THE ESTATE PLANNER

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GST taxes
PLAN CAREFULLY TO AVOID SURPRISES

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GST taxes

Plan carefully to avoid surprises

If you wish to share some of your wealth with your grandchildren or great grandchildren — or if your estate plan is likely to benefit these generations — it's critical to consider and plan for the generation-skipping transfer (GST) tax. Designed to ensure that wealth is taxed at each generational level, the GST tax is among the harshest and most complex in the tax code.

It's also among the most misunderstood. Even though the GST tax enjoys an annual inflation-adjusted lifetime exemption in the same amount as the lifetime gift and estate tax exemption (currently, $12.06 million), it works a bit differently. For example, while the gift and estate tax exemption automatically protects eligible transfers of wealth, the GST tax exemption must be allocated to a transfer to shelter it from tax.

The tax code contains automatic allocation rules designed to prevent you from inadvertently losing the exemption, but it's dangerous to rely on these rules. In some cases, the exemption isn't automatically allocated to transfers that may trigger costly GST taxes. And in others, the exemption is automatically allocated to transfers that are unlikely to need its protection, wasting those exemption amounts.

How the GST tax works

To ensure that wealth is taxed at each generational level, the GST tax applies at a flat, 40% rate — in addition to otherwise applicable gift and estate taxes — to transfers that skip a generation. The tax applies to transfers to "skip persons," including your grandchildren, other relatives who are more than one generation below you and unrelated people who are more than 37½ years younger than you.

There's an exception, however, for a grandchild whose parent (your child) predeceases you. In that case, the grandchild moves up a generation and is no longer considered a skip person.

Handle the annual GST tax exclusion with care

The annual gift tax exclusion allows you to transfer up to $16,000 to any number of recipients each year free of federal gift taxes, including properly structured gifts in trust. Annual exclusion gifts are also exempt from generation-skipping transfer (GST) taxes, but special rules apply to gifts in trust.

Transfers to a trust qualify for the annual GST tax exclusion only if 1) the trust is established for a single beneficiary who's a grandchild or other skip person, 2) the trust provides that no portion of its income or principal may be distributed to (or for the benefit of) anyone other than that beneficiary, and 3) if the trust doesn't terminate before the beneficiary dies, any remaining assets will be included in the beneficiary's gross estate.

If transfers to a trust don't qualify for the annual GST tax exclusion (because, for example, they have multiple beneficiaries), consider allocating enough of your GST tax exemption to shelter those transfers from tax.

Three types of transfers may trigger GST taxes:

1. "Direct skips" — transfers directly to a skip person that are subject to federal gift and estate tax,
2. Taxable distributions — distributions from a trust to a skip person, or
3. Taxable terminations — for example, if you establish a trust for your children, a taxable termination occurs when the last child beneficiary dies and the trust assets pass to your grandchildren.

As noted above, the GST tax doesn't apply to transfers to which you allocate your GST tax exemption. In addition, the GST tax annual exclusion — which is similar to the gift tax annual exclusion — allows you to transfer up to $16,000 per year to any number of skip persons without triggering GST tax or using up any of your GST tax exemption. Note, however, that transfers in trust qualify for the exclusion only if certain requirements are met. (See "Handle the annual GST tax exclusion with care" above.)

Beware of automatic allocation tax traps

Ordinarily, to allocate GST tax exemptions, you must affirmatively elect to do so on a timely filed gift tax return. If you neglect to do so, however, you may be saved by the automatic allocation rules.

These rules, which are intended to protect you against inadvertently losing exemptions, automatically allocate the exemptions to direct skips as well as to transfers to "GST trusts." The definition of a GST trust is complicated, but essentially, it's one that meets certain criteria that create a strong possibility that the trust will benefit your grandchildren or other skip persons down the road.

Often, the automatic allocation rules ensure that GST tax exemptions go where they'll do the most good. But in some cases, they may work against you.

For example, let's say Anita has $4 million in unused GST tax exemptions. She plans to make $2 million in outright gifts to her grandchildren and to set up a $4 million trust for their benefit. If she makes the gifts first, $2 million in GST tax exemptions will automatically be allocated to them. When she sets up the trust, she'll have only $2 million in exemptions left, so only 50% of her $4 million contribution will be sheltered from GST tax. If her initial contribution grows to $16 million and then is distributed to her grandchildren, half of that amount, $8 million, will be subject to GST tax.

Anita would have been better off opting out of the automatic allocation rules and allocating her remaining $4 million in exemptions to the trust. She'd owe GST tax on the $2 million in gifts, but the entire $16 million in trust distributions would be exempt from GST tax.

Have a plan

If you wish to make substantial gifts, either outright or in trust, to your grandchildren or other skip persons, be sure to allocate your GST tax exemption carefully. Your estate planning advisor can help you devise a strategy that leverages the exemption and minimizes your GST tax liability. ▮

To file or not to file a gift tax return, that is the question

If you made gifts last year you may be wondering if you need to file a gift tax return. The short answer is that there are many situations in which it's necessary (or desirable) to file Form 709 — "United States Gift (and Generation-Skipping Transfer) Tax Return" — even if you're not liable for any gift taxes. Let's take a closer look at the reasons why.

What gifts are considered nontaxable?

The federal gift tax regime begins with the assumption that all transfers of property by gift (including below-market sales or loans) are taxable, and then sets forth several exceptions. Nontaxable transfers that need not be reported on Form 709 include:

- Gifts of present interests (see below) within the annual exclusion amount ($16,000 per donee in 2022, up from $15,000 in 2021),
- Direct payments of qualifying medical or educational expenses on behalf of an individual,
- Gifts to political organizations and certain tax-exempt organizations,
- Deductible charitable gifts,
- Gifts to one's U.S.-citizen spouse, either outright or to a trust that meets certain requirements, and
- Gifts to one's noncitizen spouse within a special annual exclusion amount ($164,000 in 2022, up from $159,000 in 2021).

The federal gift tax regime begins with the assumption that all transfers of property by gift are taxable, and then sets forth several exceptions.

If all your gifts for the year fall into these categories, no gift tax return is required. But gifts that don't meet these requirements are generally considered

taxable — and must be reported on Form 709 — even if they're shielded from tax by the lifetime exemption ($12.06 million in 2022, up from $11.7 million in 2021).

Are there tax traps to be aware of?

If you make gifts during the year, consider whether you're required to file Form 709. And watch out for these common traps:

Future interests. The $16,000 annual exclusion applies only to present interests, such as outright gifts. Gifts of future interests, such as transfers to a trust for a donee's benefit, aren't covered, so you're required to report them on Form 709 even if they're less than $16,000. Be aware, however, that it's possible for gifts in trust to meet the present interest requirement by giving beneficiaries Crummey withdrawal powers (the right to withdraw a contribution for a limited time after it's made).

Spousal gifts. As previously noted, gifts to a U.S.-citizen spouse need not be reported on Form 709. However, if you make a gift to a trust for your spouse's benefit, the trust must 1) provide that your spouse is entitled to all the trust's income for life, payable at least annually, 2) give your spouse a general power of appointment over its assets and 3) not be subject to any other person's power of appointment. Otherwise, the gift must be reported. And watch out for gifts to a non-citizen spouse: If they exceed the annual exclusion amount ($164,000 for 2022, up from $159,000 for 2021), they must be reported whether they're outright gifts or gifts in trust.

Gift splitting. Spouses may elect to split a gift to a child or other donee, so that each spouse is deemed to have made one-half of the gift, even if one spouse wrote the check. This allows married couples to combine their annual exclusions and give up to $32,000 for 2022 (up from $30,000 for 2021) to each donee. To make the election, the donor spouse must file Form 709, and the other spouse must sign a consent or, in some cases, file a separate gift tax return. Keep in mind that, once you make this election, you and your spouse must split *all* gifts to third parties during the year.

529 plans. If you make gifts to a 529 college savings plan, you have the option of bunching five years' worth of annual exclusions into the first year. So, for example, you can contribute $80,000 to the plan ($160,000 for married couples) and treat the gift as if it were made over the next five years for annual exclusion purposes. To take advantage of this benefit, you must file an election on Form 709.

Any benefits to filing voluntarily?

It may be a good idea to file a gift tax return, even if it's not required. For example, if you make annual exclusion gifts of difficult-to-value assets, such as interests in a closely held business, a gift tax return that meets "adequate disclosure" requirements will trigger the three-year limitations period for audits.

If you're unsure of whether you need to file a gift tax return, contact your estate planning advisor. ∎

Think twice before splitting charitable bequests

When you leave property to charity in your will or revocable trust, it's reasonable to assume that it won't be subject to estate tax. After all, the charitable estate tax deduction excludes the value of donated property from your estate. But if you split a charitable bequest of property among two or more charities, your heirs may be in for an unpleasant tax surprise.

One family learned this lesson the hard way in a recent U.S. Tax Court case — *Estate of Miriam M. Warne*. In that case, a bequest of a 100% interest in an LLC was split between two charities. This created a mismatch between the value included in Warne's estate and the amount allowed as a charitable deduction for estate tax purposes. The result: Warne's estate was increased by about $2.5 million because of the reduced charitable contribution, triggering $1 million in additional estate tax — plus interest and penalties.

> ***Both the Tax Court and the IRS agree that different principles apply when valuing assets for estate tax purposes and charitable deduction purposes.***

A generous donation

When Warne died in 2014, her estate included a 100% interest in Royal Gardens, LLC, which was wholly owned by a revocable family trust. The parties stipulated that the value of the LLC, which held an interest in a mobile home park, was $25.6 million at the time of Warne's death. In an amendment to the family trust, Warne left 75% of her interest in Royal Gardens to a family charitable foundation and the remaining 25% to a church. On its estate tax return, Warne's estate valued the two donations at $19.2 million and $6.4 million, respectively, which combined to equal the full value of the 100% ownership interest.

After an audit, the IRS decreased the estate's charitable deduction for the split donation of Royal Gardens from $25.6 million to approximately $23.1 million to reflect valuation discounts applicable to the fractional interests received by the two charities.

Different principles apply

The Tax Court agreed with the IRS, explaining that different principles apply when valuing assets for estate tax purposes and charitable deduction purposes. When valuing an asset as part of an estate, the court values the entire interest held by the estate, without regard to the asset's later disposition. In contrast, when property is split as part of a charitable donation, the court looks at the value of what each charity receives rather than the value of what the estate contributes.

This means that Warne's estate had to include 100% of Royal Garden's value in the estate but could deduct only the discounted value of the 25%

and 75% fractional interests received by the respective charities. The Tax Court rejected the estate's argument that this result would "subvert the public policy of motivating charitable donations."

Avoiding a mismatch

Many commentators feel that the outcome in *Warne* is unfair. They argue that there shouldn't be a mismatch between the value of property for estate tax purposes and the amount of the corresponding charitable deduction merely because the deceased chose to benefit two charities rather than one. In any event, it seems that this result can be avoided by leaving the entire property interest to a single charity, such as a private foundation, which then shares the property with other charities.

ESTATE PLANNING RED FLAG

You haven't reviewed your life insurance needs recently

Life insurance is a powerful tool for providing for your loved ones in the event of your untimely death. The amount of life insurance that's right for you depends on your personal circumstances, so it's critical to review your life insurance needs regularly in light of changing circumstances.

For example, you should reevaluate your coverage if you're:

- Getting married,
- Getting divorced,
- Having children,
- Approaching retirement, or
- Facing health issues.

The right amount of insurance depends on your family's current and expected future income and expenses, as well as the amount of income your family would lose should you pass away. The events listed above can change the equation, so it's a good idea to revisit your life insurance needs as you reach these milestones. For example, when you get married and have kids, your current and future obligations are likely to increase significantly for childcare, mortgage and car payments, and college tuition.

As you get older, your expenses may go up or down, depending on your circumstances. As your children become financially independent, they'll no longer rely on you for financial support.

On the other hand, health care expenses for you and your spouse may increase. When you retire, you'll no longer have a salary, but you may have new sources of income, such as retirement plans and Social Security. You may or may not have paid off your mortgage, student loans or other debts. And you may or may not have accumulated sufficient wealth to provide for your family.

There are many factors that affect your need for life insurance, and these factors change over time. To make sure you're not over- or underinsured, reassess your insurance needs periodically and especially when your life circumstances change.

The Michael Law Group, PC

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Welcomes new Of Counsel Attorney

John E. Fish

The Michael Law Group is pleased to welcome John E. Fish to the TMLG legal team.

John has been practicing in the estate tax law area for more than 30 years, specializing in estate planning, probate, trusts and estates administration, and trust income taxation.

I have personally known John for years and have great admiration for his expertise. He is both a lawyer and Certified Public Accountant (CPA), whose approach to estate planning mirrors that of TMLG. He joins our collaborative team in providing tailored estate planning advice that leverages our clients' ability to transfer wealth to future generations while minimizing taxes, risk of loss and family acrimony.

John graduated with high honors from the University of Illinois in accounting and earned his law degree with honors from DePaul University. He worked as a tax specialist with a public accounting firm prior to practicing law.

John can be reached at (312) 900-0155. His email address is: jfish@themichaellawgroup.com.

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Creating your legacy is our business. Please feel free to contact us at: (312) 900-0150.