GST Allocation Mistakes

Take-Away: The automatic allocation of a donor's generation skipping transfer (GST) tax exemption is a helpful backstop to avoid triggering the GST tax, but the automatic allocation rules also create confusion which in turn can lead to costly mistakes.

Background: As the 2026 sunset date looms for those individuals who are engaged in estate planning, either funding SLATs and dynasty-type trusts for their children and more remote descendants, it would be wise to counsel them on the efficient use of the generations skipping transfer (GST) tax exemption, which currently is $13.61 million, [IRC 2631(a)], but which is scheduled to be cut in half come January 1, 2026. An efficient use of their GST tax exemption by necessity requires a working understanding of when to rely on the automatic allocation of the donor's GST exemption, and when it is bast to opt-out of the automatic allocation rules. Some situations where the automatic allocation should be carefully considered follow, but first, a quick summary of the automatic GST exemption allocation rules.

Automatic GST Exemption Allocation Rules: These rules were designed to simplify the process of allocation the GST tax exemption to lifetime transfers.[IRC 2532(c).] The rules automatically apply a donor's GST exemption to certain transfers considered *indirect skips*, which are transfers in trust that are not considered *direct skips* but could potentially have a GST with respect to the donor.

These rules apply to trusts that meet the definition of a *GST Trust.* [IRC 2632(c)(3)(B).] The purpose of these rules is to protect the trust assets from the GST. However, relying on the automatic allocation rules for *indirect skip* transfers without making an affirmative election can lead to unintended tax consequences. A trust will not be treated as a *GST Trust* if any part of the trust would be included in the estate of a *non-skip person,* e.g., a child of the donor, if that person were to die immediately following the transfer. [IRC 2632(c)(3)(B)(iv).]

GST Allocations and Options: The following are some situations where thought needs to go into the automatic allocation of a donor's GST exemption, and some examples that hopefully explain why it is important to not always rely on an automatic allocation of the donor's GST exemption.

A. Forgetting the GST Exemption was Automatically Allocated: As an example, annual exclusion gifts are normally not reported on a Federal Gift Tax Return, Form 709. [IRC 2503(b).] But some annual exclusion gifts may not be exempt from the GST, which means that the donor will have his/her GST exemption applied to that annual exclusion gift, even if no Form 709 was ever filed. The automatic allocation of the donor's GST exemption to *direct skips* and *indirect skips* [IRC 2632(b)(c)] may occur whether or not the transfer is reported on Form 709.

Example: Don made a $10,000 gift to a trust for the benefit of his grandchildren in 2023. Don also made another $10,000 gift to a trust for his children and their descendants in the same year, which by definition is a *GST Trust.* [IRC 2632(c)(3)(B).] Both of these $10,000 gifts qualified for the gift tax annual exclusion because of the trust beneficiaries' *Crummey* right to withdraw the transfers. Since the transfers were not taxable gifts, Don did not file a Gift Tax Return. However, the transfers did not qualify for the GST annual exclusion because there was more than one *skip person* in the same trust- a highly technical rule. Because these gifts were not reported on a Form 709, the automatic allocations of Don's GST exemption occurred. In the future Don, or his tax advisor, may forget or overlook this automatic allocation of part of Don's GST exemption, which could lead to a mistake when they later determine how much of Don's GST exemption remains available. Don should consider filing a gift tax return, even if it is not required, to track the automatic allocation of his GST exemption, because the Gift Tax Return is the best source to determine how much of the donor's GST exemption was used in all prior transfers.

B. Overfunding a Trust that is Intended to be GST Exempt: What may come as a surprise to some donors is that their GST exemption and their remaining gift tax exemption may not be the same amount, even though they both started out at $13.61 million. As noted in example 1, the automatic allocation of the donor's GST exemption may apply without the donor realizing it, which can lead to a point when the donor's gift and GST tax exemptions are different amounts, yet the donor thinks they are the same.

Example: In Example 1, Don made two $10,000 gifts in 2023 that triggered the automatic allocation of part of Don's GST tax exemption. Don intends to fund a new dynasty trust in 2024 with $13.61 million and he plans to allocate his GST exemption to that $13.61 million transfer to the dynasty trust. Yet Don's full $13.61 million transfer to the dynasty trust is not available due to Don's $20,000 of GST gifts in 2023. As a result, the dynasty trust now has a mixed GST inclusion ratio, and it is not fully exempt from the GST. Again, the lesson to be learned is to keep track of all prior gifts to discern if the donor's GST exemption has been automatically allocated in past transfers.

C. Failing to Opt-Out of the Allocation: Another mistake when dealing with the GST automatic allocation rules involves the failure to make an affirmative opt-out election for gifts that are subject to the estate tax inclusion period, or ETIP. Examples of the ETIP are transfers made to a GRAT or a QPRT. The ETIP is the period during which the value of the transferred property could be included in the donor's gross estate, e.g., the donor to a QPRT must survive the retained exclusive use period, and if not the full value of the principal residence is included in the donor's gross estate. Any allocation of the donor's GST exemption to property that is subject to an ETIP cannot be made until the ETIP concludes. This delay is important because the value of the property, and consequently the allocation of the donor's GST exemption, can only be assessed at the end of the ETIP period when it is hoped using the GRAT or QPRT that the trust assets have appreciated in value. To avoid this *later* allocation of the donor's GST exemption, it is necessary to make an explicit opt-out of the automatic allocation of the donor's GST exemption.

Example: Don funds a GRAT in 2024 with $8.0 million in exchange for a qualified annuity interest. This is a 'zeroed out GRAT,' meaning that the value of the GRAT's remainder interest is set at $1.00, i.e., the value of the gift of the remainder interest. Don fails to make an opt-out election under IRC 2632(c)'s automatic GST exemption allocation on his 2024 Form 709. The remainder beneficiary of the GRAT is a *GST Trust* that provides for Don's children and their descendants. However, the way Don intends the *GST Trust* to be administered, he does not believe that his grandchildren, the *skip persons*, will ever actually benefit from the trust. When the GRAT ends in 2026, the GRAT assets that pass to the *GST Trust* are now worth $10 million. $10 million of Don's GST exemption is automatically applied at the end of the ETIP period, which wastes Don's GST exemption since he envisions that his grandchildren will never benefit from the trust. This is an example of when dealing with asset transfers subject to an ETIP of the need to make a preemptive affirmative opt-out election, which is especially the case if the donor does not think that the trust will ever benefit *skip persons.*

D. Gift-Splitting and the GST Exemption: When a donor makes a GST transfer and splits the gift with his/her spouse, the spouse is deemed to have used part of his/her GST exemption associated with the split-gift. The donor cannot 'cherry pick' which gifts to split with his/her spouse; all gifts made by the donor during the year, if one is split with his/her spouse, requires that all gifts are deemed to be split and deemed to be made one-half by the donor's spouse. Thus, a split-gift then implicates the spouse's GST exemption as well. [IRC 2513(a); IRC 2652(a)(2); Regulation 26.2652-1(a)(4).] In effect with gift-splitting, there are two transferors which can complicate future tax planning.

Example: Don makes a $1.0 million gift to a trust in 2024 for the benefit of Don's wife, Julie and his two children and their descendants. Don's two children can each withdraw $18,000 in 2024 contributions to the trust- *Crummey* withdrawal rights . In addition, Don made $36,000 in gifts to his two siblings in 2024 with the intent of making a gift-splitting election with Julie to treat those gifts to his siblings as made $18,000 by Don and $18,000 by Julie, all qualifying for the gift tax annual exclusion. The

Regulations require that because a portion of the gift is eligible for gift-splitting, Don is treated as a 50% GST transferor of the $1.0 million to the trust, and Julie is treated as a 50% GST transferor to the trust for Don's family. Although only $18,000 withdrawal right portions of the $1.0 million gift to the trust are eligible for gift-splitting [recall Julie is also a beneficiary of the $1.0 million trust so she cannot gift-split as to her own unascertainable interest in the trust] $500,000 of Don's GST exemption will be allocated to the transfer and $500,000 of Julie's GST will be allocated to the transfer to the trust.

SLAT Comment: Don may have intended the $1.0 million trust he funded to be viewed as a SLAT, with Julie as its primary lifetime beneficiary, but most SLATs are not eligible for gift-splitting, because the donor's spouse has a beneficial interest in the SLAT that is not severable from other interests. Only the severable portion, like the children's $18,000 *Crummey* withdrawal rights, can be split by Julie. The portion of the trust allocable to Julie and the portions not allocable to Julie cannot be split. This thus creates a potential misunderstanding of who the GST transferor is with respect to transfers to SLATs and how the GST exemption is allocated between spouses when a gift-splitting election is made.

Conclusion: When creating an estate plan, understanding a wealthy settlor/donor's intentions for each generation is fundamental in planning to maximize the use of that individual's GST exemption, or when to save the exemption for other uses. For those individuals who may not be so wealthy, it is important to not waste their GST exemptions when they establish trusts for the children (*non-skip persons*) and their grandchildren (*skip persons*) and who may rely on the automatic allocation of their GST exemption when it is not needed. The key take-away from this missive is that any distribution to a *non-skip person* from a trust that is exempt from the GST tax is effective a waste of that transferor's GST exemption. Creating separate trusts for *non-skip persons* and *skip persons* might provide a more efficient use of the donor's GST tax exemption.

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