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ESTATE PLANNING LIBRARY

Number Nine

Generation Skipping Transfer Tax Planning

AN OVERVIEW

1. What type of client might use this technique?

Generation skipping transfer tax planning is used by:

- Clients who want to provide asset protection for their heirs.
- Clients who want to provide professional financial management for the bequests to their heirs.
- Clients who want to avoid the imposition of an estate tax at each successive generation.

2. How does generation skipping transfer tax planning work?

The U.S. gift and estate tax system is designed to impose a transfer tax on each generation at rates rising to as high as 50%. That means the first generation might accumulate an estate of \$3,000,000 and at the death of the second spouse to die, the estate taxes imposed could be, in 2002, \$1,061,000 and everything over that at 50%. The second generation would then receive a net bequest of \$1,939,000. If that second generation was in a maximum estate tax bracket then the 1,939,000 inheritance would be subject to another \$969,500 in estate taxes. When the second generation died, if taxable gifts were made, they would be imposed before the third generation received its inheritance. Generation skipping transfer tax planning avoids transfer taxes on the subsequent generations by having the first generation leave the original \$1,930,000 bequest to a legacy trust rather than to the second generation outright.

3. How does the client benefit from generation skipping transfer tax planning?

The estate tax benefit is due to the fact that after the death of the first generation, subsequent generations have no estate taxes imposed at their deaths when the funds in the legacy trust continue for the benefit of subsequent generations. Let's use the previous example for illustration. When the first generation dies, the bequest is left to a certain type of trust referred to as a legacy trust. That trust receives the original net

bequest of \$1,939,000. Prior to the death of the last of the second generation, it is still worth \$1,939,000 when the last of the second generation dies.

However, because the original bequest was left to a legacy trust, the second \$969,500 estate tax imposed when a legacy trust was not used is avoided and the third generation begins with \$1,939,000. Not only are estate taxes avoided, but creditors of subsequent generation beneficiaries, including ex-spouses of those beneficiaries, may not attach the assets of the trust because of the way it is drafted. In addition to those benefits, financially immature or irresponsible beneficiaries can be protected from financial loss because of professional management provided by a professional trustee.

4. What does the estate planner do in these engagements?

The estate planner must consult with the client to be sure they understand the features and benefits of a legacy trust and details of its operation. Aside from designing and preparing a legacy trust in accordance with the clients' desires, the estate planner must make sure that the state in which the client lives allows legacy trusts for an unlimited number of generations if the client wants the trust to go on for many generations. Some states provide what is called a rule against perpetuities that causes a trust to terminate after a certain period of years, typically 21 years after the death of the last beneficiary alive when the first generation died. If the client wants the trust to continue longer than that, the trust must be prepared such that the law of a state that has removed any such limitation is used.

5. What are the client's responsibilities?

Once the detailed rules of the operation of a legacy trust have been explained, the client must decide if that is the method that they want their bequests to their children to be structured. Generally, the first generation is the trustee of the trust until the death of the last of the first generation. The client will need to have identified a professional trustee to manage the trust for the remainder of the term of the trust to ensure continuity of management.