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The generation-skipping transfer tax (GST)

The generation-skipping transfer tax (GST) is the third leg of the transfer tax stool – the other two being gift and estate taxes – and is designed to inhibit the build-up of dynastic wealth. It has existed in its current incarnation since 1986, and has been a very effective tax. Yet with the temporary doubling, through 2025, of the gift and estate tax exclusion and GST exemption to $10 million, indexed for inflation, transfer taxes do not affect most people. In that case, why focus on them – in particular, the GST – when the 2019 numbers are $11.4 million per individual or $22.8 million per married couple?

The answer is simple: first, barring Congressional action, in 2026, the gift and estate tax exclusions and GST exemption will revert to $5 million, indexed for inflation; at that point, those numbers might be +/-$7 million per individual or +/-$14 million per married couple. Second, if draft legislation from Sen. Bernie Sanders and comments from other Democratic presidential candidates are any guide, Democratic control of the White House, House and Senate after the 2020 (or 2022 or 2024) elections would likely mean significant tax law changes, including limiting or eliminating many estate planning techniques, significantly reducing the gift and estate tax exclusions and GST exemption (along with limiting the exemption's duration), and raising transfer tax rates, which are currently unified and top out at 40%. So while today's numbers may make transfer taxes – especially the GST – a remote concern for most, those taxes could once again affect many, depending on what happens politically.

Putting these considerations aside, the GST still merits attention. It could, for example, be a "live" issue for existing testamentary trusts that were "too big" at creation to be fully protected by, say, deceased Grandma's $1 million GST exemption (this was the size of the exemption from 1986 – 1998, after which, it started to increase slightly). In addition, unlike the gift and estate tax exclusion, the GST exemption is *not* "portable." In other words, if married couples want to take full advantage of their respective GST exemptions – a collective $22.8 million in 2019 – they must plan accordingly, as there is no way for Grandma, for example, to claim deceased Grandpa's unused GST exemption. Put simply, the GST exemption is a "use it or lose it" proposition.

Before getting into some GST planning strategies, here are some key points about the GST:

- The **GST rate** equals the top estate tax rate (currently 40%) times the amount of property subject to the GST; thus, if the entire transfer were subject to GST, the GST rate today would be 40%.

- The GST generally applies to **"generation-skipping transfers"** unless those transfers are protected by an individual's GST exemption. A generation-skipping transfer can be: 1) a "direct skip"; 2) a "taxable distribution"; or 3) a "taxable termination." These terms are probably best illustrated with examples:

  1) **Direct skip – outright.** Grandma leaves Grandson $100,000 under her will. (Grandma is the **"transferor"** and Grandson is a **"skip person"** because he is (i) a descendant of Grandma's grandparent AND (ii) at two least generations below Grandma.)

     Direct skip – in trust. Grandma transfers $2 million into a trust for her grandchildren and more remote descendants (the trust is a "skip person" because no **"non-skip person"** (such as a child) has an interest in the trust).

     Comment. In these examples, if Grandma has enough GST exemption to protect these transfers, no GST is owed; similarly, if she has enough gift or estate tax exclusion to protect these transfers, no gift or estate tax will be owed either. But here's the rub: direct skips are *already* subject to gift or estate tax, depending on whether Grandma makes the gift while she is alive or at her death. So why is the GST necessary? Because by giving property *directly* to a skip person, Grandma has skipped a generation and therefore a level of transfer tax.

  2) **Taxable distribution.** Widowed Grandma made no taxable gifts during her life, and dies in 1998 when the GST exemption was $1 million and the estate tax exclusion was $625,000; her estate is worth about $3 million. After estate tax of over $1 million, her estate passes in trust for children, grandchildren and more remote descendants. The trust is divided in two, so that one trust equals Grandma's $1 million GST exemption and is fully protected from GST (the exempt trust); the other trust equals the balance of her estate (about $1 million), and is fully subject to GST (the non-exempt trust). When Trustee distributes $20,000 to Grandchild from the non-exempt trust (a **"taxable distribution"**), Grandchild nets $12,000, assuming a GST rate of 40% (the $8,000 GST comes out of the property).

  3) **Taxable termination.** Same facts as above. The last child beneficiary of the two trusts dies. While this **"taxable termination"** doesn't trigger GST in the exempt trust, it does trigger GST in the non-exempt trust. Assuming this trust is now worth $1.5 million and that the GST rate is 40%, the trust owes $600,000 in GST and is left with $900,000. The trust beneficiaries all move up a generation, so that grandchildren are treated as children, great-grandchildren are treated as grandchildren, and so forth. Distributions to grandchildren will no longer be taxable distributions, but when all of the grandchildren die out, there will be another taxable termination, and all of the beneficiaries will again move up a generation.

Comment. When Grandma creates a multi-generational trust that includes children (what's now known as an **"indirect skip"**), this "non-skip person" trust is not immediately subject to GST, unlike with the direct skip. Yet to protect the trust from future GST consequences, GST exemption must be allocated to it. (To help save people from themselves, the GST has a number of "deemed" allocation rules regarding indirect and direct skips – proof positive that it very easy to make a mistake with the GST!)

- **Treatment of direct skips that are non-taxable gifts.** Not all direct skips trigger GST. In other words, if Grandma makes any of the following gifts, these are not subject to GST:

  1) **Annual exclusion gifts.** If Grandma gives Grandson a $15,000 annual exclusion gift, it is not subject to GST. Similarly, if Grandma contributes this amount into a trust for Grandson, the transfer is also not subject to GST *if* Grandson is the only beneficiary of the trust and the trust is includible in Grandson's estate for estate tax purposes.

  2) **Direct payments for tuition, medical expenses and health insurance premiums.** If Grandma directly pays Grandson's tuition, medical expenses or health insurance premiums, these payments are not subject to GST. ("Directly" means that Grandma makes the payment directly to the school or the provider.) Like annual exclusion gifts, direct payments are "extras" and do not reduce Grandma's gift and estate tax exclusion.

  Comment. Under current law, even if a trust is NOT protected from GST, distributions for the benefit of a skip person will not trigger GST if those distributions represent any of the direct payments described above.

- **"Grandfathered" trusts.** In general, if a trust was irrevocable as of September 25, 1985, the GST does not apply to it unless something in the trust "ungrandfathers" it. This could happen, for example, with certain "powers of appointment." For instance, if a beneficiary had a "general power of appointment" that lets the beneficiary appoint the trust property to himself, his estate, his creditors or the creditors of his estate, that property will be includible in the beneficiary's estate (regardless of whether the beneficiary actually exercises the power) and potentially subject to GST in the future.

GST and existing non-exempt trusts. Suppose that when Grandma died in 1998, the trust that was created under her will for Daughter and Daughter's Children exceeded Grandma's $1 million GST exemption. If that trust wasn't split into two pieces initially, so that one trust was fully protected from GST and other trust was fully subject to it, the result is a trust that is partially subject to GST. Administratively, this is undesirable and makes for complications in terms of investments, distributions and efficiency. To rectify this issue, the trustee could do a **"qualified severance"** and divide the trust into two trusts, one that is GST-exempt and one that is non-exempt.

Yet with respect to the non-exempt trust, when Daughter dies, there will be a taxable termination (see above) and this trust will be subject to a 40% GST haircut (using the current top estate tax rate). Is there any way to mitigate this bite? The answer could be **"decanting,"** whereby under the trust document itself or local law, the trustee "decants," or pours over, the existing trust into a new trust that

gives Daughter a “skinny” general power of appointment that lets her appoint the trust property, at her death, to her creditors or the creditors of her estate. Daughter’s mere possession of this power will make the trust includible in her estate and potentially subject to estate tax – thereby precluding a taxable termination at Daughter’s death, which will slice the trust nearly in half. This estate tax includibility may not matter, however, if Daughter has enough estate tax exclusion – again, it’s $11.4 million in 2019 – to protect the trust from estate tax.

GST and existing exempt trusts. Suppose that in 2011, Mom and Dad, who hadn’t previously made taxable gifts, created a Delaware “dynasty” trust for their descendants; by combining their respective $5 million gift tax exclusions and $5 million GST exemptions, they created a $10 million trust that is fully protected from GST and that will last “forever,” since Delaware repealed its “rule against perpetuities.” (This common law rule provides that a trust must terminate no later than 21 years after the death of the last surviving designated individual who was alive when the trust was created.) Because the gift and estate tax exclusion and GST exemption have doubled through 2025, Mom and Dad could add additional property to the trust to reflect these increases with no current transfer tax friction.

Current lifetime planning. Suppose that Mom has done no current planning to speak of, and is thinking of taking her company public within the next six months to a year. She wants to pass some of this potential appreciation to her descendants, gift-tax efficiently. If Mom were more focused on simply benefiting her children, she might consider creating a **grantor retained annuity trust (GRAT)**, whereby she creates a trust that pays her an annuity for, say, two or three years, after which, whatever is left in the trust passes the “remaindermen” (presumably, her children).

The GRAT is structured so that the present value of Mom’s annuity payments virtually equals 100% of what she put in the trust, thereby eliminating the gift to the remaindermen. Yet because of Mom’s retained interest in the trust, the GST rules preclude her from allocating GST exemption to the GRAT at its inception, and require her to wait until her annuity payments are over (the rules presumably are designed to prevent “too much” appreciation from passing free of GST).

Enter the **“sale to the defective grantor trust.”** This structure allows Mom to allocate GST exemption to a trust from its inception. Here, Mom creates a multi-generational trust that she “owns” for income tax purposes, but that won’t be includible in her estate at her death (what’s known as a “defective grantor trust”). She funds the trust with cash, and then sells stock in her company to the trust in exchange for a nine-year interest-only note. Because the trust is considered Mom’s alter ego for income tax purposes, she is not taxable on the interest payments she receives, nor does she recognize gain on the stock sale to the trust.

When the trust pays off the note to Mom, presumably using what is now highly appreciated stock, much of that same stock remains in the trust – meaning that this appreciation has passed free of gift tax and GST. This structure might involve a $500,000 seed gift to the trust (requiring a matching amount of Mom’s gift tax exclusion and GST exemption) coupled with a sale of $5,000,000 worth of stock; the gift and sale components could also be many multiples of this. The point is that because of the current $11.4 million gift tax exclusion and GST exemption, the Sale offers significant multi-generational planning opportunities.

To wrap up. Given the size of the current GST exemption ($11.4 million or $22.8 million for married couples, with proper planning), the GST might not appear to be a problem, except for the very wealthy; after all, many people are inclined to benefit their children rather than their grandchildren and great-grandchildren, who might even be born yet! Yet as discussed above, the GST could be an issue for current testamentary trusts that are not fully GST-exempt because they were "too big" to be fully protected by what was then a much smaller GST exemption. The GST could also become an issue if it reverts to half its current size in 2026, or goes even lower, depending on the political landscape. Before this potentially happens, individuals might want to consider whether multi-generational GST planning should play a role in their overall wealth planning.

September 7520 rate

The September 2019 7520 rate remains at 2.2%, where it was in August. The September mid-term applicable federal rates (AFRs) have dropped slightly, and are: 1.78% (annual), 1.77% (semi-annual and quarterly) and 1.76% (monthly). The August mid-term AFRs were: 1.87% (annual), 1.86% (semi-annual and quarterly) and 1.85% (monthly).

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