GENERATION - SKIPPING TRUSTS

The federal generation-skipping transfer ("GST") tax is primarily designed to prevent the tax-free transfer of wealth from a grandparent to his grandchild or great-grandchild. Prior to the advent of the GST tax, families could avoid the death tax that is imposed upon each generation by skipping a generation or two on at least a portion of the wealth. In other words, Grandma and Grandpa would leave some assets to the children and some to the grandchildren and, perhaps, some to the great-grandchildren. Death taxes were imposed on the grandparents' estate before it was divided up among the heirs. Later, when the children passed away, the inherited assets remaining in their estates were taxed again before they reached the grandchildren. The assets which the grandparents left directly to the grandchildren, however, were not taxed again at the children's deaths, because they were never owned by the children. Thus, a family could bypass death taxes at least once or twice as the family wealth moved down the bloodline.

The GST tax, originally enacted in 1976 and subsequently superceded by the current law enacted in 1986, represents Congress' effort to stop these generation-skipping tax-free transfers. Instead, the new tax laws impose a tax at each generation regardless of whether the assets have actually been used or enjoyed by each generation. If Grandma and Grandpa leave assets to a grandchild, the government first taxes the assets as a part of the Grandparents' estate and then re-taxes those same assets as a part of the child's estate - as if the child had received the inheritance, then died, and passed it on to the grandchild. The two taxes together could equal almost 71% of the assets so that only a small portion goes to the grandchild. A rather harsh tax, indeed!

Thanks to some effective lobbying by a few noted families, the 1986 GST tax law currently allows each person a $2.0 million exemption from the GST tax. This means that the first $2.0 million of wealth can move from one generation to another without the imposition of a death tax at each generation. For a married couple, the amount is doubled ($4.0 million). While this exemption represents a slight "drop in the bucket" for large estates, it is adequate to completely shelter many estates from inter-generational transfer taxes.

Before we proceed further, it must be pointed out that the GST tax exemptions do **not** result in any tax savings for the estate of the first generation - the grandparents' estate. Under current

law, Grandma and Grandpa can together pass $4.0 million tax-free to their heirs - $2.0 million from each of them. The death tax exemption is scheduled to increase to $3.5 million each in 2009 and to become unlimited in 2010 resulting in no estate tax (for one year only). Any assets in excess of the exempt amount will be taxed; the tax rate is a flat 46%.

For example, in 2006, if Grandma and Grandpa have an estate of $4,400,000, it is taxed at $184,000 leaving $4,216,000 for the heirs. Grandma's and Grandpa's combined GST tax exemptions ($4,000,000 total) are applied to the after-tax estate. Thus, the heirs (whether two or ten of them) will inherit $4,000,000 of GST tax-exempt property and $216,000 of non-exempt property. When an heir dies, his or her share of the GST tax-exempt property will **not** be subject to death taxes; his or her share of the non-exempt property **will** be subject to death taxes (adjusting for whatever estate tax credits are then available).

Many individuals, including professional advisors, think of skipping a generation when they think of generation-skipping. To them, this is a way to bypass one's children in order to save taxes. That limited view of the GST tax laws misses its most important feature - the ability to leave wealth to the first generation (a child) who can in turn pass it on to future generations (grandchildren and/or great grandchildren) without taxation. Here's a brief example of how valuable a GST exemption can be to an heir:

1. Mom and Dad have a $1,900,000 estate. Dad dies and passes the estate to Mom (tax free).
2. Mom dies later; the estate is valued at $2,600,000 at the time of her death. The entire estate passes to Son (tax-free, through the use of a properly drafted trust utilizing Dad's credit and Mom's credit).
3. By the time Son dies, his inheritance from Mom and Dad is now worth $4,300,000 and Son's own assets are worth $400,000, totaling $4,700,000.
4. At Son's death, his assets ($400,000) will pass to his own children tax-free, through the use of his regular estate tax credit. His inheritance from Mom and Dad ($4,300,000) is also tax-free because it remains "sheltered" within the trust created by Mom and Dad. This trust can remain sheltered for an extended period of time (around 100 years). Even when the inheritance is relatively small (say, $100,000 to $200,000), the ability to protect these assets is valuable.

A second but important benefit of the generation-skipping trust is the creditor-protection it affords to the heirs. Consider these points:

- If a child goes through a divorce, his spouse will likely have no claim to any of the inherited property;
- If a child suffers financial difficulty, even goes through a personal bankruptcy, he will likely not lose the inherited property.

An important question here is: Just how much "control" can Son have over his inheritance and still keep the inheritance from becoming part of his own taxable estate? Most parents want their children to enjoy the use of the inherited property; they aren't interested in saving taxes for the grandchildren if it means cutting out Son's control and use of the inherited funds. The balancing of "control" to the heir with the correct trust provisions to secure long-term benefits to the heir is an important element of trust design.

The following is a description of a sample generation skipping trust:

- It allows the heir to be trustee of his own trust (assuming he has reached the age of "financial maturity," whatever that age may be).
- It gives him the right to spend all of the income earned in the trust.
- It gives him the right to spend principal for his health care, maintenance, support and education. Any distribution of principal will require a notation as to its purpose.
- It gives him the right to disburse funds to others in any amount during his lifetime (the "inter vivos power of appointment"); this power can be broadly defined (i.e., it may be exercised in favor of anyone other than the beneficiary and his creditors) or it can be more narrowly defined (i.e., it may be exercised in favor of family members only). The only restriction here is that the beneficiary cannot use funds in his trust to meet his support obligation; if he voluntarily resigns as trustee and appoints an "Independent Trustee" (a person who has no vested interest in the trust), that Independent Trustee can use funds for the beneficiary's children while they are minors.
- He may select his heirs at death (the "testamentary power of appointment"); the same considerations exist here as with the inter vivos power.

These powers and discretions given to the heirs have been selected based upon a careful balance between giving control to the heir (so he or she can enjoy the inheritance to its fullest extent) and maintaining the long-term benefits of the trust. The goal is to vest the management and spending decisions affecting the heir's property at the time (or times) selected by the original estate owner and, at the same time, give the heir the best possible protection of his inheritance for the remainder of his lifetime. The generation-skipping rules permit the heir to transfer the same benefits to his heirs, in most cases.

The use of the GST tax exemption and its rewards to the family are enormous and can justify the degree of complexity, even in rather modest estates.

Think of yourself as the heir; what could be better than to receive an inheritance which you can control and use but which cannot be touched by others and which can pass without taxes to those you love?

Office...480-840-1740 Fax...480-699-1087 email...info@legacyestateplanningaz.com