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INTRA FAMILY TRANSFERS AND INTER VIVOS GIFTS

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- I. INTRODUCTION
- II. GENERAL CONSIDERATIONS
 - A. Definition of a Gift
 - B. Valuation
 - C. Split Gifts
 - D. Basis in the Property Gifted
 - E. Exclusions and Deductions From Gift Tax
- III. Gifts to Minors
 - A. General Discussion
 - B. Outright Gifts
 - C. Custodianship Under the North Carolina Uniform Transfers to Minors Act (“UTMA”)
 - 1. Advantages of a Custodianship Over a Trust
 - 2. Advantages of a Trust Over a Custodianship
 - D. Trust for Minors
 - 1. Section 2503(c) Trust
 - 2. Crummey Trust
 - 3. Section 2503(b) Income Trusts
 - E. Generation-Skipping Transfer Tax Considerations
 - F. Special Considerations for Special Need Beneficiaries
 - G. Defective Grantor Trust
 - 1. Background
 - 2. Requirements for a Defective Grantor Trust
- IV. GRITS, GRATS, and GRUTS
 - A. Introduction
 - B. The GRIT
 - 1. Pre-Chapter 14 GRIT
 - 2. Current Restrictions on the GRIT
 - C. The GRAT and GRUT
 - D. The Zero GRAT
 - E. Exceptions to the Qualified Interest Requirement
 - F. Grantor Trust Rules

- V. CHARITABLE GIFTS
 - A. Tax Consequences
 - B. Split-Interest Charitable Gifts
 - 1. Charitable Remainder Trusts
 - 2. Charitable Lead Trusts
 - 3. Pooled Income Fund

- VI. GIFTS TO SPOUSES
 - A. Marital Deduction
 - B. Tenancy by Entirety

- VII. LEVERAGE FOR GIFTS
 - A. Gifts of Appreciated Property
 - B. Family Limited Partnership (“FLP”)
 - 1. Tax Advantages
 - 2. The Availability of Minority Interest and Lack of Marketability Discounts
 - 3. Discussion of Minority Interest Discount
 - 4. Discussion of Lack of Marketability Discount

- VIII. GIFTING PITFALLS
 - A. Basis in Gifted Property
 - B. One Year Rule
 - C. Reciprocal Gifts
 - D. Retained Voting Rights
 - E. North Carolina Gift Tax
 - F. Gifts Made in Contemplation of Death
 - G. Gifts From Revocable Trusts
 - H. Property Not to Be Gifted

- IX. KEY STATUTES

INTRAFAMILY TRANSFERS AND INTER VIVOS GIFTS

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I. INTRODUCTION

A well constructed plan for making inter vivos gifts can be the single most effective way for clients to preserve family wealth through the reduction of estate and inheritance taxes. Inter vivos gifting can also be personally satisfying for clients who are able to view the enjoyment of the gifts by the donees during their lifetimes.

Significant tax savings can be accomplished through inter vivos gifting by taking advantage of various tax deductions and exemptions. The effective use of the (i) annual gift tax exclusion, (ii) Federal unified credit and North Carolina lifetime exemption, (iii) marital gift tax deduction, (iv) charitable tax deduction and (v) Federal generation-skipping transfer tax exemption allows for a wide array of tax planning opportunities using inter vivos gifts. In addition, there are numerous planning techniques which allow increased tax benefits through the “leverage” of these exemptions and deductions.

There may also be income tax savings associated with an inter vivos gift. By transferring property to a younger family member who may be in a lower income tax bracket than the donor, significant income tax savings can occur. The donor may also minimize the costs of probate by making gifts as well as protect the transferred property from the claims of creditors.

In this outline we will examine the general rules regarding inter vivos gifts. We will then look at various tax saving techniques for gifts to minors and incapacitated persons, grantor retained interest gifts, charitable split interest gifts, gifts between spouses, family limited partnerships, and pitfalls which can occur with gifting.

II. GENERAL CONSIDERATIONS

A. Definition of a Gift

Under the common law definition, a gift occurs where there is (i) a competent donor with the intent to make a gift, (ii) a transfer vesting legal title to the property in the donee without a power of revocation by the donor, (iii) relinquishment of control over the property by delivery to the donee, and (iv) acceptance of the property by the donee. However, for gift tax law purposes, donative intent is not necessarily a prerequisite for a gift and a contemplated gift occurs when a donor legally transfers property to a donee without retaining powers which would cause the property to be included in the estate of the donor. The primary focus is the relinquishment of dominion and control over the property by the donor.

B. Valuation

The donor is responsible for paying any gift tax associated with the transfer based on the fair market value of the property at the time of the gift. A taxable gift may be made to an individual, trust, partnership, corporation or any other entity. The amount of the gift is the fair market value of the transferred property defined as the price at which the property would exchange hands between a willing buyer and a willing seller, neither under any compulsion to buy or sell, and both with reasonable knowledge of the relevant facts. I.R.C. Reg. Section 25.2512-1.

C. Split Gifts

If a donor is married at the time she makes a gift, then the donor and her spouse may elect to have the gift (and any other gifts made during the year) treated as having been made one-half by her and one-half by her spouse. I.R.C. Section 2513. Both the donor and her spouse must consent to such gift splitting on the gift tax return filed for the year of the gift. This allows the donor, with the consent of her spouse, to make gifts of \$20,000 to a donee in each calendar year free of gift tax by utilizing the annual gift tax exclusions of both spouses.

D. Basis in the Property Gifted

The donee receiving the gift takes the same basis in the gifted property as the donor (a carryover basis). If the basis of the donor in the property is greater than the fair market value of the property at the date of the gift, then the basis of the property in the hands of the donee for determining loss on the subsequent sale of the property will be the fair market value of the property on the date of the gift. I.R.C. Section 1015. The holding period of the property for determining long or short term gain on the sale of the property includes both the periods which the property was held by the donor and the donee.

E. Exclusions and Deductions From Gift Tax

1. Annual Exclusion

The primary exclusion from taxable gifts is the annual exclusion. The annual exclusion allows \$10,000.00 of present interest gifts to be made to a donee each calendar year without incurring gift tax. I.R.C. Section 2503 (b). For North Carolina gift tax purposes, there is also a \$10,000.00 annual exclusion for gifts made to Class A beneficiaries (ancestors, children and other descendants) each calendar year. N.C.G.S. Section 105-188(d).

2. Medical and Educational Exclusion

There is an exclusion from taxable gifts where the donor pays tuition to an educational organization on behalf of the donee or makes payments to any person or organization that provides medical care to the donee. Tuition does not include books, supplies, meals or dormitory fees. The payments must be made directly to the educational institution or the health care

provider to qualify for the exclusion. Payments to the donee as reimbursement for payments already made by the donee will not qualify for the exclusion. I.R.C. Section 2503(e).

3. Unified Credit and North Carolina Lifetime Exemption

In addition to the annual exclusion, the donor may use his unified credit (exemption equivalent of \$600,000) during his lifetime against inter vivos gifts to avoid the payment of gift tax. I.R.C. Section 2505. North Carolina allows a \$100,000.00 lifetime exemption against gift tax. This exemption may be used entirely in one year or may be applied to gifts occurring over a number of years. When the exemption is applied against gifts made to several donees within the same year, the exemption is allocated to the gifts based on the respective values of the gifts. The lifetime exemption may only be applied to gifts to Class A beneficiaries. N.C.G.S. Section 105-188(g).

4. Marital Deduction

A marital gift tax deduction is allowed for gifts made by donor to her spouse regardless of the value of the gift. However, the gift may not be a life estate or other terminal interest unless the donee spouse is given a power of appointment over the property or an election is made to qualify the gift as qualified terminal interest property. I.R.C. Section 2523. North Carolina also allows an unlimited marital gift tax deduction for gifts to a spouse. N.C.G.S. Section 105-188(h)(4).

5. Charitable Deduction

A charitable gift tax deduction is allowed for gifts to qualifying organizations for public, educational, religious or charitable purposes. The charitable deduction from gift tax is not limited as to the amount or percentage of the property transferred, as is the case for the income tax deduction for charitable gifts. I.R.C. Section 2522. The rules in regard to split-interest charitable gifts in which there are one or more non-charitable beneficiaries are more complex and are discussed later in the manuscript. There is also an unlimited deduction from North Carolina gift tax for gifts to charitable organizations. N.C.G.S. Section 105-188(h)(2) and (3).

6. Generation-Skipping Transfer Tax Exemption

There is a \$1,000,000.00 exemption which may be allocated to generation skipping transfers by the transferor (transfers for the benefit of persons two or more generations below that of the transferor) during the lifetime of the transferor.

III. GIFTS TO MINORS

A. General Discussion

Special considerations arise in regard to gifts to minors or incapacitated donees. The donor may desire to reduce her taxable estate by taking advantage of the annual gift tax exclusion, and possibly the unified credit, by making lifetime gifts to or for the benefit of minors.

The donor may also wish to have the income from the gifted property taxed at the lower tax rate of the minor. However, the donee may not be of a sufficient age or maturity to receive the gifted property outright. In order to qualify the gift for the annual gift tax exclusion, the gift must be of a “present interest” in the property. A gift of a “future interest” in the property will not qualify. A present interest is an unrestricted right to the immediate use, possession or enjoyment of the gifted property or the income from the property. I.R.C. Reg. Sec. 25.2503-3(b). Because gifts into a trust for the benefit of a minor often involve future enjoyment careful planning is needed to qualify such gift for the annual gift tax exclusion.

B. Outright Gifts

An outright gift of property to a minor will qualify for the annual gift tax exclusion. However, there are numerous practical disadvantages in regard to an outright gift to a minor. The gifted property is essentially frozen and may not be transferred or managed by the minor until he reaches age 18. The appointment of a guardian of the estate for the minor will be necessary. A guardianship for a minor is a cumbersome and costly procedure which must be monitored by the courts and which severely restricts the use of the gifted property. Additionally, the minor will receive absolute control of the property at age 18, which is an age often considered too young by many donors. If the minor dies prior to age 18, the property will typically pass by intestacy to the parents, who are probably the original donors and who had hoped to remove the property from their estates.

C. Custodianship Under the North Carolina Uniform Transfers to Minors Act (“UTMA”)

Under the North Carolina UTMA (N.C.G.S. Chapter 33A), property may be transferred to a minor through a custodial account held by a custodian. The transfer is irrevocable and vests title in the minor which allows the transfer to qualify for the annual gift tax exclusion. However, the nominated custodian for the property holds and manages the property. The custodian may invest the property and may deliver or pay to the minor, or for his benefit, so much of the property as the custodian deems advisable without the court approval required with the guardianship. The custodianship will terminate and the custodian will deliver the property to the minor (or his estate) when the minor reaches age 21 or if the minor dies before reaching age 21.

1. Advantages of a Custodian Over a Trust

a. The custodianship may be simpler and more economical than a trust since a trust document is not required.

b. The minor is taxed on the income from the custodial property which may be at lower rates than if the income was taxed to the trust. But beware the “kiddie tax” rules which, if the minor is under age 14, will cause the income from the custodial property to be taxed at highest marginal rate of the parents.

c. Income is shown on the Form 1040 for the minor. Form 1041 required for a trust is not needed.

2. Advantages of a Trust Over a Custodianship

a. Under the UTMA, the minor will receive the custodial property at age 21, which is an age many donors believe to be too young. The trust provides much greater flexibility in regard to distributions to the minor.

b. The trustee has greater investment flexibility than the custodian.

c. If the minor dies, under the UTMA, the custodial property typically passes by intestacy to the parents who may have initially transferred the property. The trust can be drafted to provide for successor beneficiaries in a manner advantageous for practical and tax reasons.

d. The trust allows for flexible income tax planning by allowing the income to be split between the minor and the trust based on income distributions from the trust.

e. An estate tax problem occurs if the donor appoints herself as the custodian for the property. Under I.R.C. Sections 2036 and 2038, the custodian is considered to have retained powers to determine the beneficial enjoyment of the property which will cause the gifted property to be included in the donor-custodian's estate if she should die while serving as custodian. Great care should be exercised to not have the donor of the gifted property serve as custodian. See Rev. Rule. 59-357, 1959-2 C.B. 212; Rev. Rul. 70-348, 1970-2 C.B. 193. The donor may appoint her spouse as the custodian of the property without causing the property to be included in the estate of the donor at her death, even if gift-splitting had been elected. Rev. Rul. 74-556, 1974-2 C.B. 300.

D. Trusts for Minors

Although possibly more involved, the creation of the trust for the benefit of the minor has certain advantages. The donor may also desire to create an inter vivos trust for a beneficiary who is over age 21 or is incapacitated. There are several types of inter vivos trusts for minors which allow the gifts to the trust to qualify for the annual gift tax exclusion.

1. Section 2503(c) Trust

As previously mentioned, for a gift to a trust to qualify for the annual gift tax exclusion, the gift must be of a "present interest" and not a "future interest." A statutory exception to the "present interest" requirement exists under I.R.C. Section 2503(c) are met:

a. The trust must authorize the unlimited use of the trust principal and income for the benefit of the minor before his attaining the age of 21 years. Typically, the trustee is given the discretion to make distributions to or for the benefit of the minor. This requirement mandates that only one person should be a trust beneficiary. A separate trust or separate trust share must be created for each minor. I.R.C. Section 2503(c)(1).

b. At age 21, the trust property must be distributed to the minor. I.R.C. Section 2503(c)(2)(A). This requirement can be satisfied as long as the minor has the right to demand, for a limited time after attaining the age of twenty-one, that the trust property be delivered to her. If the minor fails to demand receipt of the trust property, the trust may continue by its own terms beyond age 21. The minor must be given reasonable notice of the demand right. Rev. Rul. 74-43, 1974-1 C.B. 285. A 60 day demand period has received favorable IRS rulings, as well as a 30 day period. PLR 8039023; PLR8507017; PLR 7805037. There is likelihood that, if the minor fails to exercise her power of withdrawal, the minor will thereafter be considered the owner of the trust property for income tax purposes. Also, the lapse of the general power of appointment may cause the trust property to be taxed in the estate of the minor under I.R.C. Section 2041. The fact that the minor can receive the trust property at age 21 is considered a major disadvantage of the Section 2503(c) trust for many donors.

c. If the minor dies before age 21, the trust property must pass to his estate or be subject to a general power of appointment given to the minor. This results in the trust property being included in the estate of the minor for estate tax purposes if the minor should die prior to age 21. The fact that a minor may not legally be able to exercise a testamentary power of appointment will not invalidate the grant of power. Rev. Rul. 75-351, 1975-2 C.B. 368.

2. Crummey Trust

The annual gift tax exclusion may be obtained by giving the minor the right to withdraw from the trust an amount up to the annual gift tax exclusion when a gift has been made to the trust. This withdrawal right is commonly referred to as a “Crummey power”. The ability of the minor to withdraw property under the Crummey power has been held to convert the transfer to a gift of a present interest. Crummey v. Commissioner, 397 F.2d82, 6802 U.S. Tax Cas. (CCH) P 12541, 22 A.F.T.R. 2d(P-H) P 6023 (9th Cir. 1968). If the minor does not exercise the Crummey power, the right to withdraw can lapse and the property may remain in the trust. The trust can then continue beyond age 21 for the minor.

a. 5 and 5 Limitation

There is a disparity between the amount of the annual gift tax exclusion and the lapse rules of I.R.C. Section 2514(e). provides that the lapse of a Crummey power (a general power of appointment) shall be deemed a taxable gift by the beneficiary to the extent the amount subject to the Crummey power exceeded the larger of \$5,000.00 or 5% of the value of the trust assets. Often the gift to the trust is limited to this \$5,000.00 or 5% amount so not to violate the lapse restrictions, even though the annual gift tax exclusion may not be maximized. However, it appears that the restrictions under Section 2514(e) may be avoided if the trust property will be included in the estate of the beneficiary if the beneficiary is given a testamentary power of appointment of the trust property. To accomplish this result, the trust should only have one beneficiary who can receive trust distributions. In theory, the beneficiary will not make a gift at the lapse of the Crummey power, even if the 5 and 5 limitation is exceeded, since there is only one trust beneficiary if she dies before receiving the trust assets. Since it may be unlikely that the beneficiary will die before the trust terminates or that the beneficiary will have a taxable

estate even if death occurs, the advantage from maximizing the annual gift tax exclusion may warrant this type of trust. See PLR 8142061; PLR 8229097; PLR 8337053.

b. The beneficiary will be taxable as owner of the trust income until the Crummey power lapses. PLR 8342088. To the extent the lapse exceeds the 5 and 5 limitation, the beneficiary will continue to be taxed on the income relating to the excessive lapsed amounts as well as having such property included in the estate of the beneficiary under Section 2041.

3. Section 2503(b) Income Trusts

The age 21 requirement of the Section 2503(c) trust and the 5 and 5 limitation of the Crummey trust can be avoided by requiring that the beneficiary receive all the trust income. The trust is essentially divided into two interests. The income interest is a present interest which qualifies for annual gift tax exclusion. The remainder interest is a future interest which does not qualify. For example, if a beneficiary is age 10, a lifetime income interest is valued at approximately 99% of the value of the gift. Thus, a gift of \$10,000.00 to the trust allows for an annual exclusion of \$9,900.00 and a taxable gift of \$100.00 (reducing the donor's unified credit). The fact that the gift is not entirely tax-free and the income must pass to the beneficiary limits the popularity of this trust. Also, the gift tax exclusion can be lost if the trustee can sprinkle income among more than one beneficiary or if the trustee can invest in non-income-producing property.

E. Generation-Skipping Transfer Tax Considerations

A detailed discussion of the generation-skipping transfer tax ("GST") is beyond the scope of this chapter. However, a brief mention should be made in regard to inter vivos gifts to "skip persons". A "skip person" is a person more than one generation below the transferor (i.e. grandchildren, great-grandchildren or trusts exclusively for skip persons). I.R.C. Section 2642 provides for an annual exclusion from the GST for non-taxable gifts (within the \$10,000.00 annual exclusion or for tuition or medical expenses) made to skip persons. Such gifts are not treated as generation-skipping transfers and do not reduce the \$1,000,000.00 GST exemption of the transferor. For example, an annual gift of \$10,000.00 to a grandchild is not considered a generation-skipping transfer. A non-taxable gift to even a great-grandchild or a lower generation does not result in a generation-skipping transfer even though two or more generations have been skipped. As the population ages, there is an excellent opportunity to make gifts to grandchildren or lower generations thereby removing the gifted property from the estate of both the grandparent and the parent. However, special rules exist for gifts into trust for the benefit of skip persons. I.R.C. 2642(c)(2) provides that for the \$10,000.00 GST exemption to apply, the trust must meet certain requirements:

- (i) The trust must be for the benefit of a single beneficiary; and
- (ii) During the life of such beneficiary, no portion of the principal and income of the trust may be distributed to or for the benefit of any person other than such beneficiary; and

(iii) If the trust does not terminate before the beneficiary dies, the assets of such trust must be includable in the gross estate of such beneficiary.

F. Special Considerations for Special Need Beneficiaries

Special care should be exercised by parents with a physically or mentally challenged child. Whether inter vivos transfers are made for the child or a trust is created under the wills of the parents, close attention should be paid to the type of trust created for the child. Whether or not persons may receive benefits under many assistance programs will be based on the amount of assets available to such person. Programs such as Medicaid, Supplemental Security Income (SSI) and many North Carolina care facilities require available assets to be spent before assistance is available. However, North Carolina provides that a trust created for a beneficiary in which the trustee has complete discretion as to the distribution of income and principal to the beneficiary will not cause the assets to be deemed available to the beneficiary, since the beneficiary has no right to demand distribution. This type of “discretionary trust” (usually under the wills of the parents) is often used for special need children in order that they may receive assistance while having trust assets available to provide items not covered under assistance programs.

G. Defective Grantor Trust

1. Background

In addition to the gift and estate considerations involving trusts, the trust provides an opportunity for the shifting of income from the grantor to the trust or the trust beneficiaries. Until 1993, a trust often paid tax on income at lower rates than the grantor. However, after the Revenue Reconciliation Act of 1993, this may no longer be true. The 1993 Act made significant changes in the tax brackets for trusts which may now significantly increase the income tax on income accumulates in the trust beginning in 1993, trust income is now taxed at the following rates:

\$0-\$1,500	15% tax rate
\$1,500-\$3,500	28% tax rate
\$3,500-\$5,500	31% tax rate
\$5,500-\$7,500	36% tax rate
\$7,500 and above	39.6% tax rate

2. Requirements for a Defective Grantor Trust

In the event the grantor shall have a lower income tax rate than the trust, it is possible for the grantor to make a complete gift which removes the property transferred to the trust from her estate but allows the grantor to be deemed the owner of the trust property for income tax purposes under the grantor trust rules. I.R.C. Sections 671-677. This is possible because the transfer rules for estate and gift tax purposes are not entirely consistent with the income tax rules for grantor trusts. The income tax savings may be accomplished through the use of a trust commonly called a “defective grantor trust.” The defective grantor trust has been used in the

past to allow a trust to hold stock in an S corporation (since a grantor trust is a permissible owner for S corporation stock) and to allow the grantor to personally take certain deductions, such as interest expense, generated by the trust. The defective grantor trust may now become more prevalent because of the increased trust tax rates.

In the opinion of the author, the safest retained power by the grantor to create a grantor trust but still remove the gifted property for the estate of the grantor is for the grantor to retain the power to reacquire trust assets by substituting other property of equivalent value. Such power causes the trust to be a grantor trust under I.R.C. Section 675. However, such power has been held to not cause the trust property to be included in the estate of the grantor for estate tax purposes. Estate of Jordahl, 65 T.C. 92 (1975), acq. 1977-2 C.B. 1; PLR 9037011.

IV. GRITS, GRATS, and GRUTS

A. Introduction

GRITS (grantor retained income trusts), GRATS (grantor retained annuity trusts) and GRUTS (grantor retained unitrusts) are three types of retained interest trusts which can be used to significantly reduce gift taxes. For each of these trusts, the grantor retains an interest in the trust, typically for a fixed number of years, with trust property then passing to children or other beneficiaries at the end of the trust term. The grantor retained interest trust can be an extremely effective way of reducing the federal gift tax if the value of the retained interest can be subtracted from the value of the gift. If the grantor remains alive for the entire trust term, the trust property is removed from her estate.

B. The GRIT

1. Pre-Chapter 14 GRIT

The GRIT was an extremely popular estate planning device during the 1980's. The GRIT was effective in "leveraging" the unified credit amount by reducing the amount of the gift by the retained income interest. For example, a transfer of \$1.5 million in assets to a 10-year GRIT would result under the tax tables in a gift of only \$600,000.00 (the remainder interest), as the retained income interest was valued at \$900,000.00. The grantor could also retain a reversionary interest in the property if the grantor died during the trust term and the trust property was included in her estate, there was little downside to the GRIT.

2. Current Restrictions on the GRIT

Congress became concerned that the GRIT was being abused by the grantor receiving less from trust than indicated by favorable Treasury tables, as often the trust was funded with property which generated less income than the assumed rate. To remedy the perceived problem, Congress enacted Section 2702 of Chapter 14 of the Internal Revenue Code. Subject to limited exceptions, I.R.C. Section 2702 provides that, unless the grantor retains a qualified annuity interest or a unitrust interest in the trust, the retained interest will receive a value of zero.

Accordingly, if the grantor places \$1.5 million into a GRIT, the income interest will be given a value of zero and a \$1.5 million gift will have been made. I.R.C. Section 2702(a)(2)(A).

C. The GRAT and GRUT

The GRIT has now been largely replaced by the GRAT and GRUT. The zero valuation rule for grantor retained trust interests does not apply if the grantor retains a “qualified interest” which is valued under I.R.C. Section 7520. I.R.C. Section 2702(a)(2)(B). Under a GRAT, the “qualified interest” is a retained annuity interest which provides the grantor will receive a fixed annual amount from the trust based on a specific sum or a fixed percentage of the amount of the initial trust transfer. Under a GRUT, the “qualified interest” is a retained unitrust interest which provides the grantor will receive a fixed percentage of the fair market value of the property in the trust determined annually. Since the trusts are most beneficial when funded with appreciating assets, the GRAT is often preferred because the payments are fixed rather than fluctuating as with the GRUT. However, the GRAT (and also the GRUT) can still be outstanding estate planning devices. If the income and asset appreciation from the trust property exceeds the table rate, large tax savings can result. Both the GRAT and GRUT must meet the following rules:

1. The trust interest must be a qualified annuity interest (GRAT) or a qualified unitrust interest (GRUT).
2. The trust document must prohibit distributions from the trust to any person other than the grantor.
3. The trust document must fix the term of the annuity or unitrust interest (typically a term of years expected to end before the grantor’s death).
4. The trust document must prohibit the commutation of the retained interest (i.e., paying off the retained interest at its present value).
5. The trust document must provide for adjusted payments in short tax years and corrections for any incorrect valuation similar to the requirements for charitable remainder trusts.

The GRAT may not receive additional contributions after the initial contribution. The GRUT may receive additional contributions. For gifts of closely-held stock and partnership interest, the minority and marketability discounts may be taken.

D. The Zero GRAT

The grantor may retain a payout large enough to reduce the value of the remainder interest to zero. This “Zero GRAT” will allow the grantor to transfer large amounts without transfer tax. The Zero GRAT is extremely effective if the assets are expected to appreciate significantly. For example, if a 10% table rate is assumed, a zero GRAT is produced in the following situations:

<u>Trust Term</u>	<u>Payout Rate on Initial Transfer</u>
10 years	16.3%
15 years	13.2%
20 years	11.7%

If the actual return equals the required payout rates, the grantor will have transferred the trust property to her children at no gift tax cost. The possibility that the grantor may die before the end of the trust term has raised valuation issues as to whether a completely zeroed-out GRAT is possible. Accordingly, a GRAT with the shortest possible term is preferable. The IRS has approved a two-year Zero GRAT. PLR 9239015. The grantor may also transfer the property received from the Zero GRAT under the annuity payments each year into separate GRATs to continue removing assets from her estate as long as asset appreciation is greater than the table rate.

E. Exceptions to the Qualified Interest Retirement

1. Member of the Family

If the remainder interest of the trust does not pass to a “member of the family” of the grantor, then the qualified interest requirement under I.R.C. Section 2702 is not applicable and a GRIT may be used. A member of the family is the spouse of the grantor, any ancestor or descendent (and their spouses) of the grantor or the grantor’s spouse or any brother or sister (and their spouses) of the grantor. I.R.C. Section 2702(c). Consequently, the remainder interest may pass to nieces and nephews under a standard GRIT without being subject to Section 2702.

2. Personal Residence GRIT

I.R.C. Section 2702 does not apply to a transfer into a qualified personal residence GRIT. I.R.C. Section 2702(a)(3)(A)(ii). The personal residence GRIT can significantly leverage the unified credit. The trust provides that the grantor will use the residence for a term of years and then the residence will pass to the children.

EXAMPLE:

Father (age 60) places his residence valued at \$300,000.00 in the trust with a term of ten years. Depending on the applicable table rate, the remainder interest might be valued at \$120,000.00. In ten years when the residence is valued at \$500,000.00, it passes to the children. Only \$120,000.00 of the unified credit has been used. Since the residence is included in the estate of the grantor if he dies during the trust term, a power to appoint the property by Will in the event of premature death should be included. However, this retained power can further reduce the value of the remainder interest.

A personal residence GRIT can only hold the personal residence of the grantor. If there are two personal residences, there can be two trusts. Personal property may not be held by the trust. Limited amounts of cash may be held by the trust for expenses and

improvements. If the residence is sold, the proceeds may be held no longer than two years before a replacement residence must be bought. If the trust no longer qualifies as a personal residence trust, the trust estate must be distributed to the grantor or the trust must be converted to a GRAT. I.R.C. Reg. Section 25.2702-5(c).

F. Grantor Trust Rules

The retained interest for a GRAT or GRUT will not necessarily cause the trust to be considered wholly owned by the grantor under the grantor trust rules. This may prevent the trust from being able to hold S corporation stock unless other provisions of the grantor trust rules will cause the trust to be a wholly owned grantor trust. The retained right under I.R.C. Section 675 to substitute other assets for trust assets of equal value can be effective to create the grantor trust.

V. CHARITABLE GIFTS

A. Tax Consequences

Charitable gifts to qualified organizations remove the gifted property and any future appreciation from the estate of the donor and are excluded from taxable gifts. The gift tax exclusion for charitable contributions is unlimited in regard to amount or percentage. I.R.C. Section 2553. In addition, an inter vivos charitable contribution is deductible for income tax purposes subject to limitations based on the adjusted gross income (“AGI”) of the donor. For gifts to public charities (charitable organizations with broad public support), the charitable income tax deduction for the year of the gift is limited to fifty percent (50%) of the AGI of the donor (thirty percent (30%) for capital gain property). For gifts to private foundations (charitable organizations with limited public support), the charitable income tax deduction for the year of the gift is limited to thirty percent (30%) of the AGI of the donor (twenty percent (20%) for capital gain property). Excess charitable contributions may be carried forward for five (5) years. I.R.C. Section 170(d).

B. Split-Interest Charitable Gifts

There are a number of attractive planning techniques for the donor who wishes to make inter vivos charitable contributions but also wishes to retain an interest in the property for herself or another non-charitable beneficiary.

1. Charitable Remainder Trusts

The charitable remainder trust provides that the donor (or a non-charitable beneficiary) retains an annuity or unitrust interest in the property being transferred to the trust for life or for a stated number of years. At the end of the trust term, the property passes to the charity. I.R.C. Section 664.

a. Retained Interest

The donor must retain either an annuity interest or a unitrust interest in the transferred property. Under the annuity interest, the donor will receive at least annually a fixed dollar

amount or a fixed percentage of the value of the property at the time of the transfer. Under the unitrust interest, the donor will receive at least annually a fixed percentage of the current value of the property. The annuity interest will remain constant while the unitrust interest will vary annually according to the value of the property in the trust. The charitable remainder unitrust is often more popular because additional contributions may be made to the trust and the donor benefits from asset appreciation.

b. Tax Advantages

- (i) The donor receives a charitable income tax deduction equal to the actuarial value of the remainder interest passing to the charity. The amount of charitable deduction will be dependant on the age of the donor (or the term of the trust) and the amount of the retained interest by the donor.
- (ii) If appreciated property is transferred to the trust, no taxable gain is recognized if the trust later sells the property.
- (iii) There is no gift tax if the donor retains the trust interest. If a non-charitable beneficiary other than the donor receives the retained interest in trust, then a gift has occurred but is valued at only the present value of the remainder interest.
- (iv) The property (and future appreciation) is removed from the estate of the donor.

c. Persons Likely to Benefit From a Charitable Remainder Trust

- (i) Persons who are single, childless married couples, or married couples with a child with no prospect of grandchildren.
- (ii) An individual who has a highly appreciated asset which he or she wishes to sell.
- (iii) An individual owning appreciated stock in a corporation about to be sold. Care should be taken to avoid assignment of income problems by making the transfer early in the negotiations of the sale, preferably before the letter of intent is signed.

d. IRS Prototype Forms

The IRS has issued prototype forms for the charitable remainder annuity and unitrust. See Rev. Proc. 89-20 and 89-21. If the trust substantially complies with the forms, then the trust

will qualify under Section 664. However, there are a number of reasons to avoid the prototype forms:

(i) The forms omit many typical trust provisions. For example, the forms do not provide for trustee powers, successor trustees, waiver of bond and accountings, and compensation for the trustee.

(ii) The form for the testamentary charitable remainder unitrust states that additional property may not be added to the trust. Clearly, additional property may be added to both an inter vivos and testamentary charitable remainder unitrust. The forms can also be interpreted to allow private foundations to receive the remainder interest, which may subject the trust and the contributions to the trust to the less attractive private foundation rules.

2. Charitable Lead Trusts

Under the charitable lead trust, the charity is given an annuity or unitrust interest for a fixed term of years. At the end of the term, the trust property passes to a non-charitable beneficiary (such as children). The charitable income interest reduces the value of the gift passing to the children. The value of the gift passing to the children will only be the actuarial value of the remainder interest. However, for the donor to receive a charitable income tax deduction, the donor must be taxable on the trust income under the grantor trust rules. Accordingly, the income tax deduction is only one of timing. While the donor can receive a current income tax deduction, she must remain taxable on the income passing to the charity. This requirement limits the popularity of the inter vivos charitable lead trust as opposed to the testamentary charitable lead trust.

3. Pooled Income Trust

A pooled income fund is created by the charitable organization. Donors transfer amounts to the pooled income fund and retain an income interest. In subsequent years, the donors receive a percentage of the trust income based on the value of their gift as compared to all fund assets. When the income interest terminates (usually at the death of the donor), the property is distributed to the charity.

VI. GIFTS TO SPOUSES

A. Marital Deduction

The unlimited marital deduction provides that gifts may be made between spouses without any transfer tax consequences as long as the spouse is not given a life estate or terminal interest in the property, which does not qualify under I.R.C. Section 2523. From an estate planning prospective, it is extremely important to use spousal gifting to place at least \$600,000.00 of assets into each of the individual names of the spouses. This allows for the maximum utilization of both unified credits of the spouses regardless of the order of death. It may be advantageous to have the spouse with the shorter life expectancy own property which would benefit from the step-up in basis at death.

B. Tenancy by Entirety

Upon the death of the first spouse, all property held by the spouses as tenants by the entirety will pass automatically to the surviving spouse. No portion of the property will be available in the estate of the first spouse to die to fund a credit shelter trust. Consequently, it is often necessary to prepare a deed or other document transferring title into the individual name of one spouse or terminating the tenancy by the entirety in order for the spouses to hold the property as tenants in common. If such property is held by the spouses as tenants in common, then at the death of the first spouse, the one-half interest of the deceased spouse will be available to help fund the credit shelter trust.

VII. LEVERAGE FOR GIFTS

There are a variety of estate planning techniques which allow for maximizing the tax savings of lifetime transfers.

A. Gifts of Appreciated Property

In making lifetime gifts, it is generally desirable to gift property which would be expected to have the greatest appreciation during the lifetime of the donor. All appreciation in the property after a gift which is not later included in the gross estate of the donor escapes transfer taxation. However, the tax planner must consider the loss of the step-up in basis resulting from the gift. For the donor with a reasonably long life expectancy, the estate tax savings from the transfer of future appreciation may far outweigh an increase in income tax which may result from the loss of the step-up in basis.

B. Family Limited Partnership (“FLP”)

1. Tax Advantages

The operation of a rental or business activity through the FLP provides such non-tax advantages as retained control by a donor who serves as general partner and convenient gifting of assets which are difficult to partially transfer. However, it is largely the gift and estate tax saving features of the FLP which have contributed to its current popularity.

a. Leveraging the Annual Exclusion and Unified Credit

Gifts of partnership interests owned by the donor (typically the limited partnership interests) to the donee qualify for the \$10,000 annual gift tax exclusion under I.R.C. Section 2503. See PLR 9415007. Gifting splitting by spouses under I.R.C. Section 2513(b)(2) allows for each donee to receive \$20,000 each year without reducing the unified credit of the spouses. The donor may also make gifts in excess of the annual exclusion amounts and use portions of the unified credit.

Most importantly, the gifts of the partnership interests may be significantly discounted for the lack of marketability of the partnership interests and minority interest which the donee receives. The availability of the discounts greatly contribute to the popularity of the FLP.

b. Revenue Ruling 59-60

The IRS recognizes the difficulty in valuing closely-held business interests, including a FLP, and that such valuation must be based on relevant facts and circumstances. In Revenue Ruling 59-60, the IRS sets out various factors which should be considered:

- (i) The nature and history of the business, which should show its stability, growth and risk.
- (ii) The general economic outlook and the condition and outlook of the specific industry in which the business operates, including the business' competitive position.
- (iii) The book value and the financial condition of the business, which should show the company's liquidity and capital structure.
- (iv) The earning capacity of the business, taking into account prior earnings are generally the best indicator of future earnings.
- (v) The business' dividend-paying capacity, taking into account the necessity of retaining profits to expand the business or meet competition.
- (vi) The business' good-will or other intangible value.
- (vii) Actual sales of interests in the company.
- (viii) Market price of company engaged in the same or similar line of business which are actively traded in an open market.

c. Valuation Methods

While there are numerous valuation methods in regard to valuing the interests of the FLP and other closely-held entities, the following three methods are the most commonly used.

(i) Income or Future Return Method

The income or future return method determines the value of the asset by determining the future benefits the asset is expected to produce. A projection must be made of the annual

earnings or cash flow from the asset and the expected proceeds from the sale or liquidation of the asset. Earnings (net income) are generally easier to project than cash flow, which must consider future business needs. Such projected returns are then discounted to reflect the present value of the asset. The discount takes into account both the time value of money and the risk such future benefits will not materialize. The discount rate is normally the return needed to attract investors considering the time value of money and risk involved. While future returns are an extremely important factor in normal investment decisions, the concern is that the valuation method is based upon the accuracy of projections and not current or historical information. For such reason, the method is not popular with the courts or the IRS. Since the valuation is often done by analyzing market data, a minority discount is built-in (i.e., listed stock prices reflect a minority discount). An additional minority interest discount is not appropriate. A lack of marketability discount is appropriate.

(ii) Capitalization of Earnings Method

The capitalization of earnings method involves taking the earnings of the entity and capitalizing the earnings by a factor to determine value. The most common factor is the price to earning ratio (P/E ratio) of comparable companies. A comparable company is often a publicly-traded company in a similar business. An average of recent annual earnings, such as the prior five years, may be used, with recent earnings receiving greater weight. Materials are available which give capitalization rates for various industries. The courts and IRS look favorably on this method as historical information is available. Since market data is used, a minority interest discount is generally not appropriate. A lack of marketability discount is appropriate.

(iii) Asset Value Method

The asset value method determines the net asset value of the entity. This is often book value adjusted to reflect fair market value (i.e., for land or investment assets). If an ongoing entity is involved, the value may be adjusted based on the price to net asset value index of comparable companies. Both a minority interest and lack of marketability discount are appropriate if market data is not used.

(iv) Avoiding Liquidation Value

Each of the above valuation methods values the FLP interest based on the concept of an ongoing entity. It is generally assumed that values determined under the above methods, including discounts, will be less than the value received if the entity liquidates and the owners receive their pro rata shares. This takes into account that earnings are often reapplied into the business and not distributed. Accordingly, a major factor in reducing the value of a gift of a limited partnership interest is the inability of the limited partner to liquidate the FLP. The limited partner also has no ability to receive distributions which are often reinvested in the partnership. Under the North Carolina Revised Uniform Limited Partnership Act, a limited partner cannot withdraw before the term set in the partnership agreement for liquidation (i.e., 50 years). N.C.G.S. Section 59-603. If no event or term is set for liquidation, the limited partner can withdraw upon six months notice. A general partner can withdraw from the FLP, but if the withdrawal violates the FLP Agreement, damages may be assessed against the general partner.

A withdrawing partner receives “fair value” for the interest. The FLP does not dissolve upon the withdrawal of a limited partner or even a general partner if there is a remaining general partner or the remaining partners agree to continue the partnership and appoint a new general partner. N.C.G.S. Section 59-801.

It is extremely important that the FLP have a set termination date. This prevents the limited partner from withdrawing and prevents an argument that a liquidation value must be used for gifts since the limited partner has no right to a liquidation value. This allows for the use of the above valuation methods and discounts and should produce lower valuations on the gifts than a liquidation value.

3. Discussion of Minority Interest Discount

a. General

A minority interest discount is appropriate where the owner of a minority interest cannot individually control basic policies and daily operations of the company such as selecting and compensating managers, selling or liquidating the company or controlling distributions from the company. The limited partners of the FLP are precluded by law from involvement in the management of the FLP. Controlling interests in a business will sell at a much higher price than a minority interest. Cases have often provided for minority interest discounts of 20% to 35%, although there are a number of studies which may indicate even greater discounts. See Estate of Jung v. Commissioner, 101 T.C. 412, 101 T.C. No. 28, 93 T.N.T. 232-14 (1993); Korslin v. United States, 73-1 U.S. Tax Cas. (CCH) P 12907, 31 A.F.T.R.2d (P-H) P 73-1390, 31 A.F.T.R.2d (P-H) P73-1437 (E.D. Wis. 1973); Ward v. Commissioner, 87 T.C. 78, 87 T.C. No. 6 (1986). Generally, less than 50% voting power is deemed a minority interest, although state law or organizational documents can vary this result. A discount may not be allowed where the person receives a limited partnership interest but already has voting control as the general partner. See Rev. Rul. 67-54.

b. Revenue Ruling Number 93-12

The IRS has historically made efforts to prevent the application of a minority discount for transfers of closely-held interests between family members by virtue of attribution rules. See Rev. Rul. 81-253. After various court setbacks, the IRS stated in Revenue Ruling 93-12 that the interests of family members will not be aggregated in determining whether or not the individual has received a minority interest in the entity. Consequently, even a donor-parent with a controlling interest making gifts of minority interests should provide for the discount as the interest of the donee-children will not be aggregated with the parent’s interest into a controlling interest. However, the IRS may push for legislative intervention in this area.

4. Discussion of Lack of Marketability Discount

There is usually either no market or a limited market for interests in the FLP. A second discount for lack of marketability may be appropriate. Such discount is distinct from the minority interest discount and the two discounts may be taken together. The lack of

marketability discount would appear available regardless of whether the income method, earnings method or asset value method is used. See Estate of Newhouse v. Commissioner, 94 T.C. 193, 94 T.C. No. 14 (1990), nonacq. 1991-2 C.B. 1 (1990) (35% discount); Estate of O'Connell, T.C. Memo. 1978-191, T.C.M. (P-H) P 78191, 37 T.C.M. (CCH) 822 (1978), recons. Denied, 37 T.C.M. (CCH) 1138 (T.C. 1978), and aff'd in part and rev'd in part, remanded, 640 F.2d 249, 81-1 U.S. Tax Cas. (CCH) P 13395, 47 A.F.T.R.2d (P-H) P 81-1615 (9th Cir. 1981) (30% discount from appraised value); Maris v. Commissioner, 670 F.2d 185 (8th Cir. 1982) (30% discount from earnings per share value). Even IRS expert witnesses often apply discounts for lack of marketability. Estate of Campbell v. Commissioner, T.C. Memo. P 91615, T.C. Memo. 1991-615, 62 T.C.M. (CCH) 1514 (1991) 57% discount for lack of marketability and minority interest combined). An approach for determining the lack of marketability discount in regard to corporate stock has often been a comparison of the selling price for "restricted securities" in a publicly-traded corporation as opposed to the sales price for unrestricted publicly-traded stock of the same corporation. The lack of marketability discount for the general partnership interest may be reduced if the general partner has the power to withdraw from the FLP and receive fair value for such interest minus damages caused by the withdrawal. North Carolina law is unclear as to how fair value is determined.

VIII. GIFTING PITFALLS

A. Basis in Gifted Property

The donee of gifted property takes the same basis as the donor. Consequently, the property does not receive a "step-up" in basis which would have occurred if the donor had owned the property at her death. I.R.C. Section 1014. In making gifts of appreciated property, it is necessary to balance the estate tax benefit received from removing future appreciation in the property from the estate against the income tax advantage incurred by holding the property until death. This is especially true for clients with shorter life expectancies.

B. One Year Rule

If the donee dies within one year of receiving gifted property and the property passes from the donee back to the donor, the basis of the property is not stepped up to the value at the date of the death of the donee. The basis of the property in the hands of the donor is the same as had been in the hands of the donee. I.R.C. Section 1014(e). This rule prevents the gift of property to a donee with a limited life expectancy with the understanding that the property will be bequeathed to the donor at the death of the donee.

C. Reciprocal Gifts

Donors are prevented from entering into arrangements to make gifts to selected donees in return for reciprocal gifts from other donors as an attempt to increase the number or available annual gift tax exclusions.

EXAMPLE:

Parent A makes a \$10,000.00 gift to each of her three children and to each of the three children of Parent B. Parent B makes a \$10,000.00 gift to each of her three children and to each of the three children of Parent A. This arrangement is viewed as a gift from Parent A of \$20,000.00 to each of her three children and a gift by Parent B of \$20,000.00 to each of her three children. Consequently, there are taxable gifts by each parent.

D. Retained Voting Rights

Under I.R.C. Section 2036(b), a gift of stock in a controlled corporation (i.e. the donor has 20% voting power), where the donor retains the right to vote the gifted stock, results in the stock being included in the estate of the donor. For example, if the donor gifts the stock into trust and serves as the trustee with voting authority or if a voting agreement is entered into in which the donor is able to vote the stock, then Section 2036(b) is violated and the stock is included in the estate of the donor. Also, if the donor gives up voting rights in certain stock but receives in return voting rights in other stock, Section 2036(b) may also be violated.

EXAMPLE:

Brother A gifts voting stock to a trust for the benefit of his children, naming Brother B as the trustee. Brother B gifts voting stock to a trust for his children, naming Brother A as the trustee. Since both brothers have retained the right to vote the same number of shares, this type of reciprocal arrangement causes the gifted stock to be included in the respective brothers' estates. If this situation is encountered, it is advisable to have the trust resign and, once the three year period under I.R.C. Section 2035 has lapsed, the stock will be removed from the donor's estate.

E. North Carolina Gift Tax

North Carolina gift tax will often be incurred on inter vivos gifts because the North Carolina lifetime exemption amount of \$100,000.00 is less than the unified credit exemption equivalent of \$600,000.00. In many instances the fact that North Carolina gift tax will be incurred should not discourage the making of inter vivos gifts. However the client should be advised when North Carolina gift tax will be incurred.

F. Gifts Made in Contemplation of Death

North Carolina law provides that a gift made within three years of death is presumed to be made in contemplation of death and will not be included in the taxable estate of the decedent for North Carolina inheritance tax purposes to the extent the value exceeds \$10,000.00. N.C.G.S. Section 105-2(a)(3). There is not an equivalent Federal three-year rule with the exception of gifts of life insurance and gifts which release a retained interest under I.R.C. Sections 2036-2038. Accordingly, it is possible to make death bed gifts for Federal gift tax purposes.

G. Gifts from Revocable Trusts

The IRS has taken the position that a gift from a revocable trust to persons other than the grantor within three years of the death of the grantor causes the gifted property to be included in the estate of the grantor as a release of a retained Section 2036 or 2038 power. The courts have generally held the property is not includable if the grantor was the sole permissible beneficiary of the trust or the gifts could be made from the trust only at the direction of the grantor. See Jalkut v. Commissioner, 96 T.C. 675, 96 T.C. No. 27 (1991), acq. 1991-2 C.B. 1; Estate of Barton, T.C. Memo. 1993-583, T.C.M. (RIA) P 93583, 66 T.C.M. (CCH) 1547, 93 T.N.T. 251-9 (1993); Estate of McNeely, 16 F.3d 303, 94-1 U.S. Tax Cas. (CCH) P 60155, 73 A.F.T.R.2d (P-H) P 94-2339, 94 T.N.T. 40-16 (8th Cir. 1994).

H. Property Not to Be Gifted

It may not be advantageous to gift certain types of property. A gift of installment obligations will be a taxable disposition which will cause the premature recognition of unrecognized gain. If the sale of depreciated Section 1224 stock would result in an ordinary loss, a gift of the stock should be avoided since only the original owner may take ordinary loss. It may be advisable to sell the stock and incur the ordinary loss, and then gift the sales proceeds.

IX. KEY STATUTES

I.R.C. Sec. 664.	Charitable Remainder Trusts
I.R.C. Sec. 2035.	Estate and Gift Taxes. Adjustment for gifts made within 3 years of decedent's death.
I.R.C. Sec. 2036.	Estate and Gift Taxes. Transfers within retained life estate.
I.R.C. Sec. 2038.	Estate and Gift Taxes. Revocable transfers.
I.R.C. Sec. 2041.	Estate and Gift Taxes. Power of appointment.
I.R.C. Sec. 2503.	Estate and Gift Taxes. Taxable gifts.
I.R.C. Sec. 2505.	Estate and Gift Taxes. Unified credit against gift tax.
I.R.C. Sec. 2514.	Estate and Gift Taxes. Powers of appointment.
I.R.C. Sec. 2522.	Estate and Gift Taxes. Charitable and similar gifts.
I.R.C. Sec. 2523.	Estate and Gift Taxes. Gift to spouse.
I.R.C. Sec. 2642.	Estate and Gift Taxes. Inclusion ratio.
I.R.C. Sec. 2702.	Estate and Gift Taxes. Special valuation rules in case of transfers of interest in trust.

EXHIBIT A

Generation-Skipping Exemption Devises (Excerpts from Wachovia Will and Trust Manual)

1. Fractional Share Generation-Skipping Exemption Drive.

My Executor shall distribute to my Trustee that fraction of my residuary estate, called the Generation-Skipping Family Trust, having

- (1) a numerator equal to the largest amount, if any, that can pass free of generation-skipping transfer tax under this Paragraph, taking into account only the amount of any “available GST exemption” (as that term is hereinafter defined), and
- (2) a denominator equal to the value of my residuary estate.

...the term “available GST exemption” shall mean an amount equal to the GST exemption provided by Section 2631(a) of the Internal Revenue Code that has not been allocated by me or my Executor (or by operation of law) to property transferred by me during my lifetime or at my death.

2. Pecuniary Share Generation-Skipping Exemption Devise.

My Executor shall distribute to my Trustee a sum, called the Generation-Skipping Family Trust, equal to the largest amount that can pass free of generation-skipping transfer tax under this PART, taking into account only the amount of any “available GST exemption” (as that term is hereinafter defined). My Trustee shall satisfy this gift with assets valued as of the date or dates they are distributed. My Trustee shall hold all property distributed to it under this PART IN TRUST in accordance with the provision contained in SECTION 2 of this PART.

...the term “available GST exemption” shall mean an amount equal to the GST exemption provided by Section 2631(a) of the Internal Revenue Code that has not been allocated by me or my Executor (or by operation of law) to property transferred by me during my lifetime at my death.