Time Traveling and Generation-Skipping in 2010 and Beyond

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In this article, McCaffrey and Schneider look at the GSTT, its prospects, and the complications that the 2010 suspension of its application and its future reinstatement are likely to cause. The one-year reprieve from the GSTT creates several difficult questions.

A. Introduction

Section 901 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and section 2664 have caused considerable confusion about how the generation-skipping transfer tax will be applied in 2010 and beyond.

The application of the GSTT in 2010 is uncertain despite section 2664's mandate that chapter 13, the chapter of the code that imposes the GSTT, does not apply to generation-skipping transfers (GSTs) that take place after 2009. This is because Congress could act at any time to make chapter 13 applicable to 2010 GSTs, including those occurring in 2010 before Congress acts. A retroactive reenactment of chapter 13 might survive the judicial challenges that would no doubt result.

The application of the GSTT beyond 2010 is also uncertain despite the statement in section 901 of EGTRRA (the sunset provisions) that the EGTRRA provisions, including section 2664, do not apply after 2010. The uncertainty stems not only from the impossibility of predicting whether and how Congress will act but also from the inherent ambiguities in the language of section 901(b) of EGTRRA.

If Congress fails to provide a different set of rules, subsection (b) of section 901 of EGTRRA will apply starting in 2011. That subsection says the code will be applied and administered to GSTs that take place after 2010 as if EGTRRA had never been enacted (the ''had never been enacted'' rule). The subsection clearly means that the several helpful provisions of chapter 13 that were added as part of EGTRRA, such as the qualified severance rules of section 2642(a)(3), will no longer apply. Not so clear are the answers to the following two questions:

1. If the sunset provisions apply, should we apply the GSTT after 2010 as if the estate tax and the GSTT had been applicable in 2010? When read in conjunction with section 901 of EGTRRA, section 2210 provides that chapter 11 of the code — the chapter that imposes the estate tax — will not apply to the estates of decedents who die in 2010. Similarly, section 2664, when read in conjunction with section 901 of EGTRRA, provides that chapter 13 of the code — the chapter that imposes the GSTT — will not apply to GSTs that take place in 2010. Does the ''had never been enacted'' rule mean that in determining the GSTT significance of events that occur after 2011, we must pretend that the estates of 2010 decedents were subject to the estate tax and that 2010 GSTs were subject to the GSTT? For example, for a trust to have a transferor for GSTT purposes, it must have property that was subject to the tax imposed by chapter 11 or chapter 12. If the will of a 2010 decedent creates and funds a trust, that trust will not hold property that was subject to either tax. Does that trust have no transferor, or does the application of the ''had never been enacted'' rule mean that we should pretend that an estate tax was imposed on the estate so that the trust does have a transferor?[1]

2. If the sunset provisions apply, must we change the GSTT attributes of a trust that acquired those attributes as a result of a provision of chapter 13 that was added by EGTRRA? EGTRRA added several technical pro-taxpayer provisions to chapter 13 in addition to the rate reductions and exemption increases that are generally thought of as the legislation's key elements. Some of those technical provisions merely reversed by statute positions taken by the IRS and Treasury before 2001. Application of the technical provisions has caused many

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[1]Similar questions arise under the income tax and the estate tax rules. For example, in applying section 1014 to a post-2010 sale of property inherited from a 2010 decedent, is the basis of the property to be determined as if section 1014 applied in 2010? In calculating the credit for tax on prior transfers under section 2013 in the estate of a post-2010 decedent who inherited property from a 2010 decedent, should it be assumed that the estate tax was applicable to the 2010 decedent's estate?

trusts to have inclusion rations in 2010 that are lower than they would have been if EGTRRA had not been enacted. After 2010, will these trusts be required to adjust their inclusion ratios to what they would have been if those provisions had never been enacted? One of the provisions recognized specified severances of trusts that had not been recognized for GSTT purposes before EGTRRA. Will trusts that were severed under that provision be reconnected after 2010?

This article examines the various ways in which chapter 13 works in 2010 and could work after 2010 if Congress, by inaction, permits the sunset provisions to apply. It discusses the need to review and possibly revise existing estate planning documents that define bequests and distributions with reference to terms defined in chapter 13, and it considers the advisability of current action to take advantage of what will likely be a temporary reprieve from the GSTT.

B. Chapter 13 in 2010

Although chapter 13 does not apply to GSTs that take place in 2010, it does operate to define 2010 events and, depending on the nature of those events, could have an impact on how the GSTT will be applied in the future. The 2010 events that could affect the manner in which GSTs will be taxed after 2010 are examined below.

1. GSTs and other transfers to trusts. Donative transfers will undoubtedly occur in 2010. Some of them will be GSTs. Individuals will make gifts to skip persons such as their grandchildren or to trusts for their benefit (skip person trusts). These gifts will be direct skips. Trustees will make distributions to skip persons or to skip person trusts. Those distributions will be taxable distributions. And individuals who are trust beneficiaries will die, causing taxable terminations to occur. Although none of these GSTs will be subject to the GSTT (unless Congress acts to modify the 2010 law currently in effect), property held in trust after 2010 that was the subject of a GST in 2010 could be subject to the GSTT when a taxable distribution or taxable termination occurs.

The following questions arise under current law in connection with 2010 GSTs and other transfers to trusts that will last beyond 2010, assuming Congress does not act to change the sunset rule:

a. May a transferor allocate the GSTT exemption to a 2010 *inter vivos* transfer on a timely filed 2010 Form 709?[2] The answer seems to be no, because there is no GSTT exemption available in 2010. Section 2631(c) provides that the exemption for any calendar year is equal to the applicable exclusion amount under section 2010(c) for that year. There is no applicable exclusion amount for 2010.[3] But if chapter 13 is to be applied in 2011 as if EGTRRA had never been enacted, one could argue (and the IRS might provide) that the amount of the transferor's GSTT exemption that would have been available in 2010 under pre-2001 law should be available. That amount, $1 million indexed for inflation, is about $1.34 million in 2010.[4]

b. May a transferor allocate the GSTT exemption in 2010 to a pre-2010 *inter vivos* transfer? The answer seems to be yes, but only for transfers that were made in 2009 — and then only if the allocation is made on a timely filed 2009 Form 709. A timely allocation to a 2009 transfer should be permitted because, even though there is no GSTT exemption available in 2010, a timely allocation to a 2009 transfer would be effective in 2009 when the exemption was available. A late allocation should not be permitted because there is no GSTT exemption available in 2010; however, as discussed above, if the ''had never been enacted'' rule is applied, a late exemption allocation made in 2010 could be validated in 2011 up to the $1.34 million exemption amount that should be available for 2010 in 2011.

c. Under the sunset provisions, will a transferor's GSTT exemption be deemed to have been allocated automatically to a 2010 direct skip? If in 2011 chapter 13 is interpreted as if there was a $1.34 million GSTT exemption in 2010, the ''had never been enacted'' rule would also appear to treat skip person trusts to which transfers were made in 2010 as if the transferor's unused GSTT exemption had been automatically allocated to those transfers by reason of section 2632(b). Even though section 2632(b) (as part of chapter 13) does not apply to direct skips in 2010, to the extent property that was the subject of a direct skip in 2010 continues to be held in a skip person trust in 2011, under the ''had never been enacted'' rule, the inclusion ratio of the trust would be determined as if section 2632(b) had applied to the direct skip in 2010. As a result, the amount of GSTT exemption that would have been allocated automatically if EGTRRA had never been enacted would be treated in 2011 as having been allocated to the skip person trust.

d. Will a 2010 transfer to a trust with an inclusion ratio of less than 1 require a redetermination of the trust's applicable fraction if the transfer is not a direct skip? Section 2642(d) requires that the applicable fraction of an existing trust be recomputed when property is added to it. This rule should apply to 2010 transfers that are not direct skips. The suspension of the application of chapter 13 in 2010 is limited to GSTs. Unless an addition

[2] There is little doubt that a transferor could allocate the GSTT exemption on a late-filed Form 709 if in the year of filing the transferor has a GSTT exemption. Under section 2642(b)(3) the effective date of such an allocation is the date of filing, and the resulting inclusion ratio is determined on the basis of values on that date or, with an election under reg. section 26.2642-2(a)(2), on the first day of the month.

[3] Section 2010(c).

[4] Under pre-2001 law, the GSTT exemption of $1 million allowed under section 2631(c) was indexed for inflation starting in 2004 using 1997 as the base year. Because the indexed exemption is not in effect in 2010, the IRS's annual revenue procedure cataloging the various inflation adjustments under the code does not include any reference to the GSTT exemption. Rev. Proc. 2009-50, 2009-45 IRB 617, *Doc 2009-22746, 2009 TNT 198-8*, does tell us, however, that the inflation-adjusted amount for the $1 million ''2-percent portion'' (for purposes of calculating interest under section 6601(j)) of the estate tax payment extended as provided in section 6166 is $1.34 million. Because that number is indexed over the same period, this suggests that the right number for the GSTT exemption in 2009 is also $1.34 million.

to a trust is a direct skip (the potential consequences of which are discussed above), the addition is not a GST and the inclusion ratio would therefore need to be recomputed in 2010 without regard to the sunset.

e. For a taxable distribution to a skip person trust or a taxable termination that does not result in an outright distribution of property, does section 2653(a)'s generational move-down rule apply? Section 2653(a) operates when a GST occurs for property that continues to be held in trust. It moves the transferor's generation assignment down to the first generation above the highest generation of any person who has an interest in the trust after the occurrence of the GST (the move-down rule). The move-down rule will not apply in 2010 because none of chapter 13 applies to 2010 GSTs. Whether it applies after 2010 depends on how the ''had never been enacted'' rule applies to those transfers. If the move-down rule is applied in 2011 as if section 2653(a) applies to 2010 GSTs, which would have been the case if EGTRRA had never been enacted, it should apply to a trust holding property for which there was a 2010 GST. However, the move-down rule would not apply and transfers out of trust to a skip person would be subject to the GSTT if, for purposes of applying the GSTT after 2010 to transfers that occurred in 2010, the fact that chapter 13 did not apply to GSTs in 2010 means that those GSTs are deemed not to have occurred in that year despite the ''had never been enacted'' rule. The application of the move-down rule will first be relevant in 2011.

f. Will a 2010 direct skip that is treated as a nontaxable gift under section 2642(c) have a zero inclusion ratio if it is made to a trust? The answer seems to be no, because the rule in section 2642(c) that provides that a nontaxable gift has a zero inclusion ratio (the zero inclusion ratio rule) is part of chapter 13, and chapter 13 does not apply to GSTs that occur in 2010, including direct skips that are nontaxable gifts. However, if chapter 13's zero inclusion ratio rule is to be applied in 2011 as if EGTRRA had never been enacted, the trust property that was the subject of the direct skip in 2010 should have a zero inclusion ratio starting in 2011 unless, for purposes of applying the GSTT after 2010 to transfers that occurred in 2010, the fact that chapter 13 did not apply to GSTs in 2010 means that those GSTs are deemed not to have occurred in that year despite the ''had never been enacted'' rule.

g. Will a taxable termination that occurs in 2010 at the same time as and as a result of the death of a beneficiary cause a basis adjustment under section 2654(a)(2)? This answer also seems to be no, because section 2654(a)(2) is part of chapter 13 and is inapplicable to any GST that occurs in 2010. But if chapter 13 is to be applied as if EGTRRA had never been enacted, the basis adjustment should apply starting in 2011 unless, for purposes of applying the GSTT after 2010 to transfers that occurred in 2010, the fact that chapter 13 did not apply to GSTs in 2010 means that those GSTs are deemed not to have occurred in that year despite the ''had never been enacted'' rule.

h. Will a trust created with assets that would have been included in the gross estate of an individual who dies in 2010 if death had occurred in different year be subject to the GSTT after 2010? A trust funded with assets that would have been included in the gross estate of a 2010 decedent if chapter 11 had applied to his estate will not have a transferor in 2010. Under section 2652(a) there is no transferor unless property was subject to either the tax imposed by chapter 11 or the tax imposed by chapter 12. A trust without a transferor produces strange results under chapter 13 because all of its beneficiaries will be nonskip persons. The term ''non-skip person'' is defined in section 2613(b) as any person who is not a skip person. None of the trust's beneficiaries can be skip persons because (1) section 2613(a)(1) provides that a skip person is a person assigned to two or more generations below the transferor, and (2) this trust has no transferor. This apparently means that no distribution from that trust would be a taxable distribution and no termination of an interest would be a taxable termination because every person holding an interest after a termination will be a nonskip person. That analysis is consistent with the treatment under reg. section 26.2663-2 of a nonresident alien who makes a transfer that is not subject to estate or gift tax to a trust for U.S. persons. However, if chapter 13 is applied after 2010 as if EGTRRA had never been enacted, the decedent could be treated as the trust's transferor.

2. Termination of estate tax inclusion periods (ETIPs) in 2010.

a. Did ETIPs that began before 2010 terminate on January 1, 2010? The answer seems to be yes. Section 2642(f) provides that if a transfer would be included in the transferor's gross estate (or, in some situations, in the gross estate of the transferor's spouse) under chapter 11 (other than by reason of section 2035) if the transferor died immediately after the transfer, a GSTT exemption cannot be allocated to that transfer until the earliest of (1) the time the transfer would not be so included, (2) the transferor's death (or the spouse's death, in some situations),[5] or (3) the occurrence of a GST other than a direct skip. The period during which a GSTT exemption cannot be allocated is the ETIP. The automatic allocation rules apply at the end of the ETIP based on the value of the property at that time. In the case of a direct skip, because tax would otherwise be imposed before the allocation is effective, the direct skip itself is postponed until the ETIP has ended for the property. It therefore appears that any ETIP to which a trust was subject on December 31, 2009, ended on January 1, 2010, because chapter 11 would not apply to an individual who died on that date. The provisions of section 2542(f) ending the ETIP would then apply, except perhaps in the case of a postponed direct skip, because in such a case the application of the ETIP rule would cause a GST and chapter 13 does not apply to GSTs in 2010. However, if chapter 13 is applied after 2010 as if EGTRRA had never been enacted, it is possible that as of January 1, 2011, the trust will be treated as if the ETIP had never ended.

b. Will the termination of an ETIP in 2010 cause a pre-2010 allocation of GSTT exemption to be effective

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[5]Reg. section 26.2632-1(c) provides that this rule does not apply when a reverse qualified terminable interest property election under section 2652(a)(3) is made.

in 2010? The answer seems to be yes. Despite section 2642(f)'s prohibition against the allocation of a GSTT exemption to a trust during an ETIP, reg. section 26.2632-1(c)(1)(ii) implicitly approves such an allocation and directs that the allocation will not be effective until the close of the ETIP. If an individual made a GSTT exemption allocation to a trust before 2010 and during an ETIP, and if the ETIP closes in 2010 as a result of an event that does not cause a GST to occur (see the immediately preceding question), the previous allocation of GSTT exemption to the trust should become effective in 2010.

C. Chapter 13 After 2010

After 2010 the GSTT will again apply to GSTs and the tax will be applied as if EGTRRA had never been enacted. At a minimum, this means:

- The GSTT exemption available for post-2010 transfers will be $1 million indexed for inflation occurring after 1998.
- GSTT exemptions will no longer be automatically allocated to indirect skips under section 2632(c).
- Retroactive GSTT exemption allocations will no longer be permitted under section 2632(d).
- Qualified severances under section 2642(a)(3) will no longer be permitted.
- Section 9100 relief for late GSTT exemption allocations under section 2642(g) will no longer be allowed.
- The applicable rate for post-2010 GSTs under section 2641 will be 55 percent.

What is unclear is whether trusts that had taken advantage of any of the provisions referred to in the first five items above before 2011 will lose the advantage in years after 2010. For example:

> 1. Will trusts to which GSTT exemptions in excess of the currently available amount be required to adjust their applicable fractions and their inclusion ratios to reflect the lower GSTT exemption that would have been allowable if EGTRRA had not been enacted?
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> 2. Will trusts (i) to which automatic GSTT exemption allocations occurred under section 2632(c), or (ii) to which retroactive GSTT exemption allocations were made under section 2632(d), lose their exemptions?
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> 3. Will trusts that were severed in qualified severances under section 2642(a)(3) be recombined?
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> 4. Will trusts that received late GSTT exemption allocations from transferors who received extensions to make those allocations under section 2642(g) be required to change their applicable fractions and inclusion ratios to those that would have applied if the extensions had not been granted?[6]

In each case, the answer may depend on whether the IRS and Treasury could have achieved the result mandated by EGTRRA if the act had never passed. In those cases (arguably questions 2(i),[7] (3), and (4) above) the IRS and Treasury may choose to recognize the actions taken between 2001 and 2011.

D. Existing Estate Planning Documents

Many existing estate planning documents contain provisions that describe gifts with reference to terms that are defined in chapter 13. The definitions still work. Although GSTs that take place in 2010 will not be subject to chapter 13, that chapter is still part of the code. But these types of provisions may work in unexpected ways in 2010. For example, a bequest to a trust for grandchildren of an "amount equal to my available GSTT exemption" will be a bequest of nothing in 2010 because the amount of the GSTT exemption in 2010 is nothing.[8] However, a bequest to a trust for grandchildren of the maximum amount that can pass to the trust free of the GSTT could deliver a 2010 decedent's entire estate.

It is unlikely that clients would want either of those results. The client who provided a bequest to a grandchildren's trust of an amount equal to his GSTT exemption would probably want to give some portion of his estate to the trust, particularly if no GSTT would be imposed on the gift. That client's document might be revised to provide:

> If I die at a time when chapter 13 of the code does not apply to generation-skipping transfers, my GSTT exemption for purposes of this gift shall be deemed to be [$__________].[9]

The client who provided a bequest to a grandchildren's trust of the maximum amount that can pass to the trust free of the GSTT would probably want to put an upper limit on the amount that would pass to the trust. Her testamentary document might be amended to add the following:

[6]EGTRRA also added a substantial compliance provision to section 2642(g). Section 2642(g)(2) provides that a GSTT exemption allocation that demonstrates an intent to have the lowest possible inclusion ratio for a trust shall be deemed to be an allocation of so much of the transferor's unused GSTT exemption as produces the lowest possible inclusion ratio. Because the IRS had clearly adopted that approach before EGTRRA (see, *e.g.*, LTR 199937026 (Jun. 17, 1999), *Doc 1999-30256, 1999 TNT 181-47*), the substance of this subsection should continue to apply after 2010.

[7]Arguably, the IRS would have the authority to treat automatic allocations between 2001 and 2011 as manual allocations under the substantial compliance doctrine. *See supra* note 6.

[8]Section 2631(c) provides that the GSTT exemption for any calendar year is equal to the applicable exclusion amount under section 2010(c) for that year. There is no applicable exclusion amount for 2010.

[9]To avoid disputes about the effect of a retroactive application of chapter 13 to 2010 decedents, consider adding the following construction principle to the estate planning document:

> In determining whether chapter 13 applies to generation-skipping transfers at the time of my death, if legislation enacted after my death retroactively applies chapter 13 of the code to generation-skipping transfers at the time of my death, for all purposes of this Will, chapter 13 of the code shall be deemed to apply to generation-skipping transfers at the time of my death.

In no event shall the gift made pursuant to this section exceed [$__________].

E. 2010 Actions to Minimize GSTTs

1. 2010 direct skips, taxable distributions, and taxable terminations. The 2010 actions most likely to minimize future GSTTs are outright transfers of property to skip persons by transferors in transfers subject to the gift tax, and outright distributions to individual skip persons by trustees in taxable distributions under section 2612(b). Unless Congress retroactively applies chapter 13 to 2010 direct skips and taxable distributions, either type of transfer will protect the transferred property from future GSTTs.

2. Factors to consider in connection with the use of 2010 direct skips.

a. Reducing tax exposure.

i. *Inter vivos* direct skips.

a. Using gift tax and GSTT exemptions. Individual taxpayers may be reluctant to make direct skip gifts in 2010 for two reasons. First, they may be unwilling to pay the gift taxes that would be imposed on any direct skip not protected by their lifetime gift tax exemptions (the $1 million that can be exempted from gift tax by use of the portion of the unified credit available for gift tax purposes). Second, they may be concerned that there will be a retroactive imposition of chapter 13 to 2010 direct skips.

Those individuals who have not yet used their lifetime gift tax exemptions or any of their GSTT exemptions could make direct skip gifts of up to $1 million without incurring gift tax and without running any significant risk of a retroactive imposition of the GSTT. Those gifts would be protected from gift tax by their unified credits. If the chapter 13 tax is retroactively imposed, a GSTT exemption of at least $1 million will likely be permitted. If so, their gifts will not be subject to either tax. If the chapter 13 tax is imposed prospectively — after the direct skip gifts are completed — and the individuals elect out of the automatic GSTT exemption to direct skips that might otherwise apply to the direct skips, they will not have used any of their GSTT exemptions.

b. Net gifts. An individual whose 2010 direct skips would be subject to a retroactively imposed GSTT could reduce the amount of her exposure by structuring the gifts as a gift subject to the donee's obligation to reimburse her for any GSTT imposed on the gift and for any gift taxes imposed under section 2515 on any GSTT imposed on the gift. A gift subject to such an obligation would amount to only 60.5 percent of the amount transferred and would reduce the two taxes from 65.3 percent to 39.5 percent of the amount transferred.

c. Recission. An individual willing to run some risk might be willing to rely on the rescission doctrine for protection from the retroactive imposition of chapter 13 if the doctrine applies in her jurisdiction. The doctrine of rescission has been used to undo gifts that were made under a mistake of law and to justify a refund of the gift taxes paid on those gifts. For example, the taxpayer in *Neal v. United States*[10] had released her contingent reversion in a trust to avoid the tax liability that would result from the application of section 2036(c) to the trust. The release was a taxable gift on which she paid gift tax. The year after her release, section 2036(c) was repealed retroactively. The taxpayer then executed a document rescinding her release, obtained judicial approval of the rescission, and requested a refund of gift taxes paid on the release. The local court approved the rescission because the taxpayer's release had been motivated by an erroneous belief that section 2036(c) applied to her trust. The Third Circuit agreed that under the law of Pennsylvania, the taxpayer's jurisdiction, a transfer based on a mistake of law is rescindable and that, for all practical purposes, the retroactive repeal of section 2036(c) made the law at the time she released her reversionary interest something other than what she believed it to be. Accordingly, the transfer was incomplete and nontaxable. What works to undo a gift for gift tax purposes should be equally effective to undo a gift for GSTT purposes if chapter 13 is imposed retroactively on 2010 direct skips.

d. Using formula clauses. Another approach is to use a formula-type gift structured to limit the amount of a transfer of the transferor's interest in a particular property to the portion that could be transferred without attracting a GSTT. An assignment form similar to the one below could be considered:

> I hereby transfer a fraction of a [5 percent] interest in the T-LLC to my grandchild G. The numerator of the fraction is an amount equal to the lesser of (i) the maximum amount I can transfer to G on the date of this transfer without the imposition of a GSTT or (ii) an amount equal to the fair market value of a [5 percent] interest in the T-LLC on the date of the transfer. The denominator of the fraction is an amount equal to the fair market value of a [5 percent] interest in the T-LLC on the date of the transfer. In determining whether this transfer is subject to the GSTT, the GSTT shall be deemed to apply to this transfer if an act of Congress retroactively imposes the GSTT on transfers that take place on the date of this transfer.

Some might suggest that this type of clause could be successfully challenged by the IRS under the authority of *Commissioner v. Procter*.[11] Such a challenge should be unsuccessful, because none of the policy reasons underlying the *Procter* decision would be implicated by a

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[10]*Neal v. United States*, 187 F.3d 626 (3d Cir. 1999), *Doc 1999-15703, 1999 TNT 91-5*. *See also Berger v. United States*, 487 F. Supp. 49, 51-52 (W.D. Pa. 1980).

[11]*Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). *But see Estate of Petter v. Commissioner*, T.C. Memo. 2009-280, *Doc 2009-26779, 2009 TNT 233-14*, which upholds defined value formula gifts after considering and distinguishing the public policy analysis in *Procter* and *Estate of Christiansen v. Commissioner*, 130 T.C. 1, 8 n.7 (2008), *Doc 2008-1539, 2008 TNT 17-7*, *aff'd*, 586 F.3d 1061 (8th Cir. 2009), *Doc 2009-25102, 2009 TNT 218-18*, which upholds a defined value disclaimer.

formula clause that is based on the existence of a particular tax rather than on the manner in which public officials or federal courts enforce that tax.

The clause that was invalidated in *Procter* provided:

> In the event it should be determined by final judgment or order of a competent federal court of last resort that any part of the transfer in trust hereunder is subject to gift tax, it is agreed by all the parties hereto that in that event the excess property hereby transferred which is decreed by such court to be subject to gift tax, shall automatically be deemed not to be included in the conveyance in trust hereunder.

For the clause in *Procter* to operate to return the gifted property to the taxpayer, the IRS would have had to take the position that he had made a taxable gift, and a federal court would have had to agree with that position. The Fourth Circuit articulated the following three reasons for its decision that the clause established a condition subsequent and was void because contrary to public policy:

- Such a provision would discourage the collection of tax by the IRS, because a successful attempt to characterize the transfer as a gift would defeat the gift.
- Such a provision would obstruct the administration of justice by requiring the court to address a moot case.
- Such a provision should not be permitted to defeat a judgment rendered by a court.[12]

The validity of the clause suggested above would cause none of those consequences. Its operation depends only on legislative action, not on IRS or court action. It would limit the amount of a transfer only in the event Congress retroactively imposed a tax under chapter 13. Congress may have the constitutional authority to impose the GSTT retroactively if retroactivity is a rational means of furthering a legitimate legislative purpose (for example, the collection of revenue).[13] But that does not mean Congress should have the power to provide that a tax does not apply to a particular type of transaction for a period of time in order to encourage taxpayers to engage in those transactions so that it could retroactively impose a tax on those transactions. Unless this type of bait-and-switch legislation were thought to be acceptable, it is difficult to articulate a principled argument against the validity for tax purposes of a clause that conditions a transaction on the absence of retroactive tax legislation.

e. Using QTIPs. A married transferor could make a gift to a qualified terminable interest property for the benefit of her spouse. The trust could contain a clause providing that in the event the spouse disclaimed her interest in the trust, the trust would terminate and the trust property would be distributed to a grandchild. The spouse would have nine months to determine whether it would be appropriate to renounce if no benefits are accepted from the trust during the nine-month period. If during the nine-month period it becomes clear that Congress will not retroactively impose the GSTT, the spouse would make a timely renunciation causing the trust property to be distributed to the grandchild. If Congress does retroactively enact the GSTT, the spouse would not renounce. The transferor would elect QTIP treatment on a timely filed gift tax return and would have no gift or GSTT liability.

ii. Testamentary direct skips. Individual taxpayers may also be reluctant to change their testamentary documents to provide for gifts to grandchildren if death occurs in 2010, because of concern that there will be a retroactive imposition of chapter 13 to 2010 bequests to grandchildren. The same type of formula discussed above in connection with the use of *inter vivos* direct skips in 2010 could be used in testamentary instruments. For example, a client's will could be revised to say:

> I give my grandchild G an amount equal to the lesser of [$_______] and the maximum amount that can pass to a grandchild of mine at my death free of the generation-skipping transfer tax.

In theory, this type of formula clause could be attacked on the same basis as the formulas used to limit the amount of *inter vivos* gifts. But similar clauses in testamentary documents have not been challenged by the IRS. For example, clauses that limit bequests to children to the maximum amount that can pass free of estate tax on account of the credit against estate tax allowed by section 2010 are widely used and, to the best of our knowledge, have never been subject to challenge.

b. Using skip person trusts to receive direct skip gifts. Most individuals who would like to make direct skip gifts in 2010 would prefer to make their transfers in trust rather than outright for good nontax reasons as well as tax reasons. The intended recipients of the gifts may be too young to have the legal capacity to make decisions regarding the gifted property or may lack the sophistication to make rational decisions. Also, outright transfers expose the transferred property to claims by the donee's creditors, including possible unhappy spouses, and could expose investment income to state income taxes that could be avoided by a transfer in trust.

Unfortunately, for the reasons discussed above, there is no assurance that a transfer to a skip trust would offer any long-term protection against imposition of the GSTT.[14] Unless the generational move-down rule of section 2653(a) applies to such a trust after 2010, distributions from the trust to skip persons will be taxed as taxable distributions if made when chapter 13 applies to GSTs.[15]

Some of the problems presented by outright transfers to minors and others who lack the ability to manage

[12]*Estate of McClendon v. Commissioner,* T.C. Memo. 1993-459.

[13]*United States v. Carlton,* 512 U.S. 26 (1994), *Doc 94-5582, 94 TNT 114-1.*

[14]*See supra* question d under Part B.1.

[15]The problem of making gifts to minors cannot be avoided by making gifts to custodians under the Uniform Gifts to Minors Act or the Uniform Transfers to Minors Act, because those accounts are treated as trust equivalents under section 2652(b). *See* reg. section 26.2652-1(b)(2), Example 1. The same is probably true for gifts to section 529 accounts.

investment assets can be handled by transferring the assets to be gifted to a limited partnership or limited liability company before the direct skip gift takes place. The subject of the direct skip gift could then be an interest in the partnership or company. And that partnership or company could be managed by a family member or another person who has the ability to effectively manage it. Some protection against creditor claims could be obtained by an adult donee who transfers his gifted property to a trustee in a jurisdiction such as Delaware or Alaska that offers protection from creditors for assets in self-settled trusts.

3. Factors to consider in connection with the use of 2010 taxable distributions.

a. Tax exposure. Unlike direct skip gifts, taxable distributions will not incur a gift tax. Trustees making taxable distributions may, however, be concerned that there will be a retroactive imposition of chapter 13 to 2010 taxable distributions. Although the chapter 13 tax is the liability of the distributee rather than the trustee, the trustee might have been unwilling to make a distribution if the trustee thought that the distribution would be subject to the GSTT.

A formula-type distribution similar to the formula-type gift discussed above should work equally well to limit exposure to the GSTT for taxable distributions if chapter 13 is retroactively imposed on 2010 distributions.

In structuring taxable distributions, trustees should keep in mind the potential income tax that could be imposed on the distributee. For example, suppose that a trustee decided to make a taxable distribution to the trust's transferor's grandchild G of a $1 million interest in the family holding company (FHC). If the trustee's basis in that interest is $1 million, if the trust's distributable net income in the year of distribution is $1 million, and if no distributions are made to any other beneficiaries, G will have gross income of $1 million on account of the receipt of the FHC interest. Thought should be given to G's available sources of funds to G to pay the tax.

In the event of a retroactive imposition of the GSTT, the distributee's tax liability could be substantial. Ignoring state income taxes and assuming that G is in the highest income tax bracket, G's total income tax would be calculated as follows:

Amount of Distribution	$1,000,000
GST Tax	$450,000
Gross Income	$1,000,000
Section 164 Deduction for GST Tax	$450,000
Taxable Income	$550,000
Income Tax at 35%	$192,500
Total Taxes	**$642,500**

If G were subject to the alternate minimum tax, so that the income tax deduction for the GSTT was not permitted, G's tax would be calculated as follows:

Amount of Distribution	$1,000,000
GST Tax	$450,000
Gross Income	$1,000,000
Section 164 Deduction for GST Tax	$—
Taxable Income	$1,000,000
Income Tax at 28%	$280,000
Total Taxes	**$730,000**

b. Using skip person trusts to receive taxable distributions. For the reasons discussed above in connection with direct skips, most trustees would prefer to make taxable distributions to skip person trusts rather than to individual beneficiaries. As discussed above, however, distributions in trust rather than outright could result in the imposition of a GSTT when distributions are made in a later year to skip persons.

4. Factors to consider in connection with the use of 2010 taxable terminations. Taxable terminations generally do not occur voluntarily. They commonly occur when a person's interest in a trust terminates by reason of his death or the termination of an interest that was measured by a term of years. Taxable terminations are not always accompanied by a speedy distribution of trust assets to skip person beneficiaries. Assets could be retained in the trust after the termination because the terms of the trust permit or require the trustees to retain assets or because the trustees want to retain trust assets until an accounting has been prepared and the trust beneficiaries have signed appropriate releases.

If a taxable termination occurs in 2010 at a time chapter 13 does not apply to GSTs, the trustees should consider making prompt distributions to trust beneficiaries to avoid the possibility that a subsequent enactment of chapter 13 could cause a trust distribution to skip persons occasioned by the termination to be treated as a taxable distribution when made rather than as a taxable termination occurring on the termination of the interest in question.[16]

5. Dealing with 2010 transfers that are not GSTs. Individuals are likely to continue making transfers in 2010 to trusts that could make future taxable distributions or that could have future taxable terminations. Those transfers would include, for example, a continued pattern of gifts to an insurance trust or other family trust that are protected from gift tax by section 2503(b), or a continued pattern of annual exclusion gifts to a grandchild's trust that is eligible to receive nontaxable gifts for GSTT purposes.

Unless Congress changes the law in unexpected ways, it is unlikely that the future taxable distributions or taxable terminations of these trusts will be protected from the GSTT by some kind of effective-date legislation.

[16]*See* reg. section 26.2612-1(f), examples 7-10. If the distribution is not required but is merely discretionary with the trustee and section 2653(a) is inapplicable, the taxable distribution would be in addition to the taxable termination.

It is therefore important to plan carefully for how the transferor's GSTT exemption should be allocated to these transfers.

Consider, for example, an outright gift to a grandchild in 2010. If chapter 13 is not retroactively imposed to apply to that gift, it will be unnecessary to use any portion of the transferor's GSTT exemption to protect the gift from the GSTT. But unless the transferor elects out of section 2632(b)'s automatic allocation rule, GSTT exemption could be wasted by an automatic allocation to such a trust in 2011 under the "had never been enacted" rule.

As another example, consider a trust that qualifies as a GST trust under the automatic GSTT exemption allocation rules of section 2632(c). If the law is not changed, those automatic GSTT exemption allocation rules will not apply to 2010 additions. If the transferor wants GSTT exemption to be allocated to his additions, a manual allocation of GSTT exemption should be made on a timely filed gift tax return for 2010.