newsletter

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GENERATION-SKIPPING TRANSFERS UNDER TRA 1986

A provision of the Tax Reform Act of 1986 completely repeals the generation-skipping transfer (GST) tax provisions, retroactive to the original enactment on June 11, 1976. The government's policy behind the change in the GST tax laws is to tax property at a maximum rate of 50% (55% until 1988) at each generation even if the transferor "skips" a generation in making the transfer. The prior law is replaced by new Sections 2601-2663, and the tax is effective, in general, for transfers made after September 25, 1985. That the GST laws have been completely repealed should not come as a surprise; the law had been widely criticized as being overly complex and exceedingly difficult to administer. Although the new Act makes several significant changes to prior law, the GST tax remains complex and highly technical.

The new GST tax presents new challenges to estate planners who must become familiar with the provisions, develop new planning strategies and carefully review and revise clauses in will and trust forms in current use. This article will present a short overview of the new GST tax, suggest some planning ideas and refer estate planners to several other resources.

How to Spot a GST

There are three types of generation-skipping transfers: taxable terminations, taxable distributions and a new type of transfer, direct skips. Each type involves a transfer from a transferor to a transferee who is at least two generations younger than the transferor. For example, a grandchild is two generations younger than a grandparent. The transferee is called a "skip person". A skip person can also be a trust, if the beneficiaries of the trust are skip persons or if no person holds an interest in the trust and no distributions will be made to a non-skip person. For example, a trust for grandchildren of the transferor is a skip person, as all beneficiaries are skip persons.

A taxable termination is the termination of the interests of any beneficiary of a trust if, after the termination, distributions of the trust will be made to skip persons. For example, in a trust providing income to the transferor's nephew for life and remainder to the nephew's children, in equal shares, the nephew's death results in a taxable termination. A taxable distribution is a distribution from a trust to a skip person. For example, a distribution from income or principal of a trust to a grandchild is a taxable distribution. A direct skip is a transfer to a skip person, which is subject to federal estate tax or federal gift tax. For example, a taxable gift to a grandchild is a direct skip.

Under the Tax Reform Act of 1976, a direct skip of generations was not subject to the GST tax. The new Act's inclusion of direct skips as transfers subject to the GST tax is an important broadening of the law, and has the effect of taxing the transfer as though the interest had passed through the earlier generation. The inclusion of direct skips is consistent with the House Ways and Means Committee's belief that transfer tax consequences should not "vary widely depending on whether property is transferred outright to immediately succeeding generations or is transferred in ways that skip generations".

Tax, Exemptions and Exclusions

A GST is taxed at the highest federal estate tax rate in effect (55% in 1987 and 50% thereafter). Under prior law, the rate was the highest marginal rate of the "deemed transferor," a confusing concept which thankfully has been eliminated. This high rate of tax is a significant change in the law and makes it important for the planner to effectively use the exemptions and exclusions described below.

$1,000,000 exemption. Every transferor has a $1,000,000 exemption, which can be used for transfers during life or at death. The transferor (or his personal representative) makes an allocation of the exemption at any time on or before the date the transferor's death tax return is due. The allocation, once made, is irrevocable. Unless the transferor elects not to allocate a portion of his exemption to lifetime direct skips, the exemption will be allocated to such transfers. The value of the property at the time of the allocation will determine the amount of the exemption used, regardless of its value at the time of the distribution. Once a transfer, or a portion of a transfer, is designated as exempt, all subsequent appreciation in value of the exempt property is exempt from the GST tax.

Practice Tip: Allocate any exemption used during the transferor's life as soon as possible, before assets appreciate. Report the allocation of inter vivos transfers on the revised Form 709, titled "United States Gift (and Generation-Skipping Transfer) Tax Return". Plan to use the exemption of both spouses. If necessary, transfer assets by interspousal gift so that each spouse has sufficient assets to fully use the exemption. Gifts split between spouses under §2513 will also be treated as made one-half by each spouse for purposes of using their $1,000,000 exemption.

$2,000,000 grandchild exemption. Direct skips of up to $2,000,000 per grandchild of a transferor are exempt from the GST tax if

made prior to January 1, 1990. This is the so-called "Gallo Amendment". Transfers made outright to grandchildren qualify for the exemption. The $250,000 per grandchild exemption from prior law is repealed.

Practice Tip: Make direct skip transfers to grandchildren prior to January 1, 1990. Split gifts between spouses to increase exempt transfers to a grandchild to $4,000,000. Transfers in trust might qualify, but it is not clear what trust provisions would be required. Until this issue is resolved, caution would suggest not using a trust to qualify for this exemption.

Gift tax exclusion. The GST tax does not apply to inter vivos gifts which are excluded from federal gift tax due to annual exclusions, or exclusions for certain medical or tuition expenses. The GST tax does apply to any portion of a gift in excess of the annual exclusion if no exemption is allocated to the transfer.

Practice Tip: To avoid complex calculations for allocating the exemption, plan gifts to fit within the annual exclusions. Isolate transfers which are exempt from transfers which are not exempt by placing them in separate trusts.

Predeceased child exclusion. Excluded from the definition of a direct skip is a transfer to a grandchild, if at the time of the transfer, the parent of a grandchild who is a lineal descendant of the transferor (or his spouse or former spouse) is deceased. The grandchild, in effect, is moved up a generation and is treated for purposes of generation assignments as if he were a child of the transferor.

Practice Tip: This exclusion applies only to direct skips. It does not apply to transfers to a trust for a grandchild. When trust distributions are subsequently made to a grandchild, the GST tax will apply to the taxable distributions.

Review Existing Estate Plans

In light of the new GST provisions, existing wills and trusts should be reviewed to see if revisions are necessary. Consider the following when examining disclaimer provisions, tax clauses and clauses stating the authority of the executor:

Disclaimer provisions. Determine whether a disclaimer of a bequest will result in a GST, which will be the case if property passes to a person at least two generations below the original transferor. The resulting tax may be greater than if the property is subject to estate or gift tax in the intervening generation. Recognize that a partial disclaimer may be advantageous, allowing a portion of the bequest to offset the disclaimant's available unified credit. Note that unless otherwise provided, the disclaimed property, not the transferor's estate, will be primarily liable for the GST tax.

Tax clauses. Review tax clauses and redraft if needed to ensure that any GST tax will be allocated appropriately. The Code provides that unless otherwise specifically directed, the GST tax "shall be charged to the property constituting such transfer." Note that the person liable for the GST tax depends on whether the transfer is a taxable termination, taxable distribution or direct skip.

Authority of executor. Include language specifically authorizing the executor to allocate any unused $1,000,000 exemption among inter vivos transfers. Also authorize an election to allocate a portion of the exemption to property with respect to which a GST will occur upon its disposition by (or on the death of) the transferor's spouse as a result of a QTIP election. This election will have the effect of treating the decedent as the transferor of the QTIP property and will use his exemptions that might otherwise be wasted. If the election is not made, the surviving spouse will be treated as the transferor and although she would be able to use her exemption, her spouse's exemption might not be fully used. Relieve the executor from all liability in making allocations.

Additional Resources

This article has addressed the new GST tax in a limited way. Estate planners may also wish to review the following resources which further explain the GST provisions of the new Act. *e.g.*, Katzenstein, "The New Generation-Skipping Tax: A Road Map" *TAXES – The Tax Magazine*, April 1987, at 259; Plaine, "The New Generation-Skipping Transfer Tax contained in The Tax Reform Act of 1986, H.R. 3838", in *Tax Management Portfolios: The Tax Reform Act of 1986*, Volume II, (Bureau of National Affairs) at 48:1; Mulligan and Boulton, "Planning Opportunities That Take Advantage of the New Generation-Skipping Tax Provisions – Part I" *Estate Planning*, January/February 1987, at 66 and "New generation-skipping tax: higher rates, broadened scope, new exemptions – Part II," March/April 1987, at 10.

Conclusion

In planning inter vivos and testamentary transfers that skip generations, estate planners must take into account the new GST provisions. Although the new GST tax law is no less complex, new planning opportunities are available to minimize the GST tax.

Carolyn E. Wilson

OREGON PROBATE SYSTEM MANUAL INTRODUCED

A new OSB-CLE publication, *Oregon Probate System Manual*, was introduced at a seminar held in Portland on April 24, 1987, and co-sponsored by the Estate Planning and Administration Section.

This manual covers "typical estate" administration from a practical standpoint, including how to initiate probate, how to manage assets of the estate and how to file the necessary Oregon and federal tax returns. It features the most frequently used probate forms, including tax forms. Each form is keyed to a master information list to minimize the practitioner's time in completing the forms. The manual also contains an example of a cash flow spread sheet which is useful for projecting estate income and expenses.

The manual replaces the obsolete orange book, *Probate Manual*, and is intended to supplement the familiar black book, *Administering Oregon Estates*, which is aimed at the practitioner who requires assistance and references on the substantative issues which may arise during the administration of an estate.

This first edition is a product of over three years' work by dedicated Section members, headed by Mark W. Perrin and Jeffrey E. Boly. While several states now boast probate systems, Oregon's manual resulted from an interest in designing a system of forms that eventually could be integrated into a computerized probate system. It can be modified to suit the individual needs of the attorney, then computerized into an electronic version by using specific blanks or "fields" which are supplied by the master information list and then merged with the basic forms.

The *Oregon Probate System Manual* was developed primarily to permit secretaries and legal assistants to handle the nonattorney activities associated with administration and probate activities. It is approximately 500 pages in length, in looseleaf 8½ x 11″ format with binder. It can be obtained for $60 plus $4 shipping and handling fee from:

CLE Registrar
Oregon State Bar
P.O. Box 1689
Lake Oswego, OR 97035-0889

Audiocassette tapes of the seminar are also available at the same address for $50 per set.

Mark W. Perrin

THE NEW FEDERAL ESTATE TAX FOR QUALIFIED RETIREMENT PLAN BENEFITS

We all understand the federal estate tax, right? For years lawyers have woven the unified credit and marital deduction together with generally happy tax results for clients with modest estates or surviving spouses. But the Tax Reform Act of 1986 has introduced an *additional* estate tax that bears little resemblance to the tax imposed under IRC §2001. If you have a client with substantial retirement plan benefits (derived from qualified employer plans or individual retirement accounts), you had better read Code Section 4981A(d)!

For many years the federal treasury has subsidized tax-deferred accumulations of wealth by rich and poor alike, although somehow those clever people who deal with qualified retirement plans have managed to "enhance" accumulations by some people who are already quite well off. Doctors, lawyers, accountants, chief executive officers and others with substantial amounts of direct compensation have, in many instances, sheltered a large portion of their aggregate wealth in qualified retirement plans. Now, as a matter of policy, the government wants to recoup part of the tax benefit of the past by new taxes on "excess distributions" during lifetime and "excess accumulations" at death.

As an oversimplification, a new 15% nondeductible excise tax is imposed upon "excessive" periodic retirement plan distributions during life which are more than $112,500 in any calendar year. Your client who is age 65, with a life expectancy of 20 years, can pay himself $112,500 a year over his life expectancy if he has, at age 65, $1,105,000.00 in plan assets and earns a consistent 8% on his retirement plan funds. But if your client is lucky enough to have this problem, he also has another problem that you need to identify and discuss with him.

The special companion estate tax that goes with the excess distribution tax is also 15% imposed on any "excess retirement accumulation" existing at death. If at the time of your client's death his total retirement plan assets exceed the *present value* of an annuity of $112,500 for the rest of his *life expectancy* determined immediately before death, the excess over that present value is subject to a 15% estate tax. If the life expectancy and interest assumptions (to be determined later by IRS regulation) are the same as in the example above, and your client dies at age 65, every dollar of qualified benefit over $1,105,000.00 would be subject to the 15% additional estate tax.

Now for the really bad news. The unified credit and the marital deduction *do not apply* to this estate tax. The tax cannot be reduced or modified in any way, and is automatically payable by the estate. *NOTE:* Every dollar of this tax that is paid is a dollar reduction of the amount available for the unified credit exemption equivalent. If your client has an eventual effective marginal transfer tax rate of 50%, the net *effective* tax rate under 4981A(d) is 22-½%.

Can the tax be avoided? Of course it can. Clients with substantial retirement plan benefits should plan lifetime distributions to remain *below* the threshold for application of the new estate tax. It seems clear, from an estate tax standpoint, that you are better off to incur a current income tax on a lifetime distribution than to incur both the income tax and the additional estate tax which arise if the 4981A(d) tax is imposed on benefits left at death.

One last warning: It seems that no IRD deduction will be allowed for the estate tax paid under 4981A(d). This would be the worst of all worlds as the distribution may be subject to the ordinary estate tax, the new additional estate tax, and to income tax payable by the recipient without any corresponding IRD deduction for the additional 4981A(d) tax.

Stephen O. Lane

WHAT'S NEW?

The Court of Appeals in *Garrison v. Garrison*, 82 Or App 165 (1986), clarified who is entitled to benefits of the credit against inheritance tax allowed under ORS 118.035. ORS 118.035 allows a credit to each of certain beneficiaries of the decedent for deaths occurring prior to 1985. The amount of the credit is set under the statute and varies according to the year of death. No credit is allowed where the death occurs after 1984. A credit is allowed for a beneficiary who is unable to support himself due to certain disabilities. In this case, the decedent's will stated that taxes paid by the estate not be apportioned. The appellant, a beneficairy of the estate, had multiple Sclerosis and was unable to support himself and thus, qualified for a credit under ORS 118.035. The personal representative did not allocate the benefit of the credit to the appellant. Rather, the personal representative reduced the total inheritance tax due prior to allocating distributions to the beneficiaries. The appellant objected to the final account and argued that the benefit of his credit should be allocated to him rather than indirectly benefiting all of the beneficiaries of the estate. The Court concluded that ORS 118.035 requires apportioning regardless of whether the will says that no apportionment shall be made adding that the legislature intended that the credit be for the sole benefit of the qualified handicapped person. Review open estates of decedents dying before 1985 to insure that a proper allocation of this credit will be made.

The Court of Appeals ruled on the validity and applicability of pre-nuptial agreements in two cases. In *Simmons v. Simmons*, 82 Or App 540 (1986), the Court affirmed the trial court's denial of the surviving spouse's claim to an elective share of her deceased husband's estate. The surviving spouse and decedent entered into a pre-nuptial agreement four days prior to the marriage. The agreement stated: "It is expressly understood that this agreement will bar the surviving party from any elective share under the provisions of ORS 114.105 pursuant to ORS 114.115." 82 Or App 540, at 542.

The surviving spouse argued that she first became aware of the agreement on October 5, 1981, just four days prior to the wedding. She was in a rush to get ready and signed the agreement minutes after it was given to her. The testimony of the husband's attorney was that he had met with her to explain the consequences of the agreement on October 1, 1981. The Court of Appeals accepted the trial court's findings that the attorney's statements were more credible. The Court concluded that the agreement was valid.

Although decedent's assets were not formally disclosed, the Court was not convinced that the surviving spouse did not understand the extent of decedent's estate.

In *Jacobs v. Jacobs*, 82 Or App 333 (1986), the Court affirmed a decision denying the personal representative's petition to have the surviving spouse turn over certain assets to the estate. The surviving spouse and decedent entered into a pre-nuptial agreement prior to their marriage ten years before the decedent's death. The appeal focused upon whether the surviving spouse was entitled to assets held in joint tenancy with rights of survivorship or whether the estate was entitled to them by virtue of the agreement. Although the agreement stated that the property of each would forever remain separate, the agreement allowed for property to be given from one party to the other by will or otherwise. The disputed assets included certificates of deposit, amounts in a checking account, real estate in Arizona and stocks and bonds.

The Court concluded that all of the disputed property was held in joint tenancy with

rights of survivorship. The Court applied the rule that unless there is clear and convincing evidence to the contrary, the survivor is entitled to the property. Although the personal representative argued that the agreement was clear and convincing evidence, the Court disagreed. There was evidence that the decedent felt that income from the decedent's testamentary trust would not be enough for the surviving spouse to live on. The decedent's attorney testified that the decedent was a very astute businessman. The decedent transferred 90 to 95 percent of his assets into joint tenancy with his wife. There was also evidence from the decedent's attorney that in a meeting ten months prior to his death, the decedent wanted his assets to go to his children. However, the Court concluded that this evidence did not establish that decedent wanted his interest in the joint assets going to his children. The Court did not say that the agreement was invalid. It held that the assets passed to the surviving spouse under the rights of survivorship. Attorneys should take care to advise clients entering into prenuptial agreements that property later placed in joint tenancy with rights of survivorship ownership, could pass under the survivorship characteristics of ownership to the joint owner.

C. Jeffrey Abbott

INVITATION

The *Newsletter Editorial Board* invites the submission of topic suggestions for future issues and the submission of unsolicited manuscripts, as well as suggestions for improvement of the Newsletter.

Communications should be addressed to:
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520 S.W. Yamhill, Portland, Oregon 97204
Attn: Helen Rives-Hendricks (503) 226-6151

SCHEDULE OF SEMINARS AND EVENTS

The following is a selected schedule of seminars which may be of particular interest to Section members:

MAY 14-15, 1987: P.L.I., INCOME TAXATION OF ESTATES AND TRUSTS, San Francisco, Hyatt on Union Square.

MAY 21-22, 1987: P.L.I., ADVANCED WILL DRAFTING, San Francisco, Hyatt on Union Square.
Repreats: June 25-26, 1987, New York City, Golden Tulip Barbizon.

JUNE 1-2, 1987: New York University School of Continuing Education, Institute of Federal Taxtion, CONFERENCE ON TRUSTS AND ESTATE TAX PLANNING, San Francisco, Hyatt Regency Embarcadero.

JUNE 5, 1987: Willamette University Center for Dispute Resolution, TAX PLANNING FOR THE CLOSELY HELD BUSINESS.

JUNE 11, 1987: ALI-ABA Video Law Review, ABA Section of Real Property, Probate and Trust Law, SOPHISTICATED ESTATE PLANNING AFTER TRA 86 (Approximately 50 cities).

JUNE 15-19, 1987: University of Wisconsin Law School, ESTATE PLANNING IN DEPTH, Madison, Wisconsin.

JUNE 22-26, 1987: University of Wisconsin Law School, POSTMORTEM PLANNING AND ESTATE ADMINISTRATION, Madison, Wisconsin.

OCTOBER 23, 1987: Oregon Law Institute, SENIOR LAW: COUNSELING THE ELDERLY, Portland, Willamette Center.

OCTOBER 29-30, 1987: Washington State Bar Association, 32ND ANNUAL ESTATE PLANNING SEMINAR, Seattle, Westin Hotel.

DECEMBER 3, 1987: Washington State Bar, WILL DRAFTING SEMINAR, Seattle, Sheraton Hotel.

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