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**Transfer Taxation Part 3:**

**GST and Income Taxes**

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## Introduction

This course is part of a three-part series on Taxation for Estate Planning. The first two courses examined gift and estate taxes. This course completes the study of transfer taxes by examining Generation Skipping Transfer Taxes. In addition, it addresses certain aspects of income taxation that are relevant to estate planning. The material in this course, along with the other two in the series, should be considered as prerequisite to any study of estate planning techniques.

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| Objectives:  At the conclusion of this course, you will be able to:   * Explain the basics of the GST tax * Identify skip persons. * Identify triggering events that can potentially trigger a generation skipping transfer tax. * Explain the impact of the "kiddie tax" on transfers to minors. * Better understand estate planning techniques, having established a solid understanding of the primary tax issues related to estate planning by your completion of all three parts of "Taxation for Estate Planning." |

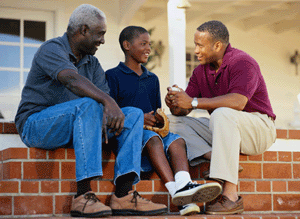
## Generation Skipping Transfer Taxes

The third aspect of the transfer tax system to be examined is the Generation Skipping Transfer Tax (commonly referred to as the GST tax or as the GSTT). This tax helps ensure that every generation gets taxed. It is IN ADDITION TO any gift or estate taxes that may be applicable to a transfer. Therefore, situations that require payment of both a gift/estate transfer tax AND a GST tax are generally to be avoided, as they may result in a combined tax that is close to the value of the transfer.

GST taxation is an area of taxation that is very complex, and usually involves a specialist when it applies. For most professionals, the primary skills needed are:

* The ability to identify skip persons.
* The ability to identify events that trigger the tax.

This course will restrict itself to those two skills. Once an event is identified as potentially triggering the tax, it is advisable that a specialist be involved in the planning.



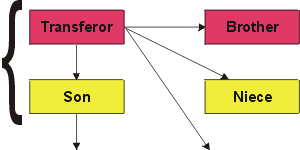
## Identifying Skip Persons

The GST tax applies to transfers of property to individuals who are two or more generations below the person making or triggering the transfer (known as the **"transferor"**). Generally, the transferor is someone who is making a lifetime gift or a deceased person who is transferring or triggering a transfer at their death.

Individuals two or more generations below the transferor are known as **"skip persons,"** because a transfer to them would "skip" a generation to get to them. Everyone else would be a **"non-skip person."**

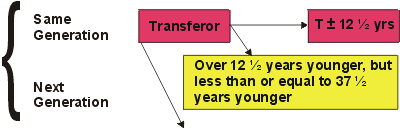
To identify an applicable situation, it is necessary to identify skip persons. Study the chart below carefully. Each arrow represents a possible transfer from the transferor. **Move the mouse pointer over each of the persons below to identify if the person is a non-skip person or a skip person.**

* If related to the transferor, a skip person is someone two or more generations below the transferor. For example:





* If not related, they are in the same generation if within 12 1/2 years of age. Each successive generation is defined in spans of 25 years. For the illustration below, "T" refers to the Transferor's age:

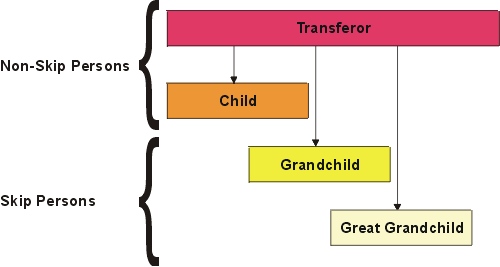


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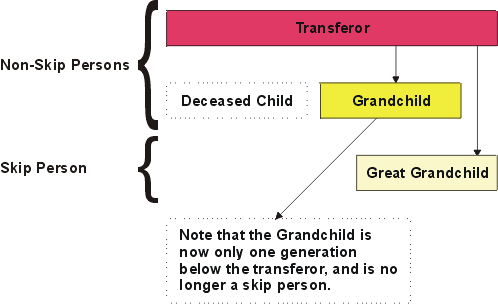
## Predeceased Parents

When making transfers to lineal descendants, what happens if the parent of a skip-person dies before the transfer? Put simply, the successive generations move up one step to fill the void.

Here is the situation before the death:



Here is the situation after the child's death:



**What happens if there are no surviving lineal descendants?**

In that case, this same adjustment to skip persons can be made for any of the descendants of the transferor's parents or the transferor's spouse's parents. ***But this only applies when the transferor has no lineal descendants of his/her own.***

**Example:**

John has no lineal descendants. His brother, who died last year, was survived by one child and two grandchildren. If John were to make transfers to his deceased brother's grandchildren, they would no longer be considered skip persons.

## Identifying Triggering Events

There are three events that can trigger the GST tax. **For an explanation, move the mouse cursor over the events below**

|  |
| --- |
| **Direct Skip**  This is a transfer from the transferor directly to a skip person. It can be a lifetime gift or a transfer from the transferor's estate upon death. |

|  |
| --- |
| **Taxable Termination**  This is not a transfer directly from the transferor. Rather, it is a trust or other arrangement in which the present interest of non-skip beneficiaries terminates and only skip beneficiaries remain.  Example. The trust states that when Mr. Smith dies, the current beneficiary of the trust will be his grandchild (skipping over his child who is still alive). |

|  |
| --- |
| **Taxable Distribution**  When a distribution is made out of a trust to a skip person, this is considered a taxable distribution for GST purposes.  Example. Mrs. Worth creates a trust where the trustee can choose to use funds (income or principal) for Mrs. Worth's daughter or granddaughter. As long as no transfers are made from the trust to the granddaughter, GST is not an issue. But it is deemed a taxable distribution if the trustee ever makes distributions for the granddaughter. |

## The GST Tax Rate and Exemption

The GST tax rate is a ***flat tax*** that is equal to the highest rate on the Unified Transfer Tax Rate Schedule, which is **40%** under current law.

As with gift and estate taxes, not all transfers to skip persons are taxed. The following two rules constitute transfers that can be made without having to pay a GST tax:

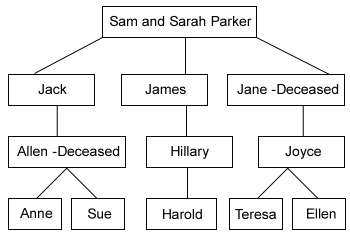
|  |
| --- |
| * All transfers that are excluded from gift taxation are also excluded from GST taxation. This includes annual exclusion gifts, direct payment of tuition, and direct payment of health care. * There is a cumulative exemption amount for GST tax purposes. That cumulative exemption amount is always equal to the Applicable Exclusion Amount for estates. Only cumulative taxable transfers to skip persons that exceed that exemption amount are subject to payment of the GST tax. For 2016, the GST exemption is $5,450,000 (adjusted each year for inflation). |

Note, however, that while a deceased spouse’s estate can pass on the Deceased Spousal Unused Exclusion Amount (DSUE amount) to the surviving spouse, this ***portability is NOT AVAILABLE for the GST tax exemption***.

Given that the GST tax is ***in addition to any gift or estate tax that may be due***, the GST tax essentially results in a doubling of the transfer tax liability. This is generally prohibitive! The end result is that the GST tax is generally to be avoided and all transfers subject to the tax should be limited to those that can be protected from having to pay the tax by use of the GST tax exemption.

## Review Exercise

**The following chart shows the family tree of Sam and Sarah Parker. Their son, Jack, plans to make a number of transfers.**



1. From the list below, select the skip person(s) to Jack:

⭘ James

⭘Anne

⭘ Sue

⭘ Hillary

⭘ Harold

|  |  |
| --- | --- |
| Answer Key | |
| 5 | **Correct. James is in the same generation as Jack, Hillary is only one generation below Jack, and Anne and Sue are no longer skip persons due to the predeceased parent rule.** |
| Others | Incorrect. Try again. [Hint: there is only one skip person listed.] |

1. From the list below, select the skip person(s) to Jack:

⭘ Joyce

⭘Teresa

⭘ Ellen

⭘ Hillary

⭘ Harold

|  |  |
| --- | --- |
| Answer Key | |
| 2,3,5 | **Correct. The predeceased parent rule does not apply to collateral heirs so long as Jack has lineal descendants, therefore Teresa and Ellen are skip persons to Jack, as is Harold.** |
| Others | Incorrect. Try again. [Hint: remember that the predeceased parent rule does not apply unless there are no lineal descendants; therefore there are three skip persons listed. |

1. From the list below, select the skip person(s) to Jack:

⭘ Anne

⭘Sue

⭘ Harold

⭘ Teresa

⭘ Ellen

|  |  |
| --- | --- |
| Answer Key | |
| 3,4,5 | **Correct. Anne and Sue are not skip persons to Jack due to the predeceased parent rule; the rest are skip persons to Jack.** |
| Others | Incorrect. Try Again. [Hint: remember that the deceased parent rule only applies to collateral heirs if there are no lineal descendants. In this case, there ARE lineal descendants.] |

1. In addition, Jack plans to make distributions to the following non-related persons. If Jack is 50 years old, select all the persons who are skip persons to Jack.

⭘ Steve (age 55)

⭘Irene (age 30)

⭘ William (age 15)

⭘ Wendy (age 10)

|  |  |
| --- | --- |
| Answer Key | |
| 4 | **Correct. Nonrelated persons are skip-persons ONLY if their age is at least 27½ years below the age of the transferor.** |
| Others | Incorrect. [Remember that non-related skip persons are those persons at least 37½ years younger than the donor.] |

1. **For 2016 transfers, the GST tax rate and the maximum gift and estate tax rate is:**

* 55%

**Incorrect**. Try again.

* 50%

**Incorrect.** Try again.

* **40%**

**Correct.**

* **35%**

**Incorrect**. Try again.

* 30%

**Incorrect.** Try again.

## Summary Review of Transfer Taxes

This concludes the three-part overview of transfer taxation relevant to estate planning. As a review, the chart below puts together the preceding changes regarding transfer taxation into a single chart. Here are the most important points to remember:

* The Applicable Exclusion Amount, GST Tax Exemption Amount, and Gift Tax Exclusion Amount are all $5,450,000 in 2016.
* The maximum rate for gift and estate taxes is 40% in 2016.
* The GST Tax rate, a flat tax at the maximum rate on the Unified Transfer Tax Rate Schedule, is 40% in 2016.

For your reference only, the following table depicts how these numbers have changed since the turn of the century.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Calendar Year** | **Estate Tax Applicable Exclusion Amount** | **GST Lifetime Exemption** | **Gift Tax Exclusion Amount** | **-Max Estate Tax Rate -Max Gift Tax Rate -GST Tax Rate** |
| 2001 | $675,000 | $675,000 | $1,000,000 | 55% |
| 2002 | $1,000,000 | $1,000,000 | $1,000,000 | 50% |
| 2003 | $1,000,000 | $1,000,000 | $1,000,000 | 49% |
| 2004 | $1,500,000 | $1,500,000 | $1,000,000 | 48% |
| 2005 | $1,500,000 | $1,500,000 | $1,000,000 | 47% |
| 2006 | $2,000,000 | $2,000,000 | $1,000,000 | 46% |
| 2007, 2008 | $2,000,000 | $2,000,000 | $1,000,000 | 45% |
| 2009 | $3,500,000 | $3,500,000 | $1,000,000 | 45% |
| 2010 | $5,000,000 | $5,000,000 | $1,000,000 | 35% for gifts & estates (unless elect no estate tax)  0% for GST tax |
| 2011 | $5,000,000 | $5,000,000 | $5,000,000 | 35% |
| 2012 | $5,120,000\* | $5,120,000\* | $5,120,000\* | 35% |
| 2013 | $5,250,000\* | $5,250,000 \* | $5,250,000\* | 40% |
| 2014 | $5,340,000\* | $5,340,000\* | $5,340,000\* | 40% |
| 2015 | $5,430,000\* | $5,430,000\* | $5,430,000\* | 40% |

*\* Adjusted for inflation using 2010 as the base year.*

## Income Taxes Relevant to Estate Planning

Having concluded our study of transfer taxes, we need to give attention to some key features of the income tax system that have bearing on estate planning. Obviously, income taxation can be an exhaustive subject unto itself. For purposes of this course, we will simply note three income tax issues that are of concern to estate planners. The first two are listed below.

**For more information, move the mouse cursor over the issues below:**

|  |
| --- |
| **Charitable Deductions**  With some limitations, gifts to qualified charities are deductible items for income tax purposes. Given that they are also deductible items for gift and estate taxes as well, gifts to charities are among the most tax-efficient transfers possible. |

|  |
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| **Taxation of Minors**  Because estate planning may involve transfer of assets to minors, particularly where there is a desire to transfer income-producing assets to persons with lower income tax brackets, it is important to know that there is a "kiddie tax" for children under the age of 19 (under age 24 if a full-time student). Here is how the tax works for 2016:  For minors under the age of 19 (under age 24 if full-time student):   * A child under the age of 19 (under age 24 if full-time student) can receive $1,050 in investment income (interest, dividends or capital gains) free from tax. * The next $1,1050 is taxed at the child's rate. * Everything beyond this initial $2,100 is taxed at the parents' rate (assuming the parents’ rate is higher than the child's). * This amount is indexed for inflation and should increase in future years.   Obviously, this tax makes it more difficult for a parent to lower their income tax burden on investment income by gifting assets to minor children. Where the primary goal is to shift wealth out of the parent's estate, it also makes it advisable to shift low-income assets so as to maximize the amount that can be shifted over the years. Many mutual fund companies have funds that are specifically designed to minimize taxable gains and income. |

## Step-Up in Basis at Death

The third aspect of income taxes to be examined is the step-up in basis that occurs at death. Under current law, when a person dies, most assets owned in the estate (with some exceptions such as certain interests in foreign entities and income in respect of a decedent) receive a "step-up" in tax basis for federal income tax purposes. The result is that instead of using the decedent's purchase price for computing the tax basis of an asset, its tax basis is re-established to the the date of death market value (or the alternate valuation date 6 months later, if elected by the executor).

|  |
| --- |
| **"Stepped-Up" Basis Example**  An individual purchased a security for $50,000. Years later, when the individual dies, the fair market value of the security is $100,000.  If the asset is liquidated by the executor or distributed to an heir, the basis used for calculating capital gains will be $100,000, not $50,000. |

This has been an important feature of estate planning because it is often possible to avoid paying capital gains taxes simply by holding the asset until death, when the step-up takes place. Since there was no limit on the amount of step-up available for deaths, substantial income taxes can be avoided in this manner.

## Review Exercise

Review the preceding content by answering the following questions.

1. **The earliest age at which the "kiddie tax" no longer applies is:**

* 12 years of age

**Incorrect.** Try again.

* 14 years of age

**Incorrect.** The age used to be 14, but this is no longer the case. Try again.

* 16 years of age

**Incorrect.** Try again.

* **19 years of age**

**Correct.**

1. **In 2016, for children young enough for the "kiddie tax" to apply, what amount of investment income escapes any income tax?**

* The first $550

**Incorrect.** Try again.

* The first $750

**Incorrect.** Try again.

* **The first $1,050**

**Correct.**

* The first $1,550

**Incorrect.** Try again.

* The first $2,100

**Incorrect.** Try again.

1. **In 2016, the "kiddie tax" comes into play after the minor's investment income reaches:**

* The first $500

**Incorrect.** Try again.

* The first $700

**Incorrect**. Try again.

* The first $900

**Incorrect.** Try again.

* The first $1,100

**Incorrect.** Try again.

* **The first $2,100**

**Correct.**

1. **Jimmy is 14 years old and has a part time job mowing lawns. In 2016, he earns $2,500 and had no other income from other sources. How much of his earnings will be subject to the kiddie tax?**

* **None**

**Correct**. The kiddie tax only applies to *unearned* income and Jimmy only had *earned* income.

* $400

**Incorrect**. Try again.

* $1,000

**Incorrect**. Try again.

* $1,500

**Incorrect.** Try again.

* $2,000

**Incorrect.** Try again.

## Summary

The following is a quick review of the key concepts contained in each section of this course:

|  |  |
| --- | --- |
| **Section:** | **Key Points** |
| **Generation Skipping Taxes** | **How to identify skip persons**  **When can a skip person become a non-skip person**  **Events that trigger the GST tax**  **Characteristics and amount of the GST exemption** |
| **Income Taxes Relevant to Estate Planning** | **Charitable deductions**  **Taxation of minors**  **Step-up in basis at death** |

## Conclusion

This concludes the material for this subject. At this time you may return to any sections in which you feel the need for further study