

Beware the GST tax when transferring assets to grandchildren

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As you plan your estate, don't overlook the generation-skipping transfer ("GST") tax. Despite a generous \$5.49 million GST tax exemption, complexities surrounding its allocation can create several tax traps for the unwary.

GST basics

The GST tax is a flat, 40% tax on transfers to "skip persons," including grandchildren, other family members more than a generation below you, nonfamily members more than 37½ years younger than you and certain trusts (if all of their beneficiaries are skip persons). If your child predeceases his or her children, however, they're no longer considered skip persons.

GST tax applies to gifts or bequests directly to a skip person and to certain transfers by trusts to skip persons. Gifts that fall within the annual gift tax exclusion (currently, \$14,000 per recipient; \$28,000 for gifts split by married couples) are also shielded from GST tax.

Allocation traps

To take full advantage of the GST tax exemption, you (or your estate's representative) must properly allocate it to specific gifts and bequests (on a timely filed gift or estate tax return). Allocating the exemption wisely can provide substantial tax benefits.

Suppose, for example, that you contribute \$2 million to a trust for the benefit of your grandchildren. If you allocate \$2 million of your GST exemption to the trust, it will be shielded from GST taxes, even if it grows to \$10 million. If you don't allocate the exemption, you could trigger a seven-figure GST tax bill.

To help prevent costly mistakes like this from happening, the tax code and regulations provide for automatic allocation under certain circumstances. Your exemption is automatically allocated to direct skips as well as to contributions to “GST trusts.” These are trusts that *could* produce a generation-skipping transfer, subject to several exceptions.

Often, the automatic allocation rules work well, ensuring that GST exemptions are allocated in the most tax-advantageous manner. But in some cases, automatic allocation can lead to undesirable results.

Suppose you establish a trust for your children, with the remainder passing to your grandchildren. You assume the automatic allocation rules will shield the trust from GST tax. But the trust gives one of your children a general power of appointment over 50% of the trust assets, disqualifying it from GST trust status. Unless you affirmatively allocate your exemption to the trust, distributions or other transfers to your grandchildren will be subject to GST taxes.

Handle with care

If you plan to make gifts to skip persons, or to trusts that may benefit skip persons, consider your potential GST tax exposure. In addition, repeal of the GST tax, along with the gift and estate tax, has been proposed. We’ll keep you abreast of any tax law changes that affect estate planning, and we can answer your questions regarding the GST tax.

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