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BETTER LATE THAN NEVER:
ALLOCATING TO PARTIALLY GST-EXEMPT TRUSTS AFTER THE
TAX CUTS AND JOBS ACT OF 2017

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*Melissa L. Dougherty**

I. INTRODUCTION

Signed into law on December 22, 2017, the Tax Cuts and Jobs Act of 2017¹ (TCJA) effectuated wide-ranging changes to United States tax laws, particularly for individuals.² Several of these changes present unique opportunities for estates and trusts practitioners and their clients. In particular, taxpayers may wish to analyze the federal generation-skipping transfer (GST) tax treatment of existing irrevocable trusts in order to confirm each trust's inclusion ratio for federal generation-skipping transfer tax purposes, and, if appropriate, take affirmative steps to allocate GST exemption to partially exempt trusts.

II. THE TAX CUTS AND JOBS ACT OF 2017

The United States imposes three federal taxes upon the transfer of assets by individuals for less than full and adequate consideration: federal estate

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¹ Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017).

² *E.g.*, MOLLY F. SHERLOCK & DONALD J. MARPLES, CONG. RESEARCH SERV., R45092, THE 2017 TAX REVISION (P.L. 115-97): COMPARISON TO 2017 TAX LAW 1 (2018), <https://fas.org/sgp/crs/misc/R45092.pdf>.

tax,³ federal gift tax,⁴ and federal GST tax.⁵ All three taxes serve a similar purpose—they tax transfers of wealth for less than full and adequate consideration.⁶ The federal estate tax focuses on transfers that occur at death.⁷ If only the federal estate tax existed, an individual could seek to avoid the tax altogether by giving away all of her wealth prior to death.⁸ To prevent this result, the federal gift tax applies to transfers of wealth during an individual's life made for less than full and adequate consideration.⁹ If only the federal estate and gift taxes existed, an individual could seek to minimize her tax liability by giving or bequeathing wealth to more distant generations of descendants.¹⁰ For example, a grandmother could bequeath an asset directly to a grandchild, instead of bequeathing to a child and the child, in turn, bequeathing the asset to the grandchild at the child's death, to avoid federal estate and/or gift tax at each generational level.¹¹ To prevent this result, the federal GST tax imposes an additional tax on transfers of wealth to individuals who are two or more generations removed from the transferor.¹² The TCJA amended significant sections of the Code affecting each of these three taxes.¹³

³ I.R.C. § 2001(a).

⁴ *Id.* § 2501(a)(1).

⁵ *Id.* § 2601.

⁶ *See id.* §§ 2001(a), 2501(a)(1), 2601.

⁷ *See id.* § 2001(a).

⁸ *See id.*

⁹ *See id.* § 2501(a)(1).

¹⁰ *See id.*

¹¹ *See id.*

¹² *See id.* §§ 2601, 2611(a), 2612.

¹³ *E.g.*, Tax Cuts and Jobs Act, Pub. L. No. 115-97, §§ 11002(a)–(b), 11061(a), 131 Stat. 2054, 2059, 2091 (2017) (codified at §§ 1(f)(3), (6), 2010(c)(3)).

A. The Federal Estate and Gift Taxes

The federal estate tax is imposed upon the “transfer of the taxable estate of every decedent who is a citizen or resident of the United States,”¹⁴ and it includes all assets and interests owned by the decedent at death, wherever they are located.¹⁵ The federal gift tax is “imposed . . . each . . . year on the transfer of property by . . . any individual” for less than full and adequate consideration, regardless of whether they are a United States citizen or resident.¹⁶ The federal estate tax and federal gift tax are unified, meaning that transfers made during life and at death are totaled, with only one tax rate and one applicable credit amount applied.¹⁷ The tax rate begins at 18% and increases pursuant to a compressed rate schedule, with the maximum rate being 40%.¹⁸ The tentative tax owed is reduced by certain credits, the most significant of which is the applicable credit amount.¹⁹ Also known as the “unified credit,” “the applicable credit amount is . . . determined [by calculating the] . . . tentative tax . . . [on] the applicable exclusion amount” (also referred to as the basic exclusion amount).²⁰

Prior to the TCJA, the applicable exclusion amount was \$5.49 million; in other words, an individual could give away, during her lifetime or at her death, assets valued at up to \$5.49 million before owing tax on any amounts in excess of \$5.49 million.²¹ This amount was scheduled to be adjusted for inflation in each year after calendar year 2010 pursuant to the Consumer

¹⁴ I.R.C. § 2001(a).

¹⁵ *Id.* §§ 2001(a), 2031(a).

¹⁶ *Id.* § 2501(a)(1).

¹⁷ *Id.* § 2505(a). This was not always the case, as the unified credit was first introduced under the Tax Reform Act of 1976 and the credit amounts were separated from 2004–2010. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(a), 90 Stat. 1520, 1848; see *Federal Estate and Gift Tax Rates, Exemptions, and Exclusions, 1916–2014*, TAX FOUND. (Feb. 4, 2014), <https://taxfoundation.org/federal-estate-and-gift-tax-rates-exemptions-and-exclusions-1916-2014/>.

¹⁸ I.R.C. § 2001(c).

¹⁹ See *id.* §§ 2010–2015.

²⁰ *Id.* § 2010(c)(1).

²¹ *Id.* § 2010(c)(3)(A)–(B) (2017). Note that prior to the TCJA, § 2010(c)(3)(A) defined the basic exclusion amount as \$5 million, adjusted for inflation in each year after 2011. *Id.* § 2010(c)(3)(A)–(B) (2017).

Price Index (CPI).²² The TCJA amended § 2010(c)(3) by adding a new subparagraph that both increases the basic exclusion amount and changes the index used to adjust the basic exclusion amount for inflation each year.²³ As a result, the applicable exclusion amount is now calculated based upon a basic exclusion amount of \$10 million²⁴ as indexed for inflation using the Chained Consumer Price Index for All Urban Consumers (C-CPI-U),²⁵ which is published by the Bureau of Labor Statistics of the Department of Labor.²⁶ The applicable exclusion amount as indexed for inflation in 2018 is \$11.18 million.²⁷

The practical consequence of the TCJA's amendment is that in 2018, an individual can now give away during her lifetime or at her death assets valued at up to \$11.18 million before owing tax—a nearly 104% increase over last year.²⁸ Accordingly, even less of the population will be in a position to owe federal estate tax at death.²⁹ In 2017, 2.7 million people were projected to die in the United States but only 5,500 estate tax returns actually owing tax were projected to be filed.³⁰ It can be expected that an even tinier portion of the population will die actually owing a federal estate tax in 2018.³¹ Another consequence is that utilizing a different inflation index (C-CPI-U in 2018 compared to CPI in 2017) is expected to slow the rate at which the basic

²² *Id.* § 1(f)(3) (2014).

²³ Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 11002(a)–(b), 11061(a), 131 Stat. 2054, 2059, 2091 (2017) (codified at §§ 1(f)(3), (6), 2010(c)(3)).

²⁴ *Id.* § 11061(a), 131 Stat. at 2091 (codified at § 2010(c)(3)).

²⁵ I.R.C. § 1(f)(3).

²⁶ Tax Cuts and Jobs Act § 11002(b), 131 Stat. at 2059 (codified at § 1(f)(6)(A); *Chained Consumer Price Index for All Urban Consumers (C-CPI-U)*, U.S. BUREAU OF LABOR STATISTICS, <https://www.bls.gov/cpi/additional-resources/chained-cpi.htm> (last updated Jan. 12, 2018)).

²⁷ Rev. Proc. 2018-18, § 3.35, 2018-10 I.R.B. 392, 397.

²⁸ Compare I.R.C. § 2010(c)(3)(A) (2017), with Tax Cuts and Jobs Act § 11061(a), 131 Stat. at 2091 (codified at § 2010(c)(3)).

²⁹ *Estate Tax Returns and Liability Under Current Law and the House and Senate Versions of the Tax Cuts and Jobs Act*, TAX POL'Y CTR. (Dec. 6, 2017), <https://www.taxpolicycenter.org/model-estimates/estate-tax-and-tax-cuts-and-jobs-act-dec-2017/t17-0308-estate-tax-returns-and>.

³⁰ *The Key Elements of the U.S. Tax System*, TAX POL'Y CTR., <https://www.taxpolicycenter.org/briefing-book/how-many-people-pay-estate-tax> (last visited Nov. 17, 2018).

³¹ TAX POL'Y CTR., *supra* note 29.

exclusion amount is indexed for inflation each year, resulting in smaller increases.³² It is important to note that these changes are not permanent, as they are scheduled to sunset on December 31, 2025, and revert back to pre-TCJA levels (indexed for inflation in 2026) absent legislative action.³³

This increase in the applicable credit amount becomes even more substantial when combined with the advent of “portability,” the concept added to § 2010(c) by § 302(a) and § 303(a) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.³⁴ Portability is the method by which the estates of decedents dying after December 31, 2010 can elect to transfer any unused applicable exclusion of the deceased spouse to the surviving spouse.³⁵ The exact amount that can be ported to the surviving spouse depends upon how much exemption a deceased spouse has not yet used.³⁶ For example, the maximum amount that could be ported to a surviving spouse in 2017 was \$5.49 million (now increased to \$11.18 million in 2018).³⁷ As a result, a married couple could together, effectively, gift or devise up to \$22.36 million of assets to beneficiaries in 2018 without incurring federal gift tax or federal estate tax.³⁸

³² Sho Chandra, *What You Need to Know About ‘Chained CPI,’* BLOOMBERG (Nov. 20, 2017, 12:00 AM), <https://www.bloomberg.com/news/articles/2017-11-20/why-chained-cpi-has-links-to-u-s-tax-debate-quicktake-q-a>.

³³ Tax Cuts and Jobs Act § 11061(a), 131 Stat. at 2091 (codified at § 2010(c)(3)). As of this writing, additional legislation designed to make these changes permanent by removing the sunset provision, known as “Tax Reform 2.0,” is under consideration by the United States Senate Committee on Finance, having already passed a vote by the House of Representatives. H.R. 6760, 115th Cong. (2018), <https://www.congress.gov/bill/115th-congress/house-bill/6760>.

³⁴ Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, §§ 302(a), 303(a), 124 Stat. 3296, 3301–02. These portability provisions were made permanent by § 101(a) of the American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 101(a), 126 Stat. 2313, 2315.

³⁵ This procedure is often referred to as a “portability election” and the amount transferred to the surviving spouse, known as the deceased spouse unused exclusion amount, is often referred to as “DSUEA.” Treas. Reg. § 20.2010-1(d)(4) (2015).

³⁶ I.R.C. § 2010(c)(4).

³⁷ Rev. Proc. 2018-18, *supra* note 27, § 3.35, at 397; I.R.S. Instructions for Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return 18 (2017).

³⁸ Assuming that both spouses had not used any of their exemption and the surviving spouse had made a timely portability election on the deceased spouse’s timely filed federal estate (and generation-skipping transfer) tax return, Form 706. It should be noted that surviving spouses who are not U.S. citizens

B. The Federal Generation-Skipping Transfer Tax

The federal GST “tax is . . . imposed on every generation-skipping transfer,” and is in addition to any federal estate or gift tax imposed.³⁹ This tax is designed to prevent taxpayers from avoiding the imposition of federal estate or gift tax by directing assets to individuals who belong to a generation that is two or more generations below the transferor-taxpayer (for example, a grandparent to a grandchild).⁴⁰ Transferors are entitled to a GST exemption amount that can be allocated by the transferor (or the transferor’s executor) to property during life or at death.⁴¹ The amount of the GST exemption is not unified in the sense that the federal estate and gift tax exemption amounts are, but in 2017 and for the foreseeable future, the GST exemption amount will “be equal to the basic exclusion amount” for federal estate and gift tax purposes.⁴² Tax at a flat 40% rate will be assessed after an individual has utilized all of her GST exemption amount.⁴³ For 2017, the GST exemption amount was \$5.49 million.⁴⁴ Similar to the federal estate and gift tax, this amount was also adjusted for inflation in each year after calendar year 2010 pursuant to the CPI.⁴⁵

Because the GST exemption amount is equal to the basic exclusion amount for federal estate and gift tax purposes, the TCJA’s amendments to § 2010(c)(3) (federal estate tax basic exclusion amount) identically affected the GST exemption amount by increasing the basic exclusion amount and changing the index used to adjust the basic exclusion amount for inflation

or residents cannot elect portability, except to the extent allowed by an estate tax treaty with the surviving spouse’s country of citizenship. Treas. Reg. § 20.2010-3(e) (2015).

³⁹ I.R.C. § 2601.

⁴⁰ *See id.* § 2613(a)(1).

⁴¹ *Id.* § 2631(a).

⁴² *Id.* § 2631(c).

⁴³ *Id.* § 2602. The applicable tax rate is a flat rate equal to the product of (1) the maximum federal estate tax rate (40% in 2017 and in 2018) and (2) the inclusion ratio with respect to the transfer. *Id.* § 2641(a).

⁴⁴ I.R.S. Instructions for Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return 16 (2017).

⁴⁵ *See* I.R.C. §§ 1(f)(3), 2631(c).

each year.⁴⁶ As a result, the applicable GST exemption amount is now calculated based upon a basic exclusion amount of \$10 million as indexed for inflation using the C-CPI-U.⁴⁷ The GST exemption amount as indexed for inflation in 2018 is \$11.18 million.⁴⁸

Unlike the federal estate and gift tax exemption amount, the GST exemption amount is not “portable” between spouses.⁴⁹ Because there is no portability election for unused GST exemption, many taxpayers are opting to take a “use it or lose it” approach to this newfound and seemingly temporary increase of GST exemption. When determining how a taxpayer may best take advantage of this sudden doubling of GST exemption, one important first step is to determine the amount of GST exemption that a taxpayer has already used, either by affirmative or automatic allocation.

III. AUTOMATIC (AND AT TIMES, INADVERTENT) ALLOCATION OF GST EXEMPTION TO GST TRUSTS

It should be relatively straightforward to calculate the amount of GST exemption affirmatively allocated by a taxpayer.⁵⁰ GST exemption can be affirmatively allocated by a taxpayer on a timely filed federal gift tax return (Form 709) or by the taxpayer’s executor on a federal estate tax return (Form 706).⁵¹ Review of these tax returns should provide sufficient clarification as to how much GST exemption has been affirmatively allocated by the taxpayer to transfers over the years. It is advisable for taxpayers to keep these documents as a permanent part of their tax records.

⁴⁶ Tax Cuts and Jobs Act, Pub. L. No. 115-97, §§ 11002(a)–(b), 11061(a), 131 Stat. 2054, 2059, 2061 (2017) (codified at §§ 1(f)(3), (6), 2010(c)(3)); *see* discussion *supra* Part II.A.

⁴⁷ I.R.C. § 1(f)(3); Tax Cuts and Jobs Act § 11061(a), 131 Stat. 2091 (codified at § 2010(c)(3)).

⁴⁸ I.R.C. § 2631(c); Rev. Proc. 2018-18, *supra* note 27, § 3.35, at 397.

⁴⁹ STAFF OF JOINT COMM. ON TAXATION, JCX-55-10, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS CONTAINED IN THE “TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010” SCHEDULED FOR CONSIDERATION BY THE UNITED STATES SENATE 52 n.56 (Comm. Print 2010).

⁵⁰ *See* I.R.C. §§ 2631(a), 2632(c).

⁵¹ *See id.* § 2631(a). If property is held in trust, the GST exemption is allocated to the entire trust instead of to specific trust assets. Treas. Reg. § 26.2632-1(a) (as amended in 2005).

Nevertheless, determining the amount of GST exemption allocated by automatic allocation can be unpleasantly complex. Effective for any transfers made after December 31, 2000, any unused portion of an individual's GST exemption will be automatically allocated to any "indirect skips" made by such an individual during her lifetime, without the need for any affirmative action by the taxpayer,⁵² in an amount "necessary to make the [GST] inclusion ratio for such property zero" (0.000).⁵³ This "automatic allocation is irrevocable after the due date [for] the [federal gift tax return] for the [tax] year in which the transfer [was] made."⁵⁴ A transfer will be considered to be an "indirect skip" if the transfer is made to a "GST Trust."⁵⁵ A "GST Trust" is broadly defined as any "trust that *could* have a generation-skipping transfer . . . unless" one of the six exceptions contained in § 2632(c)(3)(B)(i)–(vi) applies at the time of the transfer.⁵⁶

Section 2632(c) was originally enacted as a savings provision to aid taxpayers who transferred property to irrevocable trusts that were intended to be generation-skipping but, for one reason or another, inadvertently did not allocate the needed GST exemption to the transfer.⁵⁷ However, in practice this wide-sweeping definition of what constitutes a "GST Trust,"⁵⁸ and

⁵² I.R.C. § 2632(c). Taxpayers do have the ability to opt out of the automatic allocation rules by making an affirmative election pursuant to § 2632(c) on a timely filed federal gift tax return (Form 709). *Id.* § 2632(c)(5); Treas. Reg. § 26.2632-1(b)(2)(ii) (as amended in 2005). For these purposes, it is presumed that no such election has been made. It should be noted that a transferor's unused GST exemption is first automatically allocated to lifetime *direct* skips in an amount necessary to make the transferred property's inclusion ratio equal to zero. I.R.C. § 2632(b)(1). This article focuses on indirect skips (such as those made to a trust) and primarily on situations where no election with respect to the § 2632(c) automatic allocation rules has been made by the taxpayer.

⁵³ I.R.C. § 2632(c)(1). A GST inclusion ratio of 0.000 designates a trust as being fully exempt from GST tax. *See id.* A trust's GST inclusion ratio can range between 0.000 and 1.000, where 0.000 is fully exempt from GST tax and 1.000 is fully subject to GST tax. *See id.* The calculation of this ratio is detailed further in § 2642(a).

⁵⁴ Treas. Reg. § 26.2632-1(b)(2)(i) (as amended in 2005). Filing a Form 709 is not necessary to report the automatic allocation of GST exemption. *See id.*

⁵⁵ I.R.C. § 2632(c)(3)(A).

⁵⁶ *Id.* § 2632(c)(3)(B) (emphasis added).

⁵⁷ Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 501, 115 Stat. 38, 69; H.R. REP. NO. 107-84, at 8 (2001) (Conf. Rep.).

⁵⁸ *See* I.R.C. § 2632(c)(3)(B).

therefore to which trusts GST exemption will be automatically allocated,⁵⁹ has ensnared many trusts that were not intended by taxpayers to be GST exempt.⁶⁰ As a result, unless one of the exceptions listed in § 2632(c)(3)(B) applied to each transfer made to the trust, some amount of GST exemption was automatically (albeit inadvertently and in some situations, unknowingly) allocated to the trust.⁶¹

Accordingly, the amount of GST exemption that has been automatically allocated to an irrevocable trust pursuant to § 2632(c) will depend upon whether the trust is deemed to be a “GST Trust” under § 2632(c)(3)(B) at the time of the transfer to the trust.⁶² This analysis is nuanced and focuses upon several factors including the ages of the trust’s beneficiaries at the time of the transfer,⁶³ the trust’s total value in a given year,⁶⁴ and the value of accumulated hanging *Crummey* withdrawal powers possessed by beneficiaries over trust principal.⁶⁵ Because the required analysis is highly fact-intensive, the determination of whether one of the exceptions applies to a transfer (and therefore, whether GST exemption was automatically allocated to that transfer) may, and often does, change from year to year. Each exception provided under § 2632(c)(3)(B) is discussed in more detail below.

A. Exception (i): I.R.C. § 2632(c)(3)(B)(i)

Section 2632(c)(3)(B)(i) provides that a trust will not be a GST Trust if “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 . . . non-skip persons” either (1) before the date the non-skip person turns forty-six,⁶⁶

⁵⁹ *See id.*

⁶⁰ *See id.*

⁶¹ *See id.*

⁶² *See id.* § 2632(c)(1).

⁶³ *See id.* § 2632(c)(3)(B)(i).

⁶⁴ *See id.* § 2632(c)(3)(B)(vi).

⁶⁵ *See infra* Part III.E.1 for a discussion of *Crummey* powers.

⁶⁶ I.R.C. § 2632(c)(3)(B)(i)(I).

(2) on or before one or more dates specified in the trust agreement that will occur before the non-skip person turns forty-six,⁶⁷ or (3) upon the occurrence of an event that may reasonably be expected to occur before the non-skip person turns forty-six (in accordance with regulations prescribed by the Internal Revenue Service (IRS)).⁶⁸ It is generally understood that the death of both parents is not reasonably expected before a child turns forty-six.⁶⁹ This may be more easily understood when comparing Example #1 and Example #2, below.

Example #1. Parent creates and funds an irrevocable trust for the benefit of Child, and the trust agreement provides for discretionary distributions of income and principal to Child. Pursuant to the terms of the trust agreement, Child has the right to withdraw one-third of the trust property upon attaining age thirty-five, one-half of the trust property upon attaining age forty, and the child has the right to withdraw the remaining trust property upon attaining age forty-five. No election with respect to the GST exemption automatic allocation rules has ever been made on a federal gift tax return with respect to this trust. The trust is not a charitable trust.

The trust in Example #1 meets the exception set forth in § 2632(c)(3)(B)(i). A child is a non-skip person with respect to the child's parent (the transferor of the trust) because a child is fewer than two generations below their parent.⁷⁰ In this example, the child has the power to withdraw more than 25% of the trust property before attaining age forty-six (in fact, upon the child attaining age thirty-five), and there are no conditions precedent to the child possessing this withdrawal right other than the child's attainment of the stated age. Therefore, since this trust meets the exception set forth in § 2632(c)(3)(B)(i), the trust will not be considered to be a GST Trust. As a result, GST exemption will not be automatically allocated to a transfer made to this trust.⁷¹

⁶⁷ *Id.* § 2632(c)(3)(B)(i)(II).

⁶⁸ *Id.* § 2632(c)(3)(B)(i)(III).

⁶⁹ CAROL HARRINGTON ET AL., GENERATION-SKIPPING TRANSFER TAX A-43 (2018 ed. 1996); *see* I.R.C. § 2631(c)(2)(B)(i)(III).

⁷⁰ Treas. Reg. § 26.2651-1(a)(1) (2005).

⁷¹ *See* I.R.C. § 2632(c)(4).

Example #2. Grantor creates and funds an irrevocable life insurance trust for the benefit of Spouse and Child, and the trust agreement provides that during Grantor's lifetime, the trustee has the discretion to distribute income and principal to Spouse and Child. Upon Grantor's death, the trust agreement provides that the property would continue in trust for the benefit of Spouse. Upon the death of Spouse (or upon the death of Grantor, if Spouse predeceases Grantor), the trust agreement provides that the property would be held in a separate trust for the benefit of the Child. Under the terms of the article creating the separate trust, Child would have the power to withdraw portions of the principal of the separate trust as follows: one-third upon attaining age thirty-five, one-half upon attaining age forty, and the remaining principal upon attaining age forty-five. Grantor, Spouse, and Child are all currently living. Child is age eight. No election with respect to the GST exemption automatic allocation rules has ever been made on a federal gift tax return with respect to this trust. The trust is not a charitable trust.

The trust in Example #2 does not meet the exception set forth in § 2632(c)(3)(B)(i). Although Spouse and Child are non-skip persons with respect to Grantor, because they are fewer than two generations below the Grantor, the Child's power to withdraw more than 25% of the trust property only vests upon the death of both Grantor and Spouse. In Example #2, even if the child had already attained age thirty-five, the child still would not have a right to withdraw any of the trust property because the withdrawal powers are granted under the terms of a separate trust for the child's benefit that is only created after the death of both Grantor and Spouse.⁷² The IRS has issued guidance indicating that the death of both parents is not reasonably expected before a child turns forty-six.⁷³ Therefore, since this trust does not meet the exception set forth in § 2632(c)(3)(B)(i), the trust will be considered to be a GST Trust. As a result, GST exemption will be automatically allocated to a transfer made to this trust.⁷⁴

The required analysis with respect to the exception set forth in § 2632(c)(3)(B)(i) can be expected to remain static over the years until the

⁷² See *id.* § 2632(c)(3)(B). In Example #1, Child's withdrawal power would have vested merely upon the child's attainment of a certain age. But in Example #2, Child's withdrawal power would require another event or condition to occur.

⁷³ HARRINGTON ET AL., *supra* note 69, at A-44.

⁷⁴ I.R.C. § 2632(c).

earlier to occur of (1) a beneficiary attaining an age related to age-based withdrawal powers provided in the trust agreement, or (2) the death of one or more trust beneficiaries whose death(s) are conditions precedent to the vesting of a withdrawal power. As illustrated below, with regard to the other exceptions set forth in § 2632(c)(3)(B), that will not always be the case.

B. Exception (ii): I.R.C. § 2632(c)(3)(B)(ii)

The exception provided in § 2632(c)(3)(B)(ii) states that a trust will not be a GST Trust if the trust agreement provides that more than 25% of the trust corpus must be distributed to one or more non-skip persons who are living on the date of death of another person identified in the trust agreement (whether identified by name or by class) who is more than ten years older than the non-skip person.⁷⁵ Alternatively, a trust will not be a GST Trust if the trust agreement provides that more than 25% of the trust corpus may be withdrawn by one or more non-skip persons who are living on the date of death of another person identified in the trust agreement (whether identified by name or by class) who is more than ten years older than the non-skip person.⁷⁶ Example #3 and Example #4, below, illustrate this exception more clearly.

Example #3. Assume the same facts as Example #2, except assume Child is age forty-one. Assume further that Grantor and Spouse are more than ten years older than child.

The trust in Example #3 meets the exception set forth in § 2632(c)(3)(B)(ii). Both Grantor and Spouse are identified in the trust agreement by name. Under the terms of the trust agreement, if both Grantor and Spouse die, the trust property is distributed to a separate trust for Child. If Child is currently age forty-one, Child will be immediately able to exercise the withdrawal power granted to Child under the trust agreement over one-half of the trust property (with absolute power to withdraw one-half of the trust property upon attaining age forty), which is greater than the 25% requirement set forth in the exception. Therefore, since this trust meets the exception set forth in § 2632(c)(3)(B)(ii), the trust will not be considered to

⁷⁵ *Id.* § 2632(c)(3)(B)(ii).

⁷⁶ *Id.*

be a GST Trust. As a result, GST exemption will not be automatically allocated to a transfer made to this trust.⁷⁷

Example #4. Assume the same facts as Example #3, except assume Child is age eight.

The trust in Example #4 does not meet the exception set forth in § 2632(c)(3)(B)(ii). Both Grantor and Spouse are identified in the trust agreement by name. Under the terms of the trust agreement, if both Grantor and Spouse die, the trust property is distributed to a separate trust for Child. If Child is currently age eight, Child will not be immediately able to exercise any withdrawal power granted to Child under the trust agreement because Child has not attained the minimum age required to vest the withdrawal power (per the terms of the trust agreement, the power to withdraw one-third of the trust property only vests upon Child attaining age thirty-five). At Child's current age, even if both Grantor and Spouse die the Child would still not possess the absolute right to withdraw any of the trust property, let alone the 25% requirement set forth in the exception. Therefore, since this trust does not meet the exception set forth in § 2632(c)(3)(B)(ii), the trust will be considered to be a GST Trust. As a result, GST exemption will be automatically allocated to a transfer made to this trust.⁷⁸

Example #3 and Example #4 illustrate that the determination as to whether a trust meets the exception provided in § 2632(c)(3)(B)(ii) depends in large part upon the terms of the trust agreement and the beneficiaries' current ages in relation to any age-based withdrawal powers granted in the trust agreement. Practitioners should be mindful of changes in a client's family circumstances and, if possible, should consider exploring methods of setting notifications or reminders for years and dates on which a beneficiary will attain a certain age.

C. Exception (iii): I.R.C. § 2632(c)(3)(B)(iii)

A trust will not be a GST Trust if, should a non-skip person die before the transferor, the trust agreement provides that more than 25% of the trust

⁷⁷ *Id.* § 2632(c).

⁷⁸ *Id.*

corpus: (1) must be distributed to the estate of one or more non-skip persons, or (2) is subject to a general power of appointment exercisable by one or more non-skip persons.⁷⁹

Careful examination of the trust agreement should be sufficient to determine whether the trust agreement provides for either of these scenarios in the event that a beneficiary dies before the transferor.

Exception (iv), in § 2632(c)(3)(B)(iv), is discussed in detail below.⁸⁰

D. Exceptions (v) and (vi): I.R.C. § 2632(c)(3)(B)(v)–(vi)

Sections 2632(c)(3)(B)(v)–(vi) further provide that a trust will not be a GST Trust if the trust is a charitable lead annuity trust (CLAT), charitable remainder annuity trust (CRAT), or a charitable remainder unitrust (CRUT),⁸¹ or if the trust is an annuity trust for which a charitable deduction was allowed.⁸²

Examination of the trust agreement should be sufficient to determine whether the trust meets any of these requirements. Unlike the other exceptions described in this article, this determination is unlikely to change over time.

E. Exception (iv): I.R.C. § 2632(c)(3)(B)(iv)

Section 2632(c)(3)(B)(iv) provides that a trust will not be a GST Trust if any portion of the trust would be included in a non-skip person's gross estate for federal estate tax purposes (other than the transferor) if such non-skip person (other than the transferor) were to die immediately after the transfer.⁸³ However, a non-skip person's right to withdraw trust property in an amount not to exceed the federal gift tax annual exclusion amount will *not* count as being includible in her gross estate or as being subject to a right of

⁷⁹ *Id.* § 2632(c)(3)(B)(iii).

⁸⁰ *See infra* Part III.E.

⁸¹ I.R.C. § 2632(c)(3)(B)(v).

⁸² *See id.* § 2632(c)(3)(B)(vi).

⁸³ *Id.* § 2632(c)(3)(B)(iv).

withdrawal.⁸⁴ For these purposes, it is assumed that powers of appointment held by non-skip persons are not exercised.⁸⁵

This analysis will turn, in large part, on whether “hanging *Crummey* powers” are granted to trust beneficiaries under the trust agreement.

1. *Hanging Crummey Powers*

A taxpayer’s taxable gifts for any calendar year, as calculated for federal gift tax purposes, will be the total amount of gifts made during the year, less exclusions and deductions, including the “annual exclusion” amount.⁸⁶ The annual exclusion amount is an amount that a taxpayer is permitted to gift to an unlimited number of donees in any calendar year before using any of the taxpayer’s applicable exclusion amount.⁸⁷ In 2018, the annual exclusion amount is \$15,000; therefore, the first \$15,000 of any gift made by a donor to any donee will not be included in the donor’s taxable gifts for that year.⁸⁸ Because this amount is not included in the calculation of the donor’s taxable gifts, the annual exclusion amount does not use any of the donor’s applicable exclusion amount.⁸⁹ Accordingly, in 2018 a taxpayer can gift up to \$15,000 to multiple donees without spending down any of the taxpayer’s \$11.18 million applicable exclusion amount.⁹⁰

The federal gift tax annual exclusion amount is only available for gifts of a present interest to a beneficiary, and cannot be applied to gifts of future

⁸⁴ *Id.* § 2632(c)(3)(B).

⁸⁵ *Id.*

⁸⁶ *Id.* § 2503(a).

⁸⁷ *Id.* § 2503(b)(1). The annual exclusion amount is per individual donee (not per donor). *See id.*

⁸⁸ Rev. Proc. 2017-58, § 3.37(1), 2017-45 I.R.B. 489, 495. This “annual exclusion” amount is indexed for inflation each year, and increases slowly. *See* I.R.C. § 2503(b)(2). In 2012, the annual exclusion amount was \$13,000 and for years 2013 through 2017, inclusive, the annual exclusion amount was \$14,000. *Frequently Asked Questions on Gift Taxes*, INTERNAL REVENUE SERV. (Aug. 20, 2018), <https://www.irs.gov/businesses/small-businesses-self-employed/frequently-asked-questions-on-gift-taxes>. A married couple can effectively combine their annual exclusion amounts to give up to \$30,000 to a donee through the use of “gift splitting.” I.R.C. § 2513(a).

⁸⁹ I.R.C. § 2503(b).

⁹⁰ *See id.*; *see also* Rev. Proc. 2017-58, *supra* note 88, § 3.37(1), at 495 (“[T]he first \$15,000 of gifts to any person (other than gifts of future interest[] in property) are not included in the total amount of taxable gifts . . .”).

interests.⁹¹ A gift will be considered to be a gift of a present interest if the donee has the “unrestricted right to the immediate use, possession, or enjoyment of [the] property or the income from [the] property.”⁹² Gifts to trusts that “are limited to commence in use, possession, or enjoyment at some future date or time” (e.g., a reversionary or remainder interest) are not gifts of a present interest, and therefore the annual exclusion cannot be used to reduce the amount of the taxable gift.⁹³ However, if a trust agreement gives designated beneficiaries the power to demand immediate possession and enjoyment of a certain portion of the principal or income of a trust, despite other provisions in the trust agreement for the deferred distribution of trust principal, the beneficiaries’ power will be deemed to be a present interest.⁹⁴

This often manifests in a trust agreement where certain beneficiaries of a trust are given an unfettered right to withdraw a portion of any contribution to the trust each time a contribution is made. The designated beneficiaries will be deemed to have a present interest in the amount of the contribution over which they possess a right of withdrawal—therefore qualifying the contribution for the gift tax annual exclusion.⁹⁵ These withdrawal rights are often referred to as *Crummey* powers.⁹⁶ A *Crummey* power will “hang” to the extent that it does not fully lapse by the end of the calendar year (such a power will “hang in the air” or “hang around” for future years). The extent to which a *Crummey* power lapses is specified in the trust instrument.

Therefore, in order to utilize the annual gift tax exclusion on contributions made to a trust, the trust agreement must contain a provision providing certain beneficiaries with the right to withdraw from the trust a

⁹¹ Treas. Reg. § 25.2503-3(a) (as amended in 1983).

⁹² *Id.* § 25.2503-3(b).

⁹³ *Id.* § 25.2503-3(a). Generally, a gift to a trust where assets stay in trust for the beneficiary is a gift of a future interest. *Id.* § 25.2503-3(a), (c); Rev. Rul. 79-47, 1979-1 C.B. 312.

⁹⁴ See *Crummey v. Comm’r*, 397 F.2d 82, 82, 85–86 (9th Cir. 1968).

⁹⁵ *Id.* at 85–86.

⁹⁶ *Crummey* powers to create present interests eligible for annual exclusion were first approved in *Crummey v. Commissioner*, 397 F.2d at 87–88. A beneficiary will be deemed to have a present interest in property if the beneficiary is given the power to demand immediate possession and enjoyment of the income or principal. Rev. Rul. 73-405, 1973-2 C.B. 321.

portion of each contribution made to it, usually capped at some amount.⁹⁷ Often, but not always, the cap is equal to the federal gift tax annual exclusion amount.

The exception provided in § 2632(c)(3)(B)(iv) provides that a trust will not be considered to be a GST Trust, and therefore GST exemption will not be automatically allocated, if any portion of the trust property would be included in a non-skip person's gross estate (other than the transferor) if the non-skip person (other than the transferor) were to "die[] immediately after the transfer."⁹⁸ At first glance, this would seem to broadly include any trust that provides children (non-skip persons) with *Crummey* withdrawal powers over property contributed to a trust created by a parent, and the *Crummey* powers are designed to not lapse fully (i.e., will "hang") at the end of each year; thus implicating the vast majority of irrevocable trusts created by taxpayers over the last few decades. After all, if a *Crummey* power holder dies before her withdrawal right fully lapses, the value of her unexercised withdrawal right is includible in her gross estate for federal estate tax purposes.⁹⁹ Realizing that the death of any *Crummey* power holder could potentially prevent the allocation of GST exemption with unintended results, the Code limits the application of this exception to situations where the total value of property subject to a *Crummey* power (hanging and current) exceeds the federal gift tax annual exclusion amount for that particular year.¹⁰⁰ Unfortunately, many common irrevocable trusts with hanging *Crummey* powers will still run afoul of this exception because hanging *Crummey* powers can accumulate to an amount in excess of the federal gift tax annual exclusion amount (although not necessarily in every year), resulting in a trust that is not fully exempt or nonexempt for GST purposes. This major dilemma is illustrated in Examples #5–7 below.

Example #5. Assume the same facts as Example #4. Assume the trust agreement provides that Child possesses a *Crummey* withdrawal power over any contribution to the trust equal to the lesser of (1) the amount of the contribution or (2) the federal gift tax annual exclusion amount available

⁹⁷ Rev. Rul. 73-405, *supra* note 96, at 321.

⁹⁸ I.R.C. § 2632(c)(3)(B)(iv).

⁹⁹ *Id.* § 2632(e)(3)(B)(vi); see HENRY J. LISCHER, GIFTS TO MINORS A-63 (2015 ed. 1979).

¹⁰⁰ HARRINGTON, *supra* note 69, at A-45. See I.R.C. § 2632(c)(3)(B).

from Grantor to Child at such time. The trust agreement further provides that on December 31 of each year, all *Crummey* withdrawal powers will lapse by an amount equal to the greater of (1) \$5,000 or (2) 5% of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsing power could be satisfied pursuant to § 2514(e). Assume Child's current hanging *Crummey* power amount is \$0, the value of the trust is currently \$10,000, and Grantor contributes \$15,000 to the trust on June 1, 2018. Assume Grantor has not made any other gifts to Child in the calendar year and Child does not exercise this *Crummey* withdrawal power.¹⁰¹ Assume Child dies on June 2, 2018, prior to the lapsing of any withdrawal powers.

The trust in Example #5 does not meet the exception set forth in § 2632(c)(3)(B)(iv). Upon Grantor's contribution of \$15,000 to the trust on June 1, 2018, the trust agreement provides that Child has the power to withdraw an amount equal to the lesser of (1) the amount of the contribution (\$15,000) or (2) the federal gift tax annual exclusion amount available from Grantor to Child (\$15,000 in 2018). Therefore, Child has the power to withdraw the entire \$15,000 contributed to the trust. If Child died on June 2, 2018, immediately after the Grantor's contribution to the trust on June 1, 2018, the amount of Child's total withdrawal power (including any current hanging *Crummey* power amounts) would be \$15,000 (\$15,000 current withdrawal amount plus \$0 hanging *Crummey* power amount). The exception provided in § 2632(c)(3)(B)(iv) specifies that the withdrawal power amount will be considered to be includible in the power holder's gross estate for purposes of determining whether the trust is a GST Trust only if the total withdrawal power amount is greater than the federal gift tax annual exclusion amount.¹⁰² In this example, Child's total withdrawal power amount is \$15,000, which is not greater than the federal gift tax annual exclusion amount (\$15,000 in 2018). Therefore, this trust does not meet the exception set forth in § 2632(c)(3)(B)(iv) and the trust will be considered to be a GST

¹⁰¹ Assume also that Grantor and Spouse do not split gifts pursuant to § 2513. A detailed discussion of gift-splitting between spouses is outside the scope of this article.

¹⁰² The determination of whether a withdrawal power is deemed to be included in the power holder's gross estate under § 2632(c)(3)(B)(iv) for purposes of determining whether the trust is a GST Trust is not the same as the determination of whether a withdrawal power is generally deemed to be included in the power holder's gross estate for federal estate tax purposes under § 2041(a)(2).

Trust. As a result, GST exemption will be automatically allocated to a transfer made to this trust.¹⁰³

Example #6. Assume the same facts as Example #5, except assume that Child's current hanging *Crummey* power amount is \$10,000. Again, assume that Child does not exercise any portion of Child's *Crummey* withdrawal power. Assume Child dies on June 2, 2018, prior to the lapsing of any withdrawal powers.

The trust in Example #6 meets the exception set forth in § 2632(c)(3)(B)(iv). Upon Grantor's contribution of \$15,000 to the trust on June 1, 2018, the trust agreement provides that Child has the power to withdraw an amount equal to the lesser of (1) the amount of the contribution (\$15,000) or (2) the federal gift tax annual exclusion amount available from Grantor to the Child (\$15,000 in 2018). Therefore, Child has the power to withdraw the entire \$15,000 contributed to the trust. If Child died on June 2, 2018, immediately after the Grantor's contribution to the trust on June 1, 2018, the amount of Child's total withdrawal power (including any current hanging *Crummey* power amounts) would be \$25,000 (\$15,000 current withdrawal amount plus \$10,000 hanging *Crummey* power amount).¹⁰⁴ Because Child's total withdrawal power amount is greater than the federal gift tax annual exclusion amount (\$15,000 in 2018), the withdrawal power amount will be deemed to be included in Child's gross estate for purposes of determining whether the trust is a GST Trust.¹⁰⁵ Therefore, this trust does not meet the exception set forth in § 2632(c)(3)(B)(iv) and the trust will not be considered to be a GST Trust. As a result, GST exemption will not be automatically allocated to a transfer made to this trust.¹⁰⁶

Example #5 and Example #6 illustrate the critical importance of calculating hanging *Crummey* powers in determining whether a trust is a GST Trust. Indeed, the existence of a hanging *Crummey* power amount is the sole determining factor in these two examples. The slow accumulation of hanging *Crummey* power amounts over many continued years of repeated annual

¹⁰³ I.R.C. § 2632(c).

¹⁰⁴ In Example #5 the amount of Child's total withdrawal power was \$15,000 because the Child did not possess any hanging *Crummey* power amount.

¹⁰⁵ See HARRINGTON ET AL., *supra* note 69, at A-45.

¹⁰⁶ I.R.C. § 2632(c).

contributions to trusts, together with a federal gift tax annual exclusion amount that gradually increase over time, can cause a trust to oscillate between not meeting the definition of a GST Trust in one year but qualifying as a GST Trust in a subsequent year. The need to keep meticulous records of contributions made to trusts and the corresponding *Crummey* withdrawal powers granted to beneficiaries in order to track this progression is hopefully evident.

This analysis becomes exponentially complex in situations involving both multiple beneficiaries that possess *Crummey* withdrawal powers and multiple trusts under which multiple beneficiaries possess hanging *Crummey* withdrawal powers. A simplified illustration follows.

Example #7. In calendar year 2000, Grantor creates and funds an irrevocable life insurance trust for the benefit of Spouse, Child 1, and Child 2, and the trust agreement provides that during Grantor's lifetime, the trustee has the discretion to distribute income and principal to the Spouse and Children 1 and 2. Upon Grantor's death, the trust agreement provides that the property would continue in trust for the benefit of Spouse. Upon the death of Spouse (or upon the death of Grantor, if Spouse predeceases Grantor), the trust agreement provides that the property would be divided equally and held in separate trusts for each of Child 1 and 2. Under the terms of the article creating the separate trusts, each child would have the power to withdraw portions of the principal of her separate trust as follows: one-third upon attaining age thirty-five, one-half upon attaining age forty, and the remaining principal upon attaining age forty-five. Assume the trust agreement provides that each child possesses a *Crummey* withdrawal power over any contribution to the trust equal to the lesser of (1) a per capita amount (i.e., one-half) of the contribution or (2) the federal gift tax annual exclusion amount available from Grantor to the child at such time. The trust agreement further provides that on December 31 of each year, all *Crummey* withdrawal powers will lapse by an amount equal to the greater of (1) \$5,000 or (2) 5% of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsing power could be satisfied pursuant to § 2514(e). Assume that Grantor does not make any other gifts to the Child 1 and 2 in any year and that neither child exercises this *Crummey* withdrawal power.¹⁰⁷ Grantor, Spouse and both children are all currently living. No election with respect to the GST

¹⁰⁷ Assume also that Grantor and Spouse do not split gifts pursuant to § 2513.

exemption automatic allocation rules has ever been made on a federal gift tax return with respect to this trust. The trust is not a charitable trust.

Year by year analysis:

Year	Hanging <i>Crummey</i> Amount Remaining from Prior Years ¹⁰⁸	Contribution to Trust and Calculation of Withdrawal Power Amount ¹⁰⁹	Calculation of New Hanging <i>Crummey</i> Amount Following Lapse of Power ¹¹⁰	§ 2632(c)(3)(B)(iv) Analysis
2000	\$0 per child	\$14,500 2 children living. <u>Per capita:</u> \$7,250 per child <u>Federal annual gift exclusion amount for year in question:</u> \$10,000 per donee	Assume total value of trust is less than \$100,000. <u>Amount of withdrawal power lapsing as of December 31:</u> \$5,000 per child <u>Hanging <i>Crummey</i> amount (carries forward to next year):</u>	Not applicable—automatic allocation only applies to indirect skips made after December 31, 2000 <u>Conclusion:</u> GST Trust analysis is not applicable. <u>GST Inclusion Ratio of Trust Following Transfer:</u> 1.000

¹⁰⁸ Calculated immediately prior to current year contribution.

¹⁰⁹ Total withdrawal amount will be (1) the lesser of the per capita amount of contribution or the federal gift tax annual exclusion amount available from Grantor to each child, plus (2) the amount of any prior hanging *Crummey* withdrawal powers held by the child.

¹¹⁰ Per the terms of the trust agreement in Example #7, *Crummey* withdrawal power will lapse on December 31 of each year by an amount equal to the greater of (1) \$5,000 or (2) 5% of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsing power could be satisfied pursuant to § 2514(e).

		<u>Total Amount Withdrawable by Child as of Date of Gift</u> ¹¹¹ : \$7,250 per child (\$7,250 current + \$0 prior hanging <i>Crummey</i>)	\$2,250 per child (\$7,250 withdrawal power minus \$5,000 lapse)	(no affirmative election made by taxpayer)
2001	\$2,250 per child (see calculation from year 2000)	\$14,500 2 children living. <u>Per capita:</u> \$7,250 per child <u>Federal annual gift exclusion amount for year in question:</u> \$10,000 per donee <u>Total Amount Withdrawable by Child as of Date of Gift</u> ¹¹² : \$9,500 per child	Assume total value of trust is less than \$100,000. <u>Amount of withdrawal power lapsing as of December 31:</u> \$5,000 per child <u>Hanging Crummey amount (carries forward to next year):</u> \$4,500 per child (\$9,500 withdrawal power minus \$5,000 lapse)	This is an indirect skip made after December 31, 2000. Section 2632(c) automatic allocation rules apply to this transfer. The exception in § 2632(c)(3)(B)(iv) does not apply to this transfer. No part of this trust would cause a child's interest to be included in the child's gross estate if child had died immediately following the contribution to the trust for purposes of determining if trust is a GST Trust. Although hanging <i>Crummey</i> withdrawal rights have accumulated (total amount

¹¹¹ Including prior hanging *Crummey* amount.

¹¹² Including prior hanging *Crummey* amount.

		(\$7,250 current + \$2,250 prior hanging <i>Crummey</i>)		<p>withdrawable by each child is \$9,000), the amount is not greater than the federal gift tax annual exclusion amount.</p> <p><u>Conclusion:</u></p> <p>Trust is a GST Trust for this year. \$14,500 of Grantor's GST exemption was automatically allocated to this contribution.</p> <p><u>GST Inclusion Ratio of Trust Following Transfer:</u></p> <p>0.500</p>
2002	\$4,500 per child	<p>\$14,500</p> <p>2 children living.</p> <p><u>Per capita:</u></p> <p>\$7,250 per child</p> <p><u>Federal annual gift exclusion amount for year in question:</u></p> <p>\$11,000 per donee</p>	<p>Assume total value of trust is less than \$100,000.</p> <p><u>Amount of withdrawal power lapsing as of December 31:</u></p> <p>\$5,000 per child</p> <p><u>Hanging <i>Crummey</i> amount (carries forward to next year):</u></p>	<p>The exception in § 2632(c)(3)(B)(iv) does apply to this transfer. Immediately following the contribution to the trust, the total amount withdrawable by each child (including prior hanging <i>Crummey</i> amounts) is greater than the federal gift tax annual exclusion amount. The withdrawal amount in excess of the federal gift tax annual</p>

		<u>Total Amount Withdrawable by Child as of Date of Gift</u> ¹¹³ : \$11,750 per child (\$7,250 current + \$4,500 prior hanging <i>Crummey</i>)	\$6,750 per child (\$11,750 withdrawal power minus \$5,000 lapse)	exclusion amount (\$750) would be included in child's gross estate if child had died immediately following the contribution. <u>Conclusion:</u> Trust is not a GST Trust for this year. No GST exemption was automatically allocated to this contribution. <u>GST Inclusion Ratio of Trust Following Transfer:</u> 0.750
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The above illustration reflects the typical contributions made to many irrevocable trusts, particularly irrevocable life insurance trusts. Such trusts often hold life insurance policies with moderate premiums that build cash value. Over time, these trusts may actually experience a bell curve of GST exemption allocation if the grantor contributes cash to the trust annually to pay premiums. The beneficiaries' hanging *Crummey* powers can accumulate slowly for the first several years after the trust's creation (resulting in the automatic allocation of GST exemption), until the aggregate value of the hanging powers hits a tipping point that exceeds the federal gift tax annual exclusion amount (stopping the automatic allocation of GST exemption). Then, the hanging *Crummey* amounts eventually lapse as the insurance policy's cash value grows in value to the point that 5% of the trust's value is greater than \$5,000 (resulting again in the automatic allocation of GST exemption to future transfers).

¹¹³ Including prior hanging *Crummey* amount.

Serious tax consequences exist for a trust that is only partially exempt from GST tax. A trust that is fully exempt from GST tax (i.e., having an inclusion ratio of 0.000) will not incur GST tax on transfers made from the trust to beneficiaries, regardless of: when trust property is distributed to a beneficiary, a beneficiary's relationship to the transferor of the trust, and, most importantly, the extent to which trust property appreciates in value inside the trust.¹¹⁴ A trust that is fully subject to GST tax (with an inclusion ratio of 1.000) will incur GST tax at the 40% flat rate upon every taxable termination or taxable distribution of the trust property to a beneficiary who is a skip person with respect to the transferor of the trust.¹¹⁵ A trust that is neither fully exempt nor fully subject to GST tax (that is, with an inclusion ratio between 0.000 and 1.000) will experience a partial taxable termination or partial taxable distribution of the trust property, and therefore owe GST tax *each time* that a distribution is made to a beneficiary who is a skip person.¹¹⁶ The amount of GST tax due in each such event must be calculated based upon the current flat 40% tax rate and multiplied by the trust's GST inclusion ratio.¹¹⁷ This can quickly become extremely administratively burdensome, tax inefficient, and requiring additional annual tax filings and tax payments that could have otherwise been avoided entirely.¹¹⁸

IV. BEST PRACTICES MOVING FORWARD (OR, CLEANING UP THE MESS)

Of course, one way to avoid the need for this complex analysis is to timely file a federal gift tax return for the year in which a contribution is first made to the trust and make an affirmative election to opt in or opt out of the GST exemption automatic allocation rules for that trust, for not only the current transfer to the trust but also for all subsequent transfers. Other options

¹¹⁴ I.R.C. §§ 2641(a), 2642(a)(1)-(2), (b).

¹¹⁵ *Id.* § 2641(b).

¹¹⁶ Treas. Reg. § 26.2612-1(b)(2), (c)(1) (as amended in 2005). The GST tax assessed against the transfer will be assessed against all assets being transferred to the beneficiary (not just specific assets). See HARRINGTON, *supra* note 69, at A-38 to -39. This can be particularly problematic for assets that have increased substantially in value since their contribution to the trust. *See id.*

¹¹⁷ I.R.C. §§ 2602, 2641(b).

¹¹⁸ See generally I.R.S. Instructions for Form 706-GS(D-1), Notification of Distribution From a Generation-Skipping Trust (2017).

must be explored for trusts to which contributions have already been made in prior years.

In the situation that a trust has become partially GST exempt, two remedying steps may be necessary. First, practitioners should consider making an affirmative election to opt in or opt out of the GST exemption automatic allocation rules for the trust on the next possible federal gift tax return that can be timely filed. This effectively draws a line in the sand so that in all subsequent years transfers to the trust receive the same GST treatment regardless of whether a federal gift tax return is filed.

Second, thought should be given to what action (if any) should be taken in order to address the trust's current GST status. If the trust was not intended to be GST exempt but some portion of the taxpayer's GST exemption has been automatically allocated to the trust, no remedy exists to recapture that GST exemption for reuse by the taxpayer.¹¹⁹ It has been irrevocably lost. Similarly, no remedy exists to remove that amount of automatically allocated GST exemption from the trust property.¹²⁰ If, however, the trust was intended to be GST exempt but it is not fully exempt because it became ensnared over the years by one of the exceptions discussed above,¹²¹ few palatable options exist by which a taxpayer can cause an existing trust to become fully exempt.

A. Late Inter Vivos Allocation of GST Exemption

One option is to consider making a late allocation of GST exemption to the trust in an amount necessary to make the trust fully GST exempt. This approach may be particularly desirable for a taxpayer who does not anticipate using all of her GST exemption amount during life or at death, whether by choice or because her taxable estate is significantly smaller than the new, and increased, GST exemption amount following the TCJA.

¹¹⁹ Treas. Reg. § 26.2632-1(b)(2)(i) (as amended in 2005) (“An automatic allocation is irrevocable after the due date of the Form 709 [federal gift tax return] for the calendar year in which the transfer is made.”).

¹²⁰ *Id.*

¹²¹ *See supra* Part III.

A taxpayer can make a late allocation of GST exemption to a transfer made to a trust by filing a federal gift tax return.¹²² However, in order to allocate sufficient GST exemption in order to cause a partially exempt trust to become fully exempt, for GST purposes, the amount of GST exemption allocated must equal the fair market value of the transferred property as determined on the date of the late allocation, not the date on which the property was initially contributed to the trust.¹²³ This could be particularly problematic for trusts holding assets that have significantly increased in value since the date on which the assets were transferred into the trust.¹²⁴ Furthermore, should a taxpayer's estate unexpectedly increase significantly, the taxpayer may later regret using a large amount of her GST exemption in this manner.

B. Allocation of Remaining GST Exemption at Death

Alternatively, a taxpayer may choose to delay allocating GST exemption to a partially exempt trust until the taxpayer's death. This approach may be desirable if the trust is only expected to make distributions of property to beneficiaries who are skip persons after the taxpayer's death.¹²⁵ Additionally, given that the TCJA provides that the increased GST exemption will sunset after December 31, 2025 and revert to significantly lower levels,¹²⁶ it is possible that wary taxpayers may wish to use as little GST exemption as possible until it becomes apparent that the amount of GST exemption will be permanent.¹²⁷ In these instances, the executor of the taxpayer's estate has the ability to make an affirmative allocation of the

¹²² *Id.* § 26.2642-2(a)(2) (1996).

¹²³ *Id.*

¹²⁴ *See id.*

¹²⁵ *See id.* § 26.2632-1(d)(1).

¹²⁶ Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 11061(a), 131 Stat. 2054, 2091 (2017) (codified at § 2010(c)(3)).

¹²⁷ Given that the amount of GST exemption has risen dramatically over the past few decades and nonetheless appears to fluctuate each year because the exemption amount is indexed for inflation, it is doubtful that the GST exemption amount will ever remain static enough to be considered "permanent." *See* I.R.C. § 2010(c)(3)(B).

taxpayer's remaining GST exemption after the taxpayer's death.¹²⁸ The executor could affirmatively allocate the taxpayer's remaining GST exemption to any *inter vivos* trust to which the taxpayer was a transferor.¹²⁹

If no federal estate tax return is expected to be filed, the executor may also consider relying upon the deemed allocation rules set forth in the Code.¹³⁰ If no affirmative allocation of GST exemption is made following the taxpayer's death, the decedent taxpayer's remaining GST exemption will be automatically allocated pro rata: first to direct skips occurring at death, and second, to trusts that could possibly be distributed to skip persons.¹³¹ Similar to the rules regarding *inter vivos* late allocation of GST exemption, the trust value as of the taxpayer's date of death is used to calculate the amount of GST exemption deemed to be allocated and the trust's resultant inclusion ratio.¹³² However, given that the increased GST exemption amount is scheduled to sunset on December 31, 2025, waiting until death may be a gamble for taxpayers.

C. Request Relief from the IRS

In limited situations, the IRS has granted a taxpayer's request for an extension of time in order to opt in or opt out of the automatic allocation rules under § 2632(c).¹³³ Requests for relief in these situations must be made, and considered by the IRS, in accordance with the provisions of Treasury Regulation section 301.9100-3, which permit a taxpayer to request a private letter ruling from the IRS.¹³⁴ Relief is only granted pursuant to these provisions if the "taxpayer provides . . . evidence . . . to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the

¹²⁸ Treas. Reg. § 26.2632-1(d)(1) (as amended in 2005).

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ *Id.* § 26.2632-1(d)(2).

¹³² *Id.*

¹³³ I.R.C. § 2642(g)(1)(A)(ii).

¹³⁴ I.R.S. Notice 2001-50, 2001-2 C.B. 189.

Government.”¹³⁵ Relief in these situations is not automatically granted, and the scenarios in which it has been granted often demonstrate failure by a professional advisor to take necessary action to make the desired automatic allocation election.¹³⁶ Furthermore, the \$10,000 user fee required to file a private letter ruling request may discourage taxpayers from seriously considering this option.¹³⁷ It is no surprise then that obtaining relief in this manner is often considered to be an option of last resort.

V. CONCLUSION

The TCJA creates a potential opportunity for taxpayers who previously created irrevocable trusts that are no longer fully exempt from GST tax.¹³⁸ Such taxpayers may wish to file a 2018 federal gift tax return with two goals. First, a return can be filed to stop any inadvertent hemorrhaging of GST exemption by making an election to opt out of the § 2632(c) automatic allocation rules with respect to the trust. Second, it may be appropriate for some taxpayers to use a portion of their newly doubled GST exemption to make a late allocation to any trusts that were intended to be fully exempt from GST tax but are suspected to be only partially exempt. With careful navigation of the automatic allocation rules and proactive (albeit late) allocation of GST exemption, many old trusts can soon look brand new.

¹³⁵ Treas. Reg. § 301.9100-3(a) (1997).

¹³⁶ I.R.S. Priv. Ltr. Rul. 2016-36-020 (Sept. 2, 2016) (allowing late election to opt out of automatic allocation rules where taxpayer’s lawyer and accountant each assumed that the other was preparing the federal gift tax return on which the election should have been made); I.R.S. Priv. Ltr. Rul. 2016-35-005 (Aug. 26, 2016) (allowing late election to opt out of automatic allocation rules where taxpayer’s tax professional filed a federal gift tax return for year one of a trust and elected out of the automatic allocation rules for that particular transfer but did not also elect out for future transfers, and failed to file a similar election for subsequent transfers to the trust); I.R.S. Priv. Ltr. Rul. 2010-25-019 (June 25, 2010) (allowing a late allocation of GST exemption to a non-GST Trust to be treated as timely made when the taxpayers were not advised by their attorney that they had to file a federal gift tax return in order to allocate GST exemption).

¹³⁷ See Rev. Proc. 2018-1, app. A, 2018-1 I.R.B. 1, 81.

¹³⁸ See, e.g., Tax Cuts and Jobs Act, Pub. L. No. 115-97, §§ 11002(a)–(b), 11061(a), 131 Stat. 2054, 2059, 2091 (2017) (codified at §§ 1(f)(3), (6), 2010(c)(3)).

