GST "Fixes"

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Take-Away: It may be possible to fix some 'mistakes' when a trust is subject to the generation skipping transfer tax.

Background: Many of us have pretty much ignored the generation skipping transfer tax (GSTT) over the past several years due to the large GSTT exemption. But mistakes can be made, leading to an inclusion ratio of a trust, that in turn determines the portion of the trust assets that is subject to the generation skipping transfer tax (GSTT.) That ratio is calculated under IRC 2642(a). The 40% flat GSTT is imposed on three different events: (I) a *direct skip* with no remaining GST exemption available (under IRC 2612(c)); (ii) a *taxable distribution* from the trust with an inclusion ratio other than 0.0000 [IRC 2612(b)]; and (iii) a *taxable termination* of a trust with an inclusion ratio other than 0.0000. [IRC 2612(a).] A 'mixed' GSTT inclusion ratio of a trust can cause plenty of headaches. How to deal with those headaches are summarized below.

Unintended Mixed Inclusion Ratio Due to Unreported GST Transfers: The existence of GSTT exemptions has changed over the years, and it is possible that some transfers to an irrevocable trust were not automatically sheltered by the donor's GST exemption. For examples, transfers made to a trust in 1998, 1999 and 2000 are not protected from the GSTT with automatic allocations of the donor's GST exemption.

- Timely Manual Allocation of Exemption: Revenue Procedure 2004-46 provides a special rule for pre-2001 present interest gifts under the gift tax annual exclusion. It allows the donor to go back and file gift tax returns as if they are timely making manual allocations using the date of transfer values. If the donor does not take advantage of this Revenue Procedure or the gifts that were made do not qualify for this method, there are other remedies available, discussed below.

Inadvertent Automatic Allocation of the Donor's GST Exemption: Sometimes when the donor files a federal gift tax return, the return preparer fails to make an affirmative GST election. If the trust was formed after 2000 and is a *GST Trust*, the available exemption will be allocated to the trust. However, if the trust is not classified as a *GST Trust* no GST exemption would be allocated to the transfers to the trust, unless made manually. Restated, the automatic allocation rules were enacted as a *safety net* to protect trusts from exposure to the GSTT. Yet these rules can have unintended consequences. For example, if the trust is a *GST Trust* but it will ever benefit a *skip person,* an automatic allocation of the donor's GST exemption to the trust could be a waste of the donor's GST exemption.

- Private Letter Ruling: To rectify the failure to make an election for GST purposes for relief, IRC 9100 is available. This relief is generally available only when no election has been made and the donor is seeking relief to make a timely election. Section 9100 grants an extension of time to makes some, but not all, regulatory elections. If the IRS relief is granted, it provides the same effect as if an *opt out* election had been timely made. Extensions of time for GST purposes may be granted per Notice 2001-50. [Regulation 301.9100-3.] However, the cost for a private letter ruling request is $12,600 plus an additional $3,800 for an identical spousal letter when gift-splitting is involved on the gift tax return.

Erroneous *Opt Out* Election is Made On a Gift to a Trust Intended to be GST Exempt: Unfortunately, a donor cannot use IRC 9100 relief if an erroneous election was made. In short, IRC 9100 relief is not available to undo an *opt out* election by the donor.

- Late Allocation: A late allocation is available for trusts that are not fully GST exempt trusts where the donor wishes to allocate an available GST exemption to a trust. There are two situations where a late allocation may be helpful: (I) in an economic downturn, opting out of the automatic allocation rules for higher value transfers, when making a late allocation of GST exemption is based on a lower value to preserve a larger portion of the donor's GST exemption; and (ii) when a GST exemption was not allocated on the original gift tax return and the donor now wants to allocate his/her exemption to protect the assets in the trust from GSTT. This late allocation is reported on a late gift tax return. However, this election is not available for life insurance if the donor dies before the effective date of the late allocation. If this remedy is pursued, the donor will also want to terminate the opt out election on his/her next timely filed gift tax return and, instead, make an opt-in election.

Death of *Non-skip* Person Results in Unexpected *Skip Person* Receiving Nonexempt Assets: Generally, a donor will not allocate his/her GST exemption to a trust that they expect will benefit only *skip persons but* would instead save their GST exemption for other planning that is intended to benefit future generations.

- Example: Donna funded a trust for her daughter. The trust agreement provides that assets will be distributed outright to the daughter when she reaches age 40. When Donna originally transferred assets to the trust, she did not expect the trust would benefit *skip persons* or be subject to the GSTT. However, Donna's daughter died in 2023 at age 30, and an unexpected GSTT is due, since the assets remain in trust for Donna's grandchildren. Thus, with the death of Donna's daughter a *taxable termination* has occurred, and the trust is fully subject to the GSTT due to its inclusion ratio of 1.000. Because Donna did not allocate any of her GSTT exemption to the trust, the trust is liable for the GSTT, even though Donna has GST exemption remaining.

- Retroactive Allocation of the Donor's GST Exemption: A retroactive allocation can provide a remedy for an untimely death. [IRC 2632(d).] This rule allows a GST exemption to be chronologically allocated at original date-of-transfer values effective the moment right before the *non-skip* person's death. This allocation must be made on a timely filed gift tax return for the year of the *non-skip* person's death. This retroactive allocation will protect distributions made to *skip persons* after the death of the *non-skip* person.

Mixed Inclusion Ratio with Respect to an Indirect Skip Trust: Trusts can benefit both *non-skip* and *skip* persons with a mixed inclusion ratio. This can expose trust assets to unnecessary GSTT. It can also be time consuming and expensive to manage the related GSTT compliance when distributions are made to *skip persons* from the trust.

- Qualified Severance of Trust: To solve the problems that are associated with a mixed inclusion ration trust that has both *skip persons* and *non-skip persons* beneficiaries, the trustee might want to sever the trust. A *qualified severance* is the division of a single trust with a mixed inclusion ratio into two or more identical, but separate, trusts, one of which is GST exempt (including a ratio of 0.0000) and one of which is not (with an inclusion ratio of 1.0000.) [IRC 2642(a)(3)(B).] These trusts must receive a fractional share of the total value of assets equal to the fraction of the single trust before the severance. The trust and the severance must meet several criteria [see Regulation 26.2642-6(d)] including being allowed by the trust instrument, being effective under local law, and having the same succession of interest to the beneficiaries. The trustee must establish a date of severance and funding must occur within 90 days of the effective date of the severance. The *qualified severance* is then reported on Form 706-GS(T).

Conclusion: The GSTT is bewilderingly complex. If the GSTT exemption is not correctly applied, the exposure to the 40% GSTT or dealing with a mixed exclusion ratio can prove to be expensive. Fortunately, there are some provisions in the Tax Code or the Regulations that can provide a donor or a trustee some after-the-fact fixes.