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GENERATION SKIPPING— THE $1 MILLION EXEMPTION

— by **Neil E. Harl***

For most farm and ranch families, the most significant feature of the generation skipping transfer tax (GSTT) is the $1 million exemption per transferor.[1] An exemption of $2 million was available *through 1989* for transfers to grandchildren.

Allocation of the exemption. The $1 million exemption can be used in about any way the property owner wishes. Once made, the allocation is irrevocable.[2] The exemption may be allocated to one or more transfers and has the effect of exempting, from the outset, all or part of the property. Once allocated to a transfer, the exemption, in effect, shields all skip transfers, taxable terminations and taxable distributions resulting from that transfer for its entire duration.

Allocation of the exemption is automatically made by statute if not allocated otherwise by the transferor —

- To inter vivos direct skips as they are made,
- To direct skips occurring at death, at any time until the federal estate tax return (with extensions) is due,
- To inter vivos and testamentary trusts from which taxable distributions or terminations will or might occur at or after the transferor's death.[3]

If sufficient in amount, an exemption allocation serves to exempt completely the transferred property including, for trusts, all subsequent distributions and terminations. In the event the exemption allocated to a particular portion of property or trust is insufficient to cover the full value of the property, an "inclusion ratio" is calculated.[4]

The "inclusion ratio." The inclusion ratio determines, in effect, the portion of a fund or trust that is subject to tax.[5]

Actually, the inclusion ratio is applied to determine the *tax rate* to be applied against the *entire* fund or trust where the exemption allocated to the fund or trust covers only a part of the value.

Example: $600,000 is transferred to a trust and the transferor allocates $360,000 of the transferor's $1 million exemption to the trust. The inclusion ratio determines what tax percentage (somewhere between 55 percent and 0 percent) to be levied against the entire $600,000 amount. Allocating $600,000 of the $1 million exemption to the $600,000 fund will produce a zero inclusion ratio with a tax rate of zero imposed. Allocating none of the exemption would produce an inclusion ratio of one with the result that the tax rate imposed would be 55 percent. Obviously, the objective of most planners is to produce an inclusion ratio of zero for funds or trusts that are potentially taxable under the GSTT.

The calculation of the inclusion ratio begins with the "applicable fraction."[6] The applicable fraction is determined by using, in the numerator, the exemption amount allocated to the exemption.[7] The denominator is the value of the property transferred reduced by — (1) federal and state death taxes actually recovered from the trust or fund attributable to the property and (2) any federal estate or gift tax charitable deduction allowed with respect to the property.[8] Amounts to be distributed immediately to children are not included in determining the denominator of the applicable fraction for the inclusion ratio with respect to property distributed to children's trusts in a generation-skipping transfer.[9] Federal estate tax values may be used to determine the denominator of the applicable fraction only when the value of the assets distributed from the estate to the generation skipping fund or trust is fairly representative of the net appreciation or depreciation in value of all property available for the distribution.[10]

The applicable fraction is then subtracted from one to determine the inclusion ratio.

Example: Returning to the facts of the above example, if $600,000 is transferred to a trust and the transferor allocates $360,000 of the transferor's $1 million exemption to the trust, the applicable fraction would be —

$$\text{A.F.} = \frac{360{,}000}{600{,}000} = 0.6$$

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Assuming no adjustments in the denominator as noted above,[11] the inclusion ratio would be

I.R. = 1 – 0.6
= 0.4

Thus, any taxable distributions or terminations from that trust would be subject to tax at a rate of —

= 0.4 x .55
= .22

The GSTT would be imposed on that trust at a rate of 22 percent.

After 1992, the maximum rate of 55 percent is scheduled to drop to 50 percent.[12] The additional 5 percent estate and gift tax surcharge for portions of estates exceeding $10 million does not apply for purposes of the generation skipping transfer tax.[13]

Who pays the tax. The question of who pays the tax varies with whether a trust is involved and whether it is a direct skip, taxable termination or taxable distribution.[14]

- For a direct skip not from a trust, the transferor pays the tax.[15]
- For a direct skip from a trust, the tax is paid by the trustee.[16]
- For a taxable termination, the tax is paid by the trustee.[17]
- For a taxable distribution, the tax is paid by the transferee.[18]

Regardless of liability for payment, the GSTT is a charge on the property constituting the generation skipping transfer unless the dispositive instrument directs otherwise by specific reference to the generation skipping transfer tax.[19]

FOOTNOTES

1 I.R.C. § 2631(a). See 5 Harl, **Agricultural Law** § 44.08 (1991).

2 I.R.C. § 2631.

3 I.R.C. § 2632. Ltr. Rul. 9037058, June 21, 1990 (unused exemption allocated proportionately to non-exempt portions of children's trusts).

4 I.R.C. § 2642.

5 *Id.*

6 I.R.C. § 2642(a)(2). See Ltr. Rul. 9009007, Nov. 27, 1989 (disclaimer effective to transfer property for purposes of inclusion ratio).

7 I.R.C. § 2642(a)(2)(A).

8 I.R.C. § 2642(a)(2)(B).

9 Ltr. Rul. 9037058, June 21, 1990.

10 Ltr. Rul. 9007016, Nov. 16, 1989. Compare Rev. Proc. 64-19, 1964-1 C.B. 682.

11 See note 8 *supra*.

12 I.R.C. § 2001(c)(1).

13 I.R.C. § 2001(c)(3).

14 I.R.C. § 2603.

15 I.R.C. § 2603(a)(3).

16 I.R.C. § 2603(a)(2).

17 *Id.*

18 I.R.C. § 2603(a)(1).

19 I.R.C. § 2603(b).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL

EXEMPTIONS. The debtor's interest in an ERISA qualified retirement plan was not eligible for an exemption under ERISA as a federal nonbankruptcy exemption. ***In re* Brown, 130 B.R. 304 (Bankr. E.D. Mo. 1991)**.

The debtor claimed a homestead in a residence of which a portion of the two story garage was rented out as rooms. The court held that the debtor was eligible to claim the entire property for the homestead exemption because the rented portion was not severable under local law which zoned the property as a single family residence. ***In re* Makarewicz, 130 B.R. 620 (Bankr. S.D. Fla. 1991), *aff'g on reh'ing*, 126 B.R. 127 (Bankr. S.D. Fla. 1991)**.

CHAPTER 11

PLAN. The farm debtors failed to submit a plan within the 120 days after filing bankruptcy but filed a plan prior to the creditors' filing of a liquidating plan. The Bankruptcy Court confirmed the creditors' plan and the debtors objected, arguing that their plan should have been confirmed because it was filed first. The appellate court held that the Bankruptcy Court properly considered both plans and confirmed the creditors' plan as most appropriate. ***In re* Tranel, 940 F.2d 1168 (8th Cir. 1991)**.

CHAPTER 12

ELIGIBILITY. The debtors' pre-bankruptcy income included social security benefits in excess of 50 percent of the debtors' gross income which were excluded from gross income on the debtors' tax returns. The debtors' gross income included income from discharge of indebtedness. The court held that the social security benefits were included in the debtors' gross income for purposes of Chapter 12 eligibility, even though the benefits were not included in the debtors' taxable gross income. In addition, the court held that the taxable income from discharge of indebtedness was not included in the debtors' income for purposes of Chapter 12, even though the discharge of indebtedness produced taxable income. The court focused primarily on whether the item of income produced any actual cash income to the debtors, instead of relying on whether the income was included in gross income for federal tax purposes. Query: are social security benefits income or return of contributions