

Katten

PRESENTATION TO BMO FINANCIAL GROUP

GST Overview

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Outline of Today's GST Presentation

- I. Introduction to Generation Skipping Transfers
- II. Terminology
- III. Types of Generation Skipping Transfers
- IV. How Trusts Become GST Exempt
- V. Trust Drafting Issues
- VI. Trust Administration Issues
- VII. Final Thoughts / Questions

Introduction to Generation Skipping Transfers

- Why do we have a GST tax? Clever estate planners.
- Original GST tax implemented in 1976. Congress designed it “to remedy the perceived abuse of using a trust to benefit several generations while avoiding Federal Estate Tax during the term of the trust.”
 - GST tax is a back stop to make sure wealth is taxed at each generation.
- 1976 tax was problematic, so Congress repealed and replaced with the 1986 tax that we know and love today.
- Original GST exemption in 1986 was \$1 million per person. Today it is \$11.7 million per person.
 - Temporarily doubled exemption scheduled to sunset on December 31, 2025.

Terminology

- **Transferor** (e.g., grantor or decedent)
 - This is where we start to determine the skip person for GST purposes.
 - What if the beneficiary of a trust has a general power of appointment?
 - ***Meaning the beneficiary can appoint assets to himself/herself, his/her creditors, his/her estate or the creditors of his/her estate (pursuant to IRC 2041)....***
 - Then the trust assets are includable in the estate of this beneficiary for estate tax purposes, and the beneficiary becomes the transferor for GST tax purposes.
- **Non-skip person**: IRC 2613(b) defines a “non-skip person” as any person who is not a skip person.

Terminology

- **Skip person** (IRC 2613(a))
 - Grandchild or more remote descendent, or other family member in the same generation as those persons [i.e., a natural person assigned to a generation which is 2 or more generations below the generation assignment of the transferor]
 - A trust (A) if all interests in such trust are held by skip persons, or (B) if (i) there is no person holding an interest in such trust, and (ii) at no time after such transfer [funding the trust] may a distribution (including distributions on termination) be made from such trust to a non-skip person

Terminology

- **Generation assignment** (IRC 2651)

- An individual who has been married at any time to the transferor shall be assigned to the transferor's generation.
- A nonfamily member (i.e., not a lineal descendant of a grandparent of the transferor):
 - An individual born not more than 12 ½ years after the date of birth of the transferor is assigned to the transferor's generation;
 - An individual born more than 12 ½ years but not more than 37 ½ years after the date of birth of the transferor is assigned to the first generation younger than the transferor; and
 - Similar rules for a new generation every 25 years so that a nonfamily member who is more than 37.5 years younger than the transferor is a skip person.
- An individual who would/could be assigned to more than 1 generation will be assigned to the youngest such generation.
- Charities are assigned to the transferor's generation – and are non-skip persons.
- Under the move-up rule of IRC 2651(e), descendants are moved up to their parent's level if the parent dies **before the date of the relevant transfer** – i.e., a grandchild will not be treated as a skip person if his or her parent dies before the trust is established (or before the grandparent establishing the trust) and not just before the distribution to the grandchild.

Terminology

- **Inclusion ratio** (see IRC 2642(a)(1))
 - The fraction of a distribution from an individual or trust that is subject to GST tax.
 - An inclusion ratio of 0 means the entire distribution is exempt from GST tax;
 - While an inclusion ratio of 1 means the entire distribution is subject to GST tax.
 - Of course, some trusts will have an inclusion ratio somewhere between 0 and 1.
 - For example, was GST exemption applied to the entire trust at funding (on a gift tax return reporting the gift, or pursuant to a ***late allocation of GST exemption on a later gift tax return***)? Was there not enough exemption for the entire trust, even if automatic allocation was used?

Types of Generation-Skipping Transfers

- **Direct Skip**. A transfer of an interest in property subject to gift/estate tax to a skip person.
- **Indirect Skips**.
 - Taxable Termination (IRC 2612(a)).
 - Definition: The termination (by death, lapse of time, release of power or otherwise) of an interest in property held in a trust unless (A) immediately after such termination a non-skip person has an interest in such property, or (B) at no time after such termination may a distribution (including distributions upon termination) be made from such trust to a skip person.
 - If, upon the termination of an interest in property held in trust by reason of the death of a lineal descendant of the transferor, a specified portion of the trust's assets are distributed to 1 or more skip persons (or 1 or more trusts for the exclusive benefit of such persons), such termination shall constitute a taxable termination with respect to such portion of the trust property.
 - Taxable Distribution (IRC 2612(b)). Any distribution from a trust to a skip person (other than a taxable termination or a direct skip).

Liability For Different Types of Generation-Skipping Transfers

- **Direct Skip** (IRC 2603(a)(3)). “In the case of a direct skip (other than a direct skip from a trust), the tax shall be paid by the **transferor**.”
- **Indirect Skips**.
 - Taxable Termination (IRC 2603(a)(2)). “In the case of a taxable termination or a direct skip from a trust, the tax shall be paid by the **trustee**.”
 - Taxable Distribution (IRC 2603(a)(1)). “In the case of a taxable distribution, the tax imposed by Section 2601 shall be paid by the **transferee**.”
- IRC 2603(b). “Unless otherwise directed pursuant to the governing instrument by specific reference to the tax imposed by this chapter, the tax imposed by this chapter on a generation-skipping transfer shall be charged to the property constituting such transfer.”

Examples

- **Direct Skip.**
 - Grandmother writes check to grandchild.
 - Grandfather creates trust for the benefit of grandchildren (all interests in the trust are held by skip persons).
- **Taxable Termination.** Trust created by mother is held for son. Upon son's death, trust terminates and separate sub-trusts created for son's children (mother's grandchildren). Son's death creates a taxable termination (and thus a "generation-skipping transfer"). But, if upon termination of the trust a pot trust is created for son's brother and son's descendants, then there is no taxable termination because "immediately after such termination a non-skip person has an interest in such property."
- **Taxable Distribution.** Trust created by mother is held for son and son's child. Trustee distributes \$10,000 to son and son's child. \$10,000 distribution to son's child is a taxable distribution, \$10,000 distribution to son is not a "generation-skipping transfer."

How a Trust Becomes GST Exempt

- **Grandfathered**. Treas. Reg. 26.2601-1(b).
 - The provisions of chapter 13 do not apply to any generation-skipping transfer under a trust that was irrevocable on **September 25, 1985**. If additions were made to the trust after September 25, 1985, then chapter 13 applies to the portion that was added after September 25, 1985. Additions to the trust could be actual (i.e., a transfer of additional property to the trust) or constructive (e.g., trustee fails to distribute mandatory income interest, 3rd party pays obligation of the trust).
 - Be careful with subsequent modification to grandfathered trusts. Treas. Reg. 26.2601-1(b)(4) sets forth safe harbors for modification (discussed in later slides).

How a Trust Becomes GST Exempt Continued

- **Affirmative Allocation.**

- Affirmative allocation of GST exemption can be made on Form 709.
- Treas. Reg. 26.2632-1(b)(4)(i). “The allocation must clearly identify the trust to which the allocation is being made, the amount of GST exemption allocated to it, and if the allocation is late or if an inclusion ratio greater than zero is claimed, the value of the trust assets at the effective date of the allocation. . . The allocation should also state the inclusion ratio of the trust after the allocation. Except as otherwise provided in this paragraph, an allocation of GST exemption may be made by a **formula**; e.g., the allocation may be expressed in terms of the amount necessary to produce an inclusion ratio of zero.”
- Treas. Reg. 26.2632-1(b)(2)(ii). An affirmative allocation of GST exemption will prevent the automatic allocation of GST exemption with regard to an indirect skip by making an affirmative allocation of GST exemption on a Form 709 of an amount that is less than (**but not equal to**) the value of the property transferred as reported on that return.
- Affirmative allocation of GST exemption requires a “Notice of Allocation” (see IRS Form 709 instructions for specific details that must be included).

How a Trust Becomes GST Exempt Continued

- **Automatic Allocation.**

- Direct Skip. IRC 2632(b)(1). “If any individual makes a direct skip during his lifetime, any unused portion of such individual’s GST exemption shall be allocated to the property transferred to the extent necessary to make the inclusion ratio for such property zero.” (can elect out under IRC 2632(b)(3)). Schedule A, Part 2, Column C of IRS Form 709 provides “2632(b) election out”).

How a Trust Becomes GST Exempt Continued

- **Automatic Allocation.**

- Indirect Skip. IRC 2632(c)(1). “If any individual makes an indirect skip during such individual’s lifetime, any unused portion of such individual’s GST exemption shall be allocated to the property transferred to the extent necessary to make the inclusion ratio for such property zero.” (can elect out under IRC 2632(c)(5)(A)(i)).
 - Schedule A, Part 3, Column C of IRS Form 709 provides “2632(c) election”.
 - Election 1. Elect not to have automatic allocation rules apply to current transfer made to a trust.
 - Election 2. Elect not to have the automatic allocation rules apply to both the current transfer and any and all future transfers made to a particular trust
 - Election 3. Elect to treat any trust as a GST Trust for purposes of automatic allocation.
 - Must attach a statement to the Form 709 that describes the election you are making and clearly identifies the trusts and/or transfers to which the election applies.
 - For purposes of IRC 2632(c), “indirect skip” means a transfer subject to gift tax (other than a direct skip) made to a “GST Trust”
 - GST Trust generally means a trust that could have a generation-skipping transfer with respect to the transferor, but subject to six exceptions.
 - Applies to transfers after December 31, 2000.

“GST Trust” Exceptions (IRC 2632(c)(3)(B))

- (i) the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons—(I) before the date that the individual attains age 46, (II) on or before one or more dates specified in the trust instrument that will occur before the date that such individual attains age 46, or (III) upon the occurrence of an event that, in accordance with regulations prescribed by the Secretary, may reasonably be expected to occur before the date that such individual attains age 46,
- (ii) the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons and who are living on the date of death of another person identified in the instrument (by name or by class) who is more than 10 years older than such individuals,
- (iii) the trust instrument provides that, if one or more individuals who are non-skip persons die on or before a date or event described in clause (i) or (ii), more than 25 percent of the trust corpus either must be distributed to the estate or estates of one or more of such individuals or is subject to a general power of appointment exercisable by one or more of such individuals,
- (iv) the trust is a trust any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer,
- (v) the trust is a charitable lead annuity trust (within the meaning of section 2642(e)(3)(A)) or a charitable remainder annuity trust or a charitable remainder unitrust (within the meaning of section 664(d)), or
- (vi) the trust is a trust with respect to which a deduction was allowed under section 2522 for the amount of an interest in the form of the right to receive annual payments of a fixed percentage of the net fair market value of the trust property (determined yearly) and which is required to pay principal to a non-skip person if such person is alive when the yearly payments for which the deduction was allowed terminate.

For purposes of this subparagraph, the value of transferred property shall not be considered to be includible in the gross estate of a non-skip person or subject to a right of withdrawal by reason of such person holding a right to withdraw so much of such property as does not exceed the amount referred to in section 2503(b) with respect to any transferor, and it shall be assumed that powers of appointment held by non-skip persons will not be exercised.

“GST Trust” GRAT Trap

- IRC 2632(c)(4). “For purposes of this subsection, an indirect skip to which section 2642(f) [the ETIP provisions] applies shall be deemed to have been made only at the close of the estate tax inclusion period. The fair market value of such transfer shall be the fair market value of the trust property at the close of the estate tax inclusion period.”
- GRATs! If the remainder beneficiary is a skip person or a GST Trust, then automatic allocation would apply and IRC 2632(c)(4) would allocate GST exemption based on the appreciated GRAT assets upon termination. Because GRATs are usually not intended to be GST exempt vehicles, care should be taken (which generally means electing out of automatic allocation).
- Relief may be requested (see, e.g. PLR 202117002 (4/30/21)).

Where to Find GST Status of a Trust

- Look at Schedule D on the Form 709 and any attachments clarifying GST allocation.
- Because of the automatic allocation rules, you may have to dig a little deeper if questions remain.

Trust Drafting Issues

- GST issues in a Katten Revocable Trust:
 - Division of trust at death of first spouse
 - Allocation to Marital Trust and Family (or credit shelter) Trust
 - Further subdivision of Marital Trust
 - Surviving Spouse's Powers of Appointment
 - Limited vs. General
 - Testamentary vs. Lifetime exercise
 - Descendant's Discretionary Trust
 - No rights of withdrawal
 - Power of Appointment
 - Ascertainable Distribution Standard
 - Division and Merger
 - Rule Against Perpetuities

Trust Drafting Issues

- GST issues in a Katten Irrevocable Trusts:
 - Dynasty Trusts
 - ILITs
 - Annual Exclusion Gift (2503(c)) Trusts

Common Administration Issues: Unknown inclusion ratios

- What do you do if you are unsure about the inclusion ratio (meaning you are not sure whether a trust is exempt from GST tax)?
 - Review the relevant gift and estate tax returns.
 - Review trust terms to consider whether allocation would make sense, or whether automatic allocation would apply.
 - Note that ***gift tax returns can also opt out of automatic allocation for a trust on a going forward basis.***

Common Administration Issues: Qualified severance

- Qualified severance

- When an inclusion ratio is neither 0 nor 1, a qualified severance can simplify the administration of the trust by allowing the trustee to divide the trust (pursuant to the inclusion ratio) into two separate trusts, one of which is fully exempt and the other of which is fully non-exempt.
- Requirements (26.2642-6 of the Regulations):
 - The single trust is severed pursuant to the terms of the governing instrument, or pursuant to applicable local law, and the severance is effective under local law.
 - Funding must occur within a reasonable time (but no more than 90 days after the valuation date).
 - Each new resulting trust must be a fraction or percentage totaling 100% of the original trust; and severance based on a pecuniary amount does not satisfy this requirement, e.g., the severance of a trust is not a qualified severance if the trust is divided into two trusts, with one trust to be funded with \$1.5 million and the other trust to be funded with the balance of the original trust's assets.
 - The terms of the resulting trusts (*in the aggregate*) must provide for the same succession of interests of beneficiaries as are provided in the original trust.

Common Administration Issues: Payment and Reporting of GST Tax

- IRS Form 706-GS(T) for taxable terminations
 - Trustee's responsibility to file and pay GST tax
- IRS Form 706-GS(D) for distributions to skip persons
 - Skip person's responsibility to file and pay GST tax
 - Trustee's separate responsibility to report distribution to skip persons on IRS Form 706-GS(D-1) *Notification of Distribution*
- Due April 15th of year after trust termination or distribution
- 40% GST tax rate
- Deductions
- Penalties and interest
- No checks of \$100 million or more accepted.

Common Administration Issues: Modifications to GST Trusts

- Modern trust law gives estate planning attorneys, trustees and grantors many tools to modify trusts
 - Non-judicially via NJSAs, decantings and exercise of powers of appointment
 - In court
- Slow down! Just because we can tinker with just about any trust provision – should we?

Common Administration Issues: Modifications to GST Trusts

- 26.2601-1(b)(4)(D)(1). The modification of the governing instrument by judicial or nonjudicial reformation that is valid under state law will not cause an exempt trust to be thereafter subject to GST tax if the modification:
 - Does not **shift a beneficial interest** in the trust to a lower generation; and
 - Does not **extend the time for vesting** of any beneficial interest in the trust beyond the period provided for in the original trust. Many PLRs have addressed this issue (e.g., PLRs 201820007-008, PLR 201814005, PLR 201947004). If a trust must be terminated by a beneficiary attaining a certain age, generally PLRs state that it is ok to modify the trust to extend the trust to the beneficiary's lifetime, but the beneficiary must be granted a general power of appointment (the general power of appointment is seen as the functional equivalent of granting outright ownership). These PLRs (which cannot be cited as precedent) indicate that the IRS is worried about the generations who receive the trust assets after the modification, not necessarily that the term of a trust is extended.

Shifting Beneficial Interest

- If the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer. If the result cannot be immediately determined, then a shift in the beneficial interest to a lower generation will be deemed to have occurred.
- If the modification is administrative in nature and only indirectly increases the amount transferred (e.g., lowering administrative costs or income taxes) will not be considered a shift in beneficial interest.
- Look to local law as well – if local law defines the trust income as a unitrust interest (or permits an income interest to be satisfied using a unitrust concept), then no shift in beneficial interest will be deemed to occur.
- If Trustee has discretion to apportion between income and principal under state law, then the Trustee's discretion in doing so will not be considered a shift in beneficial interest.

Be Cautious of a Modification

- As we have said, slow down... Be cautious of any kind of modification of an exempt trust, including (not exhaustive):
 - Amendment
 - Nonjudicial settlement agreement
 - Exercise of a power of appointment
 - Trust protector
- Even if an amendment sounds like a good idea for all parties, if the trust is GST exempt, stop and ask yourself, about the safe harbors... E.g., it might make sense to allow the trustee to make distributions to the grandchildren in addition to the children, but this shifts beneficial interest in the trust. Is there something else you can do instead? Nontaxable gifts to pay for educational or medical expenses? Is there another trust already available to the grandchildren?

Final Thoughts: Areas of Risk

- Potential areas of risk:
 - Attorney malpractice
 - Breach of fiduciary duty
 - IRS audit
- You do not need to be an expert by yourself. If you are not sure, ask for help.

Final Thoughts: Proposed Legislation

- For the 99.5 Percent Act. Introduced by Senator Bernie Sanders on March 25, 2021.
 - Introduced in some form since 2010 (originally called the “Responsible Estate Tax Act”). The January 31, 2019 act was called the “For the 99.8 Percent Act”.
 - Would mandate inclusion ratio of 1 other than for a “qualifying trust”. A “qualifying trust” is a trust that will terminate within 50 years of its creation.
 - Trusts created prior to implementation would retain its inclusion ratio and then switch to an inclusion ratio of 1 after 50 years.

Final Thoughts & Questions

Any questions?

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