

GENERATION-SKIPPING TRUST

A generation-skipping trust - what is it? First of all, it is a misnomer. The term sounds like it is a trust which skips your children and benefits only your grandchildren or more remote descendants. Although this type of trust would be a generation-skipping trust, the type of generation-skipping trust I want to talk about is primarily for the benefit of your children. The trust has come to be referred to as a generation-skipping trust since it "skips" taxation in your children's estates. This type of trust can be used for your children even if your children have no children. If your children have children, then the generation-skipping tax (discussed at the beginning of this chapter under the title "Transfer Taxes - An Overview") limits the amount of property you can leave in this type of trust.

Trusts created upon death

Leaving property in trust for our grown children may feel like "ruling from the grave" - so we decide that our death is the time to relinquish control to our children.

We give all of our estate outright to our children. We do not give any property to our grandchildren, we leave that decision

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to our children. We do not leave the property in trust. We do not want to restrict our children's use of the property we leave them. With this purpose in mind, you may be inclined to skip this chapter. Please don't.

As you'll see, your child actually has *more* control with the type of generation-skipping trust I discuss here. The type of generation-skipping trust I discuss in this

chapter is a trust in which your children can "have their cake and eat it too." Although this discussion is by no means exhaustive, the points raised here will give you a flavor of the type of trust you can create.

Let's assume that your children are all responsible adults. You are close to your children and would like them to be the primary beneficiaries of your estate upon your death. Your intent is to divide your property equally between your children and give them all of your estate outright. Our objective will be to provide a trust which provides as many benefits of

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outright ownership as possible with as much additional protection as possible, including preventing the property from being taxed in your child's estate for tax purposes.

But estate tax savings are not the only savings. In fact, even when tax savings are completely irrelevant, these trusts still provide significant benefits which many of us would enjoy and many of us would like to provide for our children. What are some of these other benefits? Creditor protection and some estranged spouse protection. Ahh, the benefits begin to look more attractive. By protecting the assets held in the trust from the claims of creditors and, to some extent, from estranged spouses, a generation-skipping trust actually increases the control your child has over the property. Think of control as the ability to determine the investment and the use of your assets unfettered by claims of third parties.

Let's look at some of the changes in society as well as the laws which have increased the attractiveness of this type of

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trust. In the 1980s we experienced an economic boom, particularly in the real estate and oil and gas markets. Leverage was the name of the game, and property could not be acquired fast enough. Then the bottom fell out of the market. The savvy businessmen who could increase their profits exponentially with leveraging - scrambled. Some of them were able to pull themselves out - some went under, some went into bankruptcy, many lost most of their net worth. Perhaps it can happen to me or my family

During this same period, lawsuits proliferated. Personal injury lawsuits, malpractice lawsuits -- sometimes it almost seemed like "gee whiz, I need some money, and you have some" lawsuits. Insurance companies have become more reticent to insure and have increased their premiums for insurance. The security that you could work hard, save, invest wisely and retire in comfort could be wiped out through a single lawsuit. Statistically unlikely, but a scary thought. Perhaps it can happen to me or my family

And social security? As mentioned in this booklet earlier, a statement at a seminar I attended to the effect that "more people believe in UFOs than in social security" pretty much sums it up. Will it be there for us? Will it be there for our children? Perhaps it can happen to me or my family

Another increasingly frequent occurrence is divorce. Marriages used to be for a lifetime. Many of us who felt that way are among the ranks of the divorced. We may love our son-in-law or daughter-in-law, but for most of us this affection comes largely from their relationship with our child. As long as you make my child happy, I love you. If you hurt my child, leave my child - all bets are off. To add insult to injury, the estranged spouse may claim that the money we have given our children has been "commingled" with the couple's other property and now has become community property. An insult to watch, but a travesty if we have already died and our child's retirement security nest egg is taken away. Perhaps it can happen to me or my family

These are the situations from which we want to protect our children. We want our property to help our children, give them the security in their lives, the extras in their lives without interference from others. Have I piqued your interest? as a parent? as a child of a parent from whom you will inherit?

What is a trust? A trust is an agreement between two people to hold property for the benefit of another person. The parent creates a trust, usually created on their death, with the terms set forth in their Will or revocable living trust. The parent

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requests another person, the Trustee, to hold money for the benefit of the beneficiary. The Trustee is the one who has control over the management and investment of the property and distributes the income and principal to the beneficiary according to the terms of the trust. The parent decides on the terms of the trust. Our objective is to give the child as much control over the property and benefit from the property as possible, and still gain the benefits of estate tax avoidance, creditor protection, and estranged spouse protection.

First, we want the child to have control over the management and investment of the property; therefore, we want each child to be the Trustee of his/her own

trust. We want the child also to be the beneficiary of the trust so the trust will provide that the trust income and principal may be distributed to the child. If the child is the Trustee, then the distribution of principal must be limited to distributions for the child's "health, education, support and maintenance according to his/her standard of living." Since the type of distributions are determined by the child's standard of living, I have not found this provision to be too limiting. The child can have the power to designate who will receive the remaining trust assets upon his/her death, with the only limitation generally being that the child cannot designate that the property be distributed to his estate or to the creditors of his estate. This limitation is also important from a creditor protection standpoint. In addition, to provide protection from creditors, the trust must have a spendthrift clause prohibiting the beneficiary from pledging the assets as collateral on a loan or assigning an interest in the trust to creditors.

Protecting the assets from estranged spouses provides some additional planning. Income earned on separate property is community property. If all of the income of the trust is distributed, then the property remaining in the trust is protected as his/her separate property just as it would be if the child owned the property outside the trust, since the court cannot "divest" or take away a spouse's separate property. By holding the property in a trust, the property is kept segregated from the couple's community avoiding the risk of commingling the separate and community property.

However, if the income is not distributed and the child is the Trustee of the trust, then there is a risk that the income will be considered community property and the community property could be mixed with the separate property in the trust, thereby enabling the spouse to make a claim against the assets in the trust. This area of the law is not clear. To avoid this risk, I have added a provision in some trusts that no distributions can be made from the trust while a child is married unless his/her spouse signs a marital or premarital agreement in which the spouse waives all rights to the income and/or principal of the trust.

Assuming these trusts are really as beneficial as they seem, then let's leave all of our property in trust for our children. If we are very wealthy with millions or even tens of millions of dollars in assets, the benefits outlined here are invaluable. Ahh, too good to be true? The IRS thought so. At the IRS's urging, beginning in 1976 Congress has tried to cut back the dramatic tax benefits enjoyed from these trusts. The first law which was passed to avoid the tax benefits, was unworkable and, in 1986, Congress passed a new tax -- the generation-skipping tax.

The generation-skipping tax is a flat tax at the highest estate tax level, currently 49%, dropping to 45% by 2007 and returning to 55% in 2011. The tax is imposed on all transfers to grandchildren and all distributions from a trust to grandchildren or more remote generations. The generation-skipping tax is in addition to the estate and gift tax. For example, on a bequest to your

grandchildren when the maximum gift and estate tax rate is 50% you could owe a gift tax of 50% and a generation-skipping tax of 50%. However, each person has

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an exemption from this tax of \$1 million adjusted further for inflation and in 2004 and thereafter increased in the same amount as the estate tax. This year each of us can give up to \$1.12 million (\$2.24 million for both parents) to our children in a "generation-skipping trust." One of the "games" to play in this arena is to maximize the use of the exemption. For a more detailed discussion of the generation-skipping tax see the chapter titled "Transfer Tax - An Overview."

Use it or lose it. It is far too beneficial not to be seriously considered. If you will inherit property from your parents, ask them to consider leaving the property to you in this type of trust. If you want to leave property to your children, consider leaving it to them in this type of trust.

Trusts Created During a Lifetime

My primary purpose in writing this section of the Guidebook was to illustrate the benefits of leaving property in trust for your children upon your death. However, if a trust is created during your lifetime, the assets can compound for a longer period of time.

Let's look at how you might use a generation-skipping trust as part of your estate plan. Let me begin by giving you some of the "traditional wisdom". Let's assume you are very wealthy and your children cannot possibly spend the inheritance they will receive from you. In this situation, your generation-skipping exemption is best used on a trust from which your children will never receive distributions. In the remainder of this

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discussion, I will assume that you do not fall into this category and will structure the generation-skipping trust with the intent that your children will be the primary beneficiaries.

One advantage to creating a generation-skipping trust during your lifetime is to fully utilize your \$11,000 annual exclusion from gift tax if you are not currently making full use of that amount. Another is to set aside a fund of money which cannot be used to enhance their current lifestyle. You may give your children money when they "need" assistance, but do not make regular gifts to them, or you may give them regular gifts, but not as much as \$11,000 per year. Perhaps one of the reasons you do not make larger gifts is that you do not want your children to

spend the funds you give them. You would like more control over the availability of these funds. In this situation you can make gifts to a trust for their benefit with the intent that these funds be accumulated and reinvested for their future use. If the intent is to have the funds invested over a long period, then creating a trust which will continue for your children's lifetime is consistent with this objective. In the earlier portion of this section, I suggested that you make your child the trustee of his/her own trust. If one of your desires is to restrict access to these funds, you may prefer to serve as trustee or to have a third person serve as trustee.

However, we do have some hurdles to get over if we want the trust to qualify for the annual exclusion from gift tax. Ahh, you are beginning to get used to this type of digression, aren't you. In order for a gift to qualify for the \$11,000 annual exclusion from gift tax, the beneficiary must have a "present interest" in the money or other property given. If the

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property is given to a trust, the beneficiary does not have the right to use the funds. We create this right by giving the beneficiary the right to withdraw the contribution for a period of time. In the section on Gifts to Minors, I discussed the "Crummey Trust". A Crummey Trust is

simply a trust which gives the beneficiary the right to withdraw the amount of the contribution to the trust for a period of thirty days. If you are giving your child \$6,000 per year, you can give the additional \$5,000 (or if you are married an additional \$16,000) to a trust for your child. If you anticipate that your child will

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use all of the funds in this trust during your lifetime and you will leave at least \$1 million to your children upon your death, then the trust should not be a generation-skipping trust. The trust can continue until your child reaches a certain age and then can terminate with the funds distributed to your child at that time. However, let's assume that these funds are not anticipated to be needed by your child. The trust can be structured as a generation-skipping trust to continue for your child's lifetime.

Now let's look at another extension of the use of this type of trust. Let's assume that you are married and that your child has two children. You are making gifts of \$22,000 to your child each year. You do not make regular gifts to your grandchildren. In the past you may have given them some money in a custodial account to be used for their education, but the amount held in this account is now sufficient to pay for the grandchild's education, and you do not want your grandchild to have any more money until

you have the opportunity to see how your grandchild is going to mature. However, you are not concerned about giving your child additional funds which he/she can distribute to your grandchildren if he/she so chooses.

You can create a generation-skipping trust of which your child and his/her children are the beneficiaries. Your child can be the trustee of this trust. By giving your grandchildren the right to withdraw their share of the contribution to the trust, you can make your \$11,000 (\$22,000 including your spouse) annual exclusion gifts to this trust. The funds are then available to your child if your child should need them. Your child could also make distributions to his/her children if he/she feels that is prudent. Your child can have the power to change the distribution of the trust to his/her children upon his/her death.

Fully utilizing your annual exclusion gift amounts is very advantageous. For example, assume you make an additional \$40,000 gift to the trust each year. Over

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a twenty year period, this amount will grow to \$2,882,098 assuming the funds are invested at 12%. Assuming your estate is taxed in the 50% bracket, making these annual exclusion gifts saves \$1,441,049 in estate taxes. These gifts

only used \$400,000 of your generation-skipping exemption and \$400,000 of your spouse's generation-skipping exemption.

One very important caveat - you must either file a gift tax return each year allocating a portion of your \$1 million generation-skipping exemption to this trust or you must file a gift tax return when the trust is created and elect to have the trust be treated as a trust to which generation skipping exemption is automatically allocated each year. If you have not allocated your generation skipping exemption and/or if generation skipping is not automatically allocated to the trust, then when you do allocate your exemption, the amount of the exemption

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allocated to the trust will be the value of the assets held in the trust at the time the gift tax return is filed making the allocation. In our above example, you would not have sufficient exemption remaining to make the trust exempt if you did not file a gift tax return until the end of the twenty year period.

In the section entitled "Defective Grantor Trust" I discuss the use of a trust created during your lifetime which is structured so that you are taxed on the income earned in the trust. I frequently use a generation-skipping trust as the trust which is structured in this manner. By structuring

the generation-skipping trust so that the income is taxed to you individually, you will increase the amount retained in the trust. As discussed in the Defective Grantor Trust section, this trust can also be used to purchase assets from you on a long term note so that most of the appreciation in the asset is transferred to the trust tax free.