AUTOMATIC ALLOCATION OF GST EXEMPTION,
NEW 9100 RELIEF, AND
QUALIFIED SEVERANCES

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SCOPE OF OUTLINE:

This outline only addresses three GSTT changes made by the Economic Growth and Tax Relief Reconciliation Act (the “Act.”)

I. The Act’s Expanded Automatic Allocation of GST Exemption.

A. **Automatic allocation to GST trusts.** New I.R.C. § 2632(c) expands the automatic GST exemption allocation rules to trusts for which GST exemption is likely to be desirable. These trusts are referred to in the new law as “GST trusts.” Transfers to these kinds of trusts are called “indirect skips.” Any unused portion of a transferor’s GST exemption will be allocated to property he or she transfers during his or her lifetime in an indirect skip to the extent necessary to make the inclusion ratio for the property zero. For this purpose, an indirect skip subject to the ETIP rules of § 2642(f) is deemed to have been made at the close of the ETIP. The fair market value of a transfer subject to the ETIP rule is the fair market value of the trust property at the close of the ETIP.

1. **Not available at death.** The new rule does not apply to transfers at death.

2. **Not mandatory.** A transferor may elect, on a timely-filed gift tax return for the year in which the transfer was made or deemed to have been made (or on such later date or dates as may be prescribed by the Treasury Secretary), not to have the automatic allocation rules apply to a particular transfer.

3. **Applicability.** The provision applies to transfers subject to gift tax made after December 31, 2000, and to transfers, whenever made, that are subject to estate tax inclusion periods or ETIPs ending after December 31, 2000.

4. **Only GST trusts.** Whether the new automatic allocation applies to a particular transfer depends on whether the trust meets the definition of a GST trust. GST trusts will have an automatic allocation of GST exemption; non-GST trusts will not.
5. **GST trust defined.** The term “GST trust” is defined broadly as a trust that could have a generation-skipping transfer with respect to the transferor. Because most trusts have some generation-skipping transfer potential, this definition, standing alone, would likely include many trusts to which it would be inappropriate to allocate GST exemption. In an effort to narrow the definition so that inappropriate allocations are excluded, the new section provides six exceptions to the general definition.

a. A trust is not a GST trust if the trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more non-skip persons before that individual reaches 46 years of age, on or before one or more dates specified in the trust instrument that will occur before such individual attains 46 years of age, or upon the occurrence of an event that (in accordance with Treasury regulations) may reasonably be expected to occur before the date that such individual attains age 46. For example, a trust that will terminate in favor of its beneficiary when the beneficiary reaches age 45 would fit within this exception. Because most individuals reach age 45, no more than 75% of a trust that fits within this exception is likely to be exposed to the generation-skipping transfer tax. This exception to the automatic allocation rules reflects the drafters’ conclusion that most individuals would not want to allocate GST exemption to a trust if more than 25% of it was not likely to be subject to the GST tax.

b. A trust is not a GST trust if the trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more non-skip persons who are living on the date of death of another person identified in the instrument (by name or by class) who is more than ten years older than such individuals. For example, a trust that will terminate in favor of a beneficiary on the death of one of the beneficiary’s parents would fit within this exception to the automatic allocation rules. Because most individuals outlive other individuals who are ten or more years older, this exception, like the exception described in paragraph (a) above, applies to a trust if 25% or more of the trust is not likely to be subject to the GST tax.

Neither this paragraph (b) exception nor the one that is described in paragraph (a) applies to the following common type of trusts: (1) a trust that provides for a parent and his or her child or children until the parent’s death and then holds the trust property in further trust until the child reaches a specified age, with an outright distribution of the property thereafter, or (2) an insurance trust that provides for
distribution of the trust property on the later of the insured’s death or when the insured’s child reaches a specified age. These type of trusts do not fit within the exception described in paragraph (a), because the death of an individual’s parent, in most instances, may not reasonably be expected to occur before the child reaches age 46. It also does not fit within the exception described in paragraph (b), because no portion of the trust property would be distributed to the child at the death of the parent unless the child had already reached the specified age. Because these trusts are not described in either paragraph (a) or (b), and assuming that none of the other exceptions apply, the trusts would be GST trusts and GST exemption would be allocated automatically. The oldest child’s attainment of the specified age could, if his or her share is 25% or more, cause the trust to shift from a GST trust to a non-GST trust at some point, and the automatic allocation would not apply to transfers to the trust that occur after that event. Because most individuals outlive their parents and reach age 46, if the specified age is younger than age 46, it is likely that most transferors would not want to allocate GST exemption to the trust. When that is the case, and the trust is classified as a GST trust, the donor should elect out of the automatic allocation. Further, if the insurance trust provided for the payment to the child at the later of the death of the insured and the insured’s spouse, it is unclear whether the exception described in paragraph (b) would apply, because the death of more than one person who is more than ten years older would be involved.

c. A trust is not a GST trust if the trust instrument provides for mandatory distribution of more than 25% of the trust corpus to the estate or estates of, or subjects such corpus to a general power of appointment held by, one or more such non-skip persons if one or more of such non-skip persons dies on or before a date or event described in paragraphs (a) or (b) above.

d. A trust is not a GST trust if any portion of it would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer. Without more, this exception would apply to any trust with annually lapsing withdrawal rights (generally referred to as “Crummey powers”) held by non-skip persons, such as the spouse or a child of the transferor. Because many trusts that grant these powers are likely to give rise to generation-skipping transfers, an exception to this automatic allocation exceptions provides that the value of transferred property is not 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 annual exclusion amount referred to in I.R.C. § 2503(b), currently $11,000, with respect to any transferor. Thus, a Crummey trust with withdrawal rights of $11,000 or less per transferor and that does not fall within any of the other exceptions will be a GST trust and the automatic allocation will occur.

This exception to the exceptions, however, does not seem to reach trusts with so-called “hanging powers.” Hanging powers are powers that lapse each year only to the extent that the lapse will not cause the power holder to be treated as having made a taxable gift. For any transfers made at a time when the total amount that may be withdrawn is greater than $11,000 with respect to any transferor, the trust will meet the paragraph (d) exception and thus will not be a GST trust for those transfers. Thus, in the first year that transfers are made, if the amounts that could be withdrawn are within the $11,000 exclusion amount, the trust will be a GST trust and the automatic allocation will apply. In the second year, the continuation of a portion of a power from one year to the next will give the power holder, if the transferor makes a $11,000 gift in the second year, the right in the second year to withdraw an amount in excess of the amount referred to in I.R.C. § 2503(b). The trust will no longer be a GST trust and no automatic allocation will apply. Obviously, the automatic allocation rules should not be relied on in this situation as inconsistent results can occur from year to year.

e. A trust is not a GST trust if it is a charitable lead annuity trust, charitable remainder annuity trust, or a charitable remainder unitrust.

f. A trust is not a GST trust if it is a charitable lead unitrust the noncharitable beneficiary of which is a non-skip person.

To ease the administrative burden of annually electing out of the automatic allocation rules if a transferor does not want GST exemption allocated to a particular trust, I.R.C. § 2632(c) permits transferors to elect to have the automatic allocation rules not apply to any or all transfers made by such individual to that trust. It also permits transferors to elect to treat any trust as a GST trust, whether or not it fits within the definition of a GST trust, with respect to any or all transfers made by the individual to such trust. These elections must be made on a timely filed gift tax return for the calendar year for which the election is to become effective.

A. Reasons for change. According to the House Report, the “Committee recognizes that there are situations where a taxpayer would desire allocation of generation-skipping transfer tax exemption, yet the taxpayer had missed allocating