ADVISING GST TRUST BENEFICIARIES

BOULDER COUNTY ESTATE PLANNING COUNCIL

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"There probably is no area of the tax law more complicated or less understood than the federal GST tax."

- CAROL A. HARRINGTON, LLOYD L. PLAINE & HOWARD M. ZARITSKY, GST TAX: ANALYSIS WITH FORMS (2d ed. 2007).

This outline is not a comprehensive treatment of the GST. The law is evolving and complicated. Sample forms, language or planning ideas included herein are provided for discussion purposes only. None of this outline should be relied upon without independent legal research and thorough review and analysis of the relevant documents.

INTRODUCTION

The Tax Reform Act of 1986, signed into law on October 22, 1986, retroactively repealed the 1976 generation-skipping tax and replaced it with a new generation-skipping transfer tax ("GST Tax" or "GSTT") in Chapter 13 of the Internal Revenue Code ("IRC"). Subsequent legislation, especially the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") and the Taxpayer Relief Act of 1997, made important additional corrections and amendments to that act. The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") also made many changes to the law, the most significant of which is the repeal of the GSTT (and the federal estate tax) in 2010. The repeal and other changes "sunset" after December 31, 2010, and the GSTT (and the federal estate tax) will return to the form of their existence prior to the 2001 legislation. Section 901, EGTRRA. In addition, extensive regulations have been issued by the Treasury Department construing Chapter 13, including, in many cases, provisions scheduled to sunset on December 31, 2010.

The GST Tax applies to direct and indirect transfers to skip persons (*e.g.* grandchildren and more remote descendants of a transferor). Many estate planners became enamored of the new planning opportunities occasioned by this unique legislation and began encouraging their planning clients to consider the creation of generation-skipping transfer ("GST") trusts for their descendants. Without focusing too much on the planning and drafting side of the equation, most estate plans which intentionally incorporated GST Tax planning were based on the creation of GST exempt and non-exempt shares. In a simple plan, the GST exempt shares would stay in trust at least for the life of the child of the transferor. The child would have either no power of appointment or a non-general (special) power of appointment and distributions would be limited by ascertainable standards if the child were also the trustee or if the child can remove and appoint a trustee without a limitation as provided under IRC § 672(c) so that the trust would not be included in the child's estate for estate tax purposes. On the death of the child the trust assets could either pass as directed in the exercise of the special power or, pursuant to the provisions in the instrument, such as to the then living descendants of the settlor (or in some cases, in further trust). The planning can also be (and often is) coordinated with marital deduction planning, the centerpiece of which, from a GST perspective, is a GST exempt family trust which would continue in trust for the life of a child or children after the death of the surviving spouse. See Exhibit B (GST Planning Diagram). GST exempt trusts can also be created as inter vivos trusts. Irrevocable life insurance trusts ("ILITs") are popular vehicles for GST planning. GST trusts that are designed to continue for more than the child's generation are sometimes referred to "dynasty trusts". These early plans are now over 20 years old. The creators of the plans are dying, and their children, the life beneficiaries, are your clients!

Finally, as discussed below, trusts that were irrevocable on September 25, 1985, are exempt from application of the GST rules due to their grandfathered status on the effective date of Chapter 13. This can be very valuable, but without careful planning, that exempt status can be lost.

I. But I Don't Do GST Planning! Do I?

A. Don't be so Sure - The Case of the Client With the Pre-Existing Trust

Increasingly, planning clients are coming to the first meeting, not just with the new client information form and related documents, including maybe a financial statement or spreadsheet, some deeds and insurance and retirement information, but with a stack of estate planning documents prepared by another attorney. These documents may have been prepared for your new client by his or her former attorney, and may include an ILIT, which holds a policy insuring your client's life, or a testamentary credit shelter trust for the benefit of your client. In many cases, they consist of estate planning originally prepared for another individual, but affecting your client because the client is a beneficiary of a trust created therein.

These trusts may have been created by a parent of the client or the deceased spouse of the client. In many cases a grandparent or other collateral relative of the client such as an aunt or uncle (or even a brother or sister) may have created the trust. It is imperative that you review all of the trusts in which the client has a beneficial interest and, yes, understand the tax consequences to your client, including GST Taxes.

B. Crimes of Omission – Do You Know What You Don't Know?

What kind of estate planning do you do? Unless you eschew any estate and gift tax planning at all (and even then, there may be some risk) and only represent clients with a combined net worth, including any anticipated inheritances and insurance proceeds, that is never expected to exceed the lowest possible GST exemption which may be expected in the next few years ($1.3M?), and who have no beneficial interest in a trust, you are doing GST planning whether you intend to or not. The following list represents only a small number of planning matters you could easily become involved in on behalf of a client that may have GST (not to mention estate or gift tax) consequences:

1. Trust mergers, reformations, divisions or terminations;
2. The exercise, release or lapse of a power of appointment;
3. Trust distributions either during the term of the trust or on termination;
4. Disclaimers of interests in trusts;
5. Making transfers to trusts – including funding an existing ILIT;
6. Failing to allocate GST exemption or elect out of automatic allocation;
7. Creating a contingent trust for minors, or any other trust, that could someday terminate and be distributed to a grandchild or more remote descendant of your client;
8. Drafting trusts with Crummey powers;
9. Creating payable-on-death or joint tenancy accounts for grandchildren;
10. Making gifts to grandchildren;
11. Drafting trusts with powers of appointment; and
12. Funding UTMAs or 529 plans for grandchildren.

II. The Law

What follows is a broad overview of the GST rules (and related planning opportunities) intended to highlight the considerations that should be taken into account when advising a client who is a beneficiary of a trust which may be subject to the GST Tax. The GST Tax is complex and a complete explanation is beyond the scope of this outline. A basic understanding of the GST Tax (Chapter 13), the estate tax (Chapter 11) and the gift tax (Chapter 12) is assumed for productive use of this outline.

References to the "Code" or "IRC" mean the Internal Revenue Code of 1986. References to the GST shall refer to generation-skipping transfer and references to the GST Tax or GSTT shall refer to the GST Tax imposed by IRC Chapter 13. PLR shall refer to the Letter Rulings issued by the IRS to individual taxpayers.

A. The Tax

A tax is imposed on every GST. IRC § 2601.

B. GSTs Defined

GSTs are defined as a "taxable distribution", a "taxable termination" or a "direct skip." IRC § 2611.

1. Direct Skip

A direct skip is defined by the Code as a transfer of an interest to a skip person, which is subject to either gift tax or estate tax. IRC § 2612(c)(1). (Note: a trust may be a skip person. See below.)

***Example**: Grantor created an irrevocable trust and contributed $1 million to the trust. The beneficiaries of the trust are the grandchildren of Grantor or their descendants. The trust is a skip person and the transfer into the trust is a direct skip.*

Taxable amount: The taxable amount of a direct skip is the property received by the transferee, reduced by any consideration paid by the transferee. IRC §§ 2623, 2624(d). The tax on direct skips is "tax exclusive" as opposed to the tax on taxable terminations and taxable distributions which are both calculated on a "tax inclusive" basis. The result is that GST Tax on direct skips is cheaper than on other GSTs.

Liability: It is the obligation of the transferor to pay the tax on a direct skip. IRC § 2603(a)(3).

2. Taxable Termination

A taxable termination is defined by the Code as 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. IRC § 2612(a).

***Example:** Grantor created an irrevocable trust with income payable to child, C, for life. On C's death, the trust principal is to be distributed to Grantor's grandchild GC. Since C had an interest in the trust, the trust was not a skip person. Assuming that the trust was not exempt, when C, (the only non-skip person with an interest in the trust) died, there was a taxable termination because no non-skip person had an interest in the trust and the trust would be distributed to skip persons.*

Taxable amount: The amount of a taxable termination is the value of the property (on the date of the taxable termination) less deductions for expenses, indebtedness and taxation. IRC § 2622(a). The tax is determined on a tax inclusive basis.

Liability: The tax must be paid by the trustee. IRC § 2603(a)(2).

3. Taxable Distribution

A taxable distribution is defined by the Code as any distribution from a trust to a skip person (other than a taxable termination or a direct skip). IRC § 2612(b).

> ***Example:*** *Grantor created an irrevocable trust. The trustee has discretion to pay income and principal to Grantor's living descendants until termination of the trust. Trustee makes a discretionary distribution to grantor's grandchild, GC. Assuming the trust is not exempt, a taxable distribution has occurred because GC is a skip person.*

Taxable amount: The value of the property received by the transferee, reduced by certain expenses. IRC § 2621(a).

Liability: The transferee is liable for the tax. IRC § 2603(a)(j).

Warning: *The portion of a lapsed withdrawal right in excess of the IRC § 2514(e) ("five and five") limitation, if not exempt, could be considered a taxable distribution to the holder of the power (if he or she is a skip person to the transferor) followed by a transfer by the skip person back to the trust. Treas. Reg. § 26.2652-1(a)(5), Example 5. The problems with the transfers of property subject to lapsed powers are discussed at II.F.1.f. below.*

C. Necessary Definitions

1. Transferor

The term **transferor** generally means the decedent with respect to property subject to the tax imposed by Chapter 11 (estate tax) and the donor with respect to property subject to the tax imposed by Chapter 12 (gift tax). IRC § 2652(a). If a decedent possesses a testamentary general power of appointment as defined in IRC § 2041 which was created after October 21, 1942, the property subject to the general power will be included in the decedent's gross estate whether the power is exercised or not and the decedent will be considered the transferor. A similar rule applies to the holder of an *inter vivos* general power of appointment as defined under IRC § 2514 who exercises or releases the power, or allows the power to lapse.

2. Interest in Property Held in Trust

A person has an **interest in property held in trust** if at the time the determination is made such person either: (a) has a present right to receive income or principal from the trust, (b) is a permissible non-charitable current recipient of income or principal, or (c) is a charitable beneficiary and the trust is a charitable remainder trust under IRC § 664 or a pooled income under IRC § 642(c)(5). IRC § 2652 (c); Treas. Reg. § 26.2612-1(e). A trust can be a skip person even though a non-skip person may have a future interest in the trust principal.

3. Skip Person and Non-Skip Person

A **skip person** is a person assigned to a generation that is two or more generations below the generation assignment of the transferor. IRC § 2613(a). A **non-skip person** is a person who is not a skip person. IRC § 2613(b). The spouse, parents and children of a transferor are all non-skip persons.

A trust will be a skip person if:

a. all of the present interests in the trust are held by skip persons; or

b. if there is no person holding an interest in the trust and at no time may a distribution be made to a non-skip person.

Example: *Transferor, T, created an irrevocable trust. The only current beneficiaries of the trust are T's grandchildren and great grandchildren. The transfer to the trust is a direct skip.*

4. Generation Assignment

Generation Assignment is determined under Chapter 13 on the basis of either relationship (lineage) or age. IRC § 2651.

a. Lineal Descendents

To constitute a lineal descendant an individual must be a lineal descendant of a grandparent of the transferor. Skip persons who are such lineal descendants include, among others, grandchildren, grandnephews, grandnieces and first cousins twice removed.

b. Persons Who Are Not Lineal Descendants

When making the determination for persons who are not lineal descendants, a generation is defined as 25 years. Any person more than 37.5 years younger than the transferor is a skip person. Any individual born more than 12.5 years after the transferor, but less than 37.5 years is assigned to one generation below the transferor. Any individual born less than 12.5 years after the transferor is assigned to the transferor's generation.

c. Individuals Assigned to More Than One Generation

Any individual who could be assigned to more than one generation under the rules of IRC § 2651 shall be assigned to the youngest such generation. IRC § 2651(f)(1). However, the regulations create an exception to this rule for an adopted individual as long as the adoption is not primarily for the purpose of avoiding GST Tax. Treas. Reg. § 26.2651-2(b).

d. The Predeceased Parent Exception (now located at IRC § 2651(e))

Very generally, the current rule provides that if the child of a transferor (or the niece or nephew of the transferor if the transferor has no descendants) has predeceased the transferor at the time of a transfer which would be a direct skip, the grandchild (or grandniece or grandnephew, if applicable) will be reassigned to his or her parent's generation thus averting a GST. Prior to changes made by the Taxpayer Relief Act of 1997, the predeceased parent exception was not applicable to transfers in trust. The 1997 Act added some relief by applying the exception to transfers to a trust for benefit of a lineal skip person if the applicable child, niece or nephew was deceased at the time of the initial transfer to the trust. However, if the child, niece or nephew dies after that time, all subsequent transfers to the trust will not be entitled to the exception and distributions to skip persons will be taxable terminations or taxable distributions, unless qualifying for another exception or the trust is exempt. As discussed further below, EGTRRA provided some additional relief by providing for retroactive allocation of GST exemption on the death of a non-skip person if the non-skip person predeceases the transferor. IRC § 2632(d).

e. Disclaimer

An individual who disclaims, even if valid under state law and IRC § 2518, is not treated as a predeceased parent. Treas. Reg. § 26.2651-1(a)(2)(iv).

D. "Pre-Effective Date" Grandfathered Trusts

1. In General

Chapter 13 does not apply to a trust that was irrevocable on September 25, 1985. Treas. Reg. § 26.2601-1(b)(1)(i). However, if additions (either actual or constructive) are made to a trust after this date, the GST rules will apply to the addition. If such additions are made, the trust is considered to consist of two portions: the "non-Chapter 13 portion" and the "Chapter 13 portion." Treas. Reg. § 26.2601-1(b)(1)(iv)(A); *See also examples under* Treas. Reg. §§ 26.2601-1(b)(1)(iv)(C)(2), (b)(1)(v)(D). Each portion has a separate inclusion ratio. The non-Chapter 13 portion's inclusion ratio will be zero. The inclusion ratio for the Chapter 13 portion is determined under IRC § 2642, thus based on the amount of GST Exemption allocated to it.

2. Constructive Additions

Constructive additions are deemed transfers to a pre-effective date trust, in contrast to actual additions to such a trust. Treasury Regulations specifically identify constructive additions as: (i) the release, exercise or lapse of a power of appointment that is treated as a taxable transfer under Chapter 12 or Chapter 11 (*i.e.*, involving the exercise, release, or lapse of a general power of appointment as defined under IRC §§ 2041 or 2514); and (ii) the payment of trust liabilities. Treas. Reg. §§ 26.2601-1(b)(1)(v)(A), (C).

3. Regulatory RAP – How Long Can This Go On?

References to "RAP" mean the rule against perpetuities. The release, exercise or lapse of a general power over a portion of a pre-effective date trust that is treated as a Chapter 11 or 12 transfer is treated as a withdrawal and immediate retransfer to the trust. The holder of the power is treated as the transferor and the result is a constructive addition.

However, the release, exercise or lapse of a non-general power of appointment over a pre-effective date trust will not be treated as a constructive addition, unless the exercise of the non-general power may postpone or suspend vesting beyond the perpetuities period described in the regulations (the "Regulatory RAP"). Treas. Reg. § 26.2601-1(b)(1)(v)(B). The Regulatory RAP is described as the period measured from the date of creation of the trust and extending for the period of any life in being at the date of trust creation plus a period of 21 years, plus, if necessary, a reasonable period of gestation; or a term not more than 90 years measured from the creation of the trust. If a power is exercised by creating another power, it is deemed to be exercised to whatever extent the second power may be exercised. Treas. Reg. § 26.2601-1(b)(1)(v)(B)(2); *see also examples under* (1)(v)(D).

Planning Tip 1: *Special care must be taken to limit the term of any trust to which property is appointed and any new powers created by exercise of a non-general power of appointment in a pre-effective date trust. The following language limiting the exercise of a new power created by the exercise of a non-skip person's (child's) power over a pre-effective date trust to exempt trusts for child's children (transferor's grandchildren) was approved by the IRS in PLR 200631009:*

> [N]o power shall be exercised over any property over which a power has been previously exercised to cause or permit the vesting of any property or interest in property, or the termination of any trust, to be postponed for a

period beyond the perpetuities period applicable to the Grantor of the original trust under the Will.

Planning Tip 2: *In trusts governed by Colorado law, the Colorado Statutory Rule Against Perpetuities Act may prevent creation of new powers (through exercise of a power in a pre-effective date trust) that would violate the Regulatory RAP. C.R.S. § 15-11-1102.5(3)(c). However, it is still preferable to draft in an explicit limitation.*

4. Merging, Dividing and Reforming Pre-Effective Date Exempt Trusts – The Four Safe Harbors

Before undertaking a merger, partition, consolidation, reformation, construction, or any other act affecting the terms of, or resulting in a transfer to a pre-effective date trust, the planner must consider the effect of those actions on the trust's pre-effective date exempt status. Problems most commonly arise when it is desirable to reform a pre-effective date trust motivated by goals unrelated to the GST (*e.g.*, the settlement of a bona fide dispute over trust administration, the desire to divide a pot trust for the benefit of different children, or conversion of an income interest to a unitrust).

Regulations issued on December 20, 2000, created safe harbors for four types of modifications, none of which will affect the GST exempt status of a pre-effective date trust. Treas. Reg. § 26.2601-1(b)(4). These safe harbors are discussed in more detail below. Note that the regulations specifically provide that the four safe harbors apply only for purposes of determining whether a pre-effective date trust retains its exempt status for GST purposes, and are not to be used to determine whether the transaction results in gift tax, inclusion in the gross estate of a beneficiary, or realization of capital gain for income tax purposes. *Id*. at (b)(4)(i).

The regulations do not purport to express a general rule regarding what actions will result in forfeiting a trust's pre-effective date exempt status. Because no general rule is stated in the regulations, it is unclear what happens if a change to the trust fails to qualify under any safe harbor.

Prior to the issuance of the final regulations, the IRS issued hundreds of rulings regarding the effect of proposed changes to pre-effective date trusts. These rulings have consistently adopted the position that a modification of a pre-effective date trust that changes the quality, value, or timing of any powers, beneficial interests, rights or expectancies originally provided for under the terms of the trust after the effective date of Chapter 13 will forfeit the exempt status of the trust. *See, e.g.,* PLRs 9424026, 200052007, 200015003, 200006001. The standard promulgated by the numerous IRS rulings is sometimes referred to as the "no-change" standard.

It is unclear whether the letter ruling "no-change" standard will still apply to changes that do not meet any of the safe harbors. Of course, private letter rulings are not authority and cannot be cited by either the IRS or other taxpayers in court to support either side's position. However, private letter rulings, particularly when issued in large numbers over a long period of time, give valuable insight into the position of the IRS on the issue.

Note that, if no safe harbor applies and if a trust would lose its pre-effective date exempt status under the "no-change" standard discussed above, the IRS would probably take the position that the change in GSTT exempt status would extend to the entire trust. Some commentators believe that the effect of a prohibited modification could be limited by dividing a trust so that the division meets the fourth safe harbor (see below) and then changing only one of the resulting trusts. *See, e.g.*, CAROL A. HARRINGTON, ET. AL., GST TAX: ANALYSIS WITH FORMS, 2007 CUMULATIVE SUPPLEMENT NO. 1 at S7-54-55 (2d ed. 2007). Under this approach, an argument could be made that the loss of exempt status, if any, should be confined to only the one trust that was further modified after the division.

a. The Four Safe Harbors for Modification of Pre-Effective Date Exempt Trusts

The regulations now provide rules for determining when a modification, judicial construction, settlement agreement or trustee action with respect to a pre-effective date trust will not cause the trust to lose its exempt status for GST purposes.

On December 20, 2000, the Treasury issued final regulations providing four safe harbors as follows: (1) the exercise of certain trustee discretionary powers; (2) certain court approved settlements; (3) certain judicial constructions; and (4) certain modifications, none of which will affect the GSTT exempt status of a pre-effective date trust. Treas. Reg. § 26.2601-1(b)(4). These safe harbors are not mutually exclusive. They read as follows:

(A) Trustee's Discretionary Powers

Exempt status will not be lost if distribution of trust principal occurs from an exempt trust to a new trust if:

(1) Either:

(i) The terms of the governing instrument of the exempt trust authorize distributions to the new trust or the retention of trust principal in a continuing trust without the consent or approval of any beneficiary or court; or

(ii) At the time the exempt trust became irrevocable, state law authorized distributions to the new trust or retention of the principal in the continuing trust, without the consent or approval of any beneficiary or court; and

(2) The terms of the governing instrument of the new or continuing trust do not extend the time for vesting of any beneficial interest in the trust in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period, measured from the date the original trust became irrevocable, extending beyond any life in being at the date the original trust became irrevocable plus a period of 21 years, plus if necessary, a reasonable period of gestation. For purposes of this paragraph (b)(4)(i)(A), the exercise of a trustee's distributive power that validly postpones or suspends the vesting, absolute ownership, or power of alienation of an interest in property for a term of years that will not exceed 90 years (measured from the date the original trust became irrevocable) will not be considered an exercise that postpones or suspends vesting, absolute ownership, or the power of alienation beyond the perpetuities period. If a distributive power is exercised by creating another power, it is deemed to be exercised to whatever extent the second power may be exercised.

(B) Settlement

A court-approved settlement of a bona fide issue regarding the administration of the trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to the provisions of Chapter 13, if:

(1) The settlement is the product of arm's length negotiations; and

(2) The settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. A settlement that results in a compromise between the positions of the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes.

(C) Judicial Construction

A judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause an exempt trust to be subject to the provisions of Chapter 13, if:

(1) The judicial action involves a bona fide issue; and

(2) The construction is consistent with applicable state law that would be applied by the highest court of the state.

(D) Other changes

(1) A modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A),(B), or (C) of this section) by judicial reformation or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of Chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2652) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

(2) For purposes of this section, a modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is measured against the effect of the instrument in existence immediately before the modification. If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. A modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administration costs of income taxes) will not be considered to shift a beneficial interest in the trust. In addition, administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of §1.643(b)-1 of this chapter.

b. Revisions and Divisions Recently Approved by the IRS

The IRS has recently issued many rulings (generally following the Safe Harbor criteria) that certain actions by trustees and beneficiaries of pre-effective date trusts will not result in the loss of exempt status under Chapter 13. Examples of a few of these common requests are set forth below. The IRS will no longer issue rulings in a number of these areas, however. See discussion in II.D.4.c. below.

i. Division of a single trust for the benefit of multiple descendants into separate trusts, each for the benefit of a descendant and his or her descendants will not be subject to Chapter 13, as long as the terms of the trusts are identical except for the identity of the beneficiaries. See PLR 200629021 (citing Treas. Reg. § 26.2601-1(b)(4)(i)(E)). This PLR was obtained by Stover & Associates LLC, and further held that the division would not result in a taxable gift or the interest of any beneficiary being included in the beneficiary's gross estate under IRC §§ 2036-2038. Neither would there be any income tax consequences under IRC § 1001.

ii. The proposed conversion by court action pursuant to state statute of an income interest to a unitrust interest will not be considered to shift any beneficiary's interest in the trust and will not cause the trust to lose its GST exempt status or result in any beneficiary being treated as having made a taxable gift. PLRs 200752026, 200752027, 200752028.

iii. The proposed conversion of a total return trust under state law will not cause the trust to lose its status as exempt from the GST, will not cause any beneficiary to have made a gift for gift tax purposes and will not cause either the trust or the beneficiary to realize capital gain. PLRs 200801011–200801024.

c. Limitation on Ruling Requests After January 2, 2007

In Rev. Proc. 2007-3, the IRS announced that it will no longer issue rulings regarding a trust's retention of its GST exempt status when there is a modification of a trust, change in administration of a trust, or distribution from a trust in a factual scenario that is similar to a factual scenario set forth in one of the examples contained in Treas. Reg. § 26.2601-1(b)(4)(i)(E). There are twelve examples.

d. Safe Harbor Examples Treas. Reg. § 26.2601-1(b)(4)(i)(E)(1)-(12)

The examples in the above cited regulation should be read with care when confronted with a request by a client to take some action with regard to a pre-effective date trust, especially in light of Rev. Proc. 2007-3 described above. A complete discussion of the examples is beyond the scope of this outline, but they are briefly summarized as follows:

Examples (1) and (2) address the trustee's power to make discretionary distributions to a new trust, either under the authority granted in the trust instrument (*Example (1)*) or pursuant to state statute (*Example (2)*). *See* Alan Halperin & Michelle R. Wandler, Decanting Discretionary Trusts: State Law and Tax Considerations, 29 Tax Mgmt. Est., Gifts & Tr. J. 219 (Sept. 9, 2004).

Warning: *Colorado does not have a so-called "decanting" statute, nor is it clear that Colorado common law authorized decanting on September 25, 1985. Therefore, unless the governing instrument authorizes decanting, the second trust must avoid increasing the interest of lower generations or extending the trust duration.*

Example (3) addresses construction of an ambiguous term in the instrument.

Example (4) addresses change in trust situs. Before changing situs of a pre-effective date trust, be satisfied that the change will not lengthen the applicable rule against perpetuities, if for example, the instrument contains no RAP provision and no choice of laws provision. In this case, a move from a common law state to a state with a longer rule could result in loss of Chapter 13 exempt status, because the time for vesting of beneficial interests could be extended beyond the period provided in the original trust. Also see Treas. Reg. § 26.2601-1(b)(1)(v)(B), discussed above.

Example (5) addresses trust division.

Example (6) addresses trust mergers.

Example (7) addresses trust modification.

In *Examples (5)-(8)*, as in all the examples, the IRS reiterates its position that the exempt status will be lost if the action will (1) shift the beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in IRC § 2651), or (2) the action extends the time for vesting of any beneficial interest beyond the period provided in the original trust.

Example (8) addresses court approved conversion of an income interest to a unitrust.

Example (9) addresses a trust modification to allow allocation of capital gain to income.

Example (10) addresses an administrative change to the terms of a trust, such as a decrease in the number of trustees.

Examples (11) and (12) were added as part of the IRC § 643 regulations, which apply to tax years ending after January 2, 2004. *Example (11)* provides a safe harbor for unitrusts created pursuant to certain state statutes, and *Example (12)* provides a safe harbor for the actions taken under the power to adjust recognized by state statute. See the relevant portion of Colorado's Uniform Principal and Income Act. C.R.S. § 15-1-404 (Trustee's power to adjust) and 15-1-404.5 (Conversion-unitrusts-administration).

E. Exempt and Non-Exempt Trusts

1. Exemption Allocation in a Nutshell

Every individual has an amount of GST exemption which may be allocated by such individual or such individual's executor to any property with respect to which that person is the transferor. IRC § 2631(a)-(c). The GST exemption was originally $1,000,000, indexed for inflation beginning in 1999. After December 31, 2003, EGTRRA changed the rule to provide that the GST exemption amount for any calendar year shall be equal to the applicable exclusion amount (relating to the estate tax) under IRC § 2010(c) for such calendar year. The applicable exclusion amount (and hence, the GST exemption) under Section 2010(c) is:

2004, 2005	$1,500,000
2006, 2007, 2008	$2,000,000
2009	$3,500,000
2010	GST and estate taxes repealed
2011	$1,000,000 as adjusted for inflation pursuant to IRC § 2631(c) (prior to EGTRRA)

2. Lifetime Transfers

Individuals may elect to allocate or not allocate exemption to lifetime transfers. While automatic allocation has always applied to direct skips (see below), since January 1, 2001, exemption will be automatically allocated to many transfers which may result in a GST at a later date.

a. Allocation by Transferor

During life, GST exemption may either be 1) affirmatively allocated on a gift tax return, or 2) automatically allocated under automatic allocation rules. An affirmative allocation is made by making a proper election to allocate GST exemption on a gift tax return (Form 709). The GST rules also provide that in some circumstances GST exemption will be automatically allocated, unless the taxpayer opts out of allocation. Opting out is done on a Form 709. The automatic allocation rules are complex, and it sometimes can be difficult to determine whether they apply.

Gift tax returns track taxable gifts that were made and also track the use of GST exemption. Whether GST exemption was affirmatively allocated or whether it was automatically allocated, any filed gift tax returns should show the amount of GST exemption used for the taxable year of the return and the amount of available GST exemption remaining at the end of such year.

b. Automatic (Deemed) Allocation – Direct Skips

Unused GST exemption is automatically allocated to direct skips to the extent necessary to make the inclusion ratio zero. IRC § 2632(b). The regulations provide that a gift tax return (Form 709) need not be filed to report an automatic allocation. Nevertheless, it is often desirable to do so for record keeping and to begin the running of the statute of limitations on the valuation of the gift and the inclusion ratio. IRC § 6501(a). An individual may elect out of automatic allocation on a timely filed gift tax return. IRC § 2632(b)(3). This rule was in existence before 2001 and continues to be the law.

c. Automatic (Deemed) Allocation – Transfers Other Than Direct Skips

i. Before January 1, 2001

(a) An affirmative election on a Form 709 was required by attachment of a Notice of Allocation.

(b) Allocations in excess of the amount necessary to obtain a zero inclusion ratio were, and continue to be, void. Treas. Reg. § 26.2632-1(b)(2)(i). (Currently 26.2632-1(b)(4)).

(c) Allocations to trusts that have no GST potential were and continue to be void. Treas. Reg. § 26.2632-1(b)(2)(i). (Currently 26.2632-1(b)(4)). For this purpose, a trust has GST potential even if the possibility of a GST is so remote as to be negligible. _Id._

(d) Formula allocations are expressly authorized by the regulations (*e.g.* "the amount necessary to produce an inclusion ratio of zero"). Treas. Reg. § 26.2632-1(b)(2)(i); (Currently 26.2632-1(b)(4)).

(e) An allocation of exemption is effective as of the date of the transfer if made on a timely filed gift tax return. Treas. Reg. § 26.2632-1(b)(2)(ii).

ii. After December 31, 2000

(a) EGTRRA and the Expansion of Automatic Allocation

As a result of the complexity of the rules relating to the GST Tax and allocation of the GST exemption to transfers other than direct skips, many errors were made by taxpayers and their advisors, including: failure to make any allocation, failure to make a timely allocation, allocation of an incorrect amount, allocation to the wrong trust and so on. EGTRRA made an important change to the exemption allocation rules for lifetime transfers with inclusion of new IRC § 2632(c). This section causes a taxpayer's GST exemption to be allocated automatically in many of the cases where errors were occurring. However, under the new IRC § 2632(c) taxpayers now often have GST exemption allocated when allocation of exemption is not intended. Also be aware that EGTRRA will sunset on December 31, 2010, and most provisions of, and amendments made by, EGTRRA will not apply to estates of decedents dying, gifts made, or GSTs after December 31, 2010. Thus, the IRC as it existed on the date of the enactment of EGTRRA will spring back to life and be applied to estates, gifts, and GSTs after December 31, 2010, as if the provisions and amendments made by EGTRRA had never been enacted.

(b) Indirect Skips and the GST Trust

The new IRC § 2632(c) created new terms for application of the enhanced automatic allocation rules:

i. The term "**indirect skip**" means any transfer of property (other than a direct skip) subject to the gift tax made to a GST Trust;

ii. The term "**GST Trust**" means a trust that could have a GST with respect to the transferor, **_unless_** one of six exceptions applies. Two of the exceptions (IRC § 2632(c)(3)(B)(v) and (vi)) relate to qualified charitable trusts and are quantifiable and understandable. However, the first four exceptions, (IRC § 2632(c)(3)(B)(i)-(iv)) attempt to describe distribution scenarios to non-skip persons, at least one of which anticipates the issuance of Treasury Regulations, which have not been forthcoming, leaving the taxpayer (and his or her advisors) unclear about when automatic allocation will actually occur. For example, does (B)(iv), which provides, "the trust is a trust any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer," exclude any trust subject to a contingent general power of appointment (discussed below) from the definition of GST trust? If a trust is not a GST trust, then automatic allocation under IRC § 2632(c) will not apply.

(c) Deemed Allocation Rule

If a taxpayer makes an indirect skip during life, any unused portion of his or her GST exemption will be allocated to the property transferred to the extent necessary to make the inclusion ratio for such property zero. IRC § 2632(c)(1).

(d) Uncertainties Abound

Under IRC § 2632(c)(5), an individual can choose to elect out of automatic allocation as to a particular transfer or as to all transfers made by an individual to a particular trust. An individual may alternatively elect to treat any trust as a GST Trust so that exemption will be automatically allocated to all transfers to the trust. It is imperative that the advisor (you!) obtain copies of any gift or estate tax returns filed by any transferor or his or her executor to such trusts. However, in many cases gift tax returns were not filed when gifts were made to trusts to either allocate or elect in or out of automatic allocation. The same goes for estate tax returns, especially where the transferor died without a taxable estate even though the regulations provide that a Schedule R may be filed to allocate GST exemption even if a 706 is not required. Treas. Reg. § 26.2632-1(a). If the client believes that 709s or 706s were filed but does not have copies, copies of the returns may be ordered from the IRS. The taxpayer may submit either Form 4506 (to request an actual copy of the return) or Form 4506-T (to request a transcript of return information). Most needs for tax return information can be met by the transcript, which is merely a computer print out of the taxpayers return information. If returns were not filed, as is often the case, the advisor must carefully analyze the exempt (or non-exempt) status of the trust before proceeding with planning for the client/beneficiary of that trust.

Planning tip: *Consider a late allocation of GST exemption if the transferor is still alive, or if GST exemption may still be allocated by the executor of the transferor's estate under IRC § 2632(e) (as explained below), if it is imperative that a trust be exempt, and it is not clear whether GST exemption has been automatically allocated. A late allocation can be made using a formula. Since an allocation cannot exceed the amount necessary to obtain an inclusion ratio of zero, exemption will only be used to the extent necessary to fully exempt the trust. Of course, the transferor must have remaining GST exemption to allocate, and it will be allocated to the trust at its value on date of allocation.*

Warning: *Remember that the elections under IRC § 2632(c)(5) are available only for transfers made after December 31, 2000 and will not change allocations made (or not made) for transfers prior to January 1, 2001.*

3. Transfers at Death of Transferor

a. Allocation by Executor – Schedule R

To avoid application of the deemed allocation rules which apply to transfers at death, Form 706 and Schedule R must be filed by the executor to allocate GST exemption to trusts that may later have taxable terminations or distributions under IRC § 2612 even if the form is not required to be filed to report estate or GST Tax. Treas. Reg. § 26.2632-1(a), (d)(1).

b. Automatic (Deemed) Allocation

If the executor of the transferor's estate fails to allocate the transferor's remaining GST exemption on or before the due date for the transferor's federal estate tax return (including any extensions actually granted), the exemption will be deemed allocated, whether or not a return is actually required to be filed. IRC § 2632(e); Treas. Reg. § 26.2632-1(d)(2). The exemption is first allocated to direct skips occurring at death and secondly, prorata among all trusts to which the decedent was the transferor and from which a taxable distribution or a taxable termination might occur at or after the individual's death. The automatic allocation of GST exemption is irrevocable, and an allocation made by the executor after the automatic allocation is made is ineffective. *Id.*

c. Reverse QTIP Election

In the case of property for which a marital deduction is allowed to the decedent's estate under IRC § 2056(b)(7) (QTIP election), IRC § 2652(a)(3) allows the executor to treat such property for purposes of the GST Tax as if the election to be treated as QTIP property had not been made. This is referred to as a reverse QTIP election. If such an election is made, then the decedent will for GST Tax purposes be treated as the transferor of all the property in the trust for which a marital deduction was allowed under IRC § 2056(b)(7). This election and allocation of GST exemption must be made on Schedule R.

A reverse QTIP election can be made only as to all or none of the QTIP property. If a QTIP election is made as to the entire trust, the reverse QTIP election must be made as to all or none of the trust. If the QTIP trust exceeds the amount of available GST exemption a separate QTIP trust should be created prior to allocation in the exact amount of the GST exemption to be allocated to it. If the trust is not divided prior to allocation of GST exemption, the qualified severance rules under IRC § 2642(a)(3) may be used to subsequently divide the trust. PLR 200303004 allowed for a qualified severance into exempt and non-exempt QTIP trusts after the filing of a flawed Form 706 wherein the IRC § 2652(a)(3) election was not made.

4. Understanding the Inclusion Ratio

The tax on GSTs is calculated by multiplying the maximum federal estate tax rate times the ***inclusion ratio*** to obtain the ***applicable rate***. The inclusion ratio is determined by subtracting the ***applicable fraction*** from one. The numerator of the applicable fraction is the GST exemption allocated to the trust (or the property transferred in the case of a direct skip) and the denominator is the value of the property transferred (with certain adjustments). IRC § 2642(a).

Example: *On January 1, 2007, when the maximum federal tax rate was 45%, Grantor created a trust which allowed distributions to his children* *and grandchildren. He transferred property worth $1,000,000 to the trust and timely allocated $400,000 of his GST exemption to the trust.*

The applicable fraction is:	*$\frac{\$400,000}{\$1,000,000}$ (or 40%)*
The inclusion ratio is:	*1 – 40% (or 60%)*
The applicable rate of tax (for 2007) is:	*60% X 45% (or 27%)*

5. Merging Two Exempt (or Non-Exempt) Trusts

Two trusts which are both GST exempt by way of allocation of a single transferor's GST exemption (as opposed to pre-effective date grandfathered trusts not subject to Chapter 13, discussed above) may in many cases be merged without losing GST exemption or creating a GST. The treasury regulations do not really address modification of trusts exempt by way of allocation of exemption. However, the terms of the trusts should be substantially similar. If the interests of the beneficiaries are changed too significantly, the IRS could take the position that a new trust was created by the current beneficiaries with gift or GST Tax repercussions.

If there is more than one transferor with respect to a trust, the portions of the trust attributable to the different transferors are treated as separate trusts for purposes of Chapter 13. Treas. Reg. § 26.2654-1(a)(2)(i). To insure that the entire trust (even if treated as separate shares for GST purposes) retains a zero inclusion ratio, sufficient GST exemption must be allocated by each transferor to his or her separate share. Such a single trust treated as separate trusts may be divided at any time into separate trusts to reflect that treatment. Treas. Reg. § 26.2654-1(a)(3).

The merger of two ***non-exempt*** trusts with the same transferor should not give rise to additional GST concerns. However, the merger of trusts with different transferors could result in an inadvertent taxable distribution or taxable termination if beneficiaries are skip persons as to one transferor but not the other.

Of course, all trust mergers require consideration of state law limitations, including fiduciary duties and may give rise to gift, estate or income tax considerations.

6. Merging an Exempt Trust and a Non-Exempt Trust (Zero and One Trusts)

The merger of a GST exempt with a Non-exempt trust should be avoided. In addition to the considerations discussed above with regard to the merger of GST exempt trusts, the merger of a zero inclusion ratio trust with a trust to which no exemption has been allocated (a "one trust") will result in a trust with an inclusion ratio between zero and one. This is almost always undesirable.

7. Merging an Exempt Trust and a Pre-Effective Date Trust

This may be a beguiling prospect in a number of circumstances, but great care must be exercised. While these trusts are both free of the GST Tax on distribution or termination, that is where the similarity ends. As discussed above, even minimal changes to a pre-effective date trust can cause the loss of grandfathered status. Trust mergers are often, in effect, trust modifications, unless the terms of the grandfathered trusts remain unchanged in all respects. IRS rulings have consistently adopted the position that a modification of an exempt trust that changes the quality, value, or timing of any powers, beneficial interests, rights or expectancies originally provided for under the terms of the trust after the effective date of the GST will forfeit the exempt status of the trust. Particular attention should be paid to the perpetuities and distribution provisions of the resulting post-merger trust. As discussed above, the standard in the Safe Harbor regulations (s*ee* Section II.D.4. of this outline), is that the new (merged) trust cannot extend the time for vesting of beneficial interests, or shift the beneficial interest in the trust to a lower generation.

8. Merging Pre-Effective Date Trusts

The same considerations generally apply to the merger of two or more pre-effective date trusts as apply to the merger of exempt and pre-effective date trusts. *See* Treas. Reg. § 26.2601-1(b)(4)(i)(E), *Example (6) Merger of two trusts*. In general, trusts that are exempt due to the date of their creation are more susceptible to the loss of their GST exempt status than trusts exempted by allocation of GST exemption.

9. Downstream Division and the Qualified Severance

a. In General

As has been alluded to, an optimal GST plan will create trusts with inclusion ratios of zero or one. See Exhibit B. “One trusts” are subject to the GST Tax on a distribution to a skip person or in the event of a taxable termination, while “zero trusts” are not. Unfortunately, trusts sometimes end up with inclusion ratios between zero and one. For example, the deemed allocation rules may have allocated a decedent/transferor’s remaining GST exemption ratably among those trusts “with respect to which a taxable termination may occur or from which a taxable distribution may be made,” not fully exempting any one trust (Treas. Reg. § 26.2632-1(d)(2)); or alternatively, a trust transfer may have been revalued on audit without sufficient remaining GST exemption to completely exempt it; or insufficient GST exemption may have been allocated to a reverse QTIP. A qualified severance may be the solution.

Prior to EGTRRA, a trust with an inclusion ratio between zero and one could only be divided into exempt and non-exempt trusts if the trust consisted solely of separate and independent shares for different beneficiaries or the trust was includible in its entirety in the gross estate of the transferor for federal estate tax purposes. Treas. Reg. § 26.2654-1(a), (b). EGTRRA added IRC § 2642(a)(3) allowing qualified severances, or so-called “downstream divisions” of such trusts if the requirements of the new section are met. If a trust is divided in a qualified severance into two or more trusts, the separate trusts resulting from the severance will be treated as separate trusts for GST Tax purposes and the inclusion ratio of each new resulting trust will differ from the inclusion ratio of the original trust, in that it must be zero or one. Prior to issuance of these regulations, any trusts divided “downstream” would result in two or more resulting trusts with the same inclusion ratio as the trust which was divided.

b. New Final Regulations

i. The IRS has issued final regulations setting forth the requirements for a qualified severance of a trust for GSTT purposes under IRC § 2642(a)(3), effective August 2, 2007. Treas. Reg. § 26.2642-6.

ii. A qualified severance must satisfy each of the following requirements:

(a) The single trust must be severed pursuant to the terms of the governing instrument, or pursuant to applicable local law (Colorado law provides authority to divide or consolidate trusts. C.R.S. § 15-16-401.);

(b) The severance must be effective under local law;

(c) Strict date of severance rules including date of funding requirements must be followed;

(d) The original trust must be severed on a fractional (not a pecuniary) basis which may be determined by means of a formula. However, the resulting trusts may be funded on a non-pro rata basis (see below);

(e) The terms of the resulting trusts must provide, in the aggregate, for the same succession of interests of beneficiaries as are provided in the original trust. Examples are provided in the regulations. Further, the severance may not shift a beneficial interest in the trust to any beneficiary in a lower generation than the person or persons who held the beneficial interest in the original trust and the severance may not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in (or applicable to) the original trust;

(f) If zero or one trusts are severed the resulting trusts must equal the inclusion ratio of the original trust; and

(g) If a trust with an inclusion ratio greater than zero and less than one is severed, one resulting trust must receive that fractional share of the total value of the original trust as of the date of severance that is equal to the applicable fraction and the other must receive a share equal to the excess of one minus the applicable fraction (an amount equal to the trust principal times the inclusion ratio). In other words, the resulting trusts must have inclusion ratios of one and zero.

iii. A qualified severance must be reported by filing Form 706-GS(T).

iv. Non-pro rata funding of the resulting trusts will not be treated as income taxable under Treas. Reg. § 1.1001-1 if authorized by state statute or the governing instrument. C.R.S. § 15-1-804(2)(u) authorizes a fiduciary to make distributions in kind at fair market value on date of distribution without requiring pro rata distribution of specific assets.

c. New Proposed Regulations

New proposed regulations were issued on August 1, 2007, providing, among other things, for qualified severances into more than two resulting trusts and creating a new anti-discounting rule where the original trust's assets are divided into two or more of the resulting trusts. Proposed Treasury Regulations under Section 26.2642-6.

10. Retroactive Allocation of GST Exemption

EGTRRA enacted a new section IRC § 2632(d) which provided for retroactive allocation of a transferor's unused GST exemption to a trust if a non-skip person (to the transferor) with a "future interest" in the trust predeceases the transferor. If the transferor has sufficient unused GST exemption, he or she may allocate it to the trust on a timely filed 709 for the year of the non-skip person's death. If timely filed, the allocation will be based on the value of the transfers when they were made, not on the date of the retroactive allocation and will be effective immediately before the non-skip person's death. IRC § 2632(d)(2).

Warning: *Retroactive allocation based on the value of the property at the time of transfer is only available if allocated on a timely filed 709 for gifts made in the year of the non-skip person's death. The non-skip person must have a lineal relationship to the transferor.*

F. General and Non-General Powers of Appointment

1. General Powers of Appointment

a. Definitions

A general power of appointment ("GPOA") is a power of appointment which is exercisable in favor of the donee, his estate, his creditors, or the creditors of his estate. C.R.S. § 15-2-103(1).

IRC § 2041(b(1) provides that the term "general power of appointment" means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate, with certain exceptions.

IRC § 2041(a)(2) provides that the value of a decedent's gross estate shall include the value of all property with respect to which the decedent has at the time of his death a general power of appointment created after October 21, 1942.

b. Property Subject to a General Power

The value of property subject to a general power possessed by a decedent which was created after October 21, 1942, will be included in a decadant's estate whether exercised or unexercised. The value of property subject to a general power created on or before October 21, 1942, will be included in a decedant's estate only if it is exercised.

c. Lapse or Release of a General Power

The lapse or affirmative release of a general power created after October 21, 1942, is treated as an "exercise" of the power. IRC § 2041(b)(2). Accordingly the property subject to such a lapsed or released power is includible in the decedent's estate if a lifetime exercise of the power would have led to inclusion.

A lapse or a "complete release" of such a power created on or before October 21, 1942, is not an exercise of the power. Treas. Reg. § 20.2041-2(d).

Planning tip: *When reviewing old trusts with powers, check the date of creation of the power. Estate tax inclusion of property subject to a pre-October 21, 1942, power may be avoided by allowing the power to lapse. PLR 200752018.*

d. Five and Five Powers

Where the decedent has a noncumulative power to withdraw funds from a trust annually, a failure to exercise the power (by lapse, but apparently not by an affirmative release) in any year is not treated as the exercise of a general power to the extent of the greater of $5,000 or five percent of the value of the property to which the power relates. IRC § 2041(b)(2).

e. Gift Tax General Power Parallels Estate Tax General Power

IRC § 2514 is virtually identical to IRC § 2041. IRC § 2514 addresses the lifetime exercise (or release or lapse, post-1942) of a power that effectively transfers the property subject to the power to another. As with IRC § 2041, the lapse of a noncumulative annual power is exempt from the gift tax to the extent of the greater of $5,000 or five percent of the value of the property out of which the power could be satisfied. IRC § 2514(e).

f. Crummey Withdrawal Powers and the Five and Five Limitation

i. The Law

Very generally, a "Crummey Trust" provides that upon a transfer to the trust, beneficiaries of the trust are given a limited right to withdraw a portion of the property transferred to the trust. This right to withdraw is considered to be a general power under IRC § 2514, thus rendering the portion of the transfer subject to the withdrawal power a present interest under IRC § 2503(b). The trust instrument may limit the power of withdrawal to the amount of the annual exclusion under 2503(b) (currently $12,000). The power is limited to a period of time (often about 30 days). At the end of the withdrawal period, the power holder's general power lapses. The lapse of a power is treated as a release of a power, but only to the extent that the property which could have been appointed by exercise of such lapsed power exceeded in value the greater of $5,000, or 5% of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied. IRC § 2514(e).

A full discussion of Crummey powers is beyond the scope of this outline. *See* Marc A. Chorney, Transfer Tax Issues Raised by Crummey Powers, 33 Real Prop. Prob. & Tr. J. 757 (Winter 1999).

ii. The Problem(s)

If a full annual exclusion is provided for a trust beneficiary under a Crummey power (currently $12,000), the lapse of the power may result in a taxable lapse (*i.e.* release) for gift tax purposes under IRC § 2514(e) by the Crummey beneficiary and the Crummey beneficiary will be considered the transferor of the lapsed amount for GST purposes. Treas. Reg. § 26.2652-1(a)(5), Example 5. Further the trust for GST purposes will be treated as two trusts. Treas. Reg. § 26.2654-1(a)(2). Assuming allocation of exemption by the transferor, the trust attributable to the transferor will have an inclusion ratio of zero, but the trust attributable to the Crummey beneficiary will be subject to the estate tax inclusion period ("ETIP") rules, and hence not be GST exempt. IRC § 2642(f). Additionally, a portion of the trust will be included in the Crummey beneficiary's gross estate on his death. IRC § 2036(a)(1).

iii. The Solutions (In Brief)

This outline is not intended to address drafting of GST trusts, but various trust provisions have been used to address this problem and may account for what you encounter as you review trusts drafted for your clients by other attorneys. To avoid the lapsed gift problem, trusts may be drafted (a) without Crummey powers; (b) with a limitation on the withdrawal right to the greater of $5,000 or 5% of the value of the trust principal (often with a reference to IRC § 2514(e)); or (c) with hanging powers of withdrawal limited in any given year to an amount that will not exceed the five and five limitation. *See* Chorney above. If one of these provisions does not exist, but gifts exceeding the five and five limitations have been made to the trust, remedial steps, such as a qualified severance or a trust division under IRC § 2654 may be necessary.

g. Disclaimer of a General Power

A disclaimer or renunciation of a general power of appointment created in a transfer made after December 31, 1976, is not considered to be the release of the power if the disclaimer or renunciation is a qualified disclaimer as described in IRC § 2518. To be a qualified disclaimer the required writing must be delivered to the appropriate person within 9 months of the later of –

i. The date on which the transfer creating the interest in the disclaimant is made, or

ii. The day on which the disclaimant attains age 21.

Treas. Reg. § 25.2518-2(c)(1).

In the case of a general power of appointment, the holder of the power has a 9-month period after the transfer creating the power in which to disclaim. Treas. Reg. § 25.2518-2(c)(3). This would be either 9 months after creation of an inter vivos trust granting a general power or 9 months after date of death creating a testamentary trust with a general power.

Planning tip: *Consider advising the surviving spouse of a general power of appointment marital trust, which would qualify for the marital deduction under IRC § 2056(b)(5) to disclaim her general power of appointment in a qualified disclaimer. If the other requirements of IRC § 2056(b)(7) are met, the executor can make a QTIP election and reverse QTIP election for the resulting trust. See PLRs. 9104048 and 9442032. This technique would only be advantageous if the decedent's GST exemption will not be fully utilized on other transfers.*

h. Contingent General Powers or Appointment

i. The Plan

An increasingly common planning device is the contingent formula general power of appointment for the benefit of the non-skip person trust beneficiary (usually the transferor's child). The goal is to make the non-skip person child the transferor of the portion of a trust that would incur GST Tax because of a taxable termination on the child's death. The amount of the trust subject to a taxable termination is equal to the inclusion ratio of the trust. The expectation is that GST Tax will be avoided by making the non-skip person child the transferor of a fractional portion of the trust equal to the trust's inclusion ratio by including a fraction of the trust equal to the trust's inclusion ratio in the child's taxable estate under IRC § 2041. This technique changes the transferor to a younger generation and potentially avoids a GST (taxable termination in most cases) on the death of the child. This was more of an obvious advantage when there were marginal estate tax rates and the GSTT was levied at the highest rate. Now there is only one rate for estates and the GSTT (currently 45%). Nevertheless, as the estate tax exemption has increased, inclusion in the non-skip person's estate can be beneficial if the non-skip person has no, or only a small, taxable estate by wiping out the GST Tax and providing a stepped-up basis in the included assets under IRC § 1014.

Warning: *Consider the source of payment of estate taxes if your client will have trust assets included in his or her estate under IRC § 2041 by way of* *a GPOA, contingent or otherwise. A traditional "pay from the residue" tax clause may not yield the desired result. However, a right of recovery may be available under IRC § 2207.*

ii. Legal Analysis

Other than the tacit approval now provided in the new final qualified severance regulations, discussed below, and a couple of PLRs, there is scant authority for use of the contingent formula general power of appointment in the context of the GST, and therefore should be used with caution. *See* PLR 9527024 (generally approving an analogous arrangement), PLR 9110054 (ruling that a power of appointment which was contingent on the donee dying before age 35 was a valid general power of appointment within the meaning of IRC § 2041(b)).

Consider the following actual formula provision (not drafted by us and in a trust which was terminating due to the death of the child for whom the trust was created) which attempts to create a contingent GPOA and which provides in pertinent part as follows: "to the extent that a portion of trust principal or accumulated income would be subject to a generation-skipping tax" at (child's) death, child is also granted "the power to appoint such portion of the trust principal as (child) shall designate to (child's) estate."

The legal analysis to support the legal effectiveness of the contingent GPOA in Colorado is as follows:

- For GST Tax purposes, the individual with respect to whom property was most recently subject to federal estate or gift tax is the transferor of that property. Treas. Reg. § 26.2652-1(a)(1).
- For federal estate tax purposes, the value of the decedent's gross estate includes the value of all property with respect to which the decedent has a general power of appointment at the time of the decedent's death. IRC § 2041(a)(2).
- Under Colorado law, a power of appointment is any power other than a power held in a fiduciary capacity created or reserved by any person, institution, or corporation having property subject to its disposal, enabling itself or another to designate, within such limits as it shall prescribe, the appointees of the property or of any right, interest, or estate therein or the shares in which it shall be received. A power of appointment shall include all powers which are in substance and effect powers of appointment regardless of the language used in creating them. C.R.S. § 15-2-102(1); See also RESTATEMENT (FIRST) OF PROP.: FUTURE INTERESTS PARTS 3 & 4 § 318(1) (1940).
- A contingent power of appointment is a power that is not presently exercisable or a power that is presently exercisable but subject to divestment or defeat by the occurrence or nonoccurrence of any contingency, condition, or event. C.R.S. § 15-2-104. A power may be made exercisable only upon the happening of some future event or only at some future time, provided that no rule against remoteness [*i.e.* rule against perpetuities] is violated." RESTATEMENT (FIRST) OF PROP.: FUTURE INTERESTS PARTS 3 & 4 § 318 cmt. e.
- In Colorado, a general power of appointment created between May 31, 1991 and May 31, 2001, which is not presently exercisable because of a

condition precedent is invalid unless, when the power is created, the condition precedent is certain to be satisfied or become impossible to satisfy no later than twenty-one years after the death of an individual then alive or within ninety years after its creation. C.R.S. § 15-11-1102.5(2)(b)(II). In the case of the trust described above, this power, created during the relevant years, was valid, as it had to be exercised or lapse within the life of child who was alive at the creation of the power.

- Treas. Reg. § 20.2041-3(b) specifically recognizes the existence of contingent powers unless on the power holder's death the contingency had not, in fact occurred. Here, the contingency was met on the child's death, that is, that a portion of trust principal or accumulated income would be subject to a GST Tax at child's death.

iii. New Qualified Severance Final Regulations

Example 10 of the final regulations (Treas. Reg. § 26.2642-6) approves severance of a trust subject to a contingent general power of appointment into two trusts one of which will be equal in size to a portion of the original trust multiplied times the inclusion ratio. This trust will have an inclusion ratio of one and be subject to the contingent general power of appointment. The other resulting trust will be equal to a fraction of the original trust calculated by subtracting the inclusion ratio from one, will have an inclusion ratio of zero and will not be subject to the contingent general power of appointment. The qualified severance can only be made before there is a taxable termination. In other words, if the non-skip person trust beneficiary dies and the only persons with an interest in the trust are non-skip persons, it is too late to effect a qualified severance. Even if the trust is not divided, the IRS may still recognize a valid contingent GPOA under the analysis in the PLR request described above.

Planning tip: *To the extent you draft contingent general powers of appointment, consider drafting in accordance with Treas. Reg. § 26.2642-b, Example 10. Example 10 uses language generally as follows: "If, at the time of child's death, the trust's inclusion ratio is greater than zero, then child may also appoint that fraction of the trust corpus equal to the inclusion ratio to the creditors of child's estate."*

The general power could be broadened to also include the child, the child's creditor's and the child's estate.

2. Non-General (Special) Powers of Appointment

a. In General

IRC § 2041(b)(1) provides that the term "general power of appointment" means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate, with certain exceptions. A non-general (sometimes referred to as a special) power of appointment is any power that is not a general power and is often created by allowing appointment only among a designated class of persons specifically excluding as objects of the power the decedent, his estate, his creditors, or the creditors of his estate.

In a document you are reviewing, the non-skip person beneficiary (possibly your client) may have a non-general power of appointment under which the beneficiary can create further trusts and further powers of appointment.

b. **Rule Against Perpetuities – How Long Can This Go On? Part II**

i. **Under current Colorado law** (Colorado Statutory Rule Against Perpetuities, or CSRAP) a nonvested property interest is invalid only if it fails to vest or terminate within 1,000 years after its creation. C.R.S. § 15-11-1102.5(1)(b)(I). A non-general power of appointment or a general testamentary power of appointment is invalid unless the power is irrevocably exercised or otherwise terminates within 1,000 years after its creation. C.R.S. § 15-11-1102.5(1)(b)(III).

However, that is not the end of the story when reviewing documents which were irrevocable before June 30, 2006. Consider the following analysis from Professor Wayne Gazur:

ii. **Trusts created after May 31, 2001 and before July 1, 2006** will be subject to the same rules as trusts created after June 30, 2006, unless the beneficiary of an affected interest or the holder of an affected power of appointment files an election to block the retroactive application of the statute on or before July 1, 2008. C.R.S. § 15-11-1106.5.

iii. **Trusts created after May 30, 1991 and before June 1, 2001** are generally subject to rules that restate those that were in place when the Colorado Statutory Rule Against Perpetuities (CSRAP) first was adopted – notably the ninety year wait-and-see period. C.R.S. § 15-11-1102.5(2).

iv. **Trusts created before May 31, 1991** would remain subject to the common law RAP, except that the reformation remedy of current law is retained for property interests created prior to May 31, 1991 that violate the common law Rule Against Perpetuities ("RAP"). C.R.S. § 15-11-1106(2).

v. **The exceptions for the exercise of non-general powers of appointment:** Notwithstanding the foregoing, the part of the current statute prescribing the 1,000 year limitation applies to **powers of appointment** created after May 31, 2001, which essentially would encompass all powers of appointment created through the exercise of a power of appointment after June 30, 2006. C.R.S. § 15-11-1102.5(1)(a).

vi. **Savings Provisions:**

The new statute, in an effort to prevent inadvertent triggering of the ***Delaware Tax Trap***, described below, provides that a power of appointment created through the exercise of a non-general power of appointment "**shall** be considered as created when the first power of appointment is created." C.R.S. § 15-11-1102.5(3)(b). Accordingly, that interest must vest within 1,000 years from the creation of the trust granting the power, no matter how many successive non-general powers are created or exercised.

Further, to avoid loss of exempt status on account of a constructive addition to a grandfathered ***"pre-effective date" trust***, the exercise of a non-general power of appointment over any part of a trust that was irrevocable on September 25, 1985, is not made subject to the 1,000 year limitation, defaulting instead to the ninety year limitation of the new statute that resembles the CSRAP. C.R.S. § 15-11-1102.5(3)(c).

See Wayne M. Gazur, Colorado Revisits the Rule Against Perpetuities, 35 Colo. Law. 75 (Nov. 2006).

c. Read Powers Very Carefully Before Exercising

i. If the terms of the trust provide for a shorter perpetuities provision than under current law, the trust terms will control the exercise of the power. Exercising the power in excess of the RAP provision in the instrument could subject the new trust to attack by a disgruntled beneficiary and possibly cause loss of pre-effective date status. Treas. Reg. § 26.2601-1(b)(1)(v)(B).

ii. Any powers you intend to exercise should be reviewed closely so that the power is only exercised on behalf of permissible objects of the power. For example, if a power may only be exercised among the client's descendants, you may not appoint to the client's spouse or the spouse of a descendant of the client.

iii. When reviewing the group of permissible objects, also confirm that the power wasn't inadvertently drafted to, for example, include the non-skip person as an object of his own power, thus rendering the power a general power when a special power was intended.

d. The Delaware Tax Trap

i. In General

The "Delaware Tax Trap" is the name generally given by practitioners to IRC § 2041(a)(3) and its gift tax counterpart IRC § 2514(d). The estate tax section provides that the decedent's gross estate includes assets subject to the decedent's non-general power of appointment if the decedent exercised the power by creating another power that "under applicable local law can be validly exercised so as to postpone the vesting of (such assets)… for a period ascertainable without regard to the date of the creation of the first power." The reference to local law refers to the rule against perpetuities. Thus if a non-general power can be exercised in a manner that effectively restarts the perpetuities period, the trap would be sprung and the holder of the power would be treated as if he or she had a general power of appointment over the assets subject to the power. It is not clear if current CSRAP would allow exercise of a non-general power in such a manner as to spring the trap as the Delaware Tax Trap savings provision described above does not appear to provide an exception.

ii. Intentionally Triggering the Delaware Tax Trap

The benefit of intentionally springing the trap is that the non-skip person beneficiary of a non-exempt (or partially exempt) trust becomes the transferor for GST purposes by including the assets subject to the power in his or her estate under IRC § 2041, effectively swapping the GST Tax which would be due on his death for estate tax. An advantage of this technique is that it lies within the complete discretion of the power holding beneficiary who is, presumably, best able to determine the desirability of incurring estate or gift tax as opposed to GST Tax.

Additional authority: James P. Spica, A Practical Look at Springing the Delaware Tax Trap to Avert Generation Skipping Tax, 41 Real Prop. Prob. & Tr. J. 165 (Spring 2006).

e. Consider the Object of the Power

i. If allowed under the terms of the power held by a non-skip person trust beneficiary, avoid a taxable termination (or taxable distribution) by appointing assets of non-exempt or partially exempt trusts to non-skip persons.

ii. If the power in the non-skip person is broad enough, an exercise for the sole benefit of a charity, or charities, would avoid a taxable termination on death of the non-skip person. Charities are assigned to the transferor's generation. IRC § 2651(f)(3).

G. Making Distributions During the Life of the Non-Skip Person

1. Non-Exempt ("One") Trusts

Depending on the terms of the trust, it may be prudent to make significant distributions to the non-skip person beneficiaries from the non-exempt trust so that they may carry out their own gift giving programs to reduce their taxable estates, including through the use of the annual exclusion under IRC § 2503. In a typical GST trust plan, the non-skip person beneficiary will have a general power of appointment over the non-exempt trust, so all assets remaining in the trust will be included in his or her estate. However, in making distributions, the trustee must always remain cognizant of its fiduciary obligations to remainder beneficiaries.

a. Skip Persons and IRC § 2611(b)(1)

Transfers to skip persons from a non-exempt trust will be taxable distributions. If the trust document so provides, however, the trustee should consider distributions under IRC § 2611(b) as they are excluded from the GST. Section 2611(b)(1) provides that the term "GST" does not include any transfer which, if made inter vivos by an individual, would not be treated as a taxable gift by reason of IRC § 2503(e) (relating to exclusion of certain transfers for educational or medical expenses)

To qualify, these transfers must be made to the provider of the services and not outright to the skip person beneficiary.

2. Exempt ("Zero")Trusts

While it may be tempting to make lifetime distributions from exempt trusts, generally avoid the temptation if non-exempt assets can be used instead. If drafted properly, exempt trusts will last for at least the life of your non-skip person client, avoid inclusion in his or her estate and probably afford some level of creditor protection.

H. Payment of Expenses

Read the trust carefully. A thoughtful draftsperson may have included directions about what expenses may or may not be paid from the non-exempt trust for the benefit of the exempt trust. Many documents provide, for example, that estate taxes due from the exempt QTIP trust may be paid by the non-exempt QTIP.

Generally, if a pre-effective date trust is relieved of any liability properly payable out of the assets of such trust, the person or entity who actually satisfies the liability is considered to have made a constructive addition to the trust in an amount equal to the liability. *See, e.g.*, Treas. Reg. § 26.2601-1(b)(1)(v)(C).

However, if a reverse QTIP election was made for GST Tax purposes, the discharge of a GST exempt trust's estate tax liability should not be treated as a constructive addition to the trust because the trust property is not treated as includible in the surviving spouse’s gross estate for GST purposes, notwithstanding the right of recovery under IRC § 2207A. *See* Treas. Reg. § 26.2652-1(a)(3), (5) at Examples 6-8.

I. The Annual Exclusion and Nontaxable Gifts Under Chapter 13

Be aware that the annual exclusion for gifts under Chapter 11 does not mesh exactly with the GST. This is a source of much confusion and will often require allocation of GST exemption for transfers completely excluded from the gift tax. Do not assume that prior gifts made to trusts you are reviewing were nontaxable GST gifts, even if excluded from the gift tax.

1. The Gift Tax Annual Exclusion

IRC § 2503(b) provides:

“In the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year, the first $10,000 of such gifts to such person shall not…be included in the total amount of gifts made during such year…”

These gifts of present interests in property are generally referred to as “annual exclusion” gifts and since January 1, 1998, the amount has been indexed for inflation. The amount of the annual exclusion gift allowable in 2008 per donee is $12,000.

2. GST Nontaxable Gifts

IRC § 2642(c)(3) defines transfers under IRC § 2503(b) and (e)(exclusion for certain transfers for educational expenses or medical expenses) as “nontaxable gifts.” IRC § 2642(c)(1) provides that in the case of a direct skip which is a nontaxable gift, the inclusion ratio shall be zero. However, IRC § 2642(c)(2) excludes such transfers to a trust unless –

a. during the life of such individual, no portion of the corpus or income of the trust may be distributed to (or for the benefit of) any person other than such individual, and

b. if the trust does not terminate before the individual dies, the assets of such trust will be includible in the gross estate of such individual.

Thus, IRC § 2642(c)(2) undercuts the use of annual exclusion gifts to trusts for GST purposes (even skip person trusts), because the trust must comply with the section’s rigid requirements. Such trusts can be useful, but only in limited circumstances. (For example, an IRC § 2503(c) trust would qualify as an IRC § 2642(c) trust; therefore, a transfer of an annual exclusion gift to an IRC § 2503(c) trust which is a skip person would result in an inclusion ratio of zero). Because of the requirement that the trust be included in the gross estate of the trust beneficiary, however, gifts to a dynasty-type trust would not be nontaxable gifts under IRC § 2642(c) even if they qualified under IRC § 2503(b)(*e.g.* by the use of Crummey powers, discussed above) and some of the transferor’s GST exemption would need to be allocated to the transfer to result in the trust having an inclusion ratio of zero. If the Crummey powers are not limited by a “five and five power,” the Crummey beneficiary might also be treated as having made a taxable transfer, as discussed above. Trusts with multiple current beneficiaries will not qualify as IRC § 2642(c) trusts either.

Warning 1: *Do not assume that gift tax exclusion will result in exclusion from the GST.*

Warning 2: *As discussed above, always obtain and review 709s to ascertain the status of GST exemption allocation. Unused GST exemption is automatically allocated to direct skips to the extent necessary to make the exclusion ratio zero, but an individual may elect out of automatic allocation in a timely filed Form 709. If the client elects out of automatic allocation to a direct skip, then GST Tax will be due. IRC § 2632(b).*

III. Questions You Should Always Ask the Client– and Why

A. What You Need to Know

This outline is predicated on the proposition that an increasing number of your estate planning clients are the non-skip person beneficiaries of trusts created for their benefit by third parties. For the most part, these trusts are irrevocable and unamendable. These trusts may, or may not, be included in the taxable estate of your client on his or her death. A GST may or may not occur on the death of your client. Your client may or may not be the trustee of the trust, etc.

It is imperative that you review and understand the consequences of your client's interest in the trust (or trusts, in many cases). The following list of questions, to be considered in conjunction with this outline, is intended to alert you to some of the more significant GST issues which should inform your planning advice.

The client questions are in bold type. The "whys" follow:

1. Are You the Beneficiary of Any Irrevocable Trusts?

Under Colorado law, a trust beneficiary includes any person who has any present or future interest, vested or contingent, in a trust. It also includes a donee, appointee, or taker in default of a power of appointment, and a person in whose favor a power held in any individual, fiduciary or representative capacity is exercised. *See* C.R.S. § 15-10-201 (5). This definition is quite broad. Not only should the terms of any trusts possibly affecting the client be read, but also the will (if that is the appropriate document) of any power holder who may have exercised their power for the benefit of your client. An example of this would be a case where the client's father predeceased client's mother who had a power of appointment over a bypass or marital trust. As the generations pass, it will be important to dig ever more deeply into the history of family trusts which may directly or indirectly affect a client. We have seen cases where siblings create powers in favor of another sibling along with an income interest for life, with the unappointed portion of the remainder passing to the descendants of the sibling. Unmarried couples may also engage in this type of planning. Several types of trusts might include a beneficial interest in favor of your client. Ask about the following:

- Bypass (Family) trust created by deceased spouse
- Marital trust under IRC § 2056 (QTIP (b)(7) or GPOA (b)(5)) created by deceased spouse
- ILIT created by spouse or parent
- Crummey trust created by parent (or grandparent)
- GST exempt or non-exempt (often testamentary) trust created by parent, grandparent or other collateral relative. See Exhibit B.

2. **When Did the Trust Become Irrevocable?**
   - Is the trust a pre-effective date trust; *i.e.* irrevocable on September 25, 1985? (Treas. Reg. § 26.2601-1(b)(1)(i))
   - Does the trust contain a general power of appointment created on or before October 21, 1942?
   - What version of the Colorado Rule Against Perpetuities applies (if governed by Colorado law)?

3. **What is Your Interest in the Trust? (What are the Terms of the Trust?)**

   Can (must) the client receive present distributions of income or principal? Are distributions subject to the trustee's discretion? Is the client a remainder beneficiary? Vested or contingent? Is the client now, or has he or she ever been, a Crummey beneficiary? Is the client a trustee or co-trustee? Who are the other beneficiaries?

   - Is the client a skip person or non-skip person? See Exhibit A. IRC §§ 2613, 2651.
   - Does the client have an interest in the trust? IRC § 2652(c).
   - Does the client have withdrawal powers that lapsed making the client a transferor? Treas. Reg. § 26.2652-1(a)(5).
   - Is the trust a skip person? IRC § 2613.
   - Will there be a taxable termination when the client dies? IRC § 2612(a).
   - Will distributions be taxable distributions? IRC § 2612(b).
   - Will distributions be direct skips? IRC § 2612(c).
   - Who pays the tax and how much? IRC §§ 2603, 2622.
   - Can a unitrust election be made? C.R.S. § 15-1-404.5.
   - Is a power to adjust available? C.R.S. § 15-1-404.

4. **Does the Trust Grant You a Power of Appointment? (What are the Terms of the Power?)**
   - Is it a general or a non-general (special) power?
   - If the trust is a pre-effective date exempt trust, will the release, lapse or exercise result in a constructive addition? Treas. Reg. § 26.2601-1(b)(1)(v)(A), (C).
   - Should (can) the power be disclaimed (for example, to convert a 2056(b)(5) marital trust to a QTIP)?
   - Should a special power be exercised to create new trusts with new powers? C.R.S. § 15-11-1102.05.

- Is the trust subject to a contingent general power of appointment? Will it work? Should (can) it be exercised?

- Consider a qualified severance if the trust contains a contingent GPOA. IRC § 2642(A)(3); Treas. Reg. § 26.2642-6, Example 10.

- Will an exercise of a non-general (special) power trigger the Delaware Tax Trap? IRC § 2041(a)(3); C.R.S. 15-11-1102.5(3)(b).

- Is there a special power of appointment that could be exercised for the benefit of non-skip persons in order to avoid a taxable termination?

- If the client has a GPOA, how will estate taxes be apportioned on the property included in his or her estate under IRC § 2041?

5. What is Your Relationship to the Settlor of the Trust?

- Is the client a skip person or a non-skip person? IRC §§ 2613, 2651.

- Is the trust a skip person or a non-skip person? IRC § 2613.

- Is generation assignment determined by lineage or age? IRC § 2651. Does the predeceased ancestor exception apply? IRC § 2651(e).

- If the client is not a lineal descendant of a grandparent of the transferor (T) or an ancestor of T, how much older than the client is T? IRC § 2651

- Should (can) a retroactive allocation of GST exemption be made? IRC § 2632(d).

6. When Were Contributions Made to the Trust? Who Made the Contributions?

- Who is the transferor? IRC § 2652(a).

- The problem of multiple transferors. Treas. Reg. § 26.2654-1(a)(2) (Separate-share rule)

- Were there post effective date additions to a pre-effective date trust? Treas. Reg. § 26.2601-1(b)(1)(iv).

- Was GST exemption properly allocated to the trust if it is not a pre-effective date trust? (The rules were different before and after December 31, 2000.) IRC § 2632.

7. Were 709s Filed by the Transferor(s) to the Trust?

- Obtain copies of all filed 709s for the transferor and transferor's spouse. (Check for gift-splitting.) IRC §§ 2513, 2652(a)(2).

- What is the inclusion ratio of the trust? IRC § 2642(a).

- Should a qualified severance be considered? IRC § 2642(a)(3); Treas. Reg. § 26.2642-6.

- Should (can) a retroactive allocation of GST exemption be made? IRC § 2632(d).

8. Was a Form 706 Schedule R Filed by the Decedent Transferor's Executor?

- Same questions as under 7, except a retroactive allocation of exemption may not be available because the Transferor is deceased.

9. What Happens to the Trust When You Die?

- Will there be a taxable termination on the client's death? IRC § 2612(a).
- Is there a power that was exercised or allowed to lapse? IRC § 2041. General or Special? When was it created?
- Consider the questions under 4.

10. What State's Law Applies?

- Has the trust changed situs?
- Especially with an old trust, when will it terminate under the applicable RAP?
- How long may a new trust created by exercise of a power of appointment stay in existence? E.*g.* creation of a dynasty trust (or a trust subject to Colorado's new 1,000 year rule) by exercise of a power over a trust subject to the old common law rule (pursuant to the trust's choice of law provision) could make the new trust void ab initio, or subject to attack.
- Could the Delaware Tax Trap be sprung to transform a special power into a general power?
- Would change of situs change the effective RAP and jeopardize the exempt status of an effective date trust? Treas. Reg. § 26.2601-1(b)(4)(i)(E) Example (4) (Safe Harbor).
- Will Colorado's RAP savings provisions apply to the exercises of any powers of appointment? C.R.S. § 15-11-1102.5(3)(b),(c).

11. Was the Trust Ever Merged, Divided or Reformed?

If merged, what type of trust was merged into what type of trust? *See* Section II.E.5.-8.

- Possible loss of pre-effective date status. *See* Treas. Reg. § 26.2601-1(b)(4) (Safe Harbor Rules) and PLRs issued using "no change" standard.
- Merger of an exempt trust with a non-exempt trust could result in a trust with an inclusion ratio between zero and one.
- Even mergers of two exempt or two non-exempt trusts could trigger the separate share rule under Treas. Reg. § 26.2654-1(a)(2); or (especially in the case of two non-exempt trusts) lead to inadvertent taxable distributions or a taxable termination.

- Were the terms of the merged trusts similar?

12. Are You the Settlor (Transferor) of Any Irrevocable Trusts?

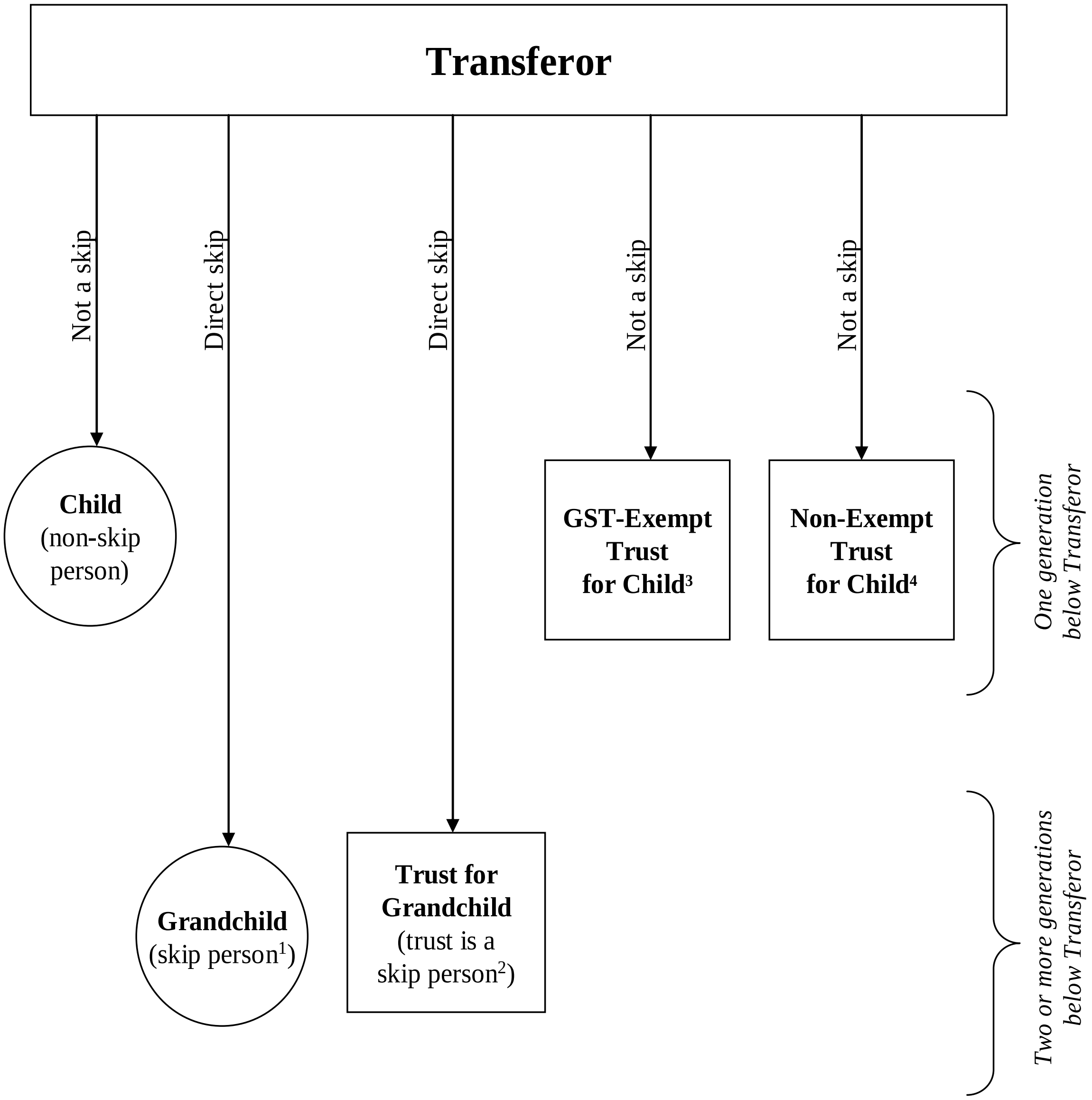
- Has GST exemption been allocated to the trusts of which your client is the transferor?
- Should the client consider a retroactive allocation? IRC § 2632(d).
- Should the client consider a late allocation of GST exemption? Treas. Reg. §§ 26.2632-1(b)(4)(ii), 26.2642-2(a)(2).
- Did the client become the transferor because of a lapsed Crummey power?

B. In Conclusion

The GST Tax is all pervasive and its application is not always readily apparent. It is important that you ask, and get answers to, the questions presented above when advising trust beneficiaries.

Exhibit A

GST Skips and Non-Skips


Transferor
Not a skip
Direct skip
Direct skip
Not a skip
Not a skip
Child (non-skip person)
GST-Exempt Trust for Child[3]
Non-Exempt Trust for Child[4]
One generation below Transferor
Grandchild (skip person[1])
Trust for Grandchild (trust is a skip person[2])
Two or more generations below Transferor

[1] Grandchild is a skip person if Grandchild's parent (who is a child of Transferor) is alive. IRC §2613(a)(1).

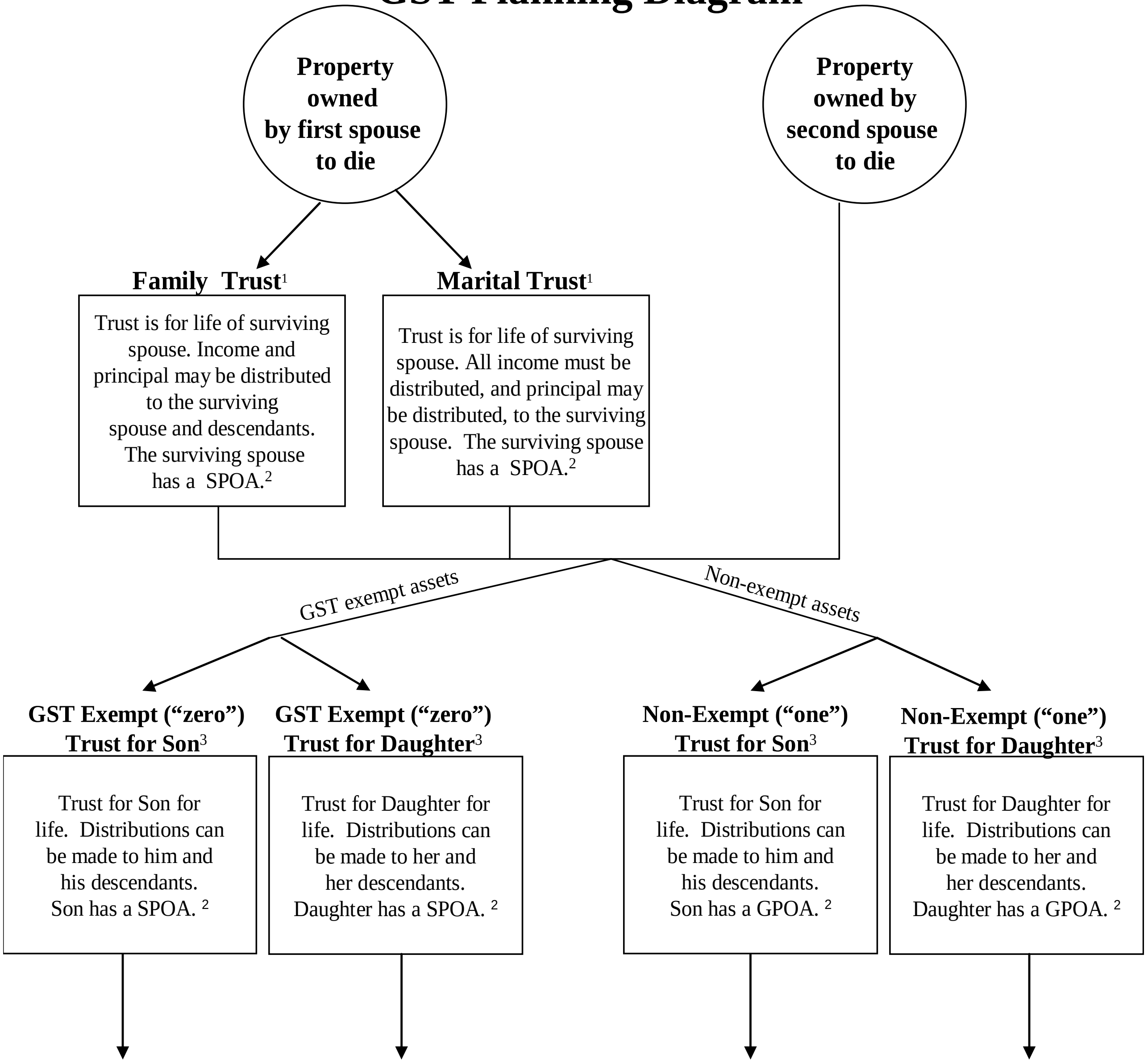
[2] A trust is a skip person if 1) all of the interests in the trust are held by skip persons, or, 2) if there is no person holding an interest in the trust and at no time may a distribution be made to a non-skip person. IRC §2613(a)(2).

[3] Need to allocate GST exemption to the GST Exempt Trust for the Child in order to make it exempt. Automatic allocation rules may apply to allocate GST exemption to the trust, but it is better to affirmatively allocate.

[4] Non-Exempt Trust for Child may be a "GST Trust", in which case Transferor needs to elect out of automatic allocation of GST exemption to that trust.

Exhibit B

GST Planning Diagram



Property owned by first spouse to die

Property owned by second spouse to die

Family Trust[1]

Trust is for life of surviving spouse. Income and principal may be distributed to the surviving spouse and descendants. The surviving spouse has a SPOA.[2]

Marital Trust[1]

Trust is for life of surviving spouse. All income must be distributed, and principal may be distributed, to the surviving spouse. The surviving spouse has a SPOA.[2]

GST Exempt ("zero") Trust for Son[3]

Trust for Son for life. Distributions can be made to him and his descendants. Son has a SPOA. [2]

GST Exempt ("zero") Trust for Daughter[3]

Trust for Daughter for life. Distributions can be made to her and her descendants. Daughter has a SPOA. [2]

Non-Exempt ("one") Trust for Son[3]

Trust for Son for life. Distributions can be made to him and his descendants. Son has a GPOA. [2]

Non-Exempt ("one") Trust for Daughter[3]

Trust for Daughter for life. Distributions can be made to her and her descendants. Daughter has a GPOA. [2]

To (or in trust for) children's descendants, if the powers of appointment are not exercised

[1] Assets totaling the available applicable exclusion amount will be distributed to the Family Trust and the balance of the first spouse's estate will be distributed to the Marital Trust. The applicable exclusion amount was $2,000,000 in the year 2008 and is $3,500,000 in 2009. The family trust and marital trust can be divided into GST exempt and a non-exempt trusts, if appropriate provisions were included in the governing instrument. See Treas. Reg. § 26.2654-1(b). An IRC § 2652(a)(3) ("Reverse QTIP") election must be made for the exempt marital trust.

[2] A SPOA (special power of appointment) or a GPOA (general power of appointment) allows the trust beneficiary to determine who will receive the remaining assets of the trust at death. A GPOA causes the trust to be included in the beneficiary's estate.

[3] GST Exempt Trusts will be created under both spouses' wills and can be merged together so each child has one GST Exempt Trust; similarly with the Non-Exempt Trusts.

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