

# UBS Insight

Managing the generation-skipping transfer tax



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# Managing the generation-skipping transfer tax

**Preserving a family fortune from generation to generation requires sophisticated tax management strategies**

As a result of the 2010 Tax Act, the Generation-Skipping Transfer Tax (GST) will have a \$5 million exclusion per individual and a 35% rate of tax above this exclusion. This law will expire on December 31, 2012 at which point (if there is no further legislation), the GST will revert to a \$1 million exclusion (adjusted for inflation since 1997) and a 55% rate. Accordingly, there is considerable legislative uncertainty as to what will occur in the future.

There is also the possibility that GST transfers made in 2011-12 could be recaptured if the exemption is lowered in the future. In light of this uncertainty, this article will focus solely on planning for the GST in 2011 and 2012, and will not address any "recapture" risk or any other issues for subsequent years. (If you are doing GST planning, however, it is critical to consult with your tax and legal advisors on all GST issues, including the possible future outcomes.)

**Estate planning involves the acknowledgement of two particularly unpleasant but inescapable realities: death and taxes. For wealthy individuals and families, however, the sooner they begin the process of strategic estate planning, the better will be their opportunity to maximize the eventual legacy they are able to pass on to their families—and not just to their children, but potentially to their grandchildren, great-grandchildren and descendants who are even more remote.**

Central to any successful wealth transfer strategy are techniques that minimize the impact of taxes on family fortunes, especially when the transfer spans multiple generations. There is, of course, the federal estate tax, which is imposed on the transfer of substantial estates, as well as the federal gift tax, which imposes a levy on outright gifts above annual and lifetime thresholds. In addition, many states impose significant estate taxes.

Of equal importance to families interested in passing assets to their grandchildren and possibly beyond is the generation-skipping transfer tax (GST tax), a tax that is separate from—and in addition to—the estate and gift taxes and is levied on transfers to people who are at least two generations removed from the transferor.

Like the estate and gift taxes, the GST tax has the potential to erode a significant amount of transferred wealth, but competent and experienced attorneys, accountants and financial planners can help to minimize its burden. With proper planning, wealthy families can preserve and grow family wealth for multiple generations by protecting it from unnecessary taxation by the government, imprudent management by members of subsequent generations, and potential future confiscation by creditors and former spouses of their descendants.

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### **Taxation for each generation**

Congress originally enacted a tax on generation-skipping transfers in 1976 and modified it into its current incarnation as part of the Tax Reform Act of 1986. The government’s intent was to levy a tax on transfers that would otherwise have sidestepped the federal estate and gift tax system. Patriarchs and matriarchs of families with considerable wealth had traditionally been able to pay the estate tax (which has been around since 1916) due when they died, but also transfer portions of their estate directly to grandchildren or into trusts that would benefit multiple generations of their descendants—skipping their own children, who often received more than ample inheritances in their own right.

Transfers made in this fashion were still subject to estate tax at the death of the patriarch or matriarch but had the effect of bypassing the estate tax that would have been paid at the death of each subsequent generation had those assets simply been left from parent to child each time. The GST tax attempts to close this loophole by imposing a tax equal to the highest estate tax rate in effect at the time of the transfer (35% in 2011) to any “skip person,” defined as a relative two or more generations removed from the transferor or someone who is unrelated but more than 37½ years younger than the transferor. The skip person can also be a trust that provides exclusive benefit to individuals who meet these criteria.

### **When the GST tax applies**

The Internal Revenue Code provides for GST tax levy on three different types of transfers that skip a generation:

- Direct skips
- Taxable distributions
- Taxable terminations

A direct skip occurs, for example, when a grandparent gives a grandchild a gift directly, triggering a tax payable by the grandparent to the extent that the gift exceeds the annual exclusion (\$13,000 in 2011). A distribution is taxable when a grandchild (or any other skip person) receives money from a trust created by the transferor, usually a grandparent or great-grandparent. The levy on a taxable distribution is payable by the skip person who receives it. A taxable termination occurs when the last member of a generation of beneficiaries of a trust dies and the remaining beneficiaries are all skip persons; in this situation, the GST tax liability is imposed on the trust.

There are some common types of multi-generational transfers that are not subject to the GST tax. Outright transfers that qualify for the annual gift tax exclusion of \$13,000 also qualify for the GST tax exclusion. Similarly, transfers in trust that qualify for the annual gift tax exclusion of \$13,000 also qualify for the GST tax exclusion, but only if the trust has a single beneficiary and if that beneficiary or his or her estate will eventually receive all of the income and principal of the trust. A grandparent may also directly pay a grandchild’s qualified educational and medical expenses free of GST tax, provided they are paid directly to the educational or healthcare institution. Contributions to a grandchild’s Section 529 college savings plan are also allowable—including accelerating five years’ worth of \$13,000 contributions (\$65,000) into one calendar year—free of gift or GST tax. Direct transfers from a grandparent to a grandchild when the parent of the grandchild is already deceased are also free of the GST tax.

### **GST tax exemptions**

The GST tax also permits each individual to exempt the first \$5 million (in 2011–12) of generation-skipping transfers from the tax. This GST exemption is the same as the estate tax exclusion amount of \$5 million in 2011–12. With proper planning, a married couple may protect a total of \$10 million of wealth from GST taxes.

That planning often involves a reverse qualified terminable interest property trust (reverse QTIP), which is a variation on a standard marital trust where the first spouse to die is considered the transferor for GST tax purposes even though the trust is not subject to estate tax at the first death but only at the death of the surviving spouse.

The GST and estate tax exemptions can also be used concurrently. For example, a married couple with a \$3 million estate wishes to pass their entire estate when they die into a trust set up for the benefit of their grandchildren and great-grandchildren—and leave nothing to their two children, who both acquired significant wealth over their lifetimes. Assuming the couple made no lifetime taxable gifts, there is no estate tax payable when they die. In addition, there will be no GST tax payable on the \$3 million they use to establish the trust.

### **Leveraging the exemption**

Although the maximum amount a couple may exclude from GST taxation is \$10 million, it may be possible to pass on a far greater amount to future generations through the use of trusts and the proper choice of assets used to fund them. The GST exemption shields not only the original transfer of

assets into the trust, but also all future appreciation.

“Because the assets in trust are allowed to grow without the imposition of additional transfer taxes, you want to choose those assets that have the greatest potential to appreciate,” says prominent attorney Robert E. Madden, a partner in the Washington, D.C., office of Blank Rome, LLP and a member of the UBS Attorney Network program.\* “Life insurance makes an excellent candidate, since the tax and exclusion limits apply to the premiums paid and not to the death benefit.”

One strategy Madden uses with clients is to set up an irrevocable life insurance trust (ILIT) during their lifetime. A married couple can arrange to have the trustee take out a second-to-die life insurance policy and to pay the premiums with funds that are gifted into the trust. The couple can also allocate part of their GST exemption to provide the trust with funds to pay premiums. At the death of the second spouse, the death benefit is paid to the ILIT, resulting in proceeds that may be a large multiple of the premiums paid, depending on the age, health and other actuarial factors of the insured.

Additionally, because the trust is not part of the couple’s estate, it is not subject to estate tax. To the extent that the funds used to pay premiums are within annual or lifetime gift tax exemptions and exempt from GST tax, the proceeds of the policy will be available to grandchildren or more remote descendants free of additional estate or GST tax.

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### **Dynasty trusts**

One of the most effective ways of providing a family legacy in perpetuity is through the use of a dynasty—or perpetual—trust, an irrevocable trust that can provide income and support to a virtually unlimited number of generations. Dynasty trusts have traditionally been restricted in length by “the rule against perpetuities,” which stipulates that the trust must terminate 21 years after the death of any beneficiary alive when the trust was created. Delaware and several other states have abolished the rule against perpetuities and made it possible for dynasty trusts to continue indefinitely.

The trustee manages the affairs of the trust and can make distributions of income and/or principal to members of each generation. The grantor of the trust may stipulate the conditions under which the assets may be distributed, in effect exercising control “from the grave” by rewarding particular achievements, such as graduating from college or starting a family, and penalizing certain behavior, such as compulsive gambling or criminality. Also, there are usually provisions allowing discretionary payments to be made by the trustee, often for the health, education, maintenance or support of beneficiaries.

An additional benefit of a dynasty trust is the measure of asset protection it provides. Since the assets are not owned directly by any of the beneficiaries, they are protected from the claims of creditors and judgments in lawsuits—a feature that is especially valuable for descendants who may pursue careers as business owners, physicians or any other profession often associated with frequent litigation or liability claims.

Had the transferors given the property to their descendants outright, the property would not have enjoyed exemption from such claims.

Excluding assets held in trust from personal estates additionally protects them from division at divorce. “It does do a nice job of protecting a family legacy from the multiple-marriage syndrome,” says Mr. Madden.

### **Generation skips for business owners**

For the owner of a closely held business, the largest single component of wealth in his or her estate is usually equity in the business. This ownership interest, however, is usually illiquid and difficult to value precisely. For owners of these types of businesses, an installment sale of an interest in the business to an intentionally defective irrevocable trust (IDIT)—also called a defective grantor trust—is an option that offers substantial GST and estate tax advantages. In this type of arrangement, the business owner funds the IDIT with approximately 10% of the funds needed to buy the business (subject to gift tax) and applies GST exemption to those funds so the trust is GST-exempt. The owner then sells an interest in the business to the trust in exchange for a promissory note, which must bear interest at a rate prescribed by the Internal Revenue Service. This sale will necessitate a valuation of the interest sold because the sale must be at fair market value to be exempt from gift and GST tax, but the valuation may incorporate discounts for lack of marketability and control, which reduce the price the trust would need to pay. The trust pays off the promissory note either through cash flow of the business or from

the proceeds of an available sale. To the extent the interest in the business appreciates more than the prescribed interest rate on the note, the business owner will have succeeded in transferring wealth to the trust (and therefore indirectly to grandchildren or more remote descendants) with no additional gift, estate or GST tax. Because the trust is a grantor trust, neither the sale itself nor the receipt of interest on the note is a taxable event. The business owner is still responsible for paying income tax on the trust's assets, which essentially allows them to appreciate in an income-tax-free environment. And although any remaining balance on the note would be includible in the estate of the business owner if he or she died before the note was fully paid off, the trust assets themselves are excluded from his or her taxable estate.

### **Making the decision to skip**

While numerous techniques and vehicles are available to transfer assets in a tax-advantaged manner to grandchildren and subsequent generations, the choice of whether to do so should be considered carefully. "If the children will have estate tax issues of their own, or if they are unfit for one reason or another to manage transferred wealth directly, skipping a generation can be a great idea," says Mr. Madden. If the children do not have a financial cushion, however, Mr. Madden counsels against skipping a generation.

"The critical factor is planning very carefully and making sure that you understand the various options and alternatives that are open to you," says Mr. Madden. "A good planner has a sense of the practical alternatives, and they are as important as the technical tax alternatives."

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