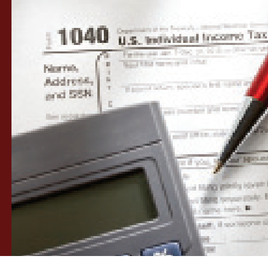

By **Brian G. Smith**, **Solange Etessami** & **Brianna Johnson-King**

How Mismatched GST and Gift Tax Exemptions are Like Lost Socks in the Wash

Planning strategies for practitioners

Few things in life are more frustrating than losing socks in the wash and searching desperately around the house for a match or manufacturing one to the best of your abilities. Similar to the quest to find the perfect match for a lone sock, the struggle is real for trusts and estates practitioners who either inherit a client who's used more gift tax exemption than generation-skipping transfer (GST) tax exemption or whose exemption becomes mismatched due to planning and gifting strategies and opportunities that have evolved as the client's net worth and financial position have improved and transformed over a long and successful career.

Because portability of exemption is only applicable to the gift and estate tax exemptions, practitioners should do more careful analysis and planning to ensure the GST exemption is used in full before a client's death and before the Tax Cuts and Jobs Act (TCJA) sunsets at the end of 2025 (assuming it's not extended). We'll explore several tools available to practitioners, including relief provided directly in the Internal Revenue Code and Treasury regulations, late allocation to non-exempt trusts and testamentary planning as a last line of defense.

Section 2642(g)(1) Relief

Under various IRC provisions, a transferor's GST tax exemption is automatically allocated to transfers that are either characterized as (1) a direct skip,[1] or (2) an indirect skip made to a GST trust.[2] For a taxpayer to avoid the application of these automatic allocation provisions, they must affirmatively elect to opt out of such treatment. In some situations, a taxpayer (or a taxpayer's accountant) could erroneously make an opt-out election, thereby failing to allocate GST tax exemption to a trust that was otherwise intended to be GST-exempt.

In May 2024, the Internal Revenue Service promulgated final regulations (regs) that solidified and simplified the previously confusing and often challenging process set forth under the proposed regulations for correcting mistakes with respect to GST tax exemption allocation and related elections. Before the issuance of the final regs, the IRS granted relief under Treasury Regulations Section 301.9100-3 (9100 relief) for certain late elections and allocations of GST tax exemption pursuant to Notice 2001-50. However, under the prior regime, no relief was available for an accidental opt-out election. Although 9100 relief still exists for other types of late elections,[3] the final regs dictate that GST tax exemption allocation and election relief will be granted solely under IRC Section 2642(g)(1).

Under the final regs, the law is much clearer and allows for a taxpayer to take advantage of curing an accidental mismatch between gift and GST tax exemption allocation. Now, a taxpayer who meets the regulatory requirements (summarized briefly below) can submit a request for relief to undo an opt-out election made in error, thereby allocating GST tax exemption to a trust that was intended to be GST-exempt.

Automatic 6-month extension. The IRS now grants an automatic 6-month extension to a taxpayer who timely filed a gift or estate tax return for allocating GST tax exemption not allocated on the

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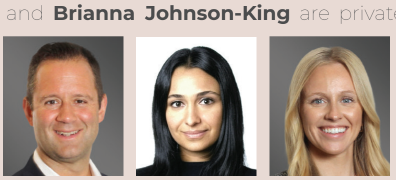
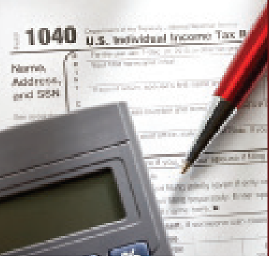




originally filed return. The regulations specify that the taxpayer must simply file a supplemental return within the 6-month period, being sure to write "FILED PURSUANT TO SECTION 26.2642-7(i)(1)" on the front page of the return.[4]

Private letter ruling. Under the new regs, after the expiration of the 6-month period, the taxpayer is required to submit a request for a PLR for GST tax exemption allocation relief (instead of submitting a request under Section 9100).[5]

The taxpayer must provide evidence establishing to the satisfaction of the IRS that: (1) the transferor acted reasonably and in good faith; and (2) the grant of relief won't prejudice the government's interests.[6]

A client may have trusts that are intentionally non-exempt, to which one could explore allocating GST tax exemption.

The regs provide a nonexclusive list of factors that the IRS will consider in determining reasonableness and good faith,[7] namely: (1) the transferor's intent; (2) intervening events; (3) lack of awareness; (4) consistency of prior similar transfers; and (5) reasonable reliance by the transferor on the advice of a qualified tax professional and a nonexclusive list of factors to be considered in determining lack of prejudice to the government,[8] namely: (i) use of hindsight to obtain economic advantage; (ii) timing of the request coming shortly after the window for gift tax assessment closes; (iii) intervening events such as a taxable termination or taxable distribution; and (iv) gross undervaluation of the assets.

The taxpayer and any parties involved in the original GST tax exemption allocation (for example, accountants and attorneys) are each required to submit an affidavit describing the events that led to the incorrect election.[9] While useful, these options to cure the mistaken mismatch are fairly limited, leaving practitioners to consider many other options to the extent these statute-prescribed solutions aren't available.

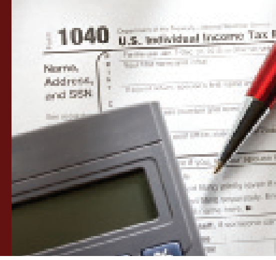
Late Allocation

Even if there wasn't an accidental failure to allocate GST tax exemption, a client may have trusts that are intentionally non-exempt, to which one could explore allocating GST tax exemption. For example, life insurance trusts, successful grantor retained annuity trusts (GRATs) and successful qualified personal residence trusts (QPRTs) are typically non-exempt. The client could consider a late allocation of GST tax exemption to shelter existing assets held in such trusts and future appreciation of such assets from GST tax.

Late allocations of GST tax exemption (or allocations after the due date for a timely filed gift tax return has passed, including any applicable extensions of time to file) can be accomplished by filing an additional Form 709 gift tax return reporting the allocation to the specific trust.[10] The allocation will be made based on the fair market value (FMV) of the trust property as of the effective date of the allocation of GST tax exemption.[11] The effective date will either be the filing date or the first day of the month during which the late allocation is made, in the taxpayer's discretion.[12]

While assets such as publicly traded securities have easily ascertainable values, other assets may require appraisals to value the interests as of the effective date of the allocation of GST tax exemption, which can complicate the process given the limited time frame from valuation date to filing of the gift tax return. Although the trust property may have appreciated since the initial gift to the trust, a late allocation of GST tax exemption, when it may otherwise be lost, makes this a valuable option to consider.

Remainder trusts. Because GST allocation to GRATs and QPRTs can't occur until the estate tax inclusion period (ETIP) is terminated, taxpayers typically structure these trusts as non-exempt trusts. On the expiration of the ETIP period, the remaining assets, if any, pass to a remainder trust free of all gift tax. If GST tax exemption isn't allocated to the remainder trust at the end of the ETIP period, such remainder trust will be entirely non-exempt for GST purposes (with an inclusion ratio of one).



Life insurance trusts. In many cases, life insurance trusts aren't GST-exempt, especially if annual exclusion gifts are used to fund the trust to pay insurance premiums. While the insured (usually the grantor of the trust) is alive, the FMV of the insurance trust assets may be relatively low compared to the value on the death of the insured, because the insurance policy's value during the insured's lifetime will be determined by its cash value and interpolated terminal reserve, rather than its death benefit.

The FMV of the trust assets will also include the value of any other assets held in the insurance trust, such as cash or marketable securities used to pay policy premiums. Importantly, the use of GST tax exemption will be most effective in instances in which the insurance trust already has assets available to pay annual policy premiums and future contributions to the trust aren't needed. Alternatively, if premiums will continue to be paid by annual exclusion gifts to the insurance trust, the taxpayer should consider evaluating whether they'll apply GST tax exemption to each contribution in the future or use loans to pay future premiums, to avoid a mixed inclusion ratio.

Ultimately, allocating the remaining GST tax exemption to insurance trusts can be particularly impactful, given that the FMV of the trust assets during the grantor's lifetime is likely to be significantly less than the ultimate death benefit. This could provide a great opportunity to leverage the remaining GST tax exemption.

Other considerations. In certain instances, an individual's remaining GST tax exemption may be significantly less than the FMV of the assets of a trust to which they may want to allocate their remaining GST tax exemption. In those instances, the trustee may have the power to sever the trust, either under the trust agreement or pursuant to state law. The trustee could fractionally sever such portion of the trust with an FMV equal to the taxpayer's remaining GST tax exemption, creating two separate and distinct trusts from the original trust. The taxpayer may then make a late allocation of their remaining GST tax exemption to one of the severed portions of the original trust, creating one exempt trust and one non-exempt trust. To the extent these trusts require mandatory distributions to the grantor's children at specified ages, practitioners should consider decanting the severed portion to provide for lifetime trusts, if that option is available, given the trust terms and governing law.

In these instances, even if children or other non-skip persons are beneficiaries of the trust, a severed trust would provide the opportunity to prioritize distributions to non-skip persons from the non-exempt portion, while preserving the exempt trust assets for current skip person beneficiaries or future generations of skip persons.

ETIP Period Termination

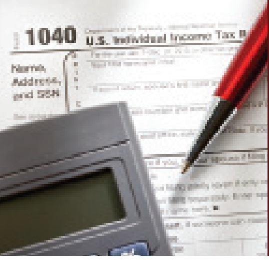
As described above, GRATs and QPRTs have ETIP periods that limit the use of GST tax exemption on the funding of the trusts. However, if a GRAT or QPRT is successful, on the termination of the ETIP period, the appreciated assets won't be subject to any additional gift tax and would escape estate tax on the death of the taxpayer who created the trust.

If the taxpayer initially opted out of GST tax exemption on funding the GRAT, they may want to consider allocating GST tax exemption to the remainder trust on the termination of the ETIP period to shield the remainder trust from GST tax

SPOTLIGHT

Snow White

Untitled Winter Scene by Peter Ellenshaw sold for $5,440 at Doyle's Fine Art auction on Feb. 12, 2025 in New York City. Prior to focusing on his painting, Ellenshaw was a recognized designer and special effects creator in the film industry, working on many Disney features, including classics such as *Mary Poppins,* for which he won an Academy Award for Best Visual Effects.



if the trust has the potential to be subject to GST tax in the future. Alternatively, if the taxpayer didn't opt out of allocating GST tax exemption on funding the GRAT, automatic allocation of GST tax exemption will only be applicable on the termination of the ETIP period if the remainder trust is a GST trust.[13] If the remainder trust requires distributions of the entire trust estate to the taxpayer's children at specified ages, it wouldn't be the appropriate remainder trust to allocate GST tax exemption to (and wouldn't automatically have GST tax exemption allocated to it on the ETIP termination), whereas, lifetime trusts for children that will ultimately pass to future generations would be appropriate trusts to consider whether GST tax exemption should be allocated or whether it will automatically be allocated on the termination of the ETIP period.

Practitioners should consider actively identifying and rectifying situations in which clients have excess GST tax exemption.

If a taxpayer's mismatched exemption is the product of making large, outright gifts to children, the only trusts remaining may already be GST-exempt. Thus, having the client use GRATs and chipping away at the mismatched GST tax exemption by allocating exemption at the termination of the ETIP period for each successful GRAT is an option to consider (though there wouldn't be time to implement this program and use such exemption before the end of 2025, if the exemptions sunset).

Testamentary Planning

Unlike the gift and estate tax exemption, which is portable between spouses, an individual's unused GST tax exemption can't be used by their surviving spouse on the survivor's death (or during the survivor's life) and will be lost to the extent not allocated on the death of the first spouse.

As a final catch-all to ensure a client's GST tax exemption isn't wasted, they should consider including provisions in estate-planning documents that allocate any unused GST tax exemption not otherwise allocated during life. This kind of provision is likely already part of a client's plan if they're domiciled in a state with a lower state estate tax exemption than the federal estate tax exemption but should be considered for any taxpayers who have a mismatch. On the death of a first spouse, the plan would set up a GST-exempt marital trust (or reverse qualified terminable interest property trust), and if there's no surviving spouse, a separate bequest of GST tax exemption to lifetime trusts would be made.

Maximize Appreciation and Growth

The ease or difficulty in finding matches for excess GST tax exemption depends greatly on the client's larger picture of their estate plan, as well as the assets they may have to use for additional gifting or late allocation of GST tax exemption. Unlike what most of us do with lost socks in the wash—ignore them and hope the match turns up at some point—practitioners should consider actively identifying and rectifying situations in which clients have excess GST tax exemption. By using this exemption as early in the client's life as possible, practitioners can help maximize the appreciation and growth of GST-exempt assets, rather than relying on the failsafe testamentary provisions to use it.

Endnotes

1. Internal Revenue Code Section 2632(b)(1).
2. IRC Section 2632(c).
3. Treas. Regs. Section 301.9100-3.
4. Treas. Regs. Section 26.2642-7(i)(1).
5. Treas. Regs. Section 26.2642-7(i)(2).
6. Treas. Regs. Section 26.2642-7(d)(1).
7. *See* Treas. Regs. Section 26.2642-7(d)(2).
8. *See* Treas. Regs. Section 26.2642-7(d)(3).
9. *See* Treas. Regs. Section 26.2642-7(i)(3); *see also* Treas. Regs. Section 26.2642-7(i)(4).
10. Treas. Regs. Section 26.2632-1(b)(4).
11. Treas. Regs. Section 26.2642-2(a)(2).
12. *Ibid.*
13. *See* 26 U.S.C. Section 2632(c)(3)(B) for the definition of a "GST trust."