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The GST Tax: A Limit on Spoiling the Grandchildren

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Rebecca Rosenberger Smolen and Amy Neifeld Shkedy

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In prior articles, we've focused on the federal gift and estate taxes and the advisability of engaging in careful estate planning to minimize the need to pay these hefty transfer taxes, which are imposed at a 40 percent rate to the extent an individual's cumulative taxable wealth transfers exceed the $5.25 million exemption. There is another burdensome transfer tax to be concerned about at the federal level — the generation-skipping transfer (GST) tax, which is imposed at the same rate as the other transfer taxes, in addition to those taxes. The GST tax applies to transfers of wealth, either directly or via trust, to a "skip person" (i.e., a beneficiary in a generation more than one generation below that of the transferor, such as a grandchild, or more remote descendant). The simplest example of a transfer subject to GST tax is when a grandparent leaves a bequest to his or her grandchild, which bypasses or "skips" a living child. Fortunately, just as is the case with the federal gift and estate taxes, there is a $5.25 million exemption available for the GST tax. Thus, only GST taxable transfers above that amount (on a cumulative basis for each taxpayer/donor) would be taxed at the 40 percent rate.

The GST tax was created in 1986 to limit the amount wealthy families could "tax shelter" from the federal gift and estate taxes at future generational levels through the use of long-term trusts. Before the GST tax existed, it was possible for parents to avoid the imposition of future estate and gift taxes on the wealth they left behind, upon the death of subsequent generations of their family, by funding long-term trusts with their entire asset base (or by less egregiously simply skipping the tax at the child's generation through direct gifts to grandchildren). Had the children instead received those funds outright and later passed them onto their own children (i.e., the grandchildren) at death, a federal estate tax would have been imposed on the portion of their asset base attributable to their inheritance from their parents — so, the same assets would have been subject to an estate tax in the children's estate as well as the grandparents' estates — a double tax. By skipping the tax at the children's generation, and potentially subsequent generations as well, more family wealth could be preserved.

The GST tax is imposed on "generation-skipping" transfers to beneficiaries who are more than one generation below the transferor's generation (for non-family members, this would be 37-and-a-half years younger than the transferor). There are three types of generation-skipping transfers that can trigger the tax: (1) direct skips, (2) taxable terminations and (3) taxable distributions.

• **Direct skip:** A direct skip occurs when someone makes a gift, either during lifetime or at death, to a grandchild or other skip person (which can include a trust designed exclusively for grandchildren and/or more remote descendants).

• **Taxable termination:** A taxable termination occurs when an interest in property held in trust terminates (such as by death, lapse of time or otherwise) and after the termination all interests in the trust are held only by skip persons (i.e., grandchildren or more remote generations). So, for example, if there is a lifetime trust for the benefit of a child and that child dies, with the remainder passing, either outright or in further trust, to that child's children (i.e., the grandchildren), a taxable termination has occurred at the child's death. A taxable termination does not occur if as a result of the event triggering the "termination," the property is subject to federal estate or gift tax. So, in the prior example, if as a result of the child's death, the trust assets were includible in that child's taxable estate, a taxable termination would not have occurred.

• **Taxable distribution:** A taxable distribution is any distribution from a trust to a skip person other than a taxable termination or a direct skip. An example of this would be if there is a trust for the benefit of children and grandchildren and the trustee makes a distribution of income or principal to a grandchild. That distribution would be subject to the GST tax.

The GST tax, when combined with the estate or gift tax, can be surprisingly confiscatory. To illustrate its impact, let's consider a client who dies in 2013 with no remaining exemption from the gift, estate or GST taxes. A bequest under such client's will to a grandchild (i.e., a direct skip) of $100,000 would "cost" $233,333. The $133,000 of taxes is composed of a $40,000 GST tax on the $100,000 net amount passing to the grandchild and another $93,333 of estate tax based on the total pre-tax amount (gross amount) needed to produce the net amount for the grandchild, for an effective tax rate of 133 percent. And if you think that's bad — another form of transfer subject to the GST tax, a testamentary taxable termination or distribution, could trigger an effective tax rate of nearly 178 percent — in such case it would take $277,778 of assets to provide $100,000 to the grandchild.

Accordingly, to both avoid the imposition of the GST tax and to benefit from the opportunity to avoid the unnecessary imposition of gift or estate taxes at subsequent generations, proper estate planning involves careful GST planning. The overall goal should be to help maximize coverage of the available GST exemptions and nearly always eliminate distributions to grandchildren (and more remote descendants) from sources that are not exempt from the GST tax. While these days, in theory, this is only an issue for a client whose asset base is (or has a chance of becoming) greater than $5.25 million (or who might have children with asset bases exceeding that amount), it's important to remain mindful that the exemption amounts could be reduced in future years, considering that the gift and estate tax exemptions were $600,000 per person less than 20 years ago (at which time the GST tax exemption was $1 million per person).

In order to maximize coverage of the available GST exemption, it is generally advisable to allocate the $5.25 million exemption to trusts as early as possible. The tax savings on an early GST allocation to a trust can be substantial because once a trust is GST-exempt, all later appreciation in the value of the exempt property is also exempt from GST tax and, under current law, no part of the trust would ever be subject to GST tax. A trust worth $2 million today can appreciate to $10 million or more, in the future. (Note, for example, based on the "rule of 72," an asset base that grows at 7.2 percent a year will double every 10 years, so with an annual return of 7.2 percent or higher, an untapped asset base of $2 million can reach $10 million in less than 25 years.) If the donor of the trust had allocated GST exemption to the trust when it was established (either on a gift tax return, estate tax return, or pursuant to the automatic allocation rules), this trust would be forever protected from the GST tax. If, however, there was no GST allocation, then there could be gift, estate and/or GST tax payable in the future, either when the children's interests in the trust terminate or if there are intermittent taxable distributions to grandchildren. These taxes could have easily been avoided with proper GST planning.

When determining whether to allocate GST tax exemption to trusts, it is important to understand that the GST tax exemption is not portable between spouses. This is a key difference from the federal estate and gift tax exemptions, which are now (under recent changes in the law) portable on the death of the first spouse to die to the surviving spouse (if properly claimed upon the death of the first spouse). Without portability, this means that if the first dying spouse does not use all of his or her GST tax exemption, either during lifetime or at death, any unused exemption will be lost, and the surviving spouse cannot inherit that unused exemption amount. Thus, the GST exemption remains "use it or lose it" — like a coupon that expires on each taxpayer's death.

That all sounds great. What, then, do you do when a client's assets exceed the $5.25 million GST exemption? For those wealthier individuals, there will inevitably be assets passing to trusts that cannot be designated as GST-exempt since their exemption ran out. Anytime a taxable termination or taxable distribution occurs from a non-exempt (or "GST subject") trust, a GST tax will be incurred. Distributions to grandchildren from these trusts should be minimized to the extent possible. If a grandchild needs funds, transfer tax savings can often be accomplished by making the distribution to the child who is such grandchild's parent, and having that child, in turn, make the transfer. The best scenario would be if the child's gift to the grandchild qualifies for the gift tax annual exclusion or, to the extent it doesn't, the child may have gift tax unified credit/exemption available to tax shelter all or part of this gift. However, even without those factors, any gift tax that the child might incur in making the gift would likely still be less than the GST tax that could have been imposed on the taxable distribution to the grandchild directly from the trust. This is because the gift tax is imposed on a tax-exclusive basis, compared with the GST tax, which is imposed on a tax-inclusive basis in the case of a taxable distribution.

Similarly, to avoid a future GST tax on a taxable termination, it may be advisable to cause the assets in the non-exempt trust to be includible in a child's taxable estate at death. This will avoid a future taxable termination since the inclusion in a child's estate for federal estate tax purposes is an exception to the taxable termination rules. The child can then apply his or her remaining federal estate tax exemption to the property, or an estate tax might be due, but possibly at a lower effective rate than the GST tax that would otherwise be payable.

Another way to avoid the GST tax, and perhaps one of the most basic, involves making carefully structured gifts on behalf of a grandchild for his or her education or medical expenses (paid directly to the service provider), which can pass completely free of GST tax (regardless of the amount). Similarly, the GST tax does not apply to outright gifts and gifts to carefully structured trusts that are exempt from gift tax due to the annual exclusion (up to $14,000 per donee or $28,000 per donee if the donors are married).

The rules related to the imposition of the GST tax can be quite complex (sort of the rocket science of estate planning) and caution should be taken when planning for it (or, even worse, not planning for it, and inadvertently triggering a GST tax).

__Rebecca Rosenberger Smolen__ and __Amy Neifeld Shkedy__ are co-founders of the boutique firm Bala Law Group (www.balalaw.com) and concentrate their practices in trust and estate planning and administration.
