Does Your Estate Plan Account For Generation-Skipping Transfer Tax?

Does your estate plan call for making gifts to your grandchildren or other loved ones more than one generation below you? Or, perhaps to nonrelatives more than 37½ years younger than you? If so, your plan must address not only gift and estate tax, but also generation-skipping transfer (GST) tax. Beware: The GST tax is among the harshest and the most misunderstood and complex in the tax code.

Understanding The GST Tax Exemption

The GST tax enjoys an annual inflation-adjusted lifetime exemption in the same amount as the lifetime gift and estate tax exemption (currently, $12.92 million). However, the GST tax works a bit differently. For example, while the gift and estate tax exemption automatically protects eligible transfers of wealth, the GST tax exemption must be allocated to a transfer to shelter it from tax.

The tax code contains automatic allocation rules designed to prevent you from inadvertently losing the exemption, but it’s dangerous to rely on these rules. In some cases, the exemption isn’t automatically allocated to transfers that may trigger costly GST taxes. And in others, the exemption is automatically allocated to transfers that are unlikely to need its protection, resulting in wasted exemption amounts.

3 Types Of GST Tax Triggers

To ensure that wealth is taxed at each generational level, the GST tax applies at a flat 40% rate — in addition to otherwise applicable gift and estate taxes — to transfers that skip a generation. The tax applies to transfers made to “skip persons,” including your grandchildren, other relatives who are more than one generation below you and unrelated people who are more than 37½ years younger than you.

There’s an exception, however, for a grandchild whose parent (your child) predeceases you. In that case, the grandchild moves up a generation and is no longer considered a skip person.

Three types of transfers may trigger GST taxes:

1. “Direct skips” — transfers directly to a skip person that are subject to federal gift and estate tax,
2. Taxable distributions — distributions from a trust to a skip person, or
3. Taxable terminations — for example, if you establish a trust for your children, a taxable termination occurs when the last child beneficiary dies and the trust assets pass to your grandchildren.

As noted above, the GST tax doesn’t apply to transfers to which you allocate your GST tax exemption. In addition, the GST tax annual exclusion — which is similar to the gift tax annual exclusion — allows you to transfer up to $17,000 per year to any number of skip persons without triggering GST tax or using up any of your GST tax exemption.

Beware Of Automatic Allocation Tax Traps

Ordinarily, to allocate GST tax exemptions, you must affirmatively elect to do so on a timely filed gift tax return. If you neglect to do so, however, you may be saved by the automatic allocation rules.

These rules, which are intended to protect you against inadvertently losing exemptions, automatically allocate the exemptions to direct skips as well as to transfers to “GST trusts.” The definition of a GST trust is complicated. Essentially, it’s one that lays the necessary foundation for a strong possibility that the trust will benefit your grandchildren or other skip persons down the road.

Often, the automatic allocation rules ensure that GST tax exemptions go where they’ll do the most good. But in some cases, they may work against you.

Leave GST Tax Planning To The Experts

If you're considering gifts to, or for the potential benefit of, your grandchildren or other skip persons, consult with your estate planning advisor. The rules regarding allocation of the GST tax exemption are complex, and mistakes can be costly.

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