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Federal Estate, Gift, and Generation-skipping Taxes: A Description of Current Law

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Summary

This report contains an explanation of the major provisions of the Federal estate, gift, and generation-skipping transfer taxes. The discussion divides the Federal estate tax into three components: the gross estate, deductions from the gross estate, and computation of the tax, including allowable tax credits. The Federal estate tax is computed through a series of adjustments and modifications of a tax base known as the "gross estate." Certain allowable deductions reduce the gross estate to the "taxable estate," to which is then added the total of all lifetime taxable gifts made by the decedent. The tax rates are applied and, after reduction for certain allowable credits, the amount of tax owed by the estate is reached.

This discussion divides the Federal gift tax into two components: the taxable gift and the gift tax computation. The Federal gift tax is imposed on lifetime gifts of property. The tax depends in large part upon the fundamental element—the value of the "taxable gift." The taxable gift is determined by reducing the gross value of the gift by the available deductions and exclusions. The gift tax liability determined on the basis of the donor's taxable gifts may be reduced by the available unified transfer tax credit.

The purpose of the generation-skipping transfer tax is to close a loophole in the estate and gift tax system where property could be transferred to successive generations without intervening estate or gift tax consequences. There are two basic forms of generation-skipping transfers; the indirect skip, where the generation one level below the decedent receives some beneficial interest in the property before the property passes to the generation two or more levels below, and the direct skip, where the property passes directly to the generation two or more levels below the decedent. This discussion describes the tax on these types of transfers, its computation and implementation, and use of such concepts as generation assignment and inclusion ratios.

The Economic Growth and Tax Relief Reconciliation Act of 2001 generally repealed the Federal estate and generation-skipping transfer taxes at the end of the year 2009, provided for the phase out of these taxes over the period 2002 to 2009, lowered and modified the gift tax, provided new income tax carry-over basis rules for property received from a decedent, and made other general amendments which will be applicable in the phase out period. The phase out of the estate tax is to be accomplished primarily by adjusting three features of the tax. The top rate is to be gradually lowered. The applicable exclusion amount is to be gradually raised. The credit for death taxes (estate or inheritance taxes) paid to a State is to be gradually lowered and replaced by a deduction for such taxes. Also, the 5% surtax used to recapture the benefits of the graduated tax rates on taxable estates of over $10,000,000 is repealed, and, after the applicable exclusion amount has surpassed the $1,300,000 level used to protect family owned businesses, the family owned business deduction is repealed.

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Introduction

The Federal estate, gift, and generation-skipping tax laws are, necessarily, rather lengthy and complex. This report discusses those major provisions which play the dominant role in the determination of estate, gift, and generation-skipping tax liability. The discussion relates only to the taxation of United States citizens and resident aliens. Different rules apply to the taxation of nonresident alien individuals.

The Federal Estate Tax[1]

The Federal estate tax is computed through a series of adjustments and modifications of a tax base known as the "gross estate." Certain allowable deductions reduce the gross estate to the "taxable estate," to which is then added the total of all lifetime taxable gifts made by the decedent. The tax rates are then applied The result is the decedent's estate tax which, after reduction for certain allowable credits, is the amount of tax paid by the estate. This discussion will divide the Federal estate tax into three components: the gross estate, deductions from the gross estate, and computation of the tax, including allowable tax credits.

The Gross Estate: The Federal Estate Tax Base

The gross estate of a deceased individual includes both property owned by the decedent on the date of the decedent's death and certain interests in property which the decedent had transferred to another person at some time prior to the date of death. The conditions under which such property and interests in property may be included in the decedent's gross estate often constitute an important problem area in the administration of the estate tax laws.

The gross estate of a decedent includes the value of all property, real or personal, tangible or intangible, wherever situated, in which the deceased owned an interest on the date of the decedent's death.[2] The property and interests in property included in the decedent's gross estate are valued at their fair market value on the

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[1] The Federal estate tax is entering a phase out period from 2002 to 2009, at the end of which it will be repealed.

[2] 26 U.S.C. § 2031(a).

date of death or, if elected by the executor, the alternate valuation date. The alternate valuation date is the earlier of the date of distribution or disposition of the property by the estate or the date six months after the date of death.[3] The "fair market value" of property is normally described as the price at which a willing buyer would purchase the property and a willing seller would sell it, both being fully informed as to all relevant facts. It is, consequently, the value of the property at its "highest and best use," rather than its current use.[4] There is, however, a special rule under which the real estate used in certain family farms and closely held businesses will, under certain conditions, be valued for estate tax purposes at less than its highest and best use.[5]

Certain types of property are included in a decedent's gross estate under special rules. The proceeds from a life insurance policy on the life of the deceased will be included in the decedent's gross estate if either the proceeds are payable to or for the use of the executor or the estate, or if the decedent held any "incidents of ownership" in the policy on the date of death or gave away such incidents of ownership within three years of the date of death.[6] An incident of ownership is an economic right in the policy, such as the right to cancel the policy, change the beneficiary, or borrow against its cash surrender value. The value of a survivor's annuity payable because of the death of the decedent will be included in the decedent's gross estate if the deceased had the right to receive a lifetime annuity under the same contract.[7]

The value of property owned by the decedent jointly with a right of survivorship in another person, other than the decedent's spouse, is fully included in the decedent's gross estate, except to the extent it can be shown that someone other than the decedent contributed money or money's worth of consideration towards the cost of acquiring the property.[8] Only one-half of the value of property owned jointly with a right of survivorship by a decedent and the surviving spouse will be included in the decedent's gross estate, regardless of the relative contributions of the decedent and the surviving spouse.[9]

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[3] 26 U.S.C. § 2032(a). The alternate valuation date is useful when the value of the property contained in the gross estate has decreased following the death of the decedent, such as might be the case when the estate holds a substantial quantity of stock in a corporation in which the decedent was a dominant figure.

[4] Treas. Regs. (26 C.F.R.) § 20.2031-1(b).

[5] 26 U.S.C. § 2032A. An election for special use valuation may be made by the executor where the majority of the estate is made up of closely-held business property. Under this election the executor may choose to value the property at its closely-held business value rather than its value at its highest and best use. The special use valuation cannot, however, reduce the gross estate by more than $840,000 (This limit is indexed for inflation.).

[6] 26 U.S.C. § 2042.

[7] 26 U.S.C. § 2039(a). Annuities are valued according to the actuarial life expectancy of the annuitant, the frequency of the payments, and the size of the payments. Treas. Regs. Sec. 20.2039-1.

[8] 26 U.S.C. § 2040(a).

[9] 26 U.S.C. 2040(b).

In a number of instances, the value of a decedent's gross estate includes the value of property not owned by the decedent on the date of death. A decedent's gross estate includes the value of lifetime gifts over which the decedent retained a life interest[10] or a power to alter, amend, terminate, or destroy the beneficial enjoyment of the property.[11] The value of lifetime gifts which are not to take effect until the date of death are also included in the donor's gross estate.[12]

The gross estate includes the value of these types of property which have been transferred, irrespective of the number of years which have elapsed between the date of the gift and the date of the donor's death. The value of property sold during the decedent's lifetime, for full and adequate consideration in money or money's worth, is not included in the decedent's gross estate under these sections of the Internal Revenue Code.

The gross estate, also, includes the value of interests in property given away within three years of the date of death if, had the property been retained, it would have been included in the decedent's gross estate under one of the three special rules noted above or under special rules for life insurance proceeds. Property given away within three years of the date of death is also included in the decedent's gross estate for purposes of qualifying for certain estate and income tax benefits.[13]

The value of all property subject to a general power of appointment held by the decedent on the date of death will be included in the decedent's gross estate, even if the decedent died without exercising the power. A power of appointment is a right, held by a person other than the owner of property, to determine who will enjoy the ownership of or benefit of the property. A power of appointment is "general" if it may be exercised by its holder in favor of the holder, the holder's estate, the holder's creditors, or the creditors of the holder's estate. If a power cannot be exercised in favor of these classes of persons, it is not a general power of appointment, regardless of the size of the classes of beneficiaries in whose favor the power can be exercised.[14]

Deductions from the Gross Estate: Reaching the Taxable Estate

[10] 26 U.S.C. § 2036. The retention of an estate, the duration of which is not ascertainable except with reference to the lifetime of the donor, is also treated as a retained life interest, as is the retention of the right to vote the stock of certain closely-held corporations. 26 U.S.C. § 2036(b); *see also, United States v. Byrum,* 408 U.S. 125 (1972).

[11] 26 U.S.C. § 2038. These transfers are also known as "revocable transfers" because the retained power allowed the deceased donor to revoke the transfer and return to himself or herself the enjoyment of the transferred property.

[12] 26 U.S.C. § 2037.

[13] 26 U.S.C. § 2035.

[14] 26 U.S.C. § 2041. Certain other powers are statutorily classified as limited or non-special powers of appointment, including the right to invade the corpus (principal) subject to the power, only under an ascertainable standard relating to health, education, support or maintenance, or the non-cumulative right to withdraw up to the greater of $5,000 or 5% of corpus annually.

A decedent's taxable estate is determined by reducing the gross estate by allowable deductions, including estate administration expenses, certain debts and losses, the amount of qualified transfers to a surviving spouse, charitable bequests and certain family-owned business interests.

The first deduction to which an estate is entitled is for the funeral expenses, administration expenses, claims against the estate, and unpaid mortgages paid by the estate (to the extent not reflected in the reduced value of estate assets). These payments may be deducted to the extent that they are paid by the estate and to the extent they are allowable under the laws of the applicable jurisdiction in which the estate is administered.[15] Additionally, the estate may deduct the amount of any casualty or theft losses sustained by the estate during settlement, to the extent such losses are not compensated by insurance.[16]

The estate is, also, entitled to a "marital deduction" for the value of all property passing to the decedent's surviving spouse.[17] Interests which may terminate in favor of another person upon the lapse of time, the occurrence of an event or contingency, or the failure of an event or contingency to occur, generally do not qualify for the estate tax marital deduction.[18] The estate tax marital deduction is allowed only for non-terminable interests passing to the surviving spouse. These interests may pass to the spouse under the terms of the decedent's will, by law of intestacy, by contract, by operation of law, or otherwise. Special exceptions to the terminable interest rule are made for certain transfers in trust of a lifetime income interest if the executor elects to include the value of the trust property in the surviving spouse's gross estate, and for certain life estates coupled with a general power of appointment, as well as for certain life insurance settlement options and certain interests conditioned upon survivorship for a reasonable period not exceeding six months.[19]

The gross estate is, also, reduced by the value of certain charitable bequests and devises to qualified charitable organizations.[20] An estate tax deduction is generally permitted for any transfer which, if made during the decedent's lifetime would have been deductible for income tax purposes, though the rules are not identical.[21]

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[15] 26 U.S.C. § 2053.

[16] 26 U.S.C. § 2054.

[17] 26 U.S.C. § 2056.

[18] 26 U.S.C. § 2056(b). Generally, the unlimited marital deduction is not allowed for transfers to a surviving spouse who is not a citizen of the United States and does not become a citizen before the estate tax return is filed unless the transfer utilizes a qualified domestic trust. *See*, 26 U.S.C. § 2056(d). A qualified domestic trust is defined in 26 U.S.C. § 2056A to be a trust which has at least one trustee who is a United States citizen and which citizen trustee has veto power over distributions from the trust.

[19] 26 U.S.C. § 2056(b).

[20] 26 U.S.C. § 2055.

[21] *Compare*, 26 U.S.C. §§ 2055(a) and 170(c).

The gross estate may be reduced by the value of certain qualified family-owned business interests. Under this deduction, the executor of a qualified estate is empowered to elect special estate tax treatment for these qualified interests. The deduction is limited to a total of $1,300,000 when combined with the applicable exclusion amount of the unified credit.[22] If an executor elects to use this deduction, the estate tax liability is calculated as if the estate is allowed a maximum qualified business deduction of $675,000 and an applicable exclusion amount of $625,000, regardless of the year in which the decedent died. If the estate includes less than the $675,000 of qualified family-owned business interests, the applicable exclusion amount is increased on a dollar for dollar basis, limited to the applicable exclusion amount generally available for the year of death.[23]

A "qualified estate"is defined to be the estate of a U.S. citizen or resident of which the aggregate value of the decedent's qualified family-owned business interests that are passed to qualified heirs exceeds 50% of the decedent's adjusted gross estate.[24] "Qualified heir" is defined to include any individual who has been employed in the business for at least 10 years prior to the date of the decedent's death, and members of the decedent's family.[25] A "qualified family-owned business interest" is defined as any interest in a business with principal place of business in the U.S. if ownership of the business is held at least 50% by one family, 70% by two families, or 90% by three families, as long as the decedent's family owns at least 30% of the business.[26] To qualify for this deduction the decedent (or a member of his family) is required to have owned and materially participated in the business for at least five of the eight years preceding the death of the decedent. Also, each qualified heir is required to materially participate in the business for at least five years of any eight year period within ten years following the decedent's death.

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[22] 26 U.S.C. § 2057.

[23] 26 U.S.C. § 2057(a)(2)&(3).

[24] 26 U.S.C. § 2057(b).

[25] 26 U.S.C. § 2057(I). Incorporated by reference is the definition of "family member" from 26 U.S.C. § 2032A(e)(1), which includes the individual's spouse, the individual's ancestors, and the lineal descendants of the individual or his spouse or parent (and the spouses of such lineal descendants).

[26] 26 U.S.C. § 2057(e).

Computation of the Estate Tax Liability

Under the unified estate and gift tax system, computation of a decedent's estate tax liability requires a grossed-up, a combining, of the decedent's lifetime taxable gifts and the decedent's taxable estate to which the tax rate schedule is applied. Then, any available credits are taken to obtain the decedent's actual estate tax liability.[27]

The estate rate schedule[28] is as follows:

Taxable Estate	Tentative Tax
not over $10,000	18% of such amount
$10,000-$20,000	$1,800 + 20% of excess over $10,000
$20,000-$40,000	$3,800 + 22% of excess over $20,000
$40,000-$60,000	$8,200 + 24% of excess over $40,000
$60,000-$80,000	$13,000 + 26% of excess over $60,000
$80,000-$100,000	$18,200 + 28% of excess over $80,000
$100,000-$150,000	$23,800 + 30% of excess over $100,000
$150,000-$250,000	$38,800 + 32% of excess over $100,000
$250,000-$500,000	$70,800 + 34% of excess over $250,000
$500,000-$750,000	$155,800 + 37% of excess over $500,000
$750,000-$1,000,000	$248,300 + 39% of excess over $750,000
$1,000,000-$1,250,000	$345,800 + 41% of excess over $1,000,000
$1,250,000-$1,500,000	$448,300 + 43% of excess over $1,250,000
$1,500,000-$2,000,000	$555,800 + 45% of excess over $1,500,000
over $2,000,000	$780,800 + 49% of excess over $2,000,000

There are four major estate tax credits presently in effect: the unified transfer tax credit, the credit for State death taxes, the credit for foreign death taxes, and the credit for Federal estates taxes paid by previous estates. Each credit is a dollar-for-dollar offset against an estate's Federal estate tax liability.

The unified tax credit is available against both lifetime gift tax liabilities and the estate tax liability. To the extent it is used to offset gift taxes, it is unavailable to offset estate taxes. The credit is expressed in the code as an "applicable exclusion amount," *i.e.* the amount of taxable gifts or estate that the credit would cover. The applicable exclusion amount in 2002 is $1,000,000. This amount is scheduled to

[27] 26 U.S.C. § 2001(b).

[28] 26 U.S.C. § 2001(c). The 55% and 53% brackets were repealed at the end of the year 2001. Each year from 2003 through 2007 the top bracket is scheduled to drop1% (2003 = 49%, 2004 = 48%, 2005 = 47%, 2006 = 46%, and 2007 -2009 = 45%) of the excess over $2,000,000. For examples of use of this schedule and the applicable exclusion amount, *se*e, CRS Report RL31092, *Calculating Estate Tax Liability During the Estate Tax Phasedown Period,* by Nonna A. Noto.

increase during the phase out period to $3,500,000.[29] The $3,500,000 applicable exclusion amount is to be reached by a gradual phase-in as follows:

Year of Transfer	Applicable Exclusion Amount
2003	$1,000,000
2004-2005	$1,500,000
2006-2008	$2,000,000
2009	$3,500,000

Each estate is also allowed credits for State and foreign death taxes, including estates, inheritance, legacy, or succession taxes actually paid by the estate or any heir with respect to property included in the Federal gross estate.[30] The Code contains a table setting out the limits for the allowable State death tax credit, graduated by the size of the adjusted taxable estate (the taxable estate less $60,000).[31] The credit for foreign death taxes is limited to the amount of U.S. estate taxes paid on the same property. The credit is computed as the same proportionate share of the total U.S. estate taxes as the value of the foreign taxed property bears to the total of the U.S. taxable estate.[32]

The credit for previously taxed property (the PTP credit) is provided to relieve some of the harshness that could otherwise result when an individual dies soon after inheriting property upon which a Federal estate tax has already been imposed. The PTP credit is allowed for all or some portion of the Federal estate taxes paid on property transferred to the decedent within the past ten years. The PTP credit is graduated according to the amount of time that has elapsed between the date the property was transferred to the decedent and the date of death. The maximum PTP credit is 100% of the previously paid taxes, when the decedent received the property within the first two years prior to the date of death. The minimum PTP credit is 20% of the previously paid taxes, when the decedent received the property during the ninth and tenth years preceding the date of death.[33]

[29] 26 U.S.C. § 2010.

[30] 26 U.S.C. §§ 2011, 2014.

[31] 26 U.S.C. § 2011. This credit is to be phased out over the period 2002 to 2004 and be replaced by a deduction in 2005. Prior to this phase-out, the maximum state death tax credit was $1,082,800 plus 16% of the adjusted taxable estate above $10,040,000. The maximum amount of the credit allowed in 2002 was 75% of the prior credit. In 2003 the maximum amount of the credit is 50% of the pre-phase-out credit. In 2004,the maximum amount of the credit will be 25% of the pre-phase-out credit.

[32] 26 U.S.C. § 2014.

[33] 26 U.S.C. § 2013.

The Federal Gift Tax

The Federal gift tax is imposed on lifetime gifts of property.[34] The tax depends in large part upon the fundamental element—the value of the "taxable gift." The taxable gift is determined by reducing the gross value of the gift by the available deductions and exclusions. The gift tax liability determined on the basis of the donor's taxable gifts may be reduced by the available unified transfer tax credit.

The Taxable Gift

Determining the amount of a taxable gift is fundamental to determining the donor's ultimate gift tax liability. The amount of the taxable gift is the fair market value of the gift at the time it was made, less certain exclusions and deductions.[35] The major deductions and exclusions are the annual per donee exclusion, the gift tax marital deduction, and the gift tax charitable deduction.

Every donor may exclude from the Federal gift tax base the first $11,000 of cash or property given to each donee annually. An unlimited exclusion is available for gifts made by paying an individual's tuition or medical expenses.[36] The annual exclusion is unavailable, however, for gifts of future interests which vest in the donee only upon some future date. The present interest rule often requires complicated drafting techniques to obtain the annual exclusion for the value of a gift of a life insurance policy made in trust, or a gift to a minor, to be held in trust until the minor reaches a certain age.[37]

The annual exclusion may be doubled through "gift-splitting," in which one spouse consents to being treated as having made one-half of the gifts made by his or

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[34] The word "gift" is not defined in the tax laws, but the Code does state that the amount of a gift is ascertained when "property is transferred for less than an adequate and full consideration in money or money's worth.." 26 U.S.C. § 2512(b). Generally, the regulations state that a gift is made, for gift tax purposes, when there is a transfer for inadequate consideration and the transaction does not take place in a business context. Treas. Regs. § 25.2511. This should be distinguished from the definition of a "gift" for income tax purposes, which requires that the transfer be made from "detached and disinterested generosity." *Comm'r v. Duberstein*, 363 U.S. 278 (1960). A transfer may, therefore, be a gift for gift tax purposes, because there was no legally sufficient consideration, but not constitute a gift for income tax purposes, because it was not motivated by detached and disinterested generosity.

[35] 26 U.S.C. § 2512. Special valuation rules for valuation freezing transactions are set forth in 26 U.S.C. § 2701 through 2704.

[36] 26 U.S.C. § 2503. This figure is indexed for inflation.

[37] *But see*, 26 U.S.C. § 2503(c), for a special rule granting the annual exclusion for gifts to certain trusts created for the benefit of minors which permit the income to be expended for the benefit of the minor until the minor attains age 21, and requires the minor to be given outright ownership of the trust assets at that age or, if the minor should die prior to attaining age 21, to designate by will or otherwise the disposition of the property.

her spouse in that taxable year.[38] The election is made by a small notation on the gift tax return, and results in each spouse receiving a $11,000 per donee exclusion for one-half of the value of the same gift. Therefore, $22,000 per donee may be excluded annually from tax by gift-splitting.

A deduction is also allowed for all of the value of certain interspousal gifts.[39] Like its estate tax counterpart, no gift tax marital deduction is allowed for most gifts of terminable interests.[40]

A donor may also deduct the value of certain charitable gifts. The value of the gift may be deducted only if the charity is of a type described in the applicable statutory provision, which contains most, but not all, of the same charities for which deductible income tax contributions may be made.[41]

The division of property incident to a divorce or separation agreement may result in the interspousal transfer of property for a consideration which is not adequate for gift tax purposes. Consequently, the Code provides that interspousal transfers pursuant to a written agreement dividing the property of the spouses and occurring within two years before and one year after a decree of divorce will not be treated as taxable gifts, as long as the marital rights of the spouses are settled by the agreement or it provides for a reasonable allowance for the support of minor children.[42]

The renunciation of property given one by another person might be viewed as either the negation of the initial gift, resulting in no gift tax liability, or as a reciprocal gift, resulting in two gift tax liabilities. If a disclaimer is made in writing, before the donee has accepted any benefits of the property, and within nine months of the date the gift was made, the gift will be ignored for gift tax purposes.[43]

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[38] 26 U.S.C. § 2513. Gift-splitting also permits use of both spouses' unified transfer tax credits to eliminate present tax on lifetime taxable gifts.

[39] 26 U.S.C. § 2523(a).

[40] 26 U.S.C. § 2523(b),(f).

[41] 26 U.S.C. § 2522, *compare*, 26 U.S.C. § 170(c).

[42] 26 U.S.C. § 2516.

[43] 26 U.S.C. § 2518.

The Gift Tax Computation

The tax on a taxable gift is measured initially by the value of the transferred property, and is cumulative in nature.[44] The applicable rate of tax on a taxable gift is determined by the total of the donor's lifetime taxable gifts. The applicable rate of tax on each successive lifetime taxable gift is higher than on previous gifts. The estate and gift tax rate tables are identical.[45]

The actual computation of the gift tax for each calendar year is completed in three steps. First, the donor's total taxable gifts for the calendar year and preceding calendar periods are determined and the tax rate tables applied. Second, the tables are applied to the total taxable gifts for preceding calendar periods. Third, the figure from step two is subtracted from the figure in step one, and the total is reduced by any of the donor's unused unified transfer tax credits.[46]

The Tax on Generation-Skipping Transfers[47]

The Tax Reform Act of 1986 repealed the generation-skipping transfer tax, enacted in 1976, as being unduly complicated and replaced it with a simplified flat-rate tax.[48]

The purpose of the new generation-skipping transfer tax is the same as its 1976 predecessor, to close a loophole in the estate and gift tax system where property could be transferred to successive generations without intervening estate or gift tax consequences. The traditional generation-skipping transfers were trusts established by a parent for the life time benefit of the children with the remainder passing to the grandchildren. If properly drafted, no estate or gift tax would be imposed when the trust corpus passed from the settlers children to the settlers grandchildren because the estate tax is not imposed on interests which terminate at death.

There are two basic forms of generation-skipping transfers; the indirect skip, where the generation one level below the decedent receives some beneficial interest in the property before the property passes to the generation two or more levels below, and the direct skip, where the property passes directly to the generation two or more levels below the decedent. The 1976 law only taxed the indirect skip. The current system taxes both types of transfers.

[44] 26 U.S.C. § 2501.

[45] 26 U.S.C. § 2001(c).

[46] 26 U.S.C. §§ 2502, 2001(c), 2505.

[47] The Federal generation-skipping transfer tax is entering a phase out period from 2002 to 2009, at the end of which it will be repealed

[48] Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986*, 1263 (1987).

The generation-skipping tax is a flat-rate tax. The rate is set at the highest estate tax rate, currently 549.[49] This tax rate is applied to three different events, a taxable distribution, a taxable termination, or a direct skip.

A taxable distribution is a distribution from a trust, other than a taxable termination or direct skip, to a skip person.[50] A skip person is a person assigned to a generation two or more generations below the transferor's.[51]

A taxable termination is a termination by death, lapse of time, release of power, or otherwise of an interest in property held in trust, unless immediately after the termination a non-skip person has an interest in the property or at no time after the termination may a distribution be made from the trust to a skip person.[52]

A direct skip is a transfer to a skip person. A transfer to a trust is a direct skip if all the interests in the trust are held by skip persons.[53]

All persons are assigned a generation level under the statute. Persons related to the transferor or spouse are assigned along family lines. For example, the transferor, spouse, and brothers and sisters are in one generation, their children in the next and grandchildren the next. Lineal descendants of a grandparent of the transferor or spouse are assigned to generations on the same basis. Anyone ever married to a lineal descendant of the transferor's grandparent or the spouse's grandparent are assigned to the level of their spouse who was a lineal descendant. Non-relatives of the transferor are assigned generations measured from the birth of the transferor. Persons not more than 12 ½ years younger are treated as members of the same generation as the transferor. Each 25 year period thereafter is treated as a new generation. A grandchild of the transferor or spouse is moved up one generation if his parents are deceased at the time of the transfer.[54]

Several exemptions are provided in the statutory scheme. For transfers made prior to January 1, 1990, each grantor may exempt $2,000,000 in direct skips per grandchild ($4,000,000 for married individuals who elect to treat the transfers as made one-half by each).[55] The exclusion for tuition and medical expense payments from the gift tax[56] are also excluded from the generation-skipping tax.[57] The $11,000

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[49] 26 U.S.C. § 2641(a). *See,* note 28 for schedule changes to this rate.

[50] 26 U.S.C. § 2612.

[51] 26 U.S.C. § 2613.

[52] 26 U.S.C. § 2612.

[53] 26 U.S.C. § 2612.

[54] 26 U.S.C. § 2651.

[55] Pub. L. 99-514, § 1433(b)(3).

[56] 26 U.S.C. § 2503.

[57] 26 U.S.C. § 2611(b).

annual exclusion of the gift tax is recognized against taxation of direct skips only.[58] A $1,120,000 GST exemption is allowed to each individual for generation-skipping transfers during life or at death.[59] Again, the exemption is doubled for married individuals who elect to treat the transfers as made one-half by each.[60]

The GST exemption may be allocated by the transferor or the executory to any generation-skipping transfer. Once the allocation is made it is irrevocable. Unless a contrary election is made, all or any portion of the exclusion not previously allocated is deemed allocated to a lifetime direct skip to the extent necessary to make the inclusion ratio for the transfer zero.[61]

The inclusion ratio is figured by subtracting from one a fraction, the numerator of which is the portion of the GST exemption allocated to the transfer, the denominator of which is the value of the property transferred.[62] To compute the generation-skipping tax, the value of the transfer is multiplied by the tax rate (49%) and by the inclusion ratio.[63]

The liability for the tax is determined by the type of transfer. In the case of a taxable distribution, the tax shall be paid by the transferee. The tax on taxable terminations or direct skips from a trust shall be paid by the trustee. Direct skips, other than those from a trust, are taxed to the transferor.[64]

Current Developments

The Economic Growth and Tax Relief Reconciliation Act of 2001[65] generally repealed the Federal estate and generation-skipping transfer taxes at the end of the year 2009, provided for the phase out of these taxes over the period 2002 to 2009, lowered and modified the gift tax, provided new income tax carry-over basis rules for property received from a decedent, and made other general amendments which will be applicable in the phase out period.

The phase out of the estate tax is to be accomplished primarily by adjusting three features of the tax. The top rate is to be gradually lowered. The applicable exclusion amount is to be gradually raised. The credit for death taxes (estate or

[58] 26 U.S.C. § 2642(c).

[59] 26 U.S.C. § 2631. Starting in 2004, the GST exemption is to be equal to the estate tax applicable exclusion amount. *See*, discussion of increases of the applicable exclusion amount on page 7, above.

[60] 26 U.S.C. § 2652.

[61] 26 U.S.C. § 2632.

[62] 26 U.S.C. § 2642.

[63] 26 U.S.C. § 2641.

[64] 26 U.S.C. § 2603.

[65] P.L. 107-16.

inheritance taxes) paid to a State is to be gradually lowered and replaced by a deduction for such taxes. Also, the 5% surtax used to recapture the benefits of the graduated tax rates on taxable estates of over $10,000,000 is repealed, and, after the applicable exclusion amount has surpassed the $1,300,000 level used to protect family owned businesses, the family owned business deduction is repealed.