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Generation  
Skipping

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# GENERATION SKIPPING

## What Is Generation Skipping?

Generation skipping is an estate planning technique whereby assets are placed in trust for the benefit of the children, rather than passing to the children outright. 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. The children can receive not only all of the benefit, but can control the assets as well. It is only estate taxes, not benefit to the children, that is skipped. Such trusts are often also referred to as Family Income Trusts, Dynasty Trusts and by 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 only 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 exemption, as shown in Figure 1, measured as of the date the assets are transferred to the trust;

- To protect the trust assets from creditors, divorce courts, or bankruptcy and assure the financial security of the children and the grandchildren;
- In circumstances where the child may be very young or without any financial background or a good history of financial management, 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 addition, as described in the section below entitled *Advanced Uses for Generation Skipping*, you will see that in some circumstances a generation skipping trust established for your benefit can result in significant savings and asset protection in transfer taxes in your generation as well.

## 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 below that of the donor. For example, a transfer from a grandparent to a grandchild is a generation skipping transfer. The generation skipping tax will also apply if property is placed in trust for the first generation (the children) and then passes to a second generation (the grandchildren) at the children's deaths.

## How Does the Trust Save Taxes?

When the new generation skipping tax law was enacted in 1986, the government gave all donors an *exemption* from the tax of \$1,000,000. With the Taxpayer Reform Act of 1997, the \$1,000,000 per donor exemption is adjusted for inflation until 2003, and the 2001 tax act further modifies the exemption amounts as shown in Figure 1. For simplicity, we will refer to the “\$1,000,000 exemption” when we really mean the exemption as adjusted, for the year of transfer.

If a donor places \$1,000,000 of property into a trust for a child, and allocates his or her \$1,000,000 exemption to that transfer, the resulting trust is called an *exempt trust* and will not be subject to estate or generation skipping tax at the child's subsequent death. This is true even if the value of the trust at the child's death has grown to \$2,000,000, \$5,000,000 or more! The key to an exempt trust is that the value of assets going into the trust is matched by an equal amount of exemption. For a husband and wife, each having a \$1,000,000 exemption, this means that up to \$2,000,000 can be placed into exempt trusts for the children (or even \$7,000,000 as of 2009).

By using techniques that provide discounts on values for gift and estate tax purposes, such as Family Limited Partnerships, gifts which have an actual value which is much larger than the exemption limit may be transferred to future generations free of estate tax at the deaths of one or more generations.

Keep in mind that the transfer from the donor to the child's trust is not exempt from gift or estate tax, but the subsequent transfer from the child to the following generation(s) *is* exempt from gift, estate and generation skipping tax. Thus, the estate is not cut in half by estate taxes at each generation.

Figure 1 Generation Skipping Exemption

Year	Generation Skipping Exemption
2001	\$1,060,000
2002	\$1,060,000 plus inflation adjustment (if any)
2003	\$1,060,000 plus inflation adjustment (if any)
2004-05	\$1,500,000
2006-08	\$2,000,000
2009	\$3,500,000
2010	No Limitation
2011 on	\$1,060,000 plus inflation adjustments from 2003

## What Happens in the Grandchildren's Generation?

The assets can be distributed from the children's exempt trust to the grandchildren if that is desired. However, once a generation skipping trust is established, it can continue for as long as the trust is permitted to exist by law -- and can avoid estate taxes at each successive generation! In California, the maximum life of a trust is 21 years after 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, as illustrated below (assuming a 50% tax at each generation).

**Multi-Skip / Next Generation / One Generation = 20 years**  
**GSX USED BY HUSB: \$1,000,000 / WIFE: \$1,000,000**  
**Husband & Wife / Opt Marital / Growth Rate 3.00%**

<b>WITHOUT GENERATION SKIPPING TRUST</b>	<b>WITH GENERATION SKIPPING TRUST</b>	<b>BENEFIT</b>
Children's Estate \$7,631,350	Children's Estate \$10,133,544	\$2,502,194
Grandchildren's Estate \$6,891,533	Grandchildren's Estate \$13,259,555	\$6,368,021
Great Grandchildren's Estate \$6,223,438	Great Grandchildren's Estate \$19,394,344	\$13,170,906

## **What are the Non-Tax Benefits of Generation Skipping?**

Even where tax saving is not a primary concern, the 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 "high risk" professions);
- Division by a spouse in a divorce action;
- Improper use by a child who is a spendthrift, or not money-wise;
- 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 property, and have any of the principal used for needs in the event it becomes necessary. Thus, the heirs have a nest-egg to provide lifetime financial security that cannot be taken from them.

## **Who Would be the Trustee of the Generation Skipping Trust?**

If the children are mature and responsible, each can be named as Trustee of his or her own trust. This gives 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 be available to the child over his or her lifetime.

## **What are the Advanced Uses of Generation Skipping?**

Generation skipping is not just for your children. The same benefits discussed above can be arranged for *your* benefit for any prospective gifts or inheritances that may be coming to you. We could create a trust for you and simply have your parents or other donors make a small change in their Wills or Trusts leaving assets to your generation skipping trust instead of directly to you outright.

The property in that trust will not only escape estate tax at your death (and at the death of your spouse, children and possibly even grandchildren), but you will have an excellent form of "asset protection" from potential creditors.

Another very effective planning technique for persons who are starting a new business enterprise can be implemented with a generation skipping trust. In such a situation you can have someone (the Trustor) create a trust for your benefit and fund it initially with a nominal amount of cash (having the Trustor allocate some of their generation skipping exemption to the gift to make the trust an "exempt" trust for generation skipping tax purposes). That trust then creates the new business enterprise, typically in corporate form, which employs you to run the business. The beauty of this approach is that all the increase in value in the business will not be taxed at your death and can pass entirely tax free to the next generation, as well as not being subject to any of your creditors or divorce courts!

Another common technique is to create a generation skipping trust for the children which can then be used to purchase assets from your estate, typically with an installment note. In that way, we can shift assets with high growth rate or

income potential out of your estate, and replace them with a note which will not increase in value. The note also provides an income stream back to you as the payments are made.

### **What if the Amounts Passing to the Children are in Excess of the Generation Skipping Exemption?**

It is critical to have the generation skipping trust receive only the dollar value equal to the 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 to allocate, we would create two trusts for the children -- an *exempt* trust to receive the assets to which the exemption is allocated, and a *non-exempt* trust to receive the balance of the estate. In many cases, we would allow the children to withdraw the assets of the non-exempt trust since those assets will be taxed at the children's deaths in any event. However, if asset protection or outside management of assets is of importance to you, we can place restrictions on the non-exempt trust to provide many of the non-tax benefits which are available with the exempt trusts.

## **Can I Make Annual Exclusion Gifts to a Generation Skipping Trust?**

It is possible to make gifts to a generation skipping trust which are eligible for the \$10,000 annual exclusion from gift tax, but for technical reasons, the maximum amount which can be given in this fashion each year is \$5,000 per donee (or 5% of the assets in that donee's trust, if greater). This is achieved by giving the beneficiary a temporary right, for 30 days after the gift is made, to withdraw the assets placed in the trust. The beneficiary must be notified of the gift and of his or her withdrawal right. If no withdrawal is made the gift becomes an asset of the generation skipping trust.

In addition, even without granting a withdrawal right, an amount equal to the value of the right to the income from the trust is eligible for the annual exclusion, as long as the trust terms provide that all the income is paid to the beneficiary at least once annually. For a 40 year old child, the value of that income right is between 80 and 90% of the value of the gift (based on current interest rate levels).

However, **any** gift to an exempt trust in a generation skipping trust requires the filing of a gift tax return to allocate your

generation skipping exemption(s) to the gift -- even if there is no gift tax due on the transfer.

## **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.
- All income can be paid to the child or, perhaps even better, income can be "sprinkled" among the child and his or her spouse and children so as to give the grandchildren some taxable income for their education or other expenses. Income which is deflected to the grandchildren will usually be taxed at lower rates (up to a maximum of \$1,300 of income for any child under age 14). We could even allow income to be accumulated in the trust, if that were appropriate. Income which is accumulated would allow the trust to grow, and any such growth will also be excluded from the child's estate for estate tax purposes. However, if the child were acting as his or her own Trustee, and you elect to include discretionary income payments, a Co-Trustee would have to be appointed to make the decisions as to payments of

income. (Another drawback is that income which is accumulated in a trust is currently taxed at extremely high income tax rates.)

If the trust is being used to purchase assets, we would typically want the income to be accumulated in the trust so it can be used to make payments on the purchase.

- Any of the property in the trust can be used for the child's health, support, education, and other reasonable needs.
- The child can have a right to appoint (i.e. give) trust property, either at any time 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 any funds needed for the grandchildren's education and then use the power to direct the manner in which the property would be distributed at the child's death. Typically, if the child does not exercise this power, the property would 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 Generation Skipping Trust?**

Today. Since the amount of exemption required to be applied to make an exempt trust 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 generation skipping 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 in 2005, then there would be no additional assets which could be placed in the exempt trust for the children. 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 of as much as 35% or 40% may

well reduce the \$750,000 value down to around \$487,500, leaving the opportunity for \$1,000,000 of future exempt gifts as of 2005.

In any event, the generation skipping 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 generation skipping trusts for their own benefit because once property passes to them, the opportunity for using this powerful tax avoidance device is lost.

Similarly, if you are going to receive gifts or inheritances, the person from whom those assets will be received must create the generation skipping trust for your benefit and have those assets pass to your trust and not to you directly.

## **Instruction Forms**

If you are interested in having a generation skipping trust created for your children or for yourself(selves), we have included instruction forms with this booklet that will help us gather some of the information that is required to prepare the trust. If the trust is for your children, you may wish to have different trust terms for each child, and you may photocopy the forms and fill them out separately for each child. If you have any questions with regard to the forms, or any aspects of generation skipping, please contact us at your convenience.

# Instruction Forms

## Beneficiaries

Beneficiaries - Indicate below the beneficiaries of the Generation Skipping Trust and the share each is to receive. If the share is left blank, we will assume an equal share for each beneficiary.				
Full Name	Address	Relationship to You	Date of Birth	% Share
	_____ _____		_/_/_	
	_____ _____		_/_/_	
	_____ _____		_/_/_	
	_____ _____		_/_/_	
	_____ _____		_/_/_	
Please add information for any additional beneficiaries on a separate sheet of paper and attach it to this booklet.				

## Income Payments

With regard to payments of income from the trust:
<input type="checkbox"/> All the income should be paid to the beneficiary at least once annually.
<input type="checkbox"/> The income should be "sprinkled" among the beneficiary, his or her spouse, and his or her children.
<input type="checkbox"/> The income can be either paid to the beneficiary or accumulated in trust at the discretion of the Trustee.

## Power Of Appointment

The beneficiary will have a power of appointment (the right to direct the distribution of the trust) as follows:

- The beneficiary will have the broadest power permitted, that is, a power exercisable in favor of anyone the beneficiary chooses (other than to the beneficiary or for his or her own benefit) in order to eliminate estate tax at his or her death and to avoid creditors.
- This power will be limited so it is exercisable only in favor of (check all that apply):
  - The spouse of the beneficiary (outright).
  - The spouse or former spouse of the beneficiary as to a life income only, with principal to pass to the children at the spouse's death.
  - The issue of the beneficiary.
  - The spouses and former spouses of issue of the beneficiary.
  - Others (please specify):

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Giving the beneficiary the ability to exercise his or her power of appointment during life (e.g. permitting the beneficiary to give assets away during lifetime) provides the most flexibility, but a gift tax could be incurred if a gift is actually made. In addition, if the beneficiary is too generous, the financial security of the beneficiary could be impaired. Please indicate below your preference with regard to when appointments may be effective:

- The power of appointment may be effective at any time the beneficiary desires (that is, the beneficiary will have the power to give away the trust property during his or her lifetime).
- The power of appointment will only become effective after the beneficiary's death.

## Income To Spouse

If desired, you can arrange to have income paid to the beneficiary's spouse after the beneficiary's death, recognizing that the beneficiary could use his or her power of appointment to remove that benefit if desired. Alternatively, depending on the permitted appointees specified in Item 3 above, you could allow the beneficiary to make this decision at a later date, which would require the beneficiary to take the action to arrange for the benefit to his or her spouse. Please indicate below your preference in this matter:

- After the beneficiary's death, the income should be paid to the beneficiary's spouse for the spouse's lifetime.
- Do not include benefit for the spouse currently, but allow the beneficiary to decide if such benefit is appropriate.
- Do not include any benefit for the spouse.

## Power Of Appointment In Spouse

(Complete only if the trust will be held for the child's spouse through the spouse's lifetime after his or her death.)

The beneficiary's spouse can be given a power of appointment to change the disposition of the assets among the issue and spouses of issue of the beneficiary, to retain flexibility to meet changes in circumstances and retain parental control. Please indicate below your preference in this respect:

a. As to the creation of such a power:

- The spouse should have such a power of appointment.
- No power of appointment should be given to the beneficiary's spouse.

b. As to when the spouse's power of appointment would be effective:

- The power of appointment may be effective at any time the beneficiary's spouse desires.
- The spouse's power of appointment will only become effective after the spouse's death.

## Trustees

The Trustee and successor Trustees of the beneficiary's trust (i.e. the original Trustee and the person(s) or entity to serve in the event each person named cannot serve) will be:

The beneficiary (Strike if this does not apply), then, if he or she is not able to serve:

\_\_\_\_\_, then  
\_\_\_\_\_, then  
\_\_\_\_\_.

(It is usually wise to name a bank or other entity that will not die as the ultimate Trustee for the trust).

## Distribution If No Issue

Since there will be reduced benefit from generation skipping if the beneficiary has no issue, consider the choice of providing either:

- The beneficiary's trust should terminate and pay out to him or her if the beneficiary reaches a certain age and has no issue. That age will be: \_\_\_\_\_ or
- The property will stay in trust until the beneficiary's death and then pass, free of estate tax to:
  - His or her brothers and sisters.
  - Other: \_\_\_\_\_.

## Power To Withdraw

With regard to the non-exempt trust which will be subject to estate tax when the children die, please indicate if you would like to:

- Allow the children to withdraw those assets and use or spend them as they please; or
- Retain the assets in trust for the children to provide asset protection and/or to keep the assets in the family.

## Trust Advisor

The Generation Skipping Trust is **not revocable or amendable by either of you after it is signed**. Therefore, it is crucial that you be very sure that all terms are correct and reflect your wishes. However, it is possible to give a third party the right to seek court approval to alter the terms of the beneficiaries' trusts. Such person is called a Trust Advisor. He or she cannot be a Trustor (you), or a trust beneficiary. Most corporate Trustees will not accept this responsibility. Naming a Trust Advisor with such a right can provide flexibility to meet changes in the beneficiaries' circumstances or a change in the law. You might consider naming a trusted relative or friend in this capacity.

- I do not want to have a Trust Advisor to make changes in the trust.
- I want to use the following person(s), in succession, as Trust Advisor(s).

Name	Address	City, State, Zip	Phone
	_____	_____	Bus _____ Res _____
	_____	_____	Bus _____ Res _____
	_____	_____	Bus _____ Res _____
	_____	_____	Bus _____ Res _____

## Changing Trust Advisors

In order to have a Trust Advisor available for as long as possible, you may wish to give each advisor the right to select a substitute advisor if there is no other person already appointed as successor or if the person appointed cannot serve. Please indicate any specific background or qualifications of the group from which the selection is to be made (recognizing that beneficiaries of the trust cannot serve) (e.g. Persons with a specific background such as an attorney, CPA, Financial Planner, or Individual Professional Trustee [possibly with ten years or some other level of experience]):

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## Name Of Trust

Name of Trust (e.g., Smith Gift Trust)	
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# Authorization

After you have filled out the questionnaire to the best of your ability, please contact us to go over any questions you have.

Please indicate, by your signature(s) below, your authorization for us to go forward with the drafting of your generation skipping trust. Please bring this questionnaire to the meeting with the attorney.

\_\_\_\_\_  
Signature

\_\_\_\_\_  
Signature

Date \_\_\_\_\_



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