§13.1 BRIEF OVERVIEW OF THE GST TAX

Before the existence of the GST tax, many wealthy families transferred property to their descendants in trust rather than outright. At each subsequent death the beneficiary’s life estate was not includable in the beneficiary’s gross estate, and for succeeding generations the family’s wealth went untaxed. The GST tax was designed to stop this tax-free transmission of wealth. The GST tax was initially adopted in 1976, and then replaced in its entirety with a new set of GST tax rules in 1986. The 1976 version of the GST tax was overly complicated. A lack of understanding, inability by the IRS to devise appropriate GST tax reporting forms, and scattered compliance all led to the demise of the original version of the GST tax. The 1986 version of the GST tax (as amended) is still in effect at this time (but will be repealed for calendar year 2010, and then reinstated on January 1, 2011). The GST tax is set forth in Chapter 13 of the Internal Revenue Code of 1986 (as amended), and is structured on a series of defined terms, many of which are discussed below. The purpose of the GST tax is to prevent the dynastic accumulation of inherited wealth that can occur when multiple generations of a transferor’s family are benefited by property transfers that are not subject to additional estate taxation at each succeeding generation. Simply put, Congress wants to ensure that significant wealth transferred to a person’s descendants (or transferees) is eventually taxed even though the transferred wealth is insulated from successive estate or gift taxation. The imposition of the GST tax occurs at generations that are two or more below that of the transferor, such as the transferor’s grandchildren or more remote descendants, and can occur in even the “simplest” of estate plans.

Example: After the death of the surviving spouse, the balance of the credit shelter trust, which is not GST tax exempt, is payable outright to the transferor’s descendants, per stirpes. Six months after the transferor’s death, the transferor’s son dies leaving surviving issue. Upon the death of the transferor’s surviving spouse, the trust distribution to the deceased son’s issue will be subject to the GST tax, as a taxable distribution.

Example: After the surviving spouse’s death, the balance of the credit shelter trust, which is not GST tax exempt, remains in trust for the benefit of the transferor’s descendants for as long as is permitted under the rule against perpetuities. At the death of each descendant, as his or her interest passes to the next generation, that interest in the trust generally escapes estate tax, but is instead subject to the GST tax.

§13.2 GENERATION-SKIPPING TRANSFER DEFINED

The following events constitute a generation-skipping transfer: (1) a taxable termination; (2) a taxable distribution; or (3) a direct skip. IRC section 2611(a). A transfer under IRC section 2503(e) (concerning direct payment of medical expenses and tuition) does not constitute a GST event; nor does any transfer: (1) to the extent the property transferred was subject to a prior GST tax; (2) the transferee in the prior transfer was assigned to the same generation as (or a lower generation than) the generation assignment of the transferee in the current transfer; and (3) the current transfer does not have the effect of avoiding the GST tax with respect to any transfer. IRC section 2611(b).

Practice Point: Certain transfers from trusts or wills that were executed before a certain date are not subject to the GST tax. Treas. Reg. §26.2601-1. However, a modification of such instrument or an addition (including a constructive addition) to such trust may cause the trust to lose its GST grandfathered status.

Three types of trusts are GST tax purposes (and are automatically GST tax exempt): (i) a trust that was irrevocable on 9/25/1985, but only to the extent that a GST transfer is not made out of corpus that was added to the trust after 9/25/1985, or out of income attributable to such corpus (Treas. Reg. §26.2601-1(b)(1)); (ii) any trust (or testamentary trust to be established under a will) executed before 10/22/1986, and not amended thereafter if the decedent died before 1/1/1987 (Treas. Reg. §26.2601-1(b)(2)); and (iii) any trust made by a person who on 10/22/1986, and at all times thereafter, was mentally incompetent and the trust was included in the incompetent person’s gross estate. (Treas. Reg. §26.2601-1(b)(3)).

Treas. Reg. §26.2601-1(b)(4) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a GST grandfathered trust will not cause the trust to lose its GST tax exempt status. Safe harbors are provided for: (i) certain distributions of trust principal from a GST grandfathered trust to a new trust or retention of the trust principal in a continuing trust; (ii) certain court-approved settlements of bona fide issues regarding the administration of the GST grandfathered trust or the construction of terms of the trust; (iii) certain judicial constructions of the GST grandfathered trust to resolve ambiguities in the terms of the trust or to correct a scrivener's error; and (iv) certain modifications of the GST grandfathered trust (including a trustee distribution, conversion to a unitrust (Priv. Letter Rul. 200417014; Treas. Reg. §1.643(b)-1; Treas. Reg. §§26.2601-1(b)(4)(i)(D)(2), 26.2601-1(b)(4)(i)(E), Example 8), settlement, or construction that does not satisfy items (i) through (iii) immediately preceding) by judicial reformation, or non-judicial reformation that are valid under applicable state law, provided the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in IRC section 2651) than the person(s) who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

If a non-general power of appointment in a GST grandfathered trust is exercised in a manner that may postpone or suspend the vesting of an interest in trust property beyond the period relating to the rule against perpetuities (i.e., beyond a life in being plus 21 years or beyond 90 years), this will result in the exercise being treated as a constructive addition to the trust, and will change the identity of the transferor for GST purposes if the exercise of the power is treated as a taxable transfer for estate or gift tax purposes. Treas. Reg. §§26.2601-1(b)(1)(v)(A) and (B). See also, IRC sections 2041(a)(3) and 2514(d). Additionally, if the period for vesting is the “longer of a life in being plus 21 years or 90 years,” this too will cause the GST grandfathered trust to lose its GST tax exempt status, except where state law prohibits the use of the longer of the two periods. Treas. Reg. §26.2601-1(b)(1)(v)(D), Examples 6 and 7.

Furthermore, when a GST grandfathered trust is relieved of any liability properly payable out of the assets of such trust, the person who actually satisfies the liability is considered to have made a constructive addition to the GST grandfathered trust in an amount equal to the liability satisfied by that person. The constructive addition occurs when the GST grandfathered trust is relieved of liability (e.g., when the right of recovery is no longer enforceable by the person who paid a tax on behalf of the GST grandfathered trust). Treas. Reg. §26.2601-1(b)(v)(C). The person satisfying the trust’s liability becomes the transferor (for GST tax purposes) of the satisfied amount. Special rules, however, apply with respect to payment of estate taxes on reverse QTIP property. Treas. Reg. §26.2652-1(a)(3). If the surviving spouse’s will waives the right to be reimbursed for estate taxes attributable to reverse QTIP property, the waiver (and payment of the estate taxes by the surviving spouse’s estate) does not constitute a constructive addition to the reverse QTIP trust. Treas. Reg. §26.2652-1(a)(3), Example 8.
Appendix 4 contains a flow chart decision tree to determine whether a pecuniary payment from a transferor’s inter vivos trust (that is included in the transferor’s gross estate) is a taxable termination, taxable distribution, or a direct skip.

§13.3 TAXABLE TERMINATION DEFINED

A taxable termination is the termination (by death, lapse of time, release of a power, or otherwise) of a beneficiary’s interest in property held in a trust5 (such as a life estate) where immediately after the termination there is no person who has an interest6 in the trust property other than a skip person, or after the termination, no distribution may be made from the trust to a non-skip person. IRC section 2612(a). A taxable termination can only occur from a trust (or a trust arrangement). A taxable termination cannot occur from a probate estate.7 Thus, a taxable termination of a trust is when all interests of non-skip persons come to an end. Because the GST tax is levied on the termination of any interest in trust property, a taxable termination can occur on more than one occasion. For example, if T creates a trust to pay income for life to T’s child (C) for life, then to T’s grandchild (GC) for life, with distribution of the remainder to T’s great grandchild (GGC), two taxable terminations will occur—once when C dies, and once when GC dies. The severity of taxable terminations underscores the need for transferors to allocate GST tax exemption to trusts that are intended to benefit skip persons.

Practice Point: A non-skip person’s interest in a trust that is used primarily to postpone or avoid any GST tax is disregarded for GST tax purposes. IRC section 2652(c)(2). An interest is considered so used if a significant purpose for the creation of the interest is to postpone or avoid the GST tax. Treas. Reg. §26.2612-1(c)(2)(ii). The interest to be disregarded does not have to be nominal.

Practice Point: A charity’s interest in a trust will not avoid a taxable termination if: (i) the charity’s interest is discretionary, or (ii) the charity’s interest is a separate share that existed at all times from the creation of the trust (or results from a qualified severance), or (iii) the charity’s interest is used primarily to postpone or avoid the GST tax. Treas. Reg. §§26.2612-1(c)(1)(ii), 26.2612-1(e)(2)(ii), and 26.2654-1(a).

§13.3(a) Amount Of GST Tax

The amount of the taxable termination that is subject to GST tax is described in IRC section 2622. Since the GST tax is paid from the property giving rise to the taxable termination, the tax is similar to the tax-inclusive nature of the estate tax, i.e., the dollars used to pay the GST tax are subject to the GST

5 For GST tax purposes, “[t]he term ‘trust’ includes any arrangement (other than…[a probate] estate) which, although not a trust, has substantially the same effect as a trust.” IRC section 2652(b). For example, life insurance proceeds that are payable over time by the life insurance company constitute a trust arrangement. Treas. Reg. §26.2652-1(b)(1). Property held in a custodial arrangement (such as an UGMA or UTMA account) for the benefit of a skip person is a trust arrangement. Treas. Reg. §26.2652-1(b)(2), Example 1.

6 IRC section 2652(c) defines what constitutes an “interest” in trust property for GST tax purposes. It is important to know who holds an “interest” in a trust for purposes of determining whether the trust is a skip person, and for purposes of determining if a taxable termination has occurred. A taxable termination may be postponed if a nonskip person has an “interest” in the trust as long as possible. However certain “interests” are disregarded for GST purposes, including certain discretionary interests of charitable beneficiaries, and interests that are used primarily to postpone or avoid the GST tax. IRC section 2652(e).

7 But see, Treas. Reg. §26.2652-1(b), Example 3, which takes the position that a bequest payable under a transferor’s will is treated as a “transfer in trust” if the identity of the transferee is contingent upon the occurrence of an event (such as the transferee’s survival) that will not necessarily occur within six months of the transferor’s death.
Because the GST tax is calculated on a tax-inclusive basis, this has the effect of approximating the result of the property being subject to estate tax in the estate of the skipped person. The trustee of the trust is liable for paying the GST tax, which is paid from the assets giving rise to the taxable termination. IRC section 2603(a)(2); Treas. Reg. §26.2662-1(c)(1)(ii).

§13.3(a)(1) Meaning Of Tax-Inclusive Basis

Being on a “tax-inclusive” basis means that GST tax is paid not only on the transfer giving rise to the GST tax, but also on the GST tax actually paid as a result of the transfer—a tax on a tax. In other words, the dollars used to pay the GST tax are subject to the GST tax and are part of the transferred property’s tax base. At the 50 percent tax rate, the cost in transfer taxes for an inter-vivos direct skip is “only” 125 percent of the amount actually received by the skip person, which is the least costly method of making taxable GSTs. This is because an inter-vivos direct skip is taxed on a tax-exclusive basis, which the transferor is responsible for paying. Being on a tax-exclusive basis means that the GST tax is paid only on the transferred property and not on the dollars used to pay the GST tax. However, because of the tax-inclusive nature of the federal estate tax, direct skips at the transferor’s death, direct skips from a trust, taxable distributions, and taxable terminations from trusts created during the transferor’s lifetime generally result in transfer taxes of 200 percent of the amount actually received by the skip person. The most expensive form of GST transfers are taxable terminations or taxable distributions occurring from trusts established at the transferor’s death that are subject to federal estate tax. In those instances the total transfer tax cost (at a 50 percent GST and 50 percent federal estate tax rate) to transfer $1 million to a skip person is 300 percent of the amount actually received by the skip person, to wit, $4 million devise $1 million = $3 million (in other words, to be able to pay $1 million plus the $500,000 GST tax ($1.5 million), it is necessary to start with twice that amount because of the 50 percent estate tax). Transfer taxes (estate and GST taxes) will total $2 million, which amounts to 200 percent of the amount ($1 million) transferred to the grandchild. Thus, it will take $3 million to transfer $1 million to the grandchild.

Example (Direct Skip During Transferor’s Lifetime): Grandfather makes an inter-vivos transfer gift of $1 million to his grandchild. No applicable exclusion amount credit and no GST tax exemption are available for allocation to the gift. The total cost of the transfer will be $2.25 million. Transfer taxes will total $1.25 million, computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gift tax on $1 million gift</td>
<td>$500,000 (Paid by grandfather)</td>
</tr>
<tr>
<td>GST tax on $1 million gift</td>
<td>$500,000 (Paid by grandfather)</td>
</tr>
<tr>
<td>Gift tax on $500,000 GST tax</td>
<td>$250,000 (Paid by grandfather)</td>
</tr>
<tr>
<td>Total transfer taxes</td>
<td>$1,250,000</td>
</tr>
</tbody>
</table>

Total transfer taxes ($1.25 million) amount to 125 percent of the amount ($1 million) gifted to the skip person. Thus, it will take $2.25 million to transfer $1 million to the grandchild. (The GST tax paid by grandfather will be removed from the grandfather’s death-time taxable estate, as will the gift tax paid by the grandfather (assuming he lives for more than three years after the gift (IRC section 2035(b))), ultimately saving 50 percent of the lifetime transfer taxes paid.)

Example (Direct Skip At Transferor’s Death): Grandfather devises $1 million to his grandchild. No applicable exclusion amount credit and no GST tax exemption is available for allocation to the devise. The total cost of the transfer will be $3 million. The formula is: [(1 million (devise) + $500,000 (GST tax))/1-.50 (where .50 is the applicable federal estate tax rate) = $3 million (in other words, to be able to pay $1 million plus the $500,000 GST tax ($1.5 million), it is necessary to start with twice that amount because of the 50 percent estate tax). Transfer taxes (estate and GST taxes) will total $2 million, which amounts to 200 percent of the amount ($1 million) transferred to the grandchild. Thus, it will take $3 million to transfer $1 million to the grandchild.
Example (Taxable Termination From Trust Established During Transferor’s Lifetime):
Grandfather gifts $2 million in trust with income only to his only son and remainder to his sole grandchild. The grandfather desires the grandchild to receive $1 million net of all transfer taxes. No applicable exclusion amount credit and no GST tax exemption are available for allocation to the inter-vivos gift. The total cost of the transfer taxes will be 200 percent of the $1 million amount received by the grandchild. The total cost of the transfer will be $3 million. Transfer taxes will total $2 million, computed as follows:

\[
\text{Gift tax on $2 million gift} = 1,000,000 \text{ (Paid by grandfather)} \\
\text{GST tax on $2 million termination} = 1,000,000 \text{ (Paid from the gifted funds)} \\
\text{Total transfer taxes} = 2,000,000
\]

Total transfer taxes ($2 million) amount to 200 percent of the amount ($1 million) received by the skip person. Thus, it will take $3 million to transfer $1 million to the grandchild. (The gift tax paid by the grandfather (assuming he lives for more than 3 years after the gift (IRC section 2035(b)), will be also removed from the death-time taxable estate, ultimately saving 50 percent of the gift tax paid.)

Example (Taxable Termination From Trust Established At Transferor’s Death):
Grandfather devises $2 million in trust with income only to his only son and remainder to his sole grandchild. No applicable exclusion amount credit and no GST tax exemption are available for allocation to the devise. Estate tax of $2 million will be paid at death on the $4 million needed to pay the tax, leaving a $2 million bequest. Another 50 percent GST tax ($1 million) is due at the taxable termination, leaving $1 million to the grandchild. The total cost of the transfer taxes will be 300 percent of the remaining amount received by the grandchild. The formula is: \( \frac{[1 \text{ million (remaining devise)} + 1 \text{ million (GST tax)}]}{1-.50} \) (where .50 is the applicable federal estate tax rate) = $4 million. Transfer taxes (estate and GST taxes) will total $3 million, which amount to 300 percent of the amount ($1 million) transferred to the skip person. The total amount transferred is $4 million for a $1 million distribution to the grandchild.

§13.3(b) Simultaneous Terminations

Simultaneous termination of two or more interests creates only one taxable termination. Treas. Reg. §26.2612-1(b)(3), (f), Example 8 (redesignated per T.D. 9214 (7/18/2005)).

§13.3(c) Change In Identity Of Transferor

Because the estate tax and gift tax supersede the GST tax and determine the identity of the transferor, a transfer from a trust that would otherwise be a taxable termination is not subject to GST tax if the transfer is subject to estate or gift tax. Treas. Reg. §26.2612-1(b)(1)(i).

§13.3(d) Death Of Lineal Descendant

If a portion of a trust is distributed outright to a skip person because of the death of a lineal descendant of the transferor, the distribution to the skip person is a taxable termination (and not a taxable distribution) since there has been a termination of a portion of the trust estate. IRC section 2612(a)(2); Treas. Reg. §26.2612-1(b)(2), (f), Example 9 (redesignated per T.D. 9214 (7/18/2005)).

§13.3(e) Reporting Requirements

Taxable terminations must be reported by the trustee, even if the taxable termination has an inclusion ratio of zero and does not generate any GST tax. The trustee must file IRS Form 706-GS(T) (Generation-Skipping Transfer Tax Return For Terminations) and pay any GST tax that may be owing. Treas. Reg. §26.2662-1(b)(2).