ALLOCATING GENERATION-SKIPPING TRANSFER TAX EXEMPTION

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Advisors to taxpayers with estates larger than the $5.45 million exemption often plan carefully to reduce the imposition of the generation-skipping transfer ("GST") tax. However, generous exemptions and careful estate planning are for naught if clients and their advisers fail to properly and effectively allocate their GST exemption on the Form 709*, U.S. Gift (and Generation-Skipping Transfer) Tax Return*.[1]

Unfortunately, the Form 709 is not well adapted for GST reporting, particularly in the context of gifts to trusts. In addition, when the Form 709 was updated to reflect the deemed allocation rules at sections 2632(b) and (c) of the Internal Revenue Code (the "Code"), the revisions were not nearly extensive enough, making the return cumbersome to use. Combined with the complicated underlying law, it is no surprise that estate planners, return preparers, and their clients regularly make improper and imprudent GST exemption allocations.

And of course, because each year's Form 709 builds on GST exemptions allocated in previous years, an error in identifying or reporting allocated GST in one year can lead to a cascade of errors and improper allocations in future years, culminating in potentially incorrect estate tax returns.

This article focuses on the mechanical process of properly allocating the GST exemption on the Form 709 and identifies best practices to avoid common allocation errors. The authors assume a basic familiarity with the substantive principles of the GST and set forth the law only as necessary to illuminate specific points.

I. The GST Exemption

The GST tax is imposed on each "generation skipping transfer" passing to a "skip person" (defined as an individual two or more generations below the transferor, a trust, the only current beneficiaries of which are skip persons, or a trust in which there are no current beneficiaries and from which no distributions can be made to non-skip persons)[2] by gift or bequest. There are three categories of GSTs: direct skips, taxable terminations, and taxable distributions. A direct skip is a transfer directly to an individual or a trust that meets the definition of a skip person.[3] Thus a direct skip can occur whether the transfer is in trust or outright. A taxable termination occurs when all non-skip persons who were current trust beneficiaries cease to be current beneficiaries– due to a death or other event or provision of the trust – so that non-skip persons no longer have an interest

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1 References herein to Form 709 or the Instructions to Form 709 are to the versions of the form and instructions for use with respect to gifts made in calendar year 2015.

2 IRC § 2613(a).

3 IRC §§ 2612(c), 2613(a).

in the trust.[4] Finally, a taxable distribution occurs when property is distributed to a skip person from a trust. [5]

The GST exemption can be allocated at any time on or before the date prescribed for filing the estate tax return for such individual's estate (determined with regard to extensions).[6] With respect to direct skips and certain transfers to "GST trusts," allocations are deemed to have been made without the donor's action, unless the donor "elects out" of such treatment. [7] For a timely allocation of GST exemption (including deemed allocations), the transferred property to which the allocation is made is valued as of the date of the gift for the purpose of determining how much GST exemption must be allocated to produce an inclusion ration of zero.[8] Late allocations of GST exemption must be applied to the value of the transferred property as of the date of the allocation, unless the taxpayer elects to use the value on the first day of the month in which the allocation is made.[9] Both deemed allocations and manual allocations are irrevocable after the due date of the return.[10]

In addition to the GST exemption, there is also a form of "annual exclusion" found at section 2642(c) of the Code. This exclusion differs in key respects from the gift tax annual exclusion. The GST tax version of the annual exclusion applies to both outright direct skips, excluded from the gift tax under the gift tax annual exclusion[11] or the medical/educational exclusion,[12] and to direct skips in trust, but only if the trust (a) is for the primary benefit of a single individual "skip person" beneficiary, (b) provides that no income or corpus is payable to anyone other than that beneficiary during the beneficiary's lifetime, and (c) is includible in the beneficiary's estate if the trust does not terminate prior to his or her death.[13] Many trusts crafted to comply with the gift tax annual exclusion will not pass this test. For example, neither a *Crummey* trust with multiple beneficiaries nor a *Crummey* trust that gives the single beneficiary a limited power of appointment over the trust assets such that they will not be included in the beneficiary's gross estate will qualify for the GST annual exclusion.

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4 IRC § 2612(a). See IRC § 2652(c), which provides that an individual has an "interest in property held in trust" only if the individual may currently receive distributions from the trust. A different rule applies for charities. However, for convenience, this article uses the phrase "current beneficiary" to refer to persons with an interest in property held in trust.

5 IRC § 2612(a). Note that a skip person often becomes a non-skip person after a GST occurs causing the transferor to move down a generation under IRC § 2653.

6 IRC § 2632(a)

7 IRC §§ 2632(b) and (c).

8 IRC § 2642(b)(1).

9 IRC § 2642(b)(3); Treas. Reg. § 26.2642-2(a)(2).

10 IRC § 2631(b); Treas. Reg. §§ 26.2632-1(b)(1)(ii), 26.2632-1-1(b)(2)(i), 26.2632-1(b)(4)(i). The authors use the term "manual allocation" to refer to any allocation that is affirmatively made by the taxpayer on the gift tax return (as compared to a deemed allocation).

11 IRC § 2503(b). The 2016 annual gift tax exclusion amount is $14,000. A gift of a future interest does not qualify for the annual exclusion. IRC § 2503(b)(1).

12 IRC § 2503(e). To qualify for this exclusion, the payment must be made directly to an educational organization as tuition or directly to a medical provider.

13 See IRC § 2642(c)(2) (allowing transfers to certain trusts to qualify for an automatic zero inclusion ratio); Treas. Reg. § 26.2612-1(a) (defining when a gift in trust is a direct skip).

II. File Returns Every Year and Include All Gifts on the Return

The authors recommend filing a gift tax return every year in which a gift was made in trust and listing on the return all gifts, even when not strictly required to do so. By law, a return must be filed for any calendar year in which the donor makes one or more gifts other than (a) transfers that are excluded from the amount of gifts by reason of the annual exclusion or the medical/educational exclusion, (b) transfers for which a marital deduction is allowed (other than gifts to qualified terminable interest property ("QTIP") trusts, for which an election must be made on the return), or (c) certain transfers that qualify for the gift-tax charitable deduction.[14] If a return is required, only gifts "included in computing taxable gifts" are reported.[15] Therefore, the donor is not required to report gifts to a donee who receives from the donor during the year total gifts of no more than $14,000.[16]

For example, if Client gave $14,000 to each of four *Crummey* trusts for her grandchildren as part of her regular estate planning in January 2015 and made no other gifts that year, she need not file a Form 709. However, if she made an additional gift of $100,000 in March 2015 to one of her grandchildren to enable that grandchild to buy a house, she has a return obligation. All gifts to the new homeowner ($114,000) should be listed on the Form 709, but the gifts to the trusts for her other grandchildren are not reqired to be reported.

The authors recommend going above and beyond these requirements by also reporting all gifts in trust that fully qualify for the gift tax annual exclusion (but not for the GST tax counterpart). In addition to the obvious statute of limitations benefits, this approach helps prevent common errors, including errors resulting from the differences between the annual exclusion from gift tax and its GST tax counterpart. Schedule A is the foundation of the Form 709 and should include all taxable gifts, whether subject to the GST tax or not. Schedule D then builds on Schedule A to determine the GST tax consequences of the taxable gifts (direct skips are reported in Part 1 of Schedule D, GST exemption is allocated in Part 2 and GST tax is calculated in Part 3).[17] If the instructions for the Form 709 are followed but no additional steps taken, many gifts qualifying for the gift tax annual exclusion would not be reported on Schedule A, and their GST tax implications might be missed. For example, if an "annual exclusion" gift to a trust with potential future GSTs does *not* qualify for the GST tax counterpart to annual exclusion,

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14 IRC § 6019; Treas. Reg. § 25.6019-1.

15 IRC § 6019; Treas. Reg. § 25.6019-3(a).

16 See IRC § 2503(b)(1) ("the first [$14,000] of … gifts to [any] person shall not, for purposes of [defining a "taxable gift" under] subsection (a), be included in the total amount of gifts made during such year"); see also Instructions for Form 709 (2015), at page 7 ("*Gift splitting not elected.* If the total gifts of present interests to any donee are more than $14,000 in the calendar year, then you must enter all such gifts that you made during the year to or on behalf of that donee, including those gifts that will be excluded under the annual exclusion. If the total is $14,000 or less, you need not enter on Schedule A any gifts (except gifts of future interests) that you made to that donee.").

17 The instructions for Schedule D instruct the return preparer to put "all of the gifts you listed in Part 2 of Schedule A, in the same order and showing the same values" in Part 1 of Schedule D. Instructions for Form 709 (2015), at page 16. The total of these gifts is then entered on Line 4, Part 2 of Schedule D and subtracted from the available GST exemption.

most likely there will be a deemed allocation of GST exemption to the gift; if in accordance with the instructions to Form 709, the gift in trust is not reported, there may be no record whatsoever of the deemed allocation to the gift because it would not be included in Schedule A of the gift tax return. Thus the omission of a non-taxable gift from Schedule A can cause major issues for later return preparers and estate planners who rely on previously filed Forms 709 as evidence of clients' remaining GST exemptions. In the less typical situation where there is no deemed allocation of GST to the gift, return preparers are unlikely to remember to attach a Notice of Allocation if the gift is not reported on Schedule A of the Form 709. This failure could lead to inadvertently subjecting the trust to GST tax in the future. The risk of these problems occurring can be minimized by including all gifts in trust on Schedule A, even if not required to do so, to prompt coordination with Schedule D.

III. Properly Categorize Direct Skips and Indirect Skips

Part 1 of Schedule A should list gifts subject only to gift tax or put differently, gifts that are not currently, and cannot in the future be, subect to GST tax. Part 2 should list gifts that are direct skips and thus are currently subject to GST tax (including direct skips that were postponed due to an ETIP).[18] Part 3 should list gifts that are "indirect skips," gifts not currently subject to GST tax but that may later incur such tax. In practice, categorizing gifts into the proper Part is far from straightforward.

One common mistake is that gifts made to a trust for the benefit of a non-skip person are incorrectly listed in Schedule A as gifts made directly to the donee, with no mention of the trust arrangement. This is particularly common with *Crummey* trusts, all gifts to which qualify fully for the gift tax annual exclusion. This can make it difficult for later reviewers relying on the Form 709 to spot potential GST tax problems.

A second very common error is the assumption that any gift to a trust is an "indirect skip" that should be listed in Part 3. As noted above, a trust that has only skip persons as beneficiaries is itself a skip person, such that transfers to the trust are direct skips – currently taxable generation skipping transfers – that should be listed in Part 2. Direct skips have GST exemption deemed allocated to them.[19] Allocation to a direct skip is usually a good use of GST exemption because it avoids immediate imposition of a GST tax. Nevertheless, if for some reason the taxpayer does not want exemption automatically allocated to the direct skip, the donor can "elect out" of the deemed allocation on the gift tax return on which the gift is reported. Failure to list the transfer in Part 2 will obscure all of these issues.

Finally, a third common error occurs when gifts to a trust with potential future GST tax consequences are listed in Part 1. Despite its title ("Indirect Skips"), Part 3 should list not only gifts defined in Code section 2632(c) as "indirect skips" (that is, transfers to "GST trusts" that may have future taxable terminations and taxable distributions), but also gifts to trusts that are not technically "GST trusts" but nonetheless

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[18] The instructions seem to say that other types of GSTs occurring at or after the end of an ETIP should also be repored on Part 2, but this seems incorrect. Instructions for Form 709 (2015), at page 10.

[19] See IRC § 2632(b).

"may later be subject to GST tax."[20] If there is any possibility that a trust can make a distribution to a skip person, the trust should be listed in Part 3. This is true even if the trust is for the primary benefit of (and likely to pay out entirely to) a non-skip person.

For example, assume Client has funded a short-term asset-management trust for the benefit of her child, a young adult. The trust will terminate when the child reaches age 35. Client does not yet have grandchildren, so GST issues are not on her radar, but the trust contains commonly-used language giving the child a limited power of appointment over the trust assets and providing that if the child does not exercise her power, the assets will pass outright to the child's descendants as the primary contingent remaindermen. This trust is not a "GST trust," but it should be listed in Part 3 because of the potential for trust assets to be distributed to the client's future grandchildren without being subject to estate tax on the child's death.[21] Depending on Client's other assets and plans, this trust may not be an appropriate recipient of GST exemption, but that does not change the identity of the gift to the trust as a gift that "may later be subject to GST tax."

Listing a gift in Part 3 of Schedule A does not require that GST exemption be allocated to it. However, listing the gift in Part 3 is an important reminder to consider the wisdom of an allocation of GST exemption to the trust (for example, if the client has plenty of exemption) and to make sure GST exemption is allocated (either automatically or manually) if desired and not allocated by operation of the automatic allocation rules if not desired.

IV. Properly Account for Deemed Allocations to Direct Skips

Schedule D of the Form 709 reconciles the filer's allocated and remaining GST exemption and calculates the GST tax currently payable. Recall that GST tax is paid by the donor only on direct skips that are not GST exempt, and direct skips have deemed GST exemption allocation unless the donor "elects out" of such treatment. Although this seems simple enough in theory, the Form 709 is not set up intuitively to incorporate these rules.

To determine the tax owing on direct skips, the direct-skip gifts listed in Part 2 of Schedule A are copied over to Part 1 of Schedule D at their full value (after taking into account gift splitting), and Column C is then used to subtract the GST counterpart of the annual exclusion, if any, to reach a "net transfer" amount in Column D. This net transfer amount should then be copied over to Part 3 of Schedule D, where the amount of "GST Exemption Allocated" is entered in Column C and used to determine an inclusion ratio and, ultimately, GST tax owed for each gift. Of course, having to complete Column C

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20 Instructions to Form 709, at page 10.

21 Note that if the child dies after the trust is funded and before age 35 and the trust property passes to one or more descendants of the child (or any other skip person), the death will cause a taxable termination to occur. The deceased parent rule of Code section 2651(e) applies only to a trust's funding when the parent "is dead at the time of the transfer" and the asset will not be part of the deceased parent's estate. See IRC § 2651(e)(1)(B).

limits the utility of the deemed allocation rules for direct skips[22] and in fact creates room for the introduction of errors.

The authors suggest filling out Part 3 of Schedule D (and Column C in particular) as if there were no deemed GST allocations to direct skips. First, determine if the direct skip is in fact the best use of a client's exemption. While the preparer's first inclination will be to allocate GST exemption to all direct skips in order to avoid the immediate imposition of tax, it might be preferable to pay GST on an outright gift to a grandchild, for example, if the client intends to fund a dynastic trust next year. If the decision is made not to allocate GST exemption, enter a zero in Column C and then take the prescribed steps to "elect out" of the deemed allocation: check the box next to the appropriate gift in Schedule A, Part 2 and attach a statement to the return describing the election.[23] Second, determine the amount of GST exemption to be allocated and make any applicable disclosures. For cash gifts, this step is easy enough, but if valuation of the gift could possibly be an issue, a disclosure and either a formula clause or a statement of the taxpayer's intent that the deemed allocation rule applies to the direct skip should be incorporated. Although the authors do not believe the entry of an incorrect value in Column C should override the deemed allocation rules, the IRS may disagree in the absence of an affirmative statement to the contrary.[24] Moreover, awareness of the valuation issue (and thus the uncertainty regarding the amount of GST exemption remaining) will be helpful to the client's future estate planners and return preparers. Thus we suggest footnoting the entry with a disclosure statement as follows:

> The taxpayer intends the deemed allocation rule of IRC section 2632(b) apply to this transfer. Accordingly,the GST exemption allocated is the amount the taxpayer believes to be necessary to make the inclusion ratio for such transferred property zero. The entry should be construed to allocate the smallest amount of GST exemption that will produce an inclusion ratio of zero for such transferred property. The amount of exemption allocated under this formula allocation will reflect the value and other characteristics of the gift as finally determined for gift tax purposes. Based on the return as filed, the

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22 The deemed allocation rules were designed to prevent errors by automatically allocating exemption to transfers to which most taxpayers would want to allocate exemption.

23 See Treas. Reg. § 26.2632-1(b)(1); see Instructions to Form 709, at page 10. The authors suggest a statement such as: "The taxpayer elects *not* to have the deemed allocation provisions of Section 2632(b) apply to [any portion / $______] of the following transfer: _______."

24 Treasury Regulation section 26.2632-1(b)(1)(i) states, with respect to a lifetime direct skip, that a "transferor may prevent the automatic allocation of GST exemption by describing on a timely filed [Form 709] the transfer and the extent to which the automatic allocation is not to apply" or by timely filing a "Form 709 accompanied by payment of the GST tax (as shown on the return with respect to the direct skip)." Compare Treasury Regulation section 26.2632-1(b)(2)(ii), which pertains to indirect skips from a GST trust: "[T]he transferor may also prevent the automatic allocation of GST exemption with regard to an indirect skip by making an affirmative allocation of GST exemption on a Form 709 filed at any time on or before the due date for timely filing … of an amount that is less than (but not equal to) the value of the property transferred as reported on that return … ."

amount of GST exemption allocated to this transfer is the amount shown above. The taxpayer is not electing out of the Section 2632(b) deemed allocation.

V. Actively Manage Deemed Allocations To Indirect Skips

Allocations to the "indirect skip" gifts listed in Part 3 of Schedule A are made, deemed made, or not made on lines 5 and 6 of Part 2 of Schedule D and in many cases must or should be accompanied by Notices of Allocation for manual allocations, and Code section 2632(c)(5) election statements. Recall that Part 3 will include entries for both "GST trusts" (to which exemption is deemed allocated) and non-GST trusts (to which no deemed allocation applies), and many gifts may not fall clearly into one category or the other (in which case the taxpayer should certainly make an election one way or the other).

The preparer is instructed to place a checkmark in Column C if an election is currently being made with respect to a transfer as per Code section 2632(c). A statement must be attached to the return with respect to each such election. There are many types of elections that can be made pursuant to Code section 2632(c), including any one or combination of the following:[25]

- Elect out of deemed allocations to a GST trust for one or more prior-year transfers made to a specified trust or trusts but only if the prior year transfer was subject to an estate tax inclusion period ("ETIP")that either has not ended at the time of the election or ended in the year for which the return is being timely filed.
- Elect out of deemed allocations to a GST trust for one or more (or all) current-year transfers made to a specified trust or trusts.
- Elect out of deemed allocations for one or more (or all) future transfers made to a specified GST trust or trusts.
- Elect out of deemed allocations for all future transfers to all GST trusts (whether or not in existence at the time of the election).
- Elect to treat a trust as a GST trust for any or all current-year transfers, any selected future transfers, and/or all future transfers, thereby having deemed allocations made (unless and until electing out of particular deemed allocations pursuant to the above).
- Terminate any, all, or some of the above elections for any current-year transfer, future transfer, and/or prior-year transfer subject to an unexpired ETIP.

The authors recommend placing "N/A" in Column C next to each gift made to a non-GST trust to make clear that the deemed allocation rules will not apply. If it is unclear whether a trust receiving a transfer is a GST trust, determine the client's preferred treatment, placing a check mark in Column C regardless, and then attaching either an election to be treated as a GST trust or an election out for all transfers to the trust, as appropriate to carry out the client's wishes. Treasury Regulation section 26.2632-1(b)(4)(iv) provides a number of examples of language to be used for making section

[25] Treas. Reg. §§ 26.2632-1(b)(3), 26.2632-1(b)(2)(ii), 26.2632-1(b)(2)(iii)(E)

2632(c) elections. The authors recommend that the election to treat a trust as GST trust also include a specific statement regarding how the deemed allocation rules are to apply (*i.e.* – "The taxpayer elects to treat as a GST trust all transfers made by the taxpayer in [insert year] and at any time thereafter to each trust listed below, such that the deemed allocation provisions of Section 2632(c) apply to to such trusts: [list trusts]").[26]

If the deemed allocation regime or election made with respect to previous-year transfers is no longer preferred, this can also be managed prospectively through statements attached to the return. The Treasury Regulations are clear that elections "out" can be made under Code section 2632(c) in the year the trust is funded or in a later year, regardless of whether a transfer was made to the relevant trust in that later year.[27] All such elections are purely prospective, however: they cannot affect any manual or deemed allocation for a year for which the return's due date has already passed or GSTs that have already occurred before the election becomes effective except as discussed above, in the case of a certain transfers subject to an ETIP.[28]

The amount of any exemption believed to be allocated to an indirect skip through deemed allocation is listed on Schedule D, Part 2, Line 5. The amount of any exemption manually allocated or believed to be allocated in the case of a formula allocation to an indirect skip in a Notice of Allocation is then listed on Schedule D, Part 2, Line 6.

VI. Exhibit Healthy Skepticism of Past Forms 709

Estate planners and return preparers rely on past Forms 709 to inform us about clients' remaining gift tax exemption and the deemed allocation status of trusts previously settled. However, as should be obvious from the foregoing, errors abound in Forms 709. As such, a healthy skepticism is one of the most important items in your toolbox in dealing with previously filed Forms 709. Although previous allocations are irrevocable once the due date for that year's Form 709 has passed, prospective elections can be made with respect to indirect skips to ensure proper treatment going forward, and the GST Exemption Reconciliation at Part 2 of Schedule D can be corrected to prevent further mistakes going forward.

VII. Use the Client's Increased Exemption

Some clients may have trusts that have an inclusion ratio between one and zero (*i.e.,* are only partially exempt) for any of a number of reasons. For example, the trust may have been settled during a time when the available GST exemption was lower, contributed property may have been valued higher than anticipated, or clients may have mistakenly failed to allocate GST exemption to all transfers to the trust either before the deemed allocation rules to indirect skipes were enacted or at a time when the trust did not

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[26] This sample language is based on language suggested in C. Harrington, L.L. Plaine & H. Zaritsky, Generation-Skipping Transfer Tax (Thomson Reuters/Tax & Accounting, 2d ed. 2001, with updates through Oct. 2014) (online version), App. A, Gift Tax Return No. 7 (hereinafter referred to as "Harrington, Kwon, Plaine, and Zaritsky").

[27] Treas. Reg. § 26.2632-1(b)(2)(iii)(B).

[28] Treas. Reg. § 26.2632-1(b)(2)(iii)(D).

meet the definition of a GST trust. Suppose Client made a gift of $6,000,000 to a dynastic trust in 2008, when the GST exemption was $2,000,000, and her spouse agreed to gift split; both allocated their full exemptions.[29] That trust would have an inclusion ratio of 0.33, meaning that one-third of any distribution to a skip person would be subject to GST tax. Assume that no distributions have been made and the assets of the trust are now worth $12,000,000. The trust has a one-third inclusion ratio so it will take an additional allocation of $4,000,000 of GST exemption to give the trust a zero inclusion ratio.[30] Client and her spouse now (in 2016) have a combined $6,900,000 of GST exemption available.[31]

Because Client's spouse agreed to gift split the original gift each spouse is the transferor of one-half of the trust and each can now allocate GST exemption to his or her half. Client's GST exemption is allocated to her trust funded by her prior-year gift by attaching a Notice of Allocation to the Form 709. The amount of the GST exemption allocated using the Notice of Allocation is then listed on Schedule D, Part 2, Line 6. Client's spouse should do the same, allocating his or her GST exemption to the portion of which he or she is treated as transferor. If valuation of the trust assets could possibly be an issue, a standard formula allocation clause, such as this one, should be included on the Notice of Allocation:

> Taxpayer allocates to the trust listed above the smallest amount of the Taxpayer's GST Exemption necessary to produce an inclusion ratio (as defined in Section 2642(a)) for the trust that is closet to or, if possible, equal to zero. The amount of exemption allocated under this formula allocation will will reflect the value and other characteristics of the gift as finally determined for gift tax purposes. Based on the return as filed, the amount of GST exemption allocated to this transfer is the amount shown above.[32]

In order to use the value of the trust assets on the first day of the month in which the late allocation is being made, the following language should be used:

> The taxpayer hereby elects pursuant to Treasury Regulation section 26.2642-2(a)(2) to treat the allocation of GST exemption as having been made on the first day of the month during which this allocation is made. For purposes

[29] Throughout the examples in this section we will assume that the children of the donor are beneficiaries of the dynastic trust so that the gift to the dynastic trust is not a "direct skip." On the ability of gift-splitting couples to allocate both spouses' exemptions, see Section 2652(a)(2) of the Code.

[30] A Form 709 filed in 2015 would be "late" with respect to the allocation of GST exemption to a 2008 gift. See IRC § 2642(b)(3); Treas. Reg. § 26.2642-2(a)(2).

[31] $3,450,000 each ($5,450,000 less the $2,000,000 each used in 2008

[32] This sample language is based on Harrington, Kwon, Plaine, & Zaritsky, *supra,* App. A, Gift Tax Return No. 1.

of this election, the applicable valuation date for this allocation is ________ 1, 2016.[33]

Note that using the value of the gifted property on the first day of the month does not change the effective date of the allocation, which is the actual day the allocation is made. Thus, for example, if there is a taxable distribution made on May 18, an allocation made on May 25 using a May 1 valuation date will not be effective to allocate GST exemption to shelter the May 18 distribution from GST tax.

The procedure is less clear when, for example, the taxpayer wishes to allocate the additional indexed GST exemption available in 2015 to a gift made in 2014. Assume Client made a gift of $5,400,000 in 2014 to a dynastic trust. At the time the gift was made, Client had GST exemption available of $5,340,000. If she were to allocate all of that exemption to the dynastic trust on her 2014 Form 709, the trust would have an inclusion ratio of approximately .011, meaning that 1.1 percent of any distribution to a skip person would be subject to GST.

However, by the time Client is preparing her 2014 gift tax return in the spring of 2015, the GST exemption has increased again due to indexing and she actually has $5,430,000 of GST exemption available. There is no question that she is entitled to use some or all of the additional $90,000 of exemption granted under the indexing provision by applying it to her 2014 gift;[34] the only questions are (i) on what date will the allocation be effective, (ii) to what value must the exemption be applied, and (iii) how should the allocation be made.

First, the normal rule for a timely allocation is that it relates back to the date of the gift.[35] Here, the Treasury Regulations give support for the position that the allocation of

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[33] This sample language is based on Harrington, Kwon, Plaine & Zaritsky, *supra,* App. A, Gift Tax Return No. 2.

[34] The Instructions for Form 709 (2015) are actually quite confusing on this point. At page 17, they discuss the annual increase in the exemption. The instructions state that, "In general, each annual increase can only be allocated to transfers made (or appreciation occurring) during or after the year of the transfer [*sic*]." Assuming the last word of the quoted sentence was intended to be "increase", the example that follows, which states that a donor cannot assign the 2015 increased exemption to GSTs completed through 2005, makes sense. In other words, if the event that triggered a GST tax to be due has already occurred, the donor cannot allocate additional exemption to it now and avoid the tax. The instructions then follow with, "However, if in 2005 [when the exemption was $1,500,000], the donor made a $1,750,000 transfer to a trust that was not a direct skip, but from which generation-skipping transfers could be made in the future, the donor could allocate the increased exemption to the trust, even though no additional transfers were made to the trust." In this second example, there is no discussion of such allocation's being applicable only to the growth in the trust.

Both examples are then followed by the confusing instruction to "Enter on line 1 of Part 2 the maximum GST exemption you are allowed. This will not necessarily be the highest indexed amount if you made no generation-skipping transfers during the year of the increase." Given that the second example, however, explicitly allows you to use the highest indexed amount against prior gifts in trust, this admonishment makes no sense.

In any case, it is clear under Section 2613(c) of the Code and Revenue Procedure 2014-61 that $5,450,000 in GST exemption is currently available as of January 1, 2016, and the quoted second example above makes clear that indexed exemption can be applied to prior-settled trusts.

[35] Treas. Reg. §§ 26.2632-1(b)(1)(ii), 26.2632-1(b)(4)(ii).

GST exemption on the timely 2014 Form 709 "is effective as of the date of any transfer" in 2014, except that $60,000 of the GST exemption amount that is needed to give the trust a zero inclusion ratio was not available to the taxpayer until January 1, 2015. It seems unlikely that the allocation of the additional exemption could be effective on any date in 2014 when Client did not actually have that exemption until January 1, 2015. Another possible effective date for the allocation of the additional exemption resulting from the inflation adjustment would be the date of the allocation, but this position is actually contrary to the Treasury Regulations. Under the Treasury Regulations, only a "late allocation" is effective on the date of its filing.[36] If the Client is filing the Form 709 on or before its due date, the allocation of the additional GST exemption for 2015 to the 2014 gift would not be a "late allocation" under the definition in the Code and Treasury Regulations and the late allocation rules would not be applicable.[37] Therefore, the authors believe the best answer is that the allocation of the increased exemption is effective as of January 1, 2015. It did not take any action of the client to make the additional exemption available on January 1, 2015; Code sections 2631(c) and 2010(c)(3)(B) provided for that, and Revenue Procedure 2014-61 confirmed it. The only impediment to the effectiveness of the allocation of $60,000 of GST exemption as of the date of the transfer was that it was not available, not any untimeliness of the donor. That impediment was removed by operation of law on January 1, 2015, arguably making that the effective date of the timely allocation of the 2015 additional GST exemption to the 2014 transfer.

Second, having established that an allocation of GST exemption to a 2014 gift on a timely-filed gift tax return is not a "late allocation," the Code and Treasury Regulations indicate that the proper value to use is the date of gift value. That conclusion could be considered problematic as it does not align with the effective date of the allocation, which is believed to be January 1, 2015. In the absence of authority on this question, the taxpayer should recognize that the IRS may take the position that the value on the effective date of the election – January 1, 2015 – should be used, and exemption may need to be allocated to any appreciation that occurred between the date of the gift and January 1, 2015.

Finally, the Form 709 instructions do not address how donors are to allocate the annual additional GST exemption amount to a gift in the immediate prior year for which the gift tax return is being timely filed. In the absence of IRS instructions, the following technique is recommended, with the objective of making the intention of the client abundantly clear.

Continuing with the above example, Client will allow the deemed allocation rules to apply to the 2014 transfer (and complete the return accordingly) or include with her 2014 gift tax return a Notice of Allocation in which the $5,340,000 of GST exemption

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36 Treas. Reg. § 26.2632-1(b)(4)(ii).

37 Of course, if the allocation is made on a return filed after October 15, 2015 (the due date for a timely filed return, including a valid extension), it is clearly a late allocation and the rules governing late allocations apply.

available in 2014 is manually allocated to the 2014 dynastic trust.[38] The authors recommend also attaching a separate Notice of Allocation to the 2014 gift tax return, which would be used solely to allocate up to $60,000 of additional 2015 exemption to the 2014 dynastic trust. The separate Notice of Allocation should clearly indicate that it is the additional exemption that is being allocated on the return, and contain an explanation that the taxpayers are entitled to use that additional exemption any time on or after January 1, 2015, because $5,430,000 *is* the GST exemption amount in effect as of January 1, 2015. The following language can be used for that purpose:

> Pursuant to Section 2613(c) and Section 3.33 of Revenue Procedure 2014-61, the taxpayer's exemption from GST is $5,430,000 as of January 1, 2015. The purpose of this Additional Notice of Allocation is to allocate part of the additional $90,000 of GST exemption available to the Taxpayer on January 1, 2015, due to indexing of the GST exemption amount, to the [name of trust] dated [date].

The standard language for formula allocation should also be amended to take the position that the effective date of the $60,000 of additional exemption allocated to the 2014 gift is January 1, 2015. That can be accomplished by including the following italicized language in the standard formula clause:

> Taxpayer allocates to the trust listed above the smallest amount of the Taxpayer's GST Exemption necessary to produce an inclusion ratio (as defined in Internal Revenue Code Section 2642(a)) for the trust that is closest to or, if possible, equal to zero *as of the earliest date on which this allocation is effective, believed by the taxpayer to be [insert date of gift or if you wish to be more conservative, the date on which the exemption became available]*. The amount of exemption allocated under this formula allocation will reflect the value and other characteristics of the gift as finally determined for gift tax purposes. Based on the return as filed, the amount of GST exemption allocated to this transfer is the amount shown above.

If Client has an extension until October 15 but has already filed the 2014 gift tax return, it is not recommended to file a second 2014 return allocating only the additional 2015 exemption because the IRS may construe that second return to be an amended

[38] If you wish to take the more conservative position that the effective date of the election is January 1, 2015, and the gifted property appreciated between the date of the gift and January 1, more than $60,000 of additional exemption may need to be allocated. For example if the original gift in 2014 was valued at $5,400,000, timely allocation of the $5,340,000 exemption resulted in an inclusion ratio of 0.011. If the trust property appreciated by 10% between the date of the gift and January 1, 2015, the January 1, 2015 value would be $5,940,000. Applying the 0.011 inclusion ratio to the January 1, 2015 value, it would take an allocation of $65,340 of additional exemption to bring the inclusion ratio down to zero.

return that supersedes the first 2014 gift tax return filed.[39] A safer procedure would be to actually amend the earlier return and restate all of the gift and GST tax information initially reported on a second amended return filed before the due date (as extended).

If the value of the gifted property has declined by the time the gift tax return is ready to be filed, it may be in Client's's interest to make a late allocation. If so, the allocation of the 2014 exemption should be delayed until after the due date of the 2014 gift tax return (including actual extensions), so that the allocation will be a "late allocation" and it will not be effective until made (or on the first day of the month if the required election is made). An argument can be made that this approach to allocating the increased exemption should be followed in all cases (even if the property has increased in value) because there is no uncertainty with repect to it. Moreover, depending on the inclusion ratio determined without regard to the indexed amount, the amount of the additional exemption required by waiting could be small. The greater risk in waiting is likely to be that of a GST occurring prior to the late allocation.

The impact of a late allocation can be observed in the previous example in which the Client made a gift of $5,400,000 to a new trust in 2014 and at the time the gift was made Client had GST exemption available of $5,340,000. After all of that exemption is allocated to the trust, it would have an inclusion ratio of approximately .011 and an applicable fraction of .989 (1 less.011). If the trust increases in value by 150% so that on October 1, 2015, its value is $8,100,000 and the Client waited until late October to allocate the additional indexed exemption to the trust (electing an October 1 valuation date), the Client would have to allocate $89,100 (.011 times $100,000) of the $90,000 increase in exemption, rather than only $60,000 if the date of gift value is used.

[39] Treasury Regulation section 26.2632-1(b)(4)(ii) states that if "more than one timely allocation is made, the earlier allocation is modified only if the later allocation clearly identifies the transfer and the nature and extent of the modification." Nevertheless, because of the way in which the IRS Service Center processes gift tax returns, a taxpayer can reduce the possibility of processing errors by completely amending the return (and so indicating on the second timely-filed return).