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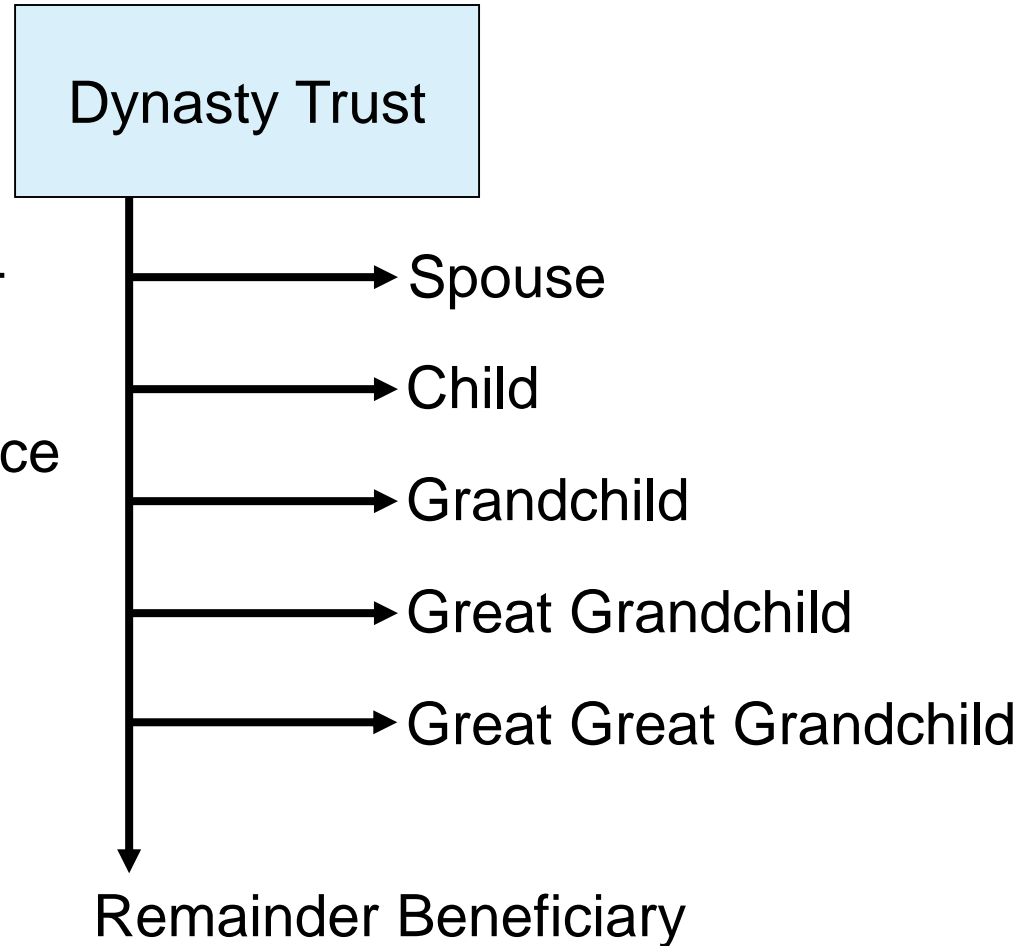
GENERATION SKIPPING TRANSFER TAX

What it is,
How it works,
What to do, and
What to watch out for

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Executive Vice President
CANNON FINANCIAL INSTITUTE

Dynasty Trust

- Trend in HNW & UHNW
- Generation Skipping Arrangement
- Takes advantage of GSTT exemption
- Can distribute in accordance with trust's terms
- In some states there is no rule against perpetuity

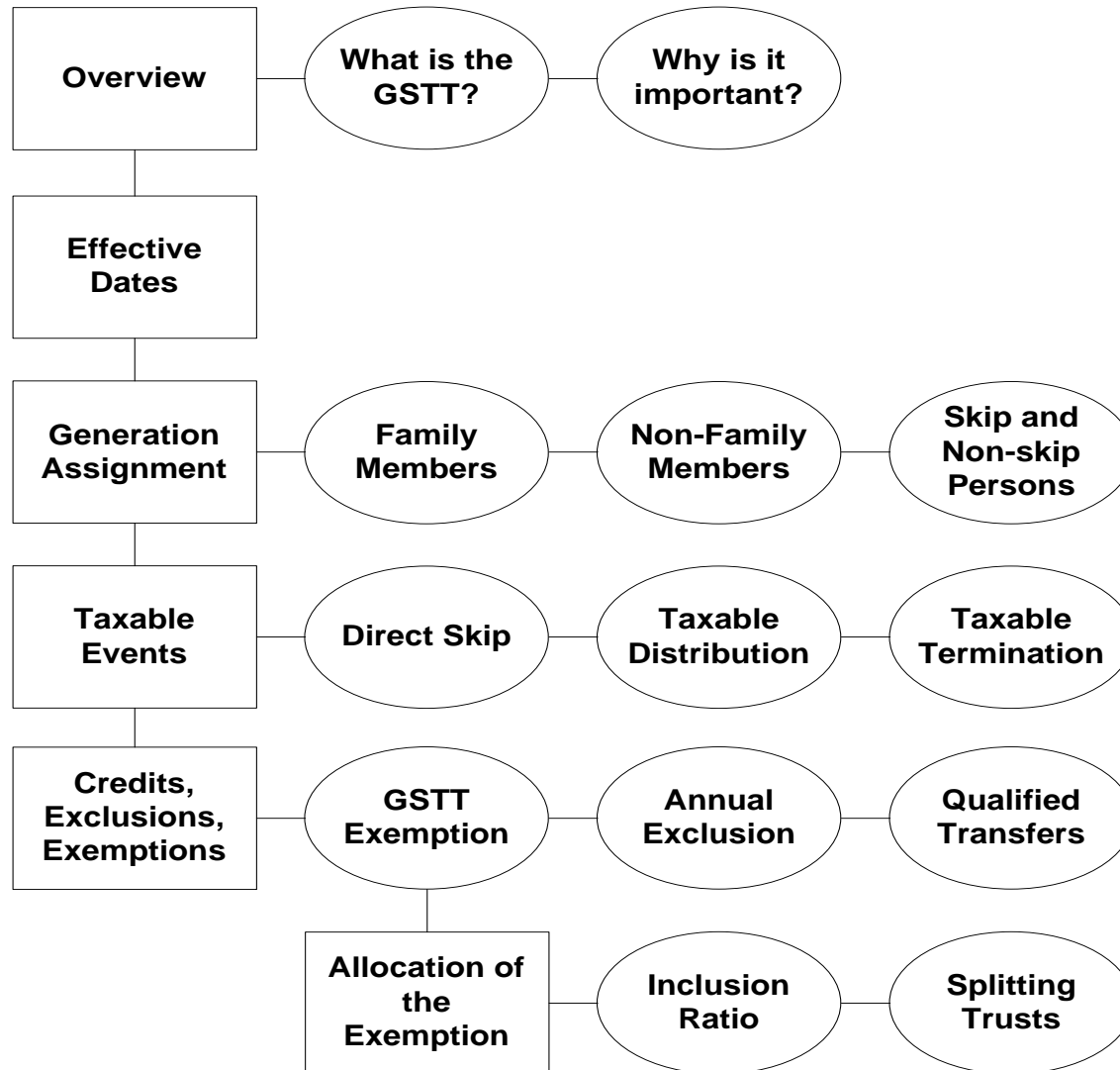


The Dynasty Trust

- T funds a long term trust with \$5,000,000 and allocates his entire GST exemption to it. If the trust is invested so that it returns 7% after tax annually, it will double in value every 10 years (rule of 72). Thus, it will grow in value as follows:

◆ After 10 years	\$10,000,000
◆ After 20 years	\$20,000,000
◆ After 30 years	\$40,000,000
◆ After 40 years	\$80,000,000
◆ After 50 years	\$160,000,000
◆ After 100 years	\$5,120,000,000

Generation Skipping Transfer Tax Learning Map





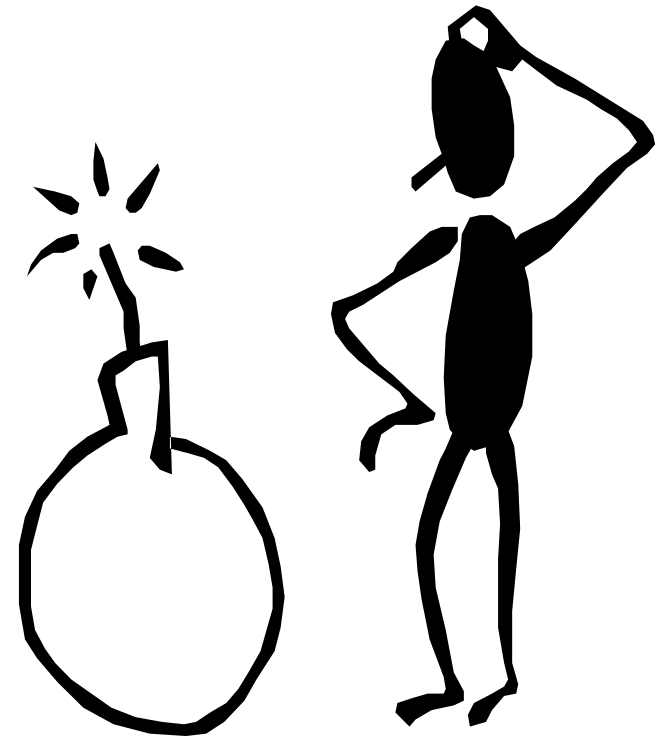
What is GSTT?

- A Transfer Tax similar to Gift and Estate tax
- Applies when assets are transferred two or more generations below the transferor
- NOT UNIFIED with Gift and Estate Tax, GSTT is a distinct transfer tax
- Imposed at the maximum estate tax rate
- GSTT Exemption \$10,000,000 indexed for inflation



Why GSTT Is Important

- Not widely or well understood
- Widespread impact in wealth management industry
- Impact can last generations, even forever
- Unintentional skips 
 - ◆ Staff Education
- Many existing plans were created prior to enactment of GSTT 
 - ◆ Search Will Vault



Two Options

Parent

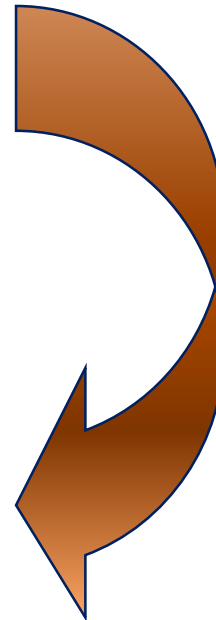
Child

Grandchild



Estate/Gift
\$11,400,000
40%

Estate/Gift
\$11,400,000
40%



Estate/Gift
\$11,400,000
40%

GSTT
\$11,400,000
40%

Effective Dates, When Does GST Apply?

- When a generation is “skipped”
- When, in a trust or similar arrangement, interests pass down multiple generations without Estate or Gift tax vesting in each generation
- When a trust has no General Power of Appointment to a beneficiary
- All transfers after 10/22/86 and lifetime transfers after 9/25/85 are subject to GSTT

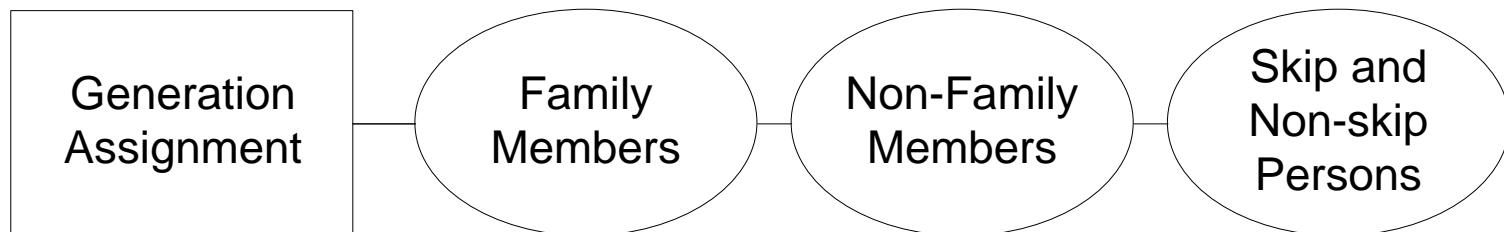


When Does GSTT Not Apply?

- When trust contains a General Power of Appointment to each generation
- When grandfathering rules apply:
 - ◆ Lifetime transfers (gifts) before 9/26/85
 - ◆ Intervivos irrevocable trusts created before 9/26/85
 - ◆ “Gallo Amendment” transfers before 1/01/90
 - ◆ Testamentary irrevocable trusts before 10/22/86
 - ◆ Decedents with revocable plans who have been incompetent from 10/22/86 until death
 - Do we know?



Generation Assignment



Generation Assignment Rules

Family ***Non-Family***

Relationship

Age

Skip/Non-skip

- Family members assigned by relationship
- Non-family members assigned by relative age to transferor
- Determines relative generation to transferor

Generation Assignment – ID at Acceptance

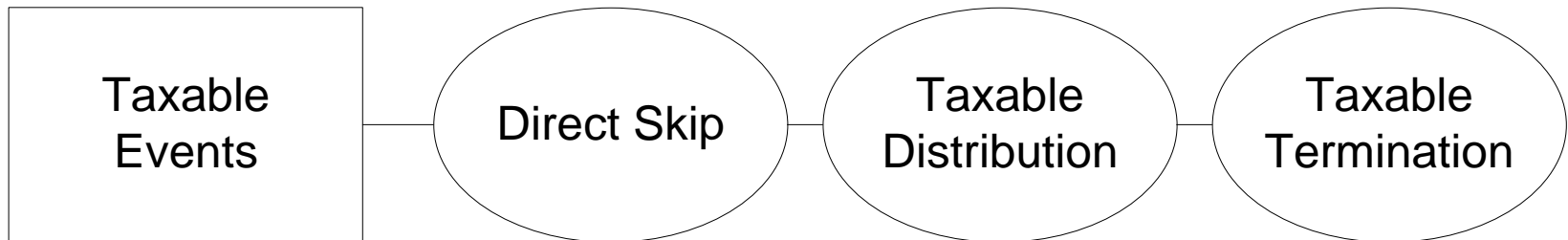
“Skip Person”

- Family member two or more generations below transferor
- Non-family member 37½ years younger than transferor
- Trust with **only** skip person beneficiaries

“Non-skip Person”

- Family member within two generations of transferor
- Non-family member with age within 37½ years of transferor
- Trust with any non-skip person beneficiary

Types of Skips




Types of Skips – Coding of Accounts

Direct

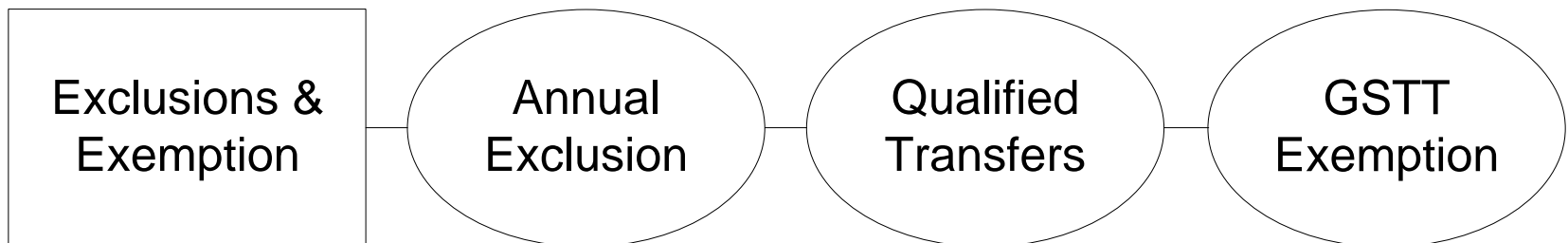
- Skip takes place when transfer becomes irrevocable
- GSTT due at same time Gift or Estate tax applies
 - ◆ Direct Skip

 Who Pays the Tax?

In-Direct

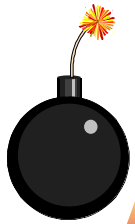
- Skip ***might or will*** take place in the future 
- Gift or Estate tax due on initial transfer
- GSTT due in future at occurrence of a taxable event-Indirect
 - ◆ Taxable Distribution
 - ◆ Taxable Termination

Exemption & Exclusions



Annual Exclusion

- Similar to Gift Tax Annual Exclusion
- Applies to outright direct skips and direct skips to a special trust
 - ◆ Income or corpus can be distributed only to the person benefited by the gift, and
 - ◆ The trust must be includible in the person's estate at death [IRC 2642 (c)]



Beware the application to Crummey trusts



Often not our problem now, but may be later

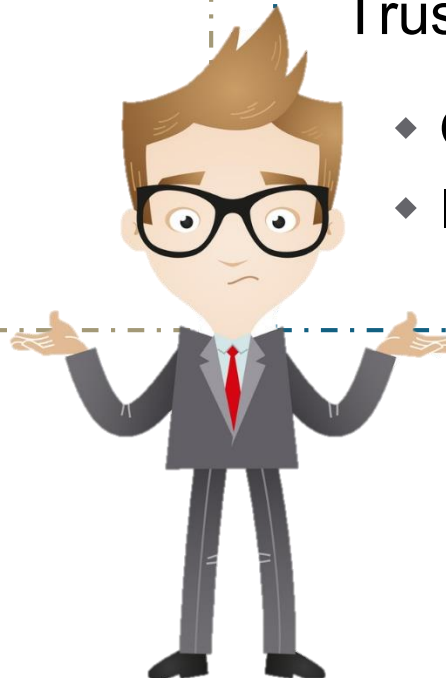
Different Rules for Gift & GSTT

Gift Tax Annual Exclusion (Present Interest)

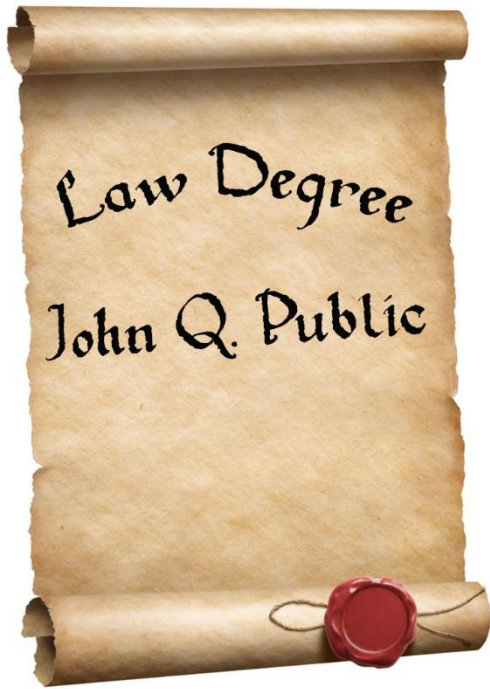
- Outright
- Simple Trust
- Minor's Trust
- Crummey Powers


GSTT Annual Exclusion (Direct skip)

- Outright Direct Skip
- Direct Skip to "Special Trust"
 - ◆ One current beneficiary
 - ◆ Includible in his/her estate



Exclusion for Qualified Transfers



- Direct payment to the service provider of tuition and medical expenses is exempt (as for Gift Tax)
- Unlimited amount
- No relationship need exist
- Applies to donor or distribution from a trust 
 - ◆ So distribute from Non-exempt trust
- §2611(b)(1)

“Gallo” Amendment (Expired)

- \$2,000,000 per grandchild exemption
- Lifetime or death transfers, subject to gift or estate tax
- Transfers made are grandfathered as exempt
- Expired 12/31/89 back to \$1,000,000 per transferor
 - ♦ Are these coded or documented?



GSTT Exemption

- Originally set at \$1,000,000
- Indexed starting in 1999
- Changed in 2004 to new phased in amount = to estate tax basic exclusion amount
- **GSTT Exemption is equal to the Basic Exclusion Amount**
- Allocated by transferor or personal representative on Gift or Estate tax return
- Irrevocable election
- If not allocated, automatic allocation applies
- ◆ Beware Successor Trusteeship and Mergers

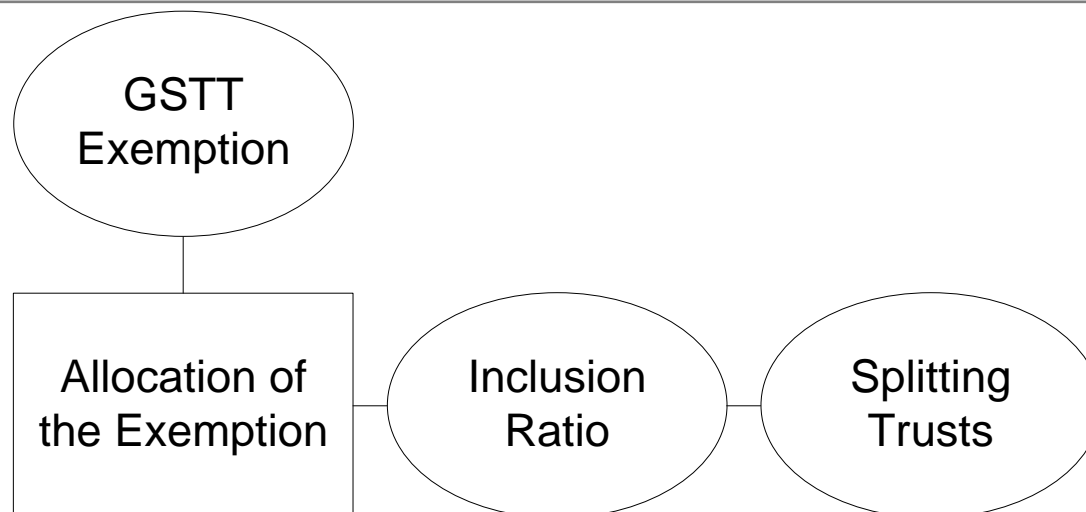


GSTT Exemption Full History

1986 – 1998	\$1,000,000
1999	\$1,010,000
2000	\$1,030,000
2001	\$1,060,000
2002	\$1,100,000
2003	\$1,120,000
2004 – 2005	\$1,500,000
2006 – 2008	\$2,000,000
2009	\$3,500,000
2010	\$5,000,000 with 0% rate

2011	\$5,000,000
2012	\$5,120,000
2013	\$5,250,000
2014	\$5,340,000
2015	\$5,430,000
2016	\$5,450,000
2017	\$5,490,000
2018	\$11,180,000
2019	11,400,000

Allocation of the Exemption

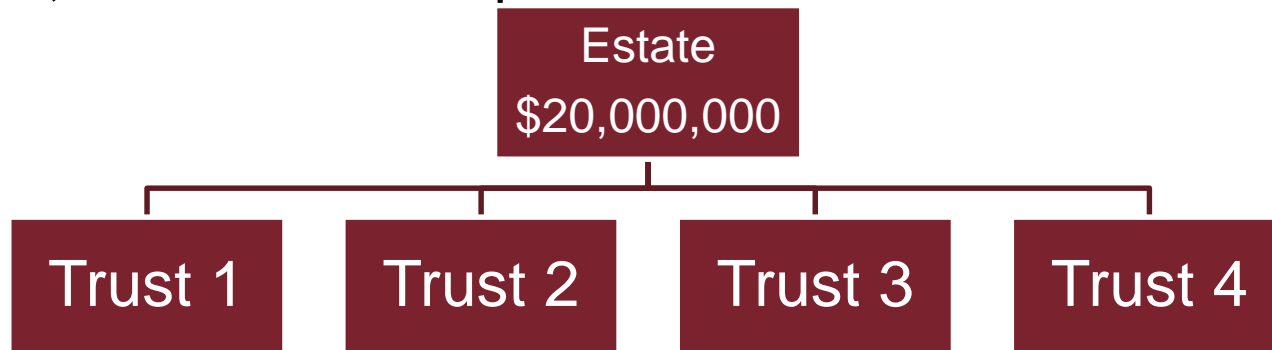


Inclusion Ratio

- Determines the amount (ratio) of the transfer subject to (inclusion) GSTT
- Inclusion Ratio = $1 - \text{Exemption Allocated} / \text{Net Amount Funded}$
- Inclusion ratio = one minus *the applicable fraction*
- Applies at time of direct skip or for the life of the arrangement for an irrevocable trust
- Can be adjusted for later transfers

Example: Inclusion Ratio

- \$20,000,000 net estate
- \$5,000,000 GSTT exemption



$$1 - \frac{1,250,000}{5,000,000} = \frac{3}{4} \Rightarrow 75\% \text{ inclusion ratio for each trust}$$

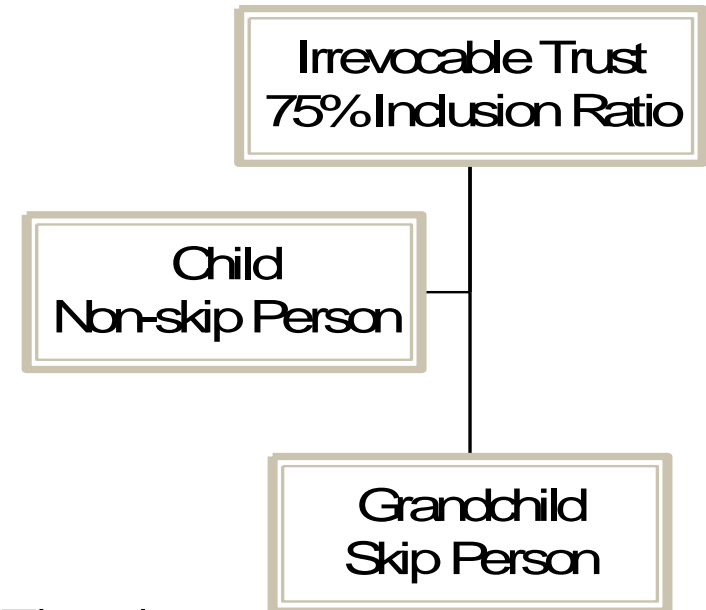
Not always a Tax Decision, do we know the family and see all the variables?



Splitting Trusts

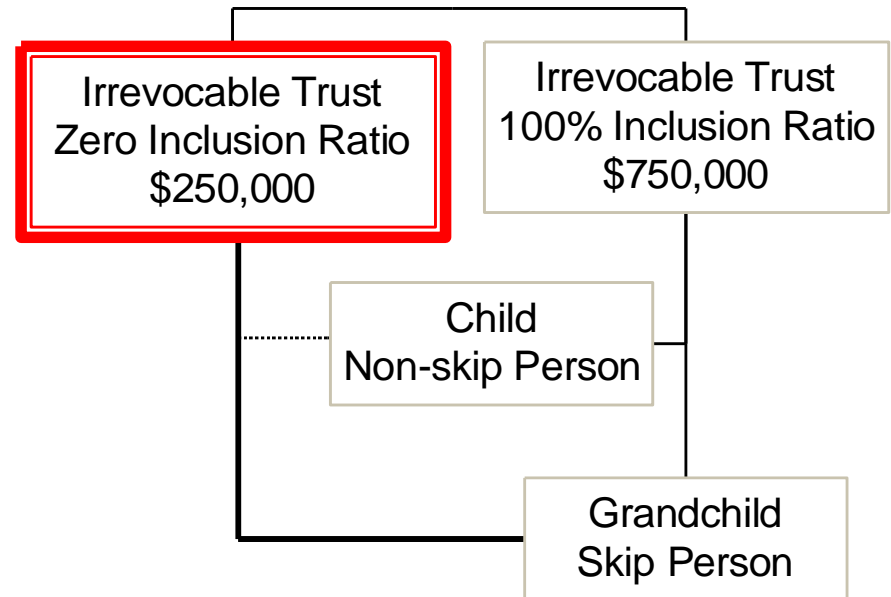
Splitting Trusts Example: No Split

- Start with \$1,000,000
- Distribute \$500,000 at discretion, to Child
- Remainder to grandchild
- $\$500,000 - (500,000 \times (.75 \times .40 \text{ GSTT}) .3) =$
\$350,000 Net to Grandchild



Splitting Trusts Example: Split

- Start with \$1,000,000
- Distribute \$500,000 at discretion, to Child
- Remainder to grandchild



- $\$250,000 + (250,000 - (.40 (250,000) GSTT)) =$
\$400,000 Net to Grandchild

Always, Always, Always...

...split trusts to achieve a zero inclusion ratio!!!



***Did I mention
ALWAYS???***



Watch Mergers and
Successor Trusteeship

Split Trusts, How?

① Formula in document

② Power to split

- ◆ In document
- ◆ Under state law

Staff awareness at
acceptance and initial review



③ Qualified Severance

Qualified Severance

- The division of a single trust and the creation of two or more trusts if:
 1. The single trust was divided on a fractional basis, and
 2. The terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as in the original

- Trustee may elect to sever a trust at any time

“Reverse QTIP” Election

An election to determine transferor

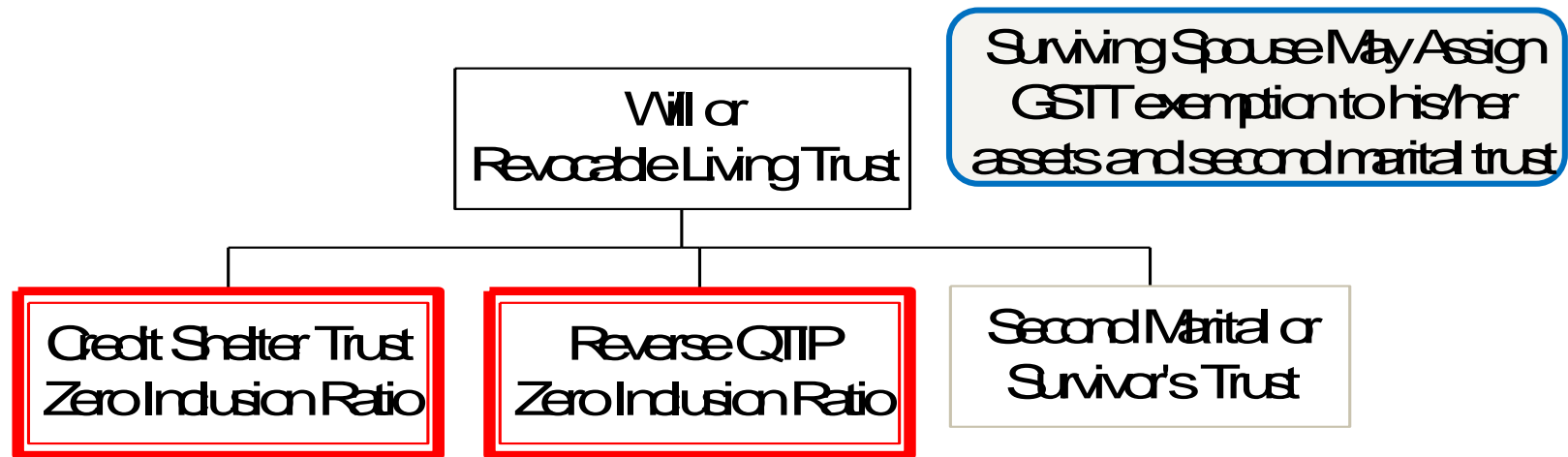
QTIP for Gift/Estate Tax

- Qualifies for marital deduction only if elected
- Treats spouse as transferor even though spouse has no GPOA

Reverse QTIP for GSTT

- Does not affect estate tax marital deduction achieved by QTIP election
- Treats decedent as transferor even though assets are included in survivor's estate
- Enables optimum use of GSTT exemption

Standard GST Estate Plan



Special Rules

Unnatural Order of Death
Deemed Allocation

Unnatural Order of Death

- Transferor may retroactively allocate GSTT exemption when:
 1. Deceased beneficiary is a non-skip person,
 2. Is a lineal descendant of transferor's or transferor's spouse's grandparent,
 3. Is in a generation younger than transferor, and
 4. Dies before the transferor

- Effective Date: 1/1/01

Automatic Allocation

- Applies only if transferor (or executor) does not allocate, and in the following order:
 - ◆ Lifetime Direct Skips
 - ◆ Some Indirect Skips (as discussed on the next page)
 - ◆ Testamentary Direct Skips
 - ◆ Pro-rata to all other transfers which could skip a generation.
Namely trusts which could have a taxable distribution or taxable termination in the future.

Automatic Allocation to Indirect Skips

- Any transfer to a trust subject to gift tax that is a “generation-skipping transfer trust” (i.e., it could have a generation skip)
- Does not apply when:
 - ◆ Over 25% of trust corpus is to be paid to non-skip persons before age 46
 - ◆ Over 25% of trust corpus is to be paid to non-skip person(s) upon the death of another person who is more than 10 years older than the non-skip person(s)
 - ◆ Trust is includible in the estate of a non-skip person
 - ◆ Is a CLT or CRT
- **Transferor can opt out of this deemed allocation**
- Effective Date: 1/1/01

Great Opportunity Harbors Manageable Risks

- ✓ Risk in Vault (unintentional skips)
- ✓ Risk in Inadequate Staff Knowledge (can you see every issue upon reading the document?)
- ✓ Risk in Specific Transactions (ex. gift tax annual exclusion, specific bequests)
- ✓ Risk in Acceptance (identifying issues in advance)
- ✓ Risk in Mergers and Successor Trusteeships (forensic accounting and fixing what is not optimal)
- ✓ Risk in Distributions (controls through account coding and tax compliance)