CHAPTER 20

Generation-Skipping Transfer Tax and the Rule Against Perpetuities

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THE GENERATION-SKIPPING TRANSFER TAX

The generation-skipping transfer (GST) tax is imposed on any transfer you make to a skip-person (i.e., a relative two or more generations below you, such as a grandchild or great-grandchild, or an unrelated person 37½ years younger than you). The reason for the tax is that the federal tax system seeks to tax transfers at each generational level. Otherwise, if you transferred property directly to your grandchild, you would have "skipped" a generation so that there would be no estate tax triggered on the property when your child dies because your child would not have owned the transferred property at the time of his or her death.

Congress enacted the GST tax to capture this lost tax revenue. The GST tax is a second additional tax to the estate and gift tax that applies to any transfers to any skip-person. The GST tax is more punitive than the estate and gift tax in that property is taxed as a flat tax at the highest estate and gift tax rate in effect at the time of a transfer. It taxes every dollar at this highest rate, whereas the estate and gift tax rate schedule taxes property at increasing rates. Because of this, it is almost always better to pay an estate tax rather than a GST tax on all but the largest estates. Table 1 shows the GST tax rates and exemption amounts between 2008 and 2011.

Table 1: GST Tax Rates

YEAR	GST RATE	GST EXEMPTION
2008	45%	$2 million
2009	45%	$3.5 million
2010	Highest Individual Income Tax Rate (Applies Only for Gift Transfers)	Repealed (Except for Gifts)
2011	55%	$1 million (Indexed for Inflation)

THE GST EXEMPTION

Like the estate and gift tax, you have a GST tax exemption you can use to exempt property from the GST tax. The exemption is a dollar-for-dollar reduction. In 2008, the GST tax exemption is $2 million, which means you can transfer up to $2 million of your property to your grandchild and have it avoid the GST tax. The GST exemption is available for lifetime gifts you make to your grandchildren. Any unused GST exemption remaining at your death is available to exempt your estate, wholly or partially, on transfers you make to your grandchildren.

The GST tax exemption increases to $3.5 million in 2009. Unless new legislation is passed, the exemption will decrease to $1 million (indexed for inflation) in 2011 and thereafter.

USING THE GST TAX EXEMPTION WITH DYNASTY TRUSTS

One highly effective way to preserve, grow, and protect wealth for several generations is through use of a dynasty trust. Since wealth that is never taxed grows far greater than wealth that is taxed at each generation, a dynasty trust is a great wealth builder. To illustrate the effectiveness of a dynasty trust, you need to understand the effect of estate taxes when wealth passes to several generations:

> **EXAMPLE:** Assume John Knight inherits $2 million in 2008 directly from his parents. Since the government taxes everything owned at death, at John's death, his $2 million inheritance is subject to estate taxes. Each time wealth passes down a generation, the government will again tax it. So, assuming no investment growth, if everyone in the Knight family is already in the 50% estate tax bracket and everything they inherit is added to their taxable estates and subject to estate taxes, not only will John's inheritance be subject to estate tax, shrinking it to $1 million when it passes to John II, but at John II's death, the amount will again be subject to estate taxes and will shrink further to $500,000 before it passes to John III. At John III's death, the amount will once again shrink further after estate taxes to $250,000. After three generations, 87% of the family's wealth will have been paid to the government, leaving less than 13% for the Knight family.[1]
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> If John Knight had received his inheritance in a dynasty trust, however, and his parents had allocated their unused $2 million GST exemption to it, there would be no estate taxes at each generational level. This outcome occurs because the entire trust is exempt from GST tax. Once exempted, the assets of the trust, including all future growth and appreciation of the trust assets, remain exempt from estate and GST taxes as long as the assets stay in the trust. Thus, John Knight would be able to pass the entire $2 million at his death to John II. If John II were named as the Trustee of the trust, he could control and invest the trust's assets. Assuming he were able to double the trust assets over his lifetime, John II would be able to pass $4 million to John III free of estate and GST

> taxes. If John III were also able to double his $4 million received in trust over his lifetime, he would be able to pass $8 million to John IV. This is because the assets of the dynasty trust avoid paying GST and estate taxes. Moreover, the example does not account for the power of compounding. Assuming a 7% annual growth rate, a dynasty trust funded with $1 million could grow to $867.7 million after 100 years according to an analysis done by Wilmington Trust.[2]

It is because this type of planning is so effective in transferring significant wealth without being taxed that Congress enacted the GST tax. However, with proper planning, you and your spouse can leave up to $4 million to your children and grandchildren free of estate and GST taxes in 2008. In doing so, you will have used your GST tax exemption to its fullest extent instead of wasting it.

Besides the enormous tax savings to your family over time, there are other important reasons to plan with a dynasty trust. Proper long-term planning can protect your family's wealth from lawsuits, divorces, and your beneficiaries' poor money management skills. Furthermore, you can pass your values to your children and grandchildren. Proper long-term planning can provide for future education, influence behavior, promote entrepreneurship, promote family harmony, and encourage philanthropy. For many families, it only seems logical to extend these planning benefits to children, grandchildren, and beyond.

LEVERAGING GST TAX PLANNING WITH YOUR INSURANCE TRUST

One of the most powerful techniques for building wealth for generations is to create an irrevocable life insurance dynasty trust that utilizes your GST tax exemption to its fullest extent. In 2008, you can make annual exclusion tax-free gifts of up to $12,000 per beneficiary ($13,000 in 2009) to the life insurance trust. These tax-free gifts can be made without reducing your gift tax exemption. If your spouse is not a beneficiary of the trust, he or she can also transfer $12,000 annually to it for each beneficiary. So, if you and your spouse have three children and two grandchildren, you can both transfer up to $120,000 ($12,000 x 2 [of you] x 5 [children and grandchildren]) tax-free to the irrevocable life insurance dynasty trust each year. In doing so, you and your spouse can also allocate part of your GST tax exemptions to the gifts, so that the entire $120,000 gift is exempt from GST tax.

Your trustee can use the trust money to purchase a second-to-die life insurance policy on you and your spouse. When the life insurance pays the death benefit to the trust, the entire amount will be exempt from estate and GST tax for generations. If you and your spouse make these gifts to the trust for ten years, you will have both used $1.2 million of your combined $4 million lifetime GST tax exemption (as of 2008). However, when the death benefits are paid to the trust, the entire amount, which could be several million dollars, will be exempt from estate and GST tax. As the trust grows exponentially, you will have leveraged your GST tax exemption and created significant wealth for many generations.

THE RULE AGAINST PERPETUITIES

As discussed above, the use of a dynasty trust can provide many generations with tax-efficient transfers and protection from lawsuits, divorces, irresponsible behavior, and money mismanagement. State law determines how long a dynasty trust can last, however. Many states have limited the duration of dynasty trusts through an old law known as the Rule against Perpetuities. This law is complex and in most states limits a trust's existence to around 90 years.

Many states have modified or abolished the Rule against Perpetuities. In these states, no limits exist on the duration of a trust, or the limits have been greatly extended. Table 2 sets forth those states that have modified or abolished the Rule against Perpetuities.

Table 2: States That Have Abolished or Extended the Rule Against Perpetuities

STATE	LIMIT
North Carolina, South Dakota, Washington	150 yrs
Florida	360 yrs
Alaska, Delaware, Idaho, Maryland, Nevada	365 yrs
Colorado, Maine, Nebraska, New Jersey, Rhode Island, Utah, Virginia, Wisconsin, Wyoming	1,000 yrs
Arizona, District of Columbia, Illinois, Missouri, New Hampshire, Ohio	opt out

The good news is that you do not have to live in a state that has abolished the Rule against Perpetuities to receive all of the trust and tax benefits of a perpetual dynasty trust. The trust only needs to be located in one of these states to receive the benefits. A dynasty trust may contain a provision to allow the trust to change its location to a state that has abolished the Rule against Perpetuities. Below is an example of language that may be used to add flexibility to a dynasty trust and allow it to be moved to a state that has abolished the Rule against Perpetuities:

> ***Changing the Governing Law and Situs of Administration***
> *Our Trustee may, at any time, change the governing law of the trust, remove all or any part of the property or the situs of administration of the trust from one jurisdiction to another, or both. Our Trustee may elect, by filing an instrument with the trust records, that the trust will thereafter be construed, regulated, and governed as to administration by the laws of the new jurisdiction. Our Trustee may take action under this Section for any purpose our Trustee deems appropriate, including the minimization of any taxes in respect of the trust or any beneficiary of such trust, and may do so with or without providing notice to any beneficiary.*

Jimmie Joe's practice specializes in assisting clients with their estate and business planning needs by helping clients understand the opportunities available through planning to attain specified goals and objectives.

1. W. Edward Dean, "Multi-Generational Trusts: Planning, Drafting, and Implementing Multi-Generational Tax-Exempt Trusts," *Wealthcounsel, LLC* (2005) II-2.

2. Rachel Emma Silverman, "Building Your Own Dynasty," *The Wall Street Journal*, September 14, 2004: D2.

Three Types of Generation-Skipping Transfers

TYPE	DESCRIPTION	GST TAX PAID BY
Taxable distribution	Trust makes payment to skip-person	Trust or skip-person
Taxable termination	All interest in trust passes to skip-person	Trust
Direct skip	Assets pass to skip-person: • If related, two or more generations below donor • If unrelated, 37.5 years younger than donor	Donor

Strategies to Reduce Generation-Skipping Taxes

STRATEGY USED	EFFECT
Gift-splitting	Value of gift is split with consenting spouse.
Annual exclusion	In 2008, donor can give $12,000 ($13,000 in 2009) annually to each individual without GST tax consequences. Gift-splitting allows a married couple to give $24,000 ($26,000 in 2009) per donee without GST tax consequences. Trusts must meet special rules.
GSTT exemption	In 2008, allows taxpayer to gift $2 million ($3.5 million in 2009) during lifetime without GST tax consequences.
Qualified transfers	Allows taxpayer to directly pay educational institutions and providers of medical care on behalf of others without GST tax consequences.
Reverse QTIP election	Post-mortem planning in which deceased spouse is treated as transferor of QTIP trust, so GST exemption can be allocated to the trust.