Skip the Taxes With a GST Exempt Trust

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In 2012, each individual is allowed to give away during his or her lifetime up to $5,120,000 without any federal gift or estate taxes due to the historically high exemption for federal transfer tax purposes. The same exemption amount applies for generation-skipping transfer (GST) tax purposes this year. This exemption amount is scheduled to expire at the end of this calendar year and the future of the federal transfer tax laws is uncertain. Imagine the tax savings that may be achieved if you could give away amounts within the exemption, in trust for the benefit of future generations, and avoid gift and estate taxes that might otherwise be payable by your children or grandchildren in their own estates. Due to the all-time high generation-skipping transfer tax exemption made available this year, it is possible to give away more without triggering a tax liability.

The generation-skipping transfer tax or "GST tax" is a federal tax designed to ensure that taxes are paid at each generational level and applies to transfers of property to persons who are two or more generations below the transferor. The person receiving such property is called a "skip person". It is easy to conceptualize the skip transfer in the context of a gift from a grandparent to a grandchild. However, it also applies to transfers to a person who is not a descendant if the person is 37.5 or more years younger than the transferor. The GST tax carries a hefty rate of 35%, which is scheduled to increase to 55% in 2013 barring further changes by Congress.

In 2012, the GST exemption is worth $5,120,000. If Congress does not act to amend the law before the end of 2012, the GST exemption will revert to $1,000,000 with an adjustment for inflation that will bring it up to $1,360,000 in 2013. The GST exemption will be indexed for inflation after 2013 and is expected to result in significant increases in the exemption over the next 20-year period.

GST tax planning can be complex because transfers to skip persons may occur indirectly when property is distributed out of a trust or when a trust is terminated. For example, a parent may establish a trust to provide income to a child, who is a non-skip person, where the trust provides that upon the child's death the trust assets are to be distributed outright to a grandchild. As a result of this taxable distribution, a GST tax would be payable from the trust at termination when the trust property passes to the grandchild. Similarly, a taxable distribution may occur when there is a distribution of income or principal from a trust to a skip person. If a grandparent created a trust that authorized the trustee to make distributions of principal to a grandchild, the payments to the grandchild would be considered distributions to a skip person and subject to GST taxes.

The onerous impact of the GST tax may be avoided for distributions or trust terminations through careful planning and proper wording in the trust instrument. By applying the GST exemption to the trust when it is created, the trust would be exempt from GST taxes. Under a GST exempt trust, the trust assets may be insulated further from estate and gift taxes in the future by making sure that the provisions of the trust do not cause the trust assets to be included in the beneficiaries' estates for estate tax purposes. Married couples may double the amounts contributed by using both spouses' GST exemptions. GST trusts may also continue for the maximum period allowed by state law, and some states (e.g., Rhode Island) allow for Dynasty Trusts that may continue in perpetuity.

In 2012, the GST exemption has reached its highest level ever and there is a possibility that it will be significantly cut in 2013. Consider your options in 2012 in order to leverage your gifts, protect assets in trust for future generations, and minimize potential taxes.

Your attorney at Partridge Snow & Hahn LLP would be happy to discuss these important issues with you to ensure that your intentions are fulfilled.

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