



## What Is a “Generation-Skipping Trust”, and Why Should I Use One for a Portion of My Child’s Inheritance?

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Some trusts are known in tax jargon as “*generation-skipping trusts*”. Portions of *ARTICLE I* of your revocable trusts use generation-skipping terminology, including “*skip person*” and “*zero inclusion ratio property*”. The documents define these terms of tax art by references to certain provisions of the Internal Revenue Code. This is not particularly helpful to the lay reader struggling with new and very technical concepts. The purpose of this supplementary memorandum is to aid you and your family in understanding these technical aspects of your estate plan by summarizing some basic generation-skipping concepts.

The “*generation-skipping transfer tax*” (“GSTT”) is designed to close a loophole in the gift and estate tax (the “*wealth transfer tax*”) system. Congress intends these transfer taxes to apply to *all* wealth transfers between generations. For example, if on the second of your deaths your property is passed outright to your children, the property would first be subject to the estate tax in your generation. The children would share only what remained after the payment of the tax. If the children retain ownership of the property they inherit from you until the time of their deaths, and if the appreciated value of their inheritances when combined with the value of their other properties exceeds their estate tax exclusion amounts, upon the passing of your children’s generation your grandchildren would take the property net of any estate tax payable upon their parents’ deaths. This story would repeat itself every twenty-five years or so as further generations pass until the wealth transfer taxes consume the entire value of the property you accumulated during your lifetimes, or require the “distress” sale of any illiquid assets to produce cash to pay the estate taxes.

Wealthy families have sought to beat the intergenerational transfer tax system and preserve their wealth by using “*generation-skipping transfers*”. These are transfers designed to

avoid the imposition of wealth transfer taxes as property passes between two or more generations. The purest example of a generation-skipping transfer is a “*direct skip*” gift from a grandparent to a grandchild. It is called generation-skipping because by bypassing the child’s generation, and going directly to the grandchild, the transfer avoids gift and estate tax in the child’s generation. Families may also use “*generation-skipping trusts*” that give the skipped generation some – indeed, in many cases virtually all – of the use and enjoyment of the trust property and its income without causing its inclusion in the skipped generation’s estate for estate tax purposes.

To illustrate these concepts, if, instead of making a direct skip transfer to the grandchild as in our above example, grandparent had created such a generation-skipping trust for the benefit of the child, the trust property would skip the child’s generation for estate tax purposes while still giving the child most of the benefits of property ownership. Those benefits could include the right to receive distributions of income or principal in a third party “disinterested” Trustee’s discretion, the right to rent free use of property owned by the trust, and the power to direct the disposition of the trust property either during the child’s life or upon death through a “*special power of appointment*”. This power allows the child to control the distribution of all or a portion of the trust property to anyone except for the child him or herself, the child’s creditors, the child’s estate or the creditors of the child’s estate. If the child did not exercise the power of appointment, the grandparent’s trust could provide on the child’s death for further generation-skipping trusts for the child’s children. This pattern could continue through the generations, depriving the IRS of wealth transfer tax revenues, but still preserving the use and enjoyment of the property for the family. The descendants have their cake and can eat it too.

The GSTT system closes these loopholes by taxing all generation-skipping transfers regardless of their form. If it occurred in 2014, the direct skip transaction described above – grandparent directly to grandchild, avoiding the living child’s generation – is potentially subject to a flat generation-skipping tax equal to 40% of the value of the property transferred. Distributions to grandchildren and further descendants from a generation-skipping trust occurring either during the trust’s existence or upon its termination are likewise subject to the same flat tax. However, in 2014, the law allows each generation-skipping transferor a \$5.34

million exemption from the tax. It allows each person to make up to \$5.34 million of direct skip transfers or transfers to generation-skipping trusts without worrying about the GSTT. The allocation of this exemption to transferred property gives that property a “*zero inclusion ratio*” for GSTT purposes. This allocation can be made by the transferor during his or her lifetime -- for example, to certain non-GSTT exempt gifts the transferor may make to grandchildren or to irrevocable generation-skipping trusts created and funded during the transferor’s life. The transferor’s executor can allocate it to deathtime transfers to the extent that any exemption remains unused at the time of the transferor’s death.

Thus, “*zero inclusion ratio property*” as defined in ARTICLE I of your trust agreements means property to which your executor has made the allocation after your death such that the property is exempt from the generation-skipping transfer tax. Importantly, the growth of any zero inclusion ratio property held in a generation-skipping trust – whether that growth occurs as a result of appreciation or accumulation of income – is also zero inclusion ratio property that will not be subject to tax when distributed to a “*skip person*”. A skip person is generally an individual occupying two or more generations below that of the property transferor. To reiterate, this year (2014) each of you has a \$5.34 million GSTT exemption. This allows you this year to transfer a combined amount of up to \$10.68 million to generation-skipping trusts without paying a tax.

Our plan is for your executor to allocate your generation-skipping exemptions against a portion of the value of the property held in your revocable trust at the times of your death. If the first of your deaths were to occur in 2014, the \$5.34 million of the deceased spouse’s trust’s property to which this allocation is made would be held in the “Family Trust” to be created under the deceased spouse’s revocable trust agreement as described in the Summary in this Booklet. That \$5.34 million Family Trust fund (plus any appreciation in value at the time of the survivor’s death) will be combined in your spouse’s exemption amount upon his or her death, which again would be \$5.34 million if the second death occurred in 2014. This combined fund – \$10.68 million in my simple example – will be available to fund “GST Exempt further family trusts” (“FFTs”) that may be created upon or after the second of your deaths under your trusts for the primary benefit of one or more of your children and, ultimately, their descendants. This will be

more tax efficient for the family than simply giving your property outright to your children and possibly saddling them with an immediate estate tax problem. The child's FFT may grow in federal estate and generation-skipping tax exempt – and creditor-safe –solution until the child's death. The trust property will then be available either to be distributed estate tax free outright to the child's heirs, or be held back in a further “generation-skipping protective trust” (“GSPT”) if one or more of his or her heirs' families might benefit from generation-skipping. This decision is deferred until the death of each child. The generation-skipping pattern may continue through the generations of your family headed by your child for as long a period as the child's descendants desire, creating the opportunity to avoid estate taxes for your children's generation, their children's generation, and perhaps further generations of their families.