FEATURE:
ESTATE PLANNING & TAXATION

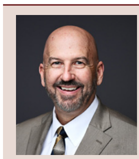
By **Christopher P. Siegle**

Moving Assets Out of GST Tax-Vulnerable Trusts

Practitioners can use a variety of strategies to shift value

The imbalance between the assets in generation-skipping transfer (GST) tax-exempt and GST tax-vulnerable trusts continues to grow. The much larger estate and gift tax exclusion and GST tax exemption amounts available to taxpayers since the enactment of the 2017 Tax Cut and Jobs Act of 2017 (TCJA) haven't slowed the increase of overfunded GST tax-vulnerable trusts. Whether the TCJA's transfer tax provisions expire as scheduled on Jan. 1, 2026, the number of large GST tax-vulnerable trusts is expected to increase.

GST tax-vulnerable trusts are deferred transfer tax time bombs, usually exposed to tax when a beneficiary dies. In many cases, the terms of those trusts provide non-tax benefits such as creditor protection for beneficiaries and centralization of asset management in a single trustee. And if, as is usually the case, those are non-grantor trusts, then income tax advantages for the beneficiaries may be available.[1] Still, trustees should prioritize distributions from those trusts when a GST tax-exempt trust for the same beneficiaries exists because growing assets in a GST tax-exempt trust would be beneficial as later generations become eligible to receive distributions. Often, coordination is needed when GST tax-exempt and tax-vulnerable trusts with the same beneficiaries have different trustees or when there are instructions in trust agreements that may hold GST tax-vulnerable and tax-exempt separate shares under the same instrument.



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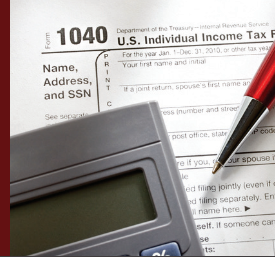
Shifting Assets

Considering the estate or GST tax that ultimately will have to be paid at the time of a trust termination, perhaps when the beneficiary of a GST tax-vulnerable trust dies, planners should consider various options available to shift value to GST tax-exempt trusts. Among those options is allocating future additions to existing GST tax-vulnerable trusts, thanks to an increased GST tax exemption. Even without additional gifts to those trusts, trustees can allocate GST tax exemptions that are inflation-adjusted each year. When making those additions, the trustee will have to recalculate the trust's applicable fraction. The applicable fraction then determines the extent of the trust's GST tax exemption applicable to the trust with an inclusion ratio greater than zero. One issue is that computing the applicable fraction becomes more complicated if the subsequent GST transferor is different from the original GST transferor. Chapter 13 of the Internal Revenue Code requires that, when there are two transferors to a trust, each transferor's portions allocated for GST tax purposes are treated as separate trusts.[2] The trust instrument should contain language describing how allocations should be made in that eventuality. A straightforward and common provision authorizes the trustee to make a qualified severance into separate GST tax-exempt and tax-vulnerable trusts.[3]

With larger trusts, the modest inflation-enhanced GST tax exemption each year doesn't eliminate the disparity between the respective sizes of GST tax-exempt and GST tax-vulnerable trusts. The situation is illustrated in "Amount Covered by GST Tax Exemption," p. 23, which shows what happens to an unmarried taxpayer's assets in a revocable living trust. If a taxpayer who dies in 2024 has, for example, a taxable estate of $50 million, the GST tax



exemption would cover only $13.61 million—around 27% of the estate. That amount presumably would be allocated to a credit shelter (that is, a bypass) trust. The remainder likely would be transferred to a GST tax-vulnerable trust, often a qualified terminable interest property (QTIP) trust, funded with $36.39 million.[4] The GST tax, or the estate tax if that's the preferred solution on the beneficiary-spouse's later passing, is significant. Notice the large GST tax-vulnerable/QTIP trust funding amounts as the estate tax exclusion increases.

New Path for Taxpayers

Typically, because of the risks involved in transactions with QTIP trusts, no action is taken to reduce that latent GST tax or estate tax.[5] The recent Tax Court case of *Anenberg v. Commissioner*[6] may pave a new path for taxpayers to move assets into GST tax-exempt trusts. In that case, a California court ordered the QTIP trust to be terminated and all its assets distributed to the surviving spouse/beneficiary. The surviving spouse/beneficiary then gifted or sold those assets to trusts for the benefit of her children and descendants. The Tax Court found this action wasn't a prohibited disposition of the beneficiary's qualifying income interest because she had received all the property under the California court's order. In addition, the court held that the surviving spouse's later gift wasn't from the QTIP trust, which had been dissolved, meaning that IRC Section 2519 didn't apply.

Reliance on this approach may be helpful to taxpayers when moving assets into GST tax-exempt trusts. However, the termination or modification of trusts must now be considered based on Chief Counsel Memorandum (CCM) 202352018.[7] In that CCM, the beneficiary's consent to a modification of a grantor trust adding a clause allowing discretionary reimbursement of the grantor for taxes the grantor paid that are attributed to trust income was held to be a taxable gift by the consenting beneficiaries. The CCM explains that the permitted reimbursement

Amount Covered by GST Tax Exemption

What happens to assets held in a revocable living trust of an unmarried taxpayer

Year	Taxable estate	Bypass trust	QTIP trust	Deferred 40% GST tax/estate tax
2013	$50,000,000	$5,250,000	$44,750,000	$17,900,000
2014	$50,000,000	$5,340,000	$44,660,000	$17,854,000
2015	$50,000,000	$5,430,000	$44,570,000	$17,828,000
2016	$50,000,000	$5,450,000	$44,550,000	$17,820,000
2017	$50,000,000	$5,490,000	$44,510,000	$17,804,000
2018	$50,000,000	$11,180,000	$38,820,000	$15,528,000
2019	$50,000,000	$11,400,000	$38,600,000	$15,440,000
2020	$50,000,000	$11,580,000	$38,420,000	$15,368,000
2021	$50,000,000	$11,700,000	$38,300,000	$15,320,000
2022	$50,000,000	$12,060,000	$37,940,000	$15,176,000
2023	$50,000,000	$12,920,000	$37,080,000	$14,832,000
2024	$50,000,000	$13,610,000	$36,390,000	$14,556,000

Key
QTIP-Qualified terminable interest property trust
GST-Generation-skipping transfer

— Christopher P. Siegle

of the grantor constitutes a relinquishment of at least some of the beneficiary's interest in the trust. The Associate General Counsel's reasoning may be extended to other contexts when beneficiary consent to trust changes is required or desired. This may include the termination of a QTIP trust.

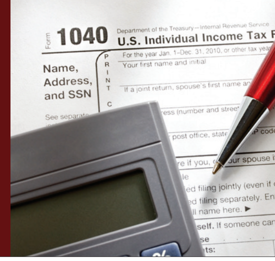
Despite the opportunities that *Anenberg* suggests, rarely is action taken to mitigate the future taxes expected to be imposed when assets in GST tax-vulnerable trusts are distributed or the trusts are terminated. GST tax-vulnerable trusts are often created in the wake of successful grantor-retained annuity trusts. In any case, acting quickly can mitigate the eventual taxes due on those trusts by moving, perhaps tax-free and perhaps not, assets from the GST tax-vulnerable trust to a GST tax-exempt trust. Among the possibilities are:

Make the GST tax-vulnerable trust and GST tax-exempt trusts grantor trusts with respect to a beneficiary of both trusts. Private Letter Ruling 201633021 (Aug. 12, 2016) opened the door for an interesting planning opportunity.[8] It held that a beneficiary's power to withdraw all or a portion of the trust's taxable income created grantor-like status in the beneficiary, even when the taxpayers were irrevocable trusts.[9] This power, found in IRC Section 678(a)(1), to vest all or a portion of the income or the principal of a trust, creates ownership, for income tax purposes, in the beneficiary. The extent of that income tax ownership depends on the definition of "income." If the trust instrument doesn't modify that definition, income is understood to mean fiduciary accounting income, which would exclude capital gains and extraordinary dividends or taxable stock dividends.[10] However, if the trust instrument defines income to mean taxable income, then income would include all items of income and gains. That creates income tax ownership for the beneficiary over perhaps all, but certainly a portion, of the trust.[11] Once a beneficiary is the deemed owner of the trust's assets for income tax purposes, then all exchanges between that trust and other trusts deemed owned by the same beneficiary could be executed tax-free, as could all other transactions, including borrowing from the trust without adequate security (if the trust allows for it).[12]

Operations between the credit bypass trust and the QTIP trust. Applying the technique to the trusts in "Amount Covered by GST Tax Exemption," if the bypass trust were owned, for income tax purposes, by the same beneficiary (let's say the surviving spouse) as the QTIP trust, then: (1) the QTIP trust assets could be exchanged with bypass trust assets free of income or capital gains tax; and (2) the beneficiary of the QTIP trust would realize all the income, gain, loss and deductions attributable to the assets in the bypass *and* QTIP trusts. Vesting this power in a GST tax-vulnerable trust beneficiary would allow the GST tax-exempt bypass trust to grow income tax-free. If the power to withdraw the taxable income could be designed from the beginning under the terms of the revocable trust from which the QTIP and bypass trusts are formed, more value could be moved to the GST tax-exempt trust.

Additional considerations for the revocable trust. Consider certain other features for the eventual funding and operations of the bypass and the QTIP trusts. First, the QTIP trust could give the surviving spouse/beneficiary a right of withdrawal over all of the taxable income of the trust. The surviving spouse/beneficiary would be the income tax owner of the entire QTIP trust. The withdrawal power would also satisfy the entitlement of a qualifying income interest for life requirement.[13] Second, the power of withdrawal granted to the surviving spouse beneficiary of the QTIP trust shouldn't be exercised. In many cases, the surviving spouse is the sole beneficiary of the QTIP trust and among multiple beneficiaries of the bypass trust. Additionally, the surviving spouse usually has other material assets in their own revocable trust in their own name. It's, therefore, unlikely that they would seek to withdraw any of the income from the QTIP trust.

Further, taxpayers seeking to avail themselves of the benefits of Section 678(a) should ensure, if possible, that the remainder beneficiaries of both the QTIP trust and the bypass trust are the same. That outcome may not be feasible to achieve in blended families, particularly if the surviving spouse isn't intended to be the primary beneficiary of the bypass trust. Finally, planners considering executing this strategy should be mindful that their



standard planning documents—including wills and revocable trusts—contain boilerplate language they must carefully examine to ensure that it's suitable or revised as necessary.

Consider power of withdrawal for beneficiaries of existing GST tax-vulnerable trusts. For clients with large GST tax-vulnerable and tax-exempt trusts with the same beneficiaries, planners should consider modifying the GST tax-exempt trust to create a power of withdrawal over its taxable income by the beneficiaries of the GST tax-vulnerable trust.[14] Commonly, GST tax-vulnerable trusts include a general power of appointment (POA) for each generational beneficiary. This general POA will prevent a taxable termination because the beneficiary holding the power must include the trust assets in their estate and be the new GST tax transferor.[15] If the trust instrument didn't initially include a power of withdrawal over all the taxable income of the GST tax-exempt trust, perhaps there's a powerholder over the GST tax-exempt trust who could add such a power. Trust protectors who aren't considered fiduciaries (based on the substantive law governing the trust) are likely candidates to create such a power. Coordination between the trustees of the GST tax-exempt and tax-vulnerable trusts (to the extent the trustees are different) must be undertaken. Perhaps different trustees could help ensure that each considers the fiduciary duties owed. Using PLR 201633021 for guidance, consider whether the beneficiaries are the same in the GST tax-exempt and tax-vulnerable trusts. In every case, ensure that beneficiaries are informed of the modifications that will change the relationship between the trusts. However, given the recent CCM discussed above, it's best to avoid beneficiary consent for any modification, if possible.[16] Flexible drafting in the original instruments has become more important than ever. Relying on the ability to modify later would constitute sub-optimal planning.

Transactions with trusts. If the concerns are addressed and coordination achieved, the same taxpayer would own the GST tax-exempt trust and tax-vulnerable trusts for income tax purposes. The GST tax-vulnerable trust can then engage in a potentially large tax-free sale of its growth assets to the GST tax-exempt trust for a promissory note. While "freezing" the value of the assets of the GST tax-vulnerable trust can be beneficial, shifting the ongoing income tax responsibility to the GST tax-vulnerable trust provides income tax-free growth for the assets of the GST tax-exempt trust. In the current environment of more elevated interest rates, this may be seen as a less accretive feature for a sale in exchange for the promissory note. In many cases, when a long-term note is used, the rates are higher but could be reduced to a lower level, so it may be a good idea to incorporate a renegotiation provision in the note. Focusing on selling growth assets to the grantor trust is important. Having the GST tax-vulnerable trust issue a promissory note in exchange for assets expected to appreciate significantly also shifts more value into the GST tax-exempt trust. A large note could even be separated into several notes, such that the obligation of the GST tax-exempt trust could be distributed from the GST tax-vulnerable trust to the beneficiaries. The beneficiaries holding the promissory notes could then gift or sell the notes to further GST tax-exempt trusts. Once the promissory notes are no longer in the possession of the income tax owner of the obligor trust, any future interest payment to the note holder would be realized as ordinary income to the holder.

Using another grantor trust power, the assets in the GST tax-exempt and tax-vulnerable trusts could be exchanged for equivalent value.[17] With the necessary coordination between the trustees of the GST tax-exempt and tax-vulnerable trusts, you can effectuate a shifting of the maximum growth assets into the GST tax-exempt trust. Because of the nonfiduciary nature of any party effecting that substitution under IRC Section 675(4)(C) on behalf of the GST tax-vulnerable trust, the trust documents should contemplate nonfiduciary trust protectors or substitution appointers.

Example. Suppose the Section 678(a)(1) power is added to an existing GST tax-exempt trust. The GST tax-vulnerable trust then sells an appreciating asset to the GST tax-exempt trust for a promissory note. Sometime later, but during the term of the note, and after substantial growth in the assets sold to the GST tax-exempt trust has been realized, the GST tax-vulnerable trust could exchange the note with other assets (perhaps poor performing

or no growth assets) of the GST tax-exempt trust with a value equivalent to the note (perhaps with discounts applied to that value). When the note is in the hands of the trustee of the GST tax-exempt trust, it's canceled, and the assets remaining in the GST tax-exempt trust can continue to grow income tax-free. Because a nonfiduciary must undertake any exchange of assets without fiduciary consent, perhaps another nonfiduciary power holder should be added or designated in each trust to conduct these transactions.

Consider using other beneficial entities. Another possibility is to use a preferred partnership between the GST tax-vulnerable trust (preferred interest) and the GST tax-exempt trust (common interest). The assets of each trust could be contributed to a partnership in exchange for partnership interests. The preferred interest in the property contributed by the GST tax-vulnerable trust would be "frozen" in value with only a preferred, set return.[18] Meanwhile, the GST tax-exempt trust would receive all appreciation over that allocated to the preferred interest. Don't shift basis in a manner prohibited in Revenue Ruling 2024-14. In that ruling, the taxpayer, with an IRC Section 754 election in place, sought to exchange the basis of contributed property with existing partnership property. The higher basis property with the exchanged basis was then distributed to a terminating partner, a related party. This wasn't allowed. The Internal Revenue Service further explained this cautionary ruling in proposed regulations that announced increasing efforts to discover abusive basis-shifting processes in certain partnerships.[19]

When planning with a preferred partnership, consider IRC Section 2701. In this case, Section 2701 shouldn't apply because these are trusts; there's no senior generation involved in the transaction. Designing the preferred partnership is a sophisticated process, and there may be several artful planning techniques combining other income tax ideas, including allocations of gains and losses, in the preferred partnership operations.[20] Using the preferred partnership benefits both GST tax-vulnerable and tax-exempt trusts. Each will enjoy portions of the appreciating assets, and potentially combining the assets of each trust can lead to synergistic advantages. Unlike the shifting of the income tax ownership among the trusts, using a non-trust entity such as a partnership involves no change of income tax ownership. Each trust remains the taxpayer for its income as a non-grantor trust.

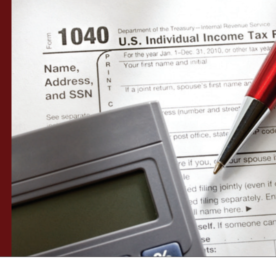
Further planning to mitigate eventual transfer tax on large GST tax-vulnerable trust assets can create more value in the GST tax-exempt trust.

Other Considerations

Further planning to mitigate eventual transfer tax on large GST tax-vulnerable trust assets can create more value in the GST tax-exempt trust. A planner can use both revocable trusts and consider existing irrevocable trusts and non-trust entities in the planning. Identification of non-fiduciary power holders to engage in future transactions with the trusts; defining income as taxable income rather than fiduciary accounting income; and effective communication and relationship with trust beneficiaries are all required to shift value to GST tax-exempt trusts successfully. Carefully consider the practice and potential requirements of beneficiary consent for any modification of trusts and the impact of any proposed regulations inhibiting basis shifting among related parties of partnerships.

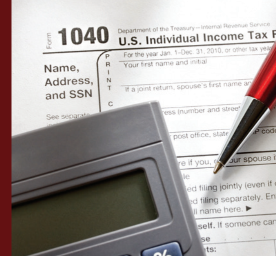
Endnotes

1. Under Internal Revenue Service Sections 651, 652, 661 and 662, a non-grantor trust receives a distribution deduction, and the beneficiary receiving distributed net income realizes the distributed amounts either received or required to be distributed to them.
2. *See* IRC Section 2654(b).
3. *See* IRC Section 2642(a)(3).
4. *See* IRC Section 2652(a)(3).
5. *But see* Christopher P. Siegle, "A Time to Rethink the Typical Testamentary QTIP Trust," *Trusts & Estates* (November 2023).
6. *See Anenberg v. Commissioner*, 162 T.C. 9 (May 20, 2024), in which the spouse-beneficiary terminated her interest in the qualified terminable



interest property trust and thereafter sold the assets to trusts for descendants. This wasn't a commutation triggering IRC Section 2519.

7. *See* Chief Counsel Memorandum 202352018 (Dec. 29, 2023).
8. *See* Private Letter Ruling 201633021 (Aug. 12, 2016). *See also* Treasury Regulations Section 1.671-2(e)(6), Example 8, in which a trust that reserves the right to revoke another trust and revest the property in the revoking trust will be the income tax owner of the trust subject to the power under IRC Section 678(a).
9. *See* Section 678(a)(1), in which a power to vest the principal of income of a trust without the consent of any person results in the power holder being the income tax owner of the trust assets.
10. *See* IRC Sections 63, 643(a)(4) and 643(b). Taxable income for a trust is the same as individuals recognize. Fiduciary accounting income is determined by state law.
11. *But see* Treas. Regs. Section 1.671-3, in which there are six separate portions of a trust, including: (1) ordinary income; (2) income allocable to corpus (gain); (3) the entire trust; (4) an undivided fraction of the trust; (5) a pecuniary amount; and (6) specific property. Arguments have been observed that ownership of the ordinary income or income allocable to the corpus doesn't extend income tax ownership to the entire trust as a portion.
12. *See* IRC Section 675(4).
13. *See* IRC Section 2056(b)(7)(B)(ii)(I).
14. States have various tools including decanting, merger and judicial settlement to potentially add powers and power holders.
15. *See* IRC Sections 2041, 2652(a)(1)(B).
16. *Supra* note 7. In the memorandum, the Chief Counsel determined that a beneficiary's consent to a trust modification that adds a discretionary grantor income tax reimbursement provision to an existing grantor trust would be a gift by the beneficiary and the beneficiary's issue to the grantor.
17. *See* Section 675(4)(C) in which any nonfiduciary person, without the approval of a fiduciary, could reacquire trust property by substituting other property of equivalent value.
18. Market rates must be used for the preferred return because the preferred interest isn't a debt obligation or an interest in a trust. *See* Revenue Ruing. 83-120.
19. *See* Rev. Rul. 2024-14; Proposed Treas Regs. Section 1.6011-18, Fed. Reg. 2024-13282 (June 17, 2024).
20. *See* Stephen M. Breitstone and Jerry Hesch, "Increasing the Income Tax and Estate Tax Benefits for the Preferred Partnership with Encumbered Real Estate with Future Leveraging," 81st NYU Inst. on Fed. Taxation (New York, Oct. 26, 2022).



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