REPORT #546

TAX SECTION

New York State Bar Association

1986 TAX REFORM ACT SEMINARS

SESSION TWO: EFFECT OF THE 1986 ACT ON DISPOSITIONS OF WEALTH AND ON COMPLIANCE RULES

Trust and Estate Provisions
Unearned Income of minor Children
Generation-Skipping Transfer Tax
Compliance Provisions

OCTOBER 16, 1986

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TAX REFORM ACT OF 1986
CHANGES IN THE INCOME TAXATION
OF MINORS AND OF
TRUSTS, ESTATES AND THEIR BENEFICIARIES*

I. Unearned Income of a Minor Child

A. General Rule

Subsection (i) of section 1 of the Internal Revenue Code (the "Code"), added by section 1411 of the Tax Reform Act of 1986 (the "Act"), provides that, for taxable years starting after 12/31/86, all "net unearned income" of a child who has not reached 14 by the end of the taxable year -- regardless of the source of the assets from which such income is derived and regardless of when the assets were transferred to the child – will be taxed at the parent's top marginal rate if that rate is higher that the child's. Conversely, if the tax owed by the child, computed as if he were an adult, is higher than it would be under the new provision, that amount is due.[1/]

[1/] Code § 1(i)(1). Section references herein are to the Code as amended by the Act.

B. Net Unearned Income

"Net unearned income" is defined as:

the child's unearned income less

(a) $500.00 and

(b) the greater of $500 or, for a child who itemizes, the amount of deductions which are directly connected with the production of unearned income.

The amount of net unearned income, however, cannot exceed the amount of the child's taxable income.[2/]

C. Exemption and Standard Deduction for Minors

The personal exemption ordinarily available to taxpayers ($1,950 in 1988 and $2,000 in 1989) is denied to someone who may be claimed as a dependent by another taxpayer.[3/] This rule applies to any child under 19 (and to any older child who is a student -– regardless of ace) if over half of such child's support is received from his parent.[4/] In addition, the standard deduction permitted to the person who may be claimed by someone else as a dependent is limited to the greater of $500 of that

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[2/] Code § 1(i)(4). "Unearned income" is defined as that portion of gross income that is not "earned income" under Section 911(d)(2) – which in turn, defines "earned income" as salaries, wages, professional fees, and other amounts received as compensation for personal services.

[3/] Code § 151(f)(2) (added by § 103 of the Act).

[4/] Code §§ 151(e)(1)(B); 1.52.

person's earned income.[5/] Other single individual taxpayers will have a standard deduction of $3,000 in 1988.

D. Examples

The following examples illustrate the effect of the new provision on a child under 14 in 1988 who can be claimed as a dependent by his parent.

(1) Child has unearned income of $500.
No taxable income.
No tax.

(2) Child has unearned income of $1,000.
Standard deduction = $500.
Taxable income = $500.
Net unearned income = 0.

(3) Child has unearned income of $1,500.
Standard deduction = $500.
Taxable income = $1,000.
Net unearned income = $500.

(4) Child has unearned income of $700 and unearned income of $300.
Standard deduction = $700.
Taxable income = $300.
Net unearned income = 0.

(5) Child has unearned income of $1,200 and unearned income of $900.
Standard deduction = $1,200.
Taxable income = $900.
Net unearned income = 0.

(6) Child has earned income of $600 and unearned income of $2,400. He also has itemized deductions (net of the 2% floor) of $400 directly connected with the production of

[5/] Code § 63(b)(5) (amended by § 102 of the Act.)

unearned income and other itemized deductions of $400.[6/]
Itemized deduction = $800.
Taxable income = $2,200.
Net unearned income = $1,400.

(7) Child has earned income of $600 and unearned income of $2,400. He also has itemized deductions (net of the 2% floor) of $700 directly connected with the production of unearned income and other itemized deductions of $100.
Itemized deduction = $800.
Taxable income = $2,200.
Net unearned income = $1,200.

(8) Child has earned income of $2,000 and unearned income of $10,000. He has a trade or business expense of $3,000.
Itemized deduction = $3,000.
Taxable income = $9,000.
Net unearned income = $9,000.

(9) Child has unearned income consisting of a capital gain of $10,000. He has a capital loss of $3,000.
Standard deduction = $500.
Taxable income = $6,500.
Net unearned income = $6,500.

As a general rule, $500 of the child's unearned income will not be taxes; $500 will be taxed to the child at the child's rate and the balance will be taxed to the child at the parent's rate and the balance will be taxed to the child at the parent's rate. The rule is subject to

[6/] Under Code § 67 (added by § 132 of the Act), certain expenses are deductible only to the extent that they exceed 2 percent of the taxpayer's adjusted gross income. Because Code § 67 establishes a single 2% floor for all taxpayers based on the amount of adjusted gross income, it is not clear how the 2% floor is to be allocated between deductions connected with the production of the child's unearned income and other itemized deductions for the purpose of calculating net investment income.

at least two exceptions. First, where the child's itemized deductions directly connected with the production of unearned income exceed $500, the amount free of tax will increase to the amount of such deductions. Second, until the unearned income does not permit the child to use either his deductions unconnected with unearned income or, apparently, his allowable capital losses to decrease the amount of unearned income taxable at his parents' rate.[7/]

E. Computation of Child's Tax

(1) Rule

The tax rate on a child's net unearned income -- his parent's marginal rate -- is based on the amount of the parent's income plus the net unearned income of all children in the family. The tax owed by the children will be the difference between the tax that the parent would have paid had his income included such net unearned income and the tax imposed on the parent's actual taxable income.[8/] Each child will pay a share of the tax equal to the ratio between his net unearned income and the total net unearned income of all the children in the family.[9/]

[7/] Under the statute net unearned income is computed on the child's gross unearned income, which under Code § 61 includes capital gains; capital losses, on the other hand are deducted from gross income to reach adjusted gross income. Code § 62.

[8/] Code § 1(i)(3)(A). For purposes of determining the tax owed by the children, their net unearned income is not to be taken into account in computing any deduction or credit of the parent. Thus, where, for instance, a child has a capital gain, his parent's otherwise unused capital loss apparently will not be used in making the calculation.

[9/] Code § 1(i)(3)(B).

(2) Examples

(a) Parents have taxable income of $29,750 without taking children's unearned income into account; child A has $1,000 of unearned income; child B has $3,000 unearned income; child C has $4,000 of unearned income and $700 of earned income.

(1) Compute net unearned income of all children:

Child A: $1,000 minus $500 standard deduction: $500 taxed at child's rate, no net unearned income.

Child B: $3,000 unearned income minus $500 standard deduction: $2,500 taxable income, $500 taxed at child's rate, $2,000 net unearned income taxed at parent's rate.

Child C: $4,000 unearned income minus $500 standard deduction: $3,500 taxable income, $500 taxed at child's rate, $3,000 net unearned income taxed at parent's rate. (also $700 earned income minus $200 standard deduction: $500 taxed at child's rate).

(2) Compute tax on parents' taxable income without children's net unearned income: $29,750.00

Tax of 15% 4,462.50

(3) Compute tax on parents' taxable income plus children's net unearned income:

$34,750.50

Tax = $4,462.50 plus $1,400

(28% of $5,000) 5,862.50

(4) Compute children's tax by allocating to each child his share of the difference between the tax payable by the parent without including the children's net unearned income and the tax payable after such inclusion (and adding any tax on unearned and earned income payable at the child's rate).

Child B owes 2/5 of $1,400	$560
plus 15% of $500	75
	$635
Child C owes 3/5 of $1,400	$840
plus 15% of $1,000	150
	$990

(b) Parents have taxable income (after exemptions for themselves and their child) of $70,000. Child has taxable income of $66,000 and does not itemize.

(1)	Net unearned income of child is $65,000.	
(2)	Tax on parents' taxable income	$15,732.50
(3)	Tax on parents' taxable income plus child's net unearned income	
	(a) Tax on $35,000	$33,932.50
	(b) Phaseout of 15% Rate adds additional tax	3,155.00
		$37,087.50
(4)	Child owes tax on net unearned income	$21,355.00
	plus 15% of 500	75.00
		$21,430.00

Note that a child's unearned income may not only shift the parents into a higher tax bracket for purposes of computing the child's tax, but may also, for that

purpose, shift them into a taxable income level upon which the 5% surcharge is imposed.[10/]

F. Other Rules

(1) If parents are not married, the rate of the custodial parent will be used, if parents are married and filing separately, the rate of the parent with the larger taxable income will be used.[11/]

(2) The parent of a child with net unearned income must provide that child with the parent's tax identification number, which is to be included on the child's tax return. The tax return of the parent is to be open to inspection by the child or by his legal representative.[12/]

[10/] Presumably, the child (whose unearned income has raised his parents' income to the level at which 15% rate is phased out) will not be subject to an additional phaseout tax on his own return, even though his taxable income is over $43,150 (the "applicable amount") under Code § 1(g).

[11/] Code § 1(i)(5).

[12/] Code § 1(i)(6). Minors are treated in the same way as other individuals in determining their liability to file returns and pay taxes. In 1986, a child under 19 or a full-time return must file a return if his unearned income is $1080 or more. The return must be made by the minor himself or by his guardian or "other person charged with the care of his person or property." Tr. Reg. 6012-1(a)(4). Presumably, therefore, if parents are separated, the custodial parent responsible for filing the child's tax return may inspect the return of the non-custodial parent if that parent has the higher income, and probably even if only to determine which parent has the higher income.
If a minor's income tax is not paid, and assessment made against the minor will be treated as having been made against the parent, but only to the extent to which the tax is attributable to amounts received by the parent for the minor's personal services and reportable by the child under Code § 73. An assessment of tax attributable to unearned income of the child is not considered to have been assessed against the parent. Code § 6201(c); Tr. Reg. 301. 6201-1(c).

G. Working with the New Children's Income Tax Rules

(1) Dependent Children Under 14

The new law seriously erodes the benefit of shifting income to family members in lower tax brackets. Assume for instance that, instead of retaining an asset generating income of $20,000, parents transferred it to two dependent children, each of whom is under 14 and neither of whom has other income. Parents, who file jointly, are in the top bracket in 1986 and will be in the 28% bracket in 1986. In 1986, the tax liability of the parents would have been $10,000 with respect to that income item. The tax liability of each child would have been $1,258 ($10,000 minus $1,080 personal exemption plus $2,480 ZBA = taxable income of $11,400). The income tax savings to the family as a result of the transfer would have been $7,484. In 1988, the tax liability of the parents would have been $5,600; the tax liability of each child would have been $2,595; the income tax savings to the family as a result of the transfer would have been $410.

(2) Dependent Children Over 14

The income tax savings resulting from transferring property to a dependent child over 14 will also be considerably less in 1986 that they are in 1986. Assume, for instance, that parents, who are in the top bracket in 1986 and who will be in the 28% brackets in 1988, have transferred to a dependent 16 year old child property generating $89,350 in 1986 -– income sufficient

to fill up all the brackets below 50% under the 1986 rate tables ($89,350 gross income minus $1080 personal exemption = $88,270 taxable income). The child's tax liability in 1986 is $31,116. Had the parents retained the asset and reported the income on their joint return, their income tax liability with respect to income item would have been $44,675. Thus, the maximum tax savings available in 1986 through shifting income to a dependent child is $13,559. In 1988, the 16 year old child reporting income on his tax return will be permitted a standard deduction limited to $500 and no personal exemption. The maximum savings to the family resulting from shifting the income to the child will be $2460.50 (28% of $500 and 13% of $17,850).

Because the potential tax savings are greater for children over 14, it may be useful to consider creating deferred income for children until they each reach that age.

(3) Children Who are not Dependents

A parent may claim the child as a dependent only if half of the child's support is provided by the parent or treated as so provided (under multiple support agreements or through a custodial, divorced parent's release of claim to the exemption).[13/] In 1989, a child who cannot be claimed as a dependent will be permitted a standard deduction of $3000 and a personal exemption of $2,000.[14/] The maximum savings to a family resulting from

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13/ Code § 152(a),(c),(e).

14/ Code § 63(c)(2)(C) (amended by § 102 of the Act); Code § 151(f)(1)(B) (amended by § 103 of the Act).

shifting the income to such a child would be $3,160.50 (28% of $3,000 and 13% of 17,850), which increases to $3,720.50 if the phaseout of the exemption is avoided. To attain this potential increase in savings of $1,260, however, substantial resources would have to be placed at the free disposal of the child.[15/]

II. Income Taxation of Trusts

A. Compressed Rates

For taxable years beginning after December 31, 1986, the accumulated income of a non-grantor trust will be taxed under a compressed rate schedule. In 1988, the first $5,000 of taxable income will be taxed at 15% and the excess taxable income will be taxed at 28%.[16/] When the taxable income of the trust reaches $13,000, the 15% rate is phased out by increasing the amount of tax by $650.00 (13% of $5,000 -– maximum amount of taxable income to which the 15% rate applies) until taxable income is $26,000 -- at which time effective rate is 28%.

[15/] The IRS has taken the position that, if the income from a trust or UGMA account is used for the support of a minor beneficiary, the income is taxable to the person liable for the child's support under state law, to the extent that he is so liable. Tr. Reg. § 1.662(a)(4); Rev. Rul. 56-484, 1956-2 C.B. 23.

[16/] Code § 1(e). The Act provides a transitional, blended rate for the calendar year of 1987 and all fiscal years beginning in 1987. Code § 1(h)(2)(E).

Trust Taxable Income	Tax	Effective Rate
$5,000	$ 750	15.0%
10,000	2,150	21.5%
15,000	3,650	24.3%
20,000	5,300	26.5%
26,000	7,280	28.0%

If a beneficiary is in the 28% bracket, accumulating income in the trust rather than paying it to such beneficiary would save only $678 ($5,000 taxed at 15% rather than at 28% = $650, plus 28% of $100 exemption) or $928 if the beneficiary is subject to the 5% surcharge.[17/] In addition, the $650 savings begins to evaporate when the trust income is over $13,000.

B. Grantor Trust Rules

(1) Grantor Treated as Holding Power or Interest of Spouse

Under an addition to Section 672, and effective for transfers made after March 1, 1986, any power or interest held by the grantor's spouse (defined as living with the grantor when such power or interest was created) will be deemed to be held by the grantor for purposes of the grantor trust rules.[18/] This rule, combined with

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[17/] Note that a trust is still permitted a deduction of $100.00 (or $300 where all trust income is distributed currently), a charitable deduction and a distribution deduction to the extent of DNI. The exemption for trusts is not phased out as is the exemption for individuals. Code § 1(g)(2)(B).

[18/] Code § 672(e) (added by § 1401 of the Act). Section 672(e) does not define "living with": The Report of the Senate Finance Committee states that, for purposes of the new provision, a spouse is considered to be living with the grantor if such person and the grantor are eligible to file a joint income tax return at the time the transfer is made.

amended Section 673 (see below), eliminates the use of spousal remainder trusts, and also may affect the use of a spouse as a trustee in certain instances.[19/]

(2) Reversionary Interests

Under new section 67, a grantor is treated as the owner of any portion of a trust in which he (or his spouse) has a reversionary interest, if, at the time the trust is created, the present value of his interest exceeds 5% of the value of such portion. (An exception is made for a reversion following the death of a minor beneficiary who is a lineal descendent of the grantor if such person has a present interest in the trust.)[20/]

The Act thus repeals the "10 year exception" to the rule that a grantor who retains a reversionary right to income or corpus is treated as the owner of the trust -- and effectively ends the use of Clifford trusts (and, in conjunction with new section 672(e), spousal remainder trusts as well). A grantor may no longer shift income tax

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[19/] A trust instrument, for instance, may give trustees the power to sprinkle, at their discretion, income and/or corpus among beneficiaries or a class of beneficiaries. Under section 674(c), if more than half of the trustees are independent and if none of the trustees is the grantor, the grantor will not be treated as owner of the trust because of such discretionary power. The 674(c) exception to grantor trust treatment is now lost if the spouse is a trustee. The exception in 674(b)(3) for a power in the grantor to appoint the income of a trust by will is also gone, if the grantor's spouse is given the discretion to accumulate income without consent of an adverse patty.

In addition, trust income which might have been previously taxed to the grantor's spouse under section 678 will now be taxed to the grantor.

[20/] Code § 673 (amended by § 1402 of the Act.)

Liability to the trust or beneficiary for 10 or more years and regain the trust property after the trust term is over -- except in the very limited circumstances provided by new section 673.[21/]

C. Working with the Compressed Rate Schedule and Grantor Trust Rules

(1) New Trusts

There is no longer much income tax incentive for the creation of new trusts based on bracket shifting. The potential benefit of accumulating income at the trust level will, as noted above, diminish in 1988 to $678 per year. And, because of the multiple trust rules, that small benefit is not greatly expandable.[22/]

[21/] Under the 10% actuarial tables used to ascertain the present value of the grantor's reversionary interest (or of a remainder in his spouse), the grantor must transfer a life estate to a person who is 31 years or younger at the time the trust is created or an interest for a term of 32 years or more in order to avoid taxation under new section 673.

The new provision uses the same language as Code § 2037, which includes in a decedent's estate the value of a reversionary interest exceeds 5% of the value of the transferred property. The value of the reversion for estate tax purposes is also computed under the actuarial tables, except that the determination is made as of the date immediately before the decedent's death rather than as of the date of the trust creation.

[22/] The Act makes clear that, in the case of a trust that was irrevocable on March 1, 1984, the multiple trust rules apply only to additions made after that date. Code § 643(f) (amended by § 1806 of the Act).

With the savings on grantor income tax virtually gone, repeal of the Clifford provision is not as serious as it might have been had the 1986 rate structure remained in effect. In fact, the expansion of the grantor trust makes it easier to insure that income will be taxed to the grantor where that is a desired income tax result. Assume, for instance, that a nonresident alien creates a trust for the benefit of his adult children who are United States residents. All income will be distributed to the children for a term of 30 years, with a reversionary interest to the grantor's wife. Trust income distributed to the children will be deemed income of the grantor under new section 673 -- and if the trust property is non-U.S. source property, he will pay no income tax on it.

Evan if the grantor in the example above is an American resident, creation of a trust would continue to be useful to him for purposes of estate and gift tax planning. He, rather than his children, will now be liable for the income tax on distributions to them. In effect, he will be making tax-free gifts to the children of an amount equal to the income tax on the distribution.

(2) Existing Trusts

Accumulation of income by a complex trust is still useful under the throwback rules. Distribution of accumulated income is taxed at the beneficiary's average marginal tax rate over a specified period of time preceding such distribution. A trust, therefore, can take

advantage of the lower tax rates starting in 1987 by postponing the distribution of accumulated income.

D. Taxable Years and Estimated Payments of Trusts

(1) Except for tax exempt and wholly charitable trusts, any non-grantor trust, whether newly created or in existence, must, beginning in 1987, adopt a calendar year as its taxable year. Thus, a trust currently using a fiscal year must file two tax returns for 1987 -- its regular return and a return covering the short period from the end of its fiscal year to December 31, 1987.[23/]

It is not entirely clear whether the trust will be obliged to annualize income for the 1987 short year. The new provision nowhere directs annualization of income, and Code § 443(b) requires annualization of income only if the taxpayer seeks to change his accounting period with the approval of the Secretary under § 443(a). In other cases, where, as here, the change in accounting period is required by law, § 443(b) does not appear to be applicable.[24/]

[23/] Code § 645 (added by § 1403 of the Act). A trust created between now and the end of the year may still choose a fiscal year.

[24/] See, e.g., Irwin Properties Inc. v. Commissioner, 43 T.C. 888 (1965) (where corporate taxpayer complied with income tax regulations requiring it to file a separate return for the short period prior to its affiliation with a group filing a consolidated return, the short period return was not made "by reason of" a change in the taxpayer's accounting period, and Code § 443(b) was inapplicable.); Rev. Rul. 74-585, 1974-2 C.B. 143; Rev. Rul. 70-378; 1970-2 C.B. 178; Rev. Rul. 67-189, 1967-1 C.B. 255.

(2) A beneficiary must spread the trust distributions included in his gross income for the short 1987 taxable year over 4 years beginning in 1987.[25/] The spread provision applies only to distributions not in excess of distributable net income. Thus, if a trust accumulated income in the fiscal year ending in 1987 and distributed such income during the short 1987 year, the amount of that income would be reportable on the beneficiary's 1987 tax return.

(3) For taxable years after December 31, 1987, all trusts will be required to pay estimated taxes in the same manner as individuals.[26/] As a general rule, taxpayers can avoid penalties by paying estimated tax based on the prior year's return.[27/] Those trusts obliged to change from a fiscal year to a calendar year in 1987, however, will not be able to take advantage of that rule, because it is unavailable, where the previous taxable year was less than 12 months.[28/] Thus, a trust distributing all of its income in 1987, but recognizing in 1988 a capital gain that is excluded from distributable net income, cannot avoid estimating in 1988. And the estimated payment for the quarter in which

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[25/] Code § 645(c).

[26/] Code § 6654(k) (amended by § 1404 of the Act). Estates must begin estimated tax payments in any tax year ending two years after the decedent's date of death.

[27/] Code § 6654(d)(1)(B)(ii).

[28/] Code § 6654 (d)(1)(B)(ii). The trust can either base its installment payments on 90% of the tax shown on its return for the current tax year or on its annualized income for the current year. Code § 6654(d) (amended by § 1541 of the Act) increases the percentage of the current year's income tax that is required to be paid in installments from 80% to 90%, and increases the percentage payable in each quarter accordingly.

the gain occurs must make up for the prior quarters in which no estimate was made.

Estimated income tax payments can be avoided altogether by the discretionary trust that distributes all of its income each year.[29/] Where capital gains are involved, steps may have to be taken to insure that the gain enters the computation of distributable net income.[30/]

Alternatively, it may be possible to reduce the estimated income tax payments required of the discretionary trust and its beneficiary by alternating the years of distribution. Assume that a trust may distribute income and/or principal to a beneficiary who has no other taxable income. In the first year, the trust distributes all income (including any capital gains) and owes no tax. In the second year, the trust makes no distributions. It will not be required to make estimated payments, although it will pay tax on the accumulated income. The beneficiary will also make no estimated payments, knowing that he will have no income. In the third year, the trust again distributes all of its current income to the beneficiary and, knowing that it will do so, makes no estimated payments. The beneficiary, having had no tax liability in the previous year, will not be required to make estimated payments.

[29/] Code § 6654(e)(2) provides that no penalty will be imposed upon an individual for failure to pay estimated income tax where such individual did not have any tax liability for the preceding taxable year (if the year was a 12-month year and if the individual was a U.S. resident or citizen during the year).

[30/] Tr. Reg. § 1.643(a)-3(a).

(4) Where estimated payments are required, the trustee may elect (on an income tax return filed within 65 days after the end of the taxable year) to credit any amount of a quarterly payment to a beneficiary as so long as the estimated tax payments exceed the trust's income tax. If the election is made, the credit is considered a distribution under the 65 day rule of section 663, and is thus deemed to have been made by the trust on the last day of the preceding taxable year for income tax purposes. The credit to the beneficiary is treated as a payment of his own estimated tax on January 15 of the year the election is made.[31/]

E. Miscellaneous Itemized Deductions

(1) Rule

Section 67 of the Code, introduced by section 132 of the Act, allows "miscellaneous itemized deductions" only to the extent that they exceed 2% of the taxpayer's adjusted gross income. "Miscellaneous itemized deductions" means all itemized deductions other than the deductions under sections 72(b)3, 163 and 164, certain deductions under sections 165(a), 170, 171, 213, 216, 217, 691(c) and 1341, deductions allowable in connection with personal property used in a short sale and deductions allowed for impairment-related work expenses.

[31/] Code § 643(g) (added by § 1404 of the Act).

Under section 67(c), the Secretary is generally to prohibit the indirect deduction of these items by the use of pass-through entities, but this provision does not apply to estates and trusts. In addition, under section 67(e), the adjusted gross income of an estate or trust is computed in the same manner as in the case of an individual, except that the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and that would not have been incurred if the property were not held in such trust or estate shall be treated as allowable in arriving at adjusted gross income.

While it seems both from these statutory provisions and the legislative history that the 2% rule is not intended to apply to estates and trusts and their beneficiaries, it is not clear how this provision will operate.

(2) Example

(a) A trust required to distribute income currently has $1,100 of dividend and interest income and $100 of miscellaneous expenses that would have been incurred absent a trust.

(1) The trust makes no distribution. The 2% floor seems to apply since neither sections 67(c) nor 67(e) are applicable.

(2) The trustee distributes $1,000. It is probable in this case that, if there were no special provision with respect to the pass-through entities under section 67(c), the beneficiary would be treated as having received $1,100 of income and as having had miscellaneous itemized expenses of $100 under section 652(c). The exclusion of estates and trusts from section 67(c) does not technically change the rule of section 652(c). In addition, the distributable, net income of the trust seems to be reduced by $22 (2% of $1,100), so that amount should remain for taxation at the trust level. In spite of these concerns, the Conference Committee Report indicates that the indirect use of the full deduction should be allowed.

(b) Same as Example (a), except that the $100 of administration expenses would not have been incurred but for the trust.

(1) The trust makes no distribution. Section 67(e) eliminates the floor. In addition, because section 67(e) reduces adjusted gross income, it operates to reduce the floor in cases in which there are other bad expenses.

(2) The trustee distributes $1,000. Now, because of section 67(e), distributable net income is reduced to $1,000. In addition, even if

section 662(c) were applicable, these deductions should be protected by section 67(e).

(c) A trust has income of $1,000 and expenses of $3,000 which were incurred in connection with administration in the taxable year in which the trust terminates. Under section 642(h), the beneficiaries are entitled to a deduction of $2,000.

It is not clear whether the $2,000 deduction would benefit from the provision of Section 67(e) or would simply be treated as a miscellaneous itemized deduction subject to the 2% rule.

(d) At least is some cases, administration expenses will have to be divided between those that would not have been incurred if the property were not held in trust and those that would have been so incurred. It is probable that trustees' commissions and the cost of trust accounting should not be subject to the 2% rule. Similarly the cost of preparing income tax returns for the Trust should also not fall under that rule. On the other hand, investment advice is probably an expense that is not necessarily attributable to the existence of the trust. Bookkeeping expenses fall somewhere in between the two extremes, since some records would have to be maintained in connection with investments in any event.

NEW YORK STATE BAR ASSOCIATION

THE NEW GENERATION-SKIPPING TRANSFER TAX

Carlyn S. McCaffrey

I. INTRODUCTION

A. Present Law

Under existing law, the generation-skipping transfer tax is imposed on certain transfers from generation-skipping trusts. [1] A generation-skipping trust is a trust with beneficiaries assigned to two or more generations below the grantor's generation. A tax is imposed on either a taxable termination, the termination of all interests, of beneficiaries assigned to the higher generation level, or a taxable distribution, a distribution to a beneficiary assigned to a generation at least two generations below the grantor's generation.

B. Problems with Present Law

The existing generation-skipping transfer tax is difficult to understand and apply. Since most trusts have at least contingent beneficiaries who are assigned to more than one generation at least two or more levels below the generation of the grantor, the tax is potentially applicable to most trusts no matter how small.

The only relief from this broad application is a limited exclusion for certain transfers to grandchildren of the trust's grantor. Since, however, the exclusion is not available for all trust interests that pass to grandchildren, the exclusion is available, as a practical matter,

[1] The Generation-skipping transfer tax was enacted as part of the Tax Reform Act of 1976. In general, it is imposed on all generation-skipping transfers that occur after June 11, 1976.

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only to those whose attorneys have drafted their wills and trusts with a specific intention to qualify transfers to grandchildren for the exclusion.

In order to determine the tax a deemed transferor must be identified and the tax must be calculated taking into account his or her prior gifts and, if he or she is deceased, his or her taxable estate.

Exceptions to the tax, such as the exception for income distributions from generation-skipping trusts, make it possible for the wealthiest families to significantly minimize its impact on their estate plans.

In its present form, the generation-skipping transfer tax seems poorly designed to accomplish what Congress now intents it to accomplish, the imposition of a tax, similar to the estate and gift tax, at least once in every generation. The existing generation-skipping transfer tax is imposed only if property is placed in a generation-skipping trust. It can be avoided by those taxpayers who are wealthy enough to "layer" their gifts and bequests to create separate trusts for each generation level.

C. The Tax Reform Act of 1986 [2]

The Tax Reform Act of 1986 would repeal the generation-skipping transfer tax retroactively to June 11, 1976. [3] The old generation-skipping transfer tax would be replaced with a new tax that is somewhat less complex than its predecessor. Significantly, the addition of a $1,000,000 per transferor exemption would eliminate the tax as a source of concern for most small and moderate size estates. The new tax applies to direct transfers to donees who are or more generations below the transferor and

[2] The Tax Reform Act of 1986, H.R. 3838, 99th Cong., 2d Sess., Rep. 99-841, as of this date, has been approved by Congress but yet signed by the President. It is expected that the President will sign it later this month.

[3] All generation-skipping transfer taxes paid under the 1976 Act are to be refunded with interest.

to trusts for their benefit as well as to transfers to individuals who are two or more generations below the transferor from generation-skipping trusts. As a result, it will have broader applicability to wealthier estates than the existing system.

This outline will discuss the principal provisions of the new generation-skipping transfer tax.

II. IMPOSITION OF THE GENERATION-SKIPPING TRANSFER TAX-SECTIONS 2601 AND 2602 [4]

The generation-skipping transfer tax is imposed on every "generation-skipping transfer". The tax is equal to the "taxable amount" multiplied by the "applicable rate". In order to understand what a generation-skipping transfer is and how the tax on one is calculated, it is necessary to learn the definitions or a set of interrelated, complicated terms. It is important not to rely on a knowledge of the defined terms under the existing generation-skipping transfer tax. Although some of the new law's terms and their definitions are similar to those used under the existing generation-skipping transfer tax, in several instances the old terms are used with new definitions. The principal defined terms are discussed in Article III below.

III. DEFINITIONS

A. Generation-skipping Transfer – Section 2611

1. In General

The term "generation-skipping transfer" means either a taxable distribution, a taxable termination or a direct skip. The definitions of these three terms are discussed below in paragraphs J, I, and K of this Article.

2. Exclusions – The exclusions described below are exclusions from the term generation-

[4] All references to "section" or "sections", unless indicated to the contrary, refer to sections of what will be known as the Internal Revenue Code of 1986 if the Tax Reform Act of 1986 is enacted.

skipping transfer only. They do not seem to apply to the definitions of taxable termination, taxable distribution or direct skip. Thus a transfer may be a taxable termination, a taxable distribution or a direct skip without being a taxable transfer. For example, if a transferor transfers funds to a university to pay his grandchild's tuition, he is making a direct skip but not a generation-skipping transfer.

a. Any transfer from a trust, other than a direct skip (for a definition of this term, see paragraph K of this Article). to the extent such transfer is subject to the estate or gift tax with respect to a person in the first generation below the grantor's [5] generation.

For example, suppose A creates a trust to pay income to his son B for life, remainder to such persons, including B's estate, as B may appoint in his will. B dies and exercises his general power of appointment in favor of his daughter C. B's death fits within the definition of a taxable termination (see discussion in paragraph I below). But, since the property will be included in his gross estate under section 2041, it is covered by this exception and will not be treated as a generation-skipping transfer. The exclusion of this transfer from the generation-skipping transfer tax is consistent with the purpose of the generation-skipping transfer tax. It is intended to serve as a substitute for the estate and gift tax when property is passed from one generation to the next either by means of a transfer in trust avoids the estate and gift tax or by means of a direct transfer that

[5] Section 2611 uses the term "grantor". This term is used in the existing generation-skipping transfer tax to refer to the creator of a generation-skipping trust. It is not a defined term in the new generation-skipping transfer tax law. The creator of a trust is referred to in the new law as the "transferor." Presumably, the term "grantor", as used here, means "transferor."

skips over intermediate generations. Since the trust in this example is subject to estate tax at the son's level, it would be inappropriate to subject it to the generation-skipping transfer tax as well.

The meaning of the parenthetical exception of a "direct skip" is unclear. In order for a transfer to be a direct skip, it must be subject to either the estate or gift tax (see paragraph K(1) below). If A is the transferor with respect to the transfer from the trust to C as described above, the transfer would be a direct skip since the transfer is subject to the estate tax and since C is two generations below A's generation. Perhaps the parenthetical refers to a transfer that would be a direct skip if B were treated as the transferor, as would be the case, for example, if he had exercised his power in favor of his grandchild D. It is important that that kind of transfer not be excluded since to do so would avoid a transfer tax at C's generation level.

b. Any transfer from a trust or by will that would have been excluded from the gift tax under section 2503(e) if it has been mace directly by an individual during his or her lifetime. This subsection excludes transfers that are made on behalf of an individual for his or her tuition or for his or her medical expenses. In order to qualify for the gift tax exclusion, the transfer must be made directly to the educational institution or to the persons or institutions providing the medical care. Payments made directly to the donee to be used for these purposes do not qualify. Presumably, the same test of direct payment to suppliers

will have to be met to fit within the generation-skipping transfer tax exclusion. Care must be taken to draft wills and trust instruments to permit these direct payments to suppliers of education and medical care.

c. Any transfer to the extent that the property was subject to a prior generation-skipping transfer tax with respect to which the transferee was either in the same or a lower generation than the transferee in this transfer if the transfers do not have the effect of avoiding the generation-skipping transfer tax.

It is unclear why this exclusion has been provided. If property is held outright by an individual after a generation-skipping transfer has occurred, that individual's future transfers to members of his or her generation or to members of a higher generation will not be subject to the generation-skipping transfer tax. If the transferred property remains in trust after the generation-skipping transfer has occurred, section 2653 (see discussion in paragraph B below) provides that the transferor of the trust for purposes of the generation-skipping transfer tax will be deemed to be assigned to the first generation above the highest generation of any person who has an interest in the trust immediately after the generation-skipping transfer. This means that future transfers from that trust (or from the portion of the trust with respect to which the generation-skipping transfer occurred) to a member of the sane generation or a higher generation than the transferee will not be treated as generation-skipping transfers.

B. Transferor - Sections 2652(a) and 2653

1. In General

In order to determine whether a transfer is a generation-skipping transfer, the identity of the transferor must be ascertained. The transferor with respect to any generation-skipping transfer or with respect to a trust from which a generation-skipping transfer [6] may be made is the decedent if the transfer is one subject to or similar to one subject to the estate tax or the donee if the transfer is one subject to or similar to one subject to the gift tax.

If a husband and wife make a gift and they elect under section 2513 of the gift tax law to treat all gifts to third parties made by either of them during the year in which the gift is made as having been made equally by each of them, each will be treated as the transferor of one-half of the gift for purposes of the generation-skipping transfer tax.

2. Exception for Qualified Terminable Interest Property

If a donor places property in an inter-vivos or testamentary trust to pay income to his or her spouse for life and he or she or his or her executor elects to treat the property as qualified terminable interest property, the spouse will ordinarily become the transferor with respect to any generation-skipping transfers. This is so because the event that permits a transfer of trust property to anyone other than the spouse will result in the inclusion of the property in the spouse’s gross estate or in his or her taxable gifts. The original donor or his or her executor may elect, however, for generation-skipping transfer tax purposes, to have the transfer treated as if the

[6] The word “transfer” as used here seems to mean the transfer to a skip person in the case of a direct skip or the earlier transfer to the trust in the case of a taxable termination or a taxable distribution.

qualified terminable interest property election had not been made. This nears that the original transferor, and not the spouse, will continue to be treated as the trust's transferor even after the trust property has been included in the spouse's gross estate or subjected to gift tax during his or her life.

It is not clear from the statute when the election must be made. It is also not clear whether a partial election can be made or whether the election must be made with respect to all property in a particular qualified terminable interest property trust.

3. Multiple Transferors

The new law makes no provision for determining the identity of the transferor of trusts that have multiple transferors. This problem was dealt with under the Proposed Regulations to the existing law, Prop. Reg. Sec. 26.2611-2(b). Since the problem is similar under both laws, the problem may be resolved in the same way.

Under the Proposed Regulations, if the contributions are made at the same time, the trust is apportioned between the grantors in proportion to their relative contributions. For example, if A contributes $100,000 and B contributes $200,000, A is deemed to be the Grantor as to 2/3 of the trust and B is deemed to be the grantor as to 1/3. If the contributions are made at different times, the proportion is re-established when each contribution is made. For example, suppose, A contributes $100,000 to a trust. Three years later when the trust property is worth $200,000, B contributes $100,000. A will be deemed to be the transferor of 2/3 of the trust and B will be deemed to be the transferor of 1/3 of the trust.

C. Generation Assignment - Section 2651

1. The Transferor's Family

An individual, other than the transferor, is assigned to a generation according to his or her place in the transferor's family tree if he or she is descended from a descendant of a grandparent of the transferor. The chart below illustrates the operation of this rule.

	Grandparent		
	Aunt or Uncle	Parent	
1	1st Cousin	Transferor	Sibling
2	1st Cousin once Removed	Child	Niece or Nephew Nephew
3	1st Cousin twice Removed	Grandchild	Great-niece or Great-nephew
4	1st Cousin three Times removed	Great-grandchild	Great-great niece or Great-great nephew

The individuals listed in row 1 are assigned to the transferor's generation; those in row 2, to the first generation below the transferor's generation; those in row 3, to the second generation below the transferor's generation; those in row 4, to the third generation below the transferor's generation.

If an individual is or was married to a descendant of a grandparent of the transferor (including the transferor), he or she is assigned to the generation of his or her spouse or former spouse who is a descendant of the grandparent.

If an individual is descended from a grandparent of an individual who is or was married to the transferor, he or she is assigned to a generation according to his or her place in the spouse's family tree. Since the spouse is assigned to the transferor's

generation, this means that the spouse’s family members have the same generation assignment that they would have had if they were related to the transferor in the same way as they are related to the spouse. Thus, a transferor’s stepchildren will be assigned to his or her children’s generation and the stepchildren’s children will be assigned to the transferor's grandchildren’s generation.

An individual who is related by adoption is treated as if related by blood. The statute does not indicate whether adoption terminates the adopted individual’s prior blood relationship. For example, suppose A creates a spray trust for the benefit of his wife, W, his children, B and C, B’s child D and C’s child E. On the death of the survivor of B, C, D and E, the trust is to terminate and the trust property is to be distributed to A’s then living issue. B dies while W is still alive; B’s wife marries again, and her husband adopts D. D is now a descendant of his mother and his adoptive father for generation-skipping transfer tax purposes. Does he continue to be a descendant of A? If not, D’s generation assignment for purposes of determining the taxability of distributions from A’s trust will be determined by comparing his age to A’s age instead of by placing him in his appropriate position in A’s family tree. This can lead to inappropriate results. For example, if a comparison of D’s age with A’s age results in D’s assignment to A’s great-grandchildren’s generation, C’s death after W’s death will result in one taxable termination, since there will no longer be any beneficiaries assigned to the transferor’s children’s generation who have interests in the trust; and E’s death, even if he is survived by 2, will result in a second taxable termination, since there will no longer be any beneficiaries assignee to the transferor’s grandchildren’s generation who have interests in the trust.

2. Individuals Not Related to the Transferor

Individuals who are not descendants of a grandparent of the transferor or of a grandparent of an individual who is or was married to the transferor are assigned to generations on the basis of the relationship of their ages to the age of the transferor. An individual who was born less than 12 1/2 years after the transferor, is assigned to the transferor's generation. Each generation thereafter consists of 25 years. Thus, an individual born more than 12 1/2 years and less than 37 1/2 years after the transferor; is assigned to the first generation level below the transferor's generation; and an individual born more than 37 1/2 years and less than 62 1/2 years after the transferor is assigned to the second generation level below the transferor's generation.

3. Entities

If an entity, such as a trust, estate, partnership or corporation, has an interest in property, the individuals who have beneficial interests in the entity are treated as having an interest in the property and are assigned to generations on the basis of their individual statuses or ages. Apparently the entity itself is not given a generation assignment. It is unclear from the statute whether it is necessary to determine each individual's proportional interest in the property and, if so, how to make the determination.

Charitable organizations described in section 511(a)(2) and charitable trusts described in section 511(b)(2) are assigned to the transferor's generation.

4. Multiple Generation Assignment

If application of the rules described above results in an individual's assignment to more than one generation, he or she is to be assigned to the lowest generation. For example, suppose a transferor, after the

death of his daughter, adopts his daughter's son. The son, unless the adoption is deemed to terminate his grandchild relationship to the transferor (see discussion above), has a dual generation assignment. He is to be treated as a member of the lowest of these two generations, the second generation level below the transferor's generation.

The Treasury may provide contrary rules by regulation.

5. Multiple Skips - Section 2653

The problem of dealing with transfers from a trust after the occurrence of a generation-skipping transfer is dealt with by changing the generation assignment of the transferor. Section 2653(a) provides that the transferor of a trust or portion of a trust with respect to which a generation-skipping transfer has occurred shall be deemed to be assigned (for all purposes other than the application of section 2651) to the generation immediately higher than the highest generation to which a person who has an interest in the trust is assigned immediately after the generation-skipping transfer.

D. Skip Person - Section 2613

A skip person is any individual who is assigned to a generation more than one generation below the generation of the transferor. Thus, a transferor's grandchildren and his or her great-grandchildren are all skip persons. A transferor's children are not skip persons.

A trust is a skip person if all persons who have interests in the trust are skip persons. Thus, for example, a spray trust for the transferor's grand children is a skip person since no persons other than skip persons have interests in the trust.

A trust is also a skip person if no person has an interest in the trust (see paragraph F below for a discussion of the meaning of the term

"interest") and if no distribution may be made at any time to any person other than a skip person. Thus, for example, if A creates a trust to accumulate income for 3 years and then to pay income to A's grandchildren and to terminate in favor of the grandchildren when the youngest of them reaches age 21, the trust is a skip person unless there is a possibility that trust property may be distributed to a person in a generation higher than the grandchildren's.

E. Non-skip Person

A non-skip person is any person who is not a skip person. Thus, a transferor's child and a trust of which the child is a current beneficiary is a non-skip person.

F. Interest - Section 2652(c)

1. In General

An interest in a trust is either the present right or present eligibility to receive income or principal from the trust. For example, a person who has the right to receive all of the income from a trust annually, has an interest in that trust; if the right to receive income is to commence in three years, he or she would not have an interest in that trust. A person who may receive income or principal if a trustee's discretion is exercised in his or her favor or if a power of appointment is exercised in his or her favor has an interest in the trust; if the trustee's discretion or the power of appointment is not exercisable currently, he or she would not have an interest in the trust.

Under the existing generation-skipping transfer tax law, it is believed that if a person's liabilities, such as his or her liability to support a trust beneficiary, may be paid by a trust, that person has a beneficial interest in the trust. If a person's minor child is the beneficiary of a trust and the trustee has the power to use trust property for the child's benefit in

such a way as to discharge his or her parents' obligation to support him or her, the parents have interests in the trust. Although it would seem that this type of interest should be treated as a present interest if the trustee can exercise his or her power to pay the liabilities currently, under Proposed Reg. Sec. 2613-4(d), the interest becomes a present interest only after the trustee's power has been exercised to relieve the parents of their obligation. It is unclear how this issue will be resolved under the new law. Accordingly, until the issue is resolved, if it is undesirable for a person in the generation of a minor beneficiary's parents to have an interest in a trust, the trust should specifically provide that trust property may not be used in such manner as to discharge anyone's obligation to support the child.

In addition, a charitable entity described in section 2055(a) is deemed to have an interest in a trust if the trust is a charitable remainder annuity trust or unitrust or if the trust is a pooled income fund even though the charity's right to receive trust property is a future right. Since an organization described in section 2055(a) is also described in either section 511(a)(2) or 511(b)(2), this means that a taxable termination (see discussion in paragraph I below) will never occur in a charitable remainder annuity trust or unitrust or in a pooled income fund even when an annuitant assigned to one generation dies and is succeeded by a member of a lower generation. This eliminates the risk that a potential liability to pay a generation-skipping transfer tax would destroy a trust's eligibility for charitable remainder annuity trust or unitrust or pooled income trust status.

2. Exception for Nominal Interests

Interests created "primarily to postpone or avoid the generation-skipping transfer tax" are to be disregarded. No criteria are provided to help determine when an interest

is of the type to be disregarded. The Proposed Regulations under the existing generation-skipping transfer tax, Prop. Reg. Sec. 26.2613-2(b)(3) contain a set of guidelines for making this determination These may form a basis for making a similar determination under the new law. Under the Proposed Regulations, the determination is to be made based on all of the facts and circumstances. More specifically, the following interests are characterized as substantial: (1) a beneficiary's right to receive trust property the value of which is at least 5% of the value of the trust, (2) any interest if the beneficiary is a descendant of the grantor's grandparent and (3) if the beneficiary is not a descendant of the grantor's grandparent, a discretionary interest if at least 5% of the value of the trust is distributed to the beneficiary annually. Even if a person's interest satisfies one of the tests described above, it may still be disregarded if it is determined that, under all the facts and circumstances, it was not intended that the person benefit from the interest.

G. Trust - Section 2652 (b)

The meaning of the term "trust" is not restricted to the word trust in its common law sense. It also includes "an arrangement (other than an estate) which has substantially the same effect as a trust." The statute contains the following examples of the arrangements that may be deemed to be "trusts": life estates and remainders, estates for years and insurance and annuity contracts. It is not clear what arrangements the term is intended to include other than those specifically listed.

The existing generation-skipping transfer tax contains a similar definition for the term "generation-skipping trust equivalent." An important distinction is that under existing law the intent was to reach arrangements which had a generation-skipping effect, i.e., they permitted more than one generation to share the same property successively or simultaneously. Thus a

life estate for a son followed by a remainder interest to a grandson has a generation-skipping effect because the son and the grandson each have successive temporal shares in the property and they are assigned to different younger generation levels. A life estate for a spouse followed by a remainder interest to a grandson would not be a generation-skipping trust equivalent since it does not permit sharing between two different beneficiaries who are assigned to different younger generation levels. Similarly, under the Proposed Regulations, a custodianship under the Uniform Gifts to Minors Act for a grantor's grandchild with a living parent who has an obligation under local law to support him is a generation-skipping trust equivalent because the funds can be used for the economic advantage of the parent as well as the child and because the parent and child are assigned to different younger generation levels. Prop. Reg. Sec. 26.2611-4. If the grandchild's parents were not alive, the custodianship would not be a generation-skipping trust equivalent since it would not be an arrangement that permits sharing of property by members of different younger generation levels.

The new law's "arrangements" that have the same effect as trusts do not have to have any multi-generation sharing. Thus a life estate for a grandchild followed by a remainder to another grandchild is probably a trust. A custodianship under the Uniform Gifts to Minors Act is probably a trust whether or not the child's parents are living or whether under local law the custodianship funds may be used to discharge a support obligation. Since multi-generation sharing is not required, the term trust may be even broader. Arguably, the quality that separates trusts from other arrangements is the separation of legal title from beneficial interest that enables the title holder to manage property for the holder of the beneficial interest. This same objective can be achieved by a family controlled partnership or a family controlled corporation. For example, a grandfather who would like to give his grandson shares of the X corporation, a publicly traded corporation, but who wants the child's parent to

have control over the investment, may achieve this objective: (1) by putting the shares in a trust of which the son is trustee; (2) by putting the shares in a partnership in which the son holds a small general partnership interest and in which the grandson holds a limited partnership interest; or (3) by putting the shares in a corporation in which the son holds one voting share and the grandson 99 nonvoting shares. Does this mean that a partnership or a corporation may be characterized as a trust?

H. Trustee - Section 2652(b)

The term trustee means, in the case of an arrangement that is treated as a trust, the person "in actual or constructive possession of the property."

I. Taxable Termination - Section 2612

A taxable termination occurs whenever a person's interest in a trust terminates, regardless of the reason for the termination, unless immediately after the termination, a non-skip person has an interest in the trust or, if immediately after the termination, no person has the right to receive or may receive immediate distributions from the trust, if there is no possibility of a distribution ever being made from the trust to a skip person.

For example, if the transferor's daughter's interest in a trust terminates and at her death the trust property is to be held in further trust for her children, the daughter's death is a taxable termination. If distributions may be made from the trust after the daughter's death to another child of the transferor as well as to the daughter's children, a taxable termination has not occurred because the other child is a non-skip person and he or she has an interest in the trust. This conclusion would not apply, however, if it were concluded that the other child's interest were merely a nominal one. See discussion at F(2) above.

If at the daughter's death, the trustees were directed to accumulate the income for two years,

no person would have an interest in the trust immediately after the daughter's death. The determination of whether a taxable termination has occurred will depend, therefore, on what may happen at the end of the two year period. If at the end of the two year period, the trust property is to be paid to another child of the transferor, the termination would seem not to be a taxable termination. This is unlikely, however, unless provision for ultimate disposition, in the event designated beneficiaries who are non-skip persons die before the trust is terminated, is made in favor of a charitable organization. Unless a charitable organization is the ultimate beneficiary there would always be the possibility that trust property might be paid to a skip person. A disposition in favor of the estate of a non-skip beneficiary or in favor of the transferor or his or her estate would not satisfy this requirement, since a possible sequence of deaths could always result in property passing to a skip person.

There is no specific provision that states that, in the case of a partial taxable termination, the payment by the trustee of the generation-skipping transfer tax, a payment required by section 2603(2), is to be treated as an additional partial termination. Section 2603(b) provides that the tax shall be charged, unless the governing instrument provides otherwise, to the property that is the subject of the transfer. Suppose that a trust agreement provides that B, the transferor's son, is to receive all of the income from Blackacre, one of the trust's assets, until his 65th birthday. After his 65th birthday, B's son C is to receive all of the income from Blackacre. The trustee has the discretion to pay trust income from other sources to B or C. The trust agreement provides that, in the event of a taxable termination with respect to part of the trust assets, the generation-skipping transfer tax is to be paid from other trust assets. B's 65th birthday will be a taxable termination with respect to Blackacre. Suppose Blackacre is worth $100,000, that the applicable rate is 50%, and that the trustees pay a generation-skipping

transfer tax of $50,000 from other trust assets as they are required to do by the terms of the trust agreement. The $50,000 payment (or perhaps the mere liability for payment under the terms of the trust agreement) is arguably an additional termination since the payment will terminate B's interest in it. When the trustees pay $25,000 of generation-skipping transfer tax on this amount, the payment (or perhaps the liability for payment under the trust agreement) will create an additional termination. This process would continue until a total of $100,000 in generation-skipping transfer taxes has been paid by the trust on a total of $200,000 worth of taxable terminations.

J. Taxable Distribution - Sections 2612(b) and 2621(b)

Any distribution from a trust to a skip person is a taxable distribution unless the distribution is a taxable termination. It is unclear how a distribution could be a taxable termination. A distribution rarely occurs simultaneously with a termination. Some period of time generally passes between the terminating event and the distribution. The exception may suggest that a distribution is to be treated as a taxable termination if the distribution terminates a non-skip person's interest in the distributed property. If this is so, all distributions from trusts to skip persons will be treated as taxable terminations and not as taxable distributions if at the time of distribution no non-skip person has an interest in the trust.

In addition, the amount of any generation-skipping transfer taxes paid by the trust with respect to any taxable distribution is treated as a taxable distribution. Suppose, for example, that A, a skip person, receives a distribution of $100,000 from a trust. Suppose further that the trustee agrees to pay whatever generation-skipping tax is attributable to the distribution. Assume that the applicable generation-skipping transfer tax rate is 50%. The tax that the trustees must pay will be $100,000, 50% of $200,000. This is the sum of

the amount actually distributed to A plus the amount of taxes paid.

K. Direct Skip - Section 2612(c)

1. In General

Any transfer to a skip person that is subject to a tax imposed by chapter 11 or 12 of the Code is a direct skip. Thus, an outright, completed gift by a transferor to her grandchild is a direct skip. Similarly, a completed gift to a trust in which only skip persons have interests is a direct skip. This is so even if non-skip persons may receive or have the right to receive distributions from the trust in the future.

The phrase “subject to a tax imposed by chapter 11 or 12 of the Code” as used in section 2612(c) apparently includes donative transfers that are not actually subjected to gift tax because of the availability of a gift tax exclusion under section 2503(b) or (e) of the Code. This conclusion is suggested by the text of section 2642(c) (discussed below) which provides a special method for treating these kinds of gifts for purpose of calculating the generation-skipping transfer tax.

The transferor is liable for the tax on direct skips. Section 2603(3). His payment of this liability does not create an additional direct skip. In the case of direct skips made during the transferor’s lifetime, however, the amount of the generation-skipping transfer tax paid becomes an additional taxable gift under new section 2515. Suppose, for example, A gives $100,000 to his grandchild C. A’s gift tax bracket is 50%. The applicable rate for generation-skipping transfer tax purposes is also 50%. The amount of tax A pays on the transfer will be $125,00, calculated as follows:

generation-skipping transfer -		$100,000
generation-skipping transfer tax -		$50,000
gift -	$100,000	
	$50,000	
	$150,000	
gift tax -		$75,000
	Total Tax	$125,000

2. Exception for Transfers to Certain Grandchildren

For purposes of determining whether a particular transfer is a direct skip (but apparently for no other purposes) if a transfer is made to an individual who is a grandchild of the transferor or of a person to whom the transferor is or was married, and at the time of the transfer the grandchild's parent who is descended from the transferor or from the transferor's spouse or former spouse is dead, the individual shall be treated as if he were a child of the transferor. For example, suppose A makes a gift of $100,000 to his grandson C at a time when A's son and C's father B is dead. The gift will not be treated as a direct skip since, for purposes of determining whether it is a direct skip, C is to be treated as a child of A. If S's gift were to a trust in which only C held an interest, rather than outright, the gift would not be a direct skip because C is to be treated as A's child. A possible problem arises, however, when a distribution is made from the trust to C. There is no provision that treats C as A's child for purposes of determining whether a taxable distribution has taken place. Since the initial transfer into the trust was not a direct skip, no generation-skipping transfer took place and, as a result, section 2653's multiple skip rule (discussed above in paragraph C) will not apply to change the generation assignment of the transferor to A's children's generation.

IV. CALCYLATION OF THE GENERATION-SKIPPING TRANSFER TAX

A. In General - Section 2602

The tax is calculated by multiplying the taxable amount by the applicable rate. Section 2602.

B. Taxable Amount

1. Taxable Distribution - Sections 2621 and 2624(d)

The amount of a taxable distribution is an amount equal to (a) the value of the property received by the distributee, (b) reduced by the cost of any expenses incurred by him or her in connection with the determination, collection or refund of the generation-skipping transfer tax and (c) decreased by the amount of any consideration paid by the transferee. Presumably, the deduction for costs may give rise to deductions both for generation-skipping transfer tax purposes and, under section 212, for income tax purposes as well.

For example, suppose C, a skip person, receives a distribution of $101,000 from a trust. He pays $1,000 to an accountant to file his generation-skipping transfer tax return. The amount of the taxable distribution is $100,000. Suppose, instead, that he purchased the distributed asset from the trust for $50,000. The amount of the taxable distribution should be $50,000, $101,000 reduced by $1,000 and reduced by $50,000.

2. Taxable Termination - Sections 2621 and 2624

The amount of a taxable termination is an amount equal to (a) the value of the trust assets with respect to which the termination has occurred, (b) reduced by any expenses incurred or liabilities owed in connection with such property that are similar to the expenses that are deductible under section 2053 of the estate tax law and (c) reduced

by any consideration provided by the transferee.

Deductible expenses would presumably include trust termination expenses such as trustee commissions and legal and accounting fees. When expenses such as these are deducted for estate tax purposes, section 642(g) of the Code prevents a duplicate deduction of the same expenses for trust income tax purposes. Section 642(g) has not been amended to preclude a double deduction of these expenses for income and generation-skipping transfer tax purposes.

The method for determining the value of the consideration that may have been paid by the transferee is unclear. Suppose in year 1, A sells a remainder interest in Blackacre, retaining a life estate, to her granddaughter C for $100,000, an amount equal to the present value of the right to receive $200,OOO at A’s death. The full, fair market value of Blackacre is $200,000. The sale is not a direct skip, not because full consideration was paid, but because the life estate - remainder arrangement is a deemed trust and A’s retained interest in the deemed trust prevents the transfer from being treated as a direct skip. A’s death, which causes a taxable termination, occurs in year 5 when Blackacre, which has doubled in value, is worth $400,000. What is the amount of the taxable termination? Is it $300,000, the value of Blackacre reduced by the actual amount of the consideration paid by C? Is it $200,000, the value of Blackacre reduced by the consideration paid by C multiplied by 2 to reflect Blackacre’s appreciation? An alternative approach might be to conclude that the termination of A’s interest was not a taxable termination at all because C simply received what she paid for and in an economic sense she should be viewed as the transferor of what she received. The statute provides no answer.

3. Direct Skip - Sections 2623 and 2624

The taxable amount in the case of a direct skip, is the value of the property received by the transferee reduced by the value of any consideration paid by the transferee.

C. Valuation - Section 2624

1. In General

Property that is the subject of a generation-skipping transfer is to be valued at the time the transfer occurs.

2. Alternate Valuation

In the case of a direct skip as to property included in the transferor's gross estate, the value of the property shall be the same as the value of the property for estate tax purposes. This means that if the transferor's executor elects to use the alternate valuation method permitted by section 2032, the property will be valued as of the date 6 months after the date of the transferor's death or, if the property is disposed of prior to that date, on the date of disposition. The present version of section 2032 prohibits an alternate valuation election unless the election would reduce the size of the decedent's gross estate and the amount of the estate tax. The Tax Reform Act of 1986 would amend section 2032 to provide that the election must reduce the sum of the estate tax and the generation-skipping transfer tax as well as the value of the gross estate.

In the case of a taxable termination that occurs at the same time as and as a result of the death of an individual, an election may be made to value the trust property in accordance with section 2032. Since section 2032 does not actually asp1y to taxable terminations, the meaning of this section is unclear. It perhaps means that the principles of section 2032 should apply to taxable terminations. If this is so, it may

be that all of the principles of section 2032, including the principle that prevents an election unless the size of the tax base and the size of the tax are reduced by the election, apply to taxable terminations.

3. Special Use Valuation Election

In the case of a direct skip with respect to property that is included in the transferor's gross estate, the value of the property is date-mined with regard to the special use valuation election provided by section 2032A if the executor elects to use 2032A for purposes of determining the transferor's gross estate.

D. Applicable Rate - Section 2641(a)

The applicable rate with respect to any generation-skipping transfer is an amount equal to the maximum Federal estate tax rate multiplied by the inclusion ratio.

E. Maximum Federal Estate Tax Rate - Section 2641(b)

The maximum Federal estate tax rate is the maximum rate imposed by section 2001 on the estates of decedents who die at the time the generation-skipping transfer takes place. Under current law, this rate will be 55% for transfers taking place in 1986 and 1987 and 50% for transfers taking place thereafter.

F. Inclusion Ratio - Section 2642

1. In General

The inclusion ratio for any generation-skipping transfer is the excess of 1 over the "applicable fraction."

2. Nontaxable Gifts

The inclusion ratio of a nontaxable gift is zero. This means that the generation-skipping transfer tax with respect to the gift will be zero since the product of the

maximum Federal estate tax rate and zero is zero. If a nontaxable gift that is nay a direct skip is the first transfer to a trust, the inclusion ratio for that trust will be zero. A nontaxable gift is not, it is important to note, any gift that is nontaxable on account of a deduction allowable by the gift tax law. The term when used in the generation-skipping transfer tax provisions is limited to any gift to the extent that it is excluded from the transferor's taxable gifts by reason of section 2503(b) (applied in conjunction with section 2513) and section 2503(e). This means that the first $10,000 outright gift that a grandparent makes to his or her grandchild is a nontaxable gift for generation-skipping transfer tax purposes. Since it is a nontaxable gift, its inclusion ratio is zero and it will not be subject to the generation-skipping transfer tax. A similar result applies to the grandparent's payment of his or her grandchild's tuition or medical expenses.

G. Applicable Fraction - Section 2642

1. The Numerator

The numerator of the applicable fraction is the amount of the generation-skipping transfer exemption allocated to the trust with respect to which a generation-skipping transfer has occurred or to the property that is the subject of a direct skip. If no exemption has been allocated, the numerator is zero.

2. The Denominator

a. In General

The denominator of the fraction is the value of the property transferred to the trust or the property that is the subject of the direct skip reduced by only two amounts. Reductions are allowed for the amount of any Federal or state estate or death taxes

recovered from the trust that are attributable to the transfer and any charitable deduction permitted under section 2055 or section 2522.

It is unclear whether the estate tax payments or the gift tax payments that are permitted to reduce the denominator are limited to payments of tax with respect to the transferor. Suppose, for example that A creates a qualified terminable interest property trust for the benefit of her husband H and funds it with $200,000. A elects to treat the transfer for generation-skipping transfer tax purposes as if the QTIP election had not been made. This means that she will continue to be treated as the transferor even after H's death when an estate tax will be paid from the trust property. She also elects to allocate $100,000 of her generation-skipping transfer tax exemption to the trust. During H's life, the applicable fraction for this trust is 100,000/200,000 or 1/2. At H's death, if the trust property is worth $200,000 and the estate taxes paid by the trust are $100,000, the applicable fraction will become 100,000/100,000 or 1/1 if H's estate taxes reduce the denominator.

b. Valuing the Denominator

(1) In General

The value of the property in the denominator is to be determined as of the time the transfer to the trust or the direct skip occurs. Two explicit exceptions and one implied exception to this timing rule are described in "(3)", "(4)" and "(5)" below.

(2) Transfers Subject to the Gift Tax

If a transfer is subject to the gift tax, the value of the property in the denominator of the fraction is its value for gift tax purposes if the generation-skipping transfer exemption is allocated to it on a timely filed gift tax return or if the exemption is deemed to be allocated to it under section 2632(b)(1).

The allocation is to be effective as of the date of the gift.

(3) Transfers That Take Place and Allocations That Are Made At or After the Death of the Transferor

Property that is included in the gross estate of the transferor is to be value at its value for estate tax purposes. This seems to be so, although not explicitly stated, even if a value other than the date of death value is used for estate tax valuation purposes.

If an allocation is made after the transferor’s death it is to be effective as of the date of the transferor’s death.

(4) Allocations Made During a Transferor’s Life That Are Not Made on a Timely Filed Gift Tax Return

If a transferor allocates his or her exemption during his or her life and does not make the allocation on a timely filed gift tax return and if the allocation is not deemed to have been made, the value of the property for purposes of establishing the value of the denominator shall be the

value of the property on the date the allocation is made.

(5) Qualified Terminable Interest Property Trusts

If the spouse who is the beneficiary of a qualified terminable interest property trust is treated as the transferor of that trust and if the property in the trust is included in his or her gross estate under section 2044, the value of the property in the denominator shall be its value for estate tax purposes in the spouse's estate.

(6) Multiple Transfers to A Trust

Each time additions are made to a trust, its applicable fraction must be recalculated in the following manner. The numerator becomes the sum of the amount of the generation-skipping transfer exemption allocated to the transfer plus the nontax portion of the trust immediately before the transfer. The nontax portion of the trust is an amount equal to the value of all property in the trust multiplied by the applicable fraction of the trust (before adjusting for the addition). The denominator of the fraction is the sum of the value of all property in the trust immediately before the transfer plus the value of the property transferred reduced by the amount of any deduction allowed under section 2055 or section 2522.

To illustrate how this provision works, assume that A transfers $100,000 to a spray trust for his son B and his granddaughter C. No part of his generation-skipping

transfer exemption is allocated to the transfer. At the time of the transfer, the property in the trust is worth $200,000. When the trust was created two years ago with a transfer of $100,000, A allocated $50,000 of his generation-skipping exemption to the transfer. The applicable fraction before the addition was $50,000/$100,000 or 1/2. The nontax portion, 1/2 multiplied by $200,000, is $100,000. The numerator of the new fraction is zero (since no exemption was allocated to the addition) plus $100,000, the nontax portion. The denominator of the new fraction is $200,000, the value of the property in the trust before the addition, plus $100,000, the amount of the addition, or $300,000. The new fraction, therefore, is $100,000/$300,000 or 1/3.

(7) Treatment of Nontaxable Gifts

If a transfer to a trust is a nontaxable gift and not a direct skip, its value is not to be included in the denominator of the applicable fraction.

3. Observation

The fact that the denominator is reduced by the amount of the estate or gift tax charitable deduction allowed with respect to a transfer to a trust makes charitable lead trusts useful devices for minimizing the generation-skipping transfer tax. If a transferor transfers $100,000 to a trust to pay charity an annuity of $11,600 for 21 years and to pay the remainder to his grandchildren at the end of the 21 year term, the amount of the gift tax charitable deduction is $100,000, the present value of charity’s annuity. This means that the

denominator of the applicable fraction is 0 and that the applicable fraction is 1 (or perhaps infinity) even if no generation-skipping transfer tax exemption is allocated to the trust. As a result the inclusion ratio for the trust is 0 and the trust property will pass free of generation-skipping tax as well as gift tax at the termination of charity's annuity.

H. The Generation-skipping Transfer Exemption

Even individual is entitled to a $1,000,000 generation-skipping transfer exemption that may be allocates by the transferor or his or her executor. The allocation may be made at any time before the due date for the federal estate tax return due on account of the transferor's death. If an individual makes a direct skip while he or she is alive, the exemption will be deemed to be allocated to the direct skip to the extent necessary to reduce its inclusion ratio to zero unless the transferor elects to the contrary.

If an individual dies without using his or her exemption and if his or her executor fails to allocate the exemption on or before the due date for the estate tax return, the exemption will be allocated first pro rata among all direct skips that occur at his or her death. To the extent there is any remaining exemption, it is to be allocated among all trusts created by the transferor during his or her lifetime from which generation-skipping transfers might be made. This allocation is made in proportion to the nonexempt portions of each such trust. The nonexempt portion of a trust is an amount equal to the value of the trust property multiplied by the trust's inclusion ratio.

Since an individual who agrees to treat 1/2 of all gifts made by his or her spouse during a particular year as having been made by him or her is treated as the transferor of that 1/2 for generation-skipping transfer tax purposes, he or she has the opportunity to protect that transfer from the generation-skipping transfer tax, just as the actual transferor does, with his or her exemption. This means, for example, that a

husband or wife may transfer up to $2,000,000 to his or her grandchildren without paying a generation-skipping transfer tax if the spouse of the transferor elects to treat one-half of the gift as having been made by him or her

I. Credit for Certain State Taxes - Section 2604

A credit against the Federal generation-skipping transfer tax is allowed-for any generation-skipping transfer tax paid to any state if the generation-skipping transfer is not a direct skip and if it occurs at the time of and as a result of the death of an individual. The credit is limited to 5% of the amount of the Federal generation-skipping transfer tax.

For example, suppose A creates a trust to pay income to her son B for life, remainder to her grandson, C and funds it with $50,000 worth of property. At B's death, which causes a taxable termination to occur, the property in the trust is worth $100,000. No exemption was allocated to the trust. No estate or gift taxes were paid from the trust and no charitable deduction was permitted in connection with the transfer to the trust. The applicable fraction of the trust is, therefore, 0/50,000 or zero. The inclusion ratio is 1 minus 0 or 1. The maximum Federal estate tax rate is 50%; the applicable rate is 1 multiplied by 50% or 50%. The amount of the generation-skipping transfer tax computed before application of the credit is $50,000. The trust must pay a state generation-skipping transfer tax of $10,000. The credit that will be allowed against the $50,000 tax is the lesser of $10,000 or 5% of $50,000. Since 5% of $50,000 is $2,500, this will be the amount of the credit.

V. INCOME TAX ASPECTS OF TEE GENERATION-SKIPPING TRANSFER TAX

A. Basis Adjustments - Section 2654

The basis of property transferred in a generation-skipping transfer is to be adjusted in a manner similar to the basis adjustment permitted by section 1015 for gift taxes paid. The basis is to be increased (but not above its

fair market value) by the amount of the generation-skipping transfer tax attributable to the excess of the fair market value of the property over its basis immediately before the transfer. For example, suppose A transfers $100,000 to his granddaughter C and allocates no exemption to the transfer. The basis of the property immediately before the transfer is $50,000. He pays a $50,000 generation-skipping transfer tax with respect to the transfer. Of this amount, 50% or $25,000 is attributed to the unrealized appreciation. The basis adjustment allowed by section 2654 is $25,000.

In addition, the basis should be adjusted under section 1015. This section seems to operate simultaneously with section 2654 and should produce an additional basis increase of $25,000 calculated as follows. The amount of the taxable gift is $150,000, the $100,000 actual gift plus the $50,000 generation-skipping transfer tax, which is treated as a taxable gift. Assume A's gift tax bracket is 50%. The gift tax he must pay is, therefore, $75,000. Of this amount, $25,000 is attributable to the excess of the fair market value of the gifted property over its basis immediately before the transfer. This seems to produce an additional basis increase of $25,000. The basis of the property in the hands of C has been increased to its fair market value.

If the generation-skipping transfer is a taxable termination and if the termination occurs at and as 2 result of the death of an individual, the basis is to be adjusted in a manner similar to the basis adjustment provided in section 1014 for property included in the gross estate of a decedent. This basis adjustment produces an increase or a decrease to the fair market value for federal estate tax purposes. Application of the section 1014 approach in the context of the generation-skipping transfer tax would presumably produce a value equal to the value of the property for generation-skipping transfer tax purposes. If the inclusion ratio of the property is less than 1, section 2654 limits the basis increase (but apparently not any basis decrease) to an amount equal to the inclusion

ratio multiplied by the amount of the increase determined without taking into account this limitation.

B. Income Tax Deduction for- Generation-skipping Transfer Taxes - Sections 164 and 691

1. Section 164

Section 164 will be amended to provide an income tax deduction for the Federal generation-skipping transfer tax and any state generation-skipping transfer tax to the extent that the distribution that created the liability is included in the taxpayer's gross income. This deduction is necessary to prevent a taxpayer from paying both a generation-skipping transfer tax and an income tax on the same amount. In the absence of this deduction, a beneficiary's total tax on a taxable distribution could be 105% in 1986 (the sum of an income tax bracket of 50% and a generation-skipping transfer tax bracket of 55%), 93 1/2% in 1987 and 86% in 1988 and thereafter.

No section 164 deduction is permitted if section 666 applies to the distribution. This section requires the inclusion in a trust beneficiary's gross income of certain distributions of accumulated income. No section 164 deduction is needed to prevent double taxation since section 557 provides a tax deduction, against the special tax on accumulation distributions for generation-skipping transfer taxes paid.

2. Section 691

If a generation-skipping transfer tax is a taxable termination or a direct skip and if it occurs as a result of the death of the transferor, the amount of the generation-skipping transfer tax attributable to any item of income not included in the gross income of the trust or the transferor for a taxable period within which falls the date of the transferor's death shall be allowable as a deduction to the person or trust that

must include such item of income in his, her or its gross income. In calculating the amount of this deduction, principles similar to those used in calculating the deduction permitted by section 69l(c) for estate taxes are to be used.

C. Redemptions of Stock to Pay Generation-skipping Transfer Taxes

Under certain circumstances, section 303 permits sale or exchange treatment for redemptions of corporate stock included in a decedent's gross estate. Section 303 would be amended by the Tax Reform Act of 1986 to extend sale or exchange treatment to certain generation-skipping transfers that occur at the same time as and as a result of the death of an individual.

VI. TIME FOR REPORTING GENERATION-SKIPPING TRANSFEZS AND PAYING GENERATION-SKIPPING TRASSFES TAX

A. In General - Sections 2662 and 2603

1. Direct Skips

In the case of a direct skip, the transferor (or presumably his or her executor, if he or she is dead) is required to pay the generation-skipping transfer tax and to file the appropriate return. The return is due on or before-the-date on which the estate or gift tax return reporting the transfer is due unless the direct skip is from a trust. If the direct skip is from a trust, the return is due by the 15th day of the 4th month after the close of the trust's taxable year within which the transfer took place.

2. Taxable Distributions

In the case of a taxable distribution, the distributee is required to pay the generation-skipping transfer tax and to file the appropriate return. The return is due by the 15th day of the 4th month after the close of the distributee's taxable year within which the transfer took place.

3. Taxable Terminations

In the case of a taxable termination, the trustee is required to pay the generation-skipping transfer tax and to file the appropriate return. The return is due by the 15th day of the 4th month after the close of the trust's taxable year within which the transfer took place.

B. Extension of Tine - Section 6166

In the case of a direct skip that occurs as a result of the transferor's death, the generation-skipping transfer tax is to be treated as if it were an additional estate tax for purpose of section 6166's deferral rules.

VII. EFFECTIVE DATES - SECTION 1433 OF THE TAX REFORM ACT

A. In General

The new generation-skipping transfer tax is to apply to all generation-skipping transfers that occur after the date of enactment of the Tax Reform Act of 1986. All inter vivos transfers made after September 25, 1965 are deemed, however, to have occurred after the enactment date.

B. Exceptions

The new generation-skipping transfer tax will not app1y to:

1. A transfer from a trust that was irrevocable on September 25, 1985 except to the extent that the transfer is not made out of corpus added to the trust after September 25, 1985.

This language was presumably intended to prevent avoidance of the new generation-skipping transfer tax by means of post-September 25, 1985 additions to pre-existing irrevocable trusts. It does not, however, do a complete job. If a post-September 25, 1985 addition is made to a trust in which both skip and nonskip persons have interests, the addition itself is not subject to the new generation-skipping transfer tax. Future principal distributions from the trust to skip persons, by analogy to the regulations under the effective date rules that were enacted in connection with the Tax Reform Act of 1976, would probably be treated as in part protected and in part subject to the new tax in a ratio that reflects relative values on the date the post-September 25, 1985 addition was made. Reg. Sec. 26.2601-1(c). Because of the way the addition language is phrased, however, future income distributions, since income distributions are clearly not made out of corpus, seem to escape the new generation-skipping transfer tax entirely. If this is so, transfers to pre-September 25, 1985 irrevocable trusts may significantly minimize future generation-skipping transfer taxes.

2. Any generation-skipping transfer made under a pre-enactment will if the decedent dies before January 1, 1987.

3. Any direct skip which occurs as a result of the death of the transferor under a trust to the extent that it consists of property that is included in the Gross estate of a decedent and that was owned by the trust prior to the enactment date if the decedent on the enactment date lacke5 the legal capacity to change the disposition of his property and did not regain legal competence before his death.

4. Transfers to Grandchildren

Any transfer to a grandchild, to the extent that the transfer, when added to a transferor’s pre-September 25, 1985, does

not exceed $2,000,000 but only if such transfer is made prior to January 1, 1990.

C. Repeal of Existing Generation-skipping Transfer Tax

The existing generation-skipping transfer tax is to be repealed retroactively to June 11, 1976. Any taxes paid under the existing law are to be refunded with interest. The statute of limitations for filing for a refund is to be extended to the day prior to the first anniversary of the date of enactment of the Tax Reform Act of 1986.

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COMPLIANCE PROVISIONS
TAX REFORM ACT OF 1986

I. Penalties:

A. Penalties for Failure to file Information Returns or Statements.

Present Law: Civil penalties are imposed for failure to file required information returns (detailing wages and other types of income) and for failure to provide a copy to the taxpayer. These penalties are $50 for each failure with a maximum penalty under each provision of $50,000 per year. A penalty is imposed of either $5 or $50 (depending on the nature of the failure for failure to furnish a correct taxpayer identification number. Under present law, there is no penalty for including other incorrect information on an information return.

New Law: The maximum penalty for failure to file required information returns and failure to supply copies to taxpayers is raised to $100,000 for each category of failure. A new penalty for failure to include copy is added. The new the information return or the taxpayer copy is added. The new penalty is $5 for each information return or copy for the taxpayers, up to a maximum of $20,000 per year does not apply in cases of intentional disregard.

Effective Date: Return due (without regard to extensions) after December 31, 1986. Certain modifications of the information are effective on the date of enactment.

B. Increase in Penalty for Failure to pay Tax.

Present Law: Under current law, a taxpayer who fails to pay taxes when due must pay a penalty of one-half of one percent of the tax for the first month not paid and an additional one-half of one percent for each additional month the failure to pay continues, up to a

maximum of twenty-five percent. The penalty can be abated if the failure to pay is due to reasonable cause and not willful neglect. The penalty not only applies to a taxpayer who fails to pay taxes shown on the tax return, but also to a taxpayer who fails to pay taxes not shown on the return within ten days of notice and demand for payment by the Internal Revenue Service.

New Law: The penalty for failure to pay taxes is increased from one-half of one percent per month to one percent per month in instances where the Internal Revenue Service has notified the taxpayer that it will levy upon the assets of the taxpayer. In the situation where a notice of the intention to levy has occurred, the notice must be sent out by the Internal Revenue Service at least ten days before the levy occurs (unless the collection of the tax is in jeopardy). In that case, the increase in the penalty occurs at the start of the month following the month in which the ten day period expires. In the event the collection of the tax is in jeopardy, the Internal Revenue Service may make notice and demand for immediate payment of the tax and, if taxpayer without regard to the ten-day requirement. In this situation, the increased penalty occurs at the start of the month following the month in which notice and demand is made.

Effective Date: Generally effective for periods after December 31, 1986.

C. Negligence and Fraud Penalties.

Taxpayers are currently subject to a negligence penalty if any part of an underpayment of tax is due to negligence or intentional disregard of rules or regulations. The first component of the penalty is equal to five percent of the total underpayment where any portion of the underpayment is attributable to negligence or intentional disregard of rules or regulations. The second component is an amount equal to one-half the interest payable on the portion of the underpayment attributable negligence or intentional disregard, for the period beginning on the last day prescribed for payment of the underpayment and ending on the date of assessment of the tax. Once the Service has determined that negligence exists, the burden is on the taxpayer to establish that this determination is erroneous. In the case of omission of interest or dividend payments, however, the burden of proof on the taxpayer is greater and the portion of the underpayment attributable to this

omission is treated as due to negligence in the absence of clear and convincing evidence to the contrary. The negligence penalty applies only to underpayment of income taxes, gift taxes and the windfall profits tax.

Taxpayers also are subject to a penalty if any part of an underpayment of taxes is due to fraud. This penalty overrides the negligence penalty and both penalties cannot be applicable to the same underpayment. The fraud penalty cannot be applicable to the same underpayment. The penalty is equal to fifty percent of the total underpayment where any portion of the underpayment is attributable to fraud and an additional amount equal to one-half the interest payable on only the portion of the underpayment atributable to the fraud for the period beginning on the last day prescribed for payment of the underpayment and ending on the date of assessment. The burden of proof in establishing fraud is on the Internal Revenue Service.

New Law: The scope of the negligence penalty is expanded and made applicable to all taxes under the Code. The statute also expressly includes within the scope of the definition of negligence any failure to make a reasonable attempt to comply with the provisions of the Code. The special negligence penalty that currently is applicable to failure to include income interest and dividends shown on an information return has been expanded to apply to failures to show any amount that is show on any information return. The applicable information returns for this purpose are those that are subject to the penalties for failure to provide information returns.

The fraud penalty is modified by increasing the rate of the penalty from fifty to seventy-five percent and by narrowing the scope of the fraud penalty so that in effect it applies only to the amount of the underpayment attributable to fraud, rather than to the entire underpayment. The law provides that once the Internal Revenue Service has established that any portion of an underpayment is attributable to fraud, the entire underpayment is treated as attributable to fraud, except to the extent that the taxpayer can establish that any portion of the underpayment is not attributable to fraud.

The law provides that if an underpayment of tax is partially attributable to negligence and partially attributable of fraud, the negligence penalty will not

apply to any portion of the underpayment with respect to which a fraud penalty is imposed.

Effective Date: Applicable to returns the due date of which (determined without regard to extensions) is after December 31, 1986.

D. Penalty for Substantial Understatement of Tax Liability.

Present Law: If a taxpayer substantially understates income tax for any taxable year, the taxpayer must pay an additional tax equal to ten percent of the underpayment of tax attributable to the understatement. An understatement is substantial if it exceeds the greater of ten percent of the tax required to be show on a return or $5,000 ($10,000 in the cast of most corporations). The penalty generally does not apply to amounts with respect to which (1) there was substantial authority for the taxpayer's treatment for the amount, or (2) the taxpayer discloses the relevant facts with respect to that amount on the tax return.

New Law: The addition to tax for a substantial underpayment of tax liability is increased from ten percent to twenty percent of the amount of the underpayment of tax attributable to the understatement.

Effective Date: Returns the due date of which (determined without regard to extensions) is after December 31, 1986.

II. Interest Provisions:

A. Differential Interest Rate.

Present Law: Taxpayers must pay interest to the Treasury on underpayment of tax and the Treasury must pay interest to taxpayers on overpayments of tax. Both the rate taxpayers pay to the Treasury and the Treasury pays to taxpayers are the same rate which is determined semiannually and is equal to the prime rate quoted by large commercial banks as determined by the Board of Governors of the Federal Reserve System.

New Law: The interest rate the Treasury will pay to taxpayers on overpayments will equal the federal short term interest rate, plus two percentage points. The interest rate that taxpayers will pay to the Treasury on

underpayments will be the federal short term interest rate, plus three percentage points. The rates will be rounded to the nearest full percentage. The interest rates will be adjusted quarterly.

B. Interest on Accumulated Earnings Tax.

Present Law: Interest on the accumulated earning tax is charged only from the day Internal Revenue Service demands payment of the tax rather that the date the return was originally due to be filed.

New Law: Interest is imposed on underpayments of the accumulated earning tax from the due date (without regard to extensions) of the income tax return for the year the tax is initially imposed.

Effective Date: Returns that are due (without regard to extensions) after December 31, 1985.

III. Information Reporting Provisions:

A. Information Reporting on Real Estate Transactions.

Present Law: Treasury regulations currently require that brokers must file information returns on the business they transact for customers with respect to sales of securities, commodities, regulated futures contracts and precious metals. Reporting on real estate transactions is not currently required under the regulations.

New Law: Real estate transactions must now also be reported. The primary responsibility for reporting is on the person responsible for closing the transaction, including any title company or attorney who closes the transaction. The Treasury will provide uniform rules to determine the person with primary responsibility for the information reporting. If no person is responsible for closing the transaction, the reporting must be done by the mortgage lender or, if none, by the seller’s broker or, if none, in accordance with Treasury regulations. It is anticipated that this information will be done on a form 1099 similar to that required for other transactions effected by brokers.

Effective Date: Real estate transactions with respect to which closing on the contract occurs on or after January 1, 1987.

B. Information Reporting on Persons Receiving Contracts from Certain Federal Agencies.

Present Law: There is no provision that requires information reporting on persons receiving federal contracts.

New Law: The head of each Federal Executive Agency is required to file an information return indicating the name, address and taxpayer identification number of each person with which the Agency enters into a contract. The Secretary is given the authority to establish minimum amounts for which no reporting is necessary, as well as to extend the reporting requirements to federal license grantors and subcontractors of federal contracts.

Effective Date: All contracts signed on or after January 1, 1987.

C. Information Reporting on Royalties.

A number of provisions of the Code require that payors of specified payments report these payments to the Internal Revenue Service and provide a copy of the information report to the taxpayer receiving the payment. Treasury regulations currently require information reporting on royalties for payments totaling $600.00 or more during the taxable year.

New Law: A new provision of the Code requires that persons who make payments of royalties aggregating $10,00 or more to any other person in a calendar year must provide an information report on the royalty payment to the Internal Revenue Service. A copy of this information report must be supplied to the taxpayers.

Effective Date: Royalty payments made after December 31, 1986.

D. Taxpayer Identification Numbers Required for Dependents Claimed on Tax Returns.

Present Law: There is currently no requirement that a taxpayer claiming a dependent on a tax return

report the taxpayer identification number (TIN) of that dependent on that tax return. A taxpayer's TIN is generally that taxpayer's social security number.

New Law: A taxpayer claiming a dependent who is at least five years old must report the taxpayer identification number of that dependent on that tax return. Penalty for failing to include the TIN of a dependent (or for including an incorrect TIN) is $5.00 per TIN per return. In addition, the Internal Revenue Service may continue its current practice of denying any deduction for a dependent if it cannot be established that it is proper to claim that dependent on the return.

Effective Date: Returns due on or after January 1, 1988 (without regard to extensions).

E. Tax Exempt Interest Required to be Shown on Tax Returns.

Present Law: Currently, taxpayers are not required to record the amount of tax exempt interest they receive on their tax returns.

New Law: Tax exempt interest received or accrued during a taxable year must now be included on the taxpayer's tax return.

Effective Date: Tax years beginning after December 31, 1986.

F. Modification of Separate Mailing Requirement for Certain Information Reports.

Present Law: Payors of interest, dividends, and patronage dividends are required to report such payments to the Internal Revenue Service and to provide a copy of this information report to the taxpayer who received the payment. These information reports are made on IRS Form 1099 or authorized substitute. The Code requires that the copy of the information report be supplied to the taxpayer either in person or in a separate first class mailing. Generally, nothing other than the information report is permitted to be enclosed in the envelope.

New Law: If the information report is supplied to the taxpayer by mail, certain enclosures may now be included. The only enclosures that can be made with the information mailing are: (1) a check, (2) a letter

explaining why no check is enclosed such as, for example, because a dividend has not been declared payable), or (3) a statement of the taxpayer's specific account with the payor (such as a year-end summary of the taxpayer's transactions with the payor). The envelope must state on the outside "Important Tax Return Document Enclosed." In addition, each permitted enclosure must state "Important Tax Return Document Enclosed."

Effective Date: Information returns with respect to interest, dividends and patronage dividends filed after the date of enactment.

G. Tax Shelter Registration.

Present Law: Tax shelter organizations are required to register with the IRS tax shelters they organize, develop, or sell. A tax shelter is any investment for which the ratio of the deductions, plus 200 percent of the credits to the cash actually invested is greater than two to one. The investment also must (1) be subject to federal or state securities requirements, or (2) be privately placed with five or more investors with an aggregate amount that may be offered for sale exceeding $250,000.

New Law: Tax credits will be multiplied by 350 percent (instead of 200 percent) to conform the tax shelter ratio computation to the new tax rate schedule.

Effective Date: tax shelters in which interest are first offered for sale after December 31, 1986.

H. Penalty for Failure to Report the Tax Shelter Identification Number.

Present Law: If a taxpayer invests in a tax shelter that has a tax shelter identification number, the taxpayer is required to include that number on the taxpayer's tax return. The penalty for failure to do so is $50.00 unless the failure is due to reasonable cause.

New Law: Penalty for failure to report a tax shelter identification number on a tax return is increased from $50,00 to $250,00. The exception where failure to report the number is due to reasonable cause remains unchanged.

Effective Date: Tax returns filed after the date of enactment.

I. Penalty for Failure to Maintain a List of Tax Shelter Investors.

Present Law: Organizers and sellers of specified tax shelters are required to maintain a list of investors. The penalty for failure to do so is $50.00 for each name missing from the list unless the failure is due to reasonable cause, up to a maximum of $50,000.00 per year.

New Law: The maximum penalty that can be imposed in any calendar year is raised from $50,000.00 to $100,000.00.

Effective Date: Failures occurring are continuing after the date of enactment.

J. Tax Shelter Interest.

Present Law: If an underpayment of tax is more than $1,000,00 and is attributable to a tax-motivated transaction (such as a tax shelter), the interest on that underpayment is computed at 120 percent of the generally applicable interest rate. In a recent tax court decision, it was held that sham transactions that would be subject to this special interest rate were they not shams are not subject to this special interest rate because they are shams.

Technical Correction: Sham or fraudulent transactions specifically added to the list of transactions are subject to this higher interest rate. The law reverses the holding of the recent tax court decisions holding to the contrary. This clarification of present law applies to interest accruing after December 31, 1984, which is the date the higher interest rate took effect. The clarification does not apply to any underpayment with respect to which there was a final court decision before the date of enactment of this act.

IV. Estimated Tax Payments.

A. Individuals.

Present Law: To avoid penalty, individuals must make quarterly estimated tax payments that equal at least

the lesser of 100 percent of the previous year's tax liability or 80 percent of the current year's tax liability. Amounts withheld from wages are considered to be estimated tax payments.

New Law: The law increases from 80 percent to 90 percent the proportion of the current year's tax liability that taxpayers must pay as estimated taxes in order to avoid the estimated tax penalty. The alternate test of 100 percent of the preceding year's liability remains unchanged.

Effective Date: taxable years beginning after December 31, 1986. The estimated tax payment due January 15, 1987, which is the final payment for tax year 1986, is unaffected.

B. Certain Tax Exempt Organizations.

Private foundations are subject to an excise tax on their net investment income and tax exempt organizations are subject to the regular corporate tax on income from unrelated business. These taxes are paid when the tax returns are filed under present law.

New Law: Quarterly estimated payments must be made of the excise tax on net investment income of private foundations and of the tax on unrelated business income of tax exempt organizations. These quarterly estimated payments must be made under the same rules apply to corporate income taxes.

Effective Date: taxable years beginning after December 31, 1986.

C. Waiver of Estimated Tax Penalties.

If the withholding of income taxes from wages does not cover an individual's total income tax liability, the individual, in general, is required to make estimated tax payments. An underpayment of an estimated tax installment will, unless exceptions are applicable, result in an addition to tax on the amount of the underpayment for the period of underpayment.

New Law: The new law makes several changes that increase tax liabilities from the beginning of 1986. Individual taxpayers will be allowed until April 15, 1987 and corporations will be allowed until March 15, 1987 to

pay their full 1986 income tax liabilities without incurring any additions to tax on account of underpayments are attributable to changes in the law.

D. Authority to Rescind Statutory Notice of Deficiency.

Present Law: Under present law, once the IRS Has issued a statutory notice of deficiency (90-day letter), the IRS does not have the authority to withdraw the letter.

New Law: If the IRS and the taxpayer mutually agree, a statutory notice of deficiency may be rescinded. Once the notice has been properly rescinded, it is treated as if it never existed. Also, the IRS may issue a later notice for a deficiency greater or lesser than the amount in the rescinded notice. The Secretary of the Treasury has the authority to establish by regulation the procedures necessary to implement the withdraw of notice provisions. The regulations will also clarify the effect of rescision on other provisions of the Code.

Effective Date: Statutory notices of deficiency issued on or after January 1, 1986.

E. Authority to Abate Interest Due to Errors or Delay by the IRS:

Present Law: Under present law, the IRS does not generally have the authority to abate interest charges for additional interest caused by IRS errors and delay unless the interest has resulted from a mathematical error of an IRS employee who assist taxpayers in preparing their income tax returns.

New Law: where an IRS official fails wither to perform a ministerial act in a timely manner or makes an error in performing a ministerial act, the IRS has the authority to abate the interest attributable to such delay. No significant aspect of the delay can be attributable to the taxpayer. The interest abatement only applies to the period of time attributable to the failure to perform the ministerial act. The provision applies only to failures to perform ministerial acts that occur after the IRS has contacted the taxpayer in writing. Accordingly, this provision does not permit the abatement of interest for the period of time between the date the taxpayer files a return and the date the IRS commences an

audit, regardless of the length of that time and regardless of how long the IRS took to contact the taxpayer and request payment. The IRS is not mandated to abate the interest except in certain instances in which it issues an erroneous refund check. The requirement does not apply in instances in which the taxpayer (or a related party) has in any way caused the overstated refund to occur, and it does not apply to any erroneous refund checks that exceed $50,000. If the taxpayer does not repay the erroneous refund when requested by the IRS, interest will then begin to apply to the amount of the erroneous refund.

Effective Date: Taxable years beginning after December 31, 1978.

F. Suspension of Compounding Where Interest on Deficiency is Suspended.

Present Law: In the case of a deficiency in income, estate, gift, and certain excise taxes, a waiver of restrictions on assessments of the deficiency is filed when the IRS and the taxpayer agree on the proper amount of tax due at the conclusion of an audit. If the Secretary fails to make notice and demand for payment within thirty days after filing of the waiver, interest is not imposed on the deficiency from the 31st day after the waiver was filed until the date the notice and demand is issued. The provision does not, however, suspend the compounding of interest for the same period on the interest which previously accrued on the underlying deficiency.

New Law: Both the interest on the deficiency as well as the compounded interest on previously accrued interest are suspended, starting thirty-one days after a taxpayer has filed a waiver of restrictions on assessment of the underlying taxes and ending when a notice and demand is issued to the taxpayer.

Effective Date: Interest accruing and taxable periods after December 31, 1982. Taxpayers may obtain refunds of interest subject to this provision by filing a claim for refund with the IRS. Taxpayers who consider themselves entitled to the relief provided by this provision may apply to the IRS, and in appropriate cases, the IRS will perform the required computations.