Estate Planning Studies®

September - October 2026

Planning to Avoid the GST Tax

by Louis A. Mezzullo

Overview of the GST Tax

In General

Subject to a number of transition rules, a 40% GST tax is imposed on generation-skipping transfers made during the transferor's lifetime after September 25, 1985, and on all other generation-skipping transfers made after October 22, 1986. A generation-skipping transfer is a transfer to a skip person, who is defined as a member of a generation more than one generation below the transferor. For example, grandchildren and great-grandchildren of the transferor are skip persons. An unrelated individual is treated as being one generation below the transferor if he or she is more than 12½ years but no more than 37½ years younger than the transferor. Subsequent periods of 25 years are treated as additional generations. Consequently, an unrelated individual who is 50 years younger than the transferor would be a skip person, since he or she would be two generations below the transferor.

The transferor is usually the donor, in the case of a gift, or the decedent, in the case of property passing at death. However, the spouse of a donor is treated as the transferor of half of the gifts subject to a split-gift election, and the first spouse to die is treated as the transferor of assets in a trust for which the reverse QTIP election has been made, although the assets in the trust are included in the surviving spouse's estate for federal estate tax purposes.

A generation-skipping transfer may take one of three forms. A direct skip occurs when a transfer is made directly by gift or bequest to a skip person or to a trust having only skip persons as current beneficiaries. A taxable distribution occurs when a transfer is made from a trust to a skip person. Finally, a taxable termination occurs either when a trust terminates and the assets are distributed to a skip person, or when there are no longer any non-skip beneficiaries of the trust.

If a GST tax has been paid on a transfer to a trust, or a taxable termination has occurred but the assets remain in the trust, the transferor for purposes of future distributions from the trust is moved down to the generation that is immediately above the highest generation in which there is a trust beneficiary. For example, if a trust is created for the benefit of the transferor's children and grandchildren, with the remainder passing to the transferor's great-grandchildren, there will be a taxable termination when the last child dies. Subsequent transfers to the grandchildren will not be taxable distributions, but there will be another taxable termination when the last grandchild dies.

GST annual exclusion

There are three important exceptions to the GST tax: the GST annual exclusion, the GST exemption, and the predeceased parent rule. A transfer made directly to a skip person (or to a medical care provider or educational organization for the benefit of a skip person) qualifies for the GST annual exclusion if it also qualifies for the gift tax annual exclusion. In addition, transfers from a trust to a medical care provider or an educational organization for the benefit of a skip person qualify for the GST annual

Montecito Bank & Trust®
Wealth Management

1106-E Coast Village Road
Montecito, CA 93108

exclusion, although such transfers would not be subject to gift tax unless made from a revocable trust or pursuant to an exercise of a general power of appointment. For 2026, the annual exclusion amount is $19,000 per year per donee, except no limit applies to transfers to a medical care provider or an educational organization. The dollar amount is indexed for inflation but will only increase in increments of $1,000. A transfer to a trust qualifies for the GST annual exclusion only if the trust has only one current beneficiary and such beneficiary is a skip person, and, if the beneficiary dies before the trust is terminated, the assets in the trust will be included in the beneficiary's federal gross estate.

GST exemption

Every individual is allowed a GST exemption, which is $15,000,000 for 2026. Since 2003, the GST exemption has been equal to the estate tax applicable exclusion amount. The exemption is allocated automatically to otherwise taxable direct skips and to transfers to certain trusts during lifetime, unless the transferor elects not to have his or her exemption so applied. Otherwise, the transferor or his or her executor may allocate the exemption as he or she wishes to transfers to trusts that have non-skip beneficiaries but from which transfers may be made to skip persons. If an individual's GST exemption has not been exhausted by such allocations, the remaining exemption will be automatically allocated to direct skips occurring at death and then to trusts created by the decedent from which taxable transfers or distributions may later be made.

Exempt and non-exempt trusts

In planning to avoid the GST tax, it is imperative that trusts created during lifetime or at death have an inclusion ratio of zero or one. The GST tax on a taxable distribution or taxable termination from a trust is the product of the inclusion ratio times the maximum estate tax rate, which is 40% in 2026. The inclusion ratio is one minus the applicable fraction. In general, the applicable fraction is the amount of exemption allocated to a transfer over the value of the transferred property. For example, if $500,000 is transferred to a trust that has non-skip beneficiaries, and the transferor allocates $200,000 of the transferor's exemption to the transfer, the applicable fraction would be two-fifths and the inclusion ratio would be three-fifths. Consequently, taxable distributions and terminations from the trust would be taxed at a 24% rate (3/5 times 40%).

A trust with an inclusion ratio of zero is a fully exempt trust for GST tax purposes, *i.e.*, no distribution from the trust will ever be subject to the GST tax. A trust will have an inclusion ratio of zero if all transfers to the trust have qualified for the GST annual exclusion or a portion of the transferor's GST exemption equal to the value of the transferred property has been allocated to the transfer. A trust with an inclusion ratio of one is a non-exempt trust. All taxable distributions and terminations from such a trust are subject to a GST tax of 40%. A trust will have an inclusion ratio of one if none of the transfers were covered by the GST annual exclusion or the transferor's exemption. If some but not all of the transfers to a trust were covered by the GST annual exclusion or the transferor's GST exemption, the trust is partially exempt. Taxable distributions and terminations from a partially exempt trust will be subject to a GST tax of between 0% and 40%.

A partially exempt trust results in an inefficient use of the transferor's GST exemption. Distributions from the trust to non-skip persons effectively wastes the GST exemption previously allocated to the trust, while distributions to skip persons are subject to the GST tax.

Predeceased parent rule

Under the predeceased parent rule, if the parent of the skip person is a descendant of the transferor's parent but is deceased at the time a transfer occurs, the skip person will be elevated to the deceased parent's generation, and will therefore not be treated as a skip person. Consequently, transfers to that person will not be subject to the GST tax. Generally, the predeceased parent rule applies only to descendants of the transferor. For example, if the transferor makes a gift to a grandchild whose parent is deceased at the time of the transfer the gift will not be subject to the GST tax. However, the predeceased parent rule also applies to a transfer to a grandnephew or a grandniece, if at the time of the transfer, the transferor has no living descendants. A child of the transferor cannot disclaim the right to receive property transferred by gift or at death in order to invoke the predeceased parent rule. On the other hand, a child of a transferor may disclaim property in order to use the transferor's GST exemption. For example, if an individual, who has not previously used any of his or her GST exemption, dies in 2026 and leaves his or her entire estate of $20,000,000 to his or her only child, the child could disclaim $15,000,000 in order to pass to his or her children (the decedent's grandchildren) an amount equal to the decedent's GST exemption.

CLIENTS POTENTIALLY SUBJECT TO THE TAX

Small estates

If the value of an individual's estate or the combined estates of a husband and wife will never exceed

$15, 000,000 (or the GST exemption amount as it is adjusted), the GST tax may be disregarded since the GST exemption of the individual or of the surviving spouse can be allocated to all property passing at his or her death. However, if the individual or couple desires to take advantage of the GST exemptions available to them, one or more trusts may be created that would hold assets until the death of members of the generation below the individual's or couple's generation. For example, the couple may have a child who is independently wealthy, and who has children of his or her own. It may be advisable for the share that would otherwise go to such a child to be held in trust for that child's lifetime. The trust terms should permit distributions of income and principal to the child if he or she suffers a financial hardship, with the remaining assets passing free of both estate tax and GST tax to that child's descendants upon his or her death, provided the parents' GST exemptions were allocated to the trust and the child did not have a general power of appointment over the trust assets.

No GST dispositions

If the dispositive plans of the husband and wife do not involve generation-skipping transfers, the GST tax may be disregarded. For example, if property will pass outright to surviving children and to descendants of deceased children, there will be no generation-skipping transfer. Transfers to the children, of course, are not generation-skipping transfers, and the transfers to the descendants of deceased children will be excepted under the predeceased parent rule.

Medium-size estates

If the value of the combined estates of the husband and wife will never exceed twice the GST exemption, plus administration expenses, and estate and death taxes at the death of the survivor, the GST tax may be avoided regardless of the couple's dispositive plan, provided they use a credit shelter trust to shelter the first spouse to die's applicable exclusion amount from estate tax at the death of the survivor. At the death of the first spouse, his or her GST exemption will be allocated to the credit shelter trust, which will then have an inclusion ratio of zero. When the surviving spouse dies, the assets in the credit shelter trust, regardless of their value, will not be subject to the GST tax. The executor of the estate of the surviving spouse may then allocate the surviving spouse's GST exemption to the balance of the assets passing at the death of the survivor that are owned outright by the surviving spouse or are held in a trust that qualified for the marital deduction in the estate of the first spouse and are therefore includible in the surviving spouse's estate.

Larger estates

If the value of the combined estates of the couple exceeds twice the GST exemption, plus administration expenses and estate and gift taxes at the death of the survivor, additional planning will be required to ensure that the full GST exemption available to each spouse or spouse's estate is used. This may require segregating assets at the death of the first spouse to die into exempt and non-exempt trusts. The exempt trust will then be combined with exempt assets at the death of the surviving spouse. These exempt assets can then be used at the death of the surviving spouse to fund outright bequests to skip persons or to trusts from which taxable distributions or terminations are likely to be made. In addition, transfers during lifetime to GST exempt trusts may be advisable if the couple can do without the assets.

AVOIDING OR REDUCING THE GST TAX

Avoiding the GST tax

If it is contemplated that, regardless of the allocation of the GST exemptions of the husband and wife to generation-skipping transfers, additional transfers will be made that are potentially subject to the GST tax, any assets passing to grandchildren or more remote descendants in excess of the available GST exemption should be made includible in the estates of the children, at least to the extent that their estate tax would be less than the GST tax. When the child dies, the assets passing to his or her children would not be generation-skipping transfers.

The reverse QTIP election

The reverse QTIP election should be used to take advantage of the GST exemption available to each spouse. IRC § 2652(a)(3) allows the first spouse to die to be treated as the transferor with respect to the assets in the QTIP trust for which the reverse QTIP election is made. Because the election must be made with respect to all property in a particular QTIP trust, it is advisable to divide the marital deduction assets into at least two trusts, one for which the election is to be made and one for which the election will not be made. This will avoid having a trust with an inclusion ratio greater than zero but less than one. It will also ensure that the surviving spouse is treated as the transferor with respect to the assets qualifying for the marital deduction, to the extent their value exceeds the unused GST exemption of the first spouse to die. Since the first spouse to die will be treated as the transferor of all the assets in the trust for which the reverse QTIP election is made, the predeceased parent rule will not apply at the death of the surviving spouse to assets passing from this

trust to children of a deceased child, unless the child died before the first spouse to die. Furthermore, transfers at the death of the surviving spouse to grandchildren and more remote descendants will be taxable terminations, which are tax inclusive, while direct skips, which would have occurred if the surviving spouse had been treated as the transferor, are tax exclusive. In addition, if the surviving spouse does not have sufficient assets to use all of his or her GST exemption, his or her GST exemption may be allocated only to assets in a marital trust for which the reverse QTIP election has not been made.

Estate taxes attributable to the inclusion of assets remaining in the predeceased spouse's exempt QTIP trust in the surviving spouse's estate under IRC § 2044 should be paid out of that portion of the first spouse to die's non-exempt marital deduction trust to which the surviving spouse's leftover GST exemption has not been allocated, or out of the surviving spouse's estate, to preserve exempt assets for distributions to beneficiaries in younger generations. Reg. § 26.2652-1(a)(5), Examples 7 and 8, provide that the failure of the surviving spouse's estate to recover from the exempt QTIP trust such estate taxes paid by the estate pursuant to the right granted under IRC § 2207A is not an addition to the trust that would cause it to have an inclusion ratio of greater than zero. Nonetheless, to avoid a possible gift to the exempt trust by the residuary beneficiaries of the surviving spouse's estate, the surviving spouse's will should specifically waive any right of recovery under IRC § 2207A for the amount of any estate taxes the surviving spouse's estate pays on assets in the exempt QTIP trust by virtue of their inclusion in the surviving spouse's estate.

Lifetime transfers

If possible, transfers using the GST tax exemption should be made during lifetime so that additional appreciation in the transferred assets will be excluded from the GST tax. A wealthier individual should consider establishing one or more GST exempt trusts during life. Additional transfers to the exempt trusts can be made as the dollar amount of the exemption increases. In any event, the estate plan should take into account the possibility that there may be an additional GST exemption amount available at death, either because additional transfers have not been made as the dollar amount increased, or the transfers during lifetime were overvalued for purposes of allocating the exemption so that the allocation was void to the extent of the excess of the amount of the exemption allocated over the value of the property.

If an individual or a couple wants to pass assets to skip persons that will exceed in value their GST exemptions, it will generally be better to use a combination of transfers in trusts from which distributions are not likely to be made to non-skip persons and direct skips, allocating the GST exemptions to the transfers to trusts and not to the direct skips. A direct skip, because it is tax exclusive, will cause a lower effective GST tax rate than a taxable termination or distribution, which is tax inclusive. Moreover, the exempt trust can be designed to last for more than one generation.

For example, assume an individual wishes to make two gifts to his four grandchildren in 2009. One gift will be equal to $2,000,000 and will be given outright in equal shares to the four grandchildren. The other gift, again in the amount of $2,000,000, will be given to a trust for the benefit of his four grandchildren, but the trust will not terminate until the death of the last of the grandchildren to die, when it will be distributed to the individual's great-grandchildren. If the GST exemption is allocated to the outright gifts, the transfer to the trust will be subject to the GST tax. Although distributions from the trust to the grandchildren will not be subject to an additional GST tax, there will be a taxable termination at the death of the last grandchild when the assets in the trust pass to the great-grandchildren. If the individual's GST exemption is instead allocated to the transfer to the trust, transfers to the grandchildren during their lifetimes would still not be subject to the GST tax, but at the death of the last grandchild, the assets would pass without any additional GST tax to the individual's great-grandchildren. Furthermore, the GST tax on the outright gift will be tax exclusive, *i.e.*, the GST tax only applies to the amount actually received by the grandchildren and not to the GST tax paid by the grandparent.

The 2001 Tax Act permits a transferor to make a retroactive allocation of some or all of his or her GST exemption to a transfer to a trust if a non-skip person, who had a present or future interest in the trust and who was a lineal descendant of a grandparent of the transferor or the transferor's spouse or former spouse, dies before the transferor.

A wealthier couple should also consider establishing separate trusts for each of their grandchildren that are designed to qualify for both the gift tax and GST tax annual exclusions. Although the trust assets must be includible in the grandchild's federal gross estate if the grandchild dies before the assets are distributed outright to him or her, the trust can be designed to take advantage of any unused GST exemption of the grandchild. The trust would then be a GST exempt trust, and it could be held for the benefit of skip persons, including grandchildren and more remote descendants of the deceased grandchild.

Drafting issues

For wealthier couples, the credit shelter trust of the first spouse to die, which will hold assets equal to the predeceased spouse's unused applicable exclusion amount, may need to be divided into an exempt trust and a non-exempt trust. If the decedent made gifts during lifetime that were not subject to gift tax because of the annual exclusion, but to which the decedent's GST exemption was allocated because the transfer did not qualify for the GST annual exclusion, it is possible that the decedent's applicable exclusion amount will be larger than his or her remaining GST exemption amount.

Post-mortem planning

When proper planning has not been done or the financial condition of the decedent has changed, beneficiaries can use disclaimers to pass sufficient assets to the credit shelter trust to use fully the decedent's GST exemption amount. non-skip persons can also use disclaimers to eliminate the possibility of distributions to them from an exempt credit shelter trust. The non-skip persons would disclaim any rights to income or principal from the exempt trust. Disclaimers can also be used to cause a transfer to be a direct skip, which is tax exclusive. For example, if a grandparent leaves property to a trust for the benefit of children during their lifetimes with the remainder passing to grandchildren, and the children disclaim their interests in the trust, the transfer will be a direct skip. Otherwise, distributions from the trust to grandchildren at the death of the last child will be taxable distributions or taxable terminations, which are tax inclusive.

Judicial reformation may also be used to divide a single trust into two separate trusts, one with an inclusion ratio of zero and the other with an inclusion ratio of one. Judicial reformation can also be used to remove beneficial rights from one trust and add them to another trust, so that all the beneficiaries retain essentially the same economic rights to which they were previously entitled, but non-skip persons are entitled to distributions from trusts with inclusion ratios of one, and skip persons are entitled to distributions from trusts with inclusion ratios of zero.

IRREVOCABLE LIFE INSURANCE TRUST

In general

The GST tax complicates designing irrevocable life insurance trusts having skip persons as beneficiaries. In many instances, the proceeds payable to the trust will be held for more than one generation. To the extent that assets pass to grandchildren or more remote descendants of the insured and the assets are not exempt, the assets will be subject to the GST tax at the highest rate applicable for estate tax purposes, 40% in 2026. Note that in most cases, an irrevocable life insurance trust will not be a skip person because there will be non-skip persons (*i.e.*, the spouse or children of the grantor) who are current beneficiaries.

Allocation of GST exemption

Prior to EGTTRA, if it was desirable to exclude the trust assets in an irrevocable life insurance trust from the GST tax, the insured was required to allocate some of his or her GST exemption to each transfer used to pay premiums on the life insurance policies or each deemed transfer when the employer or other third party makes premium payments on the policies. Alternatively, the exemption could be allocated at some other time during the transferor's life or at the transferor's death, although the value of the trust assets (and therefore, the amount of GST exemption required to be allocated) would likely be significantly higher at that time. After EGTTRA, however, transfers to certain trusts will trigger the automatic allocation of the transferor's GST exemption, unless he or she affirmatively elects not to have the allocation made.

Whether the automatic allocation rules apply will depend on whether the trust is a "GST trust" under IRC § 2632(c). Generally speaking, a GST trust is one that could (but not necessarily will) have a generation-skipping transfer, unless under the trust's terms it is likely that some or all of the trust assets will be distributed to non-skip persons. As a result, a trust may be treated as a GST trust in many cases, even if the transferor's intent is not to have his or her GST exemption allocated to transfers to the trust. For example, an irrevocable life insurance trust that provides for distributions to the insured's children at the later of the death of the insured and when the children reach a certain age may be considered a GST trust. Therefore, the transferor will need to make an affirmative decision when the trust is created whether to permit the automatic allocation rules to control or whether to elect not to have the rules apply and to instead decide to allocate the GST exemption to a transfer to the trust on a case-by-case basis.

If it is intended from the beginning that the trust is to be a generation-skipping trust, with little or no possibility that the trust assets will be distributed to the insured's children or other non-skip persons, the decision to allocate the GST exemption is appropriate. In other cases, the decision of whether to automatically allocate the GST exemption to transfers to a trust, or to affirmatively allocate the exemption to a particular transfer to the trust is difficult, often involving guesswork on the part of the advisor as to the order of deaths and the sizes of the children's gross estates. For example, if the grantor intends that the trust terminate upon the death of the grantor and the assets be

distributed to the grantor's adult children, the grantor's GST exemption will be wasted if all of such children are alive when the insured dies, because there will be no generation-skipping transfers from the trust.

A generation-skipping transfer, however, may occur in two instances. First, if one or more of the children die before the grantor and under the trust agreement the deceased child's share passes to the child's descendants, some of the trust assets may pass to skip persons (the child's descendants). Second, if the trust agreement provides that a child's interest does not vest until the child reaches a certain age, and the child dies after the grantor but before the assets vest in the child, the assets also may pass to skip persons. Such asset transfers to the child's children or other skip persons occurring upon the death of either the insured or the child would be taxable terminations, subject to the GST tax, except to the extent that the grantor's GST exemption has been allocated to the trust.

If assets in a trust with an inclusion ratio other than zero immediately before the transferor's death will pass to skip persons at the death of the insured, it will be necessary to keep the trust in existence until it can be divided into separate trusts if the insured's remaining GST exemption is to be allocated to the shares passing to the skip persons and not to the entire trust. Note that the termination of the trust at the transferor's death would cause any distributions to skip persons to be treated as taxable terminations. The trust may be drafted to terminate nine months after the transferor's death, allowing the exemption to be allocated to the share passing to skip persons when the trust is divided into separate shares.

Allocating the GST exemption during lifetime

For transfers during the transferor's lifetime, the GST exemption can be allocated at the time the gift tax return is due to be filed in connection with the transfer, or at any time before the due date of the transferor's estate tax return (determined with extensions), which is nine months after the transferor's death. A timely filed allocation is effective as of the date of the transfer to the trust. A late allocation is effective as of the date that it is postmarked to the Internal Revenue Service. A late allocation is deemed to precede any taxable event occurring on the effective date of the allocation. If the allocation is made automatically or by the date the gift tax return is due (including extensions), the value of the transfer will be the same value used for gift tax purposes, *i.e.*, the value at the date of the gift. In the context of a life insurance trust, the value would be the value of the life insurance policy transferred to the trust or the premium paid in connection with the policy.

If the allocation of the exemption is made after the date the gift tax return is due, the value of the transfer will be its fair market value at the effective date of the allocation. Generally, if a late allocation is made to a trust, the transferor may, solely for valuation purposes, elect to value the transfer as of the first day of the month in which the allocation is made. However, this special election is not available for transfer of life insurance policies or transfers to a trust holding a life insurance policy if the insured has died before the allocation is made. In such a case, the value of the transfer for purposes of allocating the GST exemption will be the amount of the life insurance proceeds. In addition, if the insured is seriously ill immediately before the late allocation, the value of the policy for purposes of determining the amount of the GST exemption that must be allocated may approximate the amount of the insurance proceeds payable on the death of the insured. If an allocation to a transfer (or deemed transfer) to an irrevocable life insurance trust to pay the premium on the policy is not made on a timely filed gift tax return, the value of the transfer (*i.e.*, the value of the policy and any unexpired premium at the time of the transfer) will be less than the amount of the premium in many cases.

Estate tax inclusion period issues

If it is desirable to maintain an inclusion ratio of zero, the estate tax inclusion period (ETIP) rules must be satisfied. If the assets in the trust are includible in either the insured's estate or the spouse's estate, the GST exemption may not be allocated until the assets are no longer includible in the insured's or the insured spouse's estate or until the insured dies. Inclusion because of the three-year rule does not cause an ETIP. A power held by the insured's spouse to withdraw 5% of the assets in the trust or $5,000 does not cause an ETIP if the power lapses within 60 days.

CONCLUSION

Careful planning is required whenever the value of the client's assets exceeds the GST exemption amount and the client wishes to pass assets to grandchildren or more remote descendants. In almost every situation, the client will want to avoid the 46% GST tax, especially if it is imposed because of poor planning.

**Louis A. Mezzullo is Of Counsel with the International Law Firm of Withers Bergman LLP. His areas of practice include estate planning, business succession planning, and planning for distributions from qualified benefit plans and IRAs. He has written 14 books and numerous articles on these subjects. He also serves as an expert witness in the areas of his practice, including malpractice cases. He is past president of the American College of Trust and Estate Counsel, past chair of the American College of Tax Counsel, and past chair of the American Bar Association Section of Real Property, Trust and Estate Law. The author acknowledges that some of the material concerning Incentive Trusts was inspired by an outline by Howard M. McCue, III, "Guiding (Controlling?) The Children and Grandchildren: Planning and Drafting to Influence Behavior," 34th Annual Philip E. Heckerling Institute on Estate Planning, Miami Beach, Florida, January 10-14, 2000.*

© 2026 M.A. Co. All rights reserved.