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DEALING WITH GENERATION SKIPPING IN 2010

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The Generation Skipping Transfer Tax ("GST" Tax) is one of several taxes that can affect your estate both during your lifetime and after death. Congress recently allowed the GST Tax to expire for 2010 (but the tax will return in 2011). While this appears to be a good thing, the temporary absence of the GST Tax may be misleading, and although some types of gifts may be made now (in 2010) without ever incurring this tax, other gifts may become subject to the GST Tax in later years.

A Brief History of the GST Tax:

The generation skipping tax was first imposed in 1976 as a way of preventing families from passing wealth down to younger generations by skipping a generation (and thereby avoiding having to pay the estate tax in the skipped generation). The original generation skipping tax was intended to impose a tax equal to the amount of the "skipped" estate tax. This proved too complicated, and in 1986 the current GST Tax was enacted which imposes a flat rate tax on all "skip" gifts.¹

Before 2010, taxpayers were allowed to exempt a certain amount of gifts from GST Tax. Under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the amount of the exemption grew gradually from \$600,000 to \$3,500,000, mirroring the increased exemption from estate taxes; the tax rate on such gifts also dropped from 55% to 45%.

By 2009, fewer taxpayers chose to include generation skipping in their estate plans because the amount that could pass free of estate tax was significantly large to make generation skipping unnecessary for many taxpayers. With the expiration of EGTRRA in 2011, however, the amount exempt from GST Tax will revert to pre-2001 levels, adjusted for inflation, with the amount of the exemption expected to be \$1,200,000 in 2011 and the GST Tax rate expected to be 55%.

What Transfers are Subject to the GST Tax?

The GST Tax is imposed on gratuitous transfers (i.e., gifts) to related persons (or in trust for such persons) who are two or more generations below that of the transferor. A gift from a grandparent to a grandchild, for example, would be subject to GST Tax because the gift “skips” over the transferor’s living child (one generation below the transferor) directly to the grandchild. The GST Tax is also imposed on transfers to unrelated persons who are 37-1/2 years younger than the transferor. In each situation, the transferee is referred to as a “skip person.”

The tax is imposed on three types of transfers:

- (1) A Direct Skip: a direct transfer from a transferor to a skip person;
- (2) A Taxable Termination: the termination of a prior interest in property (such as a life estate) that results in the property being transferred to a skip person; or
- (3) A Taxable Distribution: the distribution of assets from a *non-exempt* trust to a skip person.

A trust to which a transferor applies his or her GST exemption is referred to as *exempt*, while a trust to which the exemption is not applied is referred to as *non-exempt*.

Who pays the GST Tax?

Who is responsible for payment of the GST Tax depends on the kind of transfer involved. The transferor is responsible for the taxes on a Direct Skip, as well as on a Taxable Termination (generally the trust pays the tax from trust assets).

The tax on a Taxable Distribution is paid by the transferee. Therefore, a transfer to a grandchild from a trust is taxable to the grandchild and not the trust (and if the trust pays the tax this is treated as an additional distribution to the grandchild that is also subject to the GST tax).

Giftgiving Opportunities and Risks in 2010

Because of the temporary repeal of the estate tax, coupled with its return in 2011, gifting this year requires more consideration. While certain transfers will be free of the GST Tax, others may result in costly taxes being imposed at a later date.

Outright gifts to a skip person will be free of GST Tax this year. A grandparent can gift cash or assets to grandchildren and great grandchildren in 2010 without incurring GST Tax. However, such transfers will still be subject to Gift Tax (but at a very favorable tax rate of 35%, as opposed to the 45% rate in 2009 and 55% rate in 2011). Persons whose children have substantial estates, and whose grandchildren are sufficiently mature, may therefore wish to make gifts directly to such grandchildren in 2010. This will not only avoid GST Tax, but also any estate tax at the child’s level (as the assets will skip the child’s estate).

Gifts in trust for a skip person, however, should be avoided in 2010. Distributions made from such a trust (after 2010) will most likely be subject to GST Tax.² A person whose family trust includes generation-skipping trusts for the grandchildren may want to change these provisions (for 2010 only) because of the extra GST taxes that may be incurred if the donor dies this year and skip persons receive future distributions from a trust that cannot be allocated any GST exemption. In prior years, the transferor (or his/her estate) could allocate some or all of the transferor's generation skipping tax exemption to such trusts, thereby ensuring that distributions made in later years would not be subject to GST Tax (i.e, making the trust *exempt*). However, because there is no generation skipping tax in 2010, there is also no GST exemption available to allocate to an exempt skip trust. Grandchildren's trusts established in 2010 will therefore be non-exempt, and distributions at a later time to the grandchildren will likely be subject to GST Tax.

Another planning opportunity in 2010 relates to Taxable Terminations. While some experts disagree, it appears that trusts with a prior interest (such a life estate) which is terminated in 2010 will not be subject to GST Tax on the transfer of those assets.³ For example, if a transferor left property in trust for the benefit of a child for life, with the remainder to pass to his grandchildren at the child's death, and the child were to die in 2010, no GST Tax will be imposed on the transfer of this interest to the grandchildren.⁴ Likewise, if a lifetime beneficiary has a limited power to appoint trust assets to skip persons during 2010, and exercises this power, the termination of the lifetime beneficiary's interest should not result in a GST Tax.⁵ Thus, in 2010 it may be possible to appoint assets down to a younger generation from a non-exempt trust without incurring GST Tax.

Finally, distributions to skip persons from a Non-Exempt Trust in 2010 will also not be subject to the GST Tax. In 2011, similar distributions will again be subject to GST Tax. Trustees with discretion to make distributions to skip persons from a Non-Exempt Trust may want to consider making larger distributions (or perhaps distributing all of the assets to such persons) in 2010⁶ to avoid paying GST Taxes in a later year.

Of course, distributions in 2010 must be permitted under the terms of the trust and a thorough review of the trust terms is necessary. Documenting a trustee's exercise of discretionary authority may be crucial in proving to the IRS that assets were properly distributed.

2011 and beyond

Unless Congress passes legislation to change the GST Tax, 2011 will bring a return to lower GST exemptions and higher GST Taxes (along with a lower exemption from estate tax). In this environment, the generation skipping trust will likely re-emerge as a valuable planning tool to postpone the payment of GST Tax as long as possible. Persons who do not currently have generation skipping as a part of their estate plans may want to consider incorporating this technique.

¹ Trusts in existence before 1986 are "grandfathered" and are not subject to GST Tax.

² There is some uncertainty regarding this in the estate planning community because as a provision in EGTRRA that declares that law will be treated as never having been in force. It might be possible, therefore to allocate generation skipping exemption retroactively to such gifts, but the level of exemption to apply is uncertain.

³ Experts disagree on this point, but the better interpretation of the law seems to be that termination of a prior interest in 2010 will not result in GST Tax being imposed in 2011, because the prior interest terminated in a year in which GST Tax cannot be imposed. However, we anticipate the IRS may take a different position in the event of such a termination in 2010.

⁴ This same transfer in 2009 would have constituted a "taxable termination" and resulted in a GST Tax being imposed on the assets unless the trust was GST *exempt*.

⁵ The exercise of the power of appointment should also not result in the imposition of a gift tax on the power holder because the power was granted by the transferor and is exercised in a fiduciary capacity. If the power is not exercised in a fiduciary capacity, a gift may arise having a value equal to the income interest relinquished.

⁶ Such a distribution should only be made if consistent with the Trustor's intent. Since most GST trusts include provisions indicating the Trustor's desire to minimize GST Tax, the necessary intent should not be difficult to prove.