

GST Trust Overview

Take-Away: The Tax Code will in some situations regarding the funding a trust automatically allocate to the trust the transferor's generation skipping (GST) tax exemption, classifying it a *GST Trust*. That deemed allocation is intended to protect the transferor from inadvertently failing to use his/her GST exemption when it is likely that *skip-persons*, e.g., a grandchild, will receive an interest in the transferred asset. However, there are occasions when the transferor may not want to use his/her GST exemption on transfers made to an irrevocable trust. What is, and what is not, a GST Trust requires a complicated analysis.

Background: We know that the generation skipping transfer (GST) tax is a flat 40% federal transfer tax. We also know that the GST exemption (currently \$13.6 million) is scheduled to sunset come 2026, and the unlike a spouse's applicable exemption amount for federal gift and estate taxes that can be *ported* to a surviving spouse, the GST tax exemption is not *portable* between spouses. It is critically important to use a GST exemption wisely, especially for transfers to irrevocable trusts, like SLATs or dynasty-type family trusts where more remoted beneficiaries, e.g., grandchildren, might ultimately receive GST taxed distributions from the trust. All of which leads us to the confusing world of the deemed allocation of a transferor's GST transfer tax exemption to lifetime transfers and the other-worldly concept of a GST Trust, which will cause the *deemed allocation* of the transferor's GST exemption, even when the transferor wanted to use his/her exemption elsewhere or at another time for other transfers.

GST Trust: For all lifetime transfers to trusts made on or after January 1, 2001, a *deemed allocation* of the transferor's GST exemption will apply to any *indirect skip* transfer. An *indirect skip* is a transfer that is subject to Chapter 12 of the Tax Code (a gift), to a GST Trust, which is a specific term that is used in Chapter 13 (the GST tax) of the Tax Code to identify a trust that *could* have a GST (other than a *direct skip*) with respect to the transferor, unless one of six (6) exceptions applies, or a trust for which an affirmative election is made to intentionally treat the trust as a GST Trust. (IRC 2632(c)(3).]

Key Point: If the trust is a *skip-person*, the transfer to trust is treated as a *direct skip*, thus inviting the GST tax. However, if a *non-skip person*, e.g., the transferor's child, holds an interest in the trust, but a GST *could* occur at a future date with respect to the trust because a distribution could be made to, or the trust could terminate in favor of a *skip-person*, e.g., a grandchild, then the trust is likely to be classified as a GST Trust, unless one of the 6 exceptions applies. An automatic allocation of the transferor's available GST exemption may not be consistent with his/her wishes at that time

Skip Person: The key issue is whether a trust is, or is not, a *skip-person*. A *skip-person* is (i) an individual who is more than one generation below the transferor, like the transferor's grandchild; or (ii) a trust in which either (a) all interests are held by individuals who are *skip-persons* or (b) no person holds an interest in the trust and at no time after the transfer may a distribution (including on termination) be made to a non-skip person, unless the probability of such distribution is less than 5%. [Regulation 26.2612-1(e).] An individual who has an 'interest' in the trust for purposes of this analysis if he/she has a present right or ability, whether non-discretionary or discretionary, to receive income or principal from the trust. Only the present interests of individuals, rather than future interests, are considered to determine whether the trust is a *skip-person*.

Disregarded Interests: This horribly technical description gets even worse. Some interests in trusts are disregarded when the determination is made whether a trust is a *skip-person*. For example, if a significant purpose of the interest so held is to postpone or avoid the imposition of the GST tax, that interest will be disregarded. Or, if a trustee has the ability on a discretionary basis to satisfy an individual's support obligation, that individual will not be considered to hold an interest in the trust, but he/she would be treated as having an interest in the trust if the trustee is required to make such a support distribution on their behalf.

Reason: Accordingly, a GST Trust will attract to it an automatic *deemed allocation* of the transferor's available GST exemption, unless the transferor affirmatively opts out of that automatic allocation. The thinking behind this rule is that the transferor probably would want his/her GST exemption to apply to the transfer to the trust where grandchildren, or more remote descendants, are likely to receive distributions from the trust, or a distributions of trust assets upon the termination of the trust at a future date. That tax avoidance is understandable. The Tax Code then provides exceptions to the GST Trust automatic allocation rule when the *deemed allocation* of the transferor's GST exemption will not apply. Some of these exceptions are easy to understand, and some require a close reading of the distribution provisions of the trust instrument to figure out if it will be treated as a GST Trust and whether an affirmative allocation will be required (or not.)

Exceptions to the GST Trust Assumptions. If no formal GST Trust election has been made for the trust, the following trusts are *excluded* from the definition of a GST Trust in the Tax Code, notwithstanding that a transfer could be made from the trust to, or the trust could terminate in favor of, a *skip-person*. When a trust instrument is being analyzed for this purpose, whether the trust meets one of these 6 exceptions: (i) inclusion of a portion of the trust in the beneficiary's estate resulting from a beneficiary's *Crummey* withdrawal power is disregarded; and (ii) it is assumed that any powers of appointment held by a *non-skip person* (e.g., the transferor's child) will not be exercised. [Regulation 26.2632-2(b)(3)(iv).]

1. CLUT (Easy): A trust is not a GST Trust by default if it is one for which a deduction was allowed under IRC 2522 as a charitable lead unitrust (CLUT), and it is required to pay principal to a *non-skip person* if such person is alive when the charity's unitrust term interest in the CLUT terminates.
2. CLAT and CRT (Easy): A trust is not a GST Trust by default if the trust is a charitable lead annuity trust (CLAT), a charitable remainder annuity trust (CRAT), or a charitable remainder unitrust (CRUT.)
3. Includible in the Estate of a *Non-Skip Person* (Easier): A trust is not a GST Trust if any portion of the trust would be included in the gross estate of a *non-skip person* (excluding the transferor) if such a *non-skip person* immediately died after the transfer. For example, if a *non-skip person* like the transferor's sibling held a general power of appointment over the trust, then the trust would not meet the GST Trust definition.

A Note of Caution: Note, however, the parenthetical exception *excluding the transferor*. What this means is that there is estate tax inclusion period, or ETIP, that causes assets to be included in the settlor's estate if death occurs prior to a specified event, e.g., the expiration of a GRAT's annuity period; the end of the settlor's retained exclusive use period in a QPRT. Thus, a GRAT or a QPRT, or some other trust where the settlor has retained a power or interest that will cause estate inclusion for some period, will not satisfy this exception to a GST Trust, and the trust will nonetheless be classified as a GST Trust to which deemed allocations of the transferor's GST exemption will apply.

4. General Power of Appointment (Easier): A trust is not a GST Trust by default if the trust provides that if one or more individuals who are *non-skip persons* die or before a date or event (described in the two exceptions below) more than 25% of the trust corpus either must be distributed to the estate of one or more of such *non-skip persons*, or is subject to a general power of appointment exercisable by one or more of such *non-skip persons*. However, a formula general power of appointment clause that is exercisable on the death of a *non-skip person* that is contingent on the trust's GST inclusion ratio is probably not going to cause the trust to satisfy this GST Trust exception.
5. 10-Year Older Withdrawal Right (Complicated): A trust is not a GST Trust by default if the trust provides that more than 25% of the trust corpus must be distributed to, or may be

withdrawn by, one or more *non-skip-persons* who are living on the death of another person who is identified in the trust (by name or class) who is more than 10 years older than the *non-skip persons*.

Example: A trust provides for the income and principal to be distributed to, or for the benefit of, the transferor's spouse and child, and on the spouse's death, who is the child's parent, trust assets are distributed outright to the child, or to that child's issue if the child is not then living. This is not a GST Trust. However, if the spouse was not the child's parent and the spouse was age 44 and the child was age 35 (Hollywood, anyone?) this statutory exception would not be met, notwithstanding that the trust distributes outright to a *non-skip person*, i.e., the transferor's child.

6. Distribution/Withdrawal of more than 25% by *Non-Skip Person* (Complicated): A trust is not a GST Trust by default if the trust provides that more than 25% of the trust corpus must be distributed to, or may be withdrawn by, one or more *non-skip persons*: (i) before the *non-skip person* attains the age 46; (ii) on or before one or more dates specified in the trust instrument that will occur before the *non-skip person* attains age 46; or (iii) on the occurrence of an event that is reasonably expected to occur before the *non-skip person* reaches age 46.

Example: The trust that provides for an outright distribution of trust corpus to a child of the transferor, 50% at age 30 and the balance at age 50 will meet this exception and therefore is not a GST Trust.

Conclusion: Admittedly this is confusing stuff, as if the GST tax was not already confusing on its own. Injecting even more confusion are the definitions of a GST Trust, multiple exceptions to a GST Trust, and an automatic *deemed allocation* of the transferor's GST exemption. With a \$13.6 million GST exemption available, most transferors have not paid too much attention to the precise timing, use and allocation of their GST exemption, because there was plenty of exemption to shelter most of their lifetime gifts. With the scheduled drop in the GST exemption come 2026, many more transferors will want to carefully use, and intentionally allocate, their GST exemption which will be cut in half. Hence, they will need to become familiar (or at least try to understand) with the concept of a GST Trust and its *deemed allocation* of the transferor's GST exemption allocation because once the allocation of the GST exemption is made, it is irrevocable.