



MODIFICATION OF A GST TRUST DIDN'T IMPACT ITS EXCLUSION STATUS

A recent PLR demonstrates the dangers that even judicial modifications can pose to a trust's tax status.

October 25, 2018

Authors: Caroline Demirs Calio and Andrew M. Nerney

Trusts & Estates Magazine Website

Andrew M. Nerney and Caroline Demirs Calio, attorneys in the Private Clients Group, wrote an article for *Trusts and Estate Magazine Website* entitled "Modification of a GST Trust Didn't Impact Its Exclusion Status" which was published September 26, 2018.

For a link to this article, please [click here](#).

Modification of a GST Trust Didn't Impact Its Exclusion Status

A recent PLR demonstrates the dangers that even judicial modifications can pose to a trust's tax status.

Chapter 13 of the Internal Revenue Code imposes a tax on generation-skipping transfers (that is, transfers to individuals more than one generation below the donor).

Generally, this tax applies to transfers made after Oct. 22, 1986. However, because the definition of GST includes certain distributions from trusts, Congress enacted a transitional rule that exempted from the definition of GST transfers from irrevocable trusts that were in existence on Sept. 25, 1985 but only if the transfer isn't made out of trust property that was added to the trust after that date or to income attributable to such later-contributed property. Any trusts meeting these criteria are grandfathered by the GST rules and deemed exempt from GST tax.

Judicial Modification of a Grandfathered Trust

CUMMINGS & LOCKWOOD LLC

Private Letter Ruling 201833015 (Released Aug. 17, 2018) involves an irrevocable trust that was established before Sept. 25, 1985, and no additions (actual or constructive) were made to the trust after that date. The trust was created for the primary benefit of the grantor's granddaughter and her descendants. Each year during the granddaughter's life, 80 percent of the net income would be paid to her. On the granddaughter's death, the 80 percent would, instead, be paid to the granddaughter's descendants, per stirpes. Principal would also be distributed from the trust at the trustee's discretion. Finally, the trust was required to terminate 21 years after the date of the last to die of all the descendants of the grantor who were living on the date the trust was established.

On a date after Sept. 25, 1985, a court, in response to a petition filed by the trustees, modified the trust to provide that, on the granddaughter's death, the trust would be divided into separate, independent trusts for each of the granddaughter's descendants. Each trust would be funded with a pro rata share of the assets of the trust agreement and would terminate under the terms of the trust. The income and principal of the new trusts would be distributed pursuant to the terms of the trust agreement, except that distributions of income and principal from each resulting trust would be made to the descendants for whom the resulting trust was formed, and, if none, to the rest of the granddaughter's descendants. All other provisions required by the original trust document would remain the same.

Concerned with the tax implications of the trust modification, the trustee requested three rulings from the Internal Revenue Service: (1) whether the partition of the trust results in a transfer by any beneficiary of the trust that's subject to gift tax; (2) whether the partition would subject the trust assets to GST tax; and (3) whether the partition would constitute a "taxable disposition" for purposes of IRC Section 1001.

No Transfer of Property Subject to Gift Tax

IRC Section 2512(b) provides that when property is transferred for less than an adequate and full consideration in money and money's worth, the amount by which the value of the property transferred exceeds the consideration deemed a gift for tax purposes. Based on the facts reported by the trustee, the IRS acknowledged that the beneficial interests, rights and expectancies of the beneficiaries of the trust are substantially the same both before and after the partition of the trust; therefore, there's no deemed transfer of property that will be subject to gift tax.

Partition Doesn't Terminate the Grandfathered Exclusion from GST Tax

As discussed above, to the extent a transfer from a trust is made out of corpus added to an irrevocable trust by an actual or constructive addition after Sept. 25, 1985, such transfer may be subject to GST tax. This rule threatens to subject grandfathered exempt trusts to GST tax if a judicial modification is made to them.

Fortunately, Treasury Regulations Section 26.2601-1(b)(4) offers some modifications. It states that so long as: (1) the modification doesn't shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (defined in IRC Section 2651) than the person or persons who held the beneficial interest prior to the modification; and (2) the modification doesn't extend the time for vesting of any beneficial interest in the trust beyond the period provided in the original trust, then the modification won't cause the trust to lose its GST tax exempt status (Treas. Regs. Section 26.2601-1(b)(4)(i)(D)).

The IRS held in this PLR that the partition of the trust as a result of the judicial modification neither shifts any beneficial interest in the trust to a beneficiary who occupies a lower generation nor extends the time for vesting of any beneficial interest in the trust beyond the period provided for in the original document. Thus, the grandfathered trust wasn't subject to GST tax resulting from the judicial modification.

CUMMINGS & LOCKWOOD LLC

Practitioners dealing with trusts that were irrevocable in 1985 or prior can't get too complacent when trying to make changes. Modifications, even judicial ones, to certain trusts may generate irreversible damage to the tax status of the trust and its underlying beneficiaries. Any alterations, simple or complex, must be evaluated carefully to ensure there are no unintended tax consequences.