

How To Best Allocate Your GST Tax Exemption

Transfers that skip a generation, such as between a grandparent and grandchild, are subject to the generation-skipping transfer (GST) tax, in addition to any applicable gift and estate tax. The GST tax rate equals the highest gift and estate tax rate — currently 55%. While Congress provides you with a \$1.03 million GST tax exemption, it is up to you to allocate the exemption — which can be tricky when dealing with trusts.

If you transfer assets directly to someone more than one generation younger than you (a skip person), 100% of the transfer is subject to the GST tax. First, the IRS automatically allocates the GST tax exemption to the transfer. Then it will tax 100% of the transfer exceeding the exemption. But when you make transfers to a trust, they receive different treatment.

The GST tax rules do not segregate a single trust's assets into exempt and nonexempt assets, but impose a tax on the whole trust, including any portion of the trust covered by the GST tax exemption. The tax rate is

determined by multiplying the maximum transfer tax rate (currently 55%) by the inclusion ratio, which equals one minus the applicable fraction (the available GST tax exemption divided by the total assets transferred to the trust). If the whole trust is exempt, the trust's inclusion ratio is zero and it avoids the GST tax. If the whole trust is nonexempt, the inclusion ratio will be one and the IRS will tax it at 55%. If the trust is only partially exempt, then a portion of the trust is subject to the 55% tax.

Case Study: GST Tax and Trusts

Let's look at an example. Sally creates a trust for her daughter Lisa's benefit and funds it with \$2 million. The trust provides that it will pay all income to Lisa, as well as the principal necessary for her support. When Lisa reaches age 55, the trust will distribute \$1 million of principal to her. When Lisa dies, all property left in the trust will pass to Lisa's son, Larry.

If Sally puts the full \$2 million in a single trust and allocates the entire \$1.03 million GST tax exemption to that trust, the trust would potentially be subject to a GST tax at a rate of 26.68%, as determined through this calculation:

$(\$1.03 \text{ million GST tax exemption} / \$2 \text{ million transferred into the trust}) \times 55\% = 26.68\%$

On Lisa's death, the remaining trust property that passes to Larry will be subject to the GST tax at a rate of 26.68%, which would be \$268,800 if the trust is worth \$1 million. But if Sally consulted an estate planning advisor, she would have probably created two \$1 million trusts and allocated the GST tax exemption to one of them. One trust would have an inclusion ratio of zero and would not be subject to the GST tax on Lisa's death. The other trust would have an inclusion ratio of one and be subject to a 55% GST tax.

Proper planning also would dictate that all principal distributions to Lisa come from the nonexempt trust unless or until that trust is exhausted. This would greatly reduce, if not eliminate, the eventual GST tax. For instance, if the total amount remaining at Lisa's death is \$1 million, the nonexempt trust would have been exhausted and no GST tax would be due from the exempt trust. In

that case, the full \$268,800 GST tax would be avoided. In fact, Larry benefits by receiving \$268,800 more.

Other Exempt Transfers

By allocating the GST tax exemption to a trust, you can eliminate the assessment of GST tax. You can also avoid the GST tax with two other tools: the predeceased child exemption and the nontaxable gift exclusion. You need to understand the rules so you don't waste the GST tax exemption on otherwise exempt transfers.

Predeceased child exemption. If your child is deceased at the time of the transfer and his or her lineal descendants will take transfers directly from you, then the IRS will treat the lineal descendants as though they were your children for purposes of the GST tax. This "predeceased child exemption" eliminates the GST tax without having to allocate the GST tax exemption or create a GST tax-exempt trust. For instance, if Lisa died before Sally transferred the assets to the trust, and Larry was the trust beneficiary at the time of the transfer, the predeceased child exemption would apply.

A donor who is considering creating a GST tax exempt trust and who has at least one living child with descendants and one predeceased child with descendants must consider whether to include the predeceased child's children in the GST tax-exempt trust. Property given to a separate trust for a predeceased child's children would not be subject to GST tax initially. But making this decision is not as simple as it appears.

Although allocating the GST tax exemption to a trust will protect the trust property from the GST tax at every generation, the predeceased child exemption will exempt only transfers to the trust for the grandchild and from the trust to the grandchild. Thus, when the grandchild dies, the IRS imposes the GST tax on property still held in the trust. You need to consider your objectives when creating the trust:

- Do you want the grandchildren to receive the property?
- Do you want to give the grandchildren some form of general power of appointment over the trust? This will cause the property to be included in each grandchild's estate for estate tax purposes rather than skipping another generation to the great-grandchildren.

If you want the property to remain in the trust after the grandchildren's deaths, allocating the GST tax exemption to the trust may be worthwhile.

Nontaxable gift exclusions. Just as some gifts are exempt from the gift tax, those same gifts also may be exempt from the GST tax. Some direct skips that qualify for an annual exclusion from the gift tax or for the medical or educational expense exclusion are also exempt from the GST tax. But qualifying for the annual exclusion from the GST tax takes some care. A gift to a trust that qualifies for the gift tax annual exclusion will have an inclusion ratio of zero, without allocating the GST tax exemption, only if:

1. The trust is for the skip person's benefit only, and
2. All trust assets will be includable in the skip person's gross estate if he or she dies during the trust's term, or if the skip person's death triggers the trust's termination.

Thus, a standard Crummey trust for the benefit of multiple beneficiaries would not qualify for the annual exclusion from the GST tax.

The GST tax also does not apply to any direct transfer that you make during life to a person for tuition or medical expenses. Such transfers are exempt from gift tax. Rather than waste the GST tax exemption on an otherwise exempt transfer, you may want to make transfers for these purposes from non-exempt trusts or directly.

The Best Plan

GST tax planning clearly requires careful consideration and analysis, especially when the planning includes trusts. If you have any questions about ways to shield your transfers from GST tax, please give us a call. We would be happy to help you determine how best to use your GST tax exemption.