



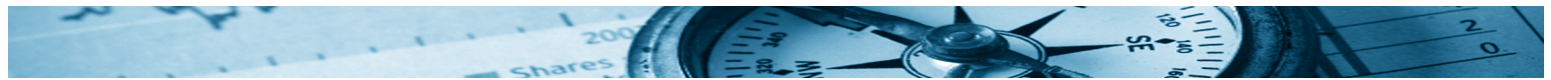
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Generation-Skipping Trust





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What is a generation-skipping trust?

By definition, a generation-skipping trust is any trust having beneficiaries who belong to two or more generations below the grantor (i.e., "skip" persons). More specifically, a generation-skipping trust is an irrevocable trust that is designed to minimize estate taxes by transferring principal to skip persons (e.g., grandchildren or great-grandchildren) and limiting distributions of income to intermediary generations (e.g., your own children). In other words, the third generation inherits property directly from the first generation, while the second generation can receive income from the property the third generation will eventually own (although the trust may be continued for several generations, acting as a dynasty trust).

What reasons might motivate grandparents to make gifts to grandchildren, skipping over their own children? One common reason is when adult children already have ample money of their own. In this situation, the grandparents might want to ensure funds for their grandchildren's future welfare, while not adding to their own children's potential federal gift and estate tax liability (and perhaps state gift and death tax liabilities).

Another possible reason is centered on less fortunate circumstances. Grandparents might consider it unwise to leave money to an adult child who does not act like an adult, or has a devious spouse or partner (or ex-spouse), substance abuse problems, or some other serious legal or financial problems. A generation-skipping trust can keep property out of this child's hands or the hands of the child's creditors.

Understanding generation-skipping transfers

Generation-skipping transfer (GST) tax

To understand the usefulness of a generation-skipping trust, you must have an understanding of how generation-skipping transfers are taxed. In addition to federal gift and estate tax, there is another federal transfer tax, the generation-skipping transfer (GST) tax. This tax applies when a transfer is made to a skip person (someone who is two or more generations below you).

There are three types of transfers that are subject to GST tax:

- A direct transfer from you to a skip person (this type of transfer is called a direct skip)
- A distribution of income or principal from a trust to a skip person (this is called a taxable distribution)
- A distribution of assets to a skip person because a trust has been terminated (this is called a taxable termination)

GST tax is flat tax at highest gift and estate tax rate

GST tax is a flat tax equal to the highest gift and estate tax rate then in effect (40% in 2022), and is imposed on any transfer (direct skip, taxable distribution, or taxable termination) made to a skip person. For example, if you make a gift of \$1 million to your granddaughter in 2022, the applicable GST tax will be \$400,000 (although the annual gift tax exclusion and a lifetime GST tax exemption may apply — see below).

It should be noted that GST tax is in addition to any gift and estate tax that must be paid. GST tax and gift and estate tax can consume a substantial portion of the underlying transfer.

Lifetime exemption from GST tax

Although GST tax may seem overly harsh at first, each individual taxpayer is given a cumulative exemption from the GST tax (\$12,060,000 in 2022, \$11,700,000 in 2021). This means that over his or her lifetime, each person can give away up to the exemption amount to skip persons and not have to pay GST tax. A married couple could give up to double the exemption amount and not incur GST tax.

Tip: The GST tax exemption is the same amount as the gift and estate tax applicable exclusion amount.

Annual exclusion

The \$16,000 (in 2022) annual gift tax exclusion applies to direct transfers to skip persons. Thus, the first \$16,000 (\$32,000 if split with a spouse) of any transfer to a grandchild or great-grandchild will not be subject to GST tax in 2022.

A gift to a generation-skipping trust, however, will also qualify for the annual exclusion, but only if the beneficiaries have a present interest in the transfer. This is accomplished by allowing the beneficiaries a limited time period during which they can withdraw gift made to the trust (this is known as a Crummey withdrawal right). However, this withdrawal right is not enough by itself. The annual exclusion for gifts to a generation-skipping trust also requires that there be only one beneficiary for the trust.

GST tax is extremely complex

The GST tax is one of the most complex areas of the entire Internal Revenue Code. If you plan to make a transfer (directly,



indirectly, or through a generation-skipping trust) to anyone who may be a skip person, you should consult a professional advisor who has experience in handling these types of transfers. Failure to comply with all of the requirements of the GST tax could have disastrous results for both you and your heirs.

Why use a generation-skipping trust?

There are many ways a generation-skipping trust that can be set up. Some generation-skipping trusts are set up to provide income to the next generation while leaving the underlying assets to a lower generation. Other generation-skipping trusts are set up exclusively for the benefit of grandchildren or great-grandchildren. Some professional advisors recommend using a generation-skipping trust to leverage the exemption each individual is given from the GST tax through the use of life insurance.

Provide income to children

One of the most common uses of a generation-skipping trust is to provide income to the children of the grantor while ultimately transferring the assets to the grandchildren or even lower generations. If the trust is drafted properly, your children can receive all income from the trust for their lifetimes, without the assets being included in their gross estates when they die. A typical trust provides that when the last child dies, the assets in the trust can be distributed to the grandchildren.

In some cases, the trust will be drafted to last for as long as legally possible. In a state where the Rule Against Perpetuities has been repealed, the trust could virtually last forever. Each generation would receive income from the trust, but the principal would not be distributed.

Use for grandchildren only

Another way to set up a generation-skipping trust is where the only beneficiaries are your grandchildren (or even your great-grandchildren). Your children would receive neither income nor principal from the trust. You may want to set up the trust this way if your children are wealthy in their own right, or if they have been provided for in other trusts that you have created.

Life insurance generation-skipping trust

Many professional advisors recommend that individuals consider leveraging their transfers to a generation-skipping trust through the use of life insurance policies. Typically, you would use your exemption to make transfers (free of the GST tax) into a generation-skipping trust. The trust would then purchase a life insurance policy on you (or on you and your spouse). At your death, the proceeds from the life insurance policy would be available to the beneficiaries of the trust. The proceeds would not be subject to GST tax. This is one way to significantly leverage your GST tax exemption.

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