Transfers to Trusts: GST Exemptions and Late Allocations

By Brian M. Balduzzi, JD, LLM (Taxation), CFP

Many financial advisers are trying to make sure their clients apply their lifetime gifting exemption amounts prior to the Jan. 1, 2026, sunset of the current exemption amount, but few may be considering generation-skipping transfer (GST) tax planning. Clients may be able to use more of their remaining GST exemption to obtain a zero-inclusion ratio for gifts by making late allocations of their remaining GST exemption to prior years' gifts and purposefully failing to make a timely allocation (or opting out of an automatic allocation) to make a late manual allocation of GST exemption for the current year's gifts.

Generally, the GST tax is imposed on any generation-skipping transfer made to a "skip person." A skip person is an individual who is two or more generations below the donor, a trust for which the current beneficiaries are only skip persons, and a trust in which there are no current beneficiaries and no distributions can be made to nonskip persons. GST tax may be imposed on a direct skip (a transfer made to an individual or trust that qualifies as a skip person); a taxable termination (when all of the non-skip persons who were current trust beneficiaries cease to be current beneficiaries); and a taxable distribution (when trust property is distributed to a skip person). Therefore, a donor may allocate some of his or her remaining GST exemption on Form 709 (federal gift tax return) to create an inclusion ratio equal to zero.

Voluntary Allocation

A donor's GST exemption is automatically allocated to a lifetime direct-skip transfer to the extent necessary to produce a zero-inclusion ratio. Generally, an allocation is irrevocable after the due date of the gift tax return (including any extensions), but can be changed or revoked before that date as a "timely made allocation." The value of the property to which the exemption is allocated for a timely allocation is the value as of the date of transfer. For GST trusts, as defined under Internal Revenue Code Section 2632(c)(2)(B), the GST exemption is automatically allocated to the trust to give an inclusion ratio of zero. Under these rules, the value to be allocated relates back to the date of the gift. Under Section 2632(c)(5), the donor can opt out of automatic allocation by making a timely election.

Some donors may have trusts that have an inclusion ratio between zero and one because of mistakenly electing out of automatic allocation, contributing property with a higher value than anticipated, or making gifts when they had a lower GST exemption to use. In 2023, the lifetime GST exemption is $12.92 million. Therefore, donors who under-allocated a GST exemption may now wish to allocate some of their additional exemption for the prior transfers. For example, if Bob made a gift of $5 million to a dynasty trust in 2009 when the GST exemption was $3.5 million and allocated his full exemption, the trust would have an inclusion ratio of 0.3. Thirty percent of any distributions to a skip person would be subject to GST tax. If the trust assets are now worth $15 million, Bob would need to allocate an additional $4.5 million of GST exemption to give the trust a zero-inclusion ratio. Assuming he did not allocate any of his exemption since then, Bob has $9.42 million of GST exemption available. Bob could allocate the necessary $4.5 million of his GST exemption to result in a zero-inclusion ratio to this prior-year gift by attaching a Notice of Allocation to the 2023 Form 709, listing the amount of GST exemption allocated on Schedule D, part 2, line 6. He may wish to make a formula allocation of the smallest amount necessary to produce an inclusion ratio closest to or equal to zero in case the IRS later adjusts the value of the assets at audit. The indexed GST exemption now may help clients fix trusts with mixed inclusion ratios to avoid the imposition of a GST tax later.

Late Allocation

Clients may also wish to time the allocation of GST exemption to more recent gifts, such as when the value of the gifted property on the transfer date is higher than the value as of the date of filing the gift tax return. For example, if Jane transferred on Oct. 25, 2022, 1,000 shares in a publicly traded company to a trust for the benefit of her daughter and grandchildren, the trust is not a skip-person. Because GST tax may be imposed later, Jane may wish to allocate the GST exemption. The shares were worth $1 million on Oct. 25, but on April 1, 2023, when she prepares her federal gift tax return, the shares are worth $800,000. She may have used more exemption than needed.

Jane may wish to make a late allocation of the GST exemption by electing out of the automatic allocation of GST exemption on her gift to the trust. This avoids the automatic allocation to the gift based on value as of the date of the gift. Following the April 18, 2023, due date, Jane may file another Form 709 for 2022 to make a late allocation of GST exemption for such gift. This late allocation will be effective as of the date Jane files this second Form 709, but a special rule under Treasury Regulation Section 26.2642-2(a)(2) allows Jane to elect to use the value as of the first day of the month. This may allow Jane to strategize when to file, provided no GST is imposed prior to this late allocation. This strategy may help Jane use less of her remaining GST exemption for the same transfer if the property has declined in value since the gift was made.

Planning in an Uncertain Market

A review of tax planning opportunities – particularly for trusts with inclusion ratios between zero and one and for recent gifts with depressed valuations – can help clients strategically allocate their remaining GST exemption prior to a potential sunset. Between now and 2026 is an ideal time for such a review. It is not too late to reallocate or make late allocations.

Brian M. Balduzzi, JD, LLM (Taxation), CFP, is an attorney with Faegre Drinker Biddle & Reath LLP in Philadelphia and is a member of the Pennsylvania CPA Journal *Editorial Board. He can be reached at brian.balduzzi@faegredrinker.com.*