NORTHERN TRUST

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Northern Trust Corporation

LUCKY NUMBER 13: THE GST TAX AND RIGHTING 13 WRONGS

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STEVE BONNEAU
Senior Tax Counsel

BAD RAP. CRAZY TALK. URBAN MYTH.

That's how I would classify most of the things said about Subtitle B, Chapter 13 of the Internal Revenue Code, also known as the Generation-Skipping Transfer Tax (the "GST" tax, sometimes affectionately referred to as "Chapter 13" in this article). Forty plus years following the GST tax's introduction into the tax code and the hits still keep coming. You've heard the list of complaints (and even might have voiced them yourself). It's too complicated. It's nonsense. It's frightening. Get rid of it, along with the "death tax." If the GST tax had a social media presence, it would not have many likes.

Well I hear you, naysayers, and I think you got it all wrong. Too complicated? I say the GST tax is rich and nuanced in its application. Nonsense? I call it misunderstood. While I am just a humble tax lawyer with no professional training in psychology, I know that fear is often rooted in a lack of knowledge and understanding. So there's no need to think that the GST tax is incomprehensible. Yes, the maximum rate applied to GST transfers is high (currently 40%), but a high rate doesn't necessarily mean high complexity. Instead, let's get to know the GST tax a little better by getting comfortable with some of its key provisions. In doing so, I've identified several false assumptions — thirteen actually—made about the GST tax (because of my fondness for this Chapter of the Internal Revenue Code and the number itself, I've settled on thirteen false GST assumptions). After setting the record straight and righting these wrongs, I am confident you will have better luck understanding Chapter 13.

FALSE ASSUMPTION 1

YOU DON'T HAVE TO PAY GST TAX IF GIFT OR ESTATE TAX WAS PREVIOUSLY PAID ON A TRANSFER OF THE SAME PROPERTY

I know many individuals whom I would describe as a "character." I typically say that they are "their own person." Well, the same can be said for the GST tax. The GST tax is its own tax.[1] As such, it is separate and distinct from the other two wealth transfer taxes under Subtitle B of the Internal Revenue Code, the estate and gift taxes, the GST tax's older siblings. And just as you start to understand someone better after meeting their family and learning where they came from, the GST tax is best understood when you learn that it literally has got its older sibling's backs. You see, the GST tax is imposed on transfers of wealth that skip a generation with respect to the estate or gift tax. So if a transfer is designed to avoid gift or estate tax at a particular generation's level (for example, at the level of a donor's child who possesses a beneficial interest in a trust but does not possess any power over the trust which would otherwise cause it to be includible in the child's estate at death), then the GST tax steps in where its transfer tax sibling should have been. The result is that the GST tax is imposed at the time when the property shifts to a subsequent generation.[2] For a trust, this will typically occur when a beneficiary dies, since death causes a beneficiary's interest in trust to terminate.

Transfers, however, are often made outright rather than in trust. If an outright transfer skips one or more generations between the transferor and recipient (for example, a grandparent's gift of cash to a grandchild, bypassing the transferor's child), the GST tax is imposed at the time when the intervening generation is skipped (in this case, when the child's generation is skipped).[3] And just because a transfer of property was initially subject to gift or estate taxes doesn't mean that the same property cannot later be subject to GST tax in succeeding generations, since the tax applies to the generation that should have been subject to estate or gift tax with respect to the property, not the property itself. Yet while the GST tax is a discrete wealth transfer tax, it can never completely separate itself from the others. Rather, it will always be linked to, and following in the footsteps of, its older transfer tax siblings.

FALSE ASSUMPTION 2

ALL TRANSFERS TO OR ON BEHALF OF A SKIP PERSON ARE SUBJECT TO THE GST TAX

There are lots of rules in life. Chapter 13 is full of them. One of these rules is that Chapter 13, given its exclusionary nature, is only concerned with two types of people: skip and non-skip persons.[4] Your status as a skip or non-skip person is always determined with respect to the transferor (the person transferring the property). If you are lucky to ever have received a gift from someone, then you fall into one of these two categories. The GST tax, however, only applies to transfers to skip persons.[5] Therefore, we are particularly concerned with identifying skip persons, because that's where the liability lies.

Skip persons are either individuals or trusts.[6] With respect to individuals, we have two additional subcategories: relatives and non-relatives. An individual related to the transferor is a skip person if that individual's generational assignment is at least two or more generations below the transferor (for example, a grandchild or remote descendant).[7] For non-relatives, if an individual is at least 37½ years younger than the transferor, then the individual is also a skip person.[8] Finally, a trust can also be a skip person if all current beneficial interest holders are skip persons (after identifying the current beneficiaries as relatives or nonrelatives).[9] As previously stated, one's status as a skip or non-skip person is determined with respect to the transferor, and the test is always binary: you are either one or the other. If you are a skip person, then the GST tax generally applies to transfers made directly to you or on your behalf. But there are exceptions (as there are bound to be with any rule).

Not to be pedantic, but what we are really talking about are exclusions rather than exceptions. There are two big exclusions with respect to the gift and GST tax. The first is the medical and education expense exclusion. Internal Revenue Code §2503(e) discusses certain "qualified transfers" which are considered nontaxable gifts. Qualified transfers, for purposes of §2503(e), include payments for tuition (and only tuition) and medical care made directly to the educational or medical care provider on behalf of an individual. The relationship or age of the individual is irrelevant. Since these qualified transfers are nontaxable gifts, they also are nontaxable for GST tax purposes (since the GST tax can only be imposed on transfers that are first subject to gift or estate tax). So, if a grandparent pays the tuition for her grandchild's education (a skip person with respect to the grandparent), the transfer will not be subject to gift and GST tax (despite being made on behalf of a skip person) as long as the tuition payment was made directly to the school.

One cannot survive on tuition alone. If a grandparent makes a cash gift directly to her grandchild (to cover the cost of books and supplies), then that transfer will not be subject to gift and GST taxes so long as the amount transferred is below the annual exclusion for gifts under Internal Revenue Code §2503(b). The annual exclusion for gifts represents the nontaxable amount of a transfer to an individual. The GST tax also has its own annual exclusion, tied to the same amount as the annual exclusion for gifts.[10] But don't assume that all transfers qualifying for the annual exclusion for gifts also qualify for the GST annual exclusion. This is certainly the case for transfers made directly to an individual. However, it would be a big mistake to assume the rules are the same with respect to transfers to trusts. So don't transfer like its 1988 (when the rule changed with respect to qualifying transfers to trusts for the GST annual exclusion), and keep reading if you want to learn more about the disconnect between the annual exclusion for gifts and the GST annual exclusion when making transfers to trusts.

FALSE ASSUMPTION

3

IF A TRANSFER QUALIFIES FOR THE ANNUAL EXCLUSION FOR GIFTS, THEN IT ALSO QUALIFIES FOR THE GST ANNUAL EXCLUSION

The 1980s were great for many reasons: the television shows; the music; and, yes, the tax legislation. The Tax Reform Act of 1986, signed into law on October 22, 1986, was the last enactment of a tax code, despite the changes in the tax law that have occurred since then (most recently in 2017). In fact, a proper citation to our tax code is accomplished by referencing the Internal Revenue Code of 1986, as amended. Even though the GST tax was only a decade old in 1986, legislators decided it was already time for a makeover. As a result, the Tax Reform Act of 1986 contained the retroactive repeal of Chapter 13, originally introduced under the Tax Reform Act of 1976, and the reintroduction of the GST tax within Chapter 13 as we know it today.

The GST annual exclusion under the 1986 Tax Act mirrored its counterpart under Internal Revenue Code §2503(b), which required the recipient to possess a present interest in the transferred property. But things changed after March 31, 1988. For transfers to trusts occurring after March 31, 1988, not only must the beneficiary have a present interest in the property transferred (often accomplished by granting the beneficiary a "Crummey" withdrawal power), but the trust must also be a vested interest, direct skip trust.[11] In order for a transfer to a trust to qualify for the GST annual exclusion, only one skip person can have an interest in the trust, and the trust property must vest in the skip beneficiary.[12] Vesting can be accomplished for tax law purposes (by being includible in the skip person's estate at death due to the possession of a testamentary general power of appointment over the trust property) or property law purposes (with the trust's assets being distributed to the skip person's estate at death). Rules are rules, and Chapter 13 is full of them. So do not be fooled by the fact that the amounts of the annual exclusions for gift and GST purposes are the same. Even though each moves in lockstep with the other as the amounts adjust for inflation, their paths diverge when a transfer to a trust occurs.

FALSE ASSUMPTION

4

TRANSFERS TO TRUSTS WHERE BOTH SKIP AND NON-SKIP PERSONS HAVE AN INTEREST ARE IMMEDIATELY SUBJECT TO GST TAX

I like people who are direct with me. I also like taking direct flights with no layovers on my way to my final destination. And while you can choose to handle your interpersonal relationships and travel plans head on or, conversely, in a more circuitous fashion, lifetime transfers to trusts for GST tax purposes can either be direct (in the form of a direct skip) or indirect (aptly referred to as an indirect skip). A direct skip is a transfer made to a skip person and is subject to both gift and GST tax at the time of transfer.[13] An indirect skip, conversely, is a lifetime transfer to a "GST trust" subject only to gift tax.[14] A "GST Trust" is a defined term under Internal Revenue Code §2632(c), which does not include any trust that is a skip person.[15] So an indirect skip involves a lifetime transfer of property to a trust where both skip and non-skip persons have a beneficial interest. These multigenerational trusts, however, must be closely monitored. Although no GST tax is due at the time of the initial transfer, that same transfer may later produce a generation-skipping transfer (specifically, a taxable distribution or taxable termination). The generation-skipping transfer might occur one year, or twenty years, following the initial transfer that was subject to gift tax. So keep a close eye on these multigenerational trusts because they are full of GST potential (call them tax overachievers).

FALSE ASSUMPTION 5

ONCE AN INDIVIDUAL'S STATUS AS A SKIP PERSON IS DETERMINED, IT CAN NEVER CHANGE

We all know people who put on a different face depending on the circumstances. In Roman religion and mythology, Janus, the god of beginnings and endings, is often pictured as two-faced, one looking to the past and the other looking to the future. This concept of duality is also present within Chapter 13, and its purpose is fairness. To prevent the same generation from being subjected to GST tax on multiple occasions with respect to a single transfer of property, the transferor "move down" rule will apply. This rule applies following a generation-skipping transfer, and only if the transferred property continues to be held in a trust after that generation-skipping transfer.[16] For example, assume a grandmother makes a lifetime transfer to a trust for the benefit of her grandchild. The grandchild is the only beneficiary who has a current beneficial interest in the trust. Therefore, the trust is a skip person and the transfer is a direct skip.[17] This lifetime transfer is subject to both gift and GST taxes. Following this transfer, the property continues to be held in trust, subject to its terms. If the trustee subsequently makes a discretionary distribution of income or principal to the grandchild, you might think that GST tax would again be due on this distribution. The beneficiary is a skip person with respect to her grandparent, right? True; but without making some adjustment for the prior GST tax paid, the result would be unfair. Looking back to the original transfer, the grandchild was in fact a skip person. However, looking forward with respect to all future distributions, the grandchild will now be treated as a non-skip person. How is this generation shift accomplished? The grandchild still literally occupies the same place in the family tree with respect to her grandmother. Under Internal Revenue Code §2653, however, the transferor's generational assignment with respect to her grandchild shifts downward to the generation that is one generation above her grandchild's generation for GST purposes. As a result of this fiction whereby the grandparent climbs down the family tree to a branch that is one above her grandchild, the grandchild is no longer considered a skip person with respect to her grandparent. Subsequent transfers of trust property attributable to the original direct skip will not be subject to GST tax. So as it turns out, generational assignments are not set in stone. But this is not necessarily a bad thing, since no one likes to pay double tax, and almost everyone likes to feel a little younger. For GST tax purposes, grandma just found the fountain of youth.

FALSE ASSUMPTION 6

THE PREDECEASED PARENT RULE APPLIES WHENEVER THE PARENT OF A DESCENDANT DIES

As we know from false assumption #5 above, an individual's generational assignment is dynamic, and may change over time depending on the type of event that occurs. There is one more rule that causes a shift in the generational assignment of an individual, but this time it applies to the recipient of the transferred property (also known as the donee). The predeceased parent rule causes the generational assignment of the donee to move-up to the generational assignment of his or her deceased parent, so long as the donee is a lineal descendant of the parent of the transferor (translation: the rule applies to both lineal descendants and collateral relatives of the transferor, encompassing the descendants of the transferor (for example, grandchildren) and those relatives descended from a sibling of the transferor (grandnieces and grandnephews).[18] However, these collateral heirs of a transferor are counted for purposes of the predeceased parent rule only if the transferor has no descendants of his or her own.[19] Most importantly, in order for the predeceased parent rule to apply, the parent of the donee who is also a descendant or collateral relative of the transferor must be deceased at the time of the transfer.[20]

Let's assume a parent ("Parent") transfers $1,000,000 to a trust this year for the current benefit of his only child ("Child"), with the remainder passing to Child's daughter ("Grandchild") at Child's death. If Child dies unexpectedly next year, Grandchild would not get the benefit of the predeceased parent rule and move up to the generation occupied by his deceased parent, Child, with respect to the $1,000,000 previously transferred to the trust. Child was alive when the initial transfer to the trust was subject to gift tax. Therefore, the predeceased parent rule cannot apply to Grandchild with respect to Parent's $1,000,000 transfer. But if Parent wants to make an outright gift to Grandchild after Child's death, Grandchild will receive the benefit of the predeceased parent rule for those transfers and, as a result, will not be considered a skip person with respect to Parent. Even though we might all like to be forever young, many won't object to being deemed to occupy a higher generation than we actually occupy within the family tree if it will save us a lot in taxes. Don't worry — it's just another tax fiction. Chapter 13 is full of them. You still look marvelous.

FALSE ASSUMPTION 7

EVEN IF YOU DO NOT FILE A GIFT TAX RETURN TO ALLOCATE GST EXEMPTION TO A LIFETIME TRANSFER, THE AUTOMATIC ALLOCATION RULES FOR GST EXEMPTION WILL STILL APPLY

GST exemption is available to taxpayers to reduce or eliminate the amount of GST tax that may be due on a generation-skipping transfer.[21] The GST exemption is $10,000,000, indexed for inflation. In 2019, the GST exemption is $11,400,000.[22] GST exemption can be affirmatively allocated to a lifetime transfer on Form 709, which is the United States Gift (and Generation-Skipping Transfer) Tax Return ("Gift Tax Return"). However, if one makes a lifetime transfer but does not file a Gift Tax Return (and hence does not affirmatively allocate GST exemption), there may be a safety net in place to reduce or minimize the GST tax due on the transfer of property (either currently with respect to a direct skip or in the future in the case of an indirect skip). The safety net is the automatic allocation rules for GST exemption. But be careful, because these automatic allocation rules are so technical (as if the rest of Chapter 13 is not); therefore, these rules will not apply to every transfer unless the transfer squarely fits within the bounds of these troublesome rules. The good news is that the automatic allocation rules for GST exemption will always be there for direct skips (both occurring during lifetime and upon death), applying the transferor's available GST exemption first to the direct skip.[23] For example, if an individual transfers $15,000 to a trust in 2019 for the individual's grandchild in a transfer that qualifies for the gift tax annual exclusion — but not the GST annual exclusion — and does not file a Gift Tax Return (because the transfer is nontaxable for gift tax purposes), then the automatic allocation rules for GST exemption will apply to allocate $14,000 of the individual's available GST exemption to the trust. Therefore, the safety net was in place to prevent GST tax from being due on the direct skip. However, the automatic allocation rules for lifetime indirect skips will only apply to transfers to "GST Trusts."[24] "GST Trust" is arguably the most complicated definition found within Chapter 13. A "GST Trust" is defined as a trust that could have a generation-skipping transfer with respect to the transferor (hint: think taxable distribution or taxable termination).[25] The definition, however, has six exceptions, and one exception to an exception. And just because you meet the definition of a "GST Trust" in one year does not mean that the trust will always be treated as a "GST Trust" for purposes of the automatic allocation rules (absent an affirmative election, which can be done). Therefore, exercise caution when relying on the automatic allocation rules for lifetime transfers to an indirect skip. They may turn out to be either friend or foe. So what can you do to win these fickle rules over? Well, you can make an affirmative election on a Gift Tax Return to either "opt out" of their application to transfers to trusts that you designate (so that these rules do not apply to a trust to which you make a current transfer or with respect to all current and future transfers you make to that trust) or, instead, "opt in" and elect to have a trust treated as a "GST Trust" for any and all transfers you make to that trust.[26] Having a say with respect to something is usually a good thing, especially when it comes to the GST automatic allocation rules for lifetime transfers.

FALSE ASSUMPTION 8

THE ONLY WAY TO PRODUCE AN INCLUSION RATIO OF ZERO FOR A TRANSFER IS BY ALLOCATING GST EXEMPTION TO THAT TRANSFER

GST exemption allows an individual to reduce or eliminate the GST tax that is, or may later be, due on a generation-skipping transfer. In order to determine the applicable tax rate that will apply to a generation-skipping transfer, one must first know the transfer's inclusion ratio.[27] An inclusion ratio is typically associated with a trust, but also applies to outright transfers that are direct skips.[28] Sticking with trusts, a trust's inclusion ratio is the key transfer tax component with regards to a trust's DNA. The inclusion ratio represents a trust's taxable portion for GST purposes. A trust with an inclusion ratio of zero will never pay GST tax.[29] This is typically due to the fact that the transferor has allocated GST exemption to the property transferred based on the property's fair market value as of the date of transfer. If the property had a fair market value of $100,000 on the date of transfer, to which GST exemption in the same amount was affirmatively allocated on a Gift Tax Return, then the trust's applicable fraction would be one (1). This is arrived at by dividing the amount of GST exemption allocated to the trust ($100,000) by the fair market value of the property transferred ($100,000).[30] The applicable fraction represents the exempt, or nontaxable, portion of the trust (since the numerator is represented by the amount of GST exemption allocated). To determine the taxable portion of the trust, just subtract the applicable fraction from one, which yields the trust's inclusion ratio.[31] In our example, the $100,000 transfer produces a trust with an inclusion ratio of zero (1-1). Any generation-skipping transfer that occurs with respect to this trust will be subject to the GST tax at a rate of zero percent. In order to determine the applicable rate of a generation-skipping transfer, simply multiply the maximum estate tax rate in effect at the time of generation-skipping transfer by the trust's inclusion ratio.[32] In 2019, the maximum estate tax rate is 40%. This rate was unaffected by Public Law 115-97, which was signed into law on December 22, 2017. Since the trust's inclusion ratio in our example is zero, the applicable rate of the generation-skipping transfer gets reduced to zero.

One does not, however, always have to allocate GST exemption to a transfer to produce an inclusion ratio of zero. The one exception applies to transfers to trusts that qualify for the GST annual exclusion. These direct skip transfers have an inclusion ratio of zero by statute.[33] As a result, taking advantage of the GST annual exclusion is a way to preserve one's GST exemption.

FALSE ASSUMPTION 9

ANY UNUSED GST EXEMPTION REMAINING AT THE TRANSFEROR'S DEATH THAT IS NOT AFFIRMATIVELY OR AUTOMATICALLY ALLOCATED IS AVAILABLE TO BE USED BY THE TRANSFEROR'S SURVIVING SPOUSE

Portability is a relatively new concept in terms of estate planning. For estate and gift tax purposes, taxpayers receive a basic exclusion amount.[34] The basic exclusion effectively works to offset taxable transfers made during lifetime or upon death with the assistance of its partner-in-tax, the applicable credit amount.[35] The basic exclusion amount is $10,000,000, indexed for inflation ($11,400,000 in 2019, just like the GST exemption).[36] Yet while the basic exclusion amount and GST exemption each work to reduce tax on transfers of property subject to estate, gift, and GST tax, the basic exclusion amount has something going for it that the GST exemption lacks: longevity. Upon an individual's death, any basic exclusion that is not applied to reduce one's tentative estate tax to zero can be applied (or transferred) to one's surviving spouse.[37] This process, known as portability, is achieved by a simple election made by a decedent's executor on IRS Form 706, which is the United States Estate (and Generation-Skipping Transfer) Tax Return ("Estate Tax Return").[38] By electing portability of a decedent's unused basic exclusion amount, a surviving spouse can augment his or her own basic exclusion by the amount of unused exclusion received from his or her deceased spouse.[39] A decedent's basic exclusion that has been transferred to a surviving spouse is known as the "deceased spousal unused exclusion amount" or "DSUE" amount.[40] So in the estate and gift tax world, the phrase "use it or lose it" does not apply to the basic exclusion amount. In fact, an individual can be survived by his or her basic exclusion. This is not the case, however, for the GST exemption. Portability of unused GST exemption is not available. Therefore, any GST exemption remaining following an affirmative or automatic allocation of GST exemption at death is forever lost. While many spouses might live by the expression "what's mine is yours and what's yours is mine" during their lifetimes, this phrase clearly does not apply to one's GST exemption. There is only one permitted owner of GST exemption during a taxpayer's lifetime (the taxpayer), and the fine print on the GST exemption label reads that such exemption is non-transferable and subject to forfeiture at the taxpayer's death.

FALSE ASSUMPTION 10

IF TIMELY MADE, ALLOCATIONS OF GST EXEMPTION TO LIFETIME TRANSFERS WILL ALWAYS BE EFFECTIVE AS OF THE PROPERTY'S DATE OF TRANSFER

It is arguable whether punctuality is a virtue. Regardless of the general consensus, punctuality can certainly have many benefits. For GST purposes, if one timely files a Gift Tax Return (either by April 15th or, with extension, October 15th, in the calendar year immediately following the year of the taxable transfer) then an allocation of GST exemption is effective as of the date of the transfer.[41] For timely allocations, those hoping to produce an inclusion ratio of zero will allocate GST exemption based on the fair market value of the property on the transfer date.[42] There are, however, certain transfers where an individual retains an interest in the property for a period of time. For example, an individual might transfer property to a Grantor Retained Annuity Trust ("GRAT"), retaining the right to receive a fixed amount in the form of an annuity, paid at least annually, for the duration of the GRAT's term. The fair market value of the property transferred is reduced by the present value of the retained annuity interest in the GRAT.[43] After subtracting out the retained annuity interest, the present value of the remainder interest in the GRAT property is often close to zero, producing a small taxable gift to the GRAT's remainder beneficiaries. If it was possible for an individual to allocate GST exemption to a GRAT based on the value of the remainder interest calculated on the date of transfer, there would be big opportunities to leverage one's GST exemption. This is especially true if it was anticipated that the property would greatly appreciate in value after the transfer date (at a rate greater than the Internal Revenue Code §7520 assumed interest rate for the month of the transfer, which is the interest rate the IRS requires to be utilized when calculating the present value of an annuity). However, the grantor's retained annuity interest causes the transferred property to be includible in the grantor's gross estate under the estate tax rules if the grantor dies during the GRAT's term.[44] So for the duration of the term, it is as if there is an imaginary clock counting down the time remaining until the grantor's retained interest in the GRAT terminates. Therefore, the grantor's transfer to the GRAT is subject to a few transfer tax conditions. First, the transferred property (or rather, any appreciation on the transferred property) is not completely removed from the grantor's gross estate until the grantor survives the term of the GRAT. If the grantor dies during the GRAT term, then some portion of the transferred property will be includible in the grantor's gross estate. Second, if the grantor wishes to allocate GST exemption to the transfer (either affirmatively or pursuant to the automatic allocation rules), the allocation will not be effective until the close of the estate tax inclusion period, or ETIP.[45] With respect to a GRAT, the ETIP covers the time over which the donor retained the annuity interest following the initial transfer. Since the grantor's annuity interest ends on the last day of the GRAT's term, this is when the ETIP terminates. Therefore, this is also the earliest date when the grantor can allocate GST exemption to the GRAT, either affirmatively or automatically.[46] Assuming the property transferred to the GRAT appreciates in value over the GRAT term, the donor must use the fair market value of the GRAT property on the last day of the GRAT's term (representing the remainder interest that has been gifted) if GST exemption will be allocated to the transferred property. So even though a relatively small gift of the remainder interest was made back in the initial year of the transfer, the value of the original gift cannot be used for purposes of allocating GST exemption to the GRAT. This inability to leverage one's GST exemption with GRAT transfers is one reason why GRATs are not often designed to benefit grandchildren and more remote descendants. We cannot all get what we want, even when it comes to some of the provisions of Chapter 13.

FALSE ASSUMPTION

11

THERE IS NO NEED FOR A TRUSTEE TO FILE A RETURN REPORTING A TAXABLE DISTRIBUTION IF THE TRUST IS GST EXEMPT

Repetition can be a good thing for some learners. As previously stated, a generation-skipping transfer only occurs with respect to a skip person. Even though a trust may have an inclusion ratio of zero due to a transferor's allocation of GST exemption, it does not mean that any potential (or actual) generation-skipping transfer will be completely eliminated. Rather, as also stated above, an inclusion ratio can have the effect of a tax antidote when a generation-skipping transfer occurs. Therefore, a trust with a zero inclusion ratio can still be subject to a generation-skipping transfer. When a trust with a zero inclusion ratio experiences a taxable distribution or taxable termination, the applicable rate of the generation-skipping transfer is knocked down to zero.[47] And zero is a tax rate that most taxpayers can live with, so the technical fact that a generation-skipping transfer has occurred should not faze many beneficiaries.

But one thing that might surprise a beneficiary who has received a distribution during the preceding tax year is when Form 706-GS(D-1) arrives in the mail from the trustee of the trust. Form 706-GS(D-1) informs the beneficiary (and the IRS) that a taxable distribution has occurred within a particular tax year. "Wait a minute…I thought the trust was exempt?" is the common response uttered by the surprised beneficiary in receipt of Copy B of Form 706-GS(D-1). While it is true that a trust having a zero inclusion ratio is completely exempt from GST tax, the trust's status as GST exempt or non-exempt does not relieve the trustee from satisfying its tax reporting obligations. So if a trustee decides to make a discretionary distribution directly to a skip person at time when a non-skip person also has a current interest in the trust, a taxable distribution will occur.[48] Granted, the applicable rate that will apply to a trust with a zero inclusion ratio is zero, so no GST tax is actually payable. Pursuant to the instructions to IRS Form 706-GS(D-1), all taxable distributions made to a skip person must be reported to the skip beneficiary and the IRS, regardless of the trust's inclusion ratio.[49] The good news, however, is that since no tax will be due on the distribution, the skip beneficiary will have no further reporting obligations of his or her own (meaning that the reporting obligations ordinarily imposed on a beneficiary receiving a distribution from a non-exempt trust can be skipped). Skipped. Did you see what I did there?

FALSE ASSUMPTION 12

IF A TRUSTEE ELECTS UNDER THE 65-DAY RULE TO TREAT DISTRIBUTIONS MADE IN THE FIRST 65 DAYS OF A TAX YEAR AS HAVING BEEN MADE ON THE LAST DAY OF THE PRIOR TAXABLE YEAR, THEN A TAXABLE DISTRIBUTION MADE WITHIN THIS 65-DAY PERIOD IS DEEMED TO HAVE OCCURRED ON THE LAST DAY OF THE PRIOR TAXABLE YEAR

I elect to discuss one more election. Under Internal Revenue Code §663(b), a fiduciary (either a trustee or executor of an estate) may make an election to treat distributions to a beneficiary occurring within the first sixty-five (65) days following the close of a tax year (Year 2) as if such distributions had occurred on the last day of the preceding tax year (December 31st of Year 1). Commonly known as the "65-day rule," this income tax rule applies to estates and trusts as well as their beneficiaries. By making this election, yet another tax fiction is created. One can pretend that the distribution is subject to income tax in the preceding tax year even though the beneficiary actually received the distribution during the year of the election (Year 2). This rule gives a fiduciary flexibility with regards to shifting income (and the taxes) from a trust or estate to the beneficiary, who just might be in a lower income tax bracket. But what happens if a trustee makes a taxable distribution to a skip person on January 31st of Year 2 while also making an income tax election under §663(b) to treat distributions made within the first 65 days of Year 2 as having been made on December 31st of Year 1? Does this mean that the taxable distribution is also deemed to have occurred on December 31st of Year 1? The answer is no — what's allowed for fiduciary income tax purposes is not also allowed for GST tax purposes. There is no counterpart to the 65-day rule within Chapter 13. As a result, if a distribution from a trust is made to a skip person on January 31st of Year 2, then the generation-skipping transfer has actually occurred on January 31st of Year 2, regardless of any election the fiduciary makes for income tax purposes. Therefore, the beneficiary receiving a taxable distribution on January 31st of Year 2 may have an obligation to file his or her own generation-skipping transfer tax return to report the taxable distribution and pay GST taxes, if any, imposed on the transfer.[50] The skip beneficiary's deadline, however, for filing a return and paying GST tax will fall within Year 3, the year following the calendar year of the generation-skipping transfer.[51] Now might be a good time to take out your calendars to help you keep all of these dates straight.

FINALLY… FALSE ASSUMPTION 13

WHEN A TAXABLE TERMINATION OCCURS, THE ASSETS IN THE TRUST RECEIVE A FULL STEP-UP IN BASIS

Well you did it. You stepped up to the challenge of getting to know the GST tax better. Before we step to the conclusion, let's address the basis adjustment rules when it comes to taxable terminations. Most people are familiar with the phrase "step-up in basis" in the context of the estate tax. When an individual dies, the basis, or cost, of the individual's assets are adjusted to reflect the fair market value of each asset as of an individual's date of death (or the value as of the "alternate valuation date" if an election is made).[52] Hopefully this is an upward basis adjustment, which would reflect the fact that an asset has appreciated in value from the date of acquisition to the date of death. A step-up in basis can reduce or eliminate any gain that will be realized when the asset is subsequently sold. Chapter 13 has its own basis adjustment rules, and some might be surprised by the results in the context of a taxable termination.

Taxable terminations embody the classic principal of causation, whereby one event is the direct result of another. Taxable terminations are generation-skipping transfers resulting from the expiration of a beneficiary's interest in trust.[53] Time can expire in many ways, but a beneficiary's own death is the common cause for putting an end to his or her beneficial interest. If there is not a non-skip person who has an interest in the trust immediately following the death of a current beneficiary, then a taxable termination has occurred.

If a taxable termination is caused by the death of an individual beneficiary, the basis of the trust's property is adjusted in the same manner as under the estate tax rules.[54] But a full step-up in basis is only available for trusts that are completely non-exempt (trusts with an inclusion ratio of one). A fully exempt trust with a zero inclusion ratio experiencing a taxable termination is subject to GST tax at a rate of 0%. Therefore, since no GST tax was due, no basis adjustment is provided. This is different in the context of the estate tax, since one's assets at death are subject to estate tax, yet no estate tax may actually be payable as a result of applying one's applicable credit amount to reduce any potential estate tax. Even though no estate tax may be payable, a basis adjustment is still available.[55] If a trust has an inclusion ratio between zero and one (often known as a mixed inclusion ratio, meaning the trust is partially exempt from the GST tax), the basis adjustment is limited to the extent of the trust's inclusion ratio.[56] For example, suppose a taxable termination occurs with respect to a trust with an inclusion ratio of .50. Assume further that the trust owns one share of stock having a basis of $100, and the fair market value of the stock is $200 on the date of the taxable termination. The step-up in the stock's basis is limited to $50 ($100—the full amount of the increase in basis from date of acquisition to date of termination—multiplied by the trust's inclusion ratio (.50), resulting in an adjusted basis of $150.

Given the number of exceptions and limitations found within Chapter 13, it is probably a smart idea to discuss these matters with someone who handles these issues on a regular…basis. Sorry, but I couldn't resist one final pun.

CONCLUSION

GST

At this point, GST might as well stand for "Get some Tylenol" after reading and pondering all of those false assumptions. And you might have even forgotten at some point along the way that the assumptions were actually false. So let's get our heads straight by ending with a bit of GST redux, restoring these false assumptions so that we instead have the following thirteen correct statements:

1. You may have to pay GST tax even though gift or estate tax was previously paid on a transfer of the same property.
2. Not all transfers to, or on behalf of, a skip person are subject to GST tax.
3. Even though a transfer qualifies for the annual exclusion for gifts, it may not qualify for the GST annual exclusion.
4. Lifetime transfers to trusts where both skip and non-skip persons have a current beneficial interest are only subject to gift tax, but may later be subject to GST tax.
5. An individual's status as a skip person is subject to change.
6. The predeceased parent rule applies when the parent of the donee, who is a descendant of the parent of the transferor, is deceased at the time of the transfer.
7. Even if you don't file a gift tax return to allocate GST exemption to a lifetime transfer, the automatic allocation rules for GST exemption may not apply to that same transfer.
8. A transfer that qualifies for the GST annual exclusion produces an inclusion ratio of zero without using any of one's GST exemption.
9. Portability does not apply to the GST exemption.
10. GST exemption cannot be allocated until the close of an ETIP.
11. A trustee must file a return reporting a taxable distribution whenever the distribution is made to a skip person.
12. The 65-day payment rule does not cause a taxable distribution occurring in the first 65 days of a tax year to be deemed to have occurred on the last day of the prior tax year.
13. When a taxable termination occurs due to the death of a beneficiary, the assets in the trust receive a full step-up in basis only when the trust's inclusion ratio is one.

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As a premier financial firm, Northern Trust specializes in Goals Driven Wealth Management backed by innovative technology and a strong fiduciary heritage. Our Wealth Planning Advisory Services team leverages our collective experience to provide financial planning, family education and governance, philanthropic advisory services, business owner services, tax strategy and wealth transfer services to our clients. It is our privilege to put our expertise and resources to work for you.

If you would like to learn more about these and other services offered by Northern Trust, contact a Northern Trust professional at a location near you or visit us at northerntrust.com.

[1] *Internal Revenue Code ("IRC") §2601*

[2] *IRC §2612(a)*

[3] *IRC §2612(c)*

[4] *IRC §2613*

[5] *IRC §2612*

[6] *IRC §2613(a)*

[7] *IRC §2651(b)*

[8] *IRC §2651(d)*

[9] *IRC §2613(a)(2)*

[1]*0 IRC §2642(c)(3)(A)*

[11] *Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647)*

[12] *IRC §2642(c)(2)*

[13] *IRC §2612(c)*

[14] *IRC §2632(c)(3)(A)*

[15] *IRC §2632(c)(3)(B)*

[16] *IRC §2653(a)*

[17] *IRC §2613(a)(2)*

[18] *IRC §2651(e)*

[19] *IRC §2651(e)(2)*

[20] *IRC §2651(e)(1)(B)*

[21] *IRC §2631*

[22] *IRC§2631(c); P.L. 115-97; Rev. Proc. 2018-57*

[23] *IRC §2632(b)*

[24] *IRC §2632(c)*

[25] *IRC §2632(c)(3)(B)*

[26] *IRC §2632(c)(5)*

[27] *IRC §2642*

[28] *IRC §2642(a)*

[29] *IRC §2641*

[30] *IRC §2642(a)(2)*

[31] *IRC §2642(a)(1)*

[32] *IRC §2641*

[33] *IRC §2642(c)*

[34] *IRC §2010(c)(3)*

[35] *IRC §2010(c)(1)*

[36] *P.L. 115-97; Rev. Proc. 2018-57*

[37] *IRC §2010(c)(4)*

[38] *IRC §2010(c)(5)*

[39] *IRC §2010(c)(2); the applicable exclusion amount is the sum of the basic exclusion and DSUE amounts.*

[40] *IRC §2010(c)(4)*

[41] *Treas. Reg. §26.2632-1(b)(4)(ii)(A)(1)*

[42] *Treas. Reg. §26.2642-2(a)(1)*

[43] *IRC §2702*

[44] *Treas. Reg. §20.2036-1(c)(2)*

[45] *IRC §2642(f)*

[46] *Treas. Reg. 26.2632-1(c)(1)*

[47] *IRC §2641*

[48] *IRC §2612(b)*

[49] *Instructions to IRS Form 706-GS(D-1), page 1*

[50] *IRS Form 706-GS(D)*

[51] *IRC §2662*

[52] *IRC §1014*

[53] *IRC §2612(a)*

[54] *IRC §2654(a)(2)*

[55] *IRC §1014*

[56] *IRC §2654(a)(2)*

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