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IS GENERATION SKIPPING PLANNING RIGHT FOR YOUR FAMILY?

By Mary J. Peshel, J.D.

What is Generation Skipping Planning?

Generation skipping is an estate planning technique whereby assets are placed in a trust for the beneficiaries rather than passing to the beneficiaries outright. Such a trust is typically created by parents for the benefit of their children. Transfers to a generation skipping trust can take place during lifetime (by gift), or at death (by a direction in the donor's Will or Living Trust). Generation skipping trusts ("GST trusts") are valuable because the children can receive all of the benefit of the assets and can manage the assets as Trustee, but estate taxes will not be imposed on those assets when the child dies. Such trusts are often also referred to as Family Income Trusts, Dynasty Trusts and other names.

What are the Benefits of Generation Skipping?

There are two major reasons for creating a generation skipping trust, along with a third important reason which may be appropriate in certain instances:

- To minimize estate taxes in the children's generation by avoiding estate tax on assets up to the value of the generation skipping trust at the child's death;

- To protect the trust assets from creditors, divorce courts, and/or bankruptcy and assure the financial security of the children and the grandchildren; and

- To provide a professional Trustee to act as Trustee or Co-Trustee, either for a limited period of time or on a permanent basis in circumstances where the child may be very young or may lack any financial background or good history of financial management.

Why is it Called Generation Skipping?

Generation skipping takes its name from the generation skipping transfer tax, which is a tax levied on transfers to persons who are two generations or more below that of the donor (aka "skip persons"). For example, a transfer from a grandparent to a grandchild is a generation skipping transfer. The generation skipping transfer tax ("GST Tax") will also apply if property is placed in trust for the life of the first generation (the children) and then passes to the second generation (the grandchildren) at the children's deaths.

How Does Having a GST Trust Save on Taxes?

When the generation skipping transfer tax ("GST Tax") law was enacted in 1986, the government gave all donors an exemption from the tax of $1,000,000. In 2012 the exemption was increased to $5,000,000 and indexed for inflation, so it increases over time. For 2014, the exemption is $5,340,000 per donor. This means that a donor can transfer up to $5,340,000 during lifetime (or at death) to benefit “skip persons” without triggering a GST Tax (although the separate gift and estate taxes may still apply to the gift).

The GST Exemption can be used to exempt gifts made during lifetime or upon death. One valuable way to use the GST Exemption is to apply it to assets transferred to a trust for the benefit of children for life, followed by the grandchildren. Generally, the donor will place assets valued at up to the current GST Exemption ($5,340,000 in 2014) into a trust for a child, then allocate an equal amount of his or her GST Exemption to that transfer. If the document includes certain provisions, the resulting trust (called an exempt trust) will not be subject to estate or generation skipping transfer tax at the child's subsequent death. This is true even if the value of the trust has grown to $6,000,000, $10,000,000 or more at the child's death. In 2014, a married couple (each having a $5,340,000 exemption), can transfer assets valued at up to $10,680,000 to exempt trusts for their children without triggering a GST Tax.

One very important consideration when making generation skipping gifts is to avoid making gifts that, in the aggregate, exceed the GST Exemption of the donor. If a gift exceeds the Exemption, a tax will be triggered. The donor should therefore ensure the donation documents include provisions that limit the value of the gift in the event the value is ever redetermined by the IRS as the result of an audit.

Another important technique used with GST planning is to maximize discounts on the taxable value of the assets gifted. For example, gifts of interests in a Family Limited Partnership, which may hold assets whose value is larger than the value of the partnership interests themselves, may be used to maximize the overall value of assets that can be transferred to future generations. Other techniques may include making gifts of partial interests in assets, or gifts of property subject to restrictive agreements between co-owners. A thorough understanding of these additional techniques, current valuation law, and the features to include (or exclude) in gifting documents, is essential to ensure the desired results can be obtained.

Keep in mind that gifts to a child’s exempt trust are still subject to gift or estate tax in the estate of the donor. Typically the donor does not want to pay gift tax (for lifetime gifts) or estate tax (for gifts at death), thus the donor must also allocate to the gift an appropriate amount of his or her Basic Exclusion Amount (which is also $5,000,000, and indexed for inflation). In the example above, the donor would need to allocate $5,340,000 of his or her Basic Exclusion Amount to the gift. However, even if the donor was unable (or chose not) to allocate any Basic Exclusion to the gift, the subsequent transfer at the child’s death from the child’s trust to the grandchildren (or in trust for the grandchildren) would be still exempt from the gift, estate and GST taxes. Generation skipping planning thus prevents the trust assets from being reduced by estate taxes at each subsequent generation.

What Happens in the Grandchildren's Generation?

The trust can arrange that, at the child’s death, the assets can either be distributed from the child’s exempt trust to his/her children, or can continue in trust for the grandchildren (or further issue) for as long as the trust is permitted to exist by law, avoiding estate taxes at each successive generation. Currently in California, the maximum life of a trust is 21 years after the death of the last to die of a specified group of individuals (usually the donor's issue) who are living when the trust is created. For example, if you have great-grandchildren living, the trust could last until the date which is 21 years after the last to die of your great-grandchildren. That could be a very long time, and your family could save a tremendous amount of death taxes over three generations.

What are the Non-Tax Benefits of Generation Skipping?

Even where tax saving is not a primary concern, a generation skipping trust can provide many other benefits. If properly drafted and maintained, assets in a generation skipping trust can be protected from:

- Attachment by the children's creditors (this is more significant for children who are doctors, engineers, lawyers, or in other professions that are at “high risk” for lawsuits);
- Division by a spouse in a divorce action;
- Improper use by a child who is a spendthrift, or not money-wise; and
- Assets being transferred to non-family members.

Although the assets are protected from outsiders, the children and grandchildren can receive all the income from the trust assets and the trust principal can be used for their “needs” (defined as health, education, maintenance and support). Generation skipping can thus provide your heirs with lifetime financial security that cannot be taken from them.

Who would be the Trustee of the GST Trust?

If the children are mature and responsible, each can be named as Trustee of his or her own trust. This would give each child control over the assets of his or her trust, and the right to make investment decisions. For children who are younger or do not have investment experience, we often arrange that they become a Co-Trustee at age 25 or 30 and act with the assistance of a corporate Trustee or an experienced individual for a period of time to "learn the ropes" before they take over sole responsibility. For some children, however, having a third party Trustee is the only way to ensure that the funds will remain available to the child over his or her lifetime.

What if the Amounts Passing to the Children Exceed the GST Exemption?

It is critical for the GST Trust to receive only the dollar value equal to the Generation Skipping Exemption allocated to it. Therefore, if the total value of the estate passing to the children exceeds the value of the exemption(s) you have available, we would create two trusts for the children -- an exempt trust to receive the assets to which the GST Exemption is allocated, and a non-exempt trust to receive the balance of the estate. Often the trust will allow the children to withdraw the assets of the non-exempt trust since these assets will be taxed at the children's deaths in any event. However, if asset protection or outside management of assets is important to you, restrictions can be placed on the non-exempt trust to provide many of the non-tax benefits which are available from the exempt trust.

You can also choose to protect a portion of the child’s share in an exempt trust and distribute the balance to him or her outright. It is not necessary to put the child’s entire share into an exempt trust, but any assets not in an exempt trust will not receive the tax and non-tax benefits discussed above.

What are the Typical Terms of a Generation Skipping Trust?

- Each child can be the Trustee of his or her own trust and manage his or her own trust property, if it is deemed appropriate.
- Income can be paid to the child, or "sprinkled" among the child and his or her children so as to give the grandchildren some income for their education and/or other expenses. Income distributed to the grandchildren will usually be taxed at lower rates. The trustee could also be given discretion to accumulate some or all of the income in the trust, which would allow the trust to grow free of estate tax. However, if the child acts as his or her

own Trustee, an independent Co-Trustee would have to be appointed to make the discretionary distributions. Another drawback of discretionary income trusts is that income which is accumulated in a trust is currently taxed at extremely high income tax rates.

- Any of the principal in the trust can be used for the child's “needs” (i.e., health, education, maintenance and support).

- The child can have a right to appoint (i.e. direct the distribution of) trust property, either during the child's lifetime or at the child's death, to anyone else in the world other than the child (technically excluding the child, the child's estate, the child's creditors, and the creditors of the child's estate). Typically, the child might use this power to provide funds for the grandchildren's education and then to direct the manner in which the remaining property is distributed at the child's death. If the child does not exercise this power, the property would generally go to his or her children or, if there are no children, back to the donor's other children.

- Similar provisions can be provided for the grandchildren and future generations if the trust is to continue through future generations.

When is the Best Time to Create a GST Trust?

Today. Since the amount of GST Exemption required to be applied to make a trust exempt is based on the value of the asset transferred, if you create a trust and make gifts to it now (before the assets increase in value), you will be able to shift more assets to the exempt trust in the long run. For example, if you have an apartment building worth $750,000 and make a gift of it today, you could allocate $750,000 of your GST Exemption to the gift and have exemption left to apply against assets passing to the trust at your death. If you wait, and the same building is worth $1,500,000 at your death, then fewer additional assets could be placed in the exempt trust for the children. Also, by making a gift now, you remove the income from such assets from your estate. Of course, gifts should only be made to the extent that your own financial security is not impaired.

If you were to take the next step and place the apartment building in a properly drafted Family Limited Partnership, a discount may well reduce the $750,000 value, leaving the opportunity for additional future exempt gifts. For example, a 20% discount could reduce the taxable value of gift from $750,000 to $600,000, preserving more of your GST Exemption for other gifts.

To take advantage of the generation skipping exclusion, the trust must be created by you either prior to your death, or as part of your Will and/or Trust at the time of your death. The children cannot create GST Trusts for their own benefit, because once property passes to them, the opportunity for using this powerful tax avoidance device is lost.

If you are interested in adding generation skipping planning to your estate plan, we would be happy to discuss this opportunity with you.

STATE TAX NEWS

DeEtte L. Loeffler, J.D., LL.M. Taxation

In November, California’s credit rating was increased after the passage of Proposition 2, the creation of the state’s new “rainy-day” fund. Now, according to the Legislative Analyst’s Office, the state is expected to take in $2 billion more in revenue through June 2015 than was projected when the budget was signed last summer. Analysts indicate that, barring a stock market downturn, the state is expected to have $4.2 billion in the “rainy day” fund by June of 2016 (although 50% of that projected amount could be diverted and spent by the legislature in its 2015 budget). Meanwhile, University of California Board of Regents voted to increase tuition by 5% over the next five years. Governor Brown accused the Board of violating its agreement with the state to continue keeping tuition costs flat in exchange for increased state funding. The Board stated the amount budgeted for universities was inadequate to keep the schools competitive and prevent them from cutting enrollment.

FEDERAL TAX NEWS

DeEtte L. Loeffler, J.D., LL.M. Taxation

Congress is running out of time to enact legislation addressing over 60 provisions in the federal tax code that expired in 2014, and it appears less likely that they will be able to pass a bill before 2015. Expired tax provisions include the deduction for state and local taxes, the above the line deduction for qualified educational expenses, and the 50% bonus depreciation for businesses. Senate Democrats and House Republicans have reached a compromise that would make some of these tax breaks permanent but would also add an estimated $450 billion to the federal deficit. Under this compromise bill, the deduction for the state sales tax would be made permanent, along with the college tuition credit and the research credit for corporations. President Obama has threatened to veto the bill unless the child tax credit and the earned income tax credit are included in the final bill. According to the IRS, it might not be able to issue new tax forms and pamphlets or open the tax return season on time because of this delayed legislation.

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