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Mastering GST Elections and Reporting: Minimizing Generation-Skipping Transfer Tax Through Indirect Skips

TUESDAY, FEBRUARY 7, 2017, 1:00-2:50 pm Eastern

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Mastering GST Elections and Reporting

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Tricks and Traps of Planning and Reporting Generation-Skipping Transfers

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5 Ways GST Exemption May Be Allocated under Section 2632

- Affirmative Allocation – Timely or Late
- Deemed Allocation to Direct Skips
- Deemed Allocation to Indirect Skips
- Retroactive Allocation
- Automatic Allocation at Death

Timing of Affirmative Allocations

> Section 2632 provides that an affirmative allocation may be made at any time before the date prescribed for filing the estate tax return, including extensions

> Depending on whether the allocation is timely or late, the value of the property will be determined on the date of transfer or on the date of allocation

> May be superseded by prior deemed allocations, including in the same year

Notice of Allocation - Now on Schedule D

- An affirmative allocation to a lifetime transfer is made by filing a Notice of Allocation
- The Notice of Allocation must be created by the return preparer, and must fulfill specific requirements set forth in the regulations and instructions to the return

Notice of Allocation

- Clearly identify the trust and trust's EIN if known
- If it is a late allocation, state the year the transfer was reported
- State value of the assets at the effective date of allocation
- State the amount of GST exemption allocated – OR USE A FORMULA
- State the inclusion ratio of the trust

When Does an Affirmative Allocation Take Effect

- An allocation of GST exemption on a timely gift tax return takes effect on the date of transfer
  - A timely allocation may be amended by a subsequent return so long as the subsequent return is also timely
- An allocation of GST exemption on a late return takes effect on the date of filing, which is the date the Form 709 is postmarked to the IRS address directed in forms or other guidance

When Does an Affirmative Allocation Take Effect

- Any allocation of GST exemption is deemed to precede taxable events occurring on that date
- Thus, a late allocation of GST exemption can be made to shelter a taxable distribution or taxable termination if it is accomplished on the date the event occurs

First-of-the-Month-Rule for Late Allocations

- The taxpayer may elect to value assets as of the first day of the month when making a late allocation
- Not for a life insurance trust if the insured has died
- Allocation takes effect on the date of filing, not the first of the month

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Effect of Affirmative Allocation

- Affirmative allocations of GST exemption are IRREVOCABLE

Deemed Allocation to Direct Skips

> Unless the taxpayer elects out, unused GST exemption will be automatically allocated to direct skip transfers (including direct skip transfers in trust)

> There is an ordering rule

> Deemed allocation to direct skips takes effect in chronological order and precedes deemed allocation to indirect skips and affirmative allocations of GST exemption

Example

> Suppose transferor has $5 million of GST exemption. Gives $214,000 to grandchild A, $4,800,000 to a GST trust and $214,000 to grandchild B. Is the GST trust exempt?

> NO!

Deemed Allocation to Direct Skips

> If you do not want automatic allocation to take effect, you must check the box on Schedule A, Part 2, Column C

> Is that enough? No.

> You must attach a statement describing the transaction and the extent to which automatic allocation is not to apply

> Or you can pay the tax – Not clear what happens if you make a partial payment

No Deemed Allocation to Nontaxable Gifts

> Nontaxable gifts include gifts qualifying for the annual exclusion and gifts for medical or educational expenses under section 2503(e)

> Transfers in trust will not qualify unless the trust is a section 2642(c) trust

> *Crummey* powers are not enough

Certain Arrangements Treated as Trusts

> Reg. §26.2652-1(b)(1) treats certain arrangements that are not trusts as trusts

- Life estate, insurance and annuity contracts and custodianships
- Transfer conditional on occurrence of an event is a transfer to a trust
- Could be subject to an ETIP if the custodian is the donor

Deemed Allocation to GST Trusts

- Code defines a new type of transfer called an “indirect skip”
- An indirect skip is a transfer to a GST trust (other than a direct skip trust)
- A GST trust is any trust that could have a generation-skipping transfer subject to six exceptions

Exceptions

> More than 25% must be distributed to non-skip persons before age 46

> More than 25% distributed to non-skip persons living on death of a person more than 10 years older

> Non-skip person dies before date or event in two prior exceptions, more than 25% subject to a GPOA in hands of non-skip person or upon death before date or event goes to estate of non-skip person

GST trusts

- Included in gross estate of non-skip person immediately after the transfer
- CLAT, CRAT or CRUT
- CLUT if principal goes to non-skip person if alive at end of annuity period

Deemed Allocation to GST Trusts

- The exceptions to the definition of a GST trust are imperfect
- Many trusts may be defined as a GST trust, yet the taxpayer would NOT want to allocate GST exemption
- Other trusts may NOT be defined as a GST trust, yet the taxpayer would want GST exemption allocated

Electing In and Out of Deemed Allocation to Indirect Skips

> The Regulations have added a great deal of flexibility

> Taxpayer can effectively elect in and out of deemed allocation, including electing to treat a trust that is not a GST trust as if it were, in order to make effective allocations

> Deemed allocations are formula allocations

> All elections in and out are revocable prospectively

Electing Out of Deemed Allocation to Indirect Skips

- Can elect out for one or more (or all) transfers made in a prior year that are subject to an ETIP
- Can elect out for one or more (or all) transfers made in the current year to a specified trust or trusts
- Can elect out for one or more (or all) future transfers to a specified trust
- Can elect out for all future transfer to all trusts (whether or not currently in existence)
- Can make an election out with respect to any combination of the above

Special Rules for Trusts Subject to an ETIP

> Can elect out of automatic allocation of GST exemption to a trust subject to an ETIP at any time up to and including the date a timely return for the year the ETIP closes can be filed

> A blanket election out of automatic allocation to future transfers will not avoid automatic allocation to transfers subject to an ETIP made in prior years

> Any affirmative allocation of GST exemption to a trust subject to an ETIP is irrevocable

Potential Problem for Short Term GRATs

- A short term, zeroed out or near zeroed out GRAT is likely to be included in the grantor's gross estate and therefore potentially subject to an ETIP
- But there is a special rule that if there is less than a 5% actuarial probability of inclusion, then the trust is not considered subject to an ETIP
- Exception to ETIP rule results in automatic allocation to the GRAT – and potentially to the entire trust, not just the remainder value

Other Exceptions

- No ETIP if spouse has a 5 and 5 Crummey power that lapses within 60 days
- No ETIP for a trust that makes a reverse QTIP election

Terminating an Election Out

- An election out of deemed allocation may be terminated in a manner similar to making the election out, and will affect only transfers described in the termination statement
- The termination statement will apply only to current year and future year transfers that were subject to the prior election out statement

Effect of Gift Splitting

- An election by spouses to split gifts under section 2513 causes the deemed allocation rules to apply with respect to the spouse’s GST exemption
- An election to split gifts may made on the first filed gift tax return for the year, even if the return is late
- This can result in irrevocable deemed allocations of the consenting spouse’s GST exemption that are in effect retroactive

Cautions about Gift Splitting

- In order for the consenting spouse to elect in or out of deemed allocation the consenting spouse must file his or her own gift tax return

Election In to Deemed Allocation

- A taxpayer may also elect in to the deemed allocation rules with the same flexibility

Automatic Allocation at Death

- Generally leads to WRONG result
- Allocation is made first to direct skips occurring at death
- Second, pro rata to trusts from which a taxable termination or taxable distribution might occur, whether created at or prior to death
- All prior elections out of deemed allocation are ignored
- Fact that a lifetime trust is not defined as a GST trust is also ignored

Trust Modifications

> Treasury Regulations provide guidance with respect to the types of modifications that will not affect the exempt status of a trust.

> Regulations apply only to GST "effective-date" Trusts (*i.e.*, trusts that were irrevocable on September 25, 1985) and not to trusts that are GST exempt by reason of an allocation of GST exemption.

> IRS has repeatedly ruled that treatment of a GST exempt trust is at least as favorable as an effective-date trust.

Distributions from One Trust to Another – By Decanting or Exercise of a Power

> Reg. 26.2601-1(b)(4)(i)(A) - A distribution of trust principal from an exempt trust to a new trust or retention of trust principal in a continuing trust will not cause the new or continuing trust to be subject to GST if:

- Either:
  - The governing instrument of the exempt trust authorizes distributions to the new trust without the consent or approval of any beneficiary or court; or
  - At the time the exempt trust became irrevocable, state law authorized distributions to the new trust; and
- The governing instrument of the new or continuing trust does not postpone vesting beyond lives in being plus 21 years.

Trust Modifications – Powers of Appointment

> The exercise, release or lapse of a power of appointment (other than a general power of appointment) will not have adverse GST consequences if the power was contained in the original trust and the power is not exercised in a manner that may postpone or suspend the vesting for a period beyond the GST rule against perpetuities.

> Private Letter Rulings 201218001, 201218002, 201143002, 201136017, 200252061, and 200252067 have held that a limited power of appointment may be exercised to appoint trust property in further trust with an expanded class of measuring lives who could be unrelated to the trust beneficiaries.

> Note: You cannot confer a power of appointment, unless the power to do so existed in the original trust.

Trust Modifications – If You Cannot Comply With the Foregoing

- Certain modifications are permissible, even if not authorized by the governing instrument – e.g. a court ordered modification
  - Reg. 26.2601-1(b)(4)(i)(D) *Other Changes*
    - Permits a modification so long as it does not extend the time for vesting beyond the period provided in the original instrument,

      AND
    - If does not shift a beneficial interest in the trust to a lower generation beneficiary

Trust Modification – Settlement of a Dispute

> Reg. 26.2601-1(b)(4)(i)(B) provides that a court-approved settlement of a bone fide issue regarding trust administration or construction will not cause an exempt trust to be subject to GST tax, if:
  - (a) the settlement is the product of arm's length negotiation; and
  - (b) the settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement.

Distinguish GST standard from *Bosch*

- In *Commissioner v. Bosch*, the Supreme Court held that federal authorities, including the IRS, are not bound by a determination made by a state trial court in a proceeding in which the United States is not a party.
- Decisions of the highest court of the State are to be followed.
- If there is no decision by the highest court of the State, IRS must apply what they find to be the state law after giving “proper regard” to the relevant rulings of other courts of the State.

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Thank You

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