

Generation Skipping Transfers and Dynasty Trusts

Estate Planning professionals have long recognized that with larger estates, it is much easier to hold the estate together for the family if it is exposed to taxation only once every two or three generations, rather than at every generational level. In order to place some limitation on this tax avoidance planning, Congress enacted the generation skipping transfer tax ("GSTT"). In effect, the GSTT is a "substitute" for the estate tax, and imposes a tax at the generational level which would not otherwise be subject to estate taxation. While the tax itself can be quite large, equal to the maximum estate tax rate in effect at that time, there are also large exemptions available. Most planning in this area, then, focuses on maximizing the use of the exemptions, and even "leveraging" them to create much larger generation skipping transfers free of any tax.

In brief, two exemptions from the GSTT are available:

The GST Exemption Every transferor has a blanket exemption applicable to all transfers during life or at death. It may be allocated to various transfers as you wish. Until 2004, the amount of this exemption was fixed at \$1,000,000, plus an inflation adjustment. Under the 2001 Tax Act, the amount of this exemption been increased as follows:

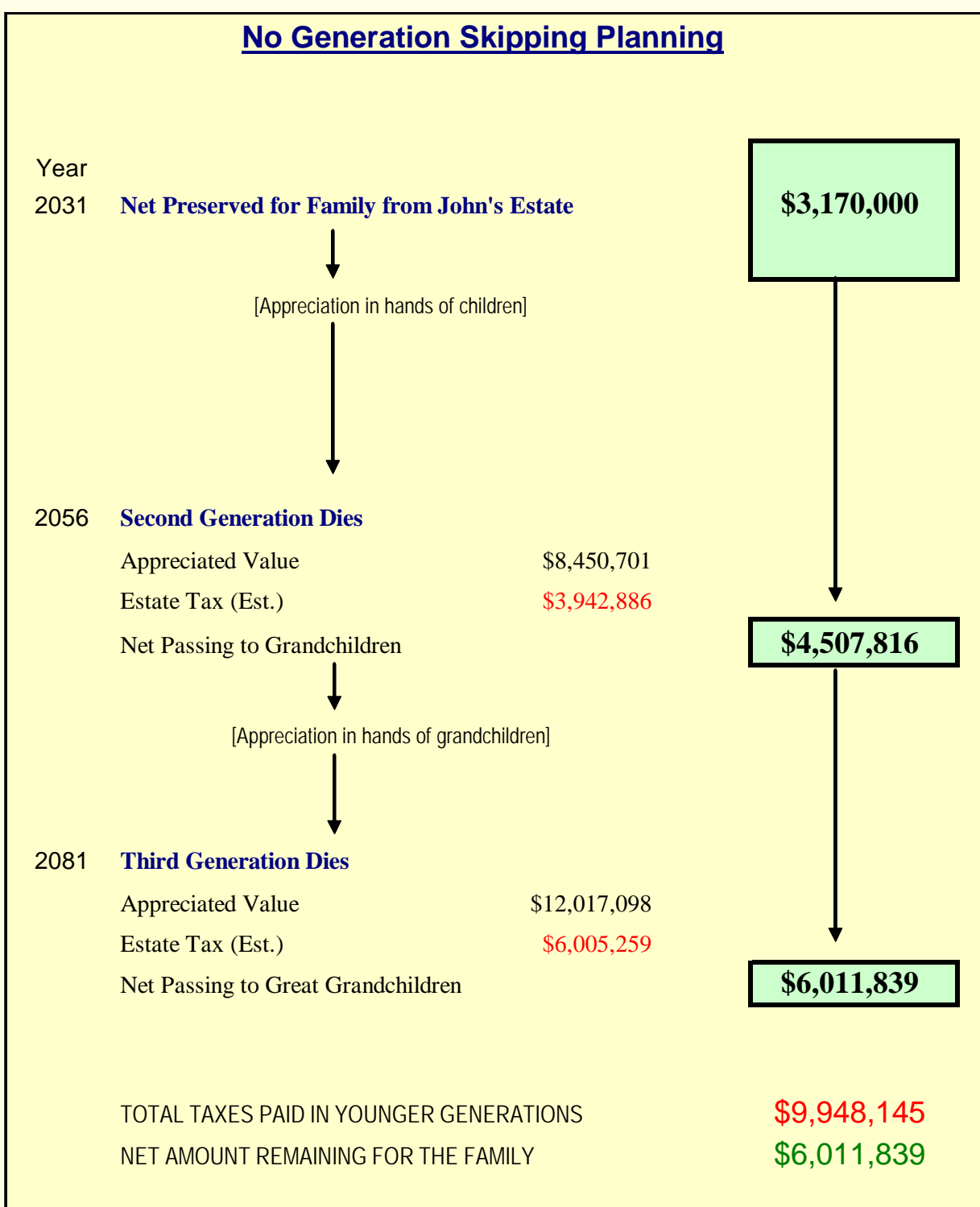
<u>Year</u>	<u>GST Exemption</u>
2006	\$2,000,000
2009	\$3,500,000

Under that Act, the GSTT is scheduled to be repealed for 2010, but would be reinstated in 2011 with an exemption based on pre-Act law (\$1,000,000 adjusted for inflation). It is expected that Congress will act prior to 2010 to provide some permanent resolution of this tax.

The Annual Exclusion Exemption Any gifts which are exempt from gift tax under the \$12,000 annual gift tax exclusion are also exempt from the GSTT, so long as the gift meets certain "vesting" requirements.

These exemptions are allocated by the taxpayer for gifts made during his or her lifetime, by filing a gift tax return and claiming the exemption on that form. For certain types of trusts, the allocation may be automatic without requiring a return to be filed. The exemption applicable to transfers taking effect at death (under a Will or Living Trust, for instance) is allocated by the taxpayer's executor when the estate tax return is filed. The proper allocation of the exemptions is crucial to effective planning in this area, and care must be taken to ensure that the estate distribution is structured to facilitate the maximum use of the exemptions.

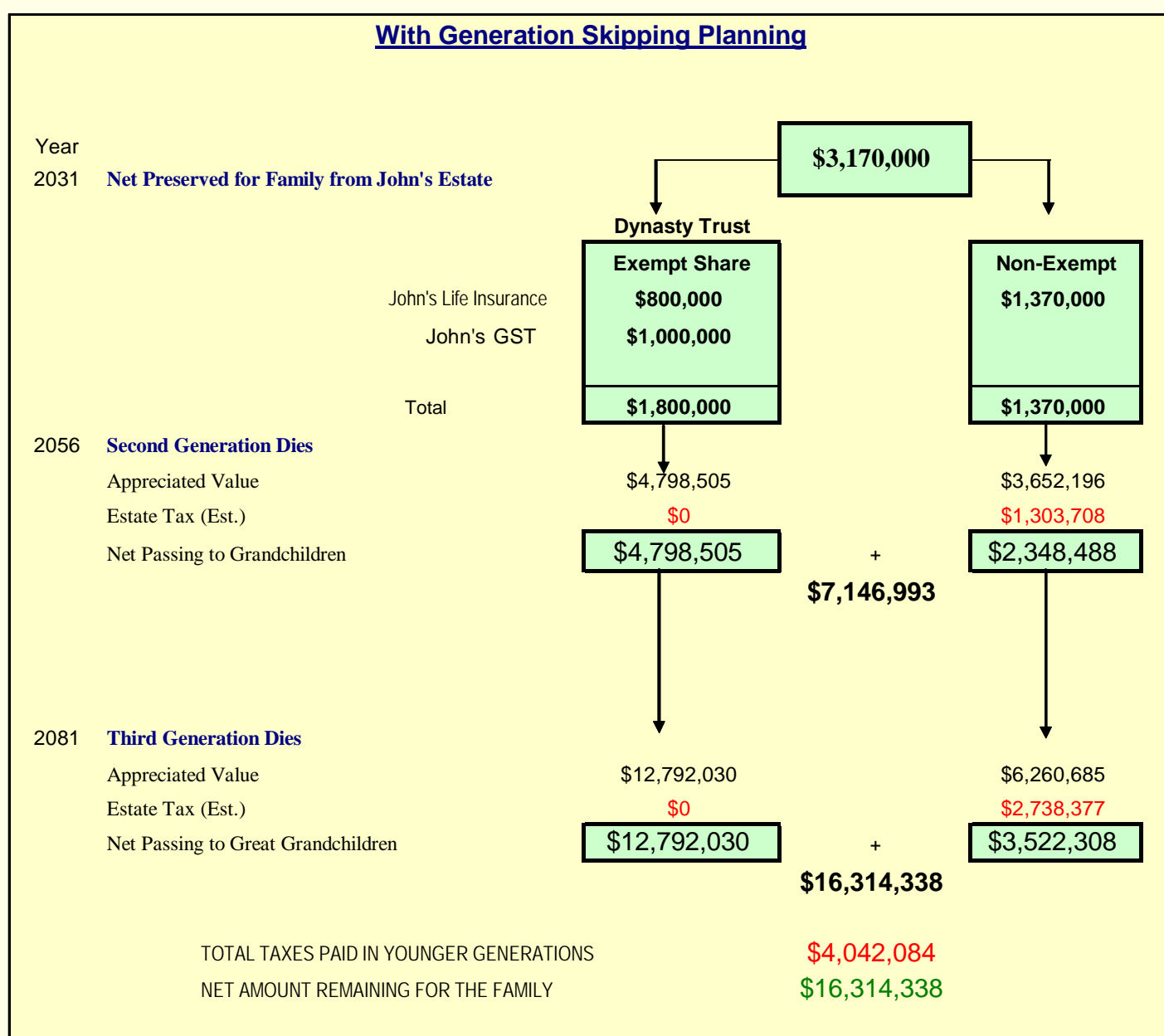
The proper use of the GST Exemption to protect family wealth from taxation through successive generations can easily have a dramatic effect on the amount of the family's wealth which can be preserved. Consider, for example, the following illustration showing John Doe's estate leaving \$3,170,000 for the children (after all estate taxes,) at his life expectancy in 2031, with the expectation that the children will leave it to their children. This illustration assumes that the estate grows at a net rate of 4% annually, and that each generation passes it along in 25 year intervals subject to normal estate taxation.



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If the real inflation rate over the years is 3% annually, then the family has lost more than one-half of the real value of its wealth in two generations, even though its investment results out-performed the inflation rate. That loss is due entirely to the estate tax. Over a 50 year period, the family's wealth should be \$13,896,982 in order to preserve its real value after 3% inflation. In this case, the family's after-tax wealth has grown to only \$6,011,839, representing an after-tax loss in real value of about (1.66%) annually.

If, on the other hand, the John Doe family had left the same estate with the life insurance trust designed as a "dynasty trust" for John's descendants, and with John's will designed to leave the maximum GSTT exempt amount protected in that trust, then at the end of the same 50 year period the wealth would have grown to \$16,314,338. That represents a 170% increase in family wealth after two generations, due entirely to tax avoidance.



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In a "dynasty trust," legal (taxable) ownership of the trust property is not distributed outright to the children or grandchildren. Instead, the trust may simply provide (liberally, if preferred) for the use of each child's share of the trust assets for the child and the child's descendants. The trust may, for instance, be authorized to expend its income and/or principal for the support, maintenance, and education of the family members. It may be authorized to invest in the family's business ventures, and to purchase and hold property (such as vacation homes) for the use of the family. Such a trust can enable the family to use the family wealth in much the same way one may contemplate it would be used if it were left outright to the beneficiaries. Upon the death of a child for whom a share of the trust is held, the deceased child can be empowered to direct the manner in which the trust property will continue for his or her own children, just as the child would be able to do in his or her Will if the property were owned outright.

The trust is controlled by the trustee or trustees. If one wishes, control can be given to the child for whom the trust is created simply by naming that child as the trustee. The child, as trustee for himself and his family, would have essentially the same scope of economic control as if the property had been distributed outright. Alternatively, multiple trustees can be named, and/or a professional trustee may be employed to manage the trust. Provisions for resignation, removal, and replacement of trustees can be included, and "committees" may be created to control certain types of decisions much as a board of directors might oversee the management of a business enterprise.

In addition to long-term tax avoidance, a dynasty trust can provide greatly enhanced protection for the family's wealth in the face of marital discord and claims arising from financial or business problems of the descendants. Because a child is not personally the legal owner of the trust's assets, a creditor or divorcing spouse will generally have a much more difficult time pursuing a claim against the trust property. Some states' laws provide much greater protection in this area than do others. It may be important, therefore, to consider where such a trust should be created for the family and whether a mechanism should be created to "move" the trust to another legal home if appropriate at some later time.

State law will also govern the length of time for which a dynasty trust can hold the property. The law in most states includes a "rule against perpetuities" requiring that the trust vest ownership of its assets in the beneficiaries within a defined time period after creation of the trust. Under the traditional common law rule against perpetuities, that time period generally may not exceed 21 years after the death of all the beneficiaries who are living when the trust is created. Many states (including Georgia) have now adopted a 90 year "safe harbor" and a few states have abolished the rule entirely.

Dynasty trusts, then, provide an opportunity to protect the family's wealth not only from the long term effect of estate taxation, but also from much of the risk of financial loss from business failures, marital discord, and other legal difficulties. Their creation requires careful planning, integration with the effects of the estate tax and generation skipping transfer tax system, and consideration of the trust administration and management issues which arise in a trust which may well last for several generations.