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Second Generation's Owner's Manual for Generation-Skipping Trusts

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A. Introduction: Your "Generation-Skipping Protective Trust" as a Self-Directed Flexible Planning Platform, Not a Gilded Cage.

Your parents have provided for the possible creation of a "generation-skipping protective trust" (referred to in the documents as a "generation-skipping trust") to hold all or a portion of your future inheritance. This does not mean that your parents may be bypassing your generation and earmarking a portion of their wealth exclusively for your descendants. Rather, your parents have chosen to give you the opportunity to take all or a portion of your inheritance in the trust which will make the trust's property available to you if needed or desired during your lifetime without subjecting it to confiscatory estate or generation-skipping taxes upon your death.

Many children react negatively when they learn that their parents are considering trusts over outright gifts for their heirs' inheritance. The children often ask: "Don't my parents trust me (no pun intended)?" Their prejudice against trusts is often fueled by anecdotal evidence of restrictive arrangements created by mean-spirited parents to rule from the grave by forcing their adult children to go begging to some indifferent (perhaps incompetent) third party "corporate Trustee" who, like a dutch uncle, gives the child the third degree anytime he or she requests a distribution.

In some cases such restrictive trusts have their uses. More often, however, such golden handcuffs can be a source of frustration and bitterness for the second generation, and can undermine their sense of dignity and independence. Your parents have not chosen to go that route. Instead, should you and your "disinterested Trustee" decide it is in your best interests, your parents have designed your trust to give you the best of both worlds: The Federal transfer tax savings and creditor protection the trust structures offers, on the one hand, while on the other hand empowering you to manage, use and enjoy the trust property to a degree almost equal to outright ownership. In short, your parents have given you the opportunity to consult with the disinterested Trustee and choose a trust which will give you all the important benefits of property ownership - use and control, without the primary burdens - vulnerability to creditors, bad marriages and the IRS. The trust provides a flexible platform

upon which you can build your own individually tailored plan to meet your unique personal and family, estate, financial and creditor protection planning goals and objectives.

The purpose of this memorandum is to provide a list of the controls and powers you will have over any separate “generation-skipping protective family trust” your disinterested Trustee decides to create for you after your parent’s deaths. It will also highlight some financial and estate planning opportunities any such trust will offer which you may wish to pursue.

B. Controls, Powers and Opportunities Created by Your Further Family Trust.

Your generation-skipping protective trust provisions incorporates several bells and whistles which you, as the “primary beneficiary”, may choose to ring and blow.

- ***As a Trustee, you can control decisions concerning the investment and management of the trust assets and purchase and retain a broad range of trust investments.*** You are nominated as the “interested” Trustee of any generation-skipping protective trust created in your name. If you choose to accept the nomination and serve as Trustee, you will legally own all trust assets. You are empowered to manage those trust assets, subject to your “fiduciary obligations” to yourself and your descendants as the other trust beneficiaries. You may have heard that the law restricts a Trustee’s investment powers to conservative, conventional investments such as stock in large capitalization companies and Treasury bonds and notes. This is generally true in the absence of language in the Trust Agreement negating or modifying this “prudent person” investment standard. Your parents have overridden these legal restrictions and given you the power to purchase and retain an almost unlimited array of assets which might be appropriate given your peculiar family, tax and financial planning circumstances. For example, the document authorizes you to purchase as trust investments:

- ***Life Insurance Policies.*** You might, for example, use some of the trust’s cash to purchase a policy on your life, or on your and your spouse’s lives. A “second to die” or “survivorship” policy on your and your spouse’s lives will be relatively inexpensive if you are young and have no major health problems. Annual premiums can be internally financed through the trust, avoiding the need for you to make gift taxable transfers of cash to pay the premiums. This can provide substantial estate and gift tax benefits to your children and further descendants, as you can use the trust assets -- and not yours -- to enhance your descendants’ generation-skipping and creditor-safe fund (in the form of the life insurance proceeds) after you’re gone without incurring any Federal transfer taxes yourself. Beware: If you choose to do this, read carefully those provisions of the trust requiring any life insurance policies to be held in a separate “subtrust” of which you cannot be Trustee.

- ***“Use” Assets.*** You may purchase in the trust non-income producing, appreciating “use” assets such as homes, antiques, artwork or jewelry. These assets can be retained by the trust and made available to you and your family for use on a rent-free basis. This may offer two benefits. First, it may be preferable to distributing cash to you to purchase these assets which will become part of your estate and subject to estate taxation upon your death. This can free you to use your own estate taxable assets to purchase “consumables”, thereby reducing your estate tax exposure and preserving the maximum amount of wealth for future generations. Second, the trust’s ownership of these assets keep them in creditor-safe solution, allowing you to live comfortably through such hazards of modern living as lawsuits, bankruptcies, and divorces. Note that as of this writing, Congress has not subjected the rent-free use of property to income taxation, and is not expected in the future to do so.

- ***Promissory Notes Evidencing Loans you Make as Trustee to Yourself, Individually, your Spouse or Other Family Members.*** The generation-skipping protective trust can serve as a “family bank”, a lender of last (or even first) resort for you and your immediately family. If, for example, you or another family member need to borrow the trust’s cash to finance the purchase of a home, educational expenses, etc., you need not resort to banks or other third parties. You, as a Trustee, are authorized to make secured or unsecured loans to yourself and other family members (the Trust Agreement expressly negates the normal rule which prohibits such “self dealing” transactions between the Trustee and him or herself). You are free to structure unconventional terms which would not be acceptable to a commercial lender, such as a “demand loan” with interest only payable until you as the Trustee make demand for payment. Be aware, however, that any interest free loan or loans bearing a below-market rate of interest may result in unexpected income tax consequences to the borrower and the lender, so you should probably be sure that any such loan bears interest at the IRS’s safe harbor rates. This “family bank” aspect can be useful for beneficiaries who are not credit-worthy, in times of tight credit, and as a means of avoiding closing costs and expensive loan transaction fees. It is also another way to have your cake and eat it, too. A home purchase fully financed by a loan from the trust and subject to a first mortgage given to the Trustee will not add to your estate taxable or creditor vulnerable net worth, but will still be available for your unrestricted use and enjoyment. Any interest you pay to the Trust will be deductible on your 1040 as home mortgage interest under the same rules applicable if you pay that interest to a third party lender such as a bank.

- ***Speculative Assets, Including Closely-Held Business Interests.*** You might form a corporation or other business entity, and have your generation-skipping protective trust purchase a stock or other equity interest during the business’ formative stages when it has a modest value. You can also achieve substantial estate tax savings and gift tax-free wealth shifting benefits by having your generation-skipping protective trust purchase a non-controlling interest in a family business entity you control. Examples include a discounted

minority interest (i.e., less than a 50% voting interest) in a closely held corporation, or limited partner interests in a family limited partnership which, for instance, might own and operate rental property. All future appreciation and growth of the business will not augment your taxable estate, but rather will accrue in the estate tax and creditor safe trust environment.

- **Other “Growth Assets”.** If you do not need the trust income, it may be prudent to invest the generation-skipping assets for capital appreciation and not current income. The purchase of low dividend yielding equities, for example, can allow all or a portion of the generation-skipping fund to grow and enhance the estate tax free inheritance your descendants will enjoy.

- **During your lifetime, you can control decisions over distributions to any beneficiary other than yourself or any person to whom you owe a legal obligation of support.** Your generation-skipping protective trust is sometimes referred to as a “sprinkle” trust. This means that you as Trustee have the authority to allocate trust net income and principal among a class of beneficiaries. Those beneficiaries are your spouse and your descendants. You are also given a non-fiduciary “special power of appointment.” This allows you in writing to direct the Trustee (yourself or any disinterested Trustee) to distribute trust property to anyone you may choose, including friends, nieces and nephews, companions and charities. No such distribution you direct has Trustee or appointment power holder will be gift taxable to you or income taxable to the recipient. This flexibility to make gifts to anyone of your choosing (and not only immediate family members) will be important to you if you are unmarried or have no children of your own. However, giving you as Trustee or appointment power holder the unlimited power to make or direct distributions to yourself or to someone to whom you are legally obliged to support will allow the IRS to treat you as the owner of the trust property and subject the trust property to estate tax upon your death. This will negate the generation-skipping opportunities the trust is intended to provide for you and your family.

- **You have indirect control over distributions to yourself through your power to choose, remove and replace a “disinterested Trustee”.** If as Trustee you cannot make distributions to yourself directly, can you do it indirectly? The answer: Yes. A “disinterested Trustee” of your choosing can exercise its discretion to distribute trust property to you. The disinterested Trustee must be a third party who is not a beneficiary of your trust. It might be a friend, an attorney or accountant, or even a corporate Trustee if you desire. If the disinterested Trustee does not make any distributions you may request, you have the power to remove that Trustee and replace it with a successor you may designate, provided that any successor you appoint after removing the Trustee is not “related or subordinate” to you. This means that generally the replacement Trustee cannot be a family member, a spouse, an employee of your business, etc. The indirect access you have through your hand picked disinterested Trustee’s discretion gives you the comfort of knowing that unlimited trust distributions are available to you if you need or desire them.

This effectively gives you the power to choose between the trust and an outright distribution for your inheritance, or something in between.

- ***You have the power to pool your generation-skipping protective trust assets with those of your siblings' generation-skipping protective trusts, if any, to achieve economies of scale.*** The trust authorizes a commingling of all or a portion of the assets of the separate generation-skipping protective trusts for investment purposes. The individual Trustees must still keep separate books and accounts for each separate trust, but common management can achieve efficiencies and negotiating leverage with investment managers and other professionals retained by the trusts such as attorneys, accountants, bookkeepers and consultants. Increasing numbers of "family offices" are realizing these benefits.

- ***You have the power to change the trust's governing law and situs to take advantage of more liberal laws of other jurisdictions.*** For example, you might appoint a disinterested Trustee in a state such as Delaware, Alaska or North Dakota which imposes no state income taxation on trust income, and also allows "perpetual trusts". This is to be contrasted with the laws of the New Hampshire which currently impose a 5% tax on certain taxable interest and dividends, and have a "rule against perpetuities" which limits the duration of trusts to a period of approximately 100 years. [Note: as of January 1, 2004, a New Hampshire trust may be drafted to be perpetual.] Thus, you or your descendants may decide to "move" your trust by appointing a Delaware resident "disinterested Trustee" and which will exercise its power to change the governing law to create a true "dynasty trust" for future generations.

- ***In your will, you can control the deathtime distribution of your generation-skipping protective trust assets through the exercise of a "testamentary power of appointment".*** This enables you in your will to direct that the trust property be distributed among your descendants or trusts for their benefit, or, for that matter, your spouse, charities or any other beneficiaries you may choose. The only limitation on your exercise is that you cannot appoint the property to yourself, your estate, your creditors or the creditors of your estate (having the power to appoint to those beneficiaries would result in estate taxation of the trust property and destroy the generation-skipping benefits). This gives you the unlimited ability to accomplish many common estate planning objectives such as creating "special needs trusts" for disabled beneficiaries which will preserve their public assistance eligibilities; disinheriting certain heirs, or disproportionately allocating the trust property among your heirs (remember a power of appointment is also a power of disappointment); benefiting charities and non-descendant heirs, such as your surviving spouse, friends and companions you may choose; creating more or less restrictive trusts to hold one or more of your beneficiaries' eventual share of trust assets, etc. - generally, whatever actions future circumstances and your desires may dictate. In short, this deathtime power of appointment, when considered together with all other powers and controls the trust gives you, provides a adaptable foundation for

your own family's estate and financial planning. Indeed, if you wish, upon your death you can provide for all of your personal assets to "pour into" your generation-skipping protective trust and integrate your own estate planning with that which your parents have done for you and your descendants.

You should consider these planning opportunities as you accomplish your own planning and consult with your financial and estate planning professional advisors. I suggest that you provide to those professionals with copies of both this memorandum and your parents' trusts, particularly those provisions dealing with the possible creation of a generation-skipping protective trust. Additional copies of this memorandum and trust are available; your parents have authorized me to release them to you and your advisors upon request. I would be happy to discuss any aspect of this plan with you or your advisors. Please call me at your convenience to do so.