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PROPOSED GUIDANCE REGARDING THE TREATMENT OF ENCUMBERED TRUST PROPERTY IN LATE ALLOCATION OF GST EXEMPTION AND QUALIFIED SEVERANCES UNDER IRC §§ 2631(a) AND 2642(a)(3), (b) (Treas. Reg. § 26.2632-1(b))

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[1] The comments contained in this paper are the individual views of the authors, and do not represent the position of the California Lawyers Association, its Taxation Section, or of the paper's reviewers.
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EXECUTIVE SUMMARY

This paper summarizes the wealth transfer tax rules pertaining to the valuation of encumbered trust property and the practical implications of those rules in the context of (1) a late allocation of GST exemption for generation-skipping transfer tax purposes and (2) a qualified severance for purposes of the generation-skipping transfer tax. This paper will also propose alternatives derived from existing law to provide guidance to taxpayers in these affected areas.

The generation-skipping transfer tax is a wealth transfer tax levied on certain transfers, whether outright or in trust, to a transferee who is two or more generations below the generation of the transferor. The generation-skipping transfer tax is computed by multiplying the value of the transferred property by the applicable rate. The applicate rate is the product of the maximum estate tax rate multiplied by the inclusion ratio, which is a function of the fair market value of the subject property and the generation-skipping transfer tax exemption of the transferor as applied to the subject property.

Accordingly, the valuation of trust property for generation-skipping transfer tax purposes is critical. In many instances, the valuation of trust property is clear for such purposes. For example, Internal Revenue Code Section[3] 2642(b)(1) and (2) generally provides that the valuation of property for generation-skipping transfer tax depends on whether such transfer is subject to gift or estate tax (i.e., gifted property shall be valued as finally determined for gift tax purposes, while property transferred at death shall be valued as finally determined for estate tax purposes).

This paper notes that (1) encumbered property is reported differently for gift and estate tax purposes and that (2) neither a late allocation of generation-skipping transfer tax exemption nor a qualified severance is a transfer, and as such neither is, in and of itself, subject to gift or estate tax. With this in mind, what body of rules ought to apply in such circumstances? After an analysis of these rules, this paper will propose options derived from existing law to provide guidance to taxpayers in the context of (1) a late allocation of generation-skipping transfer tax exemption and (2) a qualified severance for purposes of the generation-skipping transfer tax.

[3] Except as otherwise provided, all references to "Section" or "§" below refer to the Internal Revenue Code of 1986, as amended.

DISCUSSION

I. BACKGROUND

This paper will review the rules pertaining to the valuation of encumbered trust property in the context of (1) a late allocation of GST exemption and (2) a qualified severance for purposes of the generation-skipping transfer tax, and seek clarification regarding the valuation of encumbered trust property in computing the inclusion ratio or applicable fraction of a trust resulting from a late allocation of GST exemption or a qualified severance.

II. RELEVANT LAW

A. Relevant GST Tax Principles

1. Calculation of the GST Tax

The calculation of the generation-skipping transfer tax is a product of two basic components, (1) the taxable amount (i.e., the value of property subject to the generation-skipping transfer tax), and (2) the applicable rate.[4] The applicable rate is the product of the maximum federal estate tax rate (currently 40 percent) and the inclusion ratio with respect to the transfer.[5]

2. Inclusion Ratio

In general, the inclusion ratio is equal to the difference between 1 – applicable fraction.[6] The applicable fraction is a fraction the (a) numerator of which is the amount of the GST exemption allocated to the trust and (b) the denominator of which is the value of the property transferred to the trust reduced by federal estate tax or state death tax actually recovered from the trust and any charitable deduction allowed for estate or gift tax purposes.[7]

3. Observation

Given the inclusion ratio formula, the value of property transferred to the trust will have a direct impact on the calculation of the generation-skipping transfer tax. Accordingly, those with the authority to allocate the GST exemption will generally seek to allocate sufficient GST exemption to yield an inclusion rate of zero, thereby eliminating the tax. In order to obtain this result, the party making the allocation must ascertain the value of the property transferred and allocate GST exemption of an equivalent amount.

B. Rules of Valuation and Allocation Related to GST Exemption

The generation-skipping transfer tax laws provide various rules regarding the value of property for GST tax purposes. Section 2624(a) provides the general valuation rule for GST

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[4] IRC § 2602.
[5] IRC § 2641(a).
[6] IRC § 2642(a)(1).
[7] IRC § 2642(a)(2).

tax purposes, "Except as otherwise provided in this chapter, property shall be valued as of the time of the generation-skipping transfer." A generation-skipping transfer means only a taxable distribution, a taxable termination and a direct skip.[8] Subsequent Section 2642 provides more detailed guidance as to methods of valuation, but this is limited in application to only certain events related to a transfer of property that occur prior to the generation-skipping transfer and which is then used in determination of the inclusion ratio. There are differences in these rules that present open valuation questions regarding the treatment of encumbered property included in a late allocation of GST exemption or a qualified severance.

1. Timely Allocation

For purposes of a timely allocation of GST exemption, the value of such property transferred for purposes of determining the inclusion ratio shall be the value as finally determined for gift or estate tax purposes,[9] depending on whether the transfer occurred during life or at death, in most instances.[10] For a lifetime transfer, the statute makes clear that a timely allocation as to a lifetime transfer (and in turn, the use of values as finally determined for gift tax purposes) occurs whether the GST exemption allocation is being made manually on a timely filed gift tax return or is deemed to be made (automatically) pursuant to Section 2632(b)(1) (for a lifetime transfer to a direct skip) or Section 2632(c)(1) (for a lifetime transfer to a GST trust[11]). In contrast, the statute regarding GST exemption for transfers and allocations at or after death, does not make any distinction and provides simply (in relevant part) that "[i]f property is transferred as a result of the death of the transferor, the value of such property for purposes of subsection (a) [determination of the inclusion ratio] shall be its value as finally determined for purposes of chapter 11 [the estate tax]; …"[12]

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[8] IRC § 2611(a). The term "taxable distribution" means any distribution from a trust to a skip person (other than a taxable termination or a direct skip). IRC § 2612(b). The term "taxable termination" means the termination (but death, lapse of time, release of power or otherwise) of an interest in property held in trust unless (i) immediately after such termination a non-skip person has an interest in such property, or (ii) at not time after such termination may a distribution (including distributions or termination) be made from such trust to a skip person. IRC § 2612(a)(1). Finally, the term "direct skip" means a transfer of property to a skip person that is subject to Federal estate or gift tax. IRC § 2612(c)(1). A "skip person" is defined in Treasury Regulation Section 26.2612-1(d) as "(1) an individual assigned to a generation more than one generation below that of the transferor (determined under the rules of [IRC] section 2651); or (2) a trust if (i) all interests in the trust are held by skip persons; or (ii) no person holds an interest in the trust and no distributions, other than a distribution the probability of which occurring is so remote as to be negligible (including distributions at the termination of the trust), may be made after the transfer to a person other than a skip person."

[9] IRC § 2642(b); Treas. Reg. 26.2642-2(a) – (b). The inclusion ratio also becomes final when no generation-skipping transfer tax may be assessed for direct skips and upon the expiration of the later of the period for assessment for the first GST tax return or estate tax return for the transferor. *See* Treas. Reg. § 26.2642-5(a) and (b).

[10] IRC § 2642(b)(1)(A) and (2)(A); Treas. Reg. § 26.2642-2(b)(a)(1) and (b)(1). Note there are certain exceptions for lifetime transfers into trust that are subject to an estate tax inclusion period and where requirements for the allocation of post-death changes in value are not met.

[11] A "GST trust" is defined in IRC § 2632(b)(3)(B) as a trust that could have a generation-skipping transfer with respect to the transferor unless one of six exceptions is met.

[12] IRC § 2642(b)(2)(A).

2. Late Allocation

A late allocation of GST exemption is eligible to occur as to assets held in a trust to which the transferor previously made a lifetime transfer that was not a direct skip and as to which the inclusion ratio is not already zero due to a timely allocation of GST exemption.[13] For purposes of a late allocation of GST exemption, the value of such property for purposes of determining the inclusion ratio shall be determined as of the time such allocation is filed or, as permitted by Treasury Regulation, the first day of the month during the allocation is made.[14] Unlike the rules for a timely allocation of GST exemption, the rules for valuing property for purposes of a late allocation of GST exemption do not explicitly reference gift or estate tax values. A late allocation of GST exemption can occur during the transferor's lifetime or can be made after the transferor's death by the transferor's executor with the late allocation eligible to occur up until the due date (taking into account extensions) for the transferor's estate tax return, regardless of whether such a return is required to be filed.[15]

3. Qualified Severance

Qualified severances are often sought where the trust has an inclusion ration greater than zero but less than one to avoid a taxable distribution and termination. In such instances, a trust severance is only a qualified severance if a single trust is divided into two or more trusts, one of which receives a fractional share of the total value of all trust assets equal to the applicable fraction immediately before the severance.[16] That trust will have an inclusion ratio of zero and the other trust shall have an inclusion ratio of one.[17] For this purpose, the assets are valued as of the date of severance.[18] Like the rules for valuing property for purposes of a late allocation of GST exemption, the rules for valuing property for a qualified severance do not explicitly reference gift or estate tax values.

4. Observations

As discussed above, the value of the property transferred to the trust will impact both the numerator and denominator of the application fraction. Accordingly, this will also have an impact on the inclusion ratio, applicable rate and tax computed. For timely allocations of GST exemption, the value of such property, and correspondingly the amount of GST exemption needed to achieve an inclusion ratio of zero, is dependent on the value of such property determined for gift or estate tax purposes. However, as to late allocations of GST exemption or determining the resulting applicable fraction pursuant to a qualified severance the rules do not incorporate such values presumably because no transfer has occurred for gift or estate tax purposes. Instead, the applicable statute and regulations make reference to the value as of the time of the allocation or severance. How should such values be determined?

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[13] IRC § 2642(b)(3).
[14] IRC § 2642(b)(3)(A); Treas. Reg. § 26.2642-2(b)(a)(2).
[15] IRC § 2642(a)(1); Treas. Reg. § 26.2632-1(d)(1).
[16] IRC § 2642(a)(3)(B)(ii).
[17] Id.
[18] IRC § 2642(a)(3); Treas. Reg. § 26.2642-6(d)(3).

The generation-skipping tax laws also provide rules for the determination of taxable amounts of the various generation-skipping transfers (i.e., a taxable distribution, taxable termination and direct skip).[19] These rules simply refer to the value of the property received by the transferee or the trust property with reductions for generation-skipping transfer tax or amounts deductible under section 2053 (relating to expenses, indebtedness and taxes) in the case of taxable distributions and terminations, respectively.[20] There are no Treasury Regulations that provide further illumination regarding the application of these valuation rules.

In the absence of more guidance, since the occurrence of a late allocation of GST exemption or qualified severance is predicated upon there having earlier been a transfer of some kind of property by a transferor, it seems that looking to the gift and estate tax principles would be informative in determining the value of encumbered trust property for purposes of a late allocation of GST exemption or a qualified severance.

C. TREATMENT OF ENCUMBERED PROPERTY FOR GIFT AND ESTATE TAX PURPOSES

1. Variations in Transfer Tax Valuation of Encumbered Property

Despite the general similarities of gifts and bequests in the overall transfer tax regime, the valuation treatment of encumbered property for gift tax purposes and estate tax purposes is handled differently and these differences are amplified when determining GST tax allocations that are based on references to gift and estate tax principles.

2. Gift Tax Law Applicable to Valuation of Encumbered Property

When making a timely allocation of GST exemption due to the occurrence of a lifetime transfer, Section 2642(b)(1) provides in relevant part that "[i]f the allocation of the GST exemption to any transfers of property is made on a gift tax return filed on or before the date prescribed by Section 6075(b) for such transfers or if deemed to be made under Section 2632(b)(1) [applicable to lifetime transfers to a direct skip] or (c)(1) [applicable to lifetime transfers to a GST trust] the value of such property for purposes of [determining the inclusion ratio] shall be its value as finally determined for purposes of chapter 12 (within the meaning of Section 2001(f)(2))…"

In the case of encumbered property, however, chapter 12 is not as helpful as would be expected at first glance. Section 2512(a)-(b) sets forth a deceptively simple valuation rule:

> "(a) If the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift.
>
> (b) Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of

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[19] IRC §§ 2621 (for a taxable distribution), 2622 (for a taxable termination) and 2623 (for a direct skip).

[20] IRC §§ 2621(a) and 2622(a)(2). "For purposes of subsection (a), there shall be allowed a deduction *similar to* the deduction allowed by section 2053 (relating to expenses, indebtedness, and taxes) for amounts attributable to the property with respect to which the taxable termination has occurred." (emphasis added) IRC § 2622(b).

the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year."

The valuation assessment becomes less clear, however, in determining whether the gift of the encumbered property will be subject to the application of Section 2512(b) and treated as a transfer of property for less than adequate and full consideration in money or money's worth when one considers the different forms of encumbrances as recourse or nonrecourse debt. For a nonrecourse debt, if the donee accepts the property subject to the nonrecourse encumbrance (and the fair market value of the property exceeds the amount of the indebtedness), then the value of the property for gift tax purposes is determined by reducing the fair market value of the property by the amount of the encumbrance, in essence characterizing the gift as the equity in the property that the donee has received.[21]

If a recourse debt is involved with a property transferred as a gift, the valuation of the property for gift tax purposes depends on the rights of the donee against the donor in the event that the donor defaults. The amount of the debt should not be taken into account in valuing the gift for gift tax purposes, such that the fair market value of the gift is the entire value of the transferred property, if the donee has a legal right to the donor's continued payment of the debt or to subrogation if the donor defaults on the debt.[22] Similar to nonrecourse debt, the amount of the debt should be taken into account in valuing the gift for gift tax purposes if the donee assumes the debt or otherwise is unable to compel the donor to pay the debt.[23]

In all events, if the gift of the encumbered property is completed in coordination with the debt no longer being a legal obligation of the donor, any additional payments made by a donor on the debt are additional taxable gifts.[24]

Cases and rulings on the valuation of encumbered property for gift tax purposes make reference to recourse and nonrecourse debts, but in none of the cases and rulings was the identification of the debt as recourse or nonrecourse the controlling fact and instead the ultimate determination was made based on which party would liable for payments on the debt in the future - the donor or the donee (either expressly or by virtue of potential collection against the donee's new property). The focus on this fact, rather than the characterization of the debt, may be due to the fact that in the gift tax area there is no definition of these debt terms. Borrowing from the income tax arena, Treasury Regulation Section 1.1001-2(c) provides that a loan is recourse if the borrower is personally liable for the debt, and nonrecourse if the borrower is not personally liable for the debt and the creditor's recourse is limited to the secured asset. Numerous income tax cases, however, illustrate that despite these simple definitions, the Internal Revenue Service and taxpayers can still dispute the characterization of a debt as recourse or nonrecourse when supporting loan documents are silent or unclear in stating the agreed upon scope of liability for the

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[21] *See generally* Revenue Ruling 78-362; Powe v. Comm'r, TC Memo. 1966-40, aff'd per curiam, 389 F2d 46 (5th Cir. 1967), cert. denied, 393 US 826 (1968); Janos v. Comm'r, TC Memo. 1953-003; PLR 200540008 (October 7, 2005); *see also* language in S. Rep. No. 1013, 80th Cong., 2d Sess. (1948).

[22] *See* Jackman v. Comm'r, 44 BTA 704 (1941), acq.1942-1 CB 9.

[23] *See* Alexander v. United States, 640 F2d 1250 (Ct. Cl. 1981).

[24] *See* Revenue Ruling 78-362; Alexander v. United States, 640 F2d 1250 (Ct. Cl. 1981).

parties.[25] A form of hybrid recourse can also be created when loan provisions may provide for changes in the debt from nonrecourse to recourse if certain events take place.[26]

The potential lack of clarity due to the absence of defined debt terms for gift tax purposes favors the approach that has developed in the cases and rulings of a facts and circumstances test that values encumbered property for gift tax purposes without regard to the mere characterization of such debt as recourse or nonrecourse debt but instead based on the value of the property reduced by a factual assessment of the amount of the debt for which the donee becomes liable, whether by the donee's express assumption of the debt or by the donee's inability to compel payment from the donor thereby requiring donee's payment on the debt to retain the property.[27] This fact based assessment of a donee's liability is straightforward and easily replicable to other areas of fields of taxation.

3. Estate Tax Law Applicable to Valuation of Encumbered Property

In the testamentary context, allocation of GST exemption is determined by reference to Section 2642(b)(2) which provides in relevant part that "[i]f property is transferred as a result of the death of the transferor, the value of such property for purposes of [determining the inclusion ratio] shall be its value as finally determined for purposes of chapter 11…"

In the estate tax context, the value of encumbered property for chapter 11 purposes is also determined by the payor of the liability, but in a more attenuated method that is based on the deductibility of the debt by the estate. If the deceased transferor's estate is not personally liable on the debt, such as is often the case with a nonrecourse debt, only the difference (if any) between the unencumbered fair market value and the liability is included in the gross estate as the value of the property for estate tax purposes.[28] If the debt was one for which the deceased transferor's estate is personally liable, as with most recourse debts, the property is included in the gross estate at its full fair market value, unencumbered by the liability, but the debt is generally deductible under Section 2053(a)(4),[29] subject to certain limitations.[30] Again, the exact classification of the debt as recourse or nonrecourse is not the determining factor, but rather the factual assessment of

[25] *See generally*, Raphan v. United States, 759 F.2d 879, 885 (Fed. Cir. 1985); Great Plains Gasification Associates v. Commissioner, T.C. Memo 2006-276.
[26] *See* Blue Hills Office Park v. J.P. Morgan Bank, 477 F. Supp. 2d 366 (D. Mass. 2007); Wells Fargo Bank, N.A. v. Cherryland Ltd. P'ship, 300 Mich. App. 361, 370 (Mich. Ct. App. 2013) (loan provisions that effectively converted a recourse loan to a non-recourse loan due to events taking place during the term of the loan were held enforceable by the Michigan Court of Appeals but were per se invalid under the Michigan Nonrecourse Mortgage Lending Act that was enacted following the lower court's initial ruling in 2011).
[27] The authors acknowledge that while there are no express definitions of recourse and nonrecourse debt in the gift area, in practice nonrecourse debt will in most cases will meet the required fact pattern of being assumed by the donee and recourse debt will be less often be structured to transfer the liability to the donee.
[28] *See* Treas. Reg. § 20.2053-7; Estate of Johnstone v. Commissioner, 19 TC 44 (1952); Rev. Rul. 79-302, 1979-2 CB 328.
[29] *See* Treas. Reg. § 20.2053-7; Estate of Fawcett v. Commissioner, 64 TC 889, 894–898 (1975) (acq.); Estate of Killion v. Commissioner, TC Memo. 1988-244, at 1255–1256, 55 TCM 1008–1009.
[30] *See* IRC § 2053(c); Estate of Theis v. Commissioner, 770 F2d 981 (11th Cir. 1985) (no deduction where decedent was not primarily liable); Rev. Rul. 84-42, 1984-1 CB 194 (same).

whether the liability is a general liability of the donor's estate or a limited liability to collect the debt only from the encumbered asset itself.[31]

When considering the calculation of estate tax, the different treatment of encumbered property as an asset included in the estate at a gross value (with an offsetting deduction) or a net value (after reduction for the liability) will generally not result in a meaningful difference in estate tax due. However, in other estate related areas the difference can be consequential, including having an impact on whether an estate meets the threshold for having an obligation to file an estate tax return, whether an estate qualifies for estate tax deferral under Section 6166, calculation of the estate tax marital deduction taking into account Section 2056(b)(4).[32] Allocation of GST exemption when transfers occur as a result of the death of the transferor under Section 2642(b)(2), which makes reference only to the value of the property as finally determined for purposes of chapter 11 (without reference to deductibility under Section 2053, if applicable) is another area where differences can be noted.

The variation in treatment is well illustrated when looking to examples of encumbered property when a late allocation or qualified severance is at issue and considering the application of one of the existing valuation methods already included in the GST tax area.

III. EXAMPLES

A. LATE ALLOCATION OF GST EXEMPTION TO ENCUMBERED TRUST PROPERTY

1. Facts

The Smith Gift Trust (an intentionally defective grantor trust classified as a GST trust to which automatic allocation of GST tax exemption would apply) was originally funded by a gift in 2018 by Mr. Smith, the donor and grantor of the Smith Gift Trust. The original gift consisted of (i) real estate referred to as Parcel A with a value of $250x and that was unencumbered, and (ii) real estate referred to as Parcel B with a value of $400x and subject to a nonrecourse mortgage of $200x that was fully assumed by the Smith Gift Trust in coordination with the gift and extinguished all obligations for Mr. Smith to make payments on such mortgage. Mr. Smith timely filed a 2018 gift tax return reporting total taxable gifts of $450x and in such return he (i) opted-out of the automatic allocation of GST exemption otherwise applicable as to his gift to the Smith Gift Trust and (ii) did not affirmatively allocate any GST tax exemption to his gift to the Smith Gift Trust. As a result, the Smith Gift Trust has an applicable fraction of 0.0 and an inclusion ratio of 1.0.

In 2022, the Smith Gift Trust borrowed $100x from Mr. Smith to make improvements to Parcel A and Parcel B. That loan terms provided that the liability of the Smith

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[31] As in the gift tax area, there are no express definitions of recourse debt or nonrecourse debt in the estate tax area.

[32] *See* John A. Bogdanski, Federal Tax Valuation, para. 6.04[7][c][i] (detailing variations in treatment of estate matters due to inclusion of encumbered property in a decedent's gross estate at a gross value (with an offsetting estate tax deduction) or a net value (after reduction for the liability).

Gift Trust is a recourse debt that was the personal liability of the Smith Gift Trust but in which Parcel A was also provided as collateral.

In 2023, Mr. Smith decides to make a late allocation of his GST tax exemption to the Smith Gift Trust as of April 1, 2023, in accordance with Treasury Regulation Section 26.2642-2(a)(2). As of April 1, 2023, the Smith Gift Trust has assets and liabilities consisting of: Parcel A with a value of $300x, the recourse liability of $100x secured by Parcel A, and Parcel B with a value of $475x and subject to the nonrecourse liability of $175x. Mr. Smith intends to make a sufficient allocation of GST tax exemption via a late allocation of GST tax exemption for the Smith Gift Trust to have an applicable fraction of 1.0 and an inclusion ratio of 0.0. How much GST tax exemption will Mr. Smith need to have available to achieve this goal?

2. Analysis

If a transferor makes a late allocation of GST exemption to a trust, the "value of the property transferred to the trust" for purposes of determining the denominator in the applicable fraction is the fair market value of the trust assets determined on the effective date of the allocation of GST exemption.[33] No further guidance as to the method of valuation is provided.

A literal reading of Treasury Regulation Section 26.2642-2(a)(2) regarding "the value of the trust assets" could be interpreted as valuation without any consideration of encumbrances on any property. If no debts are taken into account in determining the value of the trust assets, the result would be:

Smith Gift Trust Asset Values (without regard to encumbrances)

Parcel A	$300x
Parcel B	<u>$475x</u>
Total	$775x

Allocating $775x of GST exemption to produce an applicable fraction of 1.0 and an inclusion ratio of zero should not be the right outcome, however, if immediately liquidating the trust assets after such allocation and repaying all debt obligations would leave the trust with only $500x in cash. This would result in a waste of $275x of GST exemption.

Applying the estate tax principles of valuation leads to a similarly unsatisfactory answer because there is no corollary in the late GST allocation rules to address deductibility. If in accordance with chapter 11, only nonrecourse debts are taken into account in determining the value of the trust assets, the result would be:

Smith Gift Trust Asset Values (with regard only to nonrecourse debts)

Parcel A	$300x
Parcel B	<u>$300x</u>
Total	$600x

[33] Treas. Reg. § 26.2642-2(a)(2).

Allocating $600x of GST exemption to produce an applicable fraction of 1.0 and an inclusion ratio of zero should again not be the right outcome, however, if immediately liquidating the trust assets after such allocation and repaying all debt obligations would leave the trust with only $500x in cash. While this result would be an improvement over the strict reading of Treasury Regulation Section 26.2642-2(a)(2)'s language regarding "the value of the trust assets," it would still result in a waste of $100x of GST exemption.

Applying gift tax principles that focuses on the liabilities owed by the donee holding the property, the appropriate alignment with late GST allocation is found. If all debts are taken into account in determining the value of the trust assets, the result would be:

Smith Trust Asset Values (with regard to all liabilities owed by the trust)

Parcel A	$200x
Parcel B	$300x
Total	$500x

Allocating $500x of GST exemption to what is in essence the "equity" of the trust's assets to produce an applicable fraction of 1.0 and an inclusion ratio of zero is a natural alignment of the late GST allocation rules with the adoption of the chapter 12 valuation rules in Section 2642(b)(1)(A).

B. ENCUMBERED TRUST PROPERTY IN A QUALIFIED SEVERANCE

1. Facts

In a variation of the previous facts, the Smith Gift Trust received a gift in 2018 and Mr. Smith timely filed a gift tax return, but in this fact pattern he did not prevent the automatic allocation of the GST tax exemption to be applied to the reported gift. As a further variation from the prior fact pattern, Mr. Smith's available GST exemption at the time of his gift in 2018 was equal to only three-quarters of the value of the gift. As a result, the Smith Gift Trust has an inclusion ratio of .25000 and applicable fraction of .75000. The trustee of the Smith Gift Trust seeks to divide the Smith Trust into two trusts, an exempt trust and non-exempt trust, via a qualified severance. Immediately before the severance date, the Smith Gift Trust directly owns two parcels of real property, Parcels A and B. On the severance date, Parcel A has a value of $250x and is unencumbered. On the same date, Parcel B has a value of $400x and is subject to a debt of $200x for which the Smith Gift Trust is the borrower.

2. Analysis

Depending on the treatment of Parcel B, the funding of the exempt and non-exempt trusts result in significant variation. If the debt encumbering Parcel B is not taken into account in determining its value, the result would be:

Smith Trust Asset Values (without regard to encumbrance)

Parcel A	$250x
Parcel B	$400x
Total	$650x

Applicable fraction: .75000

Funding of:

Exempt Trust:	.75000 x $650x = $487.50x
Non-Exempt Trust:	.25000 x $650x = $162.50x

If on the other hand the debt encumbering Parcel B is taken into account in determining its value, the result would be:

Smith Trust Asset Values (with regard to encumbrance)

Parcel A	$250x
Parcel B	$200x
Total	$450x

Applicable fraction: .75000

Funding of:

Exempt Trust:	.75000 x $450x = $337.50x
Non-Exempt Trust:	.25000 x $450x = $112.50x

Under the current rule, either of these outcomes is reasonable, but could result in two similarly situated taxpayers in vastly different tax results. The absence of clear valuation rules around a qualified severance involving encumbered property must be addressed to prevent potential unequal treatment of similarly situated taxpayers.

IV. CONCLUSION AND PROPOSAL

The authors propose that the rules regarding the late allocation of GST exemption and qualified severances adopt the gift tax rules for valuing encumbered property. This approach avoids reporting distinctions found under estate tax rules, which use a deduction model that is not easily utilized in the GST area for a late allocation of GST exemption or a qualified severance. The authors further propose the issuance of a pre-printed schedule or other document to be attached to a Form 709 or Form 706-GS(T) for purposes of reporting a late allocation of GST exemption or qualified severance, as such a schedule would be informative to taxpayers and their advisors.

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