

Generation-Skipping Transfer Tax: Filings and Related Procedure

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I. INTRODUCTION: BUILDING THE FOUNDATION¹

- a. Some generation-skipping transfers (“GSTs”) are reported on gift tax returns and some are reported on estate tax returns. Of the three varieties, all “direct skips” which, by definition, only occur when gift tax or estate tax is also implicated,² are reported on both gift tax returns and estate tax returns.
- b. GSTs other than direct skips (which are referred to as “taxable terminations” and “taxable distributions”) are also often reported on gift tax returns and estate tax returns.
 1. Typically, this reporting occurs in order to address allocation (or non-allocation) of the GST exemption.³
 2. The information on gift tax returns and estate tax returns regarding allocation of GST exemption is necessary in order to determine a trust’s inclusion ratio. The inclusion ratio, in turn, is necessary in order to determine the amount of tax on subsequent GSTs from that trust.

¹ The facility at which this presentation occurs was greatly influenced by the master architect, Frank Lloyd Wright. In his honor, references are included in this paper to him and his work and buildings in general.

² Direct skips are transfers to a skip person also subject to gift tax or estate tax. I.R.C. §2612(c)(1)

³ “GST exemption” is the term utilized in the Internal Revenue Code. I.R.C. §2631(a)

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3. However, the tax due on these subsequent GSTs (which will either be taxable terminations or taxable distributions) will not be determined on gift tax returns or estate tax returns.
- c. The other presenters, Lauren Y. Detzel and Glen A. Yale, will address, among other things, reporting GSTs on gift tax returns and estate tax returns and unique GST considerations in 2010. An effort has been made to avoid duplication with these materials and those of the other presenters. To the extent not successful, consider the repetition as intentional as every visible screw head being set to the horizontal at Taliesin West⁴, as a means of emphasis.
- d. The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (“TRA”) reinstated the tax on GSTs occurring during 2010. Although not enacted until December 17, 2010, this reinstatement is retroactive to January 1, 2010, albeit with a zero tax rate for GSTs during 2010. The TRA also provides for a \$5 million GST exemption.
- e. The TRA resolved many uncertainties about GSTs. The uncertainties came in three varieties: GSTs occurring (i) during 2010, (ii) after 2010 as a result of 2010 deaths; and (iii) after 2010 as a result of gifts made during 2010. These uncertainties had consumed millions of keystrokes, billions of bytes and more than a few brain cells. On at least a few significant issues, knowledgeable commentators held differing opinions. At the time this program was conceived, the challenges presented by those uncertainties loomed over trust and estate practitioners like the giant lily pads at the top of the columns loomed over workers in the Great Workroom inside the Johnson Wax Administration Building.⁵
- f. Although TRA did not resolve all of the uncertainties, the remaining issues intersecting GSTs and decedents dying during 2010 will be addressed in Ms. Detzel’s materials.

⁴ Taliesin West is considered Wright’s desert masterpiece and served as his winter escape from the Chicago area. The horizontal lines in the structure are emphasized. Wright even insisted that the slot for every visible screw head be set to the horizontal.

⁵ The columns in this room were 9 inches in diameter at the floor and over 18 feet in diameter at the top. Building inspectors in Racine, Wisconsin at the time did not believe that such columns could support the calculated load of 12 tons. The test column built by Wright actually held 60 tons before stressing. Wright received the building permit.

- g. So, what's left? More of the same. The same, that is, of the GST issues that existed before 2010.

II. TAX FORMS.

- a. Five different tax forms directly implicate GST reporting.
 - 1. The first, and most common, are the “United States Estate (and Generation-Skipping Transfer) Tax Return” and the “United States Gift (and Generation-Skipping Transfer) Tax Return.”
 - 2. The three lesser known forms, sometimes referred to in these materials as the –GS forms, are:
 - a) Generation-Skipping Transfer Tax Return for Terminations: Form 706-GS(T)
 - b) Notification of Distribution from a Generation-Skipping Trust: Form 706-GS(D-1)
 - c) Generation-Skipping Transfer Tax Return for Distributions: Form 706-GS(D)
- b. The three –GS forms, although prefaced “706,” are no more part of the estate tax return than was Frank Lloyd Wright part of the conservative Midwest establishment in the early 1900s.⁶ Returns using these –GS forms may be required when an estate tax return is not required and even independent of any death.
- c. One other tax form also requests information related to GSTs: the U.S. Income Tax Return for Estates and Trusts: Form 1041.
 - 1. On the second page, under Other Information, the Form 1041 inquires whether any “present or future trust beneficiaries” are “skip persons.”⁷

⁶ Frank Lloyd Wright left his first wife and children for the company of a wife of a client (or perhaps former client). He married three times and fathered seven children and adopted the daughter of his last wife.

⁷ Below is an excerpt from the second page of Form 1041.

2. Although the instructions for the Form 1041 are referred to in the body of the Form 1041, for this question, little guidance is actually provided. Below is the relevant portion of those instructions.

Question 9

Generally, a beneficiary is a skip person if the beneficiary is in a generation that is two or more generations below the generation of the transferor to the trust.

To determine if a beneficiary that is a trust is a skip person, and for exceptions to the general rules, see the definition of a skip person in the instructions for Schedule R of Form 706.

3. No indication is provided regarding how, if at all, the government uses the response.
4. A more relevant question might be whether any distributions were made during the year to a skip person. The government could then expect an additional filing. See discussion below.

III. FORM 706-GS(T): GENERATION-SKIPPING TRANSFER TAX RETURN FOR TERMINATIONS

- a. A trustee of a trust that has a taxable termination⁸ is required to file a return using Form 706-GS(T).⁹
- b. This form is most likely to become necessary as the result of a death. But a death is not, by any means, the exclusive reason that this form may be needed.
 1. Consider a trust created by Parent for the benefit of Child during Child's lifetime which terminates upon Child's death in favor of the Child's descendants.
 - a) Child's death will cause a taxable termination.
 - b) A return using Form 706-GS(T) is required.

⁸ As a refresher, the term "taxable termination" means the termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in a trust unless -

(A) immediately after such termination, a non-skip person has an interest in such property, or

(B) at no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person. I.R.C. §2612(a)

⁹ Treas. Reg. §§26.2662-1(b)(2); 26.2662-1(c)(ii)

2. Consider a trust with similar terms, but that terminates upon Child reaching a certain age, instead of upon Child's death.
 - a) If the trust property is distributed to Child's descendants upon Child attaining the stated age, a taxable termination would occur. A return using Form 706-GS(T) is required.
 - b) If, on the other hand, the trust property is distributed to Child, rather than Child's descendants, upon Child attaining the stated age, a taxable termination would not occur. In that situation, a return is not necessary.
- c. The trustee is responsible for filing a return using Form 706-GS(T).
 1. The return is required whenever a taxable termination occurs. Therefore, even if no tax is due because of a zero inclusion ratio, the return is still required to be filed.
 2. The return is due by April 15th of the year following the calendar year in which the taxable termination occurred.¹⁰
 3. An automatic 6 month extension of time is available to a trustee required to file a Form 706-GS(T). This extension process is similar for other returns and requires timely filing of Form 7004.¹¹
- d. The trustee is responsible for paying the tax.¹²
 1. The trustee is also personally liable for the tax¹³ just as an executor is personally responsible for estate tax.¹⁴
 2. Unlike with estate tax returns, the government does not issue closing letters when Form 706-GS(T)s are filed.

¹⁰ Treas. Reg. §26.2662-1(d)(2)

¹¹ Treas. Reg. §26.6081-1(a)

¹² I.R.C. §2603(a)(2)

¹³ Id.

¹⁴ I.R.C. §2661

- a) Because a closing letter will not be received, the trustee will not receive any “stamp of approval” after filing the Form 706-GS(T). Therefore, the trustee should consider creating a reserve and holding back assets which would be adequate to pay additional tax on the GST.¹⁵
 - b) The creation of a reserve should not impact the calculation of the amount of tax. The taxable termination, which is the event giving rise to the tax, occurs irrespective of when the actual distribution occurs to the skip person.
 - c) The duration of the period during which the reserve can be reasonably held will correspond to the duration of the statute of limitations after filing the Form 706-GS(T).
3. Two exceptions to personal liability exist, (i) where a gift tax return was not filed for a gift to the trust and (ii) where the inclusion ratio on the gift tax return was understated. In those instances, assuming that the trustee does not know or should not have known that the information was erroneous, the trustee will not be personally liable.¹⁶
- e. If the event causing the taxable termination applies to multiple trusts, the trustee is required to file a single Form 706-GS(T) with separate Schedule A when (i) portions of the trust are attributable to transfers from different transferors or (ii) a trust has substantially separate and independent shares for different beneficiaries.¹⁷
 - f. The trustee may elect alternate valuation for purposes of determining the value of the taxable termination.¹⁸

¹⁵ “The IRS apparently does not issue closing letters for returns indicating a taxable termination of a GST trust (Form 706-GS(T)). Where valuation is a substantial issue, this effectively forces the trustee to hold all or a portion of the trust assets in reserve pending expiration of the applicable statute of limitations.” J. Price and S. Donaldson, *Price on Contemporary Estate Planning* (2009)

¹⁶ I.R.C. §2664(d)

¹⁷ Treas. Reg. §26.2662-1(c)(3)(iii)

¹⁸ I.R.C. §2624(c)

1. The election is to be made in accordance with I.R.C. §2032.¹⁹
 2. If the election is made, the Form 706-GS(T) must be filed “on or before the 15th day of the 4th month after the close of the calendar year²⁰ in which the taxable termination occurred, or on or before the 10th month²¹ following the month in which the death that resulted in the taxable termination occurred, whichever is later.”²²
- g. The value of a taxable termination is determined after consideration of expenses, indebtedness and taxes which would be deductible under I.R.C. §2053 if determining estate tax.²³

IV. FORM 706-GS(D-1): NOTIFICATION OF DISTRIBUTION FROM A GENERATION-SKIPPING TRUST

- a. A trustee of a trust which makes a taxable distribution²⁴ is required to file a return using Form 706-GS(D-1).²⁵
- b. Any distribution from a trust to a skip person invokes this filing requirement.
- c. Consider a trust created by parent for the benefit of Child and Child’s descendants.

¹⁹ I.R.C. §2624(b)

²⁰ Using the long accepted Gregorian calendar, the 4th month after the close of the calendar year is April. Therefore, April 15th would seem to be another way to express the “15th day of the 4th month after the close of the calendar year.”

²¹ The construct in this portion of the Treasury Regulations does not clearly indicate which day during the 10th month is meant. The Treasury Regulations might have meant “on or before the 15th day of the 4th month ... or of the 10th month following the month ...” which could also have been expressed as “on or before the 15th day of the 4th month ... or on or before the 15th day of the 10th month following the month ...” The Treasury Regulation might also mean the day of the 10th month following the month of death which is the same day as the date of death. In other words, if the date of death was December 10, 2011, then under this construction, the due date for the return would be October 10, 2012 because that date is later than April 15, 2012.

²² Treas. Reg. §26.2662-1(d)(2)

²³ I.R.C. §2622(b)

²⁴ A taxable distribution is any distribution from a trust to a skip person (other than a taxable termination or a direct skip). I.R.C. §2612(b)

²⁵ Treas. Reg. §26.2662-1(b)(1)

1. A distribution made to Grandchild (i.e., Child's child) would generally be a taxable distribution.²⁶
 - a) The trustee must file a Form 706-GS(D-1).²⁷
 - b) If the distribution to Grandchild would have been a nontaxable gift because of being made for certain educational or medical expenses pursuant to I.R.C. §2503(e), the distribution is not a taxable distribution.
2. If the trustee pays the GST tax on the taxable distribution, then the payment of that tax is treated as an additional taxable distribution.²⁸ That additional taxable distribution will also require reporting on a Form 706-GS(D-1). Of course, if the trustee also pays the GST tax on that additional deemed distribution, another deemed distribution will occur, giving rise to additional reporting on a Form 706-GS(D-1).
3. A distribution from the same trust to Child would not be a GST. No return is required for that distribution. The distribution is not a taxable distribution because the distribution is made to a non-skip person.
 - d. The trustee is responsible for filing the Form 706-GS(D-1).²⁹
 1. The return is required even if the trust has a zero inclusion ratio.
 2. The return is due on April 15th of the year following the calendar year in which the distribution occurred.³⁰
 - e. Unlike the Form 706-GS(T), the Form 706-GS(D-1) is more akin to a Schedule K-1 than an estate tax return.

²⁶ I.R.C. §2612(b)

²⁷ Treas. Reg. §26.2662-1(b)(2)

²⁸ I.R.C. §2621(b)

²⁹ Treas. Reg. §26.2662-1(c)

³⁰ Treas. Reg. §26.2662-1(d)(2)

1. No tax is due with the return.
2. A copy is required to be provided to the distributee.³¹
3. The form includes specific instructions for the distributee.
4. The distributee is instructed to complete Form 706-GS(D) using the information from the Form 706-GS(D-1).

V. FORM 706-GS(D): GENERATION-SKIPPING TRANSFER TAX RETURN FOR DISTRIBUTIONS

- a. Unlike the Form 706-GS(T) and the Form 706-GS(D-1), the Form 706-GS(D) is not filed by the trustee.
- b. The recipient of the distribution is responsible for filing a return using Form 706-GS(D).³²
 1. The return is *not* required if the inclusion ratio reported on the Form 706-GS(D-1) is zero.
 2. The return is due by April 15th of the year following the calendar year in which the distribution occurred.³³
 - a) An automatic 6 month extension of time is available to a distributee required to file a Form 706-GS(D).
 - b) This extension process is similar for other returns and requires timely filing of Form 7004.³⁴
 3. The Form 706-GS(D-1) received from the trustee is required to be attached to the Form 706(D).
- c. The recipient of the distribution is responsible for paying the tax. Therefore, the trustee has no personal liability for the tax.

³¹ Treas. Reg. §262662-1(b)(1)

³² Treas. Reg. §26.2662-1(c)(1)(i)

³³ Treas. Reg. §26.2662-1(d)(2)

³⁴ Treas. Reg. §26.6081-1(a)

d. The taxable value of a taxable distribution is reduced by any expense incurred by the distributee in connection with the determination, collection or refund of the GST tax related to the distribution.³⁵

1. The expenses are subtracted from the value of the taxable distribution and the inclusion ratio is applied to the net amount.
2. Consider a distributee that receives a distribution of \$100,000 from a trust with a 70% inclusion ratio during a year with a 35% tax rate and incurs \$5,000 of expenses.

The amount of tax due is determined as follows:

a) Value of Distribution	\$100,000.00
b) Less: Expense	-5,000.00
c) Equals: Taxable Amount	\$95,000.00
d) Times: Inclusion Ratio	70%
e) Times: Tax Rate	35%
f) Tax Due	\$23,275.00 ³⁶

VI. GENERAL APPLICATION OF ESTATE AND GIFT TAX PROCEDURE

- a. The provisions related to the administration of estate tax apply to GSTs occurring at the same time as, and as a result of, the death of an individual.³⁷
- b. The provisions related to the administration of gift tax apply to all other GSTs.³⁸
- c. No specific authority exists for amending a –GS return once filed.
 1. The same considerations should exist for supplementing a –GS return as exists for supplementing a gift tax return or estate tax return.
 2. Similarly, the same authority exists for filing a claim for refund after filing a –GS return.

³⁵ I.R.C. §2621(a)(2)

³⁶ The –GS forms arrive at the same result in a more circuitous route. The value of the distribution provided by the trustee on the 706-GS(D-1) is already multiplied by the inclusion ratio. Therefore, when the expenses are deducted on the 706-GS(D), the instructions direct the total expenses to be first multiplied by the inclusion ratio.

³⁷ I.R.C. §2661(2)

³⁸ I.R.C. §2661(1)

VII. CONCLUSION

- a. The GST issues, for now, are as silent as Fallingwater³⁹ in the winter. As the two year freeze thaws, the GST issues will again begin to flow just like the waters of the Youghiogeny during spring.

³⁹ Fallingwater is perhaps Mr. Wright's best known structure. Built partially over a water fall, this residence has been described by Time as his most beautiful job and is on the Smithsonian's list of 28 places to visit before you die.