WRMarketplace
An AALU Washington Report

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TOPIC: Preserving the Family Dynasty - It May Be Best to Go Our Separate Ways: Qualified Severances of Generation-Skipping Transfer ("GST") Trusts.

MARKET TREND: GST planning is the backbone of many irrevocable life insurance trusts ("ILITs"), and making the most of the available GST exemption is the key. Unfortunately, given the complexity of the GST tax, the GST exemption is often wasted or misapplied, resulting in only partial exemption for trusts that were intended to be fully exempt.

SYNOPSIS: GST tax planning is integral to most multi-generational legacy plans. Due to the complexity of the GST tax and related exemption allocation rules, however, many long-term trusts end up only partially exempt from GST tax. This partially-exempt status undermines the original goals of the trust plan and can severely limit the trust's duration. One solution is a qualified severance, which can create one trust that qualifies for full exemption from GST tax and one that does not.

TAKE-AWAYS: The severance of a trust that is only partially-exempt for GST tax purposes into two separate trusts, one fully GST tax-exempt, and the other non-exempt, may be desirable as a means to streamline trust administration, reduce complexity, and potentially free the trustee to engage in different investment and distribution strategies with respect to the resulting exempt and non-exempt trusts. As the process for a severance, however, is highly technical, attached is a checklist providing a basic roadmap.

Many legacy plans involve long-term, "dynasty" trusts. One of the biggest roadblocks to the longevity of these trusts, however, is the GST tax, a flat, 40% tax that can quickly erode the value of trusts that are non-exempt or only partially-exempt from the GST tax. Thus, a major goal for dynasty trust planning will be achieving fully GST-tax exempt status – i.e., ensuring GST exemption has been allocated, as required, to every transfer to the trust. The complexity of the GST tax and exemption allocation rules, however, often results in lapses or errors in exemption allocation. These issues can result in only partially-exempt status for a trust and can generate GST taxation, as well as additional trust administration and distribution concerns. One solution to these concerns is a qualified severance of the trust.

SOME BASIC BACKGROUND

Tax on Transfers to Skip Persons. The GST tax levies a tax upon the transfer of assets to a "skip person" (i.e., an individual who is at least two or more generations below the transferor's generation, such as a grandchild).[1] When the transfer is through a trust that benefits both skip persons and non-skip persons, the GST tax typically applies either (1) to trust distributions made to a beneficiary who is a skip person (a "**taxable distribution**") or (2) when the beneficial interest of the last non-skip person terminates, such as when the last non-skip beneficiary dies (a "**taxable termination**").

GST Exempt Status and Inclusion Ratios. The GST tax applicable to the trust is based on the trust's "inclusion ratio," which determines if a trust is fully-exempt, non-exempt, or partially-exempt from GST tax:

- Fully-Exempt. If sufficient GST exemption has been allocated to cover all transfers to a trust (if and as required under the Code), it should be fully GST-exempt and have an inclusion ratio of zero (0). No taxable trust distributions or terminations should incur GST tax. Generally, fully-exempt status is the most desirable outcome for dynasty trusts.

- Non-Exempt. If **no** GST exemption has been allocated to a trust, it should be non-GST exempt and have an inclusion ratio of (1). Taxable distributions and taxable terminations, if any, will incur a flat, applicable rate of GST tax equal to the top federal estate tax rate (i.e., 40%).[2] Thus, non-exempt trusts generally are designed to benefit non-skip individuals and typically provide for total distribution to the non-skip beneficiary by a certain age or inclusion of the trust assets in his or her estate at death.

- Partially-Exempt. If some GST exemption has been allocated to the trust, but the amount allocated does not cover all transfers required to be covered under the Code, the trust will be partially-exempt, and have an inclusion ratio somewhere between zero (0) and (1), depending on the total gifts made to the trust and the total exemption allocated. In this case, taxable distributions and terminations will be subject to an applicable GST tax based on the inclusion ratio.

Computation of Inclusion Ratio and Applicable GST Tax Rate. The GST tax inclusion ratio is calculated by subtracting the "applicable fraction" (rounded to the nearest .001) from 1. For trusts, the "applicable fraction" generally is the amount of GST exemption allocated to a trust divided by the property transferred to the trust.[3] The GST tax inclusion ratio is calculated by subtracting this applicable fraction (rounded to the nearest .001) from 1. If a trust is partially-exempt, then taxable distributions and terminations from that trust will incur GST tax at an applicable rate equal to the top federal estate tax rate (40%) multiplied by the inclusion ratio.

> ***Simple Example:*** Assume John creates and funds a discretionary trust for the benefit of his descendants with $5,000,000. John allocates $1,000,000 of GST exemption to the transfer on a timely filed gift tax return. A few years later, the trustee distributes $1,000,000 to John's grandchildren, a taxable distribution.
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> The applicable fraction with respect to the trust is .20 ($1,000,000 (the amount of GST exemption allocated to the trust) over $5,000,000 (the value of the property transferred to the trust)). The inclusion ratio is .80 (1 – .20). The applicable GST tax rate to the taxable distribution is .32 (40% top federal estate tax rate x .80). Thus, an estimated GST tax of $320,000 will be due on the trust distribution.

HOW DO TRUSTS BECOME PARTIALLY-EXEMPT?

Partially-exempt status is almost never the intended goal for a dynasty trust. Generally, the client wants fully-exempt status but ends up with a partially-exempt trust through errors with GST exemption allocations to transfers to the trust, which may include:

- Improper Elections/Allocations. The Code provides a set of "automatic allocation" rules for the GST exemption that generally automatically allocate GST exemption to each transfer to a "GST Trust"[4] (many ILITs structured as dynasty trusts should qualify as GST Trusts). These rules were designed to help taxpayers achieve fully-exempt status for their trusts. An issue may arise, however, with so-called *Crummey* withdrawal trusts funded with annual exclusion gifts (**a typical funding structure for ILITs**). Although the gifts qualify for the annual gift tax exclusion, they often do not qualify for the annual GST tax exclusion.[5] If the ILIT is a GST Trust, the automatic allocation rules should allocate the client's GST exemption to the annual exclusion gifts to the trust, providing the trust with fully-exempt status (assuming the client has sufficient GST exemption to cover the gifts).

These automatic allocation rules, however, only apply to "indirect skip" transfers to GST Trusts made after 2000, so older trusts with contributions before and after that time will likely be partially-exempt. Further, many clients don't fully understand these rules or the available elections and often attempt to handle the trust administration themselves, using their family or friends as trustees, instead of relying on accountants or legal advisors to assist with proper administration and tax reporting. Clients may assume the annual funding process merely involves shuffling around "form" *Crummey* letters to potential beneficiaries, without understanding all the potential tax ramifications. And if the clients file their own gift tax returns, they may fail to make proper GST allocations or elections (for example, opting out of automatic allocations), leaving their trusts only partially-exempt.

> ***Example:*** Jack and Jill created a dynasty ILIT for their descendants in 1996 and have funded it annually for 20 years with $40,000 in annual exclusion gifts to pay premiums on a survivorship policy. While the trustee has provided *Crummey* withdrawal notices to the required beneficiaries, Jack and Jill have not filed any gift tax returns allocating GST tax exemption. Thus, although the automatic allocation rules may have applied to automatically allocate GST exemption to their gifts from 2001 and after, no GST exemption has been applied to their gifts from 1996 through 2000.
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> Currently, the applicable fraction with respect to the ILIT is .75 ($600,000 (the amount of GST exemption allocated to the trust) over $800,000 (the value of the property transferred to the trust)). The inclusion ratio is .25 (1 − .75). The applicable GST tax rate to the taxable distribution is .10 (40% top federal estate tax rate x .25). Assume after their deaths and the deaths of their children, a taxable termination occurs on $12 million of trust value. The GST tax would be $1.2 million ($12,000,000 x .10).

- Insufficient GST Exemption. A client may have insufficient GST exemption to fully cover the transfer to a trust. For example, a client may have failed to timely allocate GST exemption to a transfer. Late allocations, however, rely on the value of the transferred assets as of the date of the late allocation, not the date of transfer. If the assets have appreciated in interim, the client may no longer have sufficient GST exemption to fully cover the transfer (and will have lost the opportunity to fully-exempt the trust's growth with just an allocation of GST exemption equal to the value of the initial transfer). The issue also can arise if the IRS subsequently increases the value of the initial gift to the trust. Although a formula allocation of GST exemption can be used to match the exemption allocated to the re-valued gift, if the client has insufficient exemption to fully-exempt the trust at the readjusted value, the trust can become partially-exempt.

  Example: Joe creates a discretionary dynasty trust and funds it with $5 million of interests in his business (valued using significant discounts). He elects to allocate all his remaining GST exemption of $5 million to the transfer. The IRS subsequently revalues the gift at $8 million. The trust is now partially-exempt, with an inclusion ratio of .375 (1 - $5,000,000 / $8,000,000), resulting in an applicable GST tax rate of .15 (40% x .375). If the trust later makes a taxable distribution of $300,000 to a skip beneficiary, a $45,000 GST tax will apply ($300,000 x .15).[6]

  Other possible errors include miscalculation of the amount of the client's remaining GST exemption available for allocation to a gift to a trust (potentially due to the failure to properly track prior automatic allocations to a trust).

WHY DOES IT MATTER

Partially-exempt trusts can cause tax issues, administrative complexities, and complications with distribution and investment strategies. Each trust distribution to a non-skip beneficiary effectively wastes the client's GST exemption, since the distribution would not incur GST tax. On the other hand, each taxable distribution to a skip beneficiary requires calculation and payment of the GST tax due based on the trust's inclusion ratio, which could have been prevented entirely if the trust were fully GST-exempt. Determination of the taxable portion of each distribution also can be a hassle for the trustee, who will be concerned with the accuracy of the calculation and may be dis-incentivized to make distributions to skip beneficiaries because of the potential tax issues. Further, the overall GST tax liability from taxable distributions or terminations could be substantial, requiring the trustee to plan accordingly and possibly impacting the trust's long-term investment strategy.

POTENTIAL SOLUTION – QUALIFIED SEVERANCE

If a client has no further exemption to allocate to a partially-exempt trust in an effort to achieve a zero inclusion ratio, then a potential remedy may be a qualified severance under Code §2642(3)(B). In a qualified severance, a single trust (the "**original trust**") is divided into two or more trusts (the "**resulting trusts**") on a fractional basis. If the original trust is partially exempt, a qualified severance will split the original trust into one fully-exempt trust and one non-exempt trust.

The qualified severance enables the trustee to better preserve GST exemption and plan for the resulting trusts through separation of exempt and non-exempt trust assets, freeing the trustee to engage in different investment and distribution strategies that will benefit future generations.[7] For example, a qualified severance can permit different investment approaches for the fully-exempt resulting trust (which could be concentrated in growth assets) and the non-exempt resulting trust (which may focus on income generation for distributions to non-skip persons).

MAKING A QUALIFIED SEVERANCE

A qualified severance of a trust for GST tax purposes is a highly technical process. Clients will need to work closely with their legal advisor and accountant to ensure all the requirements are met and accurately documented and reported. A summary overview/checklist of the technical requirements for a qualified severance is attached to the end of this *WRMarketplace*.

TAKE AWAYS

The severance of a trust that is only partially-exempt for GST tax purposes into two separate trusts, one fully GST tax-exempt, and the other non-exempt, may be desirable as a means to streamline trust administration, reduce complexity, and potentially free the trustee to engage in different investment and distribution strategies with respect to the resulting exempt and non-exempt trusts. As the process for a severance, however, is highly technical, attached is a checklist providing a basic roadmap.

<u>Qualified Severance of Trust for GST Tax Purposes</u>
<u>Summary/Checklist</u>

To constitute a qualified severance, the trustee must execute a Statement of Division (Severance) to document the trustee's action and the following should occur when dividing the "original" trust into separate trusts ("**resulting trusts**").

Qualified Trust Severance for GST Tax Purposes
<u>Ensure Severance Effective under Local Law</u>.[8] Absent express authority for a trustee to sever a trust under the trust agreement or applicable law, a qualified severance may still be achieved through a judicial order or reformation or any other means available under local law.[9]
<u>Determine Severance Date</u>.[10] The trustee of the original trust may select the severance date, which will also serve as the valuation date for funding the resulting trusts, if the non-pro rata funding method is used (discussed below).[11] For a date to qualify as the severance date, funding must commence immediately upon, and occur within a reasonable time, but in no event more than 90 days before or after the selected severance date.[12]
<u>Divide Original Trust on a Fractional Basis</u>.[13] In a qualified severance, the trustee must sever the original trust on a fractional basis into two or more resulting trusts, totaling 100% of the original trust. The funding of the resulting trusts may be carried out on either a *pro rata* or non-*pro rata* basis (but <u>not</u> on a pecuniary basis -- e.g., $1,000,000 to Trust A and the balance to Trust B).[14] Before severance, the trustee must determine the applicable fraction and the inclusion ratio of the original trust for GST tax purposes. **Note:** If the trustee funds on a *pro rata* basis, each resulting trust will be funded with the applicable percentage of each asset in the original trust, whereas if the trustee funds on a non-*pro rata* basis, each resulting trust must be funded by applying the appropriate fraction or percentage to the fair market value of the original trust assets as of the severance date.[15] Thus, non-pro rata funding requires an appraisal of the original trust assets without consideration for any potential discounts that might result from the split in asset ownership.
<u>Ensure the Same Succession of Beneficial Interests</u>.[16] The terms of the original trust and the resulting trusts must provide, in total, for the "same succession of interests"[17] with respect to beneficiaries (i.e., the beneficiaries of, and their respective beneficial interests in, the resulting trusts collectively must be the same as in the original trust).[18] For discretionary trusts, this requirement is satisfied if: • The terms of each resulting trust are the same as the original trust (even though each permissible distributee of the original trust is not a beneficiary of all of the resulting

trusts); • Each beneficiary's interest in the resulting trusts (collectively) equals the beneficiary's interest in the original trust, determined by the trust instrument or, if none, on a per-capita basis; • The severance does not shift a beneficial interest to any beneficiary in a lower generation than the person or persons who held the beneficial interest in the original trust and does not extend the time for vesting of any beneficial interest beyond that applicable to the original trust.[19]
<u>Determine Inclusion Ratio of Original and Resulting Trusts</u>.[20] If the inclusion ratio of the original trust is either 0 or 1, each resulting trust must have the same inclusion ratio of the original trust. If, however, the original trust has an inclusion ratio between 0 and 1, it may initially be severed only into two resulting trusts, one of which has an inclusion ratio of 0 (fully-exempt), and one which has an inclusion ratio of 1 (non-exempt).[21]
<u>Make Severance in Time</u>. A qualified severance may occur either before or after (i) GST exemption has been allocated to the original trust; (ii) a taxable event has occurred with respect to the trust; or (iii) an addition has been made to the trust, as long it takes place before the taxable termination of the original trust.[22]
<u>Report the Severance</u>. The IRS does not require reporting of a qualified severance, but it is advisable as a best practice to track the change in inclusion ratios with respect to the resulting trusts and to accurately report and reconcile subsequent GST allocations and events. A trustee may report a qualified severance by filing Form 706-GST, "Generation-Skipping Transfer Tax Return for Terminations," with a federal gift tax return, writing "Qualified Severance" at the top of the form, and including a Notice of Qualified Severance which provides information regarding the original trust, the resulting trusts, and their respective inclusion ratios.[23]

NOTES

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DISCLAIMER

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[1] Code §2613(a).

[2] Note, however, that certain transfers to or for skip persons, even if not protected from GST tax by an allocation of GST exemption, will not incur GST tax, such as transfers made directly to a healthcare provider for medical care or to an educational institution for tuition. *See e.g.,* Code § 2503(e).

[3] The denominator is reduced by the sum of: (1) any federal estate tax and any state death tax incurred by reason of the transfer that is chargeable to the trust and is actually recovered from the trust; (2) the amount of any charitable deduction allowed under federal estate or gift tax law (except for charitable lead annuity trusts); and (3) in the case of a direct skip, the value of the portion of the transfer that is a nontaxable gift (for GSTT purposes).

[4] See Code § 2632(c)(3)(B). The term "GST trust" means a trust that could have a generation-skipping transfer with respect to the transferor unless (1) the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons (a) before the date that the individual attains age 46, (b) on or before one or more dates specified in the trust instrument that will occur before the date that such individual attains age 46, or (c) upon the occurrence of an event that, in accordance with regulations prescribed by the Secretary, may reasonably be expected to occur before the date that such individual attains age 46; (2) the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons and who are living on the date of death of another person identified in the instrument (by name or by class) who is more than 10 years older than such individuals; (3) the trust instrument provides that, if one or more individuals who are non-skip persons die on or before a date or event described in clause (1) or (2), more than 25 percent of the trust corpus either must be distributed to the estate or estates of one or more of such individuals or is subject to a general power of appointment exercisable by one or more of such individuals; (4) the trust is a trust any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer, (5) the trust is a charitable lead annuity trust (within the meaning of section 2642(e)(3)(A)) or a charitable remainder annuity trust or a charitable remainder unitrust (within the meaning of section 664(d)), or (6) the trust is a trust with respect to which a deduction was allowed under section 2522 for the amount of an interest in the form of the right to receive annual payments of a fixed percentage of the net fair market value of the trust property (determined yearly) and which is required to pay principal to a non-skip person if such person is alive when the yearly payments for which the deduction was allowed terminate.

[5] To qualify gifts to a trust for the annual GST exclusion, the trust must benefit only one individual during his or her life (who is a skip person for GST tax purposes (*e.g.*, a grandchild)), and the trust assets must be paid to that individual during life or be includible in his or her gross estate at death. Typical ILITs have multiple beneficiaries and are drafted to prevent inclusion of the trust assets in a beneficiary's estate.

[6] Assumes no further GST exemption is allocated to the trust.

[7] *See generally* Jonathan G. Blattmachr and Diana S.C. Zeydel, "Adventures in Allocating GST Exemption in Different Scenarios," 35 Estate Planning Journal, No. 4 (April 2008).

[8] Treas. Reg. § 26.2642-6(d)(2).

[9] Treas. Reg. § 26.2642-6(d)(2). A protective clause under Code § 2642(a)(3) states that "any means available under" local law or the trust instrument will be effective to make a qualified severance.
[10] Treas. Reg. § 26.2642-6(d)(3).
[11] The severance date may also be imposed by a court order for the trustee to fund the Resulting Trusts on or as of a specific date.
[12] Treas. Reg. § 26.2642-6(d)(3). The severance date may also be imposed by a court order for the trustee to fund the Resulting Trusts on or as of a specific date. Note, that, although the 90-day period provides the trustee with some guidance as to the meaning of "reasonable," it should not be considered a safe harbor, as whether a time period is considered reasonable rests largely upon the type of assets involved in the funding the Resulting Trusts (See Treas. Reg. §26.2642-6(j), Ex. 5, which treats a severance of a trust holding only stock in publicly traded companies as qualified when the trustee began and completed funding of the resulting trusts the day after the severance date; *See also* Treas. Reg. §26.2642-6(j), Ex. 11, which notes that, if an original trust contained only marketable securities and cash, then in order to satisfy the reasonable time requirement, the stock transfer and cash distribution to the resulting trusts would have to commence, and generally be completed, immediately after the date of severance). If the Original Trust owns non-publicly traded stock or real estate assets and the trustee intends to fund the Resulting Trusts on a non-*pro rata* basis, the trustee will need to obtain a valuation of the trust assets. Consequently, the actual transfer of assets from the Original Trust to the Resulting Trusts will need to take place after the determination of the severance date and a valuation as of that selected date. Alternatively, if trust assets consist of publicly traded securities, funding would be expected to occur on the date of valuation. This timing provision also recognizes that the expectation of a trustee to value all trust assets, make allocation decisions, and effect the transfer assets to Resulting Trusts on a non-pro rata basis may be impractical and requires consideration of the timeliness of funding on a case by case basis (TD 9348, 8/1/2007).
[13] Code § 2642(a)(3)(B)(i)(I); Treas. Reg. § 26.2642-6(d)(4).
[14] Treas. Reg. § 26.42-6(d)(4).
[15] Treas. Reg. §26.2642-6(j).
[16] Code § 2642(a)(3)(B)(i)(II); Treas. Reg. § 26.2642-6(d)(5).
[17] Treas. Reg. § 26.42-6(d)(5).
[18] Note that, to the extent that applicable state law specifically addresses trust severances, and if the terms of the Original Trust agreement do not specifically provide for differing terms, the terms of the Resulting Trusts may be required to be identical to the Original Trust. Under such circumstances, if it is desirable to sever a trust into trusts with different terms, a judicial reformation may be required. To this point, it may be prudent to provide the trustee with express authority under the trust agreement to sever a trust into two or more trusts with different terms, provided they collectively retain the same beneficial interests as under the Original Trust.
[19] Treas. Reg. § 26.42-6(d)(5).
[20] Treas. Reg § 26.2642-6(j), Ex 4.
[21] Treas. Reg. § 26.42-6(d)(7).
[22] Treas. Reg. § 26.42-6(f). However, with respect to the allocation of GST exemption, for practical purposes, exemption should be allocated to the Original Trust at the time of the transfer or as soon thereafter as possible to ensure the maximum appreciation attributable to the GST exempt portion of the Original Trust may be transferred to the Exempt Resulting Trust at the time of the qualified severance. *See* Code § 2642(b)(1). A timely made allocation of GST exemption to a lifetime transfer is effective as of the date of the transfer based on the federal gift tax value of such transfer (*e.g.,* fair market value). *See also* Treas. Reg. § 26.42-6(f)(2). A qualified severance of a trust is effective only as of the severance date.
[23] Form 706-GS(T) is due on the same date as the federal gift tax return, or timely filed extension, for gifts made during the year in which the severance occurred, or, if no gift tax return is filed, then by April 15th of the year immediately following the year during which the qualified severance occurred. Treas. Reg. §2642-6(e), (k)(2).