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

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Certain types of trusts are known in tax jargon as “**generation-skipping trusts**”. Provisions in your proposed irrevocable trust agreement (particularly in ARTICLE I) use generation-skipping terminology, including “**skip person**” and “**zero inclusion ratio property**”. The document defines some of these terms of tax art by references to arcane 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 memorandum is to aid you and your family in understanding these technical aspects of your estate plan by summarizing some basic generation-skipping concepts and explaining some of the purposes and benefits of creating generation-skipping trusts for your children and their families after your and your spouses’ deaths.

The generation-skipping transfer tax is designed to close a loophole in the gift and estate tax (“**transfer tax**”) system. Congress intends these transfer taxes to apply to **all** gift transfers between generations. For example, 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 share of the inheritance, when combined with the value of their other assets, was sufficient to be subject to the estate tax, upon the passing of the children’s generation your grandchildren would take the property net of any estate tax payable at the children’s generation. This story would repeat itself every twenty-five (25) years or so as further generations pass until the taxes consume the entire value of the property you accumulated during your lifetimes, or require the “distress” sale of any illiquid assets such as your real estate 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 estate and gift tax 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**” which give the skipped generation some of the use and enjoyment of the property without causing its inclusion in the skipped generation’s estate for estate tax purposes.

To illustrate how a generation-skipping trust might work, 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 -- a restriction on the child’s ability to direct the disposition of the property in his or her trust which is necessary to allow the property to skip the child’s generation for estate tax purposes. 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 estate 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 generation-skipping transfer tax law closes these loopholes by taxing all generation-skipping transfers (“GSTs”) regardless of their form. 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 (“GST tax”) equal to the maximum estate tax rate in the year in which the transfer occurs (49% in the year 2003) 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 a GST tax.

However, the law allows each generation-skipping transferor an exemption (\$1.2 million in 2003)¹ from the tax. In 2003, this exemption will allow each person to make up to \$1.2 million of direct skip transfers or transfers to generation-skipping trusts without worrying about the GST tax. The allocation of this exemption to transferred property gives that property a “**zero inclusion ratio**” for generation-skipping transfer tax purposes. This allocation can be made by the transferor during his or her lifetime. 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**” means property to which the allocation has been made such that the property is exempt from the GSTT.

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 which will not be subject to tax when distributed to a “**skip person**”. A skip person generally is an individual who is more than one generation below the transferor - grandchildren, great grandchildren, etc. Any zero inclusion ratio property to which this allocation pertains will fund the separate “GST Exempt further family trusts” to be created after both of your deaths under your trust agreement as shown on the flowcharts we have prepared for you.

Your plan builds in the flexibility for your executors to allocate your generation-skipping exemptions dollar for dollar against the appreciated value of the property passing upon your deaths. Any zero inclusion ratio property to which this allocation pertains may fund separate “generation-skipping protective trusts” which the “disinterested Trustee” may create for one or more of your children’s deaths upon or after the second of your deaths under your irrevocable trust, if, after consultation with your children, the disinterested Trustee determines that one or more branches of the family can benefit from generation-skipping to some extent. This may 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. If any of your children survive you, neither of you use any your \$1.12 million generation-skipping exemptions during your lifetimes, a generation-skipping protective trust may be funded for each child with a pro rata share of your wealth (up to a maximum of \$2.24 million). This, of course, assumes that (i) your assets have a significant value at the time of your deaths, and (ii) one or more of your children build significant wealth of his or her own, such that generation-skipping is important to the family. Any remaining inheritance set aside for each child may either be held in a non-generation-skipping protective trust which will remain creditor safe for the child’s lifetime, or be distributed to the child outright depending on decisions made by the “disinterested” Trustee after consultation with each of your children and review of each personal circumstances. Hopefully, any inheritance each child receives outside the generation-skipping trust will sustain him or her and the child will not need to receive distributions from the generation-skipping trust.

It is important to reiterate that none of this is written in stone. The trust document encourages the disinterested Trustee to make the decision whether and to what extent to create a generation-skipping protective trust for each child’s family. The flexibility exists for the disinterested Trustee immediately to distribute a trust property outright to the child or continue a child’s trust for the child’s life. You encourage the Trustee to consult with each child and his or her tax advisors in making this decision. If the disinterested Trustee decides to create a generation-skipping trust, the generation-skipping fund may grow in federal estate and generation-skipping tax exempt 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 if one or more of their heir’s 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 each of your children for a period as long as one hundred or so years following your deaths, creating the opportunity to avoid estate taxes for your children's generation, their children's generation, and perhaps a third generation of their families.