

GST Theory and Application

SW Washington Estate Planning Council

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Review of GST Terminology, GST Events, and GST Exemptions, Exclusions and Exceptions

GST — Why and What

- GST tax is a stand-alone tax system.
 - It operates as a backstop to the “unified” estate and gift tax system to impose a tax on transfers that leapfrog a generation or more.
- GST tax is imposed at a single flat rate equal to the maximum federal estate tax rate in effect at the time of the generation-skipping transfer.
 - In 2021 and 2022 the GST tax rate is 40%.



Tax Rates and Exemptions

The gift tax environment has a volatile history. Legislation put into place in 2010 stabilized tax rates and exemptions through 2017. The 2017 Tax Reform Act doubled the basic exclusion amount from \$5 to \$10 million for tax years 2018-2025.

Year	Unified Credit*	For Estate/GST Tax Purposes	For Gift Tax Purposes	Rate
		Applicable Exclusion	Applicable Exclusion	
2009	\$1,455,800	\$3,500,000	\$1,000,000	45%
2010	\$1,730,800	\$5,000,000	\$1,000,000	0%/35%
2011	\$1,730,800	\$5,000,000	\$5,000,000	35%
2012	\$1,772,800	\$5,120,000	\$5,120,000	35%
2013	\$2,045,800	\$5,250,000	\$5,250,000	40%
2014	\$2,081,800	\$5,340,000	\$5,340,000	40%
2015	\$2,117,800	\$5,430,000	\$5,430,000	40%
2016	\$2,125,800	\$5,450,000	\$5,450,000	40%
2017	\$2,141,800	\$5,490,000	\$5,490,000	40%
2018	\$4,417,800	\$11,180,000	\$11,180,000	40%
2019	\$4,505,800	\$11,400,000	\$11,400,000	40%
2020	\$4,577,800	\$11,580,000	\$11,580,000	40%
2021	\$4,625,800	\$11,700,000	\$11,700,000	40%
2022	\$4,769,800	\$12,060,000	\$12,060,000	40%

* The credit was not “unified” in the years for which the gift tax exclusion was not the same as the estate and GST exclusion (2009-2010 on this chart). This column shows the estate/GST tax credit for years 2009-2010.

GST Tax Terminology — A Review

The GST Tax is driven by several defined terms:

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- Transferor
- Skip and Non-Skip Persons
- Interest in Trust
- Direct Skip
- Indirect Skip
- GST Trust
- Taxable Termination
- Taxable Distribution
- Inclusion Ratio
- Applicable Fraction
- Estate Tax Inclusion Period (ETIP)

Skip Persons

A Skip Person can be either:

- An **individual** who is two or more generations below the transferor's generation
 - Assignment based upon relationship to transferor
 - Unrelated persons are assigned generations based on age difference between transferor and transferee
 - Spouse is assigned to the same generation as the transferor
- A **trust** if:
 - All interests in such trust are held by skip persons, **or**
 - There is no person holding an interest in such trust and at no time after such transfer may a distribution be made from such trust to a non-skip person

Speaking of Skip Persons

Effective for decedents dying after 7/18/05:

GST Predeceased Parent Rule [TD 9214 (7/18/05)]

- Transfers to collateral heirs
 - Predeceased parent rule does not apply if transferor has living lineal descendants

Adopted Skip Persons Exception

- Adopted individual will be treated as one generation below the adopted parent if the individual is:
 - Legally adopted by the adoptive parent,
 - A descendant of the parent of the adoptive parent (or the adoptive parent's spouse or former spouse),
 - Under the age of 18 at the time of the adoption, AND
 - Not adopted primarily for GST tax-avoidance purposes.

GST Events

Direct Skip

- Transfer subject to gift or estate tax to a skip person

Taxable Termination

- Termination of all or a part of an interest in property held in trust, usually by reason of death or a defined event, unless a non-skip person has an interest in the trust or there is no ability to make a distribution to a skip person

Taxable Distribution

- Distribution from a trust to a skip person

Indirect Skips and GST Trusts

Indirect Skip

- Any transfer (other than a direct skip) subject to gift or estate tax to a GST Trust

GST Trust

- A trust that could have a generation-skipping transfer with respect to the transferor, unless one of six complicated exceptions apply.
- **This means that, absent evidence to the contrary, you must assume that the trust is a GST Trust.**

Taxable Terminations

What makes a “termination” not a “taxable termination?”

- Non-skip person still has an interest
- A distribution could not go to a skip person
- New transferor rule, as in a QTIP (Qualified Terminable Interest Property) Trust

Caution: Certain event-related distributions (*e.g.*, half the trust is distributed at age 30) can be characterized as taxable terminations.

- Taxable terminations and taxable distributions are taxed differently, are reported on different forms, and the person paying the tax is different.

GST Exceptions

GST Exemption

- \$12,060,000 in 2022 – more on this in a bit

GST Annual Exclusion

- \$15,000 in 2021 and \$16,000 in 2022
- Applies only to certain direct skips
 - Outright gifts
 - Gifts to UGMA or UTMA accounts
 - Gifts to qualified tuition programs (529 plans)
 - Gifts to trusts that
 - Have only one beneficiary (ever)
 - If beneficiary predeceases the termination of the trust, must be included beneficiary's estate
 - *E.g.*, section 2503(c) trusts
 - *E.g.*, *Crummey* trusts that meet sections 2503(b) and 2642(c)(2) requirements
 - Qualify for gift tax annual exclusion

GST Exceptions (cont.)

Medical and Educational Expense Exclusion

- Section 2503(e) rules apply

Move-Down Rule

- Only one GST tax per generation
- There are NO traps here
- Example: Direct skip trust for grandkids and their descendants. All future distributions to grandkids are not “taxable distributions.” However, there will be a taxable termination on the death of the last surviving grandchild.

Multiple Skips

- Go for it! GST is levied only once when dealing with taxable distributions and direct skips.

GST Exceptions (cont.)

Grandfathered GST Trusts

- Trusts that were *irrevocable on September 25, 1985 or created under will prior to October 22, 1986 by a decedent who died before January 1, 1987*, assuming no subsequent additions are made to the trust and assuming that sections 2038 or 2042 do not cause inclusion of the trust in the taxable estate of the transferor
- The GST tax does not apply to taxable distributions from or taxable distributions of interests in these trusts!

Respect Your Elders...

If you have a Grandfathered GST Trust:

- Do not alter the trust
- Do not make additional contributions
- Be very careful about exercising limited powers of appointment.
 - In most situations, the exercise will be treated as a constructive addition to the trust notwithstanding that it isn't a completed gift.

Allocation of GST Exemption

The Inclusion Ratio of a Trust

It's what drives the taxation of Distributions and Terminations.

- Every trust has an inclusion ratio of 1 (meaning every taxable distribution and any taxable termination is 100% subject to GST Tax) unless there is an allocation of GST exemption to the trust.
- The initial inclusion ratio is 1 less a fraction, the numerator of which is the GST exemption allocated to the trust and the denominator is the value of the property at the date of the GST exemption allocation.
- Every time there is an increase to the corpus of the trust (or an allocation of GST exemption) the inclusion ratio is recalculated.
- If there is an allocation of exemption equal in value to every addition to the trust, the inclusion ratio will be zero. Otherwise, it will be between zero and one.
- It is imperative that one knows the GST inclusion ratio of every trust appearing on a Form 709 and every trust for which one prepares a Form 1041.

GST Exemption

\$12,060,000 in 2022

- May be used during life or at death
- Reduces **inclusion ratio**, and, ultimately, the tax rate on a GST event

If the ratio = 0



The trust is fully exempt from GST tax.

If the ratio = 1



All distributions from a trust, including at termination, are fully non-exempt and subject to GST tax.

- Allocated to gifts (timely) or trusts (timely or late) to the extent the gift is not covered by the GST annual exclusion, if applicable

Effectively utilizing one's GST exemption requires regulating its application while not wasting it.

Determining the Inclusion Ratio and the Applicable Fraction

$$\text{Inclusion Ratio} = 1 - \text{Applicable fraction}$$

- The Inclusion Ratio is the ratio that determines the extent to which distributions and terminations are taxable
- Rounded to the nearest .001

$$\text{Applicable Fraction} = \frac{\text{Amount of GST exemption allocated to the trust}}{\text{Value of the property held in the trust on the effective date of the GST allocation}}$$

- On a timely filed gift tax return, the effective date of the GST exemption allocation is the date of the gift.
- Once determined, the inclusion ratio remains the same until an event that requires redetermination.

The Inclusion Ratio — Redetermination

- Redetermination events include:
 - Allocation of additional GST exemption (using the \$12M+ GST exemption to improve the inclusion ratio of an existing trust)
 - Addition of property to the trust
 - A change in transferor (*e.g.*, a QTIP or a trust with a GPOA)
 - Consolidation or “decanting” assets of separate trusts having the same transferor but different inclusion ratios (*e.g.*, a GRAT that terminates in favor of a GST trust)
- For example, the applicable fraction on a second asset addition to a trust would be:

$$\text{Redetermined Applicable Fraction} = \frac{\text{Amount of GST exemption allocated to trust} + \left[\text{Value of the trust on date of second transfer} \times \text{Prior Applicable Fraction} \right]}{\text{Value of the trust immediately after the second asset contribution}}$$

GST Exemption — Protecting the Little Guy

- Automatic allocations to direct skips
- Automatic allocations to indirect skips to GST trusts
- Automatic allocations at the date of the filing of the estate tax return (you need to know where it went)

Do I have a GST Trust?

- It is often challenging to determine whether a trust is a GST Trust and therefore whether a transfer to such trust is an indirect skip subject to the automatic allocation rules
- There is no universal interpretation of these rules and clarifying regulations do not appear to be forthcoming
- This means that, **absent evidence to the contrary, you must assume that the trust is a GST Trust**

Opt-In or -Out of Automatic Allocation Rules

The most important takeaway of this training...

An individual can **elect** to have a trust treated as a GST Trust (thus invoking the automatic allocation rules) or to have a trust treated as not a GST trust (thus preventing any allocation of GST exemption except an affirmative allocation). One does this to avoid any ambiguity with respect to the trust being a GST Trust. This is particularly important if the trust is planned to skip.

The recommended version of the election out is a **permanent election** which exempts all current and future transfers made by the transferor to the trust, whether or not the trust exists at the time of the election out.

Permanent Opt-In Example

For all trusts the client does want to exempt

Example:

- This trust is clearly intended to skip with respect to a significant majority of its property but significant benefits may still pass to children who are non-skip persons.
- Client wants to allocate GST to this trust.

Solution: Simply opt-in to GST. Trust status and the automatic allocation rules will apply to all transfers to this trust. This removes all risk of subsequently missed allocations.

Permanent Opt-Out Example

For all trusts the client does not want to exempt

Example:

- This trust is very complicated, but the possibility exists that a skip person might benefit (*e.g.*, if all of his children and grantor's spouse should die young). Based on its complexity, it is difficult to tell if the deemed allocation rules will apply.
- Client does not want to allocate any GST to this trust — ever

Solution: Simply opt out of the automatic allocation for all transfers to this trust. This solves the issue definitively.

Affirmative Allocations

NOTE: “Permanent elections” are permanent until removed by the taxpayer at the taxpayer’s election or the taxpayer’s death; however, if they are revoked, the revocation applies only to transfers occurring after the revocation.

- The revocation must be attached to a Form 709 and filed
- There is no such thing as a “retroactive” revocation

Affirmative allocations are always possible but are generally effective only when filed.

- They require a Notice of Allocation filed with a Form 709
- The Notice of Allocation must recite certain information – see Treas. Reg. § 26.2632-1(b)(4)
- As a general rule, the value of the trust at the date of affirmative allocation is the key to determine the amount of GST exemption required to be allocated to obtain an inclusion ratio of zero

Affirmative Allocations (cont.)

- Timely allocations are made using notices of allocation filed with the Form 709 for the year of the gift—the return must be filed on or before the extended due date for that return
- Late allocations are made using Notices of Allocation filed after either:
 - The extended due date of the return for the year in which the gift occurred, or
 - After the effective date of an opt-out election
- The principal difference between the two allocations is that a timely allocation is made using date of gift values whereas a late allocation is based on the asset values at the date of the allocation
 - NOTE: One can make a first-of-month election which allows you to use the first date of the month as the valuation date, but you have to file the late allocation by the end of that month

Relief for Missed Allocations

Why do it?

- If assets in a trust have appreciated substantially, AND
- If it appears that the client intended to protect the trust from GST tax

Why not do it?

- It is expensive

How to do it?

- Rev. Rul. 2004-46 provides an expedited procedure for a deemed timely allocation for unreported GST transfers if they were less than the then applicable annual exclusion
 - Proposed regulations under section 2642(g) dictate the means by which a missed allocation may be corrected if the relief of Rev. Rul. 2004-46 is not applicable. Until these rules are finalized, requesting relief requires a filing under section 9100.
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Changing Allocations Once Made

- Generally not possible
- Can occur only if the allocation was to a trust incapable of giving rise to a skip – even if the possibility is so remote as to be negligible
- You have no choice but to do it right the first time
- One can seek section 9100 relief to make an opt-out election for transfers made after 2001
 - Fairly expensive proposition

ETIPs and Allocation of GST Exemption

Not all trusts subject to an ETIP are GST Trusts.

- **Estate Tax Inclusion Period (ETIP)**

- **Definition:** Generally, a period during which all or any part of the value of the transferred property would be includible in the estate of the transferor or the transferor's spouse if such individual died immediately after the transfer
 - A proper *Crummey* power is excluded
- **Rule:** An allocation of GST exemption during an ETIP is not effective until the close of the ETIP
- For purposes of the deemed allocation rules, **the indirect skip occurs at the end of the ETIP**
- **Leading Practice:** Put a tickler on your calendars to remind you of ETIPs if an allocation may occur and be sure to include this issue as a carry forward note

NOTE: If there is a GST allocation at the end of the ETIP such allocation must be reported on the Form 709 for the year in which the ETIP ended.

ETIPs and Allocation of GST Exemption (cont.)

Not all trusts subject to an ETIP are GST Trusts.

- If the client *intends not to allocate GST exemption* to a trust subject to an ETIP AND the trust is a GST Trust, do a permanent opt-out on the Form 709 that reports the transfer.
 - This is typical.
- If the client *intends to allocate GST exemption* to an ETIP trust, do a permanent opt-in on the Form 709 that reports the transfer.
 - This guarantees an allocation of any unused GST exemption that exists on the date the ETIP terminates. Your trust may still not be fully GST exempt if the value of the trust at the end of the ETIP exceeds the unused GST exemption available to cover it (*i.e.*, the trust's inclusion ratio would be between zero and one).

ETIPS and Indirect Skips — Special Case

Consider a Grantor Retained Annuity Trust (GRAT) that names a GST trust as its remainderman.

- Is the GRAT a GST trust in this instance?
- If not, then how does one effect a GST exemption allocation to the GRAT?
- While the remainder trust is a GST Trust, will the receipt of the funds from the GRAT effect an automatic allocation of GST exemption? If not, why not?
- If not, then how does one effect a GST exemption allocation to the remainder trust?
- When can the allocation be effective?

ETIPS and Indirect Skips — Special Case Answers

- Is the GRAT a GST trust in this instance?
 - No the GRAT is not a GST trust because the GRAT itself cannot generate a GST event.
- If not, then how does one effect a GST exemption allocation to the GRAT?
 - Permanent Opt-In Election
- While the remainder trust is a GST Trust, will the receipt of the funds from the GRAT effect an automatic allocation of GST exemption?
If not, why not?
 - No. An automatic allocation applies only to a transfer passing through the gift and estate tax system.
- If not, then how does one effect a GST exemption allocation to the remainder trust?
 - A “late allocation”
- When can the allocation be effective?
 - Once the property has arrived in the remainder trust

Special Situations

Retroactive GST Allocations

Retroactive GST Allocation

Section 2632(d)

- The forgotten provision of the 2001 Act (which continued under the 2017 Tax Cuts and Jobs Act)
- Provides a trust with an opportunity to become GST tax-exempt based upon the initial value of assets contributed to the trust
- Assumes that the transferor has unallocated exemption at the date of the allocation
- Avoids GST tax on a taxable termination or taxable distribution
- Retroactive allocation is applicable to trusts created in 1986 and forward.

Typical Retro GST Trust

- The typical trust was not intended to benefit skip generations
 - For example, a typical trust would involve a trust for the primary benefit of a child that terminates in favor of the child when the child turns 50. The child dies at age 48 with the result that the trust assets pass to the next generation in what would otherwise be a taxable termination.
 - If elected, and assuming the grantor has sufficient unused GST exemption, the trust can be allocated sufficient GST exemption to obtain an inclusion ratio of zero based on the value of each contribution to the trust at its value on the date of the original gift.

Retroactive Allocation — Who, What, When?

- Non-skip person of a trust with an interest or future interest in that trust
- Non-skip person is a lineal descendant of a grandparent of the transferor or of a grandparent of the transferor's spouse or former spouse
- Non-skip person predeceases transferor
- The retroactive allocation must be claimed by due date of a timely filed gift tax return for the year of the out-of-order death.



Caution!

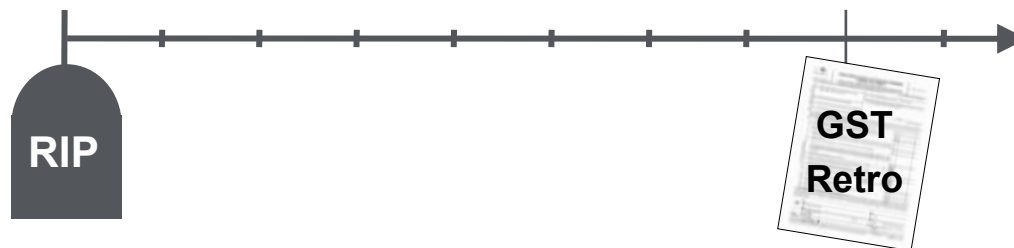
This is not information that is likely to arise in the ordinary course of gift tax preparation. You must inquire.

Timing for the Retroactive Allocation

- The window for making a retroactive GST allocation is narrow.
- The allocation of GST tax exemption must be made by the due date of the transferor's gift tax return for the year in which the out-of-order death occurs.

Example:

Non-skip person dies in May 2021. The transferor must make retroactive GST allocation by April 15, 2022, plus extensions.



Partial Inclusion Ratios

Partial Inclusion Ratios

A GST Tax Problem

- One of the primary problems in planning for the GST tax is the existence of a trust with an inclusion ratio between zero and one (a partially GST exempt trust).
- The effect of such a trust is that any GST event with respect to the trust will result in a GST tax to the extent the trust is not exempt.
- What gives rise to a partial inclusion ratio?
 - Too little GST exemption allocated
 - Avoid this with a formula allocation
 - Missed subsequent allocations
 - Relief provisions should be checked
 - Contributions will exceed available exclusion
 - Less likely with the increased GST exemption amount

Qualified Severances

Section 2642(a)(3) allows “downstream” splits of partially exempt GST trusts through a “qualified severance.”

- **Definition:** A division of a single trust into two or more trusts pursuant to either the trust instrument or applicable state law and the terms of the divided trusts provide for the same succession of beneficial interests as provided in the original trust
- **Rule:** The trust must be divided in such a way to create one trust with an inclusion ratio of zero and another trust with an inclusion ratio of one
- Severed trusts may be funded on a non-pro rata basis
- A qualified severance must be disclosed on a Form 706-GS(T) with the words “Qualified Severance” written at the top of the form

The Reverse QTIP Election

- Why?
 - It all has to do with the definition of transferor.
 - Marital trusts, because they are always included in the estate of the surviving spouse, always get a “new” transferor.
 - This creates the possibility that the GST exemption of the first spouse to die may be wasted.
- A reverse QTIP election works by designating the first spouse to die as the GST transferor of the trust to which the election applies notwithstanding the assets of the trust will be included in the gross estate of the surviving spouse.

The Difficulties of the Reverse QTIP Election

- Need to carve out a separate marital trust in order to avoid a trust with a partial inclusion ratio.
- If not careful, you may leave too few assets for the surviving spouse and his or her GST exemption may be wasted.
- Partial QTIP elections and reverse QTIP elections don't play well together.
- It is an election made by checking a box on Form 709, Schedule D, Part 2. If it is missed, then it is a costly process to obtain section 9100 relief.

Module 4

Compliance Considerations

Don't Forget to File the Necessary Returns!

Direct Skip	The transferor reports gifts to trusts on Form 709, Schedule A, Part 2 , which flows to Schedule D, Parts 1 and 3	<i>E.g.</i> , a birthday gift to a grandchild
Indirect Skip	The transferor reports gifts to GST trusts on Form 709, Schedule A, Part 3 , and allocated GST exemption (if desired) on Schedule D, Part 2	<i>E.g.</i> , gift to <i>Crummey</i> trust for benefit of child
Taxable Termination	A trustee uses Form 706-GS(T) to figure and report the tax due from certain trust terminations that are subject to the GST tax	<i>E.g.</i> , half of the trust property is distributed to a skip person at age 30
Taxable Distribution	<p>A trustee uses Form 706-GS(D-1) to report certain distributions from a trust that are subject to the GST tax and to provide the skip person distributee with information needed to figure the tax due on the distribution</p> <p>A skip person distributee uses Form 706-GS(D) to calculate and report the tax due on distributions from a trust that are subject to the GST tax</p>	<i>E.g.</i> , an income distribution from a trust to a grandchild

Key GST Tax Takeaways

What you need to know.

- Know about every trust
 - And each trust’s GST profile – What was the client trying to do?
 - Whenever possible, get any memos the attorney provided to the client
 - Make a permanent opt-in or opt-out election in the initial year of the trust and note it each year in the trust’s description on Form 709
 - Ask your clients regularly if they have any trusts that you don’t know about (and for the trust documents)
 - A “sleeper” trust will absorb exemption, which may interfere with future planning
 - Unreported ILITs (Irrevocable Life Insurance Trusts) are a common problem. Remember, the statute of limitations will not run on unreported gifts.
- You need to know the ages of all beneficiaries and power holders
- You need to know when a death occurs.

Key GST Tax Takeaways (cont.)

Questions to Ask to Identify Trusts for GST Reporting Purposes

- **Question 1: Is this trust grandfathered?**
 - In existence prior to October 22, 1985?
 - Modified/transferred/power of attorneys since 1985?
- **Question 2: Does the trust have skip potential?**
 - Generation 3 or below (based on settlor = G1)?
 - “Unrelated” beneficiaries but > 37.5 years age difference?
 - Charitable beneficiaries but not qualifying CRT/pooled income fund?
- **Question 3: If not grandfathered and has skip potential, who is the “transferor” for GST purposes?**
 - **Caution:** Trusts may have more than one transferor if additional contributions are made to the trust. Contact WNT if encountered.

Questions?



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