

Generation-Skipping Transfer Tax Reporting and Planning

WEDNESDAY, FEBRUARY 1, 2023, 1:00-2:50 pm Eastern

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Generation-Skipping Transfer Tax Reporting and Planning

February 1, 2023

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Generation Skipping Transfer Tax Reporting and Planning- February 1, 2023

Presented by
I. Richard Ploss, Esq.



PROGRAM OVERVIEW

PART I - Overview and Purpose of the Generation Skipping Transfer Tax (“GSTT”) System

Part II- GSTT System Basics

PART III- GSTT Planning

Part IV- GSTT Compliance

Part V-Case Studies in GSTT Compliance and Planning

Part V- Questions and Conclusion

Part I- Overview of The GSTT System

- Purpose Of the GSTT System

- (1) To ensure that every generation in a family pays its fair share of Gift and Estate Tax (“Wealth Transfer”) and prevent the unfettered use of dynasty trusts

- (2) The GSTT is a “piggy-back” tax that is imposed on transfers made to persons (including trusts) that are 2 or more generations below the Donor/Decedent.

- (a) It is therefore imposed *in addition* to the Estate Tax (Chapter 11 Tax) and Gift Tax (Chapter 12 Tax)

PART II- GSTT BASICS

- SUBPART A Formula For Computation of GSTT Liability
- SUBPART B Step By Step Process For Analyzing GSTT Problems
 - Step #1- Identify the Transferor
 - Step #2- Identify the Transferees and Classify Them as “Skip Persons” or “Non-Skip” Persons
 - Step #3- Determine if the Wealth Transfer is Subject To GSTT
 - Step #4- Determine the Type of GSTT Transfer (and the Timing of the Imposition of the GSTT .
 - Step #5- Determine When and Where To Allocate GSTT Exemption

SUBPART A- Computing the GSTT Liability

GSTT liability = Amount of Transfer $\cdot \{ \text{Maximum Federal Estate Tax Rate}^* (1 - \text{Applicable Fraction}) \}$

 Inclusion Ratio

Where Applicable Fraction =

(A) Numerator = Amount of Exemption Allocated To Transfer

(B) Denominator = Value of Property Transfer (reduced by Federal and State Death Tax Paid From Property and any charitable deduction allowed under IRC Sections 2055 and 2522).

See IRC Section 2642(a)(2).

Computing the GSTT Liability (cont.)

- Maximum Federal Estate Tax Rate is 40%
- An inclusion ratio of zero will result in no GSTT liability being imposed (“Zero Inclusion Ratio”)
- An inclusion ratio of one will result in GSTT liability
- One never wants an inclusion ratio between zero and one (resulting from partial allocation of GSTT Exemption)
 - In such instances it is best to divide a trust into two trusts- one having a zero inclusion ratio and one having an inclusion ratio of one.

SUBPART B- ANALYZING GSTT TRANSACTIONS

Step #1: Identify the Transferor

- In the case of an estate tax (Chapter 11 Tax) transfer, the Transferor= the decedent in whose Gross Estate the property will be included
- In the Case of a transfer that is subject to gift tax (Chapter 12 Tax)= donor
- Important Rules to Remember:
 - (1) Gift Splitting Spouses= Transferor is deemed to be each spouse for one-half the amount
 - (2) Marital Trusts- For Marital, Trusts the transferor will be the surviving spouse unless a Reverse QTIP Election is made on the first spouse to die's Federal Estate Tax Return (IRS Form 706)

STEP #2- Identify the Transferees and Classify Them As “Skip Persons” or “Non-Skip Persons.

- Generation Assignments are determined as of the date of the transfer
 - Testamentary Transfers= date of death or the alternate valuation date
 - Gift Transfers = Date of the Gift Transfer
- Assignments Are Fixed Once Made
- 90 Day Conditional Survivorship Rule- if governing instrument so provides

Skip vs. Non-Skip Persons

- Skip Person=
 - If blood relationship (through transferor's grandfather) Transferee is someone who is two or more generations below the Transferor.
 - If not- related by blood- someone who is more than 37 ½ years younger than the Transferor.
 - If someone can be classified in more than one generation, that person will be assigned to the lowest generation.
- Non-Skip Person is anyone who is not classified as a Skip Person.
- Predeceased Ancestor Rule for Blood Relatives

STEP #3- Determine Whether The Transfer is Subject to GSTT.

- “Piggy-Back” Tax Concept
 - Transfer must be subject to Chapter 11 or Chapter 12 Tax in order to trigger the GSTT.
- Almost all non-gift tax transfers are exempt from GSTT
 - Outright Annual Exclusion Gifts
 - Contributions to 529 Plans (including front loading)
 - Direct Payments of Support Obligations
 - Direct payments made under IRC Section 2503(3)- tuition, medical paid directly to the provider

Exception: Transfers To Trusts

- Trust for the Benefit of Skip Person will be subject to GSTT unless the following conditions are met:
 - Trust contributions must qualify for the annual exclusion (i.e. Crummey Power)
 - Trust must be for sole benefit of one Skip Person (no distributions of income and principal to any third person)
 - Trust principal must be includible Skip Person's Gross Estate if Skip Person dies before trust terminates

Transfers To Trusts (cont.)

- Contributions to Multiple Party Crummey Withdrawal Trusts (e.g. Irrevocable Life Insurance Trusts or “ILIT”) that qualify for the annual exclusion will not be exempt from the GSTT
- Grandfathered Trusts (created before September 25, 1985)

STEP #4- Determine The Type of Transfer

- Three Types of Wealth Transfers for GSTT Purposes:
 - Direct Skip Transfers
 - Taxable Distributions
 - Taxable Terminations
- Classification Will Impact When The GSTT Tax Is Incurred
- If a transfer can fall into one or more of the categories above,
Taxable Termination>> Taxable Distribution>> Direct Skip

HYPOTHETICAL FACT PATTERN

Grandparent (G) is a wealthy widow/widower, who has one living child (C) and two living grandchildren, who are C's biological children (GC-1 and GC-2).

Direct Skip

- Definition: Transfer Made Directly To A Skip Person
- Outright Direct Skip: Assume all parties named above are alive. If G were to gift \$1 million to both GC-1 and GC-2,
 - The transfer would be classified as a gift subject to the Federal Gift Tax liability and would be classified as a direct skip resulting in the immediate recognition of GSTT liability based on the amount of the transfer (absent the allocation of GSTT Exemption to the transfer)
- Direct Skip In Trust: Assume that all of the parties named in the hypothetical example are alive. If G gifts \$1 million to a trust for the sole benefit of GC-1 and GC-2 and their future descendants,
 - the trust would be classified as a Skip Person and the transfer would be classified as a Direct Skip subjecting the transfer to immediate recognition of GSTT liability (absent allocation of GSTT Exemption to the transfer).

Taxable Distributions

- Definition: Any distribution from a Trust that is not classified as a Taxable Termination.,
- G transfers \$1 million to an irrevocable "sprinkle trust " (i.e., Trustee has discretion to make distributions of income and principal among beneficiaries) for the benefit of C, GC-1 and GC-2. The Trustee makes a distribution of \$50,000 worth of principal to both GC-1 and GC-2.
 - (Because C is a non-Skip Person who has a current beneficial interest in the trust, the trust would not be classified as a Skip Person on the date that A makes the transfer.
 - However, the distributions to GC-1 and GC-2 would be classified as a Taxable Distribution and if there no GSTT Exemption allocated to the transfers in trust, the Trustee would need withhold \$20,000 ($\$100,000 \times .4$) and pay the same to the IRS. GC-1 and GC-2 would each receive \$40,000.

Taxable Terminations

- Definition: termination (whether by death, lapse of time, release of a power or otherwise) of an interest in trust property that results in all beneficial interests in the trust property being held by Skip Persons.
- Example: G transfers \$1 million to an irrevocable "sprinkle trust " (i.e., Trustee has discretion to make distributions of income and principal among beneficiaries) for the benefit of C, GC-1 and GC-2. Upon the death of C, the property will be distributed to GC-1 and GC-2 in equal shares.
 - C dies when the trust property is worth \$2 million and now only Skip Persons have beneficial interests in the trust property. C's death is a "Taxable Termination" and the full \$2 million is potentially subject to GSTT.

STEP #5- Determine the Amount and Timing of The GSTT Exemption Allocation

- Assuming that the transaction has the potential to trigger GSTT liability the key question is when to allocate the exemption
 - Timely allocation= allocation made on a timely filed (include extensions) IRS Form 709
 - Late Allocation= allocation not made on a timely filed IRS Form 709
- Complicating Factor
 - Automatic Allocation Rules- Per IRC Section 2632 and Treasury Regulations
 - Automatic Allocation to Direct Skips (unless elected out)
 - Automatic Allocation to a “GST Trust” as defined under IRC Section 2632 and the regulations
 - Affirmative Opt-Out Election is Available on IRS Form 709

STEP #5- Determine the Amount and Timing of The GSTT Exemption Allocation

Example: Assume all parties named above are alive. If G were to gift \$1 million to both GC-1 and GC-2, the transfer would be classified as a gift subject to the Federal Gift Tax liability and also a direct skip resulting in the immediate recognition of GSTT liability (absent the allocation of GSTT Exemption to the transfer). If taxpayer were to allocate GSTT Exemption to this transfer, the result would produce a zero liability:

$$\$2 \text{ million} * \{.4 * (2,000,000 / 2,000,000)\} = 0$$

A is allocating \$2 million to the transfer (numerator) divided by the amount of the transfer.

PART III- GSTT PLANNING

- Marital Trust Planning
 - Since Marital Trust will be includible in the taxable estate of the surviving spouse, he/she will be the Transferor for Chapter 11 purposes and also for GSTT purposes.
 - While a decedent spouse's unused Estate/Gift Tax Exemption may be ported to the surviving spouse, the GSTT Exemption cannot.
 - If you wish to take advantage of both spouse's GSTT Exemption, you will need to consider creation a QTIP (Qualified Terminable Interest Property) Trust- which will enable the Executor of the first to die spouse's estate to make a "Reverse QTIP" election thereby treating deceased spouse as transferor for GSTT purposes

PART III- GSTT PLANNING (cont.)

■ Dynasty Trust Planning

- Essentially, a Dynasty Trust is a trust that will remain in existence for multiple family generations until such trust must terminate under a jurisdiction's Rule Against Perpetuities ("RAP") period. Clients who create these trusts will allocate GSTT Exemption to the trust at the date of transfer so that the trust will remain exempt from application of the GSTT.
- Some states have rather lengthy RAP periods (Florida's is 360 years while Colorado has a 1,000 year RAP). Other states (such as DE, NV, NH NJ, PA and ME) do not have a RAP, while others have the English Common Law period of a life in being plus 21 years (e.g., MA and NY).
- Choosing a jurisdiction with a long enough period is extremely important for planning purposes; or including a decanting provision is also not a bad idea.

■ Springing General Powers of Appointment (Document Requirement)

PART IV- GSTT COMPLIANCE

- In this section of the webinar, we will apply our knowledge of the GSTT System to case scenarios and the presentation first on the IRS Form 709 and then on the IRS 706
- These examples are designed for teaching purposes only
- Examination of Schedules A and C of IRS Form 709
- Examination of Schedule R, R-1 and R-2 of IRS Form 706

Example #1- Reporting Outright Direct Skips (IRS Form 709)

Grandparent, age 86, is a widow/widower who has the following living descendants: one child, C, 56 and three grandchildren- GC-1 (age 31), GC-2 (age 29) and GC-3 (age 26). Grandparent has not made any prior taxable gifts. In 2022, Grandparent makes gifts of \$22,000 in cash to each of his/her grandchildren.

Example #2- Reporting Direct Skips In Trust (IRS Form 709)

Grandparent, age 60, is a widow/widower who has the following living descendants: one child, C, 30, three grandchildren- GC-1 (age 10), GC-2 (age 7) and GC-3 (age 5). Grandparent has never made any prior taxable gifts. Grandparent makes gifts of \$16,000 to each of three separate irrevocable trusts for the benefit of each of the grandchildren as beneficiary. Relevant trust instrument provisions are as follows:

Lifetime Provisions: During the beneficiary's lifetime, the Trustee has discretionary authority to make distributions of net income and principal to each beneficiary from the principal of the trust for his/her benefit.

Death of Beneficiary: Upon death of the beneficiary, the remaining principal is to be distributed to Grandparent's then living descendants in such proportions as the beneficiary may designate under his/her LW&T; or, if the power is not exercised, to the beneficiary's then living descendants.

Example #3- Reporting Direct Skips In Trust (IRS Form 709)

Grandparent, age 60 is a widow/widower who has never made any prior taxable gifts. Grandparent has one living child- C and three living grandchildren, GC-1, GC-2 and GC-3. In 2022, Grandparent makes \$16,000 gifts to three separate irrevocable trusts for the sole benefit of each grandchild (one trust for each grandchild). Relevant trust provisions are as follows:

Lifetime Provisions: During the lifetime of each grandchild

- Each time Grandfather or third party makes a gift to the trust, each grandchild is given a "Crummey Withdrawal Right" equal to the annual exclusion amount.
- Trustee has discretion to make distributions of income and principal to grandchild (but no one else)
- Upon death of grandchild, grandchild is granted a general power of appointment over the trust principal exercisable by Grandchild's LW&T In default of effectual exercise of the power, the remaining principal passes to Grantor's then living descendants.

Example #4- Reporting Direct Skips In Trust (IRS Form 709)

Grandparent, age 60 is a widow/widower who has never made any prior taxable gifts. Grandparent has one living child- C and three living grandchildren, GC-1, GC-2 and GC-3. In 2022, Grandparent makes \$16,000 gifts to three separate irrevocable trusts for the sole benefit of each grandchild (one trust for each grandchild). Relevant trust provisions are as follows:

Lifetime Provisions: During the lifetime of each grandchild

- Each time Grandfather or third party makes a gift to the trust, each grandchild is given a "Crummey Withdrawal Right" equal to the annual exclusion amount.
- Trustee has discretion to make distributions of income and principal to grandchild (but no one else)
- Upon death of grandchild, grandchild is granted a general power of appointment over the trust principal exercisable by Grandchild's LW&T In default of effectual exercise of the power, the remaining principal passes to Grantor's then living descendants.

Example #5- Reporting Direct Skips In Trust (IRS Form 709)

The Gift of Hard To Value Property. In 2022, Grandparent, a widower, who has never made any prior year taxable gifts, makes a gift of common stock in a closely held business corporation in to an irrevocable trust for the benefit of C, GC-1 and GC-2 . The gifted stock is a minority interest in the business and has been independently appraised as having a fair market value on the date of the gift of \$3 million which includes a 40% discount for lack of marketability, minority interest and lack of liquidity (non-discounted value was \$5 million and Grandparent's basis in the gifted stock is \$2 million). Relevant trust provisions are as follows

- (i) C, GC-1, GC-2 and GC-3 are given annual exclusion withdrawal rights.
- (ii) Independent Trustee has the discretion to distribute income and principal to or for the benefit of C, GC-1, GC-2 and GC-3.
- (iii) Upon C's death the trust principal is distributed equally to GC-1, GC-2 and GC-3 per stirpes

Example #6- The Intervivos QTIP Trust (IRS Form 709)

H and W are married and have living descendants. They interested in having their wealth remain in lifetime trusts for their children and more remote descendants. Their combined net worth is \$22 million of which W is the sole owner of \$19 million. W wants to ensure that while each is alive, H and W will continue to have access to any transferred assets and does not want to transfer assets into H's name. Acting on your advice W creates an intervivos QTIP (in FL) into which W transfers \$9 million worth of assets. Relevant document provisions are as follows

- No Crummey withdrawal rights are granted
- Assume that all QTIP requirements as prescribed under IRC Section 2056(b)(7) are satisfied.
- Following the death of H, if W is then living, the trust is to be administered for W's sole benefit during lifetime and then to their then living descendants.

Example #7- The ETIP Trust (IRS Form 709)

In December 2022, A transfers A's vacation residence into a Qualified Personal Residence Trust ("QPRT"). At the time of the transfer the fair market value of the property is \$2 million and A's basis in the property is \$1 million). Relevant trust agreement provisions are as follows:

- A retains the right to exclusively use the residence for a period of 10 years ("retained interest term"). In the event that A dies before the 10 year period, the residence reverts back to A's estate.
- If A survives the retained interest term, at A's election, A has the right to require the Trustee to retain the property in further trust for the benefit of A's descendants, and A retains the right to rent the property back from the Trustees at fair market value rent as determined at the end of the retained interest term ("Back Door Trust").
- Upon the first to occur of A's death or A's notifying the Trustee of A's decision to no longer rent the property, the Back Door Trust will terminate, and the property will be distributed to A's then living descendants, per stirpes.

The valuation of the A's retained interest is \$971,360 and the gift of the remainder interest is \$1,028,640. What would be the presentation on A's 2022 IRS Form 709

Example #8- The ETIP Allocation (IRS Form 709)

On December 1, 2018, A created a 4-year Grantor Retained Annuity Trust ("GRAT") which A funded with \$1 million worth of securities. A retained a 6% annuity payout. Relevant information is as follows:

Upon the expiration of the retained interest term, the remaining property is to be distributed in equal shares to A's children, B, C, and D, per stirpes.

At the time of the gift, the value of A's retained interest was \$219,864 and the amount of the taxable gift was \$780,136. The gift was properly recorded on A's 2018 IRS Form 709.

B dies in 2020 survived by living descendants

C dies in 2021 not survived by any living descendants

On November 30, 2022 A's retained interest term ended. The principal in the trust was worth \$1,200,000.

Example #9- The Late Allocation (IRS Form 709)

- H and W are married and have three children and four grandchildren. On January 31, 2022, H establishes a Spousal Lifetime Access Trust ("SLAT") for the benefit of W during W's lifetime and following W's death, the remaining principal is to be divided into separate stirpital shares for H and W's descendants. Each share is to be held in a lifetime trust for the benefit of a living descendant. H funds the trust with existing publicly traded securities having a fair market value of \$10 million as of the date of the gift (basis of \$4 million). By December 2022, the value of the portfolio has declined to \$8 million. Assume that no Crummey Powers have been conferred by the governing instrument.