

ABA RPTE Group Program
Diagnosing and Treating GST Exempt / Grandfathered Trusts
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1) Introduction

- a. This presentation is not intended to provide an exhaustive overview of the generation-skipping transfer (“GST”) tax rules and assumes that the audience has a general knowledge of the GST tax rules.
- b. Rather, this presentation is intended to provide the practitioner with a roadmap for determining whether a trust is GST exempt, GST non-exempt or partially GST exempt and how to “clean-up” mixed inclusion ratio trusts or non-exempt trusts that were intended to (or should) be exempt.

2) Determining the GST Status of the Trust

- a. Whenever an irrevocable trust arrives on your desk, one of the first things you need to do is to determine the GST tax status of the trust (i.e., does the trust have an inclusion ratio of zero (exempt trust), one (non-exempt trust) or somewhere in between (mixed inclusion ratio trust)).
- b. What was the intent? Why do we care?
 - i. If the trust is GST exempt, then distributions from the trust will be wholly exempt from GST tax. If the trust is non-exempt, any taxable distribution or taxable termination will be subject to GST tax in its entirety at a 40% rate.
 - ii. If the trust is a mixed inclusion ratio trust, then: (a) distributions to non-skip persons will waste some GST exemption and (b) taxable distributions or taxable terminations will be subject to GST tax at a reduced rate (i.e., the 40% GST tax rate x the inclusion ratio).
 - iii. Client may want to make the non-exempt trust or mixed inclusion ratio trust a GST exempt trust or sever the mixed inclusion ratio trust into two separate trusts, one of which is GST exempt and the other of which is GST non-exempt.
- c. The GST tax generally applies to any transfer of property to a “skip person.” Thus, transfers to a trust which is a skip person and distributions to a skip person from a trust which is not a skip person are generally subject to GST tax unless the trust is exempt from GST tax. *See* IRC Sections 2612 and 2613.
- d. A trust can be exempt from GST tax in one of the following ways:

- i. The trust is a “grandfathered trust” pursuant to Treas. Reg. Section 26.2601-1(b).
- ii. GST exemption was affirmatively allocated to the trust pursuant to IRC Section 2631.
- iii. GST exemption was automatically allocated to the trust pursuant to IRC Section 2632(b) (direct skips) or IRC Section 2632(c) (indirect skips to GST trusts).
- iv. Transfers to the trust were excluded from GST tax under IRC Section 2642(c) (the “GST tax annual exclusion”).
- v. The Gallo Trust Exception/Exclusion applied to the transfer – GST tax would not apply to a direct skip through a trust made prior to January 1, 1990 to a grandchild to the extent the aggregate transfers to that grandchild by the transferor did not exceed \$2,000,000.

3) **Is the Trust a Grandfathered Trust**

- a. A “grandfathered” trust is any trust that became “irrevocable” on or before September 25, 1985, which is the retroactive effective date of the GST provisions. *See* Treas. Reg. Section 26.2601-1(b).
- b. When was the trust executed?
 - i. If the trust was executed after September 25, 1985 (or October 22, 1986 for certain trusts created under a will or revocable trust), the trust will not be a grandfathered trust.
- c. Was the trust “irrevocable” on September 25, 1985?
 - i. If the trust was executed prior to September 25, 1985, it then needs to be determined whether the trust was irrevocable on September 25, 1985.
 - ii. General Rule – All trusts in existence on September 25, 1985 are considered irrevocable. *See* Treas. Reg. Section 26.2601-1(b)(1)(ii)(A).
 - iii. Exceptions – A trust is not irrevocable on September 25, 1985 if:
 - 1. Property Includible in Gross Estate under IRC Section 2038.
 - a. On September 25, 1985, the Settlor held a power with respect to such trust that would have resulted in gross estate inclusion under IRC Section 2038. *See* Treas. Reg. Section 26.2601-1(b)(1)(ii)(B).

- b. Not irrevocable if the transferor retained a power to alter the beneficiaries' shares. *See* Treas. Reg. Section 26.2601-1(b)(1)(ii)(B).

2. Incidents of Ownership Under IRC Section 2042

- a. A trust holding life insurance on an individual's life will not be treated as irrevocable if the insured possessed any incidents of ownership in the policy. *See* Treas. Reg. Section 26.2601-1(b)(1)(ii)(C).

3. QTIP Trusts

- a. A QTIP trust that was irrevocable on September 25, 1985 is not subject to GST tax after the death of the beneficiary spouse despite the inclusion of the trust in the gross estate of the beneficiary spouse under IRC Section 2044. *See* Treas. Reg. Section 26.2601-1(b)(1)(iii).

iv. Revocable Trusts and Wills – the GST tax does not apply to any GST under a will or revocable trust executed before October 22, 1986 provided that:

- 1. No amendments were made any time after October 21, 1986 which resulted in the creation of or increase in the amount of a GST;
- 2. No addition was made to the revocable trust after October 21, 1986 that resulted in the creation of or increase in the amount of a GST; and
- 3. The decedent died before January 1, 1987. *See* Treas. Reg. Section 26.2601-1(b)(2).

v. Mental Incompetency until Death. *See* Treas. Reg. Section 26.2601-1(b)(3).

d. Additions to grandfathered trusts

- i. Generally, taxable distributions from and taxable terminations of interests in grandfathered trusts are not subject to GST tax.
- ii. However, if an addition or a “constructive addition” is made to a grandfathered trust after September 25, 1985, a pro rata portion of subsequent GSTs will be subject to GST tax.

1. After an addition to a grandfathered trust, the trust is deemed to consist of a “non-chapter 13 portion” and a “chapter 13 portion.”
 2. Non-Chapter 13 Portion – represents value of assets of trust as of September 25, 1985 – inclusion ratio of zero.
 3. Chapter 13 Portion – represents value of all additions made to trust after September 25, 1985 – inclusion ratio determined under IRC Section 2642.
- iii. Constructive Additions to Irrevocable Trusts – Treas. Reg. Section 26.2601-1(b)(v)
1. Powers of Appointment
 - a. A constructive addition to the trust is deemed to be made after the release, exercise or lapse of a general power of appointment over the trust. For example, through the lapse of a Crummey withdrawal power.
 - b. The release or exercise of a nongeneral power of appointment is not a constructive addition to the trust unless the exercise of the power postpones vesting beyond the rule against perpetuities.
 - c. If the power creates a second power, there will be a constructive addition to the trust unless the new power of appointment may not be exercised to postpone vesting beyond the original rule against perpetuities.
 2. Where individuals have limited powers of appointment under a grandfathered trust, you need to make sure that no powers have been exercised in a manner that would jeopardized the grandfathered status.

4) Effect of Modifications on GST Exempt Trusts

- a. Grandfathered Trusts – Safe Harbors
 - i. Treas. Reg. Section 26.2601-1(b)(4) sets forth rules for determining whether a grandfathered trust will retain its GST exempt status following a modification, judicial construction, settlement agreement or other action by the Trustees.

ii. Effective Date of Safe Harbors – December 20, 2000

1. Decanting – The distribution of trust principal from a grandfathered trust to a new trust will not cause the new trust to be subject to GST tax if:

- a. Either:

- i. The terms of the governing instrument of the exempt trust authorize distribution to the new trust without the consent or approval of any beneficiary or court, or
- ii. At the time the exempt trust became irrevocable, state law authorized distribution to the new trust without consent or approval of any beneficiary

AND

- b. The terms of the new trust do not extend the time for vesting of any beneficial interest in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest beyond a period measured by 21 years after the death of any life in being at the time the exempt trust became irrevocable **[you can prevent this with language in trust agreement stating that any decanted property remains subject to the RAP of the original trust]**

2. Settlement – A court approved settlement of a bona fide issue regarding the administration of the trust or construction of terms of the governing instrument will not cause an exempt trust to be subject to GST tax if:

- a. The settlement is the product of arm's length negotiations; and
- b. The settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement.

3. Judicial Construction – A judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause an exempt trust to be subject to GST tax if:

- a. The judicial action involved a bona fide issue; and

b. The construction is consistent with applicable state law that would be applied by the highest state court.

4. Other Changes – A modification of an exempt trust that is valid under state law will not cause an exempt trust to be subject to GST tax if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

b. Non-Grandfathered GST Exempt Trusts

i. Do the Safe Harbor Rules Apply? – The safe harbor provisions are set forth in the grandfathered trust regulations, and, therefore, by their terms apply only to grandfathered trusts. However, Private Letter Rulings have extended the safe harbor regulations to trusts that are exempt from GST tax as a result of the allocation of GST exemption. *See* PLR 200822008 (May 30, 2008); PLR 200743028 (May 29, 2007); PLR 200714016 (April 6, 2007).

c. What if the modification occurred prior to the effective date of the safe harbors?

i. The safe harbor provisions are effective after December 20, 2000. However, the IRS has stated that it will not challenge the exempt status of a trust that, prior to the effective date of the safe harbors, was subject to any trustee action, judicial construction, settlement agreement, modification or other action if the action satisfies one of the safe harbors under the regulations. *See* Preamble, T.D. 8912, 65 Fed. Reg. Section 79735.

5) Withdrawal Powers

- a. Many trusts, particularly irrevocable life insurance trusts, contain withdrawal / Crummey powers in order to permit contributions to the trust (often times made to pay life insurance premiums) to qualify for the gift tax annual exclusion.
- b. Generally, a transfer that qualifies for the gift tax annual exclusion will also qualify for the so-called GST tax annual exclusion under IRC Section 2642(c).
- c. However, if the transfer is to trust, the transfer will qualify for the GST tax annual exclusion only if, in addition to qualifying for the gift tax annual exclusion, the trust is for the benefit of a single beneficiary who is a skip person and, if the

beneficiary dies during the term of the trust, the trust assets would be included in the beneficiary's gross estate. *See* IRC Section 2642(c)(2).

- d. Most trusts that we encounter are for the benefit of multiple beneficiaries (e.g., the settlor's descendants), and, thus, although transfers to such trusts may qualify for the gift tax annual exclusion, they will not qualify for the GST tax annual exclusion. Accordingly, in order for the trust to be GST exempt, the Settlor will have to affirmatively allocate GST exemption to the trust, unless the automatic allocation rules apply. **MANY ACCOUNTANTS PREPARE RETURNS ASSUMING THAT THE GST ANNUAL EXCLUSION APPLIED.**
- e. Review Type/Amount of Withdrawal Power
 - i. Spousal Withdrawal Powers – estate tax inclusion period (“ETIP”) issues (*See* IRC Section 2642(f))
- f. Review lapse provision (*See* Treas. Reg. Section 26.2652-1(a)(5) Example 5)
 - i. Is there a hanging Crummey power?
 - ii. Any shift in “transferor” for GST tax purposes?
- g. Were there any taxable lapses? If so, what are the GST tax ramifications?

6) Prior Transfers /Additions to the Trust

- a. Review prior contributions to the trust to determine the initial inclusion ratio and, with each new addition to the trust, the new inclusion ratio caused by the addition. *See* Treas. Reg. Section 26.2642-4.
 - i. Ask Client.
 - ii. Gift Tax Return Filed?
 - 1. Were prior contributions reported on Form 709?
 - 2. Was GST exemption allocated?
 - Transferor or transferor's executor may allocate the transferor's GST exemption. *See* IRC Section 2631(a).
 - Check Schedule A, Parts 2 and 3 for elections: Column C of Part 2 for direct skips may be marked to elect out of the automatic GST allocation rules (*see* IRC Section 2632(b));

Column C of Part 3 for indirect skips may be marked to make three type of elections:

Election 1: No allocation to current transfer to that trust.

Election 2: No allocation to current transfer and all future transfers to that trust.

Election 3: Treat trust as GST trust for automatic allocation purposes. *See* IRC Section 2632(c)(5).

-Check Part 2—GST Exemption Reconciliation shows the allocation of GST exemption on current Form 709 and allocation used in previous years.

3. Was an election in / out of the automatic allocation rules filed with the Return?

-Check for Election Statement or Notice of Allocation. *See* IRC Section 2632(c)(5)(A)(ii) (for election in), IRC Section 2632(b)(3) (for election out of direct skips) and IRC Section 2632(c)(5)(A)(i) (for election out of indirect skips).

-Change of election?

4. Any Late Allocation?

-Allocations may be made until the filing of the transferor's estate tax return. *See* Treas. Reg. Section 26.2632-1(a). If a late allocation was made, the allocation must be made based on the value of the transferred property on the date of the allocation (or on the first day of the month in which the allocation is made), rather than the date of transfer value of the property.

5. Gift Splitting?

-For GST tax purposes, each spouse is treated as the transferor of one-half of the transferred property, and his or her GST exemption may be allocated to such transfer. *See* IRC Section 2652.

6. Were GST allocations and reconciliation done correctly?

b. Prior Transfers Not Affecting GST Status

- i. Did the current trust receive the assets via a decanting or exercise of other limited power of appointment?

As previously explained, a decant or exercise of a power of appointment that does not extend the rule against perpetuities will not affect the trust's GST exempt status.

ii. Sale?

1. Was the sale for adequate consideration? If so, then no gift and no GST exemption need be allocated to the trust to make the trust GST exempt. If not, then there was a gift and need to check for any affirmative or automatic allocation of GST exemption.
2. Valuation issues may create an inadvertent gift and a missed allocation of GST exemption.

c. What if no gift tax return was filed?

i. Is the trust a "GST trust"?

1. A "GST trust" is a trust from which a taxable distribution or taxable termination is likely to occur in the future. *See* IRC Section 2632(c)(3)(B).
2. Or does the trust fall under one of the six exception?

-Age 46 trust—The trust provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons (1) before the date the individual attains the age of 46; (2) on or before one or more dates specified in the trust that will occur before the date that such individual attains the age of 46; or (3) upon the occurrence of an event that, in accordance with regulations prescribed by the Treasury Secretary, may reasonably be expected to occur before the date that such individual attains the age of 46.

-Ten year age difference trust—The trust provides that more than 25% 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 trust who is more than 10 years older than such individuals.

-Partial estate tax inclusion trust—The trust provides that, if one or more individuals who are non-skip persons die on or before a date or event described in the first two exceptions, more than 25% 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.

-Non-skip person estate tax inclusion trust—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.

-Charitable lead annuity trust and charitable remainder trust—The trust is a charitable lead annuity trust, charitable remainder annuity trust or a charitable remainder unitrust.

-Charitable lead unitrust—The trust is a trust with respect to which a charitable deduction was allowed 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 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 to terminate.

- ii. Bank statements or other records that show gifts to the trust may be used.

7) Transfers at Death

- a. Decedent's executor may allocate the decedent's GST exemption on the decedent's estate tax return to transfer at death. *See* Treas. Reg. Section 26.2632-1(a).
- b. Review Schedule R on the Form 706 for trusts to which a decedent's GST exemption may have been allocated.
- c. Check for a reverse QTIP election, making the decedent the transferor for GST tax purposes, instead of the surviving spouse. *See* IRC 2652(a)(3). Now, listing a trust on Schedule R, Part 1, line 9 will make the reverse QTIP election for the listed QTIP trust. *See* Schedule R.
- d. If the decedent's executor does not affirmatively allocate the decedent's remaining GST exemption, automatic allocation rules apply to allocate the decedent's GST exemption in the following order (*see* IRC Section 2632(e)(1)):
 - i. Direct skips.
 - ii. Pro rata to trusts from which a taxable termination or distribution may occur.

8) Determining the Trust's Inclusion Ratio

- a. The inclusion ratio affects the rate of the GST tax because the inclusion ratio reduces the rate of the tax.
- b. Were calculations of inclusion ratio done correctly (*see* IRC Section 2642(a))?
 - i. Inclusion ratio = $1 - \text{applicable fraction}$.
 - ii. Applicable fraction = $\frac{\text{Amount of GST exemption allocated to trust}}{\text{Value of trust property}}$
 - iii. Inclusion ratio = $1 - \frac{\text{Amount of GST exemption allocated to trust}}{\text{Value of trust property}}$
- c. Were additions properly considered and the results computed correctly?
 - i. The inclusion ratio is re-determined each time additional GST exemption is allocated to the trust or additional transfers of property are made to the trust. *See* IRC Section 2642(d).
 - ii. To re-determine the inclusion ratio at the time of an addition:

Nontax portion of trust = current value of trust including new assets x applicable fraction.

New applicable fraction = $\frac{\text{Amount of GST exemption allocated} + \text{nontax portion from above}}{\text{Current value of trust including new assets}}$

New inclusion ratio = $1 - \text{applicable fraction}$.

d. ETIPs Issues

- i. Generally, IRC Section 2642(f) prevents any allocation of GST exemption to property transferred to a trust during the ETIP and any allocation of GST exemption made during the ETIP become effective only upon termination of the ETIP. *See* Treas. Reg. Section 26.2632-1(c)(1).
- ii. The ETIP is the period that such property would be included in the gross estate of the transferor or the transferor's spouse. *See* IRC Sections 2642(f)(3) and (4).
- iii. Exception – Property is not considered as being subject to inclusion in the transferor's spouse's gross estate if the spouse possesses with respect to any transfer to a trust, the right to withdraw no more than the greater of \$5,000 or 5% of the trust corpus AND such withdrawal right terminates no

later than 60 days after the transfer to the trust. *See* Treas. Reg. Section 26.2632-1(c)(2).

- e. GST tax rules treat portions as separate in several circumstances:
 - i. Partial nontaxable gifts to 2642(c) trusts. *See* IRC Section 2642(c).
 - ii. Non-chapter 13 portion v. chapter 13 portion under the grandfathered regulations. *See* Treas. Reg. Section 26.2601-1.
 - iii. Different transferors – Did the inclusion ratio calculations properly account for these rules? (*see* IRC Section 2654(b)(1))

9) **Relief Provisions**

- a. If a trust is non-exempt (and you want it to be exempt) or if the trust has a mixed inclusion ratio, what can you do to fix it?
- b. 9100 Relief – IRC Section 2642(g)(1) and Treas. Reg. Section 301.9100-3
 - i. For inadvertently missed GST tax exemption allocations, the taxpayer may be able to obtain an extension of time to file the Form 709 to make a timely allocation of GST exemption.
 - ii. Transferors entitled to 9100 relief are permitted to allocate GST exemption based on the date of transfer value.
- c. Simplified Method of Relief under Rev. Proc. 2004-46
 - i. An alternative to the PLR process to obtain an extension of time to timely allocate GST exemption is permitted if:
 - 1. On or before December 31, 2000, the taxpayer made or was deemed to have made a transfer by gift to a trust from which a GST may be made;
 - 2. No taxable distributions have been made and no taxable terminations have occurred;
 - 3. The transfer qualified for the gift tax annual exclusion;
 - 4. The transfer, together with the value of other gifts to that donee in the same year, did not exceed the gift tax annual exclusion;
 - 5. No GST tax exemption was allocated to the transfer; and

6. The taxpayer has GST exemption available to allocate to the transfer.
- ii. Must file a Form 709 for the year of the transfer –
 1. With “FILED PURSUANT TO REV. PROC. 2004-46” indicated at the top;
 2. Reporting the value of the transferred property as of the date of transfer; and
 3. Allocating GST exemption to the trust by attaching a Notice of Allocation.
- d. Late Allocations
- i. If a timely Form 709 was not filed, and the taxpayer does not qualify for an extension of time to make an allocation of GST tax exemption, the only remaining option is to make a late allocation.
 - ii. Must determine the trust’s inclusion ratio as of the effective date of the allocation. This will require the inclusion ratio to be determined on all prior transfer dates.
 - iii. The amount of GST tax exemption required to be allocated to the trust to result in an inclusion ratio of zero is equal to the fair market value of the trust assets as of the effective date of the late allocation, multiplied by the inclusion ratio on such date.
 - iv. First of the Month Valuation Rule – Solely for purposes of determining the fair market value of the trust’s assets, the taxpayer may elect to treat the allocation as having been made on the first day of the month during which the late allocation is made.
- e. Retroactive Allocation – IRC Section 2632(d)
- i. Effective for deaths of non-skip persons occurring after 2000, a transferor may retroactively allocate the transferor’s GST tax exemption to a trust in the case where a trust beneficiary who is related to the transferor predeceases the transferor.
- f. Qualified Severance – IRC Section 2642(a)(3) and Treas. Reg. Sections 2642-6(d) and 26.2654-1(b)

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GST Trust Audit Checklist

1) Determine the Trust's Effective Date / Date of Irrevocability

- a. Was the trust "irrevocable" prior to September 25, 1985? *See* Treas. Reg. Section 26.2601-1(b).

YES → The trust is a grandfathered trust. ***Go to Section 3.***

NO → The trust is not a grandfathered trust. ***Go to Section 1(b).***

- b. Was the trust created under a will or a revocable trust executed prior to October 22, 1986 by a decedent who died prior to January 1, 1987? *See* Treas. Reg. Section 26.2601-1(b)(2).

YES → Were any amendments made to the trust or any actual or constructive additions made to the trust after October 21, 1986 that create a generation-skipping transfer ("GST") or increase the amount of a GST?

YES → The trust is not a grandfathered trust. ***Go to Section 1(c).***

NO → The trust is a grandfathered trust. ***Go to Section 3.***

NO → The trust is not a grandfathered trust. ***Go to Section 1(c).***

- c. Was the trust executed prior to January 1, 1990 and have only grandchildren as beneficiaries?

YES → Were total gifts to grandchild (including amount contributed to trust) by transferor equal to or less than \$2,000,000?

YES → The trust may qualify for the "Gallo Exception" (also called "Gallo Exclusion") *See* Section 1433(b)(3)(A), PL 99-514, October 22, 1986, as amended by Section 1014(h)(3), PL 100-647, November 10, 1988. ***Go to Section 4.***

NO → The trust does not qualify for the Gallo Exception. ***Go to Section 1(d).***

NO → The trust does not qualify for the Gallo Exception. ***Go to Section 2.***

2) Determining Date of Transfer to Trust

- a. Were transfers made to the trust after December 31, 2000? *See* IRC Section 2632(c).

YES → The automatic allocation rules may apply. *Go to Section 2(a)(i).*

- (i) Does the trust have a single skip person as beneficiary and have all transfers to the trust qualified for the gift tax annual exclusion?

YES → The trust may qualify for the so-called “GST tax annual exclusion” under IRC Section 2642(c). *Go to Section 5.*

NO → The GST tax annual exclusion does not apply. *Go to Section 6.*

NO → The automatic allocation rules do not apply.

- (ii) Does the trust have a single skip person as beneficiary and have all transfers to the trust qualified for the gift tax annual exclusion?

YES → The trust may qualify for the GST tax annual exclusion under IRC Section 2642(c). *Go to Section 5.*

NO → The GST tax annual exclusion does not apply. *Go to Section 6.*

3) Grandfathered Trusts

- a. If the trust is a grandfathered trust under Treas. Reg. Section 26.2601-1(b), then taxable distributions from the trust and taxable terminations of interest in the trust are exempt from GST tax.
- b. Have any actual or constructive additions been made to the trust since September 25, 1985?

YES → The trust will have two portions, a non-Chapter 13 portion and a Chapter 13 portion. The inclusion ratio of the non-Chapter 13 portion is zero. The inclusion ratio of the Chapter 13 portion is determined by the “allocation fraction.” The allocation fraction is equal to the amount of the addition divided by the total value of the trust immediately after the addition. *See* Treas. Reg. Section 26.2601-1(b)(v).

NO → *Go to Section 3(c).*

- c. Has the trust been modified?

YES → Do any of the Safe Harbors set forth in Treas. Reg. Section 26.2601-1(b)(4) apply?

YES → Taxable distributions from the trust and taxable terminations of interests in the trust are exempt from GST tax.

NO → The trust loses its grandfathered trust status. ***Go to Section 6.***

NO → Taxable distributions from the trust and taxable terminations of interests in the trust are exempt from GST tax.

4) Gallo Exception Trusts

- a. If the trust is a Gallo exception trust (defined in Section 1433(b)(3)(A), PL 99-514, October 22, 1986, as amended by Section 1014(h)(3), PL 100-647, November 10, 1988), then taxable distributions from the trust and taxable terminations of interests in the trust are exempt from GST tax.

- b. Have taxable gifts been made to the trust on or after January 1, 1990?

YES → Taxable distributions from the trust and taxable terminations of interests in the trust are potentially subject to GST tax. ***Go to Section 6.***

NO → Taxable distributions from the trust and taxable terminations of interests in the trust are exempt from GST tax.

5) Section 2642(c) Trusts

- a. Have transfers to the trust in any particular year exceeded the gift tax annual exclusion amount?

YES → The trust will have a mixed inclusion ratio unless GST exemption was automatically allocated to the transfers in excess of the gift tax annual exclusion amount OR GST exemption was affirmatively allocated to such transfers. ***Go to Section 6.***

NO → Taxable distributions from the trust and taxable terminations of interests in the trust are exempt from GST tax.

6) Potential GST Exempt Trusts

- a. Affirmative Allocations of GST Exemption.

i. Review Form 709s

- Check for affirmative allocations of GST exemption on Schedule A, Part 2 and Part 3.
- Check Schedule D, Part 2 for the use of GST exemption and reverse QTIP elections. *See* IRC Section 2652(a)(3).
- Check for Election Statement or Notice of Allocation for elections into or out of the automatic allocation rules.
- Check for a Form 709 filed pursuant to Rev. Proc. 2004-46. *See* Rev. Proc. 2004-46.
- Check for late allocations of GST exemption.

ii. Review Form 706

- Check Schedule R for affirmative allocations of GST exemption and reverse QTIP elections.

b. Automatic Allocations of GST Exemption.

i. Were the transfers made to the trust after December 31, 2000?

YES → Go to Section 6(b)(ii).

NO → The automatic allocation rules do not apply and taxable distributions from the trust and taxable terminations of interests in the trust are exempt from GST tax only if GST exemption was affirmatively.

ii. Is the trust a skip person or a “GST trust” (or a trust that has elected to be treated as a GST trust)?

YES → Automatic allocation rules apply, unless an Election Statement has been filed to elect out of the automatic allocation rules.

- If the transferor had sufficient GST exemption to exempt each gift to the trust, then taxable distributions from the trust and taxable terminations of interests in the trust are exempt from GST tax. *See* IRC Section 2632(c)(3)(B).
- If not enough GST exemption was available to exempt the trust during transferor’s lifetime or at death, then taxable

distributions from the trust and taxable terminations of interests in the trust are subject to GST tax. ***Go to Section 7.***

NO → Automatic allocation rules do not apply and taxable distributions from the trust and taxable terminations of interests in the trust are exempt from GST tax only if GST exemption was affirmatively.

- If transferor is dead, was sufficient GST exemption automatically allocated at death? *See* IRC Section 2632(e)(1).

7) Inclusion Ratio

- a. Was inclusion ratio determined properly? *See* IRC Section 2642(a).
- b. Did the estate tax inclusion period delay the effective date of any allocation of GST exemption and potentially create a mixed inclusion ratio? *See* IRC Section 2642(f).
- c. Did a lapse of a withdrawal right change the transferor? *See* Treas. Reg. Section 26.2652-1(a)(5), Example 5.
- d. Were there multiple gifts to trust, requiring redetermination of the inclusion ratio? *See* IRC Section 2642(d).