

Strengthen the Generation-Skipping Transfer Tax to Address Dynasty Trusts

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Summary

Assets of perpetual dynasty trusts can grow indefinitely and benefit multiple successive generations with little to no federal gift, estate, or generation-skipping transfer (GST) tax consequences. This proposal recommends that Treasury and the IRS strengthen existing regulations for the GST tax and propose additional regulations to clarify the application of GST tax rules and raise GST tax revenues from perpetual dynasty trusts.

Current Law

The GST tax is a tax intended to apply (in addition to the gift or estate tax) to transfers that skip a generation (e.g., a gift from a donor to her grandchild). The GST tax is imposed on cumulative generation-skipping transfers by a donor in excess of an exemption amount,¹ which is \$12.06 million in 2022.²

GST tax exemption may be allocated to a trust to which a donor or decedent transfers assets.³ Allocating GST exemption does not directly exempt any assets or portion of a trust from tax. Rather, allocating GST exemption to a trust reduces the applicable rate that applies to taxable generation-skipping transfers with respect to that trust. The GST tax is imposed as a flat tax rate equal to the highest estate tax rate (currently 40 percent⁴) multiplied by the trust's "inclusion ratio."⁵ Generally, the inclusion ratio is determined by subtracting the "applicable fraction" from one.⁶ The numerator of the applicable fraction is generally equal to the amount of GST exemption allocated to the trust and the denominator is equal to the fair market value of property transferred to the trust.⁷ For example, if the amount of GST exemption allocated to the trust is equal to the value of property transferred to the trust, the inclusion ratio will be zero and the applicable tax rate will be 0% (40% multiplied by the inclusion ratio). Such a trust will be considered fully exempt from the GST tax.

A trust can remain fully exempt from the GST tax for the entirety of its duration, in some cases forever, regardless of how much the trust assets appreciate above the maximum GST exemption

¹ See sections 2601, 2602, 2641, 2642, and 2631(a) and (c). Unless otherwise noted, all references to "section" are to sections of the Internal Revenue Code of 1986 (as amended), and all references to "Treas. Reg. §" are to Treasury regulations issued thereunder.

² See section 2010(c)(3); Rev. Proc. 2021-45, 2021-48 IRB 764, section 3.41.

³ See section 2631(a); see also section 2632. For example, a donor can gift \$10 million to a trust and allocate \$10 million of GST exemption to that transfer.

⁴ See sections 2641(b) and 2001(c).

⁵ Sections 2602 and 2641(a).

⁶ Section 2642(a)(1).

⁷ Section 2642(a)(2).

amount. When Congress originally enacted a tax on generation-skipping transfers, it understood that “[m]ost States have a rule against perpetuities which limits the duration of a trust”⁸ within the foreseeable future. However, since the enactment of the GST tax and corresponding exemption from the GST tax, many states have eliminated their applicable rule against perpetuities or substantially lengthened the duration of a trust permitted thereunder.⁹ This development in state law has led to the rise of perpetual trusts that avoid estate, gift, and GST tax on trust assets for multiple generations. Assets of perpetual dynasty trusts can grow indefinitely and benefit multiple successive generations with no federal transfer tax consequences.¹⁰

A trust will only recompute its inclusion ratio in a handful of situations that typically would not arise for a well drafted perpetual dynasty trust.¹¹ Often these trusts can be modified and amended without loss of their GST exempt status. However, the IRS has stated that it is studying the issue of whether a trustee’s distribution of property from an irrevocable GST exempt trust to another irrevocable trust (i.e., “decanting”) resulting in a change in beneficial interests gives rise to a loss of GST exempt status or constitutes a GST taxable termination or taxable distribution.¹²

Finally, the GST tax generally does not apply to any transfer from a trust that was irrevocable on September 25, 1985 (an “effective date trust”).¹³ Treasury regulations finalized in 2000 provide four safe harbors for the kinds of modifications that can be made to effective date trusts that will not result in a loss of the trust’s GST exempt status (the “2000 Regulations”).¹⁴ However, the full consequences of failing to satisfy a safe harbor are unclear.

⁸ Joint Comm. on Tax’n, JCS-33-76, [General Explanation of the Tax Reform Act of 1976](#) 564 (1976). The rule against perpetuities generally requires trust assets to vest in the beneficiaries no later than 21 years after the death of a person who was alive when the trust was created. *See id.*

⁹ Some states, like South Dakota, have entirely abolished their rule against perpetuities. *See* S.D. Codified Laws § 43-5-8. Other states, like Nevada, have instead adopted longer fixed periods for the rule against perpetuities. *See* Nev. Rev. Stat. § 111.1031 (providing an applicable perpetuities period of 365 years).

¹⁰ In their promotional materials, The Northern Trust Institute illustrates the efficiency of the perpetual dynasty trust as follows: “[The] ability to contribute assets to a trust that will continue for generation after generation without the imposition of any transfer tax, and potentially no state income tax, is an extraordinary opportunity when compared to the alternative of passing assets outright, from generation to generation, subject to a federal transfer tax at each generation. Based on a \$12.06 million contribution to a trust, a 5 percent after-tax rate of return on the investment assets, a new generation every 25 years, and a federal estate tax of 40 percent applied at each generational transfer, the GST-exempt trust would have an approximate value of \$468 million after only 75 years. The same sum of \$12.06 million held outside of a trust (and subject to a gift tax or estate tax upon transmittal to each successive generation) would have an approximate value of \$101 million.” The Northern Trust Institute, [Nevada Trusts: Safeguarding Personal Wealth](#) (2022).

¹¹ Circumstances in which a trust will recompute its inclusion ratio include if (i) the trust property is subject to estate or gift tax, (ii) additional GST exemption is allocated to the trust, (iii) the trust is divided into two or more separate trusts in a “qualified severance” under section 2642(a)(3), or (iv) there are additional transfers of property to the trust. *See* section 2642(d)(1) and (4); Treas. Reg. § 26.2642-4(a).

¹² Rev. Proc. 2022-3, 2022-1 IRB 144, section 5.01(21).

¹³ *See* Tax Reform Act of 1986, Pub. L. 99-514, § 1433(b)(2)(A), 100 Stat. 2085, 2731 (1986); Treas. Reg. § 26.2601-1(b)(1)(i).

¹⁴ Generation-Skipping Transfer Issues, TD 8912, 65 Fed. Reg. 79735 (December 20, 2000). The regulations governing changes to grandfathered trusts do not provide a general rule for when a trust may lose its grandfathered status.

Reasons for Change

While the 2000 Regulations provide some clarity to taxpayers regarding modifications to effective date trusts, there are still open questions that make administering the 2000 Regulations difficult for the IRS and taxpayers. In particular, the 2000 Regulations do not address the effect of losing GST exempt status on an effective date trust. It is not settled whether exempt status is lost for the entire trust or just the portion that is shifted to a lower generation or extended. Furthermore, the regulations do not identify the transferor of an effective date trust once GST exempt status is lost. GST tax cannot be administered without identifying the transferor.¹⁵ Additionally, there is no guidance specifically concerning trust modifications to a trust with an inclusion ratio of zero or to any trust that is not an effective date trust (“post-effective date trusts”).¹⁶

Proposals

Treasury and the IRS should make clarifying changes to the 2000 Regulations with respect to effective date trusts. Treasury and the IRS could revise the 2000 Regulations to: (i) address the effect of a loss of exempt status (i.e., whether the entire trust is subject to tax or just the portion subject to the modification); (ii) articulate the rule for identifying the “transferor” of an effective date trust; and (iii) impose a reporting requirement for modifications and transactions involving effective date trusts, which would put the IRS on notice of such transactions for future audit.

Additionally, Treasury and the IRS could propose regulations regarding post-effective date trusts. Treasury and the IRS could propose regulations addressing decantings and other modifications made to post-effective date trusts. These regulations could (i) impose a reporting requirement for modifications and transactions involving trusts that are fully or partially exempt from the GST tax, and (ii) contain rules that result in a loss of GST exempt status for trusts subject to substantial modifications through amendments, exercises of powers to appoint or direct trust property to other beneficiaries/trusts, or decantings. Substantial modifications might include any change or modification that extends the time for vesting of any beneficial interest in a trust or alters in any manner the beneficial class or distribution standards of such trust.

Such changes would add clarity for taxpayers while raising some GST tax revenues. These proposals would likely consume a moderate amount of resources for Treasury and the IRS to implement.

Scope of Impact

A revenue estimate of these changes is not available and would likely be difficult to produce, but we expect that the proposals would raise a small amount of revenue over the long term. Two legislative proposals to limit the duration of GST tax exemption were expected to raise “no” or “negligible” revenue over a ten-year window.¹⁷ However, these proposals would go beyond such

¹⁵ A GST tax is imposed on generation-skipping transfers. Section 2601. A generation-skipping transfer occurs if property is transferred to a “skip person.” Sections 2611 and 2612. The characterization of a beneficiary as a “skip person” or “non-skip person” is made by reference to the transferor. *See* section 2613(a).

¹⁶ *See* PLR 200141024 (July 11, 2001) (noting that no guidance had been issued concerning trust modifications to a trust with an inclusion ratio of zero).

¹⁷ *See* Dep’t of the Treas., [General Explanations of the Administration’s Fiscal Year 2013 Revenue Proposals](#) 81, 203 (2012) (describing a proposal to terminate the GST exclusion allocated to a trust on the 90th anniversary of the

legislative proposals by applying the GST tax in connection with trust transactions and modifications that may occur more frequently than the specified intervals.

Additional Discussion

Authority: Section 2663 grants the Secretary broad power to issue regulations to carry out the purposes of the GST tax chapter. Section 2662(b) grants the Secretary power to require, by regulation, information returns to be filed as necessary for the purposes of the chapter.

creation of the trust); Dep't of the Treas., [General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals](#) 48, 112 (2022) (describing a proposal to limit the duration of the GST exemption to “only as long as the life of any trust beneficiary who either is no younger than the transferor’s grandchild or is a member of a younger generation but who was alive at the creation of the trust.”).