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# PLANNING FOR THE GENERATION-SKIPPING TRANSFER TAX: OUT WITH THE OLD AND IN WITH THE NEW

*Craig J. Langstraat\**

Since its inception in 1976,<sup>1</sup> the generation-skipping transfer tax has been a matter of consternation and confusion. Interpretation of the statutes involved has been difficult for both practitioners and the Internal Revenue Service. Several clarifying amendments have been enacted,<sup>2</sup> but substantive regulations have never been finalized. The call for retroactive repeal of the generation-skipping transfer tax provisions began at their inception and has accelerated over the years. Even the IRS joined the repeal lobby in 1983 by offering a proposal that was ultimately introduced into Congress.<sup>3</sup>

Finally, in the Tax Reform Act of 1986,<sup>4</sup> the long awaited repeal of the original generation-skipping transfer tax has come to fruition. In its place, however, is a new generation-skipping transfer tax that may cause the critics to remember the original version with fondness.

This article will discuss the specifics of the repeal as well as the specifics of the new generation-skipping transfer tax. In addition, the changes necessary in previously completed planning will be outlined, along with planning strategies for current and future use under the new law.

## I. OUT WITH THE OLD

Prior to the 1986 reform of the Internal Revenue Code, the generation-skipping transfer tax was only assessed on taxable distributions<sup>5</sup> and taxable terminations<sup>6</sup> of interests in generation-skipping trusts or

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1. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2006, 90 Stat. 1520, 1879-90.

2. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 428, 95 Stat. 172, 319; Technical Corrections Act of 1979, Pub. L. No. 96-222, § 107(a)(2), 94 Stat. 194, 222 (1980); Revenue Act of 1978, Pub. L. No. 95-600, § 702(n), 92 Stat. 2763, 2935.

3. H.R. 6260, 98th Cong., 2d Sess. (1984); see also *Hearings on the Generation-Skipping Transfer Tax Before the Committee on Ways and Means, House of Representatives*, 98th Cong., 2d Sess. (1984).

4. Pub. L. No. 99-514, 100 Stat. 2085.

5. See *infra* note 31 and accompanying text.

6. See *infra* notes 32-33.

trust equivalents.<sup>7</sup> Generation-skipping trusts were trusts having beneficiaries belonging to two or more generations, both younger than the grantor's generation; for example, a trust benefiting the children *and* grandchildren of the grantor is a generation-skipping trust. Otherwise taxable transfers to the grandchildren of the grantor were excluded from taxation to a maximum exclusion of \$250,000 for each of the grantor's children, with each \$250,000 exclusion being split between the offspring of a specific child.<sup>8</sup> The generation-skipping transfer tax was levied using the same progressive rate structure applicable to estate and gift taxes,<sup>9</sup> with possible application of the unused portion of the estate tax unified credit.<sup>10</sup>

The Tax Reform Act of 1986 retroactively repealed the original generation-skipping transfer tax by providing that any tax calculated under the original provisions is not to be assessed.<sup>11</sup> If the tax has already been assessed, the assessment is to be abated by the IRS.<sup>12</sup> If any tax has been collected, that tax is to be treated as an overpayment.<sup>13</sup>

The taxpayer can choose whether to have the overpayment credited against other tax liabilities of the taxpayer or to have the overpayment refunded with appropriate interest.<sup>14</sup> Regardless of any statute of limitations, the taxpayer will have a minimum of one year after October 22, 1986, to claim the credit or refund.<sup>15</sup>

## II. IN WITH THE NEW

The old concept of a generation-skipping trust or trust equivalent<sup>16</sup> is not part of the new law. But there is a new key party in the generation-skipping transfer tax arena. This is the "skip person."

A skip person is defined as someone "assigned to a generation which is 2 or more generations below the [transferor's generation.]"<sup>17</sup> A trust can be a skip person itself "if all interests in such trust are held by skip persons," or if there is no person holding an interest in such trust, and the trust contains a restriction against distribution to any

7. I.R.C. § 2611(a) (1976) (amended 1986).

8. *Id.* § 2613(b)(6) (1976) (amended 1986).

9. *Id.* § 2602(a) (1976) (amended 1986).

10. *Id.* § 2602(c)(3) (1976) (amended 1986).

11. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1433(c)(1), 100 Stat. 2085, 2731.

12. *Id.*

13. *Id.*

14. *Id.*

15. *Id.* § 1433(c)(2), 100 Stat. at 2731-32.

16. See I.R.C. § 2611(a)-(b) (1976) (amended 1986).

17. *Id.* § 2611(c)(1) (1986).

non-skip person.<sup>18</sup> In typical Internal Revenue Code style, a non-skip person is defined as anyone who is not a skip person.<sup>19</sup>

The determination of assigned generation under the new law is identical to the provisions of the old law.<sup>20</sup> For lineal descendants of a grandparent of the transferor or his spouse, "the transferor . . . shall be assigned to that generation which results from comparing the number of generations between the grandparent and such individual with the number of generations between such grandparent and such spouse."<sup>21</sup>

#### EXAMPLE:

The transferor's grandchild is the fourth generation from the transferor's grandparents. The transferor is the second generation from the transferor's grandparents. Since the grandchild's generation (fourth) is at least two generations below the transferor's generation (second), the grandchild is a skip person under the new statute.

Relationships by half-blood and those created by legal adoption are treated the same as whole-blood lineal descendants.<sup>22</sup> "[I]ndividual[s] who [have] been married at any time to the transferor [or any other lineal descendant] shall be assigned to the transferor's generation."<sup>23</sup>

Recipients who are not lineal descendants are assigned to a generation by a comparison of their age with the transferor's age. Those "born not more than 12½ years after the . . . transferor [are] assigned to the transferor's generation."<sup>24</sup> Those "born [between] 12½ years [and] 37½ years after the . . . transferor [are] assigned to the first generation younger than the transferor."<sup>25</sup> A younger generation is created for each additional twenty-five year period.<sup>26</sup>

#### EXAMPLE:

Transferor is 65 years of age. Recipient *A* is 55 years old. Recipient *B* is 45 years old. Recipient *C* is 25 years old. *C* is a skip person because his birth date is 40 years after the transferor's birth date, thereby assigning *C* to the second generation younger than

18. *Id.* § 2613(a)(2).

19. *Id.* § 2613(a)(1).

20. *Compare id.* § 2611(c) (1976) (repealed 1986) with *id.* § 2651 (1986).

21. *Id.* § 2651(b)(1)-(2) (1986).

22. *Id.* § 2651(b)(3).

23. *Id.* § 2651(c)(1)-(2).

24. *Id.* § 2651(d)(1).

25. *Id.* § 2651(d)(2).

26. *Id.* § 2651(d)(3).

the transferor's generation. *A* and *B* are non-skip persons.

If by those rules one person is "assigned to more than 1 generation," then such person will be treated as belonging "to the youngest . . . generation."<sup>27</sup> Owners of beneficial interests in recipient estates, trusts, partnerships, corporations, or other entities will be individually assigned to a generation.<sup>28</sup> Charitable organizations and charitable trusts "shall be assigned to the transferor's generation."<sup>29</sup>

#### A. *What Is a Generation-Skipping Transfer?*

Although defined somewhat differently, two of the three new generation-skipping transfers have names familiar to estate planners. They are the taxable distribution and the taxable termination.<sup>30</sup>

A *taxable distribution* occurs when a skip person receives a distribution from a trust that is not otherwise characterized as a taxable termination or a direct skip.<sup>31</sup>

#### EXAMPLE:

The trustee makes a discretionary \$100,000 distribution to the grantor's great-granddaughter. The great-granddaughter is a skip person, because she is at least two generations below the grantor's generation; therefore, the payment is a taxable distribution.

A *taxable termination* occurs when an interest in property held in a trust terminates unless "immediately after such termination, a non-skip person has an interest in such property, or at no time after such termination [is] a distribution . . . made from such trust to a skip person."<sup>32</sup> This definition also includes partial terminations to the extent that "a specified portion of the trust assets are distributed to skip persons who are lineal descendants of the holder of such interest" in property.<sup>33</sup>

#### EXAMPLE:

Grantor creates a trust with income to her son for his life, then income to her granddaughter for life, with the remainder to her great-grandchildren. A taxable termination occurs when the son dies since his interest in trust property terminates, and a skip person has an interest in the trust property. The grandchild is a

27. *Id.* § 2651(e)(1).

28. *Id.* § 2651(e)(2).

29. *Id.* § 2651(e)(3).

30. *See id.* § 2613(a)-(b) (1976) (amended 1986).

31. *Id.* § 2612(b) (1986).

32. *Id.* § 2612(a)(1).

33. *Id.* § 2612(e).

skip person because she is two generations below the grantor's generation. A second taxable termination would occur at the time of the granddaughter's death for the same reasons.

The new type of generation-skipping transfer is the *direct skip*. This is defined as any transfer of an interest in property to a skip person that is also subject to the gift or estate tax.<sup>34</sup> For the purpose of determining whether any transfer qualifies as a direct skip, however, the transferor's grandchild will be treated as the transferor's child, and therefore as a non-skip person, if the grandchild's parent is dead at the time of the transfer.<sup>35</sup>

#### EXAMPLE:

The decedent's will makes an outright bequest to his grandson of \$100,000. This transfer of property subject to the estate tax is also a direct skip for generation-skipping transfer tax purposes so long as the grandson's lineal-descendant parent is alive at the decedent's death.

#### B. *Bring Out the Exclusions and Exemptions*

Several exclusions and exemptions are available to lessen the impact of the generation-skipping transfer tax. To the extent that the transfer is subject to gift or estate tax in the tax return of a first-generation beneficiary below the grantor's generation, any transfer from a trust, other than a direct skip, is excluded from the definition of generation-skipping transfer.<sup>36</sup>

#### EXAMPLE:

Grantor creates a trust with income to her daughter for life, general power of appointment in the daughter, on default remainder to the donor's grandson. Since the daughter's interest in the trust is subject to estate tax on her death,<sup>37</sup> the termination of the daughter's interest is not treated as a taxable termination.

Any transfer directly to an educational institution for tuition or directly to a medical care provider for medical care that would qualify for the gift tax exclusion<sup>38</sup> if made during the transferor's life is not subject to the generation-skipping transfer tax.<sup>39</sup>

In addition, the current transfer is excluded when (1) "the prop-

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34. *Id.* § 2612(c)(1).

35. *Id.* § 2612(c)(2).

36. *Id.* § 2611(b)(1).

37. *Id.* § 2041.

38. *Id.* § 2503(e).

erty transferred was subject to a prior tax imposed [under the generation-skipping transfer tax]"; (2) the transferee in the current transfer is assigned to the same generation as, or a higher generation than, the prior transferee; and (3) "such transfers do not have the effect of avoiding [generation-skipping transfer tax]."<sup>40</sup>

#### EXAMPLE:

Grantor creates a trust with income to son for life, then income to granddaughter for life, then income to grandson for life, with remainder to great-grandchildren. There is a taxable termination on the death of the son, which subjects the property to generation-skipping transfer tax. The death of the granddaughter would not be treated as a taxable termination. This is because the property has already been subject to the generation-skipping transfer tax, the grandson is assigned to the same generation as the granddaughter, and the transfer does not have the effect of avoiding the tax.

The same result for the above example would be reached using the rules related to multiple skips. These rules provide that when the property subject to the generation-skipping transfer tax is held in trust after the transfer, "the transferor of such property [will be] assigned to the [first] generation above the highest generation [beneficiary]."<sup>41</sup> In the above example, upon the death of the son (with its attendant tax consequences), the grantor would be assigned to his son's generation. The subsequent transfer to the grandson would not be taxable, since the grandson would not be a skip person: he is only one generation below the son's generation, the generation to which the grantor is assigned by the multiple skip rules.

A cumulative \$1,000,000 lifetime generation-skipping transfer (GST) exemption is available for allocation by each transferor.<sup>42</sup> The allocation "may be made at any time on or before the date prescribed for filing the [transferor's] estate tax return"<sup>43</sup> and "once made, shall be irrevocable."<sup>44</sup> "If [the transferor] makes a direct skip during his lifetime, any unused portion of [his or her] GST exemption shall be allocated to the property transferred"<sup>45</sup> unless the transferor elects out.<sup>46</sup>

To the extent a transferor does not allocate the full GST exemp-

40. *Id.* § 2611(b)(3).

41. *Id.* § 2653(a).

42. *Id.* § 2631(a).

43. *Id.* § 2632(a)(1).

44. *Id.* § 2631(b).

45. *Id.* § 2632(b)(1)-(2).

46. *Id.* § 2632(b)(3).

tion within the statutory period, the statute first allocates the unused amount to any "direct skip[s] occurring at [the transferor's] death."<sup>47</sup> Any remaining GST exemption is then allocated to trusts created by the transferor "from which a taxable distribution or a taxable termination might occur at or after [the transferor's] death."<sup>48</sup> If it is necessary to allocate within these two categories, a pro rata allocation method is used.<sup>49</sup>

The definition of a direct skip is modified to exclude a cumulative amount of \$2,000,000 per grandchild of the transferor if the transfers to a grandchild occur prior to January 1, 1990.<sup>50</sup>

### C. Calculation of Tax

The amount of the generation-skipping transfer tax imposed is calculated by multiplying the taxable amount of the generation-skipping transfer by the applicable rate.<sup>51</sup> Each type of generation-skipping transfer has a different taxable-amount definition.

For taxable distribution, "[T]he taxable amount . . . shall be (1) the value of the property received by the transferee, [less] (2) any expense incurred by the transferee in connection with the determination, collection, or refund of the [generation-skipping tax]."<sup>52</sup> This amount will have been reduced by any applicable exclusion or exemption discussed above (excepting the GST exemption),<sup>53</sup> as well as by "any consideration provided by the transferee [for the transfer]."<sup>54</sup>

The taxable amount is increased by any generation-skipping transfer tax paid by the trust with respect to the taxable distribution.<sup>55</sup> This treatment obviously creates additional tax on the amount of tax treated as a distribution. A series of trial and error calculations or a mathematical simultaneous equation will be necessary to determine the total taxable amount when the trust pays the generation-skipping tax.

The taxable amount for taxable terminations is "the value of all property [subject to the] termination"<sup>56</sup> less "expenses, indebtedness, and taxes . . . attributable to the property."<sup>57</sup> If the taxable termina-

47. *Id.* § 2632(c)(1)(A).

48. *Id.* § 2632(c)(1)(B).

49. *Id.* § 2632(c)(2).

50. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1433(b)(3), 100 Stat. 2085, 2731.

51. I.R.C. § 2602 (1986).

52. *Id.* § 2621(a).

53. Due to a strange quirk in drafting, the GST exclusion reduces the applicable rate rather than the taxable amount. See *infra* text accompanying notes 65-71.

54. I.R.C. § 2624(d) (1986). The reduction in taxable amount for any consideration provided by the transferee applies regardless of the type of taxable transfer.

55. *Id.* § 2621(b).

56. *Id.* § 2622(a)(1)-(2).

57. *Id.* § 2622(c). The statute describes this deduction as "similar" to one allowed in deter-



tion occurs due to a death, an election can be made to value all property at the alternate valuation date<sup>58</sup> as utilized in the estate tax.<sup>59</sup>

“[T]he taxable amount in case of a direct skip shall be the value of the property received by the transferee.”<sup>60</sup> If the direct-skip is included in the transferor’s gross estate, then the estate tax value is used for determining the taxable amount.<sup>61</sup> This means that to the extent the estate elects alternate valuation<sup>62</sup> or special use valuation,<sup>63</sup> that benefit also applies to the generation-skipping transfer tax.<sup>64</sup>

The more complex component of the tax calculation is the applicable rate. The applicable rate is defined as “the product of (1) the maximum Federal estate tax rate [in effect at the time of the generation-skipping transfer], and (2) the inclusion ratio with respect to the transfer.”<sup>65</sup> The easy part is the determination of the maximum federal estate tax rate. Currently that rate is fifty-five percent, with a decrease to fifty percent scheduled to go into effect after 1992.<sup>66</sup>

The inclusion ratio is defined as “the excess (if any) of 1 over . . . the applicable fraction determined for the trust from which [the generation-skipping] transfer is made.”<sup>67</sup> The numerator of the transfer’s applicable fraction is the allocated GST exemption.<sup>68</sup> The denominator is “the value of the property transferred . . . [less] any Federal estate tax or State death tax actually recovered from the trust attributable to such property”<sup>69</sup> and any related allowable charitable<sup>70</sup> deduction.<sup>71</sup>

#### EXAMPLE:

A \$3,000,000 direct-skip has been made in 1987. No previous allocation of the GST exemption has occurred. The potential gen-

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mining the taxable estate under § 2053. Clearly, regulations are necessary to explain the parameters of the similarity.

58. *Id.* § 2032.

59. *Id.* § 2624(c).

60. *Id.* § 2623.

61. *Id.* § 2624(b).

62. *Id.* § 2032.

63. *Id.* § 2032A.

64. *Id.* § 2624(b).

65. *Id.* § 2641(a)-(b).

66. *Id.* § 2001(c)(1).

67. *Id.* § 2642(a)(1). The inclusion ratio for nontaxable gifts under § 2503(b) or (e) is zero.

See *id.* § 2642(c)(3)(A)-(B).

68. *Id.* § 2642(a)(2)(A).

69. *Id.* § 2642(a)(2)(B).

70. As determined under § 2055 (for estate tax) or § 2522 (for gift tax).

71. I.R.C. § 2642(a)(2)(B) (1986). Special rules for the calculation of the applicable fraction are provided for situations in which multiple transfers occur to a single trust. See *id.* § 2642(d). A trust generally retains its inclusion ratio in spite of special treatment for multiple skips. See *id.* § 2653(b).

eration-skipping transfer tax liability is \$1,100,000 calculated as follows:

$$\begin{aligned} \text{Taxable transfer} &= \$3,000,000 \\ \text{Maximum federal estate tax rate} &= 55\% \\ \text{Applicable fraction} &= \frac{\$1,000,000 \text{ (allocated GST exemption)}}{\$3,000,000} = 1/3 \\ \text{Inclusion ratio} &= 1 - 1/3 = 2/3 \\ \text{Tax} &= \$3,000,000 \times 55\% \times 2/3 = \$1,100,000 \end{aligned}$$

It should be noted that the same result could be obtained in a more straightforward manner by subtracting the allocated GST exemption from the taxable amount and multiplying that remainder by the maximum federal estate tax rate:

$$(\$3,000,000 - \$1,000,000) \times 55\% = \$1,100,000.$$

A credit is allowed for state generation-skipping transfer tax paid at death with respect to property underlying a taxable termination or a taxable distribution.<sup>72</sup> This credit is limited, however, to five percent of the federal generation-skipping transfer tax.<sup>73</sup>

The generation-skipping transfer tax return is to be filed by the person liable for paying the tax.<sup>74</sup> The transferee is liable for the tax in a taxable distribution,<sup>75</sup> the trustee is liable for the tax in a taxable termination,<sup>76</sup> and the transferor is liable for the tax in a direct-skip.<sup>77</sup> The return due-date for direct skips (other than from a trust) is the date that the applicable gift or estate tax is due.<sup>78</sup> Returns for other types of generation-skipping transfers are due on the fifteenth day of the fourth month after the taxable year in which the transfer took place. For example, April 15 is the return date for a calendar-year taxpayer.<sup>79</sup>

Unless the governing instrument provides otherwise, the source for the payment of the tax is the property underlying the transfer.<sup>80</sup> The transfer at death of an interest in a closely-held business, which qualifies for estate tax payment deferral under section 6166,<sup>81</sup> is eligible for generation-skipping transfer tax payment deferral as well.<sup>82</sup>

72. *Id.* § 2604(a).

73. *Id.* § 2604(b).

74. *Id.* § 2662(a)(1).

75. *Id.* § 2603(a)(1).

76. *Id.* § 2603(a)(2).

77. *Id.* § 2603(a)(3).

78. *Id.* § 2662(a)(2)(A).

79. *Id.* § 2662(a)(2)(B).

80. *Id.* § 2603(b).

81. *Id.* § 6166(a).

## D. Effects on Other Taxes

### 1. Gift Tax

"In the case of any taxable gift which is a direct skip . . . the amount of such gift shall be increased by the amount of [related generation-skipping transfer tax paid by the transferor]."<sup>83</sup>

#### EXAMPLE:

If *A* makes a taxable gift of \$1,000,000 that is also a direct skip generating \$550,000 of generation-skipping transfer tax, the taxable gift for gift tax calculation purposes is \$1,550,000 (\$1,000,000 + \$550,000).

The income tax basis of property underlying a taxable termination occurring at the death of an individual gets a step-up in basis to the property value at the date of transfer.<sup>84</sup> The increase in basis is limited if the transaction's inclusion ratio was less than one.<sup>85</sup> A basis step-up to the extent of generation-skipping transfer tax related to appreciation is available for other generation-skipping transfers.<sup>86</sup>

#### EXAMPLE:

If *B* makes a direct skip of property having an adjusted basis (AB) of \$500,000 and fair market value (FMV) of \$1,000,000, and pays generation-skipping transfer tax of \$550,000, then the income tax basis to the recipient is increased by \$225,000.

$$\begin{aligned} \text{Appreciation} &= \$1,000,000 \text{ (FMV)} - \$500,000 \text{ (AB)} = \$500,000 \\ \text{GST tax related to appreciation} &= \$550,000 \times \frac{\$500,000}{\$1,000,000} = \$225,000 \end{aligned}$$

It should be noted that a similar adjustment would be made for gift tax paid on the direct skip.<sup>87</sup> In no event would the recipient's adjusted income tax basis exceed the property's fair market value.<sup>88</sup>

### 2. Income Tax

The generation-skipping transfer tax levied at death attributable to a transfer of income characterized as a taxable termination or a direct skip is income tax deductible to the extent the recipient is income-

83. *Id.* § 2515. To the extent additional gift tax is paid due to this provision, the recipient will have an increase in income tax basis under the provisions of § 1015(d)(1)(A).

84. *Id.* § 2654(a)(2).

85. *Id.*

86. *Id.* § 2654(a)(1).

87. *Id.* § 1015(d)(1)(A).

88. *Id.* § 2654(a)(1), 1015(d)(1)(A).

taxable on the amount.<sup>89</sup>

#### EXAMPLE:

C received \$50,000 of income through a taxable termination occurring on the death of an individual. A generation-skipping transfer tax of \$27,500 related to the income was paid. C would have an income tax deduction of \$27,500 if he was income-taxable on the \$50,000 under the trust rules or as a recipient of income in respect of a decedent.

For taxable transfers not occurring at death, the generation-skipping transfer tax on an income distribution will also be an income tax deduction to the income taxpayer.<sup>90</sup>

#### E. Transition Rules

The general rule is that the new generation-skipping transfer provisions are effective for transfers after October 22, 1986, the enactment date of the Tax Reform Act of 1986.<sup>91</sup> In addition, any inter vivos transfer after September 25, 1985, is treated as if it occurred after the enactment date.<sup>92</sup>

The grandfathering provisions of the new law provide that the following transfers are not subject to the generation-skipping transfer tax:

(1) any generation-skipping transfer from a trust which was irrevocable on September 25, 1985, to the extent the transfer was not made out of corpus contributed to the trust after that date;<sup>93</sup>

(2) any generation-skipping transfer under a will executed prior to October 22, 1986, if the decedent dies before January 1, 1987;<sup>94</sup> and

(3) certain generation-skipping transfers attributable to a decedent who was under a mental disability on October 22, 1986, and did not regain competence before death.<sup>95</sup>

### III. UNPLANNING THE OLD LAW

The basic planning tool under the old generation-skipping transfer tax was to arrange direct transfers to members of the second or lower generation below the generation of the transferor. This was due to the fact that only distributions from trusts benefiting multiple younger gen-

89. *Id.* § 691(c)(3).

90. *Id.* § 164(a)(5)<sup>1</sup>.

91. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1433(a), 100 Stat. 2085, 2731. The section provides for some exceptions.

92. *Id.* § 1433(b)(1), 100 Stat. at 2731.

93. *Id.* § 1433(b)(2)(A), 100 Stat. at 2731.

94. *Id.* § 1433(b)(2)(B), 100 Stat. at 2731.

95. *Id.* § 1433(b)(2)(C), 100 Stat. at 2731.

erations were taxable.<sup>96</sup>

Since these types of direct transfers now qualify as direct skips and are therefore subject to taxation under the new law, all estate planning documents created under the old law should be reviewed. To the extent that irrevocable trusts were formed and funded prior to September 25, 1985, the grandfathering provisions will alleviate any potential problems.<sup>97</sup> Any additions to the corpus of such a trust after that date will be subject to the new rules.<sup>98</sup>

In addition, direct skips planned utilizing revocable trusts and/or wills should be reviewed under the new rules for potential adverse consequences. The analysis for these situations will be the same as the new planning considerations discussed below.

#### IV. PLANNING UNDER THE NEW LAW

The new generation-skipping transfer tax rules are much more comprehensive than the previous ones. This expansion is particularly evident with the addition of direct skips to the potential tax base.

To the extent that the planner and/or client want to make generation-skipping transfers, the exclusions and exceptions should be utilized to the maximum extent available. This will give each transferor a minimum of \$1,000,000 to transfer without this type of tax liability.<sup>99</sup> Also, the exclusions for direct payments for college tuition and medical care could be part of any plan.<sup>100</sup>

Clients should be advised of the relatively short time until the \$2,000,000 per grandchild exclusion for direct skips expires. If the estate plan calls for transfers to grandchildren, direct skips must be made prior to January 1, 1990, to take advantage of this exclusion.<sup>101</sup>

The potential transfer tax impact on lifetime direct skips may give all parties concerned pause before making any such transfers.

#### EXAMPLE:

*D* makes a direct skip transfer of \$1,000,000 that is not subject to any exclusion or exemption. *D* is also in the maximum gift-tax bracket.

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96. See I.R.C. § 2613 (repealed 1986).

97. See *supra* note 94 and accompanying text.

98. *Id.*

99. See *supra* note 41 and accompanying text.

100. See *supra* notes 37-38.

101. See *supra* note 49 and accompanying text.

$$\text{GST tax} = \$1,000,000 \times 55\% = \$550,000$$

$$\begin{aligned} \text{Gift tax} &= (\$1,000,000 + \$550,000 \text{ (GST tax)})^{102} \times 55\% \\ &= \$852,500 \end{aligned}$$

$$\text{Total transfer tax paid on } \$1,000,000 \text{ direct skip} = \$1,402,500$$

It should be noted that the transferor's gross estate will be reduced by the total amount of tax paid,<sup>103</sup> as well as by the future appreciation and income associated with the asset. In this particular type of factual situation, the recipient would likely have any income tax basis equal to the fair market value of the property transferred.<sup>104</sup> These positive factors may not be sufficient to overcome objections to the initial cash outlay for transfer taxes.

### V. CONCLUSION

The new generation-skipping transfer tax rules have expanded the applicability of the tax to direct skip situations. This will make the tax much more difficult to avoid for transfers benefiting grandchildren and younger generations. Estate planners should be aware of the new generation-skipping transfer tax provisions to maximize the use of exemptions and exclusions while implementing estate plans based on other tax and non-tax factors.

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102. See *supra* text accompanying note 84.

103. Assuming the transferor survives for at least three years following the transfer. See I.R.C. § 2035(c) (1986).

