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Last Chance to Foil a Gift Tax

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FAMILY VALUE / By ANNE TERGESEN

It isn't just the estate tax that's scheduled to return on Jan. 1 after a one-year absence. A lesser-known companion levy will return as well: the generation-skipping transfer tax. Not surprisingly, affluent families are rushing to transfer wealth to their progeny before the year-end deadline. But while sidestepping the GST tax may seem like a smart move, investors need to structure and time gifts to minimize the risks of a future tax hit.

First enacted in the 1970s, the GST tax is designed to prevent wealthy families from giving assets to grandchildren instead of children in order to trim their tax bills. Donors can transfer a limited amount free of GST tax to relatives two or more generations their junior, or to nonrelatives at least 37½ years younger. (In 2009, that amount, known as an exemption, was $3.5 million.)

But after that, such gifts become subject to a double layer of taxation—the GST tax and either the estate tax or gift tax, which donors pay after their transfers exceed certain levels. **As a result, Uncle Sam can end up pocketing more than the beneficiaries, says Carol Harrington, a Chicago-based estate-planning partner at McDermott Will & Emery.**

When transferring assets to grandchildren, grandparents can make several moves free of gift tax. You can give any one person as much as $13,000 a year, for example. You can also gift an additional $1 million (all at once or over a longer period), essentially by borrowing from the amount you can ultimately shelter from the estate tax. And you can pay for some or all of a grandchild's tuition and medical bills, provided the payments are made directly.

When the GST tax returns on Jan. 1, the Internal Revenue Service will allow each grandparent to shield a total of about $1.34 million, according to JPMorgan Private Bank. Advisers are urging families with a desire to give more to take action by Dec. 31. "We're having a lot of conversations about the fact that there's no GST tax this year," says Elizabeth Schurig, a partner at Schurig Jetel Beckett Tackett in Austin, Texas.

Ms. Schurig is urging one client to give each of her 12 grandchildren up to $2 million by year end. This, she says, would "reduce the grandparent's estate, and it has no GST tax implications"—and any future appreciation on the assets would occur outside the estate.

The move would require the woman to write a big check to the IRS, of course. The reason: A gift of that magnitude would trigger the gift tax, which is currently 35% but is set to rise to 55% in 2011.

"That's a lot of gift tax that I'm suggesting be paid," Ms. Schurig says. But without the GST tax, "we are paying 35% as opposed to more than 90% to get the assets in the hands of grandchildren" next year.

This strategy comes with risk. One biggie: In order to minimize the risk of running afoul of the GST tax when it returns, a grandparent must give the assets outright. That's because, with no GST tax this year, it isn't clear whether money put into a trust for grandchildren could qualify for a GST tax exemption. Without an exemption, the money could be deemed subject to the GST tax when withdrawn, says Paul Dinzeo, principal at Accredited Investors, a wealth-management firm in Edina, Minn.

"There's so much ambiguity relating to how the IRS would deal with assets put in trust for GST tax purposes this year that I see a lot of attorneys shying away from using them," Mr. Dinzeo says.

Some families are getting around this problem by putting assets into family limited partnerships or limited liability companies and transferring interests in those entities to grandchildren, advisers say. Once in an FLP or LLC, the assets fall under the control of a manager, who decides the size and timing of distributions, says Scott Winget, a senior director of planning at Wells Fargo Family Wealth. For minors, Mr. Winget says, it may be necessary to appoint a guardian.

Families who already have trusts for grandchildren may be able to capitalize on the GST tax's lapse in yet another way: When funding these trusts, some grandparents contribute only the amount they are permitted to shelter from the GST tax. Others contribute more—leaving their grandchildren to pay the GST tax when they withdraw the funds.

But this year, with no GST tax, these withdrawals can escape taxation, says Ms. Schurig. Of course, there isn't any guarantee that Congress won't enact legislation to retroactively apply the GST tax to transfers made in 2010.

Advisers say some clients are waiting until Dec. 31 to make gifts to grandchildren in case Congress acts before then—and to guard against the risk of paying a gift tax and then dying in 2010, when the money can be passed down estate tax-free.

Those who want extra insurance can make a gift to a trust for the benefit of a spouse before Jan. 1, says Kenneth Brier, an attorney at Brier & Geurden in Needham, Mass. As long as the trust allows the spouse to "disclaim"—or renounce—the gift in favor of grandchildren, the spouse would have nine months in which to wait for Congress to make a move.