-1433 amending Chapter 13]

1. A flat-rate generation-skipping transfer ("GST") tax is imposed on all generation-skipping transfers involving a sharing in benefits by more than one generation and on direct transfers that skip generations.

   a. A generation-skipping transfer is a transfer to a beneficiary (called a "skip-person" in the statute) at least two generations younger than the transferor, such as the transferor's grandchildren or great-grandchildren. § 2611(a).

   b. The rate of tax on generation-skipping transfers is equal to the maximum gift and estate tax rate imposed under § 2001 at the time of the GST. The rate is 55% through 1987 and 50% thereafter.

   c. The GST tax does not apply to lifetime transfers exempt from tax under either the $10,000 annual gift exclusion or the special exclusion for certain tuition and medical expenses.

   d. The GST tax is in addition to any estate or gift tax also due as a result of the transfer.
2. The following transactions are subject to the tax:

a. "Direct skips" involving transfers of property to a trust, all of the beneficiaries of which are skip persons, as well as direct outright transfers of property that skip generations.

i. The tax would not be imposed on direct skip transfers to or for the benefit of a grandchild if the grandchild's parent who was a lineal descendant of the transferor was deceased at the time of the transfer.

ii. Examples of direct skips are a transfer in trust for the benefit of the grantor's grandchild and an outright gift to the transferor's grandchild.

b. "Taxable distributions" by trusts involving any distributions (other than a taxable termination or a direct skip) to a beneficiary more than one generation younger than the grantor.

i. For example, under a discretionary trust established for the grantor's child and grandchild, the trustee distributes accounting income to the grantor's child and corpus to the grantor's grandchild. The distribution of corpus is a taxable distribution.

b. "Taxable terminations" of an interest or power in a trust if, immediately after the termination, all interests in the trust are held by generation-skipping beneficiaries. A taxable termination is the complete termination (by death, lapse of time, release of power, or otherwise) of the interests or powers of the last person belonging to a generation younger than that of the grantor when there are trust beneficiaries belonging to even a younger generation at the time.

i. For example, if a trust provides that the grantor's child is to receive the trust income for life with the remainder to the grantor's grandchild,
a taxable termination occurs on the
death of the grantor's child.

ii. Certain partial terminations may constitute a taxable termination where assets are distributed to generation-skipping beneficiaries who are lineal descendants of the holder.

3. Because the term "trust" is defined to include arrangements that have substantially the same effect as a trust, arrangements involving life estates and remainders, estates for years, and insurance and annuity contracts are potentially subject to the GST tax. § 2652(b).

4. The tax applies only to current and not to future interests in property, and it does not apply to powers.

C. Computation of the GST tax

1. Tax Base and Payment of Tax -- The GST tax rate is applied to the "inclusion ratio," which is the amount transferred less any portion that is exempt and any applicable deductions. § 2641. The inclusion ratio is 1 over a fraction, the numerator of which is the amount of GST exemption allocated to the trust (or to the property transferred in a direct skip) and the denominator of which is the value of the property transferred to the trust (or in the direct skip) less federal estate and state death taxes and less any charitable deduction allowed.

a. In the case of taxable distributions, the transferee pays the tax on the taxable amount received from the trust. If the trustee pays any of the tax, the trustee is treated as having made an additional taxable distribution equal to the amount of tax paid.

i. The tax is imposed whether the distribution is from trust income or corpus.

ii. The transferee may claim income tax deductions with respect to the GST tax imposed and expenses involved in determining the amount of the tax.
b. In the case of taxable terminations, the trustee pays the GST tax on the taxable value of the property in which the interest terminates.

i. The trustee may claim as a deduction expenses attributable to the property similar to those deductible under § 2053.

c. In the case of direct skips, the person making the transfer pays the GST tax on the value of the property transferred.

i. The tax is imposed on the trustee in the case of direct skips from a trust and on the donor otherwise.

2. Estate planning documents need to address which portion of a transferor's estate or trust will be responsible for the GST tax.

D. $1,000,000 specific exemption

1. Every person may make transfers (during life or at death) that are exempt from the GST tax of up to $1,000,000.

a. The grantor or his executor allocates the exemption or a portion thereof to transferred property. The allocation may be made at any time up to the date prescribed for filing the grantor's estate tax return (including extensions).

b. Once made, the allocation is irrevocable.

2. Once a transfer, or a portion of a transfer, is designated as exempt, all subsequent appreciation in value of the exempt property and income therefrom also is exempt from the GST tax. Thus, if a grantor transfers $1,000,000 to a trust and designates the transfer as exempt, no part of the trust will ever be subject to the GST tax even if the value of the trust property appreciates to $5,000,000 before it is distributed. In contrast, if a grantor transfers $1,000,000 to a trust and designates one-half of the amount of the transfer as exempt, half of each GST from the trust will be subject to tax and half will be exempt.
a. Since the value at the time of allocation determines the amount of exemption used, it is normally best to make an allocation early and apply the allocation to appreciating assets.

3. Deemed allocation rules.

a. A grantor is deemed to allocate any unused portion of his GST tax exemption to direct skips made during his lifetime unless he elects otherwise.

b. If the grantor, or his executor, does not allocate the entire amount of his GST tax exemption within the prescribed period, any unused portion is allocated first, to direct skip transfers occurring at the individual's death, and second, to trusts with respect to which the individual is a grantor and from which a GST might occur.

4. Spouses may elect to treat a lifetime transfer as made one-half by each, and each spouse's GST exemption will apply to half of the transfer.

5. By a special election, an individual may allocate all or a portion of his GST exemption to a QTIP trust created for his spouse.

6. Planning will be required to take maximum advantage of spouses' exemptions since, except with respect to the QTIP election, the exemption is not transferable.

E. $2,000,000 per grandchild special additional exemption for direct skips

1. A grantor making transfers involving direct skips to grandchildren before January 1, 1990 qualifies for an additional exemption of $2 million per donee grandchild. Act § 1433(b)(3).

2. Gift splitting by married couples is permitted, thereby allowing a husband and wife to give up to $4,000,000 to each grandchild if the transfers are made by the end of 1989. Thus, a couple with 4 grandchildren could directly transfer $16,000,000 free of the GST tax.

3. Use of this exemption will subject the transferor to substantial gift taxes.
F. Valuation of the property transferred

1. Property transferred is generally valued as of the time of the GST. The value is reduced by consideration provided by the transferee.

2. Property transferred in a direct skip occurring as a result of death has the same value for GST tax purposes as it does for estate tax purposes. Thus, the valuation under the alternate valuation and special-use valuation elections of §§ 2032 and 2032A apply and electing estates must consider the impact of the election on the GST tax.

3. Even if an estate does not elect the alternate valuation date, the valuation under the alternate valuation election rules of § 2032 applies to taxable terminations occurring at death.

G. Other provisions for administering the GST tax

1. Generations are determined along family lines where possible. Spouses are assigned to the generation of the family member to whom they are married. Lineal descendants of grandparents of the transferor's spouse are assigned to generations in the same manner as the transferor's descendants. Persons outside the family are assigned to generations based on age relative to the grantor. If the grandchild's parent who is a lineal descendant of the transferor is deceased, the grandchild and all succeeding lineal descendants are "moved-up" a generation. § 2651.

2. The provisions governing administration of the estate taxes apply to GSTs occurring as a result of death, and those governing administration of gift taxes apply in other cases. § 2661.

3. The basis of property subject to the GST tax is increased by the amount of that tax attributable to the excess of the property's value over the transferor's basis (in addition to any adjustment provided instead for under the gift or estate tax basis provisions). A basis step-up (like that provided under the estate tax in § 1014) is provided instead for taxable terminations occurring as a result of death. § 2654(a).

4. The special rules under which estate tax attributable to interests in certain closely held
businesses may be paid in installments under § 6166 also may be applied to direct skips occurring as a result of death.

5. Redemptions under § 303(d) to pay GST tax triggered as a result of death are granted exchange treatment rather than ordinary income treatment.

6. A credit, not exceeding 5% of the federal GST tax, is allowed for GST tax actually paid to a state with respect to taxable GST transfers (other than a direct skip) occurring by reason of death.

7. Spouses may elect to treat a transfer as being made one-half by each spouse.

8. Rules are provided to subject multiple skips to multiple applications of the GST tax. § 2653.

9. A trustee will not be personally liable for an increase in the GST tax attributable to erroneously claimed gift tax exemptions for the $10,000 annual gift exclusion or transfers for educational or medical purposes or erroneous inclusion ratios, unless the trustee should have known of the errors.

10. The GST tax applies if the beneficiary of an estate or trust makes a disclaimer that results in the property passing to a person two generations younger than the transferor. §§ 2654(c) and 2518.

11. The person liable for the tax is required to make the return. § 2662(a)(1). The return is to be filed in the case of a direct skip (other than from a trust) on or before the date on which an estate or gift tax return is required to be filed with respect to the transfer. In all other cases, the return is to be filed on or before the 15th day of the 4th month after the close of the taxable year of the person required to make the return in which the transfer occurs.

12. The GST tax and state GST taxes imposed on income distributions are deductible taxes.

H. Effective dates

1. In general, the GST tax applies to testamentary transfers made after the date of enactment of the
Act and to lifetime transfers made after September 25, 1985 (the latter are treated as occurring on the first day after the date of enactment). Direct skips made before these dates are not subject to tax.

2. Transfers from a trust that was irrevocable on September 25, 1985 are exempt to the extent the transfer is not attributable to additions made to the trust after September 25, 1985.

3. Transfers made pursuant to a will that was in existence on September 25, 1985 will not be subject to the GST tax if the testator was incompetent on September 25, 1985 and at all times thereafter until his death.