

Why GST tax is relevant for non-US trusts

Kozusko Harris Duncan | Private Client & Offshore Services - USA



JENNIE CHERRY



LINDSEY
BRONSTEIN

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Introduction

Non-US families establishing succession planning structures rarely think about the US generation-skipping transfer (GST) tax. Nevertheless, when a foreign trust becomes a US domestic trust so that distributions can be made in a tax-efficient manner to the settlor's US grandchildren and more remote descendants, US trustees or tax return preparers may raise questions about whether those distributions are subject to the GST tax. Advisers to these families should become familiar with the application of the GST tax rules in order to bring clarity to the situation.

Background

For details regarding US gift and estate taxes in general, please see "[Overview \(August 2022\)](#)". In addition to these transfer taxes, the United States has a third type of tax known as the GST tax. As its name implies, the GST tax is aimed at transfers that skip a generation. There are three GST transfers on which GST tax may be imposed – namely, "direct skips," "taxable terminations" and "taxable distributions":

- A "direct skip" is a transfer which is subject to US gift or estate tax and which is made to a person two or more generations below that of the transferor (a skip person). A trust is a skip person if all persons who have an interest in the trust are skip persons. For example, an outright transfer to a grandchild or to a trust for the benefit of a grandchild is a direct skip.
- A "taxable termination" is a termination of a person's interest in a trust if, after termination of that interest, only skip persons have interests in the trust. For example, in the case of a trust held for the benefit of the settlor's child, there is a taxable termination when the child dies and the trust is now held for the benefit of the settlor's grandchild.
- A "taxable distribution" is a distribution from a trust to a skip person that is neither a direct skip nor a taxable termination – for example, when the trust is for the benefit of the settlor's children and more remote descendants and the trustee makes a discretionary distribution to the settlor's grandchild.

US citizens and residents subject to tax on transfers that skip a generation

When a US citizen or a non-US citizen who is resident in the United States for transfer tax purposes (a US person) makes a transfer to a skip person, whether such transfer is made during life or at death, a GST tax is imposed in addition to any gift or estate tax that may be due. The GST tax is calculated at a flat rate equal to the top transfer tax rate of 40%.

For tax year 2022, an exemption amount of \$12,060,000 is available to shelter gifts or bequests from GST tax. If a US person does not affirmatively allocate this exemption amount to specific transfers, automatic allocation rules apply.

Non-resident aliens subject to GST tax only when also subject to gift or estate tax

The reach of the GST tax for transfers made by a non-resident alien (NRA) matches the reach of the estate and gift tax on the underlying transfer. Thus, a transfer by an NRA of non-US situs property is not subject to the GST tax, since it is not subject to estate or gift tax, but the GST tax applies when an NRA transfers US property (other than intangibles transferred by gift) to a skip person. For further details on when property has a US situs for tax purposes, please see "[Estate and gift tax situs of assets – basic rules](#)" and "[Estate and gift tax situs of assets – specific examples](#)".

The NRA transferor is entitled to the same \$12,060,000 (for tax year 2022) exemption from GST tax as a US person. Schedules to the federal estate and gift tax returns (Forms 706 and 709) are used to report generation-skipping transfers.

Application of GST tax to gifts and bequests of NRAs to skip persons

The key principle to keep in mind is that GST tax is determined by applying estate and gift tax rules. Specifically:

- GST tax applies to transfers to a skip person by an NRA during lifetime to the extent that the transferred property is US situs property for purposes of the gift tax, and therefore subject to US gift tax.
- GST tax applies to transfers to a skip person by an NRA at death to the extent that the transferred property is US situs property for purposes of the estate tax, and therefore subject to US estate tax.
- Trust distributions to skip persons and taxable terminations are subject to GST tax to the extent that the initial transfer to the trust by the NRA was a transfer at death or during life that was initially funded with US situs property, and therefore subject to US gift or

estate tax.

The time for testing whether the tax applies is the same time as under the estate or gift tax rules, even though the "skip" transfer would often occur later. Specifically, the character of the property and the non-resident alien status of the transferor are tested only at the time of the initial transfer as determined for estate tax purposes (at death) or for gift tax purposes (when the gift is complete).

Thus, the GST tax generally does not apply to transfers by NRAs of property situated outside of the United States as of the time of the initial transfer.

However, the converse is also true. If US situs property is transferred by an NRA to a trust, and that property is later reinvested in non-US situs property, GST tax will still apply on a taxable distribution or termination.

Allocation of GST exemption

As mentioned above, the NRA transferor is entitled to the same \$12,060,000 (for tax year 2022) exemption from GST tax as a US citizen or resident. This is true even though the NRA's estate tax exemption is limited to \$60,000 and there is no exemption amount for gift tax purposes.

When the transfer by the NRA is fully subject to the GST tax or when a trust is being funded with US situs property and may in the future have taxable terminations or taxable distributions, the same principles apply as for US transferors, so the NRA transferor can allocate their exemption on a timely filed Form 709, gift tax return, or Form 706-NR, estate tax return. Similarly, if the NRA does not affirmatively allocate their exemption, the automatic allocation rules will apply to certain transfers. In the case of a trust to which the NRA transferor has allocated GST exemption, the trust will thereafter have a GST "inclusion ratio" as discussed further below.

When the transfer by the NRA is not subject to the GST tax at all, or will not be subject to GST tax in the future, the exemption is not allocated.

As discussed further below, when an NRA funds a trust with US situs property, during life or at death, consideration should be given to allocating GST exemption to that trust if the transfer is a direct skip or if there could be a taxable termination or taxable distributions subject to GST tax in the future.

It is important to keep in mind that when an NRA transfers US corporation stock (an intangible) by gift during life, that transfer is not subject to US gift tax. But when an NRA dies owning US corporation stock the value of that stock is subject to US estate tax (absent an applicable treaty provision). If the NRA has bequeathed the stock to a grandchild whose parent survives the NRA decedent, GST tax will be due in addition to US estate tax.

Thus, NRAs need not consider the GST tax implications of their transfers unless the transfer otherwise requires the filing of a US gift or estate tax return. For example:

- An NRA grandmother gives non-US property or intangibles worth \$1 million to her US granddaughter. The NRA grandmother is not subject to US gift tax and need not file a US gift tax return, nor does she need to allocate any GST tax exemption to the gift because the GST tax simply does not apply. The US granddaughter will report the receipt of the gift on Form 3520 (for further details please see "[Preparing US tax and information returns: Forms 3520 and 3520-A](#)").
- If that same NRA grandmother gives artwork located in the United States worth \$1 million to her non-US grandson, she files a US gift tax return and pays gift tax. The gift tax return includes a schedule calculating GST tax and allocating her GST exemption amount.
- The NRA grandmother later dies and her will bequeaths her estate in equal shares to her US granddaughter and non-US grandson. At the time of her death, the grandmother owns stock of US corporations valued in excess of \$60,000. Her estate files a US estate tax return reporting the date of death value of the US stock and includes a schedule calculating GST tax and allocating her remaining GST exemption amount.

GST tax and trusts

In the domestic context, a US settlor can give property to a trust to be held for the benefit of the settlor's child and then to the settlor's grandchildren. When the child dies and the trust property is distributed to the grandchildren, this triggers a taxable termination subject to GST tax. However, the settlor can allocate GST exemption to the trust, which will reduce or eliminate the GST tax. The amount of GST tax imposed will be determined by reference to a formula known as the "inclusion ratio". An inclusion ratio of zero means none of the termination distribution will be subject to GST tax. An inclusion ratio of one means the entire distribution will be subject to GST tax. An inclusion ratio between zero and one means the distribution will be partially subject to GST tax.

Suppose that prior to her death, the NRA grandmother establishes a Bermuda trust and retains the right to revoke the trust. On her death, the trust holds US stock, the value of which is subject to US estate tax. Following her death, the trust will be moved to the United States and continue for the benefit of her US daughter and US granddaughter. The NRA grandmother's estate files a US estate tax return and allocates her remaining GST exemption amount. The successor US trustee will need to know the trust's GST inclusion ratio in order to determine whether distributions to the US granddaughter will be subject to GST tax.

If NRA grandmother's trust was only partially subject to the US estate tax, a special rule for non-resident aliens applies to calculate the GST inclusion ratio of the transfer so that the GST tax can be calculated in the future. The effect of this rule, as in the domestic context, is to encourage the creation of a separate trust in the amount of the allocated exemption, easing administration and minimising taxes.

Suppose that, as is more often the case, the NRA grandmother transfers non-US situs assets to her Bermuda trust and at her death the trust owns only the shares of a foreign corporation which has invested in US stock, so that no US estate tax is due (see "[Tax planning for US equities owned in a non-US trust structure](#)"). In that case, no US estate tax return need be filed and the trust is exempt from GST tax. The successor US trustee can be provided with an explanation of the tax analysis so that when distributions are made in the future to skip persons there is no question as to whether GST tax is due.

Comment

The purpose of the GST tax is to discourage multi-generational tax planning so that the Internal Revenue Service collects estate tax from every generation. The goal of GST trust planning is to allocate, to the extent possible, the transferor's GST exemption so that trusts have an inclusion ratio of zero. A trust established by an NRA settlor will not be subject to GST tax so long as property transferred to the trust

during lifetime or held in the trust at death is not subject to US gift or estate tax. Where the NRA settlor's children and grandchildren are US persons, ensuring that distributions from a trust lasting in perpetuity will never be subject to GST tax is an important consideration.

For further information on this topic please contact [Jennie Cherry](mailto:jcherry@kozlaw.com) or [Lindsey Bronstein](mailto:lbronstein@kozlaw.com) at Kozusko Harris Duncan by telephone (+1 212 980 0010) or email (jcherry@kozlaw.com or lbronstein@kozlaw.com). Please note that the authors are unable to provide legal advice to non-clients. The Kozusko Harris Duncan website can be accessed at www.kozlaw.com.