

What is a Generation Skipping Transfer Trust?

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What is a Generation Skipping Transfer Trust? It is a trust that one generation establishes for the ultimate benefit of a beneficiary or beneficiaries two or more generations below them. For example, grandparents may establish trusts which make distributions to their children, but ownership and control goes to the grandchildren, the “skip” generation. Often the generation skipping transfer trust will be referred to as a “GST”.

How does a GST work? While there is considerable variation in the provisions that can be chosen, the most flexible arrangement is to allow the trustee to pay income and/or principal to the children and/or the grandchildren as long as the children are alive. When the children are gone, whatever is in the trust goes to the grandchildren, without being subject to estate tax in the estates of the children. For example, if Mary establishes a GST trust in her estate plan, once she is gone her daughter, Sarah, as well as Sarah’s children, can receive income and/or principal from the trust. Once Sarah is gone, the funds left in the trust will go directly to Sarah’s children without ever being taxed in Sarah’s estate.

How could a GST help my family?

Reduce estate taxes. If your estate is taxed and then passes to your children, anything remaining in that inheritance could be taxed again before it goes to the grandchildren when your children pass away. There could be significant erosion of value before the assets make their way down to the youngest family members. By using a GST, you eliminate estate taxes on the funds in the trust paid to your grandchildren when your children die. Of course, there will be income taxes on what the assets earn during the term of the trust.

Protect assets. Your children do not control the assets in the GST, so those assets will not be available to your children’s “creditors and predators”. Some examples:

Divorce: New York protects inherited funds from equitable division in a divorce, but if your child has commingled inherited funds with their spouse during marriage, those assets will be very hard or impossible to protect. About half of the marriages in America end in divorce.

Business risks: Your child may give personal guarantees on business loans. Assets in the trust are not exposed to collection if the guarantee is called upon.

Liability exposure: A child in a profession or business with high liability exposure (e.g. doctor, building contractor, or architect) may be exposed to law suits

in excess of liability insurance coverage. Assets in the trust are not available to successful plaintiffs.

Inexperience or imprudence: Your child may be a wonderful person, but can't say "no" to friends, relatives, "hard cases", or sharp operators who offer deals "too good to refuse". Or your child may be brilliant, but have no head for managing finances. Your child may suffer from some type of addiction, like drugs or gambling. The trust assets cannot be given, pledged or spent without the trustee's approval.

Disability: No one knows what the future will bring. Assets in the trust can be managed competently and "sprinkling" provisions can allow payment to or on behalf of the grandchildren during your child's life if your child becomes disabled. Special provisions authorizing the trustee to treat the trust as a "supplemental needs trust" under certain circumstances could take the trust funds out of consideration as "available assets" in assessing eligibility for public benefits, while still providing "extras" for the beneficiary.

Won't my children think I don't trust them and want to "control from the grave"? Maybe, but once your children understand how you are protecting them and how much you are saving for their children, they will bless you. You will have reduced the size of their taxable estates, given them enjoyment of funds, and protected their assets from creditors and predators. What a great gift!

What's the tradeoff? Control. Your child can never have control over the assets. A trustee will have the ultimate say over how assets are invested and what distributions are made to your child or on behalf of your child. You can give your child the ability to dismiss a trustee and replace it with another (within a defined universe of choices), but control rests with the trustee, not your child. There will also be administrative costs.

Can one child be trustee for another child of mine? Yes, but it is seldom a good idea. Most adult children will not want to share confidential information about their finances with a sibling, and a good trustee will need that information in order to tailor investment decisions and make appropriate distributions. If the life circumstances of your children vary significantly, resentment is likely to be triggered. Remember too that it is hard for a sibling to say "no" to a brother or sister who tugs at their heart strings.

Who should be the trustee? It depends. It might be a trusted family member, or an attorney, accountant or other advisor you know and trust. It might be a corporation qualified to act in a fiduciary capacity. All have strengths and weaknesses which you should discuss with your attorney, but the bottom line is that it must be someone you trust!

Could the trustee give all the assets to my child and end the trust? Yes, if your documents permit it. Flexibility is best, as we are never sure exactly how our

children's lives will unfold. For example, maintaining the trust could be an unnecessary expense if your daughter turns out to be a fiscally prudent, unmarried librarian with modest income, no estate tax exposure, and no liability exposure. On the other hand, you may still want a GST to ensure that the assets go to your son's children when she dies. A trustee can adjust the investment strategy for each child and may decide that ending the trust makes sense in the case of one child, but not for the others.

How much can go into the trust? As of 2005 the maximum amount you can give free of the generation skipping transfer tax is \$1,500,000. So if you have three children you want to treat equally, it would mean \$500,000 to each. This amount is scheduled to increase in the future, but we are not certain what it will be after 2011.

How can I decide? Discuss your situation with your attorney, your other advisors, and with your children. There is no "right answer", just the answer that is best for you and your family. When in doubt, remember that while a trustee can always distribute the funds outright if the trust doesn't seem useful, if your documents do not create the trusts, it cannot be done when you die. It is easy to get the toothpaste out of the tube, but hard to put it back in!

To comply with IRS requirements, we must inform you that any tax advice in this article is not intended or written to be used, and cannot be used for the purpose of avoiding penalties. It is intended for general informational purposes only. You should seek advice based upon your particular circumstances from an independent tax advisor.

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