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# The Gallo Exemption: What It Is and Why You Should Know About It

By Joseph T. La Ferlita and Nicholas G. Moneta

While the generation-skipping transfer (GST) tax is complex, most estate practitioners who regularly deal with it eventually obtain a level of comfort, if not an expertise, concerning it. Such practitioners counsel their clients about avoiding or minimizing exposure to the tax. Some of the typical tools in the arsenal involve the GST tax annual exclusion and the GST tax lifetime exemption. For the old trusts, the issue becomes whether the trust is “grandfathered” from the tax.

These tools are taught in any basic course about the GST tax. But there is another exemption from the GST tax, one that is often not mentioned, of which some practitioners might not be aware: the Gallo exemption. While the scope of the Gallo exemption is narrow, some of those trusts to which it applies are still in existence. The practitioner should realize that certain modifications of a Gallo exempt trust, including, for example, modifications via a decanting or court proceeding, could inadvertently trigger a GST tax.

This article highlights the basic parameters of the Gallo exemption.

## History of the Gallo Exemption

In 1988, Congress provided relief from the then-two-year-old GST tax (at least in its current version) by way of a temporary exemption that benefitted wealthy families. See Albert B. Crenshaw, *Gallo Tax Exemption Works for the Very Rich: Regulations: A grandparent may give \$2 million to each grandchild and pay no more than the standard gift-estate taxes, but only until Dec. 31*, L.A. Times, Nov. 7, 1989, <https://www.latimes.com/archives/la-xpm-1989-11-07-fi-1110-story.html>. One family that benefitted significantly from this temporary exemption was the Gallo wine family of California. The exemption came to be known as the “Gallo exemption”. *Id.*

Surprisingly, the Gallo exemption rules are not contained in the Internal Revenue Code, or the Regulations promulgated thereunder. See Brown & Ross, *Diagnosing the GST Tax Status of a Trust*, 31 Prob. & Prop. 32 (July/Aug. 2017). This is one reason why many practitioners are unaware of the exemption’s existence. Instead, the rules are set forth in Section 1014(h)(3) of the Technical and Miscellaneous Revenue Act of 1988, which is an amendment to the Tax Reform Act of 1986 (i.e., the enabling legislation of the current GST tax).

## The Gallo Exemption Rules

The Gallo exemption rules provide for GST tax exempt transfers that are made either outright to a transferor’s grand-

child or in trust for the sole benefit of a transferor’s grandchild. Technical and Miscellaneous Revenue Act of 1988 § 1014(h)(3)(A) and (B).

For outright transfers, the Gallo exemption is straightforward: if a grandparent transferred \$2 million or less to a grandchild prior to Jan. 1, 1990, such transfer was not deemed to have been a direct skip and, therefore, was not subject to the GST tax—even though the transfer occurred after the enactment of the GST tax.

For transfers in trust, the Gallo exemption is more complex. The rule is as follows:

A transfer in trust was not a direct skip subject to the GST tax if the following criteria were met: Section 1014(h)(3)(B).

The transfer to the trust for the sole current benefit of the transferor’s grandchild was made before Jan. 1, 1990;

- The value of the aggregate transfers to a grandchild and/or to a trust for the benefit of such grandchild did not exceed \$2 million;
- During such grandchild’s lifetime, no portion of the trust’s corpus or income could be permitted to be distributed to or for the benefit of any person other than the one grandchild for whose benefit the trust was created;
- The trust assets would be includible in the grandchild’s gross estate if the grandchild died before the trust’s termination; and
- For periods after the grandchild attained the age of 21, all the trust’s income would have to be distributed to or for the benefit of the grandchild not less frequently than annually. Note: this last criterion only applied to transfers made after June 10, 1987.

The Gallo exemption only applies to transfers made outright to, or in trust for the benefit of, a grandchild of the transferor who was born at the time such transfers were made. Put differently, the Gallo exemption does not apply to transfers made to other “non-grandchild skip persons.” Mancini & Brody, *Estate Planning with Life Insurance*, SS014 ALI-ABA 231, 4.02(B) (Oct. 2010).

Assuming all the Gallo exemption requirements are met, a transfer from a Gallo exempt trust to the grandchild beneficiary of such trust is neither a taxable termination nor a taxable distribution. Lexis Tax Advisor—Federal Topical S. 3E:1.06 [2] Exclusions from GST Tax (citing Pub. L. No. 100-647, 100th

Cong. 2d Sess., S. 1014(h)(3)(A) (Nov. 10, 1988). Thus, such transfer is not subject to the GST tax.

The IRS has ruled privately that a disclaimer by a child resulting in the transferor's property passing outright to grandchildren or to a Gallo exempt trust has qualified for the Gallo exemption from direct skips. See PLRs 9822014; 9044075; 9034057; 9031011; 9007034; 9009007; 9008034; 9009007; 9008034; 9004015; 8946060; 8922082; 8919017; 8907028; 8907011; and 8810076. Also, as long as the date of the transferor's death was prior to Jan. 1, 1990, the filing of a timely disclaimer after 1989 should not affect the exempt status of a Gallo exempt trust because the transfer to the grandchild is deemed to occur at the time of the transferor's death. See PLR 8946060.

### Once a Gallo Exempt Trust Always a Gallo Exempt Trust?

It appears that a trust that initially qualified as a Gallo exempt trust can lose its exempt status if any one of the criteria listed in c through e above are violated after the otherwise valid Gallo exempt trust's creation. See PLRs 200102039 & 2012040.

In PLRs 200102039 and 200102040 (related matters), the IRS ruled that the Gallo exempt trusts in question would continue to satisfy the criteria for the Gallo exemption even after a court approved an amendment to the trust instrument that would eliminate mandatory periodic principal distributions. *Id.* These two PLR rulings imply that a Gallo exempt trust can lose its exempt status if the trust's terms, as amended, or the trustee's acts fail to continue to meet all the Gallo exemption requirements.

### Gallo Is Over 30 Years Old, Why Should I Care About It?

Although the Gallo exemption is over 30 years old and does not apply to new transfers, it can still be of critical importance because some Gallo exempt trusts still exist, and their exemption could be inadvertently jeopardized by a well-meaning practitioner. For example, practitioners reviewing a pre-1990 trust might see the inclusion of a testamentary general power of appointment and immediately jump to the conclusion that a major drafting error occurred, when that might not be the case if it were a Gallo exempt trust. Decanting that trust to remove the general power might inadvertently trigger an immediate GST tax. If such tax is not reported and paid timely, the interest and penalties for late payment could be significant. Similarly, a practitioner might question the wisdom of a mandatory income interest and seek to remove it through a judicial modification proceeding.

On the flip side, practitioners knowingly dealing with what is understood to be a Gallo exempt trust should confirm that all the boxes were checked both in the drafting and administration of the trust (e.g., was the income required to be distrib-

uted actually distributed?). See Williams, 1990 NYLJ LEXIS 2711 (draftsperson error caused trust to fail Gallo exemption). Fortunately, some New York courts have been sympathetic in reforming certain trusts in order to qualify them for the Gallo exemption. See, e.g., *Estate of Stern*, 2017 NYLJ LEXIS 46 (N.Y. County Jan. 9, 2017) (citing *Matter of Spear*, 146 Misc. 2d 1046 (N.Y. Surr. Ct. Apr. 4, 1990); *Estate of Penner*, 1991 NYLJ LEXIS 1989 (N.Y. Surr. Ct. Aug. 15, 1991) (court allowed reformation of will to grant grandchildren a general power of appointment and mandate distribution of trust income to grandchildren at age 21 in order to qualify such trusts for the Gallo exemption); *Will of Williams*, 1990 NYLJ LEXIS 2711 (Nassau Surr. Ct. Aug. 9, 1990) (court allowed reformation of will to give grandchild beneficiary a general power of appointment rather than a limited power of appointment to qualify trusts for the Gallo exemption); *Spear*, 146 Misc. 2d 1046 (court allows reformation of will to carry out decedent's specific intent that the trusts he created for his grandchildren qualify for the Gallo exemption); *Estate of Lewis*, 144 Misc. 2d 618 (Broome County Surr. Ct. Jul. 25, 1989) (same).

### Conclusion

At first glance, the Gallo exemption may appear to be an irrelevant creature of the past. But that is not the case. Gallo exempt trusts still exist, and the tax benefit they enjoy needs to be protected.



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