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The Generation-Skipping Transfer Tax (GSTT)

The U.S. estate and gift tax system includes a generation-skipping transfer tax (GSTT) to address circumstances in which wealth is transferred to younger generations (such as grandchildren) or unrelated persons more than 37.5 years younger than the decedent. This tax is in addition to the estate tax, and is designed to achieve the same result as if the estate had passed through two generations.

The Combined Estate and Gift Tax Exemption and Tax Rate

The total of lifetime gifts and the estate are eligible for a lifetime exemption, which is set at $13.99 million in 2025. The exemption amount is indexed for inflation, and was scheduled to be reduced by half after 2025. The higher exemption level was made permanent and slightly increased to $15 million in 2026 by P.L. 119-21, the FY2025 reconciliation bill (commonly known as The One Big Beautiful Bill Act). Any lifetime exemption not used by a spouse can be inherited by the remaining spouse. There is an additional annual exemption for gifts to each person of $19,000, also indexed for inflation. Gifts and estates that in combination exceed the exemption are taxed at 40%.

Bequests (made after the donor's death) are effectively treated differently from gifts made during the donor's life because of how the tax is applied. Tax on a taxable bequest is paid by the estate based on the total amount bequeathed, while tax on a taxable gift is paid by the transferor based on the amount given. For example, it requires a taxable estate of $1.68 million to leave an inheritance of $1 million (after paying an estate tax equal to 40% of $1.68 million, which is $0.68 million), but it costs $1.4 million to transfer the same after-tax amount through a gift ($1 million plus 40% tax). This treatment makes gifts a better means of transferring assets once the exclusion is exhausted.

At the same time, accrued capital gains on assets transferred by bequest are not subject to taxes when sold by the heirs, while those transferred by gift are, so that bequests are the best method of transfer for appreciated assets in most cases. (The treatment in estates is called a step-up in basis.)

Trusts are sometimes used to hold or accrue assets that will eventually be passed to an estate's beneficiary. There are several types of trusts. Both simple and complex nongrantor trusts are considered gifts, and the trust or the beneficiaries pay income taxes. A transfer to an irrevocable grantor trust is also considered a gift; the main difference between a nongrantor trust and an irrevocable grantor trust is that in the latter, the grantor rather than the trust pays income taxes and the tax payments are not considered gifts. These trusts are sometimes called intentionally defective grantor trusts (IDGTs) because they treat assets as gifts for estate and gift tax purposes, but are retained by the grantor for income tax purposes. These types of trusts can be used to minimize combined estate, gift, and income taxes. Finally, contributions to a revocable grantor trust are not considered gifts, but remain in the estate; however, distributions to beneficiaries are considered gifts.

The Generation-Skipping Transfer Tax

The GSTT applies when taxable transfers are made to a "skip" generation, such as a grandchild or other relative (e.g., a grandniece or grandnephew, or cousins more than one generation apart) or to an unrelated person more than 37.5 years younger than the transferor. If the parent is deceased prior to the bequest or gift, the grandchild moves up and the transfer is no longer subject to the GSTT. The GSTT is designed to prevent the avoidance of the tax by skipping generations and achieves the same result as if the transfer had been taxed at each generation. It has the same tax rate and the same exclusion as the estate and gift tax. However, an unused spousal exclusion cannot be inherited for purposes of the GSTT.

GSTTs apply to direct skips, including ordinary trusts where all the beneficiaries are skip persons, as well as to indirect skips, where some of the beneficiaries are nonskip persons. For trusts with both nonskip and skip persons, the tax is imposed on distributions to skip persons and on the trust when all nonskip persons are no longer beneficiaries.

The Direct Skip

A direct skip is a transfer to a skip person such as a grandchild. Any taxable income (after the exemption) is taxable at 40% twice, once for the estate and gift tax and once for the GSTT, or a total of 64% of the total taxable estate (40% plus 40% of 60%).

The additional tax makes gifts an even better method (relative to bequests) of transferring to a skip person. Transferring $1 million through a bequest nets $360,000 for the beneficiary and $640,000 in tax payments, while transferring by gift nets a total of $555,556 for the beneficiary and $444,444 in tax payments.

Transfers to Trusts

Another form of a direct skip is to contribute to a trust (nongrantor or revocable grantor) for which all beneficiaries are skip persons to whom the GSTT applies.

When trust beneficiaries include both skip persons and nonskip persons, the GSTT can apply either to distributions to skip persons, or to the entire trust when the last nonskip person dies. (This results in a trust termination tax.)

Use of the Exemption to Maximize Benefits

The large exemptions mean that trusts can be set up where gifts are exempt from both the regular gift tax and the GSTT through IDGTs. These assets can grow tax-free outside of the reach of transfer taxes because the grantor pays the income tax. In addition, because these trusts are "disregarded entities" for purposes of the income tax, transactions between the grantor and trust can be used for tax benefits. One technique to transfer assets into the trust is to sell an appreciated asset to the trust in exchange for a low-interest promissory note. No capital gain will be realized on the transfer, and no income tax will be owed on the interest payments. A grantor may also swap assets of equal value, which can be beneficial for tax purposes if high-basis assets (which would yield lower capital gains if sold by the trust to a third party) are exchanged for low-basis assets, which will not be subject to capital gains taxes when these assets are transferred in the grantor's estate at death. Transfers to these trusts or transfers by bequest may also be enhanced by putting assets into a family partnership, where the value of the asset may be reduced through a minority discount (the reduction in the value of the asset because of lack of control).

Tax-exempt transfers to skip persons can also be made through the annual gift exclusion of $19,000 ($38,000 for a married couple). Because the exclusion amount is from one person to another person, a couple may transfer up to $76,000 to another couple tax-free. For example, if a husband and wife wish to transfer money to their granddaughter and her spouse, the husband may transfer $19,000 tax-free to the granddaughter, the wife may transfer $19,000 tax-free to the granddaughter, the husband may transfer $19,000 tax-free to the granddaughter's spouse, and the wife may transfer $19,000 tax-free to the granddaughter's spouse.

Other Estate-Planning Tools

Grantor trusts can avoid taxes in other ways when the grantor contributes appreciating assets to a trust in exchange for an annuity (a grantor retained annuity trust). If the discounted present value of the annuity is equal to the assets contributed, the value of the gift is zero, so it is never subject to gift or GSTT taxes. The trust can appreciate and make distributions without taxes.

Since the GSTT unused exemption is not portable (i.e., not inherited by the surviving spouse), a reverse qualified terminal interest property (QTIP) trust can be used to provide for a lifetime interest to the surviving spouse, with the trust then going to specified individuals, including skip generations. The original decedent's GSTT exemption can be used by the skip heirs. (This is not the case for the basic QTIP where the surviving spouse's GSTT exemption is available).

Effects of the GSTT

There are no separate data reported on the GSTT, but the tax affects a limited number of taxpayers, given that the estate and gift tax has limited application. Under current exemption levels, the estate tax is paid by 0.07% of decedents; it was paid by 0.21% of decedents when exemptions were half as large. This limited effect is a result of the increase in the exemption that began in 2001, although at that time 2.1% of decedents paid the tax. Households in the top 0.1% of the wealth distribution (those paying the tax) had wealth of $47 million or more in 2022.

Estates are also reduced by the marital exemption and by charitable contributions. (See CRS Report R48183, *The Estate and Gift Tax: An Overview*, by Jane G. Gravelle.)

History of the GSTT

Before the GSTT, there was no tax provision preventing individuals from avoiding estate and gift taxes indefinitely by leaving assets to future descendants. This ability was constrained by a common law rule in most states called the rule against perpetuities, which prevented trusts from continuing more than 21 years after the youngest beneficiary died.

The first GSTT, adopted in 1976, applied only to multigenerational trusts. In 1986 the tax was expanded to cover single-generation gifts and trusts.

Legislative Proposals

While most legislative proposals focus on the estate and gift tax, they also have implications for the GSTT.

Reforms of Trusts and Minority Discounts, Rate Changes

The Build Back Better Act as passed by the House in 2021 would have revised irrevocable grantor trusts to recognize transactions between the grantor and the trust for income tax purposes, to include the trust in the estate and treat distributions as gifts. It would also have disallowed minority discounts for cash and marketable securities. See CRS In Focus IF11954, *Tax Changes for Estates and Trusts in the Build Back Better Act (BBBA)*, by Jane G. Gravelle. Other bills in the previous Congress proposed similar changes, and some proposals would have treated income taxes paid by grantors in irrevocable grantor trusts as gifts. Proposals would also have increased the tax rates for estates and gifts, while others would have repealed the estate and gift tax. These are discussed in CRS Report R48183, *The Estate and Gift Tax: An Overview*, by Jane G. Gravelle.

Making the GSTT Exemption Portable

Two law professors, Richard Schmalbeck and Jay Soled, have proposed making the GSTT portable. They argue that this treatment is consistent in treating married couples with the same wealth the same, regardless of their shares of wealth. If the partner with the larger amount of wealth dies first, estate-planning techniques (such as reverse QTIPs) can be used, but if the less wealthy partner dies first, part of the exemption would be lost.

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