SUMMARY OF THE GENERATION SKIPPING TAX RULES AND FILING REQUIREMENTS

While most tax practitioners during tax season are busy preparing income tax filings for individuals and businesses, many may not be as familiar with the filing requirements for Forms 706 GS(T), 706 GS(D-1) or 706 GS(D). As with all required IRS tax forms, clients and tax practitioners risk late filing and late payment penalties for their clients if reporting and payment requirements are not met. Moreover, failure to file these forms on a timely basis could cause a delay in starting the statute of limitations for purposes of documenting the GST inclusion ratio for a trust. This is especially true, for example, if all the historical gifts to the trust weren't reported correctly on prior gift tax returns and there wasn't an affirmative allocation of GST exemption with respect to such gifts. This summary provides a refresher on the basic Generation Skipping Tax ("GST") tax rules and also highlights the often overlooked GST tax-sensitive filing requirements when a trust either terminates or makes a non-terminating distribution to a "skip person."

Direct and Indirect Skips

Three types of taxable transfers could trigger GST tax:

- ***Direct Skips*** – A transfer subject to a tax imposed by Chapter 11 or 12 of the Internal Revenue Code consisting of an interest in property to a "skip person."

- ***Taxable Terminations*** – The termination (by death, lapse of time, release of power or otherwise) of an interest in property held in a trust unless: (i) immediately after such termination, a "non-skip person" has an interest in such property, or (ii) at no time after such termination may a distribution (including distributions on 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 death of a lineal descendant of the transferor, a specified portion of the trust's assets are distributed to one or more "skip persons" (or one 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 Distributions*** – Any distribution from a trust to a "skip person" (other than a taxable termination or a "direct skip").

A "skip person" is any natural person assigned to a generation which is two or more generations below the generation of the transferor, or a trust if (i) all interests in such trust are held by "skip persons", or (ii) if:

(a) there is no person holding an interest in such trust, <u>and</u>

(b) at no time after such transfer may a distribution (including distributions on termination) be made from such trust to a "non-skip person."

A “non-skip person” is any person that is not a “skip person.” A transfer made directly to a “skip person,” either during life or at death, is a "direct skip." A transfer made to a trust in which all beneficiaries are "skip persons" is also a "direct skip."

No GST tax is due upon an outright gift or gift in trust as long as the amount of the gift does not exceed the donor’s GST exemption. In contrast, for gifts in trust, if the GST automatic allocation rules do not apply and the requisite exemption is not timely allocated, a GST tax could be triggered later when the trust makes distributions to beneficiaries who are “skip persons.” Confiscatory GST tax consequences could therefore result if the assets have grown significantly since the original transfer.

Transfers to trusts that have both skip and non-skip persons as beneficiaries are considered “indirect skips.” Under the current law, certain trusts, known as “GST Trusts,” are automatically allocated GST exemption each time certain types of transfers in trust are deemed to have occurred. The automatic GST allocation rules were put into place in 2001 and are complex. An individual may elect out of the automatic allocation rules. They can also elect to treat any trust as a GST trust, thereby qualifying it for automatic allocation for subsequent years to the extent future contributions are made to such trust.

Taxpayers and their advisors should not rely on the automatic GST allocation rules given the following:

- Examples where the automatic allocation rules apply but are likely not desired:

  - There is a high probability that the “non-skip” trust beneficiaries will spend all the assets of the trust during their lifetimes.

  - The primary asset of the trust consists of term life insurance that is likely to lapse at some point in the future without being converted to permanent insurance.

- Examples where the automatic allocation rules do not apply but could be desired depending on the circumstances:

  - The trust provisions include springing powers of appointment to “non-skip persons” or grant a powerholder the ability to grant a general power of appointment to “non-skip persons” and it is unlikely that the “non-skip persons” would spend all the assets of the trust during their lifetime.

  - A trust that includes hanging powers that are in excess of the annual exclusion amount for taxable gifts. For example, assume that a single taxpayer initially funds a trust equal to $300,000 for the benefit of his two children and future descendants. The trust provides that each beneficiary may withdraw the lesser of their pro rata share of the gift or the annual exclusion amount; however, the demand right of the beneficiary shall lapse by an amount equal to the greater of $5,000 or 5% of the value of such trust on an annual basis. In the first year, each beneficiary would not have a

hanging power in excess of the annual exclusion and an automatic allocation of GST exemption should apply. Let's assume that the taxpayer makes a $30,000 cash gift in year two and the trust is worth $355,000 after considering such gift. At such time, the beneficiary would have a hanging power equal to $2,750 (($355,000 * 5%) - $15,000)) and there would not be an automatic allocation of GST exemption with respect to any portion of the $30,000 gift. Without an affirmative allocation of GST exemption in the second year, the trust would have an inclusion ratio between zero and one.

Computation of the GST Tax

The GST Tax is computed by multiplying 40% by the taxable gift, distribution or termination. A lifetime exclusion of $11.4 million of taxable gifts is available to every taxpayer (per 2019 tax year, adjusted for inflation annually).

If the transfer is to a trust and a portion (or all) of the GST $11.4 million exemption is allocated to the trust, an "inclusion ratio" is computed at the time of the gift. The computation is detailed. Its effect, though, is to determine the taxable fraction of the trust. For example, if $7.5 million of an exemption is allocated to a $11.4 million gift in trust, approximately 2/3rds of any trust distribution to a "skip person" or trust termination will avoid GST Taxes (i.e., $7.5 million/$11.4 million = 65.7%).

Reporting Requirements

For lifetime transfers to "direct skip" individuals or trusts, the U.S. Gift and GST Tax Return (Form 709) must be filed, and any GST Tax paid, within 3 ½ months of the taxpayer's year end (April 15th for a calendar year taxpayer unless extended to October 15th). Unless otherwise elected on Form 709, the $11.4 million exemption will automatically be allocated to "direct skips." The tax is payable by the donor.

"Direct skips" outright to an individual or to a "direct skip" trust that benefit a single "skip person" may qualify for the $15,000 annual Gift Tax exclusion and for a separate GST annual exclusion. However, gifts in trust that are not "direct skips" that can benefit more than one skip or non-skip person (i.e., sprinkle trusts) do not qualify for the GST Tax annual exclusion, even though they may qualify for the Gift Tax annual exclusion. A common example includes gifts to a trust that benefits multiple skip and non-skip persons that utilizes a Crummey withdrawal provision. Although these transfers may qualify for the Gift Tax annual exclusion, they do not qualify for the GST annual exclusion. As such, the donor will need to consider whether it is more appropriate to rely on the automatic allocation rules or specifically allocate GST exemption to gifts in these trusts on a timely filed Gift & GST Tax Return Form 709.

If the "direct skip" occurs not during life, but at death (for example, the gift in the above example is made as a testamentary bequest), the decedent's Federal Estate Tax Return (Form 706) would report the transfer and the application of any unused GST exemption.

If a GST taxable termination has occurred, a Generation Skipping Transfer Tax Return for Terminations, Form 706 GS(T), should be completed by the trustee and the GST Tax paid, if any, with the form. As noted earlier, generally a termination occurs when all non-skip interests in a trust have ended. The difficult task for a trustee is to determine how much of the termination value is taxable (the "inclusion value"). The instructions to this form provide more specific definitions, exemptions and transitional rules. This form and the associated tax is due April 15th (or October 15th with extension) of the year following the termination. The tax is paid by the trust. The return is required to be filed even if no tax is due with the taxable termination.

If a GST taxable distribution (either income or principal) is made from a trust to a "skip person," the trustee must report the distribution to the skip beneficiary and the IRS using the Notification of Distribution From a Generation Skipping Trust, Form 706 GS(D-1), effectively a generation-skipping version of a Schedule K-1. The trustee must include the description of the property distributed, the date of distribution, the "inclusion ratio" of the trust and the value of the distribution on this information form.

The skip beneficiary, in turn, uses the information on Form 706 GS(D-1) to file Generation Skipping Transfer Tax Return for Distributions, Form 706 GS(D). The computed GST Tax is paid by the beneficiary with this return.

Due Dates

Forms 709, 706 GS(D), 706 GS(D-1) and 706 GS(T) are due on the 15th day of the 4th month following the year the transfer, termination or distribution occurs (normally April 15th for calendar year taxpayers or October 15th upon extension). Transfers at death are reported on Form 706, which is due nine months after death plus extensions.

Statute of Limitations

The IRS is generally permitted to challenge a trust's GST inclusion ratio and assess GST tax and penalties until the later of: (i) the expiration of the statute of limitations for filing Forms 706 GS(T), 706 GS(D-1) or 706 GS(D) as a result of a taxable termination or distribution, or (ii) upon the expiration of the statute of limitations period applicable to the grantor/decedent's Form 706 Estate Tax Return.

If the donor originally timely filed Form 709 US Gift (and Generation-Skipping Transfer) Tax Return back when the original gift in trust was made and expressly allocated GST exemption via a formula GST allocation clause, there is little risk of additional GST Tax being assessed after the Form 709 statute of limitations period expires. The same is true if the decedent's executor expressly allocated GST exemption to any testamentary trusts via a formula allocation clause on Schedule R of the decedent's Form 706 Estate Tax Return. However, this might not always be the case, especially if the taxpayer's tax return preparer did not always expressly allocate GST exemption via a formula allocation clause on Form 709 or Form 706, there was a revaluation of prior lifetime gifts or testamentary bequests in trust without a corresponding

amendment to the donor or decedent's GST exemption allocation to such gifts or bequests, or there is a concern that all historical gifts weren't reported correctly on prior gift tax returns.

Examples

The GST Tax is calculated by multiplying 40% against the "direct skip," or, in the case of a transfer from a trust to a beneficiary, only upon either a "taxable distribution" or a "taxable termination."

- **Example 1:** Grandfather gives $100,000 to his granddaughter. Because his granddaughter is two generations below that of the grandfather, the transfer is a "direct skip." The automatic GST allocation rules (unless taxpayer elects out of the automatic rules) would utilize up to $100,000 of his remaining GST exemption to avoid or mitigate GST Tax.

- **Example 2:** If Grandfather instead gives $100,000 to a trust for his grandson, the sole beneficiary, this will also be a "direct skip" because only a "skip person," the grandson, has an interest in the trust. The automatic GST allocation rules (unless taxpayer elects out of the automatic rules) would utilize up to $100,000 of his remaining GST exemption to avoid or mitigate GST Tax. Assuming the grandfather has enough GST exemption to allocate to the total gift, no GST Tax will be due at the time of the gift and any future distributions made to the grandson will not be subject to the GST Tax regardless of whether the trust grows to many times more than its original balance.

- **Example 3:** Grandfather gives $100,000 to a trust for the benefit of father and son. The father is not a "skip person" because he is one generation below the donor grandfather. The son is a "skip person" because he is two generations below the grandfather. Because the trust has both a "skip person" and a "non-skip person," no tax is payable upon the funding of the trust assuming GST exemption is allocated properly on Form 709 at the time the gift is made. In this example, the trust would be fully GST exempt and no GST Taxes would ever be due upon subsequent distributions or upon the trust's termination.

- **Example 4:** The trust in Example 3 provides that, upon the death of the father, the trust continues for the life of the son. When the father dies, the son is the sole beneficiary. Because all non-skip interests have terminated (i.e., the father), a taxable termination has occurred and a GST Tax would be imposed if the original trust were not fully GST exempt. The same would be the case if, prior to the death of the father, a distribution of $50,000 is made to the son. In that case, a taxable distribution would be deemed to have occurred and a GST Tax would be payable as a result of the distribution if the original trust were not fully GST exempt.

- **Example 5:** Grandfather creates a trust and transfers $20 million of hard-to-value assets to the trust at a time when he only has $11.4 million of GST exemption. The trust benefits father and

descendants (often referred to as a dynasty trust). At the time of the gift, grandfather files Form 709 and reports a taxable gift of $20 million and allocates $11.4 million of his GST exemption to the trust. Since the trust is not fully GST exempt, some portion of future distributions will create GST Tax. Many trusts provide that, upon funding, the trust will be divided into a GST exempt trust and a GST non-exempt trust. The GST exempt trust would initially consist of $11.4 million of assets and would have a GST inclusion ratio of zero (0), while the GST non-exempt trust would initially consist of $8.6 million and have a GST inclusion ratio of one (1). This means that no taxable termination or taxable distribution would trigger a GST Tax in the future with respect to the GST exempt trust. However, all future taxable terminations or taxable distributions from the GST non-exempt trust would trigger GST Taxes.

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