Planning During a GST Tax Holiday

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The generation-skipping transfer (GST) tax does not apply this year, but it returns next year. This one-year GST tax holiday opens many opportunities, but also has significant traps that should be avoided.

The tax is complicated. When it applies, it is a flat tax at the highest estate or gift tax rate and may be triggered by a gift to or distribution from a trust to a "skip person." Under the GST tax, a skip person is a grandchild, great-grandchild, grandniece/grandnephew or someone other than a spouse who is more than 37.5 years younger than you.

A Good Year for Gifts

As noted elsewhere in this issue, the gift tax continues to apply in 2010. Thus, annual exclusion gifts, gifts sheltered by the $1 million lifetime gift tax exclusion, or taxable gifts are free of GST tax in 2010. So, this year is a particularly good year for gifts. The value of many assets are down, and if a gift made in 2010 attracts a gift tax, the rate will be the lowest rate (35%) in decades.

The gift tax was enacted in 1924, and only the 33.5% rate that applied in 1932-1934 is lower. Also, unless the law is changed, the estate tax returns next year with rates as high as 55% and an exemption of only $1 million. There is also a subtle but very valuable advantage that makes a gift tax payment more attractive than an estate tax payment. For those who pay a gift tax and survive three years beyond the gift, the gift tax paid is not an asset in their estate.

These factors, combined with the absence of the GST tax, make 2010 an excellent year for outright gifts to anyone, including skip persons. The gift tax still applies, but the GST tax does not. If, however, a 2010 gift is in a trust or a "trust equivalent," the assets are exposed to GST tax when the GST tax returns next year. This is a trap for the unwary.

Watch for Pitfalls

An outright gift to a grandchild or other skip person is generally appropriate when the recipient is an adult and is able to manage the gift. If, however, the recipient is a minor or someone who might not appropriately manage an outright gift (for example, the recipient is disabled, has exhibited an inability to properly manage money or has creditor problems), a gift to a trust permits the trustee to manage the gifted assets. Unfortunately, however, when those assets are distributed next year or thereafter, the distribution will most likely be exposed to the GST tax. The same rule applies to a gift to custodianship under the Uniform Transfer to Minors Act.

In some situations, the tax savings from a gift that avoids GST tax may be so compelling that strategies will be implemented to permit an outright gift to a minor. This will usually involve a large taxable gift of an interest in a family-held corporation, LLC or partnership this year and a petition to the probate court, perhaps next year, for the appointment of a conservator to manage the assets until the minor attains majority. While not free from doubt, it appears that assets in a conservatorship estate will not be later exposed to the GST tax when it returns next year.

Another trap exists for trusts that have previously been protected from GST tax by the application of GST exemption to all prior gifts to the trust. There is no GST exemption to apply in 2010. Thus, a gift this year may taint a trust that was previously GST exempt. We generally recommend that no gifts be made to these trusts in 2010. If, however, the trust must have additional resources this year – for example, to pay the premium on a life insurance policy, then it is best if the donor loan the money this year and consider options next year when the GST tax returns. Short-term loans this year can have very low interest rates (less than 1%).

Thus, the GST tax holiday encourages outright gifts to adult skip persons. Outright gifts to minors are more complicated and should generally be avoided, but in some cases should still be pursued due to the tax benefits. Finally, careful attention is needed for trusts that have previously been protected with the GST exemption, as there is no exemption to apply in 2010.

A Note of Caution

One final word of caution. The current position of the administration seeks the retroactive application of the 2009 estate and GST law to 2010. There remains, therefore, the possibility that the next tax law might eliminate the 2010 GST tax holiday. Despite the traps and challenges, there are significant once-in-a-lifetime planning opportunities that will disappear at the end of this year. These gifting opportunities should be discussed with your Warner Norcross & Judd estate planning attorney.