Proposed Trust Regulations Provide Guidelines

If you are the beneficiary of an irrevocable trust created on or before Sep. 26, 1985, the good news is that the trust is grandfathered -- exempt from the 55% generation skipping transfer (GST) tax. Also exempt from GST tax is a post-Sep. 25, 1985, trust with a GST tax inclusion ratio of zero owing to allocation of the transferor's GST tax exemption. The bad news is that you may lose the exemption if you make any changes to the trust. Fortunately, the IRS has recently proposed regulations clarifying some permissible changes.

GST Tax Particulars

The GST tax is a formidable 55% tax imposed on transfers to a "skip" person -- someone two or more generations below the generation of the person making the transfer. For example, a transfer from a grandparent to a grandchild that skips a living child may be subject to GST tax. This tax is in addition to federal gift and estate tax, which ranges from 37% to 55%. The GST tax is imposed to the extent a person transfers assets to a skip person, such as a grandchild, in excess of the GST tax exemption, currently $1.03 million.

The government wants to collect a gift or estate tax on each generation. Without the GST tax, a grandparent could save one layer of transfer tax by transferring wealth to a grandchild so that gift or estate tax would be payable only at the grandchild's level and not at the child's level. (In fact, discretionary trusts can avoid several layers of tax.)

When Changes Are Needed

You may need to modify a grandfathered trust for several reasons:

- If you and other trust beneficiaries' investment philosophies differ, you may want to split the trust into individual shares.
- If you are the beneficiary of more than one GST tax-exempt trust, you may want to combine the trusts to ease administration and reduce costs.
- You may want to change the current trustee or the plan of succession to the current trustee.
- If the meaning of trust terms is controversial or the grantor's intent is unclear, other changes to a trust may be necessary.

Carefully review any changes before making them to ensure that you don't lose the GST tax exemption. Fortunately, you can probably amend a grandfathered trust even if the trust is irrevocable. But proceed with caution if your changes do not clearly comply with the proposed guidelines. Changes falling outside the proposed regulations may be permissible, though you may want to obtain an IRS private letter ruling sanctioning the changes to rely on if later challenged.

What Can You Change?

Under the proposed IRS regulations, changes that will not jeopardize GST tax-exempt status include:

1. Orders that resolve the trust terms' ambiguity,

2. Court-approved settlements of a bona fide dispute over the trust's administration or terms,

3. Distributions to a new trust to benefit succeeding generations, and

4. Changes that do not extend the time in which any beneficial interest in the trust vests beyond the original trust period.

Generally, the IRS should allow dividing or consolidating trusts if you don't change vesting of the beneficiary's interests. Similarly allowed are probably changes regarding the removal and succession of the trustee.

Do You Have the Power?

Even without the proposed regulations, you may exercise some powers over a grandfathered trust without jeopardizing the GST tax exemption:

- If you have a limited power to appoint allowing you to direct the trustee to distribute trust assets to someone other than you and your creditors, you may direct the trustee to make such distributions without losing grandfathered status.
- You may exercise a five-and-five power allowing you to annually withdraw the greater of 5% of the trust assets or $5,000 annually.
- You may exercise these powers because they are not taxable. But the proposed regulations clarify that a taxable exercise, release or lapse of an exercise of a power of appointment is treated as a transfer by the person holding the power and is not a protected transfer within the trust.

Ask for Help

Planning around the GST tax exemption can be confusing. please let us know if you have any questions about the new IRS guidelines or would like help determining whether a proposed action with respect to a GST tax-exempt trust will put the exemption at risk.