GST Allocations: Often Automatic, but Rarely Straightforward

by Brad Dillon and Michael S. Schwartz

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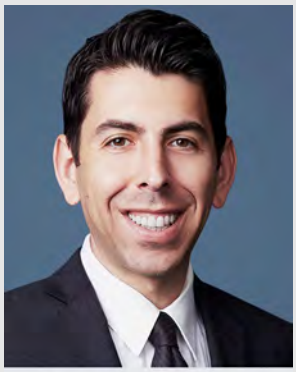

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In this article, Dillon and Schwartz review the pitfalls that tax return preparers commonly face when dealing with the automatic allocation of the generation-skipping transfer tax exemption, and they offer suggestions for how to avoid those problems.

With April 15 fast approaching, tax return preparers are bracing for the usual tax deadline crunch. In light of various changes to federal and state tax laws, including in particular those changes made by the Tax Cuts and Jobs Act, advisers have to be as vigilant as ever to prepare accurate tax returns.

One area that continues to be a particular source of confusion for practitioners is the automatic allocation of the generation-skipping transfer (GST) tax exemption on Form 709, "United States Gift (and Generation-Skipping Transfer) Tax Return." This is an important and nuanced area of the law, in which what may seem like a relatively innocuous (and easy to make) mistake on a tax return can significantly and adversely affect the client. Automatic allocation of the GST tax exemption has been a topic addressed in several recent IRS rulings seeking to correct return preparer mistakes, and it is imperative that accountants and attorneys who prepare Forms 709 pay close attention to these rules, particularly when transfers to trusts are involved.

This article reviews common missteps that tax return preparers make, together with suggestions for how to avoid them, as well as some recent IRS rulings involving the automatic allocation of the GST tax exemption.

The Basics

Before reviewing the recent IRS rulings and the associated common pitfalls that those rulings illustrate, it is important to understand the basic elements of the tax itself. The GST tax is a federal tax on specified transfers to persons who are two or more generations below the transferor, also known as "skip persons."[1] It can also apply in the context of distributions or terminations of trusts, which are not treated as skip persons, but have assets that pass to skip persons.

One purpose of the GST tax is to approximate what the transfer taxes would have been had the property been transferred to the generation directly below the transferor, and then transferred to the second generation below the transferor, to tax transfers between generations in a more uniform manner.[2] Similar to the federal lifetime gift and estate tax exemption, there is a separate federal lifetime GST tax exemption that can be

[1] *See* section 2601. In general, this means grandchildren or more remote descendants of the transferor. However, it could also include other individuals of a similar age range. The rules regarding generational assignments are found in section 2651.

[2] Joint Committee on Taxation, "General Explanation of the Tax Reform Act of 1986," JCS-10-87 (May 4, 1987).

used during the life or on the death of a donor. The GST tax exemption is $11.58 million in 2020 and is scheduled to increase for inflation annually.[3]

The GST taxation of a gratuitous transfer depends on whether it is a direct skip or an indirect skip. A direct skip is a direct transfer to a skip person of an interest in property that is subject to estate or gift tax; for example, if a donor makes an outright gift to a grandchild, the gift is a direct skip. For these purposes, a trust can also be a skip person. The most common reason a trust is treated as a skip person is when all interests in the trust are held by skip persons.[4] For example, if a grantor established a trust for the benefit of a grandchild for life, and upon the grandchild's death, the remainder of the trust is directed to pass to the grandchild's descendants, the trust would be a skip person.

Alternatively, generally an indirect skip is a transfer to a trust that has both skip persons and non-skip persons as beneficiaries. As the name implies, a non-skip person is any person who is not a skip person.[5] GST tax results from either a distribution from such a trust to a skip person, called a taxable distribution, or from the termination of an interest in the trust, called a taxable termination, unless only non-skip persons receive all interests in the trust property upon termination, or at no time after the termination may a distribution (including distributions on termination) be made from the trust to a skip person. For example, consider a trust that benefits the grantor's child and that child's descendants until the child dies, at which point the trust terminates and any remaining trust property is distributed to the child's descendants, *per stirpes*. If a distribution is made during the child's lifetime to a descendant of the child, that distribution will be a taxable distribution subject to the GST tax, because the distribution is made to a skip person. Upon the death of the child, a taxable termination occurs, because only skip persons receive the trust property.

Automatic Allocation

As a general rule, the GST tax exemption must be proactively allocated. However, the exemption may be automatically allocated to some transfers. In particular, effective after December 31, 2000, section 2632(c) expands the reach of the rules regarding automatic allocation of the GST tax exemption when property is transferred to a trust during the lifetime of a donor. These broader rules were designed to provide a safety net for taxpayers who may have inadvertently failed to allocate the GST tax exemption when they may have otherwise desired to do so. The expanded rules provide that the GST tax exemption is automatically applied to every lifetime indirect skip unless the transferor elects out of the automatic allocation rules.

As mentioned earlier, in general, an indirect skip is a transfer to a trust that has both skip persons and non-skip persons as beneficiaries. More specifically, an indirect skip is a transfer, other than a direct skip, that is subject to the gift tax, and made to a GST trust.[6] A GST trust — a term of art defined by the Internal Revenue Code — is one that either the transferor has elected to treat as a GST trust, or one that could result in a generation-skipping transfer, unless it falls into one of six exceptions.[7] If it is not a GST trust the GST tax exemption will not be automatically allocated to the transfer. The exceptions are as follows:

Exception 1: A trust that provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by non-skip persons before reaching 46, on or before a specified date or dates that will occur before the date the non-skip persons will reach 46, or upon the occurrence of an event that will or may

[3] Section 2010(a); reg. section 20.2010-1(a); Rev. Proc. 2018-57, 2018-49 IRB 827. Without further congressional action, the GST tax exemption will revert to the pre-TCJA exemption amount of $5 million (subject to annual inflation adjustments) in 2026.

[4] *See* section 2613(a)(2). A second, less common condition may also make a trust a skip person under this code section; namely, if no person holds an interest in the trust, and at no time after the transfer may a distribution (including distributions on termination) be made from such trust to a non-skip person. An example of a skip person trust would be an accumulation trust in which the grantor establishes a trust to accumulate income with distribution of the entire trust to a grandchild at age 21 or to a grandchild's estate if the grandchild dies before reaching age 21.

[5] *See* section 2613(b).

[6] Section 2632(c)(3)(A).

[7] Section 2632(c)(5)(A)(ii); reg. section 26.2632-1(b)(3).

reasonably be expected to occur before the non-skip persons reach age 46.

Example 1: A trust is established for a child of the settlor and will distribute trust assets to the child with half at 25 and the balance at 35. The trust falls under this exception, and the GST tax exemption will not be automatically allocated to the transfer.

Example 2: A trust is established for the life of a surviving spouse, with the balance in further trust for the transferor's and spouse's children, and with the continuing trust for the children required to terminate when the youngest child turns 30. This trust will generally not fall under this exception because the children are typically expected to be 46 or over when their parent dies. This fact pattern may still fall into one of the other exceptions, discussed later.

Exception 2: A trust that provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by non-skip persons living on the date of death of another person identified in the trust (by name or by class) who is more than 10 years older than the non-skip person.

Example 3: A trust is established for the life of a surviving spouse, with the balance passing outright to the transferor's and spouse's children at the spouse's death. Because the trust falls under this exception, the GST tax exemption will not be automatically allocated to the transfer.

Example 4: A trust is established for the life of a surviving spouse, with the balance in further trust for the transferor's and spouse's children, and with the continuing trust for the children required to terminate when the youngest child turns 30. This trust will generally not fall under this exception if the youngest child was under 30 when the transfer was made.

Common pitfall: The trust in Example 4 would fall under this exception (and thus the GST tax exemption would not be automatically allocated to the transfer to the trust), if the youngest child was 30 or over when the transfer was made. This is the case even if there were prior transfers to the trust when the youngest child was under 30, and the GST tax exemption was automatically allocated at that time to those prior transfers. This could result in the unwanted scenario in which a trust is partially GST tax exempt. While there may be ways of dealing with this partial exemption (for example, splitting the trust), such a scenario is typically best avoided if possible.

There is, however, a practical solution: Decide whether the trust should be GST tax exempt, and specifically allocate or elect out of the automatic allocation rules, as applicable, and do so in a consistent manner in each year in which transfers are made. In short, do not rely on the often-confused exceptions for GST trusts. Proactively allocate or elect out in each year in which a transfer is made.

Exception 3: A trust that provides that if one or more non-skip persons dies on or before a date or event described in the first two scenarios mentioned earlier, more than 25 percent of the trust corpus either must be distributed to the estate or estates of the non-skip persons or is subject to a general power of appointment exercisable by one or more of those non-skip persons.

Example 5: A trust is established for the life of a surviving spouse, with the balance in further trust for the transferor's and spouse's children, and with the continuing trust for the children required to terminate when the youngest child turns 30. The youngest child is younger than 30 at the time of the transfer, but has a general testamentary power of appointment over the trust if he or she dies before the surviving spouse. The trust falls under this exception, and the GST tax exemption will not be automatically allocated to the transfer.

Exception 4: A trust, any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if that person died immediately after the transfer.

Importantly, there is an exception to these exceptions for a general power of appointment or withdrawal power that does not exceed the gift tax annual exclusion amount under section 2503(b) for any transfer. This is targeted to *Crummey* trusts, in which an amount is contributed to a trust each year (sometimes for paying premiums on a life insurance policy held by the trust), and a beneficiary or group of beneficiaries is given the right to withdraw that amount from the trust. Assuming the beneficiary does not exercise that right after a period of time

(and there is typically an unspoken and nonbinding understanding that the beneficiary will not), the withdrawal power lapses. This strategy, which was tested and proved successful in the prominent case of *Crummey*,[8] is a way of using a donor's gift tax annual exclusion amount for the trust beneficiaries despite the general rule that transfers to trusts do not qualify for the gift tax annual exclusion.

Example 6: A trust is established for the life of a surviving spouse, with the balance in further trust for the transferor's and spouse's children, and with the continuing trust for the children required to terminate when the youngest child turns 30. The youngest child is younger than 30 at the time of the transfer but has a power to withdraw $5,000 from the trust each year. This trust will generally not fall under this exception (and will instead fall under the "exception to the exception") because $5,000 does not exceed the current gift tax annual exclusion amount ($15,000 in 2020). Thus, this trust is a GST trust, subject to automatic allocation of the GST exemption.

Common pitfall: *Crummey* powers are typically not indicative of whether the client wishes to allocate the GST tax exemption to a trust. Review trusts with *Crummey* powers carefully when deciding whether the GST tax exemption should be allocated. Do not rely on the automatic allocation rules for *Crummey* trusts, because this approach often leads to unintended results.

To add even more complexity, the exception to the exception regarding *Crummey* powers may not actually apply to many trusts that involve this strategy. This is because many trusts that allow for the withdrawal of contributions by a trust beneficiary provide that the withdrawal right lapses in a given year only to the extent that the beneficiary is not treated as having made a taxable gift to the trust by reason of the lapse of the withdrawal right. Specifically, these provisions take into account section 2041(b)(2), and provide that to the extent the amount subject to the withdrawal right exceeds the greater of $5,000 or 5 percent of the aggregate value, at the time of the lapse, of the assets out of which the exercise of the lapsed power could have been satisfied (that is, in general, the value of the trust), the right to withdraw that excess amount does not in fact lapse during the year, but instead carries over to the following year. Otherwise, if the lapse exceeds that amount, the beneficiary is treated as having made a gift to the trust.

These provisions are often known as "hanging *Crummey*" powers. To the extent that the amount from a prior year, combined with a new withdrawal amount in a current year, exceeds the gift tax annual exclusion amount, the third exception to the automatic allocation rules would apply and the trust would not be a GST trust in the current year by reason of this exception (even though it may have been in prior years).

Example 7: A trust is established for the life of a surviving spouse, with the balance in further trust for the transferor's and spouse's children, and with the continuing trust for the children required to terminate when the youngest child turns 30. The youngest child is younger than 30 at the time of the transfer, but has a power to withdraw any amount contributed to the trust each year. The trust further provides that to the extent the withdrawal power exceeds $5,000 or 5 percent of the trust assets, the beneficiary will continue to have the power to withdraw that amount in the subsequent year. The trust has no significant assets. In year 1, the transferor contributes $15,000 to the trust (the 2020 gift tax annual exclusion amount). This transfer to the trust in year 1 falls under the exception to the exception, because the withdrawal right does not exceed the gift tax annual exclusion amount. In year 2, the transferor contributes another $15,000 to the trust (assume the same gift tax annual exclusion amount). Transfer to the trust during year 2 will fall under this exception (that is, the exception to the exception does not apply), because the amount the beneficiary can withdraw (that is, the amount carried forward from year 1 that the beneficiary can still withdraw, plus the amount contributed in year 2) exceeds the gift tax annual exclusion amount. Therefore, this trust will not be a GST trust, and will not be subject to the automatic allocation of the GST exemption.

Common pitfall: Hanging *Crummey* powers can cause a complicated mess when it comes to the GST tax-exempt status of trusts. Transfers may

[8] *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968).

be GST tax exempt under the automatic allocation rules in one year, and then nonexempt in another, leading to unwanted partially exempt trusts. Thus, it is advisable for all trusts implementing *Crummey* powers to either specifically allocate the GST tax exemption or elect out of the automatic allocation rules for each transfer. In general, tax preparers should not rely on the default categorization (which as seen earlier can shift from year to year).

Exception 5: A charitable lead annuity trust, charitable remainder annuity trust, or charitable remainder unitrust.

Exception 6: A charitable lead unitrust with a non-skip person as the remainder beneficiary if living at the end of the lead period.

Trusts Subject to the ETIP

As if the automatic allocation rules were not complex enough, they get even trickier when the estate tax inclusion period (ETIP) applies. The ETIP is the period after a transfer during which the value of the transferred property would be includable in the transferor's gross estate for estate tax purposes (other than by reason of section 2035). Section 2642(f) contains special rules for allocating the GST tax exemption subject to the ETIP, and specifically, the exemption is not allocated until after the end of the ETIP.

Generally, transfers to grantor-retained interest trusts, such as qualified personal residence trusts (QPRTs), grantor-retained annuity trusts (GRATs), and grantor-retained unitrusts are subject to the ETIP rules. An allocation of the GST tax exemption to property in a QPRT, for example, would not be effective until the end of the QPRT term, which is the end of the ETIP. Importantly, that allocation of the GST tax exemption is based on the value of the assets at the end of the ETIP, which does not factor in reductions to the value of the transferred property at the beginning of the QPRT for gift tax purposes that were based on the retained use of the property by the donor. This is why QPRTs (and any vehicle subject to the ETIP, such as GRATs and other grantor-retained interest trusts) are generally not ideal vehicles for generation-skipping planning.

Depending on who the beneficiaries of the trust are at the expiration of the ETIP, the automatic allocation rules may apply. Thus, for example, for a QPRT, a gift tax return needs to be filed when the property is initially transferred to the trust, and a second gift tax return may also need to be filed at the expiration of the ETIP to elect out of the automatic allocation rules, if they apply, because the year in which the ETIP expires is the year that the GST tax exemption is allocated.

Common pitfall: Transfers to trusts subject to the ETIP are ripe for inadvertent automatic allocations of the GST tax exemption. This may happen when, for example, an accountant or attorney who assisted in the year of the transfer to the trust is not be involved when the ETIP expires. Although the matter is not explicitly addressed in the regulations, many commentators argue that instead of electing out of the automatic allocation of the GST tax on a second gift tax return at the end of the ETIP, the election out can instead be made on the gift tax return reporting the initial transfer. This position is supported by the plain language of the regulations:

> A direct skip or an indirect skip that is subject to an estate tax inclusion period (ETIP) is deemed to have been made only at the close of the ETIP. The transferor may prevent the automatic allocation of GST tax exemption to a direct skip or an indirect skip by electing out of the automatic allocation rules *at any time prior to the due date of the Form 709 for the calendar year in which the close of the ETIP occurs* (whether or not any transfer was made in the calendar year for which the Form 709 was filed, and whether or not a Form 709 otherwise would be required to be filed for that year).[9] [Emphasis added.]

A return reporting the initial transfer is due before the return for the year of the close of the ETIP is due. Thus, it may actually make sense to elect out of the automatic allocation of the GST tax exemption on the initial timely filed return, to prevent inadvertent missed filings at the end of the ETIP, even though this would not actually become effective until the end of the ETIP.

[9] Reg. section 26.2632-1(c)(1)(i).

Electing Out of the Automatic Allocation Rules

As noted above, the automatic allocation rules were designed to provide a safety net for taxpayers who may have inadvertently not allocated the GST tax exemption in situations they may have otherwise wanted to do so. However, as one can imagine, there are many scenarios in which the automatic allocation rules apply even if that does not yield a desired result. For example, there may be a trust that is never intended to pass to grandchildren, and is instead always intended to pass to children or to be used to pay estate taxes on the death of the settlor; yet if the trust is treated as a GST trust under the rules, the GST tax exemption will nonetheless be automatically allocated absent further action, thus effectively wasting this exemption.

Fortunately, there is a way to elect out of the automatic allocation rules. In fact, the code and related regulations provide specific instructions on how to do this. Reg. section 26.2632-1(b)(2)(iii)(B) provides that to elect out of the automatic allocation rules, the transferor must attach a statement to a Form 709 timely filed on or before the due date for the calendar year in which the transfer to be covered by the election out was made or, for a transfer subject to section 2642(f), the ETIP closes. In general, the statement must identify the trust and must specify that the transferor is electing out of the automatic allocation of the GST tax exemption for the described transfer or transfers.

Common pitfall: Unfortunately, the procedural rules to elect out of automatic allocation are not always followed by advisers. For example, tax return preparers sometimes seek to argue that there was an election out of the GST tax automatic allocation rules by implication. The election out cannot be implied; it must be express. For example, not reducing the GST tax exemption by the amount of taxable gifts on Part 2 of Schedule D, "Computation of Generation-Skipping Transfer Tax," of the gift tax return is likely insufficient to elect out of the automatic allocation rules. Similarly, listing the transfer under Part 1 of Schedule A, "Computation of Taxable Gifts," and describing it as a mere gift subject only to gift tax, instead of under Part 3, "Indirect Skips," likely does not in and of itself change the automatic allocation rules as applied to the trust.

Thus, when transfers are made to a trust, it is essential that the tax return preparer (in consultation with counsel as needed) determine if the trust is a GST trust and whether the client intends to allocate the GST tax exemption. If an election out of the automatic allocation rules is desired, a specific statement to that effect, in compliance with the regulations, must be included. The same is true even if the return preparer is unsure whether a trust is a GST trust (notwithstanding the hopefully helpful guidance of this article). When in doubt, either specifically allocate the GST tax exemption or affirmatively elect out of the automatic allocation rules.

Recent Rulings

The IRS rules on GST tax issues regularly; in fact, there have been several private letter rulings issued recently that specifically deal with GST tax issues. A review of these further illustrates that this is an area rife with pitfalls for tax return preparers. While the rulings run the gamut, here is a summary of some concerning the GST tax and key takeaways for return preparers.

In LTR 201850008, a CPA incorrectly allocated more of the GST tax exemption to a credit shelter trust than assets used to fund the trust. The IRS relied on reg. section 26.2632-1(b)(4)(i), which provides that an allocation of the GST tax exemption is void if the trust does not have GST tax potential; nevertheless, the ruling stated that the excess allocation was void to the extent the GST tax exemption was over-allocated. In general, an allocation to a trust is void if no generation-skipping transfers can occur for the trust at the time of allocation.[10] However, if any possibility exists for a GST, even one so remote as to be negligible, an allocation will not be voided.[11]

[10] *See* LTR 201836004 and LTR 201836007, in which the IRS voided an express allocation of the GST tax exemption made by the taxpayer to a trust for the sole benefit of a non-skip person for life, and at death, the trust was includable in the child's estate.

[11] Reg. section 26.2632-1(b)(4)(i).

Because the automatic allocation rules can often be a trap for the unwary, the IRS does sometimes provide relief by allowing for a late election out of these rules, despite the general rule that allocations of the GST tax exemption are irrevocable, even when automatically allocated. The procedures for that relief are outlined in Notice 2001-50, 2001-2 C.B. 189, and reg. section 301.9100-1 through -3. These pronouncements provide the standards the IRS will use to determine whether to grant an extension of time to elect out. These standards often require the taxpayer to provide evidence that the taxpayer acted reasonably and in good faith. Notably, reg. section 301.9100-3(b)(1)(v) provides that a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer relied on a qualified tax professional, including a professional the taxpayer employed, and the professional failed to make or advise the taxpayer of the election.

Reliance on an accountant or other tax professional who does not elect out of the automatic allocation rules is a common theme in private letter rulings since the automatic allocation rules were enacted. For example, in LTR 201826006 and LTR 201921001, the taxpayer's accountant failed to elect out of the automatic allocation rules for a transfer to a GST trust, and the IRS provided relief under section 9100 to allow a late election out. These kinds of requests for relief are not infrequent but should only be used as a last resort because the user fee for a private letter ruling plus professional fees for making the ruling request could cost tens of thousands of dollars. Still, it may be worth the cost if the only other option is to lose a potentially valuable GST tax exemption.

Similarly, in LTR 201705002, the taxpayer created several GRATs, the remainder of which passed to a family trust that had GST tax potential. The ETIP closed when each of the GRATs terminated and passed assets to the family trust. The taxpayer provided evidence that she had not wanted the family trust to be subject to the automatic allocation rules. Unfortunately, the tax professionals for the taxpayer failed to elect out, thus inadvertently allocating the taxpayer's GST tax exemption at the close of the ETIP. The amount of the exemption automatically allocated was determined based on the fair market value of the assets at the close of the ETIP (or termination of each GRAT). Luckily, the taxpayer in this instance was able to provide sufficient evidence that she relied reasonably and in good faith, under the section 9100 regulations, on a qualified tax professional, who failed to elect out of the automatic allocation rules.

Finally, in LTR 201714008, the taxpayer received conflicting advice from tax counsel regarding whether a trust the taxpayer had created was a GST trust under section 2632(c)(3)(B). The taxpayer created a trust for his brother, giving him a lifetime and testamentary limited power to appoint the assets of the trust to his spouse and descendants under an ascertainable standard, and to appoint to any charitable organization. The brother also held an annual power to withdraw the lesser of (1) the total contributions to the trust in any given year up to the gift tax annual exclusion amount (or twice this amount if the donor was married when the contributions were made) and (2) the greater of $5,000 or 5 percent of the value of the trust. Any unexercised right of withdrawal lapsed at the end of each year.

The IRS ruled that the trust was a GST trust under the definition of section 2632, because it could have a generation-skipping transfer to the brother's grandchildren or more remote descendants and none of the statutory exceptions applied. The ruling worked through the various facts and noted how the exceptions under section 2632 did not apply. The takeaway is that any trust that can potentially have a generation-skipping transfer is a GST trust, unless it falls under one of the limited exceptions. Therefore, it is important to determine in advance whether there could be any generation-skipping transfer in the trust, and if so, closely read those six exceptions.

Take Action Now

Tax deadlines arrive without fail each year, but that does not mean GST tax allocations should be made in a similarly automatic fashion. It is incumbent on all tax return preparers to familiarize themselves with the rules concerning the automatic allocation of the GST tax exemption and the recent rulings thereunder, and to pay particularly close attention to the common pitfalls flagged in this article. Given the complexity and

nuanced nature of the automatic allocation rules, a determination whether the GST tax exemption should be allocated should be made for every transfer, and an affirmative allocation or an affirmative election out of the automatic allocation rules should be standard protocol for all tax return preparers and reviewers. ■