CHIEF INVESTMENT OFFICE

Wealth Strategy Report

Generation-Skipping Transfer Tax Planning

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OVERVIEW

A tax-efficient estate plan should address not only the estate tax but also the generation-skipping transfer (GST) tax. Common GST tax planning involves establishing trusts for grandchildren and future generations. Generally, the longer these trusts last, the more estate tax that can be avoided. Just how long such a trust can last depends on the state in which you establish the trust. Some states, such as Delaware, would allow the trust to last as long as you want.

THE GENERATION-SKIPPING TRANSFER (GST) TAX

The GST tax can be understood by considering what it's meant to prevent—avoidance of multiple layers of taxation. The gift and estate taxes are designed to impose a transfer tax each time one generation transfers wealth to the next generation. So, all wealth passing from you to your children (subject to various exemptions) is to be subjected to a gift tax (if you transfer it during lifetime) or an estate tax (if the transfer takes place at death). Estate and or gift taxes would again be due when your children transfer assets to your grandchildren, and so on.

Before the GST tax was introduced (as it applies today) in 1986, this multiple (successive) level estate and gift taxation could be easily circumvented if you "skipped" your children and transferred assets to your grandchildren, either directly outright or in trust. Although you might trigger a gift or estate tax, there would not be two such taxes imposed. You would have avoided the second transfer tax described in the preceding paragraph.

Enter the GST tax. If you attempt to "skip" your children's gift tax or estate tax by making transfers to your grandchildren or further generations, the GST tax acts as a backup and imposes a second transfer tax on the transfer at the highest estate tax rate.

COMMON GST TAX PLANNING

Just as the estate tax has an exemption amount that you can shield from estate tax, you also have a GST tax exemption amount that you can indeed "skip" over your children's generation (by gift or bequest to grandchildren or further descendants) without triggering the GST tax. For both GST and estate tax purposes, this exemption amount is $12,920,000 for 2023.

If this exemption amount is transferred to a trust, the assets that remain in trust to benefit descendants can avoid succeeding generations' estate tax because those assets are not again transferred. This is the most common approach to GST tax planning—to set aside in trust the most you can shield from GST tax and have it stay in trust for an extended period of time. Under current federal tax law, those assets will not be subject to further gift or estate tax as long as they remain in the trust. While in trust, the assets can be used for the benefit of your children and/or further descendants.

HOW MANY GENERATIONS' TRANSFER TAX CAN YOU SKIP?

If your estate plan establishes a GST Trust that would not be subject to your children's estate tax, it could provide that upon the death of your children, the GST Trust would terminate and distribute its assets outright to your grandchildren. Under such an arrangement, the trust's assets would not be subject to estate tax at the deaths of your children. Upon distribution from the trust, however, the assets would become your grandchildren's, possibly subject to gift or estate tax if they transferred those assets.

An alternative would be to have those assets remain in trust another generation—for your grandchildren's lives. Your grandchildren could be permissible beneficiaries of the continuing trust, and at their death, the assets could be distributed to your great-grandchildren. Under this approach, the assets would not be subject to estate tax at your children's or grandchildren's deaths. There would be no GST tax when the trust terminated and distributed the assets to your great-grandchildren because you had shielded the trust with your GST exemption. The result is that you will have transferred your wealth yet another generation without incurring transfer tax.

Following this same approach, you could have the assets remain in trust for yet another generation, thus skipping another generation's transfer tax. This raises the question: "How many generations' transfer tax can you skip with a GST trust?"

THE RULE AGAINST PERPETUITIES AND ITS ABOLISHMENT

Most states limit how long a trust can last. Most states impose a limit of approximately 100 years. (We say "approximately" because the limit can be phrased by reference to the lifetime of a person, which can vary.) This prohibition against a trust having perpetual existence is known as "The Rule Against Perpetuities". If your estate plan establishes a GST tax exempt trust in a state that has a Rule Against Perpetuities, you would be able to skip two or three generations, at which point the assets would have to be distributed and, therefore, exposed again to the gift or estate tax.

Several states, however, have removed this limit. In Delaware, for example, a Delaware Trust can last for as long as desired. (A Delaware Trust that owns real estate can last for only 110 years.) Therefore, if your estate plan establishes a GST tax exempt Trust in Delaware, theoretically there would be no limit to how many generations' estate tax could be skipped if it holds no real estate. A trust established to exist far beyond the customary Rule Against Perpetuities is sometimes referred to as a Dynasty Trust.

HOW TO CREATE A GST TRUST THAT IS A DELAWARE TRUST

In order to be sure you create a GST tax exempt Trust that will be governed by Delaware law, you need to consult with your estate planning attorney. In general, the trustee will need to be a Delaware resident or a trust company that is located in Delaware, such as U.S. Trust Company of Delaware.

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