Taking Full Advantage of the Generation-Skipping Transfer Tax

*TD Ameritrade Institutional's Advisors Private Wealth Trust solution would like to introduce some thought-provoking third-party content from National Advisors Trust Company.**

The idea of taking advantage of a tax might sound odd, as does the thought of "skipping" anyone—let alone one's children—in an estate plan. However, it is possible to use the exclusions and exemption from the tax strategically to further one's estate planning objectives. And, while it may seem counterintuitive, you don't have to skip a generation to "generation skip."

Let's start with a brief review of how generation skipping works before addressing effective, acceptable strategies.

What is the Generation-Skipping Transfer Tax (GSTT)?

GSTT is a transfer tax, similar to the gift tax and estate tax. It's a tax on the value of assets transferring during life (gift) or at death (estate) and in the case of GSTT, moving down two or more generations from the transferor without being taxed to the middle generation(s). This will provide both problems and opportunities. Also, most estate plans that involve trusts can accidentally skip a generation, so the planner, executor, and trustee should be well versed in GSTT to provide its benefits to their plans even when no skip is anticipated. The GSTT, generally, affects plans that became irrevocable after 10/22/1986.

How does GSTT work?

GSTT is a second transfer tax imposed after the gift or estate tax on transfers that are not taxed in each generation. First, the relationship of the transferor to the recipient has to be determined. The recipient may be a "non-skip person" or a "skip person." When assets transfer to a skip person, then the tax is imposed. There are detailed rules, but generally, a skip person is a family member two or more generations below the transferor. If they are not close family members, their relative generation is determined by the age difference from the transferor. An age difference of 37 ½ years younger or more makes them a "skip person." Trusts are "skip persons" when all of their beneficiaries are skip persons. The tax is imposed immediately when assets are gifted or left at death directly to a skip person, or when they are later distributed from a trust to a skip person, or when the trust has only skip person beneficiaries.

How to Avoid the GSTT

There are basically three ways to avoid the tax:

1. The annual exclusion
2. Paying tuition and medical expenses
3. Using the GSTT exemption

The first two are exclusions, meaning not subject to the tax at all. The third is a protection from the tax.

The Annual Exclusion

The GSTT annual exclusion mirrors the gift tax annual exclusion in amount, but not in form. This disconnect in form means that special care should be taken when making transfers that are not outright, such as making a gift to a trust or similar device. Without getting into too much detail, generally outright gifts to grandchildren are fine and gifts to minors' accounts, like a Uniform Gifts to Minors Act (UGMA) or Uniform Transfers to Minors Act (UTMA), should be fine. But gifts to most trusts can be problematic. For example, a gift to an Irrevocable Life Insurance Trust (ILIT) may qualify for the gift tax annual exclusion, but *not* the GSTT annual exclusion. These trusts, however, can be drafted to meet both the gift and generation-skipping rules, thus extending the amount that can be passed GSTT tax-free.

Tuition and Medical Expense Exclusion

To maximize use of the GSTT exclusions, advisors' clients should also consider paying any or all of their grandchildren's tuition bills and medical expenses. When paid directly to the service provider, these gifts are free of both gift tax and GSTT.

GSTT Exemption

Similar to the gift/estate tax basic exclusion amount, the GSTT exemption again mirrors the amount but is different in form. The $5,000,000 base is indexed for inflation and may rise each year ($5,450,000 in 2016). But in form the GSTT exemption is different. As soon as a taxpayer's taxable gifts and taxable transfers at death exceed their applicable exclusion amount, which may include any unused exemption from a previously deceased spouse, the donor has to pay gift or estate tax. But with GSTT, not all transfers are the same; some may be more likely to skip than others, so the law allows the donor to choose where to apply the GSTT exemption.

In simple terms, it's typically a good idea to place an amount that can be protected into one trust and the balance into another trust. That way the use of the GSTT exemption can be optimized with tailored investments. The distribution language can also be tailored to different trusts, affecting where distributions are made from, based upon to whom they are going. It is also possible to keep this transfer tax protection in place for multiple generations (in some states perpetually). This is sometimes called a Dynasty Trust. It is also important to point out that the GSTT exemption is *not* portable, like the unused estate tax exemption, so special care must be taken to ensure the taxpayer can take full advantage of the GSTT exemption for married couples.

Some advisors' clients worry about long-term trusts. Their concerns typically revolve around access for the heirs and who can be a beneficiary. Let's address each of these issues individually. First, anyone can be a beneficiary of such a trust, including a spouse and children. As previously mentioned, you don't have to skip a generation in order to generation skip. The secret is to have access to the assets limited in such a way that the IRS does not consider the beneficiary an owner of the account.

So how much access can the beneficiary have and still maintain the tax and asset protection features of the trust? Below is the maximum amount of access allowed in three points; anything more restrictive will also work.

1. First, they can have access to any or all of the income for any reason.
2. Second, they can have access to any or all of the principal, if needed. This limitation can be based on special language in the document or through the use of an independent or adverse trustee.

3. Third, they can have the ability to adjust who benefits from the trust in the future, allowing future generations to make adjustments based on specific family circumstances or charitable inclinations.

That is a lot of power and access. Many clients may choose more restrictive provisions, but it demonstrates that tax protections can come with broad access to the trust funds. Naturally, if the funds are distributed, the tax and asset protection features no longer apply.

Do you have questions about the generation-skipping transfer tax?

TD Ameritrade Institutional can help with this and your other trust-related questions.

Contact us

Summary

Generation-skipping transfer tax can be complex and the coordination of all members of the estate planning team can help advisors' clients' wishes be actualized in a highly efficient and tax effective fashion. As with many things, knowledge of the rules allows you to use the rules in your clients' favor.

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