

The Grandparent's Dilemma

In many societies, the elder members are given a place of honor. In our society, we have given the wealthy elders an "honor" of a different sort: the generation-skipping transfer tax (GSTT). If you have clients with the good fortune of having accumulated wealth in excess of \$2 million (including life insurance and retirement plans), you need to plan for an understand the basic concepts of the GSTT, which can cause total transfer taxes to exceed 100% of the gift!

Overview

Congress is concerned about the ability of wealthy individuals to transfer wealth without subjecting it to estate or gift tax at each generation. The GSTT was enacted to complement the unified gift and estate tax. The transfer tax applies to cumulative transfers during lifetime that exceed \$1,000,000, and combined lifetime and estate transfers that exceed \$2 million. There are exemptions for (1) transfers to U.S. citizen spouses, (2) transfers of present interests under \$12,000 per person per year, (3) gifts to charitable organizations, and (4) payment of tuition and medical expenses of others. The GSTT is similarly applied, but with some important differences.

Transfers to Subject to the Tax

The GSTT applies to gifts (during life) and bequests (upon death) made to a person who is two or more generations younger ("skip person") than the one making the gift. For relatives, the generations are defined by the family lines (e.g. children are the first generation, grandchildren-grandnieces-grandnephews are the second, etc.) If the recipient is not related to the transferor, generations are assigned according to the person's age (e.g. the first generation is between 12-1/2 and 37-1/2 years younger). For simplicity, I will refer to the second generation beneficiary as a "grandchild" and the transferor as the "grandparent."

Trusts can also be "skip persons." This occurs when all of the trust beneficiaries are two or more generations younger than the person funding the trust. This can also occur when a charity is a beneficiary, and all other beneficiaries are skip persons. An example would be a trust set up to pay a charity for a period of time, with the remainder paid to the grandchildren. The trust is a "skip person," and trust contributions are subject to GSTT.

The GSTT is imposed on three types of gifts or bequests ("transfers"): "direct skips," "taxable distributions," and "taxable terminations." The GSTT is payable by the grandparent for a direct skip, and by the trustee for a taxable termination. The grandchild pays the tax on a taxable distribution.

Direct Skips

If a gift is made directly to a grandchild, the GSTT applies to the amount received by the grandchild. The GSTT may not apply if the grandchild's parent is deceased. While the GSTT

on the direct skip is payable by the grandparent and only applies to the amount received by the grandchild, the gift tax rules treat the GSTT as an additional taxable gift. For example, assume the grandparent has used up the \$2 million GSTT exemption (see below) and is in the 46% gift/estate tax bracket. To transfer \$1 million to the grandchild, the grandparent would pay the IRS the GSTT of \$460,000, and a gift/estate tax of \$248,400 ($\$540,000 \times 46\%$). To get \$1 million to the grandchild, the grandparent pays \$708,400 to the IRS, for a total payout of \$1,708,400!

Taxable Distributions

If distributions are made from a trust set up by the grandparent, GSTT may apply to any distributions made to grandchildren. The rate of GSTT depends on the inclusion ratio which is applied to the trust (see next page). The GSTT in this case is payable by the grandchild (if the trustee pays the tax, the amount of the GSTT is included in the amount of the transfer).

For example, assume a proposed \$1 million distribution which is subject to GSTT. The grandchild could receive the \$1 million and pay a GSTT of \$460,000, leaving the grandchild with \$540,000. Or the trust could make a distribution of \$1.85 million, with \$1 million paid to the grandchild and \$850,000 to the IRS for the GSTT ($\$1.85 \text{ million} \times 46\% \text{ tax rate} = \$850,000$).

Taxable Terminations

As with taxable distributions, taxable terminations occur when the transferred funds are in a trust. Taxable terminations arise when a non-skip person's interest in the trust terminates and a grandchild is the new beneficiary. An example would be a grandparent's trust which provides distributions to a child for life, and the remainder to the grandchildren. A taxable termination occurs upon the child's death. Even though the GSTT on the amount going to the grandchild is payable by the trustee, the GSTT is also included in the amount of the taxable transfer, as is the case with taxable distributions. With a taxable termination of \$1.85 million, \$850,000 is paid for GSTT, and only \$1 million goes to the grandchild.

Exclusions/Exemption

Each grandparent is entitled to a \$2 million GSTT exemption. The exemption is applied automatically to direct skips (unless the grandparent elects otherwise). It is applied to transfers to a trust at the time a gift tax return is filed, and to transfers upon death on the estate tax return. In addition, the following exclusions are available:

1. Direct payment of a grandchild's tuition (does not include books, supplies, room, or board) or medical expenses (includes medical insurance premiums).
2. Direct skips of \$12,000 (\$24,000 for married couples who make the proper election) per person per year.
3. Gifts under the \$12,000/\$24,000 limit and made to certain trusts with only one beneficiary.

With proper planning, your clients can utilize the exemption and the exclusions to avoid the GSTT on transfers of \$2 million (\$4 million for married couples) or more.

Inclusion Ratio

The inclusion ratio is determined by the amount of the \$2 million exemption which is applied to the GST taxable transfer. The inclusion ratio is then multiplied by the 46% tax rate to determine the GSTT on the transfer. For example, assume the transfer is a taxable direct skip of \$1 million. If the grandparent only has \$400,000 of the exemption left (because \$1.6 million of the exemption was used to exempt prior transfers), the inclusion ratio will be .6 (1 minus \$400,000/\$1,000,000). The GSTT rate would therefore be 28% (46% x .6), and the GSTT would be \$280,000.

Once an inclusion ratio is calculated, the ratio stays with the property. If the grandparent transfers \$1 million to a trust and can apply only \$400,000 of the exemption (as in the previous example), any future distributions (including any portion attributable to future asset appreciation) from the trust will be subject to the 28% rate (i.e. the inclusion ratio is .6). The goal is to achieve an inclusion ratio of zero or 1.0 for multiple trusts (to simplify the tax calculation).

Planning

The grandparent can use the exceptions when they are available (1-3 above), or consider transfers to siblings or children rather than grandchildren. If a transfer is to be made to a grandchild and it does not qualify for one of the exceptions, then the \$2 million lifetime exemption can be used. A gift tax return (Form 709) is required to apply the exemption to transfers into a trust, or to elect out of using the exemption for a direct skip. If the grandparent is insurable, the grandchildren could purchase and own life insurance on the grandparent. For couples with larger estates, multiple trusts can be established to take full advantage of the \$2 million GST exemption available to both spouses, while also taking advantage of the full marital deduction upon the first death. Lifetime gifts can also be leveraged through trust arrangements to minimize or eliminate the GSTT, and remove the future appreciation from the grandparent's estate.

Conclusion

The GSTT is expensive and therefore important for a client whose current or expected estate exceeds \$2 million. For smaller estates, the exemption should be considered for transfers into an irrevocable trust, so that all future distributions are exempt if the client's estate later grows to more than \$2 million. The exceptions should also be considered for financial and estate planning purposes.