Planning for gifts to grandchildren

The federal government currently imposes three distinct taxes on the transfer of wealth. The first two limit the total amount of assets that a person can pass tax free to others in life or at death. The gift tax and/or the estate tax take a substantial portion of all amounts above that total exemption.

The third tax, the generation-skipping transfer tax (GSTT), is imposed on top of the other two. The GSTT is charged at a flat rate equal to the highest gift and estate tax rate, 45% in 2009. This punishing tax is imposed on transfers to grandchildren or more remote descendants.

The GSTT was scheduled to fade away along with the estate tax in 2010, but it now seems that Congress will be acting at some point to keep that from happening. So it's important to be aware of the GSTT's workings before making large gifts to grandchildren.

Imposition of the tax

The tax is triggered by either "direct skips" of bequests or gifts (say, directly from grandparent to grandchild) or a transfer in trust (a trust created by a grandparent that, for example, provides income for the life of a child and, after the child's death, the payment of the trust principal to a grandchild).

Generally, the GSTT is payable when property passes to a "skip person"—someone more than one generation removed from the individual making the bequest or gift. In a trust setting, if there is a "nonskip person"—someone with an interest in the property who is only one generation below the creator of the trust—tax isn't paid until the assets pass to the skip person. The tax, however, will be based upon the trust's value at that time, which could be considerably higher than its original value.

To help mitigate the harshness of the GSTT, everyone is entitled to an exemption from the tax.

The amount that is exempt matches the amount exempt from the estate tax—$3.5 million in 2009, and the maximum tax rate is 45%. Thus, in 2009 a couple with no prior generation-skipping transfers can transfer assets equal in value to $7 million and escape imposition of the tax. (Such transfers, however, will not escape the gift tax because the amount exempt from *that* tax is scheduled to remain at $1 million through 2010.)

The exemption is discretionary, meaning that for any transfer to which the GSTT would apply, the exemption may be used in whole, in part or not at all. However, once claimed, the use of the exemption is irrevocable.

Coping with the GSTT

In many cases a trust, created either now or after death, will be the best choice for transferring assets to grandchildren.

If the trust is funded during the creator's (grantor's) life, he or she can elect to have the GSTT exemption apply to the transfer to the trust. As the trust assets appreciate over the years, the end result is that the ultimate exemption shelters far more than the current $3.5 million exemption. The appreciation in value of these assets also escapes estate tax. What's more, any gift tax paid is removed from the grantor's estate (as long as the grantor lives at least three years after making the gift).

There are benefits, too, to creating the trust by will. The grantor of the trust retains the lifetime use and benefit of the assets that eventually will pass to grandchildren. Because there may be concerns about fairness, or other issues affecting the distribution of assets among several grandchildren, the present may not be the most opportune time to transfer family assets.

Looking at all the possibilities

Married couples who plan to make bequests to grandchildren must examine their GSTT planning in conjunction with the estate tax marital deduction. Attempting to achieve the correct overall tax result, by making the best use of marital deduction planning techniques and the GSTT exemption, requires a sophisticated knowledge of the tax laws.

A good first step in planning gifts to grandchildren is to consult a professional who can discuss your aims and objectives and assist you in formulating your strategy.

Any developments occurring after January 1, 2009, are not reflected in this article.