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Trusts&Estates

Automatic Allocation Of GST Exemption: Traps for the Unwary

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Dynasty trusts for the benefit of succeeding generations are standard tools in every estate planner's toolkit. Some practitioners and their clients rely on automatic allocation of generation-skipping transfer (GST) tax exemption to these trusts to keep them exempt from GST tax.[1]

Without careful planning, however, the automatic allocation may not take place, making the intergenerational tax savings unavailable.

'Hanging Powers' Trap

One common type of dynasty trust, the so-called Crummey trust, grants beneficiaries a right of withdrawal over contributions (Crummey powers) made to the trust. Crummey powers allow these contributions to qualify for the annual gift tax exclusion by converting what would otherwise be a future interest gift to a present interest gift.[2] Although Crummey powers can avoid gift tax on trust funding, they may result in undesirable implications in the GST context.

A Crummey power is a general power of appointment. It empowers the beneficiary to withdraw trust assets that is not limited by an ascertainable standard.[3] In most cases, the beneficiary powerholder allows this Crummey power to lapse unexercised, which is treated as a gift by the powerholder to the other trust beneficiaries.[4] There is, however, an important statutory exception to this gift tax treatment.

Under the "five-and-five rule," the lapse of a general power of appointment is not treated as a gift to the extent it does not exceed the greater of $5,000 or 5 percent of the aggregate value of the trust assets (the "five-and-five amount").[5] Most practitioners draft trusts with "hanging powers," which provide that in any given year a beneficiary's right of withdrawal continues, or "hangs," with respect to the amount of principal he or she can withdraw in excess of the five-and-five amount, avoiding a gift by the power holder caused by a lapse of the withdrawal power for any amounts in excess of the five-and-five amount. Such amount would be includible in the beneficiary's gross estate if the beneficiary died while the power was still hanging.

The problem from a GST perspective is that the beneficiary's retained hanging power can prevent the automatic allocation of GST exemption to the Crummey trust. Automatic allocation only applies to transfers made to a "GST trust."[6] A GST trust is broadly defined as any trust that could have a generation-skipping transfer occur with respect to the grantor unless it falls within one of six exceptions.[7] Under one of these exceptions, 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 grantor) if such person died immediately after the transfer.[8]

This exception would appear to apply to Crummey trusts in which a spouse, child or other non-skip person holds a hanging power because the amount subject to the hanging power would be includible in such beneficiary's estate. However, to prevent all Crummey trusts from falling outside the definition of a GST trust, the statute provides an exception to the exception: The value of transferred property is not deemed to be includible in the gross estate of a non-skip person to the extent of the annual exclusion amount.[9] Thus, if the hanging power applies to an amount with respect to all non-skip beneficiaries of a Crummey trust that falls within the annual exclusion amount (and the trust does not fall within any of the other five exceptions, which is assumed throughout this article), the trust will be considered a GST trust, resulting in automatic allocation of GST exemption.

While this exception to the exception may qualify a Crummey trust as a GST trust in the first year an annual exclusion gift is made to the trust, it may not qualify as a GST trust in the second year if an additional annual exclusion gift is made at that time. Consider the following example:

Example. In 2013, T transfers $14,000 to a new irrevocable life insurance trust for the benefit of his son, C, remainder to C's (as yet unborn) issue. C is granted a 30-day Crummey withdrawal power with respect to the $14,000 contribution. C allows his Crummey power to lapse unexercised. T makes no other gifts during 2013.

Because C was granted a Crummey power, the entire $14,000 contribution is covered by the annual gift exclusion ($14,000 per donee in 2013). T is not required to file (and he does not file) a Form 709 (gift tax return) for 2013 since he did not make any other gifts that year.[10] Consequently, no affirmative allocation of GST exemption (made on a Form 709) was made to the trust in 2013. Because the amount subject to C's right of withdrawal is within the annual exclusion amount, automatic allocation of GST exemption applies to the trust, resulting in a zero inclusion ratio for the trust at the end of 2013.[11] However, at the end of the 30-day period, $5,000 of C's Crummey power lapses, and the remaining $9,000 hangs.

In 2014, T makes an additional transfer of $14,000 to the trust and makes no other gifts during that year. Again, this contribution is covered by the annual gift exclusion ($14,000 per donee in 2014), and T does not file a Form 709 for 2014. Because C now has a right of withdrawal as to the $14,000 contribution made in 2014 *and* the $9,000 hanging amount carried over from 2013, his total right of withdrawal is $23,000, which is greater than the annual exclusion amount. Consequently, the trust is no longer a GST trust, and the automatic allocation rules will not apply to the gifts made to the trust in 2014.

> One common type of dynasty trust, the so-called **Crummey trust**, grants beneficiaries a **right of withdrawal over contributions** (Crummey powers) made to the trust.

Suppose T makes $14,000 transfers to the trust each year for another 13 years. T does not file a Form 709 with respect to any of these years. When T dies, the trust collects life insurance proceeds of $2 million. Because T's GST exemption was automatically allocated to the trust only in 2013, the inclusion ratio of the trust upon T's death would be 0.9333 (i.e., $1 - (1/15)$). The insurance proceeds are invested during C's lifetime so that at the time of C's death the trust is worth $4 million. Upon C's death, the entire trust estate passes to C's issue, resulting in a taxable termination and a GST tax of $1,493,333 at the applicable 40 percent rate (i.e., $4,000,000 x 0.9333 x 40 percent).

If GST exemption had been allocated on a Form 709 to all gifts to the trust (i.e., a total use of $14,000 x 15 years = $210,000 of T's GST exemption), the trust would have been fully GST exempt. The entire $4 million passing to C's issue would be » Page 14

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exempt from GST tax, resulting in GST tax savings of $1,493,333.

Grantors can make sure that the automatic allocation rules apply by timely filing a Form 709 for the year of the transfer and electing into the automatic allocation of GST exemption for the initial transfer and all subsequent transfers, even if a Form 709 is not otherwise required to be filed.[12]

Practitioners should review trusts with hanging powers for which Forms 709 were not filed in order to determine whether the automatic allocation rules applied to make the trusts GST exempt. If not, clients should consider filing a Form 709 for the purpose of making a late allocation of GST exemption to make the trusts GST exempt.[13]

CGPOA Trap

Many beneficiaries of a dynasty trust are granted a "contingent general power of appointment" (CGPOA) which is deemed applicable only if (a) any trust property would be subject to a GST tax upon the death of the beneficiary and (b) the GST tax is greater than the estate tax that would be imposed if such property were includible in the beneficiary's gross estate.

A CGPOA can be beneficial if a non-skip beneficiary (e.g., a child of the grantor) has only assets of nominal value outside the trust. The deemed applicability of the CGPOA will cause the subject portion of the trust to be included in the beneficiary's gross estate,[14] but the beneficiary's unified credit will avoid any transfer tax on such portion. Importantly, as a result of the deemed inclusion of such property in the beneficiary's gross estate, the beneficiary now replaces the grantor as the transferor of that property for GST tax purposes,[15] thereby avoiding a GST tax on the death of the beneficiary if the subject property passes to a member of the next younger generation.[16] In the absence of this CGPOA, the grantor would have remained the transferor for GST tax purposes, and a taxable distribution or taxable termination in favor of the successor beneficiary would have given rise to GST tax.

Although granting beneficiaries a CGPOA can result in significant GST tax savings, they may give rise to other unintended GST tax consequences. As discussed above, a trust is not a GST trust if any portion of it would be included in the gross estate of a non-skip person if such person died immediately after the transfer. This exception seems to apply to a trust in which a non-skip beneficiary holds a CGPOA and that CGPOA would be deemed applicable if the beneficiary were to die immediately.

Example. In 2013, T establishes a trust for his son, C. Upon C's death, the property remaining in the trust will be distributed outright to C's issue. The trust grants C a CGPOA. When the trust is established, the total value of the trust property is $2 million, and the total value of C's own property outside the trust is $1 million. C has not utilized any of his applicable exclusion amount. A Form 709 is not timely filed reporting T's gift.

To determine whether automatic allocation of GST exemption to the trust will occur, practitioners must assume C's death immediately after T funds the trust to ascertain whether C's CGPOA would be deemed applicable. In this case, it would be: Applicability of the CGPOA would cause inclusion of the trust in C's gross estate to be fully offset by his applicable exclusion amount (i.e., C's taxable estate of $3 million ($1 million of C's own property plus $2 million of the trust's property) would be fully covered by C's applicable exclusion amount). The trust will, therefore, not qualify as a GST trust, and the automatic allocation rules will not apply.

Suppose instead that the total value of C's other property is $5.25 million when T funds the trust. In that case, the CGPOA would not be deemed applicable because C's other property would fully absorb his applicable exclusion amount. Thus, the trust will still be deemed a GST trust, resulting in the automatic allocation of GST exemption to the trust.

Finally, suppose that the total value of C's other property is $3.75 million when T funds the trust. In that case, the CGPOA would be deemed applicable *in part*. Though $3.75 million of C's applicable exclusion amount would be used to avoid estate tax on C's property outside the trust, $1.5 million of the trust property would be includible in C's gross estate pursuant to the CGPOA because that amount would be offset by C's remaining applicable exclusion amount. The CPGOA would not apply to the other $500,000 of the trust. Automatic allocation of GST exemption would occur only with respect to 25 percent of the trust (i.e., $500,000 not includible in C's gross estate/$2 million total trust property), resulting in an inclusion ratio for the trust of 0.75.

If the value of the trust is $10 million when C dies, the GST tax (assuming an applicable GST tax rate of 40 percent) would be $3 million (i.e., $10 million x 0.75 x 40 percent). If the automatic allocation rules had applied (or if a Form 709 had been timely filed to affirmatively allocate GST exemption to the trust), this $3 million GST tax could have been avoided.

If an automatic allocation of GST exemption is desired, the better approach might be to give the trustee the power to grant the CGPOA at the trustee's discretion. In the example above, the trustee would not have actually granted a CGPOA to C at the time of trust funding, and therefore no portion of the trust estate would be includible in C's gross estate. The trust could then qualify as a GST trust through the application of the automatic allocation rules.

This analysis becomes more complicated if T makes a series of contributions to the trust during his lifetime. In that case, it appears the inquiry as to whether the CGPOA would be deemed applicable must be made each time a transfer is made to the trust. In some years, C may have nominal assets of his own outside the trust so that the CGPOA would be deemed applicable. In other years, C may have more significant assets of his own so that only a portion (or none) of the CGPOA would be deemed applicable. This fluctuation in the value of C's assets could result in the trust being treated as a GST trust in some years and not others, resulting in a mixed inclusion ratio for the trust.

To avoid the inapplicability of the automatic allocation rules, the safest course for practitioners and their clients is to timely file a Form 709 to affirmatively allocate GST exemption to the trust, rather than to rely on the automatic allocation rules.

Conclusion

As this article demonstrates, granting beneficiaries of a dynasty trust hanging powers or contingent general powers of appointment may prevent the automatic allocation of GST exemption to the trust. Understanding and planning for these issues can enable practitioners to maximize intergenerational tax savings for their clients.

1. If the grantor of a trust timely files a Form 709 (gift tax return) and elects to allocate GST exemption to the initial gift and all subsequent gifts to the trust, the problems discussed in this article are avoided.
2. Section 2503(b); *Crummey*, 397 F.2d 82 (9th Cir. 1968). Section references are to the Internal Revenue Code of 1986, as amended.
3. Section 2041(b).
4. Section 2514(b).
5. Section 2514(e).
6. Section 2632(1), (3)(A)
7. Section 2632(c)(3)(B).
8. Section 2632(c)(3)(B)(iv).
9. Flush language at the end of §2632(c)(3)(B).
10. Section 6019(1).
11. As set forth in the analysis below, however, if the trust grants beneficiaries a "contingent general power of appointment," the Crummey trust may not qualify as a GST trust in 2013.
12. Section 2632(c)(5)(A).
13. Reg. 1.2632-1(b)(4)(ii)(A)(1) requires the amount of GST exemption allocated on a late filed Form 709 to be based on the value of trust assets at the time of the late allocation.
14. Section 2041.
15. Reg. 26.2652-1(a)(1).
16. Any property included in the beneficiary's gross estate will also receive a step-up in basis to the property's fair market value at the beneficiary's date of death. See Section 1014.