



# GENERATION-SKIPPING TRUSTS

*Avoiding Transfer Taxes for Multiple Generations*

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## 1. Transfer Taxes

- a. Overview: This memo explains how a trust can save transfer taxes for an estate which is potentially subject to the federal gift, estate, and generation-skipping taxes. The concepts discussed here apply to those whose estates exceed the applicable exclusion (\$2,000,000 in 2008)<sup>1</sup> or twice the applicable exclusion for couples who have established A/B or A/B/QTIP trusts that divide into subtrusts to optimize the marital deduction and the unified credit).
- b. Federal Transfer Taxes: Congress has imposed taxes on three types of transfers: lifetime gifts; transfers from decedents' estates; and generation-skipping transfers.
  - i. A *gift* is a lifetime transfer of any asset for less than its fair market value. A transfer from a decedent's *estate* includes all assets which pass from a decedent by reason of death, including transfers under a will, a revocable trust, insurance policies<sup>2</sup> and other death benefits, and property interests which pass by right of survivorship.
  - ii. Certain exemptions and exclusions are available:
    - (1) The federal estate tax and the federal gift tax are imposed at the same rate, but they have different "applicable exclusions". In 2008, the "applicable exclusion" for the federal estate tax is \$2,000,000<sup>3</sup>, and

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<sup>1</sup>Internal Revenue Code § 2010(c) provides for an "applicable exclusion", which is the cumulative amount that can pass free of gift and/or estate tax. This is sometimes called "the exemption equivalent of the Unified Credit". For ESTATE TAX purposes, the applicable exclusion has been, is, and will be: \$625,000 in 1998; \$650,000 in 1999; \$675,000 in 2000; \$1,000,000 in 2002 and 2003; \$1,500,000 in 2004 and 2005; \$2,000,000 in 2006, 2007, and 2008, \$3,500,000 in 2009; unlimited in 2010; and \$1,000,000 in 2011 and beyond. The applicable exclusion for GIFT TAX purposes is the same as that for estate tax purposes until 2004, when the applicable exclusion for GIFT TAX purposes remains frozen at \$1,000,000.

<sup>2</sup>Many people have been told that life insurance is "tax free", and that is partially true. No income tax will have to be paid on the insurance proceeds. Life insurance is **not** tax free for transfer tax purposes.

<sup>3</sup>Internal Revenue Code § 2010(c) provides for an "applicable exclusion", which is the cumulative amount that can pass free of gift and/or estate tax. This is sometimes called "the exemption equivalent of the Unified Credit". For ESTATE TAX purposes, the applicable exclusion has been, is, and will be: \$625,000 in 1998; \$650,000 in 1999; \$675,000 in 2000; \$1,000,000 in 2002 and 2003; \$1,500,000 in 2004 and 2005; \$2,000,000 in 2006, 2007, and 2008, \$3,500,000 in 2009; unlimited in 2010; and \$1,000,000 in 2011 and beyond. Prior to 2004, the applicable exclusion for GIFT TAX purposes was the same as that for estate tax purposes, but now the applicable exclusion for GIFT TAX is \$1,000,000 and no change is scheduled under current law.



the tax rate is 45%.<sup>4</sup>

- (2) Everyone can make gifts of up to \$12,000 per recipient per year without having to use up the unified credit. Certain payments of tuition and health care costs can also qualify as gifts which are exempt from the gift tax.
- (3) Gifts to spouses<sup>5</sup> and charities are also deductible for gift tax purposes.
- (4) For estate tax purposes, the net value of all assets owned by the decedent is taxable. Funeral expenses, debts (including mortgages), estate administration expenses, and certain other expenses are allowed as deductions in calculating the taxable value of the estate.

iii. A *generation-skipping transfer* is a transfer which skips a generation, such as a transfer to a grandchild or great-grandchild (referred to as a "skip person"), and can occur various ways, including as a gift, as a transfer from a decedent's estate, or as a distribution from a trust.

- (1) The generation-skipping transfer tax ("GSTT") is imposed when a transfer skips a generation, such as a lifetime gift or an estate distribution to a grandchild or someone from an even younger generation. The recipient is referred to as a "skip person".
- (2) In 2008, the GSTT is currently a flat 45%, and it applies *in addition to* any gift or estate tax due. Each person has a "GST exemption" of \$2,000,000, and transfers beyond that amount should usually not be made to skip persons because the estate tax is less burdensome than the GSTT.

c. Nevada Law: Nevada has no gift, estate, or generation-skipping tax laws which impose a Nevada transfer tax.<sup>6</sup>

## 2. Bypass Trust Planning

a. Generally: The value of assets you own when you die is included in your estate for

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<sup>4</sup>The maximum rate imposed for federal estate tax purposes was, is, and will be: 50% in 2002; 49% in 2003; 48% in 2004; 47% in 2005; 46% in 2006; 45% in 2007, 2008, and 2009; 0% in 2010; and 55% in 2011 and beyond.

<sup>5</sup>Special rules apply to spouses who are not U.S. citizens.

<sup>6</sup>Nevada's Constitution permits an estate tax only if the tax paid to Nevada is eligible for a dollar-for-dollar credit against the federal estate tax. Since 2005, Congress has only allowed a deduction, not a credit, for state death taxes, which means that Nevada will not collect any of the federal tax, and all of the estate tax will be collected by the federal government.



estate-tax purposes. Sometimes those assets are passed along to other beneficiaries who have estates of their own, and that can push the beneficiaries' estates into higher estate-tax brackets. A "bypass trust" is used to give benefits to one or more beneficiaries without giving them enough "ownership" to include the value of the trust assets in their estates. A bypass trust can also qualify as a "spendthrift trust" which is not subject to the claims of creditors, including judgment creditors, which is useful even when transfer taxes are not a concern.

- b. Maximum Benefits: The Internal Revenue Code permits a beneficiary to receive significant benefits from a trust without causing the trust or its assets to be considered part of the beneficiary's estate. Unless the assets were contributed by the beneficiary, the assets will not be considered part of the beneficiary's taxable estate if even the beneficiary has the right to:
- i. Receive all trust income;
  - ii. Receive payments from trust principal for health, education, support, and maintenance;
  - iii. Withdraw 5% of principal per year;<sup>7</sup>
  - iv. Direct distributions of the principal during life (to recipients other than the beneficiary and the beneficiary's creditors);
  - v. Direct distributions of the principal after death (to recipients other than the beneficiary's estate or creditors); and
  - vi. Act as a trustee.

A trust which gives a beneficiary all of those rights is often referred to as a "maximum benefit trust". A maximum benefit trust gives most of the flexibility that would come from outright ownership without subjecting the assets to the claims of creditors, the claims of disgruntled spouses in a divorce proceeding, or the obligation to pay federal estate taxes.

- c. Additional Restrictions: Not every bypass trust needs to be a maximum benefit trust, and the settlor can restrict or eliminate any or all of the powers. It is common, for example, to eliminate the annual withdrawal right and to limit the power to direct distributions so that the recipients are in a particular group, such as the settlor's descendants.
- d. Bypass Trusts and the GSTT: Before the enactment of the generation skipping transfer tax (GSTT), there was no restriction on the value of assets that could be allocated to a bypass trust. Under current law, only \$2,000,000 can be allocated to a bypass trust without having to pay the GSTT at one time or another.

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<sup>7</sup>A right of withdrawal held at the time of death will trigger an estate tax on the amount over which the right might be exercised. Because of that, it may be advisable not to include this right. Tax law permits withdrawals of \$5,000 or 5%, whichever is greater, and so some planners refer to this as a "5 or 5 power".



- i. For any person who names a grandchild as a beneficiary or as an alternate beneficiary, it is important to allocate as much as possible into a totally exempt trust so that all federal transfer taxes can be avoided.
- ii. Although a bypass trust can always save the federal estate tax, it cannot save the GSTT unless the trust is totally exempt. Unlike the estate tax, the GSTT has no lower tax brackets, so it is usually unwise and unnecessary to incur a generation-skipping tax.
- iii. A trust is made exempt from the GSTT by filing a federal gift tax return (IRS Form 709) each time transfers are made to it and by declaring on the return that the GST exemption equal to the value of the transfers is allocated to the trust. *Even when a 709 is not required because gifts do not exceed the annual exclusion, it is important to file the return to properly allocate the GST exemption.* After death, the GST exemption is claimed on the federal estate tax return (IRS Form 706).

### 3. Irrevocable Trusts for Generation-Skipping

- a. Generally: "Generation-skipping" is giving one generation the benefits of assets while those will not be included in that generation's taxable estate. This is done by establishing "bypass trusts" through irrevocable trust documents. A generation-skipping trust can be built into a revocable trust to govern the distribution of the residue of the trust assets upon the death of the surviving settlor, or it can be done through an irrevocable trust established during one's lifetime.
- b. Exempt and Nonexempt Trusts: If contributions to a trust are not fully covered by an exclusion or exemption, the generation-skipping transfer tax laws require that the exemption be applied to the trust on a pro rata basis. This is done by determining an "inclusion ratio" that determines how much of each distribution is taxable. Unfortunately, this ratio or fraction remains constant, even as the trust appreciates and can result in the taxation of both income and growth, as well as the original trust value. For this reason, tax planners try to keep nonexempt assets out of generation-skipping trusts. Where this is not possible, trust instruments often provide for the creation of exempt and nonexempt subtrusts so that the exempt trust can remain totally exempt at all times.
- c. Irrevocable Trusts: Gifts to irrevocable trusts are subject to federal gift and generation-skipping taxes, but if the gifts to the trust are covered by an exclusion or exemption, the trust can be an effective generation-skipping trust. Ideally, no contribution should be made to an irrevocable trust unless it is covered by a GST exclusion or exemption.
  - i. A minors' trust under IRC §2503(c) *cannot* be a generation-skipping trust because of the requirement that the child be entitled to receive the assets at



- age 21. Irrevocable life insurance trusts and other "Crummey" trusts (which permit annual gifts) are excellent candidates for generation-skipping provisions.
- ii. A person making a gift to an irrevocable trust can elect to use his or her GST exemption, up to a lifetime total of \$2,000,000.
  - iii. Annual gifts of \$12,000 or less per beneficiary are free from gift tax if the beneficiary has a right to withdraw the gift, often referred to as a "Crummey power". With direct gifts, this rule also applies to the generation-skipping tax, but with gifts to irrevocable trusts, the rule is somewhat different.
    - (1) If no beneficiary having a withdrawal right is a grandchild or other "skip person", the gift is also exempt from the application of the generation-skipping tax.
    - (2) If a grandchild or other skip person does have a withdrawal right, the gift is excluded from generation-skipping taxes only if the gift is allocated to a special trust under §2046(c) of the Internal Revenue Code, which requires a separate trust for each skip person and requires that the assets eventually be subject to estate taxes in the skip person's estate.
- d. "Dynasty Trusts": Most people establish generation-skipping trusts so that trust assets benefit their children and then eventually are distributed to their grandchildren. Why limit the benefit to just one generation? The GST exemption of \$2,000,000 can be best utilized in an irrevocable "bypass" trust that continues for several generations.
- i. A "dynasty trust" or "perpetuities trust" is a trust that continues until Nevada's "rule against perpetuities" statutes require the trust to terminate, which is after 365 years.<sup>8</sup>
  - ii. Some practitioners have added language to dynasty trusts suggesting to the trustees that beneficiaries be given the use of assets rather than ownership. A beneficiary could use a home owned by the trust rather than owning it, in order to keep the home from becoming part of his or her own taxable estate. In addition to the tax savings, the assets would be protected from lawsuits and divorce proceedings.
- e. Valuation: The valuation of the assets gifted to irrevocable trusts is critical, since the inclusion ratio must be zero in order to maximize the benefits. Even a small inclusion ratio can become a problem once inflation, appreciation, accumulation or other

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<sup>8</sup>Nevada's Uniform Statutory Rule Against Perpetuities is found in NRS 111.1031 et seq.



growth factors get a foot in the door.

- f. Lifetime Gifts: Although the GST exemption is \$2,000,000, the applicable exclusion for the federal gift tax is only \$1,000,000. Thus, a lifetime gift of \$2,000,000 to a generation-skipping trust will trigger a \$450,000 gift tax. The good news is that the gift tax is due from the taxpayer, not the trust, and so the trust can contain the full \$2,000,000. Another option would be to fund the amount that can pass tax free during lifetime and then fund the balance after death.

#### 4. Conclusion

Irrevocable generation-skipping trusts can save significant taxes by maximizing the utility of the unified credit and the GST exemption. If you are willing to make significant gifts now, the tax savings over several generations can be significant.

*NOTE: This memo provides general information only and does not contain legal, accounting, or tax advice. For brevity, this memo is oversimplified and should not be relied on for any particular situation. Although this memo may discuss tax issues, this is not a "covered opinion" as defined in Circular 230 issued by the U. S. Treasury Department, and nothing in this memo can be relied upon to avoid any tax penalties.*

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