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Report No. 1503
November 19, 2024

The Honorable Aviva Aron-Dine
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The Honorable Daniel I. Werfel
Commissioner
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The Honorable Marjorie A. Rollinson
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Internal Revenue Service
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Re: NYSBA Tax Section Report No. 1503 - Report on GST Tax

Dear Mses. Aron-Dine and Rollinson, and Mr. Werfel:

Please see attached Report No. 1503 of the Tax Section of the New York State Bar Association, which discusses recommendations in response to a generation-skipping transfer tax guidance project that was recently announced in the Treasury Department and Internal Revenue Service Priority Guidance Plan for the 2024-25 plan year.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Jiyeon Lee-Lim
Chair

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Report No. 1503

New York State Bar Association

Tax Section

Report on the GST Tax Effect of Assignments of Beneficial Interests

November 19, 2024

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New York State Bar Association
Tax Section

Report on the GST Tax Effect of Assignments of Beneficial Interests

This report (the "**Report**")[1] provides recommendations in response to a generation-skipping transfer ("**GST**") tax guidance project ("**Project**") that was recently announced in the Treasury Department and Internal Revenue Service Priority Guidance Plan for the 2024-25 plan year. While the Project is described as "Regulations under §2642 regarding the redetermination of the inclusion ratio on the sale of an interest in a trust for GST exemption purposes," it is anticipated that the Project will bring welcome clarity in an area of uncertainty and longstanding debate. In addition, as discussed in this Report, the Project is critical to the proper functioning of the GST tax. New rules can ensure that assignments of beneficial interests are not used to avoid GST tax even as property passes down generations. Conversely, new rules, if drafted without potential abuses in mind, could inadvertently make the GST tax easy to avoid.

Our primary recommendation is simple: The Treasury Department and the Internal Revenue Service (the "**Service**") should confirm, by regulation, that the assignment of a beneficial interest in a trust, whether by gift or by sale, has no effect on the GST tax attributes of underlying trust property, whether those attributes be the identity of the property's transferor or its inclusion ratio. Our solution, as discussed in this Report, is not only consistent with the statutory definition of "transferor" and existing Treasury Regulations, but also prevents abuse and protects the integrity of the GST tax. We further recommend computation adjustments in some cases.

This Report is divided into three parts. Part I summarizes our principal recommendations. Part II provides an overview of the relevant GST tax rules, as well as certain topics that are closely related to the Project, including the GST taxation of grantor retained annuity trusts ("**GRATs**") and charitable lead annuity trusts ("**CLATs**"). Finally, Part III describes our recommendations.

I. Summary of Principal Recommendations

Our recommendations are as follows:

1. New rules should address the GST tax consequences of assignments of beneficial interests made by gift as well by sale.

2. New rules should address the GST tax consequences of assignments of beneficial interests,

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[1] The principal author of this Report is Austin Bramwell. Significant contributions were made by Amy Albert, Jaime Halberstam, Alan Halperin, and Sean Imfeld. Helpful comments were received from Stephen Land, Jiyeon Lee-Lim, Carlyn McCaffrey, Michael Schler, and Libin Zhang. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of the New York State Bar Association Executive Committee or the House of Delegates.

regardless of whether an inclusion ratio is potentially required to be recomputed.

3. Rules addressing the effect of assignments of beneficial interests should apply not only to beneficial interests that can be valued using standard actuarial tables (such as remainder interests in GRATs and CLATs) but also to restricted beneficial interests that arguably can be heavily discounted in order to reflect uncertain contingencies.

4. New rules should confirm that the assignment of a beneficial interest, whether by gift or by sale, has no effect on either the identity of the transferor of trust property or the property's inclusion ratio.

5. Treas. Reg. §26.2652-1(a)(5) Example 4 should be retained, expanded, and clarified.

6. Adjustments in the computation of GST tax should be permitted in some cases following the assignment of a beneficial interest.

7. New rules should address possible tax-avoidance strategies that attempt an end-run around the general rule that an assignment of beneficial interest does not change the GST tax attributes of underlying trust property.

II. OVERVIEW OF GST TAX, GRATS, CLATS, AND THE VALUATION OF BENEFICIAL INTERESTS

A. Overview of GST Tax

Purpose of GST tax. The GST tax is designed to backstop the estate and gift tax system by ensuring that transfers of wealth from one generation to the next are taxed, including in situations where neither the gift nor the estate tax applies.[2] Prior to the enactment of the GST tax, wealthy individuals, by making gifts or bequests to long-term trusts, effectively could cause wealth to pass down multiple generations, yet only pay gift or estate tax once. The GST tax closed this gap by imposing an additional tax on transfers of property to grandchildren and other "skip" persons who are two or more generations below that of the transferor.

The GST tax is implemented through a complex lexicon of interrelated technical terms. Below, we summarize the definitions and rules that are most relevant to the discussion in this Report.

[2] *See generally* "Report to the President on Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President," Volume 1 at 144-45 (November 27, 1984)("The gift tax and the GST tax are designed on the whole to ensure that taxpayers cannot easily avoid the estate tax through lifetime gifts, multigenerational trusts, and similar arrangements."). An initial version of a GST tax was enacted as part of the Tax Reform Act of 1976. Pub. L. No. 94-455, 94th Cong., 2d Sess. (1976), § 2006. Approximately ten years later, the Tax Reform Act of 1986 retroactively repealed the initial version and replaced it in in its entirety with the GST tax in its current form (as since amended). Pub. L. No. 99-514, 99th Cong., 2d Sess. (1986), §§ 1431-33.

*Generation-skipping transfer ("**GST**").* A GST is defined as one of three categories of transfers, known as "direct skips, "taxable terminations," and "taxable distributions."[3] Each of the three types of GST involves a transfer to a "skip person," i.e., an individual, such as a grandchild, or a trust, such as a trust for grandchildren, that is assigned to a generation that is two or more generations below that of the transferor.[4] A direct skip is a transfer to a skip person that is subject to gift or estate tax.[5] A taxable termination is the termination of an interest in property held in trust,[6] unless (i) immediately after the termination, a non-skip person has an interest in the trust property or (ii) at no time after the termination may a distribution be made a skip person.[7] Finally, a taxable distribution is a distribution from a trust to a skip person, other than a direct skip or a taxable termination.[8]

Transferor. In order to determine whether a transfer of property is a GST, it is essential to identify the "transferor" of the property in question. As noted, the GST tax only applies to transfers to a "skip person," and "skip persons" are defined by reference to the transferor.[9] The term "transferor" is defined as the decedent, in the case of property subject to estate tax, or the donor, in the case of property subject to gift tax.[10] Treasury Regulations clarify that the transferor is the individual who was most recently subject to gift or estate tax.[11]

GST tax rate and effect of the inclusion ratio. The GST tax rate is generally equal to the highest estate tax rate in effect.[12] However, the applicable GST tax rate effectively can be reduced, often to as low as zero percent, through the allocation of what is known as "GST exemption."[13] The GST exemption is an amount granted to every individual in order to shield a portion of his or her wealth transfers from GST tax.[14]

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[3] IRC § 2611(a). All Section (or §) references are to the Internal Revenue Code of 1986, as amended (the "**Code**" or "**IRC**") or the Treasury regulations, unless otherwise specified.
[4] IRC § 2613(a)(1). For the rules on generation assignment, see Section 2651.
[5] IRC § 2612(c)(1); Treas. Reg. § 26.2612-1(a).
[6] The term "interest in property held in trust" has a technical meaning for GST tax purposes, as provided in Section 2652(c). In the case of an individual or a noncharitable tax-exempt entity, an interest in trust property means a current right or eligibility to receive distributions of income or principal. In the case of a tax-exempt charity, an interest in trust property means a remainder interest in a charitable remainder trust or pooled income fund or a right to current distributions of income or principal.
[7] IRC § 2612(a)(1). Treas. Reg. § 26.2612-1(b) clarifies that if a transfer subject to gift or estate tax occurs at the same time as an interest terminates, the termination is not a taxable termination.
[8] IRC § 2612(b); Treas. Reg. § 26.2612-1(c).
[9] IRC § 2613(a)(1).
[10] IRC § 2652(a)(1).
[11] Treas. Reg. § 26.2652-1(a)(1). In determining whether a transfer was subject to gift or estate tax, exemptions, exclusions, deductions, and credits are not taken into account. Treas. Reg. § 26.2652(a)(2).
[12] IRC § 2641(a)(1).
[13] By Section 2631, every individual has an amount of GST exemption equal to the "basic exclusion amount" available for estate tax purposes under Section 2010.
[14] IRC § 2631(a). In 2025, the GST exemption will be $13,990,000 per individual. Rev. Proc. 2024-40 at 2.41 (specifying the "basic exclusion amount" for 2025, to which the GST exemption is pegged pursuant to Section 2631(c)).

Mechanically, the reduction of the applicable GST tax rate works as follows:

First, all property subject to gift or estate tax, including property held in trust, is assigned an "applicable fraction." In most cases, the applicable fraction is equal to the amount of GST exemption that the transferor allocates to the property, divided by the value of the property transferred.[15]

Second, the applicable fraction produces a converse fraction, known as the inclusion ratio. The inclusion ratio is simply 1 minus the applicable fraction.[16] For example, if a donor makes a $1 million gift to an irrevocable trust and timely allocates $750,000 of GST exemption, then the trust's applicable fraction is $750,00 divided by $1 million, or 0.750. The inclusion ratio is 1 - 0.750, or 0.250.

Third, in order to determine the applicable GST tax rate, the inclusion ratio is multiplied by the highest estate tax rate.[17] The highest estate tax rate is currently 40%.[18] Thus, for example, if the inclusion ratio of a trust is 0.250, then the applicable GST tax rate is 40% x 0.250, or 10%. This rate is then used to compute the GST tax on taxable terminations and taxable distributions with respect to trust property.[19]

In practice, it is common for wealthy individuals to create irrevocable trusts that enjoy an effective 0% GST tax rate, due to the allocation of GST exemption. For example, in 2025, both the lifetime gift tax exemption amount available to all U.S. citizens and residents[20] and the GST exemption will be $13,990,000.[21] An individual in 2025, having not previously used up any GST exemption, could create an irrevocable trust for his or her descendants and fund it with $13,990,000. If the donor also allocates $13,990,000 of GST exemption, the trust will have an applicable fraction of 1 and an inclusion ratio of 0. A zero percent GST tax rate, assuming no further gifts to the trust or distributions from other trusts, will thereafter apply to all future taxable terminations and taxable distributions.

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[15] IRC § 2642(a)(2). In some cases, the denominator is reduced by (i) death taxes recovered from the transferred property and/or (ii) the amount of any gift or estate tax charitable deduction. As an example, if an individual creates a valid charitable lead unitrust or "CLUT," the denominator of the applicable fraction is reduced by the amount of the charitable deduction for the charity's unitrust interest. *See* IRC §§ 2055(e)(2)(B), 2522(c)(2)(B).

[16] IRC § 2642(a)(1).

[17] IRC § 2641(a).

[18] IRC § 2001(c).

[19] The applicable fraction is determined for the trust with respect to which a GST is made. IRC § 2642(a)(1)(A).

[20] *See* IRC § 2505. The lifetime gift tax exemption is not a true exemption but rather is the amount of aggregate lifetime taxable gifts that are shielded from tax by a credit, known as the unified credit. In some cases, the credit is increased by the unused credit amounts inherited or "ported" from a deceased spouse. IRC §§ 2010(c)(2)(B), 2505(a)(1).

[21] Rev. Proc. 2024-40 at 2.41; IRC §§ 2505(a)(1), 2631(c).

B. Overview of GRATs and CLATs

Grantor retained annuity trusts or "GRATs" and charitable lead annuity trusts or "CLATs" are both statutorily approved techniques for leveraging the taxable amount of a wealth transfer, as computed for gift or estate tax purposes. By contrast, for different reasons, GRATs and CLATs are not effective techniques for leveraging GSTs free of GST tax. The basic gift and GST tax consequences of GRATs and CLATs are described below.

GRAT overview. A GRAT is an irrevocable trust in which the grantor retains the right to a series of fixed payments for a certain period, typically defined as a fixed number of years. Once the annuity period ends, the balance of the GRAT property, after payment of the final annuity amount to the grantor, passes as directed in the trust instrument, such as in further trust for the grantor's descendants. When the GRAT is created, the grantor is treated as making a taxable gift equal to the value of the remainder interest at the time of creation.[22] In general, the value of the taxable gift is equal to the entire value of the property transferred to the GRAT, less the present value of the grantor's retained annuity interest.[23] The present value of the retained annuity interest is determined by applying the actuarial tables prescribed pursuant to Section 7520, provided that the grantor's retained interest meets the requirements of Section 2702(b)(1)[24] or, if the gift of the remainder is not made to or for benefit of a member of the grantor's family within the meaning of Section 2704(c)(2),[25] the retained annuity is susceptible of measurement.[26]

GRATs are a popular gift tax planning technique, in part because they enable donors to leverage the amount of their taxable gifts.[27] For example, suppose that an individual transfers $10 million to a GRAT and retains the right, for a period of five years, to a stream of annual payments. Suppose, further, that the present value of the stream of annuity payments, as determined under Section 7520, is $9.5 million.[28] In that case, the grantor makes a taxable gift

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[22] Treas. Reg. § 25.2511-1(e). The Code does not provide a mechanism for taxing increases in the value of property after a transfer subject to gift or estate tax is made.
[23] Treas. Reg. § 25.2511-1(e).
[24] *See* IRC § 2702(a)(2).
[25] In that case, Section 2702 does not apply and does not determine the value of the retained annuity. IRC § 2702(a)(1).
[26] Treas. Reg. § 25.2511-1(e).
[27] GRATs have other advantages besides leverage. For example, if GRAT assets underperform the Section 7520 present value discount rate, then the assets of the GRAT simply return to the grantor in the form of annuity payments. Thus, the grantor bears all the risk of underperformance, while the remainder beneficiaries remain entitled to the gains. Effectively, thanks to the Section 7520 valuation methodology, the option value of the remainder is transferred free of gift tax on formation. The tax-free transfer of option value can be maximized by creating multiple GRATs, each funded by different assets and each of which has a relatively short term, such has two years.
[28] Applying the present value discount rate for November 2024 of 4.4%, *see* Rev. Rul. 2024-24, the annuity amounts payable to the grantor would be approximately $2,158,000, assuming that payments are not set to increase (or decrease) annually, as permitted (to the extent of 20% per year) by Treas. Reg. § 25.2702-3(b)(1)(ii).

of $500,000. Nevertheless, because the grantor's retained annuity payments are fixed, the remainder beneficiaries effectively earn investment returns on the full value of the trust, less the annuity payments.

GRATs and GST tax. Although, as discussed, GRATs permit a grantor's taxable gift to be leveraged for gift tax purposes, the same leverage is not available for GST tax purposes. Consider the following example:

> Example 1: An individual (G1) funds a GRAT with $10 million and retains the right to a stream of fixed payments for a 5-year period. The present value of the annuity payments at the time that the GRAT is created is $9.5 million.[29] Upon termination of the fixed term, the reminder is directed to be paid over to G1's grandchild (G3). Thanks to relatively strong investment performance over the 5-year fixed term, which exceeds in each year the present value discount rate used to determine the value of the grantor's retained annuity interest, the value of the remaining property, after payment of the final annuity amount, is $2 million.[30]

In this example, G1 makes a taxable gift of only $500,000, yet $2 million passes free of gift tax at the end of the fixed term. Effectively, the value of the gift quadrupled in only 5 years. G3 could not have earned such impressive returns merely by reinvesting $500,000 and earning the same rate of return as the GRAT. On the contrary, in that case, G3 would only end up with approximately $735,000. The increase in the wealth passing to G3 in Example 1 is made possible by the G3's effective use of the funds dedicated to paying the annuity amount to the grantor – in short, through a very high degree of leverage.

Efficient as GRATs may be for transmitting wealth free of gift tax, they do not produce the same favorable results for GST tax purposes. On the contrary, in Example 1, the termination of G1's retained annuity interest is a taxable termination that is subject to a 40% GST tax.[31] The trustee of the GRAT must report and pay a GST tax of 40% on $2 million, or $800,000.[32] Net of a GST tax, G3 only receives $1.2 million. Put another away, both the value of the initial gift to G3 and the full amount of the increase in value over the fixed term are subject to GST tax, whereas only the initial amount of the gift is subject to gift tax.

In principle, GST tax could be reduced or eliminated if G1 allocates GST exemption to

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[29] Once again, if the GRAT in this example is created in November 2024, the annuity amounts payable to the grantor would be approximately $2,158,000 for each of the 5 years of the fixed term.

[30] If the GRAT was created in November 2024, when the present value discount rate is 4.4%, the annual investment returns would need to be approximately 8% a year in order to generate a $2 million remainder at the end of the fixed term.

[31] The termination of the grantor's retained annuity interest meets the definition of taxable termination, because (i) the grantor's interest in the trust terminates, (ii) after termination of the grantor's annuity interest, no non-skip person has an interest in the trust property, and (iii) after termination, a distribution may be made – indeed, is required to be made – to a skip person, namely, G3. IRC § 2612(a).

[32] IRC § 2603(a)(2).

the GRAT. However, an allocation of GST exemption to a GRAT, if it is possible at all,[33] is wasteful and undesirable. Suppose that, in Example 1, G1 allocates $10 million of GST exemption to the GRAT.[34] The $10 million allocated indeed would cause the GRAT to have an inclusion ratio of zero. However, because most of the GRAT property returns to the grantor in the form of annuity payments, the allocation is wasteful. G1 would have to allocate $10 million of GST exemption in order to protect an eventual transfer to G3 of only $2 million – a very poor result.[35]

Overview of CLATs. Just as a GRAT is a trust in which the grantor retains the right to a series of fixed payments, a charitable lead annuity trust or CLAT, as the name suggests, is a trust in which a charity is granted the right to a series of fixed payments.[36] The term of a CLAT may be a period of years or the lives of certain permitted measuring lives.[37] If the charitable annuity meets the requirements of a guaranteed annuity, it can qualify for a gift or estate tax charitable

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[33] Section 2642(f) provides that GST exemption generally may not be allocated to property transferred during life during the period, known as the "estate tax inclusion period" or "ETIP," that such property would be includible in the donor's (or the donor's spouse's) gross estate if the donor were to die (other than by reason of Section 2035). The grantor's retained annuity interest causes GRAT property to be included in the grantor's gross estate tax at death under Section 2036(a)(1), if the grantor dies during the fixed term. *See Badgley v. U.S.*, No. 4:17-cv-00877 (N.D. Cal. 5/17/18), aff'd 125 AFTR 2d 2020-1909 (9th Cir. 2020). Thus, in general, the ETIP rule applies to GRATs and protects taxpayers from wasteful allocations of GST exemption. Unfortunately, however, Treas. Reg. § 26.2632-1(c)(2)(ii)(A) permits an allocation of GST exemption if the possibility that the property will be included is so remote as to be negligible, which is defined as a less than a 5% probability that the property will be included in the gross estate. With a short-term GRAT, therefore, where the likelihood of death during the fixed term is low, it is at least arguable that GST exemption can be wastefully (and presumably inadvertently) allocated to a GRAT.

[34] G1's GST exemption must be allocated to the GRAT as a whole; it may not be allocated merely to a remainder interest in a trust. IRC § 2642(a)(1)(A)("[T]he applicable fraction [is] determined for the trust from which [a generation skipping transfer] is made"); *see also* Treas. Reg. § 26.2652-1(a)(5), Example 9 (providing that a spouse electing to split gifts under Section 2513 with the grantor is treated as the transferor of one-half of the entire GRAT, and not just one-half of the remainder interest). The Treasury Department and the Internal Revenue Service should be aware that some commenters nevertheless suggest that taxpayers can take the position that GST exemption can be allocated merely to the remainder interest in a GRAT. *See*, *e.g.*, Manigault and Hatcher, "GRATs and GST Planning," Probate & Property (November/December 2006) at 32 (asking "Why not try it?" and arguing that the downsides of a purported allocation merely to the remainder are low).

[35] Contrary to a widespread and oft-repeated misconception, it is not the ETIP rule of Section 2642(f) that prevents efficient GST tax planning with GRATs. On the contrary, it is that the general definition of the applicable fraction makes it unwise to allocate GST exemption to a GRAT. In fact, the ETIP rule is the taxpayer's friend, as it prevents wasteful allocations of GST exemption.

[36] IRC §§ 2055(e)(2)(B), 2522(c)(2)(B).

[37] Treas. Reg. § 25.2055-2(e)(2)(vi)(a); Treas. Reg. § 25.2522(c)-3(c)(2)(vi)(a).

deduction.[38] The remainder at the end of the charitable term passes as the grantor directs, such as in further trust for the donor's descendants.

Like GRATs, CLATs effectively enable donors to leverage the amount of a taxable gift. For example, suppose that an individual transfers $10 million to a CLAT that grants to charity a stream of fixed payments for a 20-year period. Suppose further that the present value of the charitable annuity payments, at the time of the CLAT's creation, is $9.5 million. The grantor makes a gift of $10 million to a CLAT but can claim a charitable gift tax deduction of $9.5 million. Thus, the grantor's taxable gift is only $500,000. Once again, because the annuity payments are fixed, the remainder beneficiaries benefit from the investment returns on the entire $10 million during the term of the CLAT, to the extent those returns exceed the amounts needs to pay the charitable annuity.

CLATs and GST tax. Like GRATs, CLATs, although they permit a gift to be leveraged for gift tax purpose, do not permit a gift to be leveraged for GST tax purposes. Consider the following example:

> Example 2: G1 funds a CLAT with $10 million and grants to charity the right to a stream of fixed payments for a 20-year period. The present value of the annuity payments at the time that the CLAT is created is $9.5 million.[39] Upon termination of the fixed term, the reminder is directed to be paid over to G1's grandchild (G3). Thanks to relatively strong investment performance over the 20-year fixed term, the value of the remaining CLAT property, after payment of the final annuity amount, is $13.5 million.[40]

In this example, G1 makes a taxable gift of $500,000, yet $13.5 million passes free of gift tax to G3. Effectively, the value of G3's interest increases 27-fold over a 20-year period. The leverage afforded by the CLAT structure effectively enables G3 to earn returns on funds dedicated to charity.

Despite the impressive gift tax result in Example 2, as with the GRAT in Example 1, the CLAT does not produce favorable results for GST tax purposes. On the contrary, the termination of the charity's annuity interest is treated as a taxable termination that is subject to a 40% GST tax.[41] Just as in Example 1, the trustee is required to pay a 40% GST tax. Net of a

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[38] IRC §§ 2055(e)(2)(B), 2522(c)(2)(B); Treas. Reg. § 25.2055-2(e)(2)(vi); Treas. Reg. § 25.2522(c)-3(c)(2)(vi). If the grantor is treated as the owner of the CLAT for income tax purposes, the annuity may also qualify for an income tax deduction. IRC §170(f)(2)(B).

[39] Applying the present value discount rate for November 2024 of 4.4%, *see* Rev. Rul. 2024-24, the annuity amounts payable to charity would be approximately $724,000 per year, assuming that payments are not set to increase or decrease.

[40] A remainder of $13.5 million would pass to G3 if the CLAT is able to earn annual returns of approximately 8%.

[41] The reason that a taxable termination occurs in Example 2 is similar to the reason that a taxable termination occurs in Example 1, namely, (i) the charity's interest in the trust terminates, (ii) after termination of the charitable annuity interest, no non-skip person has an interest in the trust property, and (iii) after termination, a distribution may be made – indeed, is required to be made – to a skip person, namely, G3. IRC § 2612(a).

$5.4 million tax, G3 only receives $8.1 million. Once again, as with the GRAT in Example 1, both the value of the initial gift and the full amount of the increase over the fixed term of the CLAT are subject to GST tax, even though the gift tax is only imposed on the initial amount of the gift.

Unlike an allocation of GST exemption to a GRAT, an allocation of GST exemption to a CLAT is not wasted on the annuity payments to charity. Instead, under a special rule set forth in Section 2642(e), the applicable fraction is determined at the end of the charitable annuity period. The applicable fraction of a CLAT, once the annuity period ends, is defined to be (i) the amount of GST exemption allocated to the CLAT, increased by an assumed rate of interest for the charitable annuity period equal to the present value discount rate used to value the charitable interest,[42] over (ii) the value of the property immediately after the termination of the charitable lead annuity interest. Note that the CLAT succeeds in transmitting wealth free of gift tax if the denominator – that is, the value of the CLAT property – increases over the annuity period faster the numerator – that is, the present value discount rate assumed at inception. The GST exemption, meanwhile, only increases by a rate of return equal to the present value discount rate. Thus, the special rule for computing the applicable fraction of a CLAT prevents the grantor's GST exemption from being leveraged by returns earned in excess of the initial present value discount rate.

C. Valuation of Beneficial Interests

As with other forms of property, for gift and estate tax purposes, the value of a beneficial interest in a trust, such as a right to a stream of payments or the right to the remainder, is its fair market value.[43] In the case of certain types of beneficial interests, the methodology for determining fair market value is well-established and, indeed, mandated by statute. Specifically, Section 7520 provides that the value of any annuity, life interest (i.e., a life estate or right to income for life[44]), term interest, remainder, or reversionary interest is determined based on actuarial tables, updated decennially,[45] and applying a present value discount rate updated monthly.[46] The Section 7520 valuation methodology is used, for example, to value a grantor's retained interest in a GRAT[47] and the charitable annuity interest in a CLAT.[48]

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[42] The interest rate is the same rate used to determine the present value of the charitable annuity.
[43] Generally, fair market value is determined under the willing-buyer-willing-seller test, according to which value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. Treas. Reg. §25.2512-1; *see also U.S. v. Cartwright*, 411 U.S. 546, 551 (1973) ("The willing buyer-willing seller test of fair market value is nearly as old as the federal income, estate, and gifts taxes themselves."). However, specific rules for determining fair market value apply to certain types of property, including annuities and remainders. Treas. Reg. §25.2512-5(d).
[44] Treas. Reg. §25.7520-3(b)(1)(i)(B).
[45] IRC §7520(c)(2).
[46] This rate, known as the "7520 rate," is equal to 120% of the mid-term applicable federal rate under Section 1274(d)(1), rounded to the nearest 2/10ths of a percent. IRC §7520(a)(2).
[47] IRC 2702(a)(2)(B); Treas. Reg. § 25.2512-5(d); Treas. Reg. § 25.7520-1(c).
[48] Treas. Reg. § 25.2512-5(d); Treas. Reg. § 25.7520-1(c).

As the Treasury Regulations acknowledge,[49] however, interests that can be valued using actuarial tables represent but a narrow slice of the entire universe of possible beneficial interests. Most beneficial interests cannot be valued using standard actuarial tables but must instead be valued based on all facts and circumstances.[50] Often, the value of a beneficial interest may need to be discounted, perhaps heavily, in order to reflect that a beneficial interest can be curtailed or defeated altogether.[51] An example is as follows:

> Example 3 - Variation A: G1 makes a gift of $10 million to a trust that authorizes the trustee, in the trustee's absolute discretion, to pay over any amount of income or principal, including all of it, to G1's son, G2a, during G2a's life. G2a is also granted a lifetime power of appointment to direct that trust property be paid over to any person (other than G2a, G2a's estate, G2a's creditors, or the creditors of G2a's estate). Upon G2a's death, the remainder is directed to be paid over to G1's daughter, G2b, or G2b's estate.

In this example, the trustee has absolute discretion to pay over all trust property to G2a during G2a's life. If the trustee exercises this discretion, G2b's remainder interest could be defeated altogether. Further, G2a is given a nonfiduciary power to direct that trust property be paid over to virtually anyone. G2a's power could, like the trustee's fiduciary power, be exercised in order to eliminate entirely G2b's remainder interest. Whether G2b or her estate will receive anything at all, in short, depends on the unpredictable contingencies of whether and to what extent the trustee exercises the power to distribute outright to G2a or G2a exercise his power to direct that trust property be paid over to others.

Given the highly contingent character of G2b's remainder interest, its fair market value, even though the trust holds $10 million, may be very small. There is no certainty that G2b will receive anything at all after G2a's death. Indeed, it is possible, if not likely, that the fair market value of G2b's interest is small or even *de minimis* compared to the size of the trust.

III. RECOMMENDATIONS

A. Scope of Guidance Project

We recommend, firstly, that the Project address the GST tax consequences of all assignments of beneficial interests, regardless of whether they are by gift or by sale and regardless of whether they potentially affect an inclusion ratio. In the Priority Guidance Plan,

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[49] Treas. Reg. §§ 20.7520-3(b)(1)(ii), 25.7520-3(b)(1)(ii).

[50] Treas. Reg. §§ 20.7520-3(b)(1)(ii), 25.7520-3(b)(1)(ii); *see*, *e.g.*, Treas. Reg. § 25.7520-3(b)(2)(v) Examples 3 and 5.

[51] *See, e.g.*, Rev. Rul. 75-550 (valuing an income interest at a discount to reflect all possible invasions of principal); *see also.* Rev. Rul. 67-370 (remainder interest was subject at decedent's death to a power of revocation and was to be valued accordingly); *cf. Snyder v. Comm'r*, 93 T.C. 529 (1989) (value of a gift of common stock could be discounted in order to reflect put rights of other shareholders); *see also McDougall v. Comm'r*, 163 T.C. 5 at fn. 7 (2024) (noting that the value of remainder interests subject to defeat through the exercise of a power of appointment is a "factual issue [that] remains open for decision in future proceedings").

the Project is instead defined narrowly as "Regulations under §2642 regarding the redetermination of the inclusion ratio on the sale of an interest in a trust for GST exemption purposes." Literally, the Project would not address gifts of beneficial interests (as opposed to sales) that purport to avoid GST tax. Nor would the Project address assignments of beneficial interests where there is no uncertainty as to the inclusion ratio of any property.

The Project should provide guidance on gifts of beneficial interests, as well as sales, and on assignments of beneficial interests where no GST exemption is allocated. The following is an example involving a gift of a beneficial interest:

> Example 4: G1 funds a GRAT with $10 million and retains the right to a stream of fixed payments for a 5-year period. The present value of the retained right to annuity payments, at the time that the GRAT is created, is $9.5 million. No GST exemption is allocated to the GRAT. Upon termination of the fixed term, the reminder is directed to be paid over to G1's son (G2). Shortly after creation of the GRAT, G2 makes a gift of the remainder interest to G1's grandchild (G3).

In this example, no sale of any beneficial interest occurs. Nevertheless, there is a need for guidance on the GST tax consequences of G2's assignment. As G3 is a skip person with respect to G1, who is the transferor of the GRAT, GST tax should be imposed upon termination of G1's retained annuity interest, just as if G1, as in Example 1, had originally named G3 as the remainder beneficiary. At the same time, unlike in Example 1, G2 is the transferor of the remainder interest in the GRAT (albeit not the transferor of the underlying trust property). As a result, the trustee of the GRAT, in contrast to Example 1, might arguably be able to take the position that no GST occurs at the end of the fixed term, on the theory that G2, not G1, should be treated as the transferor of the GRAT property once it is paid over to G3. Regulations issued pursuant to the Project should clarify that G1 remains the transferor of the GRAT property, notwithstanding G2's gift of the remainder interest.

Similarly, the Project should provide guidance on assignments of beneficial interests where there is no uncertainty as to an inclusion ratio. In Example 4 above, for instance, neither G1 nor G2 allocates any GST exemption to his gift. Thus, the inclusion ratio of the GRAT property, in all events, is 1. Nevertheless, the GST tax consequences of G2's assignment should be addressed.

The inclusion ratio of trust property also may be irrelevant in situations where a beneficiary sells a beneficial interest. The following is an example:

> Example 5: G1 funds a CLAT with $10 million and grants to charity the right to a stream of fixed payments for a 20-year period. The present value of the stream of annuity payments at the time that the CLAT is created is $9.5 million. Upon termination of the fixed term, the reminder is directed to be paid over to G1's son (G2). G1 does not allocate GST exemption to the CLAT.
>
> Shortly after creation of the CLAT, G2 sells the remainder interest in the CLAT to an irrevocable trust, known as "Trust f/b/o G3," that G2 had previously created for the benefit of G1's grandchild (G3). Trust f/b/o G3 pays cash to G2 in an amount equal

to the CLAT remainder interest's then fair market value. G2 does not allocate GST exemption to Trust f/b/o G3.

In Example 5, no GST exemption is allocated to any trust; thus, both the CLAT created by G1 and Trust f/b/o G3 have at all times an inclusion ratio of 1. Nevertheless, just as in Example 4, guidance is needed on the GST tax consequences of G2's assignment of the remainder interest. In particular, as with the termination of the GRAT in Example 4, a taxable termination should be considered to occur at the termination of the CLAT, because the property then passes to a skip person with respect to G1, namely, the Trust f/b/o G3.

Nevertheless, the trustee of the CLAT might arguably be able to take the position that no generation-skipping transfer occurs after all upon termination of the CLAT. The trustee's theory might be that G2 is the transferor of Trust f/b/o G3. As the Trust f/b/o G3 merely made an investment decision to purchase the remainder interest in the CLAT, the trustee of the CLAT might contend that G2, not G1, becomes the transferor of the CLAT property once it is paid over to Trust f/b/o G3. As with the GRAT property in Example 4, regulations should clarify that G1, in Example 5, remains the transferor of the CLAT property, notwithstanding G2's assignment of the remainder interest.

B. Identity of the Transferor Following Gift or Sale of a Beneficial Interest

As noted above, the Project is defined narrowly in terms of the effect of a sale of a beneficial interest on a trust's inclusion ratio.[52] Yet as shown in Examples 4 and 5 above, the inclusion ratio in many cases is not an issue. Instead, a different uncertainty arises. In particular, when a beneficiary, as in Examples 4 and 5, assigns an interest in a trust to another, whether by gift or by sale, the trustee may be in doubt as to whether the grantor of the trust remains the transferor of the trust property or whether the assigning beneficiary displaces the grantor as the transferor. In our view, the identity of the transferor of trust property is the primary issue posed by situations involving assignments of beneficial interests, whereas the effect on the inclusion ratio is merely secondary. In any event, the Project should address both questions. That is, the Project should culminate in rules clarifying the effect of an assignment of a beneficial interest on the GST tax attributes of underlying trust property.

C. Restricted Beneficial Interests

As discussed above, only a few categories of beneficial interests can be valued using standard actuarial tables prescribed pursuant to Section 7520. Most beneficial interests, by contrast, are valued in light of all facts and circumstances. We recommend, therefore, that the Project not focus solely on interests, such as remainder interests in GRATs and CLATs, whose value is easily determined but provide rules on the effect of assignments of beneficial interests of all types. In particular, the Project should make sure to address the effect of assignments of restricted beneficial interests.[53]

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[52] *See also* General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals (the "**2025 Greenbook**") at 129-30 (Department of the Treasury, March 11, 2024) (describing the policy problem in terms of a sale of a remainder interest to a trust with a zero inclusion ratio).
[53] Treas. Reg. §§ 20.7520-3(b)(1)(ii), 25.7520-3(b)(1)(ii); *see*, *e.g.*, Treas. Reg. § 25.7520-3(b)(2)(v) Examples 3 and 5.

To illustrate, consider a variation of Example 3 (Variation B):

> Example 3 – Variation B: G1 makes a gift of $10 million to a trust that authorizes the trustee, in the trustee's absolute discretion, to pay over any amount of income or principal, including all of it, to G1's son, G2a, during G2a's life. G2a is also granted a lifetime power of appointment to direct that trust property be paid over to any person (other than G2a, G2a's estate, G2a's creditors, or the creditors of G2a's estate). Upon G2a's death, the remainder is directed to be paid over to G1's daughter, G2b, or G2b's estate. No GST exemption is allocated to the trust.
>
> G2b makes a gift of her remainder interest to her own child, G3.

Once again, given the highly contingent character of the remainder interest, its fair market value is likely minimal. Thus, G2b would report only a small taxable gift to G3. We assume for illustration purposes that the value of G2b's gift is only $100,000.

Nevertheless, following G2b's gift, the trustee might choose not to make any distributions to G2a and instead allow all income and appreciation to accumulate. G2a might likewise choose not to exercise G2a's lifetime power of appointment. The $10 million might then grow very substantially over G2a's lifetime. If the trust earns 8% returns a year over a 20-year period, for example, the fund will grow to over $46 million. If that is when G2a dies, G3 will receive the entire fund – as astounding return of over 460 times the initial value of G2b's gift. The increase in the wealth transfer results in part from leverage, similar to the leverage allowed by a CLAT or a GRAT. But it also results from the failure of the fair market value determination at the time of the gift to measure the amount that G3 ultimately receives. Simply put, the contingencies that depress the fair market value of the remainder interest may grossly underestimate the actual amount of wealth that ultimately passes to G3.

In our view, as discussed in further detail below, the GST tax cannot be avoided by exploiting the potential mismatch between the value of a beneficial interest at the time of assignment and the future amounts that actually pass to the substitute beneficiary. The reasoning is straightforward: G1 is the transferor of the trust property; G3 is a skip person with respect to G1; therefore, a taxable termination occurs upon G2a's death and a 40% GST tax should be imposed. Nevertheless, without guidance, the trustee might still be able to take the position at G2a's death that no generation-skipping transfer occurs, on the theory at G2b, as a result of having made a gift of a remainder interest in the trust, effectively displaces G1 as the transferor of the trust property. If the trustee's position is correct, then no GST tax would be imposed after all. Regulations should prevent that result and confirm, just as with assignments of remainder interests in GRATs and CLATs, that an assignment of a restricted beneficial interest does not change the GST tax character of any underlying trust property.

D. Effect of Assignments of a Beneficial Interests on the GST Tax Character of Underlying Trust Property

We now come to the primary recommendation of this Report, namely, that regulations

confirm that the assignment of a beneficial interest has no effect on the GST tax character of the underlying trust property. Consider again Example 3 (Variation B):

> Example 3 – Variation B: G1 makes a gift of $10 million to a trust that authorizes the trustee, in the trustee's absolute discretion, to pay over any amount of income or principal, including all of it, to G1's son, G2a, during G2a's life. G2a is also granted a lifetime power of appointment to direct that trust property be paid over to any person (other than G2a, G2a's estate, G2a's creditors, or the creditors of G2a's estate). Upon G2a's death, the remainder is directed to be paid over to G1's daughter, G2b, or G2b's estate. No GST exemption is allocated to the trust.
>
> G2b makes a gift of her remainder interest to her own child, G3.

As discussed, the trustee might in this example take the position that G2b, thanks to G2b's gift of the remainder interest, displaces G1 as the transferor of all the trust property once it is paid over to G3.

We believe that the trustee's hypothetical position is flawed and based on a category mistake.[54] To elaborate, Section 2652(a) defines the "transferor" as the donor, in the case of property subject to gift tax, or the decedent, in the case of property subject to estate tax.[55] Importantly, the "transferor" for GST tax purposes can only be identified in relation to the property that he or she has transferred. In other words, in order to identify the *transferor*, it is necessary at the same time to identify the *property* with respect to which an individual is the transferor.

In Example 3, G1 and G2b are both transferors of property for GST tax purposes, as they both make transfers subject to gift tax. For example, if G2b had made a gift of the remainder interest to a grandchild of G2b, then the gift would clearly be a direct skip subject to GST tax. At the same time, G1 and G2b are transferors of different categories of property. G1 is the transferor of the trust property held by the trustee, whereas G2a is the transferor of a beneficial interest in that trust property.

In other words, contrary to the trustee's hypothetical position, it is not true that G2a is the transferor of any of the trust property that is in the hands of the trustee. To say that G2a is the transferor of underlying trust property is similar to saying that a donor of shares in a corporation is the transferor of underlying corporate assets. In both cases, the statement conflates the underlying property (i.e., the property of the trust or the corporation) with an interest in that

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[54] It is also worth noting that Example 3 (Variation B), and the other examples of assignments of a beneficial interest discussed in this Report, are highly artificial. Most trusts, either by operation or law or through proper drafting, contain "spendthrift" provisions that prohibit voluntary and involuntary assignments of beneficial interests. In our experience, it is highly unusual for a beneficial interest to be made assignable and then actually assigned, other than to achieve a tax planning result.

[55] Treas. Reg. § 26.2652-1(a)(1) clarifies that the transferor is the "individual with respect to whom property was most recently subject to gift or estate tax."

property (i.e., a beneficial interest in a trust or the stock in the corporation). For GST tax purposes, it is the transferor of the trust property, not the transferor of an interest in trust property, whose identity determines whether a generation-skipping transfer occurs upon termination of an interest.[56] Thus, in Example 3, G1 is the relevant transferor for purposes of determining whether a generation-skipping transfer occurs when the trust property passes to G3. Rules should be issued in order to confirm that result.

The same analysis also applies in the relatively rare case where the issue is not the identity of the transferor but the inclusion ratio. The following example illustrates the point:

> Example 6: G1 makes a gift of $10 million to Trust 1. Trust 1's governing instrument authorizes the trustee, in the trustee's absolute discretion, to pay over any amount of income or principal, including all of it, to G1's son, G2a, during G2a's life. G2a is also granted a lifetime power of appointment to direct that the property of Trust 1 be paid over to any person (other than G2a, G2a's estate, G2a's creditors, or the creditors of G2a's estate). Upon G2a's death, the remainder is directed to be paid over to G1's daughter, G2b, or G2b's estate. G1 does not allocate GST exemption to Trust 1.
>
> G1 also makes a gift of $10,000 to Trust 2, which is for the benefit of G1's descendants. G1 timely allocates $10,000 of GST exemption in order to give Trust 2 an initial inclusion ratio of zero.
>
> G2b sells the remainder interest in Trust 1 to Trust 2 in exchange for cash equal to the remainder interest's then fair market value.
>
> Upon G2a's death, the property of Trust 1 is worth $40 million. Immediately prior to the distribution of the $40 million from Trust 1 to Trust 2, Trust 2 was worth $50,000.

Just as the gift in Example 3 should not avoid a GST, so too the sale in Example 6 should not cause Trust 1's inclusion ratio to plummet from 1 to 0. Instead, when Trust 1 terminates in favor of Trust 2, the applicable fraction of Trust 2 must be redetermined.[57] Given that Trust 1, which is not exempt from GST tax, is 800 times larger than Trust 2, the practical effect is that Trust 2

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[56] *See* IRC §2612(a)(1)(defining a "taxable termination" in relation to "property held in a trust") and IRC §2622(a)(1)(defining the taxable amount as "all property" with respect to which a taxable termination has occurred). Similarly, in the income tax context, it is well established that the assignee of a beneficial interest is taxed on trust income and not the assignor. *Blair v. Comm'r*, 300 U.S. 5 (1937). In other words, the assignee is considered to receive income distributions directly from the trust (which ultimately consists of corpus transferred by the original grantor) and not as tax-free gifts from the assignor. The same principle should apply in the GST tax context.

[57] *See* Treas. Reg. § 26.2642-4(a)(2).

acquires an inclusion ratio of 0.999, nearly the same as Trust 1's inclusion ratio of 1.[58] Once again, rules should be issued to confirm that the applicable fraction and the inclusion ratio of a purchasing trust must be redetermined.[59]

Examples 3 and 6, as well as Example 4 and 5 involving a GRAT and a CLAT, are all illustrations of the same general principle, namely, that an assignment of a beneficial interest in trust property should have no effect on the GST tax attributes of underlying trust property. Examples 3 through 5 show the effect of an assignment on the identity of the transferors; Example 6 shows the effect of an assignment on the inclusion ratio of trust property. We recommend that the general principle – again, that an assignment of a mere beneficial interest in trust property cannot change the identity of the transferor of trust property itself or its inclusion ratio – be confirmed in GST tax rules. We further recommend, as discussed below, that regulations permit computational adjustments in the amount of GST tax, at least in some cases.

E. Treas. Reg. §26.2652-1(a)(5) Example 4

As it happens, GST tax regulations already confirm the principle advocated by this Report, namely, that an assignment of a beneficial interest does not change the GST tax attributes of underlying trust property. In particular, Treas. Reg. §26.2652-1(a)(5) Example 4 provides as follows:

> *Effect of transfer of an interest in trust on identity of the transferor*. T transfers $100,000 to a trust providing that all of the net income is to be paid to T's child, C, for C's lifetime. At C's death, the trust property is to be paid to T's grandchild. C transfers the income interest to X, an unrelated party, in a transfer that is a completed transfer for Federal gift tax purposes. Because C's transfer is a transfer of a term interest in the trust that does not affect the rights of other parties with respect to the trust property, T remains the transferor with respect to the trust.

(Emphasis added). The example expressly concludes, just as recommended by this Report, that a gift of a beneficial interest does not change the identity of the transferor. Unfortunately, however, although the example is certainly helpful, it also has engendered significant confusion. Treas. Reg. §26.2652-1(a)(5) Example 4 fails to resolve any of the following questions, other than by implication:

- Is the termination of the trust (as is the most obvious implication of the example) in favor of the grandchild a GST?

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[58] Technically, Trust 2's recomputed applicable fraction is as follows: ($50,000) / ($50,000 + $40 million) = 0.001. Treas. Reg. § 26.2642-4(a). The applicable fraction is rounded to the nearest one-thousandth, here 0.001. Treas. Reg. § 26.2642-1(a).

[59] We disagree with the 2025 Greenbook's statement that "it is not clear that regulations could adequately address the effect of sales between trusts." 2025 Greenbook at 130. Section 2663 grants the Treasury Department broad authority to prescribe regulations necessary or appropriate to carry out the purposes of the GST tax. Further, as discussed, regulations, if they follow the recommendation of this Report, would merely adopt the most straightforward reading of the relevant Code provisions.

- Does the assignee's status as an "unrelated party" have any effect on the GST tax consequences of transfers of trust property?

- Are distributions to the assignee, if the assignee is a skip person with respect to T, subject to GST tax?

- What effect does the assignment of a remainder interest, as opposed to a lead interest (or "term interest," in the language of the example), have on the GST tax character of trust property?

- What effect does the sale of a beneficial interest, as opposed to a gift of a beneficial interest, have on the GST tax character of trust property?

- What effect would a sale of a beneficial interest to a second trust created by the same transferor have on the inclusion ratio of trust property as it is paid over to the second trust?

We recommend that Treas. Reg. §26.2652-1(a)(5) Example 4 be clarified. Specifically, the generation assignment of the assignee, X, should be specified; the fact that the assignee is unrelated should be deleted as irrelevant; the example, as revised, should state whether income distributions are subject to GST tax[60]; the example, as revised, should clarify that the same result would follow whether the transfer of the beneficial interest is via a gift or a sale; and the example should state whether the termination of the income interest is a taxable termination. We further recommend that additional examples, which may be similar to those discussed in this Report, be added to the new regulations in order to illustrate the general principle advocated by this Report.

F. Contrary Views

Contrary to the recommendation of this Report, some may contend that the assignment of a beneficial interest should indeed cause a change in the identity of the transferor of underlying trust property.[61] Consider, once again, Example 4:

> Example 4: G1 funds a GRAT with $10 million and retains the right to a stream of fixed payments for a 5-year period. The present value of the retained right to annuity payments, at the time that the GRAT is created, is $9.5 million. Upon termination of the fixed term, the reminder is directed to be paid over to G1's son (G2). No GST exemption is allocated to the GRAT. Shortly after creation of the GRAT, G2 makes a gift of the remainder interest to G1's grandchild (G3).

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[60] Consistent with the recommendation of this Report, if the assignee is a skip person with respect to the transferor of the trust, distributions of trust property should be treated as taxable distributions, even if the assignee is not a skip person with respect to the assignor of the interest in the trust.

[61] *See*, *e.g.*, Report on Reform of Federal Wealth Transfer Taxes, *Tax Lawyer*, Vol. 58, No. 1 at 267 (2004) (suggesting that the Treasury Department adopt by regulation a rule that "the transfer of a remainder interest changes the transferor of the underlying property").

A GST tax, if imposed at the termination of the annuity interest in Example 4, would arguably represent a second tax on the same transfer to G3. In this view, G2 is subject to gift tax when the remainder interest is assigned. If the trust property later passing to G3 is also subject to GST tax when the annuity period ends, then there are two taxes on the same gift of the remainder. It could be argued that to avoid a double tax on the transfer of the remainder, G2 should displace G1 as the transferor of the GRAT property, so that a second wealth transfer tax is not imposed when the GRAT terminates.

In response, it should be noted that even before the GST tax was enacted, the wealth transfer system already subjected assignments of beneficial interests to double taxation. In Example 4, after all, when the GRAT is created, G1 is subject to gift tax on the value of the remainder interest. When G2 later assigns the remainder interest, a second gift tax on the transfer of the remainder interest is imposed, even though the second gift tax could have been avoided by having G1 name G2's assignee as the initial remainder beneficiary (or, perhaps, giving a third party, such as the trustee, discretion to determine the ultimate recipient).[62] The double taxation of the remainder interest occurs regardless of whether a GST tax is imposed or not. It is unclear why the GST tax rules should provide relief from double taxation that the older wealth transfer taxes – namely, the estate and gift tax – have never afforded, especially given the abuse inherent in the use of restricted beneficial interests.[63] In any event, as discussed below, over-taxation can be avoided through computational adjustments.

The view that G2 should displace G1 as the transferor of trust property in Example 4 may also be based on the premise that the GST tax should operate in a manner that is consistent with the gift and estate taxes. For gift tax purposes, GRATs permit taxpayers to transfer future

[62] *Cf. Estate of Regester v. Comm'r*, 83 T.C. 1 (1984) (holding that the indirect relinquishment of a right to income, via the exercise of a power of appointment over corpus, is a gift of the income interest, despite that creation of the trust had already been subject to estate tax when it was created).

[63] *D'Ambrosio v. Comm'r*, 101 F.3d 309 (3rd Cir. 1996), *Wheeler v. United States*, 116 F. 3d 749 (5th Cir. 1997), and *Estate of Magnin v. Comm'r*, 184 F. 3d 1074 (9th Cir. 1999), which are estate tax cases, are sometimes cited for the proposition that an assignment of a beneficial interest should cause a change of transferors. The *D'Ambrosio-Wheeler-Magnin* trilogy holds that where a decedent sells a remainder interest in property for full and adequate consideration, but retains a life estate, the property subject to the life estate is not included in the decedent's gross estate. As *D'Ambrosio* observes, a contrary holding would result in double taxation, "because, all things being equal, the consideration [the decedent] received will also have appreciated and will be subject to tax on its increased value." 101 F.3d at 316. At the same time, the same cases also hold that if the sale of the remainder is for *less* than full and adequate consideration, then Congress mandates double taxation of both the property subject to the life estate and the appreciation of the consideration received. *See Estate of Magnin v. Comm'r*, 184 F. 3d 1074 (9th Cir. 1999)("Although it would perhaps be most fair to both taxpayers and the government if [the taxpayer's] approach were adopted . . .this approach is not the one Congress has adopted in this statute."). Thus, the trilogy of estate tax cases on sales of remainder interests does not stand for a general principle that double taxation is to be avoided, where Congress has otherwise spoken.

appreciation tax-free to the remainder beneficiary. Some may contend that the GST tax should permit the same result. That is, if G2 makes a gift of the remainder interest, a GST tax on future appreciation should be avoided, just as a gift tax on future appreciation is avoided.

In response, it should be noted that while the GST tax is designed to backstop the estate and gift taxes, it is a standalone tax with its own unique rules and definitions, some of which deviate from similar gift and estate tax rules.[64] Further, as discussed in Part II, the rules defining taxable terminations and the inclusion ratio of trust property expressly frustrate attempts to use GRATs and CLATs as leverage techniques for GST tax purposes. No principle of consistency overrides these provisions. On the contrary, Section 2702, which licenses the use of GRATs for gift tax purposes, by its own terms applies "solely" for gift tax purposes and not also for GST tax purposes.[65] In our view, the inference that what is permitted for gift tax purposes should also be permitted for GST tax purposes is a *non sequitur*.

G. Portion Theory

We acknowledge that in nonprecedential guidance, the Service has advanced an apparently competing theory on the effect of an assignment of a beneficial interest. Specifically, in PLR 200107015, the Internal Revenue Service ruled that an assignment of a beneficial interest causes the assignor to become the transferor of a fraction or portion of underlying trust property. In that ruling, a decedent had created a CLAT under his will. Upon termination of the CLAT, the trustee was directed to hold the remaining trust property in further trust for the decedent's descendants and charities. The trustee was also given a broad power under the decedent's will to amend the dispositive provisions of the CLAT, so long as only the decedent's descendants and charities were the beneficiaries of any amendment. In the ruling, the trustee proposed to exercise this power in order to give a child of the decedent a vested interest in one-sixth of the remaining principal at the end of the fixed term. The child then proposed to make a gift of the one-sixth remainder interest to his own children, the decedent's grandchildren. The taxpayers requested a ruling that the child's gift would cause the child to be treated as the transferor of the remainder upon its payment to the grandchildren.

Consistent with the recommendation of this Report, the Service rejected the taxpayers' argument that an assignment of a beneficial interest causes a complete displacement of the transferor of the underlying trust property. Instead, the Service ruled that the child's gift of the remainder caused the child to be treated as the transferor of a portion of the underlying trust property.[66] In particular, according to the Service, the donor of the remainder interest should be treated the transferor of a mere portion of the CLAT property equal to the value of the remainder interest at the time of the donor's gift, divided by the value of the property of the CLAT; the

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[64] *See*, *e.g.*, IRC 2642(c)(2)(imposing additional requirements for a gift to qualify for the GST tax equivalent of the gift tax annual exclusion).
[65] IRC § 2702(a); *see also* T.D. 8395, 1992-1 C.B. 316 ("[S]ections 2701 and 2702 do not apply for purposes of the generation-skipping transfer tax.").
[66] PLR 200107015 ("[W]e conclude that for GST tax purposes, and consistent with the purpose of § 2642(e), there will be two transferors with respect to the trust assets in Trust as of the date of the assignment. Child A will be considered the transferor with respect to the portion of the trust assets equal to the present value of the one-sixth remainder interest on the date of the gift. The Decedent will remain the transferor with respect to the balance of the Trust.")

decedent would remain the transferor of the balance of the CLAT. Thus, contrary to the taxpayer's proposed analysis, most of the CLAT property ultimately passing to the decedent's grandchildren would be subject to GST tax.

Although PLR 200107015 correctly rejects the theory that an assignment of a beneficial interest causes a complete change of transferors, we believe that the portion theory adopted by the ruling requires clarification. Strictly applied, the theory does not work as a general solution to the question of how an assignment of a beneficial interest affects the GST tax attributions of a trust. The following is an example:

> Example 7: G1 makes a gift to a trust that pays all income to G1's son, G2, for life. Upon G2a's death, the remainder is to be paid over in equal shares to G1's grandchildren, G3a and G3b. No GST exemption is allocated to the trust. G3a makes a gift of G3a's remainder interest to charity.

If the "portion" theory is correct, and G3a in the foregoing example is treated as the transferor of a fraction of the underlying trust property, then G3a's gift would have the effect of shielding a portion of the remainder passing to G3b from GST tax, despite G3a having never made a transfer to G3b. That result does not make sense, yet it would follow from a rigid application of the theory that G3a's gift causes G3a to be treated as the transferor of underlying trust property.

The portion theory can be saved from producing those improper results, if it is modified by a rule stating that it only applies with respect to property that passes to the assignee. In example 7, the modification of the portion theory would mean that G3a does not become the transferor of any property passing to G3b. Instead, G1 would remain the transferor of all of the CLAT property passing to G3b, but would be partially displaced with respect to property passing to G3a's assignee.

The necessary qualification of the portion theory is equivalent to saying, as this Report contends, that an assignment of a beneficial interest does not cause the assignor to be considered the transferor of any underlying trust property. Nevertheless, according to the portion theory, when property passes from a trust to the assignee, the identity of the transferor changes in part. If, contrary to the recommendation of this Report, the Treasury Department and the Service choose to issues rules permitting the assignment of a beneficial interest to cause a change in the GST tax character of trust property, we recommend that those rules provide that the effect of an assignment of a beneficial interest is determined at the time that property passes to or is distributed to the assignee and only with respect to that assignee. Conversely, new rules should not avoid implying that the transferor of underlying trust property of the inclusion ratio changes prior to a distribution to a beneficiary or termination of a trust interest.

H. Computation Adjustments

We acknowledge that the solution recommended by this Report can have harsh consequences. The following is an example:

> Example 8: Under his will, G1 creates a $10 million trust that pays all income to G1's son, G2a, for 10 years. Upon the end of the 10-year term, the remainder is to be paid over G1's daughter, G2b. Five years after the creation

of the trust, when the present value of the remainder interest is $12 million, G2b assigns the remainder interest to her own child, G3. Upon termination of the trust after the 10-year period, the principal, then worth $15 million, is paid over to G3.

Example 8 illustrates how the wealth transfer tax system causes three taxes to be imposed on transfer of the same beneficial interest. First, G1 is subject to estate tax on the value of the remainder interest when the trust is created. Second, G2b is subject to gift tax when the remainder interest is assigned. Finally, a GST tax is imposed when the trust terminates in favor of G3. The trust principal passes down two generations yet is triple taxed.

As discussed above, the imposition of the first two transfer taxes – namely, estate tax on G1's estate and gift tax on G2b's assignment – is inherent in the estate and gift tax system. The GST tax imposes a third tax on GSTs. Nevertheless, the cause of over-taxation in Example 8 is not the just the GST tax but failure of the estate and gift taxes to adjust for the fact that property held in trust was already taxed when the trust was created. An assignment of a beneficial interest will typically result in some over-taxation, whether GST tax is imposed or not.

Nevertheless, we recommend that regulations issued pursuant to the Project provide relief, at least in some cases, in order to measure properly the amount of the GST. Specifically, we recommend that if the assignee of a beneficial interest is a skip person with respect to the transferor of the trust, then the amount of the generation-skipping transfer may be reduced by the sum of (a) the amount subject to gift or estate tax at the time of the assignment and (b) the consideration received by the assignor from the assignee in exchange for the interest. We further recommend that the reduction amount be increased by an interest rate factor equal to the Section 7520 at the time of the assignment. Under this suggested rule, in Example 8, after the 10-year term, the amount subject to GST tax upon the taxable termination would be $3 million – i.e., the $15 million gross amount of the taxable termination less the $12 million value of G2b's gift – plus interest through the date of the taxable termination. Similar rules could be adopted when recomputing the inclusion ratio of trust property.[67]

The Treasury Department and the Service should consider further to what extent and in what circumstances computational adjustments should be available. For administrative simplicity, for example, it may be that computation adjustments are only available in the case of an assignment to a skip person with respect to the transferor of the trust, but not in the case of assignments to other persons, such as a discretionary trust for the benefit of both skip persons and non-skip persons, where it is unclear which beneficiaries should receive the benefit of the adjustment, when, and to what extent. The Treasury Department has broad authority under Section 2663 to issue rules that provide partial relief from triple taxation, at least when GST tax is the final tax imposed.

Finally computational adjustments will require new regulations to address a number of technical issues. For example, in Example 8, the trustee is responsible for reporting and paying GST tax on the taxable termination that occurs upon the end of the fixed term. As the trustee

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[67] Specifically, the numerator of the applicable fraction could be increased to reflect consideration paid by a trust, having an inclusion ratio of less than 1, in exchange for an interest in a second trust, having an inclusion ratio of greater than 0.

may not know the finally determined amount of G2b's gift, the Treasury Department and the Service may consider making the computational adjustment optional and only available if the trustee can establish with adequate records the correct adjustment amount. In addition, if computational adjustments are permitted, then rules will be needed in order to address their effect if the skip-person assignee receives taxable distributions over time, such as if the assignee receives distributions of income and is a skip person with respect to the trust's transferor. In that case, a portion of the total adjustment amount should be considered to be used up upon each distribution, until the entire adjustment amount is exhausted.

I. Tax Avoidance Transactions

If, as recommended by this Report, regulations are issued in order to confirm that an assignment of a beneficial interest has no effect on the GST tax attributes of underlying trust property, then regulations also should clarify that the general rule cannot be avoided by transactions that in substance achieve the same effect as an assignment of a beneficial interest down generations. Examples of such transactions are as follows:

Contractual arrangements. An individual beneficiary of the trust, rather than make a direct assignment of the beneficial interest, could agree with a counterparty, such as a trust for the benefit of descendants, to pay over to the counterparty whatever amounts the beneficiary receives from the trust. In other words, the beneficiary could agree to transfer the economic value of a beneficial interest, but without any actual assignment of a beneficial interest. Rules can provide that any amounts paid pursuant to a contractual arrangement of this kind, to the extent that they exceed the price paid for the distribution-equivalent amounts, are treated as paid, for GST tax purposes, by the trust. In order to ensure proper tax reporting in case the trustee is unaware of the transactions, the Treasury Department and the Internal Revenue Service can also issue rules treating the arrangement as a trust and the payor of the distribution-equivalent amounts as the trustee.[68]

Gift and repurchase. An individual beneficiary of a trust could make a sale or a gift of a beneficial interest when the value of that interest is relatively low, and later purchase the beneficial interest back when its value is relatively high, and before any distributions are actually made to the assignee of the interest. In this manner, the beneficiary could effectively transfer the economic value of the beneficial interest but without any actual distribution to a new assignee. Rules can provide that any amounts paid pursuant to a repurchase arrangement, to the extent that they exceed the amount of the initial gift or the amount paid in the initial sale, are treated as paid, for GST tax purposes, by the trust. As with contractual arrangements, the Treasury Department and the Internal Revenue Service can also issue rules treating the arrangement as a trust and the repurchaser as the trustee.[69]

Indirect assignment. A beneficial interest could be held indirectly. For example, a grantor could name a business entity, such as a limited liability company, as the beneficiary of the trust. The owners of the entity could then make a gift or a sale of equity interests in the

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[68] IRC §§ 2652(b)(1), 2663(3) (authorizing regulations necessary to the application of GST tax in the case of an arrangement that has substantially the same effect as a trust).

[69] IRC §§ 2652(b)(1), 2663(3) (authorizing regulations necessary to the application of GST tax in the case of an arrangement that has substantially the same effect as a trust).

entity. In this manner, direct assignment of a beneficial interest can be avoided. Section 2651(f)(2) already provides that entities having interests in trust property are disregarded, at least if those entities are owned by individuals. Rules should treat any distribution from a trust to an entity, as if it is made to the owners or indirect owners, regardless of whether the owners are individuals or trusts. Similarly, rules should treat any distribution from a trust to an entity that is owned indirectly by individuals or trusts through one or more tiered entities, as if it is made to the indirect individual or trust owners.

Sale to a non-skip person. In each of the examples considered thus far in this Report (other than Example 7, involving an assignment to charity), higher-generation family members assign beneficial interests to lower-generation family members (or trusts for their benefit). Without additional rules, it may also be possible to attempt to avoid GST tax through sales of beneficial interests to non-skip persons. For example, suppose that a skip person is named as the remainder beneficiary of a GRAT, and that the remainder beneficiary sells the remainder interest back to the grantor just prior to the end of the fixed term. If this strategy is successful, no taxable termination would occur at the end of the GRAT, because the GRAT would terminate in favor of the settlor, yet wealth would still effectively be transferred free of GST tax to the skip person. Rules should treat the sale of a beneficial interest by a skip person to a non-skip person (including indirectly to an entity owned directly or indirectly by a non-skip person) as a taxable distribution.[70]

J. Effective Date of New Rules

We recommend that rules issued pursuant to the Project apply only to GSTs which occur after the issuance of either the final or proposed regulations issued pursuant to the Project (in either case, the "**issuance date**"). For example, consider a grandparent who funded a GRAT prior to the issuance of proposed or final regulations, with the remainder interest passing to a child. Prior to the issuance date, the child assigns the remainder interest to a discretionary trust, but no GST event has yet occurred. After the issuance date, assume that there is a GST event, as clarified by the new rules (for example, because at that time, all beneficiaries are skip persons). In this case, whether a GST event has occurred should be determined under the law prior to the issuance of the new rules.

[70] *Cf.* Rev. Rul. 98-8, 998-1 C.B. 541 (holding that gift or estate tax on qualified terminable interest property, as defined in Section 2056(b)(7), cannot be avoided through a purchase of the remainder interest).