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GENERATION SKIPPING — TRANSFERS SUBJECT TO TAX

— by Neil E. Harl*

For centuries, generation skipping has been utilized by wealthy property owners and those lacking confidence in succeeding generations to manage and conserve family wealth, at least to the extent allowed by the rule against perpetuities.¹ Until 1976, the U.S. federal estate and gift tax system did not take particular note of generation skipping as property owners were free to establish generation skipping arrangements with the usual federal estate or gift tax consequences as to the transferor, but with no further transfer tax consequence until gift by or death of the holders of the remainder interest. The Tax Reform Act of 1976 imposed a complex generation skipping tax that proved to be highly controversial and allegedly unworkable.² That legislation was amended substantially in 1986 to create a generation skipping transfer tax.³

Under the Tax Reform Act of 1986, generation skipping transfers are subject to tax at a flat rate equal to the maximum federal estate and gift tax rate (55 percent through 1992).⁴

Effective date. The generation skipping transfer tax (GSTT) is effective for testamentary transfers after the date of enactment (October 22, 1986) and for inter vivos transfers after September 25, 1985.⁵ Trusts which were irrevocable on September 25, 1985, are excepted from the 1986 legislation "but only to the extent that the transfer is not made out of corpus added to the trust after September 25, 1985."⁶ IRS has ruled that the division of trusts that were irrevocable on September 25, 1985,⁷ the reformation of such trusts⁸ or the partitioning of such trusts⁹ do not make the trusts subject to the GSTT. Similarly, the merger of trusts that were irrevocable on September 25, 1985 does not subject the trust to the GSTT.¹⁰ Moreover, the GSTT is not triggered by amendment of a trust to authorize the trustees to designate additional or successor trustees;¹¹ resignation of a trustee and appointment of a successor trustee other than the successor trustee designated

in the trust instrument;¹² or amendment of a trust to delete the grantor's power to remove a trustee and appoint a successor trustee, to restrict the trustee's investment powers, to provide for trustee compensation and to require trustee accountings to be filed with the court.¹³ The exercise of a special power of appointment is not treated as an addition to trust corpus.¹⁴

Persons mentally disabled on October 22, 1986, who did not regain competence before death come under a special rule whereby the GSTT did not apply to transfers that were direct skips if the decedent was under the mental disability through the date of death.¹⁵ However, this exception does not apply to property transferred by gift or by reason of death of the decedent after August 3, 1990.¹⁶ In one IRS ruling, the failure to attach the incompetency certificate to the federal estate tax return did not disqualify the trust from using the incompetency exception where the return was filed before the temporary regulations were published requiring a certificate.¹⁷

Forms. The generation skipping transfer tax is reported on Form 706-GS(D) for distributions and 706-GS(T) for terminations. Form 706-GS(D-1) is used for an information return.

Transfers subject to tax. Transfers subject to the GSTT are *direct skip* transfers, *taxable terminations* and *taxable distributions*¹⁸ except for transfers in which the transferor or transferee was subject to federal estate or gift tax on the transfer.¹⁹

• A *direct skip* is a transfer to a "skip person."²⁰ Any inter vivos transfer exempt from federal gift tax because of the federal gift tax annual exclusion or the exclusion of tuition or medical payments is not a direct skip subject to tax.²¹

Moreover, all direct skips to or for a grandchild of the transferor occurring at a time when the parent of the grandchild (child of the transferor) is dead are exempt.²² This rule does not apply to taxable terminations or taxable distributions. This "representation up" rule to the level of a deceased parent may be reapplied to exempt transfers to succeeding levels if the intervening heirs are deceased.²³

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A "skip person" is an individual at least two generations after the transferor of the property transferred or a trust in which all beneficiaries are two generations after the grantor of the trust.²⁴ For a transfer of a life estate to a skip person with the remainder interest to a non-skip person, IRS has ruled that the entire value of the property was subject to the GSTT.²⁵ In that ruling, property passed to a "friend" 40 years younger than the decedent (a skip person) with a remainder interest to a daughter, a non skip person.²⁶ This ruling illustrates the importance of careful consideration of all transfers for potential GSTT liability.

- A *taxable termination* is a transfer of an interest in trust to a skip person²⁷ unless immediately after the termination a non-skip person has an interest in the property or at no time after the termination may a distribution be made to a skip person.²⁸ For example, in a trust providing that income be paid to a child for life, remainder to a grandchild, the child's death results in a taxable termination.

- A *taxable distribution* is a distribution from trust to a skip person.²⁹ For example, in a trust with a sprinkling

power from which income or principal can be paid to children or grandchildren, any distribution to a grandchild is a taxable distribution.

Assigning individuals to generations. Individuals who are descendants of the grandparents of either the transferor or a spouse of the transferor are assigned to generations on the basis of their place in the family tree.³⁰ Any spouse or a former spouse of the transferor or of any individual on the family tree is assigned to the generation of the family member to whom the person is married.³¹

Unrelated persons and those more remotely related are assigned to generations by date of birth —

- Anyone not more than 12-1/2 years younger than the transferor is assigned to the transferor's generation.

- A person whose birth date is between 12-1/2 and 37-1/2 years after the transferor's is assigned to the first generation below the transferor, and

- Subsequent generations are assigned by additional 25-year intervals.³²

FOOTNOTES

¹ See generally 5 Harl, **Agricultural Law** § 44.08 (Supp. 1991).

² Pub.L. 94-455, enacting I.R.C. §§ 2601-2621.

³ Tax Reform Act of 1986, Pub.L. 99-514, amending and enacting I.R.C. §§ 2601-2662.

⁴ TRA 1986, Sec. 1431(a), 100 Stat. 2717 (1986), amending I.R.C. § 2641.

⁵ TRA 1986, Sec. 1433(a),(b)(1), 100 Stat. 2731 (1986). See Temp. Treas. Reg. § 26.2601-1. See Ltr. Rul. 8725022, March 20, 1987 (transfers from decedent's estate to children of decedent's heirs not subject to generation skipping transfer tax where decedent died before October 22, 1986 and heirs effectively disclaimed interest after October 22, 1986). See Rev. Proc. 87-7, 1987-1 C.B. 542 (allows ruling requests involving generation skipping transfer tax pending adoption of temporary or final regulations).

⁶ TRA 1986, Sec. 1433(b)(2)(A).

⁷ E.g., Ltr. Rul. 8726016, March 25, 1987 (separate trusts subject to same provisions as original trusts); Ltr. Rul. 8951068, no date given (original trust contained express authority to establish additional trusts).

⁸ E.g., Ltr. Rul. 9005019, Nov. 3, 1989.

⁹ E.g., Ltr. Rul. 9020017, Feb. 16, 1990 (partitioning by state court order); Ltr. Rul. 9033016, May 18, 1990 (partitioned shares not changed in timing, quality or value from original trust). See Ltr. Rul. 9122027, Feb. 28, 1991 (partitioning of trust did not constitute substantive change).

¹⁰ Ltr. Rul. 9023007, Feb. 28, 1990 (interests of beneficiaries left unchanged). See Ltr. Rul. 9124018, March 14, 1991 (merger of trusts not addition to corpus for GSTT purposes where post-1985 trust had inclusion ratio of zero).

¹¹ Ltr. Rul. 9028015, April 4, 1990.

¹² Ltr. Rul. 9102029, Oct. 15, 1990.

¹³ Ltr. Rul. 9106014, Nov. 8, 1990.

¹⁴ Ltr. Rul. 9040046, July 10, 1990 (testamentary exercise). See Ltr. Rul. 9114037, no date given; Ltr. Rul. 9125042, March 28, 1981. See Ltr. Rul. 9125018, March 22, 1991 (release reduced general power to special power of appointment); Ltr. Rul. 9137013, June 13, 1991, discussed p. 174 *infra*.

¹⁵ TRA 1986, Sec. 1433(b)(1)(C).

¹⁶ I.R.C. § 2642(c)(2), amended by Revenue Reconciliation Act of 1990, Sec. 11703(c). See Ltr. Rul. 8821026, Feb. 25, 1988 (taxpayer's testamentary trusts not subject to GSTT where taxpayer became incompetent prior to October 22, 1986, and unable to change trust provision); Ltr. Rul. 9019044, Feb. 12, 1990 (decedent had retained general power of appointment over property and, pursuant to decedent's will, property subject to power to be divided into six trusts for nieces and nephews; GSTT did not apply); Ltr. Rul. 9034057, May 30, 1990 (property passing as result of spouse's disclaimer not treated as generation skipping transfer where decedent mentally incompetent); Ltr. Rul. 9111011, Dec. 12, 1990 (disclaimer by nieces and nephews resulting in property passing to their issue did not preclude exception from applying).

¹⁷ Ltr. Rul. 9115053, no date given.

¹⁸ TRA 1986, Sec. 1431(a), 100 Stat. 2717 (1986), amending I.R.C. § 2611(a).

¹⁹ I.R.C. § 2611(b).

²⁰ I.R.C. § 2612(c).

²¹ See I.R.C. §§ 2612(c)(1), 2642(c)(1).

²² I.R.C. § 2612(d)(2). See Ltr. Rul. 9040046, July 10, 1990; Ltr. Rul. 9047028, Aug. 27, 1990.

²³ Ltr. Rul. 9114024, no date given, 1991 (child and grandchild deceased; transfers to great grandchildren from those descendants exempt).

²⁴ I.R.C. § 2613.

²⁵ Ltr. Rul. 9105006, Oct. 22, 1990.

²⁶ Id.

²⁷ I.R.C. § 2612(a).

²⁸ I.R.C. § 2612(a)(1).

²⁹ I.R.C. § 2612(b).

³⁰ I.R.C. § 2651(b).

³¹ I.R.C. § 2651(c).

³² I.R.C. § 2651(d). See N. 26 *supra*.

In the next issue:

Generation Skipping — The \$1 Million Exemption

by Neil E. Harl

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

CONTINUOUS USE. The defendants presented evidence that the disputed land was used by them continuously for grazing; that the defendants built or maintained the fences enclosing the disputed land; that the defendants built corals, pens and a small shack on the disputed land and raised crops on the land. In upholding a jury verdict for the defendants, the court held that the defendants presented sufficient evidence of continuous use of the disputed land to support title by adverse possession. **Butler v. De La Cruz, 812 S.W.2d 422 (Tex. Ct. App. 1991).**

BANKRUPTCY

GENERAL

AVOIDABLE LIENS. The debtor claimed a homestead exemption in a residence and sought avoidance of a judicial lien against the residence because the lien impaired the exemption. The Ohio exemption allowed an exemption against "execution, attachment or judgment" but the judgment creditor in the case had not yet attempted an execution of the judgment lien and argued that the lien did not yet impair the exemption. The court held that the filing of the bankruptcy petition functioned as an "execution" of all creditors' liens and caused impairment of the exemption under state law. In addition, the court held that under *Owen v. Owen, 111 S.Ct. 1833 (1991)*, the test is whether the judgment lien impairs an exemption to which the debtor would be entitled but for the lien. Thus, under both reasons, the judgment lien was avoidable. **In re Conyers, 129 B.R. 470 (Bankr. E.D. Ky. 1991).**

EXEMPTIONS. The debtors owned a residence as tenants by the entirety and claimed a homestead exemption for the residence. The trustee proposed to sell the residence and distribute the proceeds among the joint creditors, arguing that the residence was subject to joint debts of the debtor and nondebtor spouse. One creditor of the debtor asserted a joint claim based upon the nondebtor spouse's pre-bankruptcy agreement to refinance the mortgage on the house in order to repay the creditor. The court denied the

request to sell the house because the agreement did not create any obligation on the nondebtor spouse for the creditor's claim; thus, the residence was not subject to any joint debts. **In re Wickham, 130 B.R. 35 (Bankr. E.D. Va. 1991).**

The court held that the exemption under Utah Code § 78-23-6(3) did not apply to the debtor's interest in an IRA. **In re Swenson, 130 B.R. 99 (Bankr. D. Utah 1991).**

The debtor claimed an exemption, under Ill. Code Civ. Proc. § 12-1006, for the debtor's interest in an ERISA qualified retirement plan. The court held that the Illinois exemption was preempted by ERISA and that ERISA did not provide a federal nonbankruptcy exemption. **In re Wimmer, 129 B.R. 563 (C.D. Ill. 1991), aff'g, 121 B.R. 539 (Bankr. C.D. Ill. 1990).**

The debtor claimed an exemption, under Ind. Code § 34-2-28-1(a)(6), for the debtor's interest in an ERISA qualified pension plan. The Indiana exemption included interests "in a pension fund, individual retirement account, or a similar fund, either public or private." The court held that the exemption was not preempted by ERISA but was unconstitutional under the U.S. Constitution as too broad and under the Indiana Constitution because the amount of the exemption was not limited to a "reasonable amount." **In re Garvin, 129 B.R. 598 (Bankr. S.D. Ind. 1991).**

The debtor claimed a homestead exemption in a house in which the debtor owned a remainder interest in a house subject to a possessory life estate of debtor's grandmother. The court held that the debtor's interest in the house was insufficient to support a homestead exemption because the debtor could not prove that the debtor's residence in the house was imminent. **In re Dennison, 129 B.R. 609 (Bankr. E.D. Mo. 1991).**

CHAPTER 12

PLAN. The debtor's Chapter 12 plan proposed to pay one secured claim over 30 years with 5 percent interest and another secured claim outside of the plan for 30 years at 7