Now’s the Time to Review your Generation-Skipping Transfer Tax Exposure

Absent congressional action this year, the federal gift and estate exemption and the generation-skipping transfer (GST) tax exemption (currently $13.99 million) are scheduled to return to their pre-2018 levels of $5 million (around $7 million when adjusted for inflation) beginning in 2026. So, it’s a good idea to consider strategies for taking advantage of higher exemptions this year using gifts or trusts.

Now is also the time to review your estate plan for potential GST tax exposure. The GST tax is complex and potentially harsh. Plus, unlike gift and estate taxes, it’s possible to have a substantial GST tax liability regardless of how much exemption you have left.

GST tax in a nutshell

Designed to ensure wealth is taxed at each generational level, the GST tax is a flat, 40% tax (in addition to gift and estate taxes) on transfers that skip a generation. This includes transfers to “skip persons” — such as grandchildren or other relatives more than one generation below you — and to nonfamily members who are more than 37½ years younger than you. Note: if your child predeceases you *before* you make a transfer, then his or her children move up a generation and are no longer treated as skip persons.

GST tax may be triggered by outright gifts to a skip person and by certain distributions or transfers of trust assets to a skip person. Here’s why the GST tax can be dangerous: Transfers subject to gift or estate tax are automatically protected by your gift and estate tax exemption amount. In contrast, when you make transfers that are subject to GST tax (or potentially subject to the tax), you must affirmatively allocate a portion of your GST tax exemption amount to those transfers to shield them from the tax.

To prevent costly mistakes, the tax code automatically allocates your GST tax exemption to certain transfers that may result in GST tax, such as outright gifts to skip persons or transfers to “GST trusts” that may benefit skip persons in the future. Unfortunately, these provisions don’t always have the desired result.

Avoiding the pitfalls

Here are a few examples of GST tax pitfalls and how they can be avoided.

Wasted allocation of exemption to GST trusts. As previously noted, the tax code automatically allocates your GST tax exemption to GST trusts. However, if the possibility is remote that a trust will benefit skip persons, your exemption may be wasted. To avoid this result — and preserve your exemption for transfers that are more likely to trigger GST taxes — elect to opt out of automatic allocation on a timely filed gift tax return. If you neglect to opt out, obtaining relief from the IRS may be possible. Doing so allows you to make a late election so long as you can demonstrate that you acted reasonably and in good faith.

Premature death of a trust beneficiary. Suppose Jane establishes a trust for her daughter, Ella, that calls for the assets to be distributed to her when she reaches age 35. Although Ella's children (Jane's grandchildren) are contingent beneficiaries, the possibility they'll receive the trust's assets is remote, so Jane doesn't allocate any of her GST tax exemption to the trust.

If Ella dies at age 33, however, the trust will be subject to GST tax on the assets that go to Jane's grandchildren, even though Jane hasn't tapped her GST tax exemption. Fortunately, Jane can retroactively allocate her exemption to the trust by filing a timely gift tax return for the year of Ella's death.

"Blended" trusts. For various reasons, you may end up with a trust that's only partially protected by the GST exemption. For example, suppose Dick established a trust for the benefit of his children and grandchildren. The trust has an "inclusion ratio" of 0.5, meaning 50% of any distributions to his grandchildren will be subject to GST tax. (See "What's a trust's inclusion ratio" at X.)

To avoid this result, Dick could split the trust into two trusts (if permitted by the trust document and applicable law). Trust A would have an inclusion ratio of 1.0 and Trust B would have an inclusion ratio of 0.0. If Dick uses Trust A to make distributions to his children and Trust B to make distributions to his grandchildren, he'll avoid GST tax.

A dangerous tax

Unlike gift and estate tax, you can be liable for GST tax even if you haven't used your exemption. So, reviewing your estate plan and taking steps to avoid or minimize this dangerous tax is critical. Contact your estate planning advisor for help.

Sidebar: What's a trust's inclusion ratio?

A trust's inclusion ratio refers to the portion of a trust's assets that will be subject to GST tax if a taxable event occurs. If you haven't allocated any of your exemption to a trust, its inclusion ratio is 1.0. If the exemption protects all of a trust's assets, its inclusion ratio is 0.0.

How do you end up with a blended trust (one with an inclusion ratio between 0.0 and 1.0)? Here's one way: Suppose that in 2008, you transferred $4 million to a trust to benefit your children and grandchildren. At the time, the GST tax exemption was $2 million. Because the exemption only covered half of your gift, its inclusion ratio is 0.5, so 50% of any distributions to your grandchildren are subject to GST tax.