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Diagnosing the GST Tax Status of a Trust

Nathan R. Brown and Brandon A.S. Ross

Nathan R. Brown is an attorney in the Private Client Services Department of the Boca Raton, Florida, office of Proskauer Rose LLP and a 2017 member of the Fellows Subcommittee. Brandon A.S. Ross is special counsel in the Washington, D.C., and Palm Beach, Florida, offices of Pillsbury Winthrop Shaw Pittman LLP and 2018 member of the Fellows Subcommittee.

When implementing estate plans for clients, advisors routinely focus on reducing the client's future estate tax exposure, yet they all too often fail to properly take into consideration the equally important generation-skipping transfer (GST) tax consequences of such plans, and, as a result, many existing estate plans are not as efficient as they could be from a GST tax perspective. Accordingly, when an advisor represents a new client who has one or more existing irrevocable trusts, the advisor should diagnose the GST tax status of each trust to understand the potential GST tax consequences of each trust and determine whether any action should be taken to increase the GST tax efficiency of such trusts.

For GST tax purposes, a trust will be either a GST exempt trust (meaning the trust has an inclusion ratio of zero), a GST non-exempt trust (meaning the trust has an inclusion ratio of one), or a mixed inclusion ratio trust (meaning the trust has an inclusion ratio greater than zero and less than one). Taxable distributions from and taxable terminations of interests (referred to hereinafter as "GSTs") in a GST exempt trust will not be subject to GST tax. Conversely, GSTs from a GST non-exempt trust will be subject to GST tax at a 40% tax rate. GSTs from a mixed inclusion ratio trust will be subject to GST tax at a reduced tax rate. Thus, understanding the GST tax status of a particular trust is necessary to know the manner in which future GSTs from the trust will be taxed.

This article provides advisors with a roadmap for determining the GST tax status of a trust and depicts those steps in the decision tree on page 36. If it is determined that a trust is GST non-exempt or has a mixed inclusion ratio and it would be desirable for such trust to be GST exempt, a number of actions can be taken to increase the GST tax efficiency of the trust. A follow-up article will walk through the various techniques available to clean up trusts that are inefficient from a GST tax perspective. This article is not intended to provide an overview of the GST tax rules and assumes the reader has a basic understanding of such rules.

How Can a Trust Be GST Exempt?

A trust can be exempt from GST tax in any of the following five ways or a combination of them: (1) the trust is a grandfathered trust; (2) the trust is a Gallo trust; (3) transfers to the trust qualify for the so-called "GST tax annual exclusion"; (4) GST exemption was affirmatively allocated to the trust; or (5) GST exemption was automatically allocated to the trust. The remainder of this article outlines the steps an advisor must take to determine the GST tax status of a particular trust.

Is the Trust a Grandfathered Trust?

The first step in the diagnostic procedure is to determine whether the trust is a grandfathered trust under Treas. Reg. § 26.2601-1(b). A "grandfathered trust" is any trust that was irrevocable on or before September 25, 1985, which is the retroactive effective date of the GST tax provisions. If the trust was executed after September 25, 1985, the trust cannot be a grandfathered trust. If the trust was executed before September 25, 1985, the advisor must determine whether the trust was irrevocable on or before September 25, 1985.

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All trusts in existence on September 25, 1985, are considered irrevocable, unless (1) on September 25, 1985, the settlor held a power with respect to the trust that would have resulted in gross estate inclusion under IRC § 2038, (2) the settlor retained a power to alter the trust beneficiaries' shares, or (3) the trust holds life insurance on the settlor's life and the settlor possessed incidents of ownership in the policy that would result in gross estate inclusion under IRC § 2042. A special set of rules applies if the trust at issue is a testamentary trust created under a will or revocable trust. Testamentary trusts will be irrevocable only if (1) no amendments were made any time after October 21, 1986, that resulted in the creation of or increase in the amount of a GST, (2) no addition was made to the testamentary trust after October 21, 1986, that resulted in the creation of or increase in the amount of a GST, and (3) the decedent who created the testamentary trust died before January 1, 1987.

If the advisor determines that the trust is a grandfathered trust, he then must determine whether any subsequent events have occurred that may have terminated the trust's status as a grandfathered trust. Two types of events that must be carefully analyzed are additions to the trust and modifications of the trust occurring after September 25, 1985.

If an actual or constructive addition has been made to a grandfathered trust after September 25, 1985, a pro rata portion of subsequent GSTs will be subject to GST tax, unless GST exemption is allocated to the addition (discussed below). Although an actual addition to a trust may be easily identifiable, a constructive addition may be much more difficult to identify. A "constructive addition" occurs on (1) the taxable release, exercise, or lapse of a general power of appointment over the trust, (2) the release or exercise of a nongeneral power of appointment that extends the vesting period beyond the original rule against perpetuities, or (3) the creation of a second power of appointment that may be exercised to extend the vesting beyond the original rule against perpetuities.

A modification of a grandfathered trust after September 25, 1985, can terminate the trust's grandfathered trust status if such modification does not fall squarely within one of the modification safe harbors set forth in Treas. Reg. § 26.2601-1(b)(4). With the increased popularity of decanting as a mechanism to modify the terms of an otherwise irrevocable trust, the first safe harbor may be the most relevant. It provides that a distribution of principal from a grandfathered trust to a new trust will not cause the new trust to be subject to GST tax (that is, the new trust will inherit the grandfathered trust status of the decanted trust) if either (1) the terms of the governing instrument of the grandfathered trust authorize distribution to the new trust without the consent or approval of any beneficiary or court or (2) at the time that the grandfathered trust became irrevocable (which had to have been before September 15, 1985), state law governing the trust authorized distribution to the new trust without consent or approval of any beneficiary. Furthermore, the terms of the new trust cannot extend the time for vesting of any beneficial interest beyond a period measured by 21 years after the death of any life in being at the time that the grandfathered trust became irrevocable.

The second safe harbor avoids the termination of grandfathered trust status for a court-approved settlement that was a product of an arm's length negotiation and has an outcome that was a reasonable interpretation of the governing instrument and applicable state law. The third safe harbor prevents the termination of grandfathered trust status for a judicial construction of a trust instrument if the judicial action involved a bona fide issue and the construction is consistent with applicable state law that would be applied by the highest state court. The fourth and final safe harbor, which really is a catchall provision, prevents termination of grandfathered trust status for any modifications to a trust that do not (1) shift a beneficial interest in the trust to any beneficiary who occupies a generation lower than the generation occupied by the person or persons who held the beneficial interest before the modification and (2) extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the grandfathered trust.

Is the Trust a Gallo Trust?

Second, the advisor should determine whether the trust qualifies as a Gallo trust. The requirements of a Gallo trust are not outlined in any Code section or the Regulations but are contained in an amendment to the Tax Reform Act of 1986 that implemented the modern GST tax. Named for the Gallo wine family, which lobbied for the exception, GSTs from a trust for the benefit of one grandchild funded with up to $2 million before January 1, 1990, will not be subject to GST tax, unless (1) additions have been made to the trust after December 31, 1989, or (2) the trust was modified after December 31, 1989, beyond the modifications permitted in the grandfathered trust safe harbor regulations.

Does the Trust Qualify for the GST Annual Exclusion?

Third, the advisor should determine whether transfers to the trust qualified for the so-called "GST tax annual exclusion" under IRC § 2642(c). A trust meeting these requirements is commonly referred to as a "2642(c) trust." If all of the requirements are met, transfers to the trust that qualify for the gift tax annual exclusion also

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will qualify for the GST tax annual exclusion. What this means is that such transfers will be treated as GST exempt without the use of any of the transferor's GST exemption. If transfers to the trust in a given year exceed the gift tax annual exclusion amount, the transferor's GST exemption would need to be allocated to the transfer (to the extent of such excess) for the trust to remain GST exempt.

For a transfer in trust to qualify for the GST tax annual exclusion, the trust must have only one beneficiary, that beneficiary must be a skip person, and, if that beneficiary dies before the trust is completely distributed, the remaining assets of the trust must be included in that beneficiary's gross estate. Accordingly, transfers to a typical life insurance trust for the benefit of all of the settlor's descendants will not qualify for the GST tax annual exclusion even though such transfers often qualify for the gift tax annual exclusion as a result of withdrawal powers granted to the beneficiaries. This can be a trap for the unwary and a common reporting mistake on gift tax returns. Thus, it is important for the advisor to review prior gift tax returns to determine whether prior transfers to the trust have been improperly reported.

Was GST Exemption Allocated to the Transfer?

If none of the exceptions discussed above applies to exempt the trust from GST tax, the advisor should determine whether GST exemption has been affirmatively allocated to any transfers made to the trust or, if GST exemption has not been affirmatively allocated, whether the automatic allocations rules applied to automatically allocate GST exemption to transfers to the trust.

An individual can affirmatively allocate his GST exemption to transfers made by that individual during his lifetime. In addition, a decedent's executor can affirmatively allocate the decedent's unused GST exemption to transfers occurring on the decedent's death. Affirmative allocations of GST exemption are made by attaching a notice of allocation to the gift tax return or estate tax return reporting the transfer to which GST exemption is being allocated.

If GST exemption was not affirmatively allocated to transfers to the trust, the trust may nonetheless be GST exempt if the automatic allocation rules apply to the trust. Under the automatic allocation rules, GST exemption is automatically allocated to transfers to trusts that are skip persons (that is, trusts with only skip persons as beneficiaries) and so-called "GST trusts" after December 31, 2000. A GST trust is broadly defined to include any trust from which a taxable distribution or taxable termination is likely to occur in the future. This broad definition, however, is subject to six exceptions set forth in IRC § 2632(c)(3)(B).

These exceptions exclude from the definition of a "GST trust" (1) a trust more than 25% of which must be distributed to non-skip persons before age 46; (2) a trust more than 25% of which must be distributed to non-skip persons living on the death of a person more than ten years older than the transferor; (3) a trust more than 25% of which must be distributed to the estate or estates of one or more non-skip persons or is subject to a general power of appointment exercisable by one or more non-skip persons, if one or more non-skip persons die on or before a date or event described in the prior two exceptions; (4) a trust any portion of which would be included in the gross estate of a non-skip person if such person died immediately after the transfer; (5) a charitable lead annuity trust, charitable remainder annuity trust, or charitable remainder unitrust; or (6) a charitable lead unitrust if the trust principal passes to a non-skip person if alive at the end of the annuity period.

The fourth exception to the definition of a GST trust can cause unnoticed issues for automatic allocation of GST exemption. Many trusts grant the trust beneficiaries withdrawal rights over contributions to the trust so that such contributions qualify, to the greatest extent possible, for the gift tax annual exclusion. To avoid adverse transfer tax consequences, these withdrawal rights are commonly structured to lapse after a certain period of time up to the greater of 5% of the trust principal and $5,000 each year. The balance of the withdrawal right in excess of such amount (commonly referred to as "hanging powers") does not lapse and may be withdrawn in subsequent years (in addition to the amount otherwise subject to withdrawal in that particular year). These types of trusts are often structured as "dynasty" trusts intended to benefit not only the settlor's children but also the settlor's grandchildren and more remote descendants. Although this is the exact type of trust an individual would likely want to allocate GST exemption to, a common scenario would disqualify such a trust as a GST trust.

If a contribution were made to a trust and a beneficiary who is a non-skip person had the right to withdraw up to the gift tax annual exclusion amount, the trust would not be a GST trust if there is a hanging power with respect to such beneficiary. In such a circumstance, the non-skip person beneficiary would be allowed to withdraw not only the amount of the gift tax annual exclusion but also the hanging amount, meaning the withdrawable amount from years prior to that year's contribution. Because the aggregate amount that the non-skip person beneficiary may withdraw exceeds the gift tax annual exclusion amount, if the non-skip person beneficiary were to die immediately after the contribution to the trust, a portion of the trust would be

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included in the non-skip person beneficiary's gross estate. Thus, in that case, the trust would cease to qualify as a GST trust, and GST exemption would not be automatically allocated to the trust.

Automatic allocations of GST exemption apply not only during the lifetime of a transferor but also at death. At death, any of a decedent's GST exemption that remains after his estate tax return has been filed is allocated first to any direct skips resulting from his or her death and then to any GST trusts. If the GST exemption is insufficient to fully exempt the direct skips or the GST trusts, the decedent's GST exemption would be allocated, pro rata, to the direct skips or, pro rata, to the GST trusts, if the direct skips, if any, have been sufficiently covered by GST exemption.

With the definition of a GST trust being imperfect, causing unwanted allocations of GST exemption in certain circumstances and not producing allocations when desired in other circumstances, advisors need to examine the facts and circumstances surrounding past transfers to the trust when diagnosing the GST tax status of the trust.

The affirmative and automatic allocation of GST exemption is complicated by IRC § 2642(f), which prevents any affirmative or automatic allocation of GST exemption to property transferred to a trust during the estate tax inclusion period (ETIP). The ETIP is that period of time during which, if the settlor died, the assets of the trust would be included in his or her estate. For example, GST exemption cannot be allocated to a grantor retained annuity trust (GRAT) during the annuity period, because if the settlor were to die, the GRAT assets would be included in the settlor's estate. Accordingly, GRATs are typically not intended to be GST exempt. But, if the remainder beneficiary of the GRAT is a skip person or a GST trust, the settlor's GST exemption will be automatically allocated to the appreciated GRAT assets on termination. Depending on the value of the GRAT at termination, this may result in the trust named as the remainder beneficiary receiving assets having a mixed inclusion ratio. To prevent this result, the settlor must have filed an election out statement, electing out of the automatic allocation rules. Accordingly, if the trust at issue has received assets from a GRAT, the advisor must proceed with extra caution.

To determine whether GST exemption has been affirmatively or automatically allocated to a transfer to a trust, it is necessary to know whether any transfers have been made to the trust. Although the client and the client's financial advisor or accountant may be able to provide some guidance, the most accurate information is often found by reviewing all of the client's prior filed gift tax returns.

When examining the client's gift tax returns, there are numerous considerations. Generally, advisors must make sure that the gifts to which GST exemption should have been allocated were properly reported on the gift tax returns. Not all transfers to a trust require the allocation of GST exemption to be GST exempt. For example, a decanting or exercise of a power of appointment to a new trust (the "new trust") carries over the GST tax attributes from the trust from which the assets came (the "old trust"). Accordingly, as long as the vesting period of the new trust is not extended beyond the vesting period of the old trust, the GST exempt status of the old trust will carry over to the new trust. Various private letter rulings have applied this rule not only to grandfathered trusts, as discussed above, but also to trusts exempt from GST tax through allocation of GST exemption.

In addition, sales to a trust for adequate consideration are not transfers requiring allocation of GST exemption to make the assets exempt from GST tax. It is important that the advisor determine whether the sale was made for adequate consideration because, if not, there will be a deemed gift to the trust requiring the allocation of GST exemption to the trust for it to be GST exempt.

After determining that the transfer to the trust is a gift, advisors should check Schedule A, Parts 2 and 3, of the gift tax return for certain elections. Column C of Part 2 for direct skips may be marked to elect out of the automatic allocation rules. Column C of Part 3 for indirect skips may be marked to make three types of elections. Election 1 means that there will be no allocation to the current transfer to the trust (that is, the transfer being described on that return). Election 2 means that there will be no allocations to the current transfer and all future transfers to the trust. Election 3 means that the trust will be treated as a GST trust for automatic allocation purposes.

Other documents filed with the returns to examine are an election statement, notice of allocation, or termination statement. These documents explain which election the transferor made for the trust and give much more detail than a simple check of a box on the return. Because these notices and statements are written out, advisors often use these documents as a backup to elections marked on the return. Advisors also should check for any changes in GST tax elections because the transferor may change his election for a trust.

There are other parts of the gift tax return for the advisor to check to determine the GST tax status of a trust. Schedule D, Computation of Generation-Skipping Transfer Tax, shows the amount of GST tax, allocation of

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GST exemption on the current return, and GST exemption used in prior years. The first page of the return indicates if spouses have elected to split gifts. If they have split gifts for the year, each of them will be deemed to have made one-half of the gifts to beneficiaries other than their spouse and also deemed to be the transferor for one-half of those gifts for GST tax purposes. Gift-splitting is an easy way for a spouse to unknowingly use his own GST exemption.

Lastly, the gift tax returns will reveal if any late allocations of GST exemption have been made. The allocation will be effective on the postmarked date of the filing of the return, meaning the value of the trust to which the exemption applies is the value at the time of the late filing rather than the date of the gift. Solely for purposes of determining the fair market value of the trust's assets, however, the taxpayer may elect to treat the allocation as having been made on the first day of the month during which the late allocation is made (that is, the "first-of-the-month rule").

An exception to the late allocation rule is for a gift tax return filed under Rev. Proc. 2004-46. This procedure details certain requirements that, if satisfied, allow a retroactive allocation of GST exemption, dating back to the time of the original transfer. A retroactive allocation of GST exemption to the trust will be easy for the advisor to spot because the return must clearly indicate at the top of the first page that the filing is pursuant to the procedure.

The advisor's review of the gift tax returns should involve reviewing the returns not only to see how much GST exemption was shown to be used, but also to determine if the allocations and calculations were done correctly. Notably, and also contributing to some errors, the format of the gift tax return has changed over the years, making the GST tax aspects of the return easier to use and interpret, but also demonstrating that older formats of gift tax returns were not user friendly concerning GST tax elections and allocations.

Advisors also should review any available estate tax returns to determine the GST tax status of a trust, as any remaining GST exemption of a decedent will be allocated at death. Schedule R on the estate tax return allows for the affirmative allocation of the decedent's remaining GST exemption.

When reviewing Schedule R, advisors should check to see if the trust is listed on line 9 of Part 1 for reverse QTIP elections. Normally, if a QTIP election is made for a trust, the transferor of the trust assets will be the surviving spouse for GST tax purposes. A reverse QTIP election, however, makes the decedent creating the QTIP trust the transferor for GST purposes and allows for the decedent's GST exemption to be allocated to the QTIP trust. Again, advisors should check the return to see what it shows concerning the allocation of GST exemption to the trust and ensure that the allocation of GST exemption was done correctly.

The Diagnosis— The Trust Inclusion Ratio

If, after reviewing the trust, the advisor determines that the trust is only partially GST exempt, the advisor then must determine the trust's inclusion ratio to understand the tax consequences of future GSTs from the trust.

The inclusion ratio of a trust, defined in IRC § 2642(a), essentially tracks the percentage of the trust that will be subject to GST tax. To be precise, the inclusion ratio is a GST tax rate reducer. The inclusion ratio equals one minus the applicable fraction. The applicable fraction equals the amount of GST exemption allocated to the trust divided by the value of the trust property.

When new transfers are made to the trust, the inclusion ratio must be re-determined after each transfer. The new inclusion ratio equals one minus the new applicable fraction. The new applicable fraction consists of a numerator equal to the amount of the GST exemption allocated to the transfer plus the non-tax portion, and a denominator equal to the value of the trust immediately before the transfer plus the value of the new transferred assets. The non-tax portion of the trust is the value of the trust immediately before the transfer multiplied by the applicable fraction of the trust immediately before the transfer.

For a trust that has had multiple transfers to it, determining the inclusion ratio can get very complex because with each transfer the inclusion ratio must be re-determined. This determination is further complicated by the need to determine the value of each asset owned by the trust, including hard-to-value assets, such as closely-held business interests and insurance policies, on the date of each transfer. As mentioned above, some of this difficulty is mitigated by the first-of-the-month rule.

Conclusion

Wading through all of the technical rules to determine the GST tax status of a trust can be difficult. The road map outlined in this article provides a process for advisors to follow to determine the issues that they should

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research further to diagnose the GST tax status of a trust. Breaking down the diagnosis process in this manner, it is hoped, will mitigate the complexity of the GST tax analysis.

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