Administering GST Exposed Trusts

Monday, December 4, 2023

Take-Away: A trustee's duty to administer a Trust subject to the generation skipping transfer tax requires the determination and management of that Trust's GST inclusion ratio.

Background: I am the first to admit that I dread having to deal with the generation skipping transfer tax (GST). I see 'GST' and I promptly break out in hives. The GST is complicated. It lurks in unsuspecting corners of a Trust. It is unduly complex when the GST tax incorporates unique concepts and applies multiple 'start' dates to remember (a frustration that many of you will someday come to understand when you get to be my age.) Despite my whining and hives, what a trustee cannot ignore is that the GST is a flat 40% federal tax imposed in addition to the federal estate tax, and if the Trust's GST inclusion ratio is greater than 0.000 but less than 1.000, the trustee must repeatedly determine and then apply a potentially ever-changing GST *inclusion ratio* when either there is a distribution from the Trust, or there is a termination of the Trust. A GST refresher may be help to guide trustees who face the challenge of having to administer a Trust that is, or may be, subject to the GST.

Trustee Questions: In order to begin to understand the GST and its application to a Trust, several questions need to be answered by the trustee to determine if the GST applies and if GST exemptions were used to shelter the Trust and future distributions or terminations from the GST.

1.<u>When was the Trust created?</u> The GST applies to *direct skip* transfers and *indirect skip* transfers made to a Trust on or before September 25, 1985. Transfers to the Trust before that date are exempt from the GST and are deemed to have a GST inclusion ratio of zero (0.000). These older Trusts are commonly referred to a *'grandfathered'* Trusts for GST purposes. Appreciation or accumulated income from the *grandfathered* portion of the Trust are not considered *additions* to that Trust and thus are free from the GST. Additional contributions to the Trust after that 1985 date will, however, be subject to the GST unless an

allocation of the transferor's GST exemption is made to that later contribution, which results in a *pro rata* portion of the Trust being subject to the GST. Note that a release, exercise or creation of some powers of appointment will be treated as *deemed contributions* to the Trust that will compromise a Trust's *grandfathered* GST exempt status. Moreover, some modifications to a *grandfathered* Trust can cause the Trust to lose its GST exempt status, unless a modification falls in Trust modification 'safe harbor' rules that are found in IRC 2601.

Then we have the *Gallo Trust* GST exemption which is different from the *grandfathered* GST exemption. This exemption came into being in 1986. It provides that if the Trust was created for the benefit of a *single* grandchild of the settlor, it too would have a GST inclusion ratio of zero (0) if the Trust is funded with up to $2.0 million before January 1, 1990, yet again, only as long as the Trust has not been modified beyond what is permitted in the *grandfathered* Trust modification 'safe harbor' rules.

2. <u>When were the transfers made to the Trust?</u> Prior to 1988 a GST annual exclusion gift to the Trust was the same for all other annual exclusion gifts. Transfers to the Trust after March 31, 1988 subjected any GST 'annual exclusion' transfers to the Trust to narrower requirements. [IRC 2632(c)(1).] Then, in 2001, new rules were added for some *indirect skip* transfers to a Trust which have an automatic allocation of the transferor's GST exemption to the extent the transferor has remaining GST exemption available to him or her. The transferor can also affirmatively elect out of this automatic allocation of the GST exemption on a Form 709 gift tax return. Accordingly, the only way to determine if the automatic allocation of the transferor's GST exemption was elect-out is to examine prior federal gift tax returns.

3. <u>Is it a *GST Trust* (which is a statutory term-of-art, not just a description of a Trust that might be subject to the GST?)</u> A *GST Trust* is broadly defined as a Trust that *could* have a generation-skipping transfer. [IRC 2632(c)(3)(B).] But like a piece of Swiss cheese, the statute then describes six exceptions to this definition, most of which apply to rights or powers that are held by *non-skip*

persons. These exceptions will need to be reviewed because an automatic allocation of available GST exemption will occur only if an *indirect skip* is made to the *GST Trust.* The automatic allocation of a transferor's GST exemption apply to transfers made after December 31, 2000. Because these statutory exceptions are difficult to understand and apply, many attorneys prefer to make an affirmative election to have the automatic allocation rules apply to a Trust or not apply. This election is authorized under IRC 2632 and must be made on a timely filed Form 709 Federal Gift Tax Return. In addition, this election can be made to treat a Trust as a *GST Trust* even if the terms of the Trust would not otherwise meet the technical definition. Or, the transferor may opt out of having their GST exemption automatically apply to the *GST Trust* treatment. Thus, transfers to a *GST Trust,* if none of the statutory exceptions apply, will have the transferor's GST exemption automatically allocated if the transfer to the Trust is made after December 31, 2000.

4.Did the transfers to the Trust qualify for the GST *annual exclusion*? The current GST *annual exclusion* rules apply to transfers to the Trust made after March 31, 1988. In order for a Trust to qualify for the GST *annual exclusion,* it must be a Trust that is considered a *direct skip* Trust. [IRC 2642(c).] If the transfer to the Trust qualifies for the GST *annual exclusion,* that portion of the transfer will be exempt from the GST. In order for a gift to qualify for the GST *annual exclusion* it must satisfy three separate requirements: (i) the gift must be made to a Trust which is for the benefit of only one *skip person;* (ii) if the *skip person* trust beneficiary were to die before the Trust terminates, the trust assets would be included in that *skip person's* estate; and (iii) the gift to the Trust must be a *present interest* gift. In other words, the Trust created for the *skip person,* e.g., a grandchild of the transferor, must give the grandchild the right to withdraw the transfer (satisfying the *present interest* requirement) and also give to the grandchild a testamentary general power of appointment over the trust assets.

5.Was any GST exemption allocated to the transfer to the Trust? Each individual is given a lifetime GST exemption that can be allocated to transfers during lifetime or at death. Only the transferor can allocate his/her GST exemption to

the transfer, and when spouse's elect to split a gift election that on a federal gift tax return, each spouse is treated as a transferor over half of all transfers reported on the gift tax return for GST reporting purposes. As a broad generalization, a transferor will not allocate his/her GST exemption to a Trust that he/she expects will benefit only a *non-skip person.* How an allocation of the transferor's GST exemption occurs is many different ways. Before January 1, 2001 that GST exemption allocation was made manually to transfers other than *direct skips* on the transferor's Federal Gift Tax Return. But we now have automatic allocations of the transferor's GST exemption. It is first automatically allocated to any *direct skips* [IRC 2632(b)], then the deemed automatic allocation of GST exemption to *indirect skips* [IRC 2632(c)(1)] to some (but not all) transfers made after December 31, 2000. For *indirect skips,* there is the automatic allocation of the GST exemption, but only if the Trust is a *GST Trust.* [IRC 2632(c)(3)(B).] As a rule, the *deemed automatic allocation* of the exemption is intended to serve as a 'safety net.' The transferor is able to elect affirmatively to opt in or opt out of these automatic allocation rules; that decision is usually based on the perceived likelihood if trust asset will ever be available to a *skip person* or not. There is also an automatic allocation a the time of the transferor-decedent's death. [IRC 2632(e).] Any unused GST exemption is first allocated to *direct skips* at the transferor's death, then the unused GST exemption is allocated *pro rata* to any Trust of which the decedent is the transferor and from which a *taxable distribution* or a *taxable distribution* might occur after the transferor's death. However, the estate representative can affirmatively allocated [on Schedule R of the Form 706] the decedent's remaining GST exemption, and if that election is made then this automatic allocation of the GST exemption to *indirect skips* will not apply. There is also a process for late allocations of a GST exemption to previously transfers, based on current fair market values. This election can be made to trat the allocation as having been made on the first day of the month during which the late allocation is made, so long as the gift tax return on which the allocation is made is filed with the IRS prior to the end of that month. [Regulation 26.2642-2(a)(2).] This late GST exemption allocation can be a positive, particularly if the assets that were the subject of the GST have dropped in value since the transfer was made. Finally, there is a provision for a retroactive allocation of the exemption which is intended as a remedy for the untimely death

of the transferor. [IRC 2632(d).] In this retroactive allocation the GST exemption is the value of the transfer on the date the transfer was originally made.

6.Were there any general powers of appointment held by any of the trust beneficiaries? A general power of appointment over a Trust's assets can change the identity of the transferor to the Trust. An individual must be the *transferor* to allocate any available GST exemption. A beneficiary's right of withdrawal over a portion of the Trust's assets is a general power of appointment. Thus, Crummey withdrawal rights can lead to GST issues. The lapse of a withdrawal right in excess of $5,000 or 5% of the Trust's assets will cause the power holder to be deemed to have transferred the excess amount to the Trust for GST purposes; if the *deemed* transfer is made to the Trust without an allocation of the beneficiary's GST exemption can lead to a portion of the Trust not being GST exempt. . To work around this rule often a Trust which confer Crummey withdrawal rights on a beneficiary will utilize a *hanging Crummey power;* this portion of the withdrawal right remains in existence. A *hanging Crummey power* can cause estate tax inclusion for the beneficiary, since it is a retained right to withdraw assets in the future.

7.Has there been a *qualified severance* of the Trust? Some Trust instruments include language that will cause a severance automatically if the Trust's inclusion ratio is other than 0.000 or 1.000. If the Trust does not contain that type of language, a *qualified severance* may be necessary. [IRC 2642(a)(3)(B); Regulation 26.2642-6(e).] When a Trust has an inclusion ratio other than 0.000 or 1.000 the trustee may want to make a *qualified severance* which divides the Trust into tow or more Trusts so that the resulting Trusts either have an inclusion ratio or 0.000 and are exempt from the GST or they have an inclusion ration of 1.0000 and are nonexempt from the GST. Administering a Trust with an inclusion ration of other than 0.000 or 1.000 can be extremely complicated, time consuming, and expensive for the trustee. When the Trust is severed into Trusts that are either GST exempt or GST nonexempt the Trust shares can be much simpler for the trustee to administer. This can be important no only to make allocations to *skip persons* from the GST exempt Trust, but also in these days of increasing GST exemptions due to inflation, the transferor can choose to

make a late allocation of their increased GST exemption to the nonexempt portion to protect those assets from the GST.

Conclusion: All of these rules, including deemed exemption allocations, opt-out elections by the transferor, and the ever-changing exemption effective dates can easily complicate the trustee's task to determine the administered-Trust's GST inclusion ratio whenever a *taxable distribution* or *taxable termination* is made with regard to the Trust. As more assets are added to the Trust in the future, depending on whether the transferor uses, or elects to use, his/her GST exemption to shelter that additional transfer of assets to the Trust, will cause the Trust's inclusion ratio to shift over time. Whenever possible, the trustee should assure that a *qualified severance* of the Trust occurs to greatly simplify the trustee's management of the Trust's GST exposure.