

DRIVING YOU TO DRINK: MEDDELSOME (BUT FREQUENT) GST ISSUES

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Statute of Limitations and Finality of Inclusion Ratio

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Finality of Inclusion Ratio: Timely Allocations

- If an allocation of GST exemption is made on a timely-filed gift tax return or is deemed made under the automatic allocation rules, the inclusion ratio is determined using the finally determined gift tax values.

Finality of Inclusion Ratio: Timely Allocations

- If an allocation of GST exemption is made on a timely-filed estate tax return and the property is transferred as a result of the transferor's death, the inclusion ratio is determined using finally determined estate tax values.

Finality of Inclusion Ratio: Timely Allocations

- Thus, if all allocations of GST exemption are made on timely filed returns, generally the inclusion ratio will be final when the statute of limitations has expired for the gifts and/or transfers at death.

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Finality of Inclusion Ratio: Timely Allocations

- Jim creates an irrevocable trust for the benefit of his daughter, Meredith. In 2011, Jim makes a gift of stock in a closely-held corporation to the trust. Jim timely files a 2011 gift tax return to report the gift of the stock as \$1,000,000 and allocates \$1,000,000 of his GST exemption to the transfer. In 2015, Jim makes a gift of \$2,000,000 to the trust. Jim timely files a 2015 gift tax return to report the gift and allocates \$2,000,000 of his GST exemption to the transfer.

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Finality of Inclusion Ratio: Timely Allocations

- Because Jim timely-filed gift tax returns and allocated his GST exemption to the transfers, the values used in determining the inclusion ratio for the trust should become final once the statute of limitations for the 2015 gift tax return has expired.

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Finality of Inclusion Ratio: Late Allocations

- If an allocation of GST exemption is not made on a timely filed return (and the automatic allocation rules did not apply), the value of the property for purposes of determining the inclusion ratio is the value at the time the late allocation is filed (as discussed later).
- Therefore, no finally determined gift tax values or estate tax values will apply.

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Statute of Limitations

- The inclusion ratio for a direct skip will become final when no additional GST tax may be assessed for the direct skip.

Statute of Limitations

- With respect to taxable distributions and taxable terminations, the inclusion ratio will become final on the *later* of:
 - (i) the expiration of the period of assessment with respect to the first GST tax return filed using that inclusion ratio; or
 - (ii) the expiration of the period of assessment of the federal estate tax with respect to the estate of the transferor.
- If an estate tax return is not required to be filed, the period of assessment is determined as if a return were required to be filed and the return was timely filed.

Statute of Limitations

- Therefore, you would have to file the appropriate GST tax return for the inclusion ratio to become final, even if the inclusion ratio is zero.
- Taxable terminations are reported on Form 706-GS(T), *Generation Skipping Transfer Tax Return for Terminations*.
- Taxable distributions are reported on Form 706-GS(D), *Generation-Skipping Transfer Tax Return for Distributions*, by the skip person beneficiary.
- The trustee reports taxable distributions on Form 706-GS(D-1), *Notification of Distribution from a Generation-Skipping Transfer Trust*.

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Statute of Limitations

- Jim creates an irrevocable trust for the benefit of his daughter, Meredith. Upon Meredith's death, the trust will continue for the benefit of Meredith's son, Roger.
- Jim makes small gifts to the trust for the years 2002 – 2010. Jim does not file any gift tax returns reporting the gifts. In 2014, Jim files a gift tax return to make a late allocation of his GST exemption to the trust. Jim believes the trust has an inclusion ratio of zero as a result of his late allocation.

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Statute of Limitations

- Jim dies in 2017. An estate tax return is filed for Jim's estate on May 20, 2018. Meredith dies on August 3, 2018.
- Roger is now the sole beneficiary of the trust. The Trustee believes that the inclusion ratio of the trust is zero and no GST tax will be due as a result of the termination of the trust (and the distribution to a skip person).
- Even though the Trustee believes the trust has an inclusion ratio of zero, the Trustee files a Form 706-GS(T) reporting the taxable termination on April 15, 2019.

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Statute of Limitations

- The inclusion ratio of the trust will become final upon the *later* of:
 - (i) the expiration of the period of assessment for Jim's estate tax return (May 20, 2021) or
 - (ii) the expiration of the period of assessment for the Form 706-GS(T) (April 15, 2022).
- If the Trustee did not file a Form 706-GS(T), the statute of limitations for the taxable termination would have remained open.

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Move Up/Move Down Rules

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Move Up Rule: Predeceased Ancestor

- If a descendant of a transferor is deceased at the time of the transfer (from which an interest of the descendant is established or derived) then the descendants of the deceased descendant move up one generation.
- An individual's interest is established or derived at the time the transferor is subject to transfer tax on the property.

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Move Up Rule: Predeceased Ancestor

- This rule can be applied to move a descendant up more than one generation level.
- The descendant will be treated as if they are one generation below the lower of:
 - (i) the transferor’s generation; or
 - (ii) the generation assignment of the individual’s youngest living ancestor who is also a descendant of the parent of the transferor.

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Move Up Rule: Predeceased Ancestor

- Jim dies in 2014 with an estate of \$10 million. Jim is survived by his wife Susan, his daughter Meredith, and his granddaughter April. Jim’s Will leaves all of his estate to a marital trust for Susan. Upon Susan’s death, the remaining property in the marital trust will be distributed to Jim’s descendants per stirpes.

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Move Up Rule: Predeceased Ancestor

- The executor of Jim's estate files an estate tax return and makes the QTIP election for the marital trust.
- Meredith dies in 2017. Susan dies in 2019.
- Due to the marital trust being included in Susan's gross estate, Susan is treated as the transferor of the trust for GST purposes under I.R.C. § 2652(a)(1)(A). The relevant transfer date is Susan's date of death. Because Meredith died before Susan, April is treated as though she were one generation below Susan. Thus, the termination of the marital trust is not a taxable termination.

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Move Up Rule: Predeceased Ancestor

- Same facts, except the executor of Jim's estate made a reverse QTIP election on the Form 706.
- The relevant transfer date is now Jim's date of death because Jim continues to be the transferor of the marital trust for GST purposes. When the trust terminates at Susan's death, a taxable termination will occur because April was living at the time of Jim's death.

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Move Up Rule: Predeceased Ancestor

- If the same transferor, on more than one occasion, is subject to transfer tax imposed by either chapter 11 or 12 on the transferred property then the relevant time is the earliest time at which the transferor is subject to the tax imposed by either chapter 11 or 12.

Move Up Rule: Predeceased Ancestor

- Jim and Susan create a revocable trust in 2012. Jim and Susan transfer community property stock in a closely-held corporation worth \$10,000,000 to the trust.
- Jim dies in 2015. Jim's one-half of the property in the revocable trust is distributed to a family trust for the benefit of Susan and their children. Susan's one-half of the trust property remains in a revocable trust.
- Jim and Susan have two children, Meredith and Jacob. Meredith has one child, April. Meredith dies in 2016.

Move Up Rule: Predeceased Ancestor

- Susan dies on April 17, 2019. All of the property remaining in Susan's revocable trust is distributed to Jacob and April.
- Even though a portion of the remaining property in Susan's revocable trust is distributed to Susan's grandchild, the distribution is not a generation skipping transfer.

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Move Up Rule: Predeceased Ancestor

- The relevant date for purposes of determining whether the predeceased ancestor exception applies is Susan's date of death, not the date on which the property was first transferred into the trust. The reason is that this is the first date on which the transferor is subject to tax on the transferred property. Because Meredith predeceased Susan, April is treated as though she is one generation below the transferor.

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Move Up Rule: Predeceased Ancestor

- This rule also applies to descendants of a parent of the transferor (or the transferor's spouse) but only if the transferor has no descendants living at the time of the transfer.

Move Up Rule: Predeceased Ancestor

- What is the “time of the transfer”?
 - Does the transferor have to have no lineal descendants at the time of a transfer to the trust or at the time of the GST from the trust to the grandnieces or grandnephews?
 - In Section 2651(e)(1), the phrase at the time of the transfer means at the time the transferor is first subject to tax on the property. However, the phrase is modified by the parenthetical (from which an interest of such individual is established or derived).

Move Up Rule: Predeceased Ancestor

- Jim has a Will that leaves all of his estate to his nephew, George, or if George is deceased to George's children. George has two children, Karen and Ashley. Jim has no children of his own.
- George dies in 2015. Jim dies in 2016.
- Because George is deceased at the time of Jim's death, George's children are treated as members of the generation that is one generation below Jim's generation. As a result, Karen and Ashley are not skip persons with respect to Jim and the transfers to them are not direct skips.

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Move Up Rule: Predeceased Ancestor

- Same facts, except Jim has an estranged son that he has not had any contact with for 10 years. Jim does not wish to leave any of his estate to his son.
- Now, the predeceased ancestor exception would not apply because Jim has a descendant. Karen and Ashley would be treated as skip persons and the transfers to them would be direct skips.

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Move Up Rule: Predeceased Ancestor

- A living person is not treated as having predeceased the transferor solely by reason of a provision of applicable local law.
- Therefore, even though under local law a disclaimer may act to treat an individual as having predeceased the transferor, the person will not be treated as having predeceased the transferor for GST purposes.

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Move Down Rule

- Once a taxable termination or a direct skip has occurred with respect to a trust, then the transferor is treated as moving down one generation above the highest remaining generation.
- The generation assignments are not redetermined but persons who were skip persons before such GST event may no longer be skip persons.

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Move Down Rule

- Sheldon creates a trust of which his grandchild, Leonard, and great-granddaughter, Penny, are current income beneficiaries. Upon Leonard's death, the trust will continue for Penny's lifetime. As the initial transfer is a direct skip, Sheldon is treated as having moved down one generation. Distributions to Leonard will not be subject to the GSTT, but transfers to Penny will be subject to the GSTT.

Late Allocations

Late Allocations

- If an allocation of GST exemption is not made on a timely filed Form 709, then the value of the property transferred is determined as of the date the late allocation is made.
- The taxpayer may elect to value the property for late allocation purposes as of the first day of the month in which the late allocation is made.

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Late Allocations

- The election is made by stating on the Form 709:
 - (i) that the election is being made;
 - (ii) the applicable valuation date; and
 - (iii) the fair market value of the trust assets as of the valuation date.

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Late Allocations

- Jim creates an irrevocable life insurance trust in 2011. Jim makes gifts of \$50,000 to the trust in 2012, 2013, 2014, 2015, 2016, 2017, and 2018 to fund the premium payments.
- Jim does not file a gift tax return reporting any of the gifts to the trust.

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Late Allocations

- In April 2019, Jim wants to make an allocation of his GST exemption to the trust.
- Jim will need to determine:
 - The value of all of the property in the trust on April 1, 2019 (if Jim makes the election to value the trust assets as of the first date of the month in which the return will be filed).
 - The inclusion ratio of the trust using the values on April 1, 2019.
- Jim gets a valuation of each of the policies in the trust as of April 1, 2019. The values total \$500,000. The inclusion ratio is one because Jim has not allocated any GST exemption to the trust.

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Late Allocations

- On the 2019 gift tax return, Jim will report the total values of all of the property in the trust as of April 1, 2019 and state that the inclusion ratio of the trust is one. Jim will allocate \$500,000 of his GST exemption to the trust.

Allocating Increased Exemption to Previous Transfers

Allocating Increased Exemption to Previous Transfers

- The GST exemption amount increased from \$5,490,000 in 2017 to \$11,180,000 in 2018 (\$11,580,000 in 2020). This increase in the GST exemption amount gives rise to a potential planning opportunity for a transferor to make an additional allocation of GST exemption to an existing trust.

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Allocating Increased Exemption to Previous Transfers

- The TCJA states that the increase in the basic exclusion amount applies to “estates of decedents dying or gifts made after” 2017 (and before 2026).
- It was unclear whether GST exemption could be allocated to trusts created before 2018 when a current transfer is not being made to the trust.

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Allocating Increased Exemption to Previous Transfers

- Inflation Adjustment Provisions.
- Joint Committee on Taxation, 105th Cong., 2d Sess., “General Explanation of Tax Legislation Enacted in 1998: Part Two: Internal Revenue Service Restructuring and Reform Act of 1998” (Nov. 24, 1998) states: With respect to existing trusts, transferors are permitted to make a late allocation of any additional GST exemption amount attributable to indexing adjustments in accordance with the present-law rules applicable to late allocations as set forth in sections 2632 and 2642, and the regulations promulgated thereunder.

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Allocating Increased Exemption to Previous Transfers

- Section 2631(a) states that an individual may allocate his or her GST exemption amount to “*any property* with respect to which such individual is the transferor.”
- “Any property” may include property transferred in previous years.

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Allocating Increased Exemption to Previous Transfers

- Bluebook (GENERAL EXPLANATION OF PUBLIC LAW 115–97 Prepared by the Joint Committee on Taxation).
- “Because the generation-skipping transfer tax exemption under section 2631(c) is set by cross-reference to the basic exclusion amount in effect for estate tax purposes, this increase to the basic exclusion amount also increases the amount of generation-skipping transfer tax exemption available *to be allocated* from January 1, 2018, through December 31, 2025” (emphasis added).

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Allocating Increased Exemption to Previous Transfers

- On January 20, 2016, Jim created a trust for the benefit of his daughter, Meredith, and grandchildren. Jim transferred a piece of property on Lake Travis to the trust. Jim timely filed a gift tax return reporting the value of the property as \$6,000,000. Jim’s entire then-remaining generation-skipping transfer tax exemption of \$5,400,000 was allocated to the transfer.
- As of the date of the 2016 gift, the trust has an inclusion ratio of 0.100 [1 - (\$5,400,000/\$6,000,000)].

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Allocating Increased Exemption to Previous Transfers

- On July 1, 2018, when the property in the trust has a fair market value of \$7,000,000, Jim files a gift tax return and allocates \$700,000 of his remaining generation-skipping transfer tax exemption to the trust.
- This allocation reduces the trust's inclusion ratio from 0.100 to zero $[1 - ((\$700,000 + (90\% \times \$7,000,000)) / \$7,000,000)]$, effective on July 1, 2018.

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Allocating Increased Exemption to Previous Transfers

- The generation-skipping transfer tax on a taxable distribution from, or a taxable termination with respect to, the trust on or after July 1, 2018, is determined using an inclusion ratio of zero.
- In this example in the Bluebook, the individual was able to make a late allocation of the increased GST exemption for a previously created trust. However, the Bluebook is not a definitive statement of the law.

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Allocating Increased Exemption to Previous Transfers

- An allocation of the GST exemption can be made *any time* before the due date of the transferor's estate tax return (including extensions). I.R.C. §2632(a)(1)
- When an additional allocation of GST exemption is made to an existing trust, the applicable fraction of the trust is re-computed. The numerator of the new applicable fraction is the amount of additional GST exemption being allocated plus the value of exempt portion of the trust and the denominator is the fair market value of the trust at the time of the additional allocation.

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Annual Exclusion Gifts

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Annual Exclusion Gifts

- An outright direct skip transfer that qualifies for the gift tax annual exclusion is not subject to the GST tax. The transfer is deemed to have an inclusion ratio of zero.
- A direct skip transfer to a trust that qualifies for the gift tax annual exclusion does not automatically qualify as nontaxable for purposes of the GST tax.

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Annual Exclusion Gifts

- A transfer to a trust will only qualify for the annual exclusion from GST tax if:
 - (1) The trust is exclusively for one beneficiary during his/her lifetime; and
 - (2) The trust corpus is includible that beneficiary's estate if he or she dies before the trust termination.
- This rule is effective for transfers to trusts after March 31, 1988.

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Annual Exclusion Gifts

- Sheldon creates a trust for his grandchild, Leonard, and gives Leonard a general power of appointment over the trust. Sheldon transfers \$10,000 to the trust. Leonard has a power of withdrawal applicable to the transfer such that the transfer qualifies for the gift tax annual exclusion. The entire transfer will also qualify for the GST annual exclusion.

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Annual Exclusion Gifts

- Same as previous example, however, the trustee may also distribute income from the trust to Sheldon's great-grandchild, Penny. Now, none of the transfer would qualify for the GST annual exclusion even if part of the transfer will qualify for the gift tax annual exclusion.

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Annual Exclusion Gifts

- Sheldon creates a trust for Leonard and his great-grandchild, Penny. Sheldon transfers real property to the trust with a fair market value of \$600,000. Leonard has a power of withdrawal applicable to the transfer such that the transfer qualifies for the gift tax annual exclusion. Therefore, the total gift to the trust for gift tax purposes is \$585,000.

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Annual Exclusion Gifts

- The gift to the trust does not qualify for the GST annual exclusion because the trust is not exclusively for one beneficiary. Leonard must allocate \$600,000 of his GST exemption to the transfer in order for the trust to be fully exempt.

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Effective Date of Allocations

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Effective Date of Allocations: Timely Filed Gift Tax Returns

- If an allocation is made on a timely-filed gift tax return or under the automatic allocation rules, the allocation is deemed effective as of the date of the transfer.

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Effective Date of Allocations: Late Allocations

- If an allocation is made on a gift tax return that is not timely filed, the allocation is effective on the date that the late allocation is filed. A Form 709 is deemed filed on the date it is postmarked to the IRS.

Effective Date of Allocations: Allocations at Death

- An allocation of GST exemption by an executor with respect to property included in the gross estate of a decedent is effective as of the date of death.

Effective Date of Allocations: Allocations at Death

- An executor can allocate GST exemption to trusts that are not included in the transferor's gross estate.

Effective Date of Allocations: Allocations at Death

- A timely allocation of GST exemption by an executor for a lifetime transfer of property not included in the gross estate is made on a Form 709, and is effective as of the date of the transfer.
- A late allocation of GST exemption by an executor with respect to a lifetime transfer of property is made on Form 706 (filed on or before the due date of the transferor's estate tax return) and applies as of the date the allocation is filed.
 - What values? File Form 709?

Effective Date of Allocations: Allocations at Death

- A decedent's unused GST exemption is automatically allocated on the due date for filing Form 706 to the extent not otherwise allocated by the decedent's executor on or before that date.
- What is the effective date?
 - Treasury Regulation 26.2632-1(d)(2) states that the unused GST exemption is allocated on the basis of the value of the property as finally determined for estate tax purposes.
 - This would be inconsistent with the use of the filing date for affirmative late allocations.
 - This may be significant if you have a GST event either on the death of the transferor or between the date of the transferor's death and the filing of the estate tax return.

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Effective Date of Allocations: Late Allocations

- In 2013 Jim creates an irrevocable trust for the benefit of his daughter, Meredith. Jim makes a gift to the trust of stock worth \$1,000,000 in 2013 and a gift to the trust of stock worth \$1,500,000 in 2015.
- Jim did not file a gift tax return reporting the transfer in 2013 (assume that automatic allocations did not apply to the transfer). Jim timely filed a gift tax return for 2015 to report the gift of stock and allocates \$1,500,000 of his GST exemption to the transfer. The trust has a mixed inclusion ratio.

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Effective Date of Allocations: Late Allocations

- Jim dies on August 10, 2017. Meredith dies on January 12, 2018. The remaining property of Meredith's trust is distributed to Meredith's child, April.
- On the date of Jim's death, the trust has a value of \$5,000,000. Jim has \$9,000,000 of remaining GST exemption at his death.

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Effective Date of Allocations: Late Allocations

- Jim's executor timely files an estate tax return on March 10, 2018. The trust is not included in Jim's gross estate. On the estate tax return, the executor allocates Jim's remaining GST exemption to the trust so that the trust has an inclusion ratio of zero.
- The allocation of Jim's remaining GST exemption on his estate tax return is a late allocation. As a result, the allocation is effective on March 10, 2018. Therefore, Meredith's death (after Jim's death but before the filing of the estate tax return) will be a taxable termination.

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Effective Date of Allocations: Late Allocations

- Same facts, except that Jim's executor did not file an estate tax return. Jim's remaining GST exemption was automatically allocated to the trust.

Automatic Allocations

Automatic Allocations: Indirect Skips

- Applies to lifetime transfers after 2000.
- Transfers to trusts (other than direct skips) which are “GST Trusts.”
- A “GST Trust” is any trust that could have a generation-skipping transfer unless an exception under IRC § 2632(c)(3)(B) applies.

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Automatic Allocations: Indirect Skips

- The fourth exception to a GST Trust is for a trust any portion of which would be included in the estate of a non-skip person if such person died immediately after the transfer.
- What if the trust merely contains a contingent general power of appointment?
- What if the trust has “Crummey” withdrawal rights?

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Automatic Allocations: Indirect Skips

- As an exception to the exception, a trust will not be considered to be included in the estate of a non-skip person if such person possesses a right of withdrawal within the annual exclusion limits.
- It is possible that a trust will contain “hanging” withdrawal rights so even though the beneficiary only has the right to withdraw up to the annual exclusion amount, if the right from a previous year did not lapse completely the beneficiary’s total withdrawal rights may be more than the annual exclusion amount.

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Automatic Allocations: Indirect Skips

- Lois creates a trust for her son, Stewie, and her grandchildren. Stewie holds a general power of appointment over the trust. Because the trust would be included in the estate of a non-skip person, the trust is not a GST trust and automatic allocation will not occur.
- Same as previous example, however, instead of a general power of appointment, Stewie has a lapsing power to withdraw within the annual exclusion limits. The trust would be a GST trust and automatic allocation will occur.

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Automatic Allocations: Indirect Skips

- Same as previous example, however, Stewie's power of withdrawal only lapses to the extent the lapse would not cause Stewie to be treated as having made a taxable gift.
- In Year 1, Lois makes a gift of \$50,000. Stewie has the right to withdraw \$15,000. This right lapses to the extent of \$5,000 (which is the greater of \$5,000 or 5% of the trust property). The remaining \$10,000 is carried forward to next year. Automatic allocations should apply to the transfer because the withdrawal right is within the annual exclusion amount.

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Automatic Allocations: Indirect Skips

- In Year 2, Lois makes another gift of \$50,000. Stewie has the right to withdraw \$15,000 of the gift in Year 2 plus the continuing right to withdraw \$10,000 from Year 1.
- Now, the amount that Stewie may withdraw from the trust is greater than the annual exclusion amount (the total amount that he can withdraw is \$25,000). Consequently, the exception to the exception would not apply.

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Substantial Compliance

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Substantial Compliance

- An allocation of GST exemption under section 2632 that demonstrates an intent to have the lowest possible inclusion ratio with respect to a transfer or a trust shall be deemed to be an allocation of so much of the transferor's unused GST exemption as produces the lowest possible inclusion ratio. I.R.C. § 2642(g)(2).
- In determining whether there has been substantial compliance, all relevant circumstances are taken into account, including evidence of intent contained in the trust agreement.

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Substantial Compliance

- The relief applies to transfers subject to the estate or gift tax made after December 31, 2000.

Substantial Compliance

- Jim created an irrevocable trust on January 3, 2002 for the benefit of Jim's wife, Jane, and their descendants. On January 3, Jim transferred stock in a closely-held corporation to the trust with a fair market value of \$2,500,000.
- Jim's attorney prepared the Form 709 and correctly reported the transfer as an indirect skip on Schedule A, Part 3. Jim allocated his GST exemption to the transfer on Schedule C, Part 2, Line 6. However, Jim's attorney did not attach a Notice of Allocation for the transfer. The Form 709 was timely filed and a copy of the trust agreement was attached to the return.

Substantial Compliance

- In PLR 201936001, the IRS held that although the taxpayer did not attach a Notice of Allocation, the information on the Form 709 in combination with the terms of the trust agreement (which was attached to the return) demonstrated the taxpayer's intent to allocation his GST exemption to the trust.

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Substantial Compliance

- For pre-December 31, 2000 transfers, the IRS has granted relief from ineffective allocations on "substantial compliance" grounds. See, for example, PLR 200017013 ("The allocations will be deemed valid if there are enough facts and circumstances to indicate that the Taxpayers intended to allocate part of their GST exemption to Trust.")

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