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SPECIAL REPORT www.disinherit-irs.com

GENERATION-SKIPPING TRUSTS

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Generation-Skipping Trusts, also known as Dynasty Trusts, are designed primarily to avoid estate taxes each time one generation transfers wealth to the next generation. Dynasty Trusts are long-term trusts created specifically for the grantor's descendants. In Michigan, for trusts that are (or become) irrevocable after May 28, 2008, the trust can last in perpetuity. However, to take advantage of this rule with respect to real estate, the real estate must be held in an entity (i.e., a partnership, LLC or corporation) as opposed to being directly owned by the trust. Otherwise, Michigan law imposes an ultimate perpetuity period of 90 years from the date the trust became irrevocable.

Estate Tax Savings

The estate tax savings with a Dynasty Trust can be substantial. Considering that the Federal estate tax rate is now 35%, and that the tax is applied to each generation, the estate tax savings would be over 70% through four generations! For instance, suppose a father leaves $1 million of his estate to his children net of any estate tax. Assume further that the heirs use the income from the $1 million, but preserve the principal. The grandchildren will receive only $650,000 after paying a 35% estate tax. When the grandchildren die, that $650,000 shrinks to $422,500 in the hands of the great-grandchildren. By the time the great-great-grandchildren receive their inheritance, the $422,500 is worth only $274,625. In contrast, a Dynasty Trust funded with the original $1 million would have delivered the same $1 million to each generation. The estate tax savings would be even greater if the $1 million was invested and growing.

Dynasty Trusts can be created during lifetime using the grantor's $13,000 annual gift tax exclusion ($26,000 for married couples) and/or $5 million gift tax exemption ($10 million for married couples). Alternatively, Dynasty Trusts can be created at death by using the grantor's estate tax exemption. There are no estate or gift tax savings when the Dynasty Trust is created. The tax savings occur when the beneficiaries die and the assets in the trust pass – estate and gift tax free – to the next generation.

Important Note: As a result of the 2010 Tax Relief Act, for 2011 and 2012, the estate, gift and generation-skipping transfer (GST) tax exemption is $5 million per person, with a tax rate of 35%. However, without further Congressional action, on January 1, 2013, the exemption decreases to $1 million per person and the rate increases to 55%.

Design

In the typical structure, a separate Dynasty Trust is created for each child of the grantor. During the child's lifetime, the income and principal of the trust can be used for the health, education, maintenance and support of the child and his/her descendants. However, the child is the "preferred" beneficiary and his/her needs take priority. The trust agreement can also permit the trustee to acquire assets for the child's use and enjoyment (without rent) such as vacation homes, artwork, jewelry, etc. The trustee can also be permitted to invest in a business that can employ the child and/or the child's descendants.

When the child dies, the assets remaining in the trust pass (in further trust) to his/her children, in equal trust shares. The trusts for the grandchildren contain the same provisions as the trusts for the children, with the grandchildren now becoming the preferred beneficiaries. This scenario is recycled for each generation for as long as the trust is permitted to run under applicable state law.

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Adding Flexibility

To add flexibility, each preferred d beneficiary can be given a limited power of appointment (exercisable at death) over the trust's assets. Such a limited power can allow the preferred beneficiary to completely "rewrite" the terms of the trust, including changing the identity of the beneficiaries (but never beyond the class conveying the Grantor's descendants) and their respective interests. For example, the limited power could permit the preferred beneficiary to (1) include his/her spouse as an income only beneficiary of the trust, (2) treat the preferred beneficiary's children differently so as to take into consideration differing needs, (3) add charitable beneficiaries, and/or (4) direct termination of the trust and outright distributions.

Non-Tax Advantages

Besides the estate tax savings, Dynasty Trusts offer several other advantages. First, the beneficiaries of the trust are protected from their inability, their disability, their creditors and their predators, including divorced spouses. But in order to obtain maximum creditor protection the preferred beneficiary should not be the sole trustee of his/her trust. Second, the grantor is assured that the trust's assets never pass outside the reach of the grantor's lineal descendants. As mentioned above, a limited power of appointment can be included in the trust agreement to add flexibility, while still assuring the grantor that trust assets pass according to his/her wishes. Third, by careful selection of trustees, professional property management can be achieved. Many Dynasty Trusts provide that the preferred beneficiary, upon attaining a stated age (i.e. 25 to 30 years), becomes a co-trustee over his/her trust, and has the right to remove and replace the co-trustee. This way, the preferred beneficiary can always have a "friendly" co-trustee to work with.

Limitations

In 1986, Congress (recognizing that the IRS was losing billions in estate taxes) attempted to thwart Dynasty Trusts by creating the generation-skipping transfer (GST) tax. The GST tax is imposed on the transfer of assets to individuals who are more than one generation younger than the transferor (i.e., grandchildren and great-grandchildren). This includes the transfer of assets that are given outright or in trust. The GST tax is in addition to the Federal estate and gift tax, and is equal to the maximum estate tax rate (35%).

Fortunately, Congress did include a significant exemption to the GST tax. The GST tax exemption is equal to the estate tax exemption ($5 million, $10 million for a married couple). Although the GST tax exemption is the same as the estate tax exemption, tax-free gifts to a Dynasty Trust are still limited to the $13,000/$26,000 annual gift tax exclusion and the $5 million/$10 million gift tax exemption. If the GST tax exemption is allocated to a Dynasty Trust, the Dynasty Trust, including all appreciation, is entirely exempt from the GST tax for its entire term. Lifetime transfers to most Dynasty Trusts result in the automatic allocation of the grantor's remaining GST tax exemption, unless a gift tax return (Form 709) is timely filed to elect out of the allocation.

Leveraging the GST Tax Exemption

One of the most popular ways of leveraging one's GST tax exemption is through the use of life insurance. For example, assume a married couple creates a Dynasty Trust for the benefit of their descendants. They use their annual gift tax exclusion and lifetime exemptions to make cash gifts of $2 million to the Dynasty Trust. The Trustee of the Dynasty Trust uses these cash gifts to purchase a $10 million survivorship life insurance policy. After the death of both spouses, the Dynasty Trust receives $10 million – income and estate tax free. Although the couple would have used up $2 million of their $10 million GST tax exemption, their heirs would now have $10 million in a Dynasty Trust that is entirely free of the GST tax. An added benefit to this approach is that the life insurance proceeds can be used to pay any estate taxes on other assets in the grantors' estates. This is accomplished by permitting the Dynasty Trust to loan monies to, or to purchase assets from, the grantors' estates.

If properly designed and drafted, a Dynasty Trust offers significant long-term flexibility to persons who want to establish a tax-favored source of capital to future generations of family members without erosion from estate taxes and without subjecting the trust assets to the claims of the beneficiaries' creditors.

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