

# *The* ESTATE PLANNER

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The GST tax exemption

## A TOOL TO GENERATE FUTURE TAX SAVINGS

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to a trust to safeguard assets

ESTATE PLANNING RED FLAG  
You haven't planned for incapacity

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## THE GST TAX EXEMPTION

# A TOOL TO GENERATE FUTURE TAX SAVINGS

The generation-skipping transfer (GST) tax can have harsh consequences. Those who take full advantage of GST planning strategies, however, have an opportunity to shield their wealth from tax and build a lasting legacy.

Last year the GST tax exemption — along with the gift and estate tax exemptions — was increased to \$5 million for 2011 and 2012 (to be adjusted for inflation in the latter year). However, in 2013, absent further legislation, the GST exemption will drop back to \$1 million (adjusted for inflation). To leverage the exemption to maximize wealth for future generations, it may be better to act sooner rather than later.

### GST BASICS

The GST tax, in its current form, was created in 1986 to address a perceived loophole in estate tax laws. Gift and estate taxes were designed to tax property at least once in each generation. People would make taxable gifts or bequests to their children, who in turn would make taxable gifts or bequests to *their* children, and so on.

It didn't take long for affluent families to realize that they could bypass gift and estate taxes in one or more generations by making transfers that skipped a generation. For example, parents might place assets in a trust that paid income to their children for life

and then distributed the trust assets to their grandchildren. Because the children never obtained control over the trust assets, the value of those assets was never included in their taxable estates.

*If your estate is substantially larger than \$5 million, the key to making the most of your GST tax exemption is to allocate it in a manner designed to produce the greatest tax savings.*

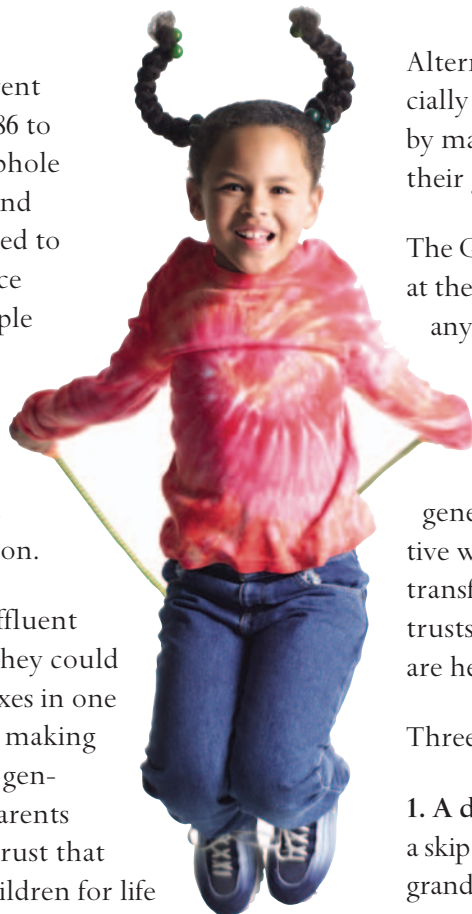
Alternatively, parents whose children were financially independent could skip a generation simply by making outright gifts or bequests directly to their grandchildren.

The GST tax prevents this tax avoidance. It applies — at the highest marginal estate tax rate and *in addition* to any gift or estate taxes otherwise due — to transfers to a “skip person.”

A skip person generally is a grandchild or other relative who is more than one generation below the transferor or a nonrelative who is more than 37.5 years younger than the transferor. GSTs also include transfers to certain trusts, including those whose beneficial interests are held only by skip persons.

Three types of transfers may trigger GST taxes:

1. **A direct skip.** This includes outright gifts to a skip person — such as writing a check to your grandchild — as well as outright bequests at death.



**2. A taxable trust termination.** For example, a child with a life interest in a trust dies, causing the trust assets to pass to your grandchildren.

**3. A taxable trust distribution.** Any distribution of trust income or principal (other than a direct skip or termination) to a skip person.

GST tax applies only to transfers that are subject to gift or estate tax. For example, outright gifts protected by the \$13,000 annual exclusion and direct payments of qualifying tuition or medical expenses aren't subject to gift tax and thus aren't subject to the GST tax. So they're ideal gifts for grandchildren.

As you plan your estate, be aware of the "predeceased child" exception: A grandchild whose parent (your child) has died "moves up" a generation and no longer is considered to be a skip person. Any transfers you make to that grandchild after the parent's death, therefore, aren't subject to GST tax.

## MAKING THE MOST OF THE EXEMPTION

If your estate is substantially larger than \$5 million, the key to making the most of your GST tax exemption is to allocate it in a manner designed to produce the greatest tax savings. You can allocate your exemption to direct skips, as well as to transfers in trust that are likely to result in GSTs in the future.

The advantage of allocating a portion of your exemption to a trust is that it shields future appreciation from GST tax, effectively leveraging your exemption to avoid taxes on amounts well in excess of the current exemption.

## Taking control of the GST tax exemption

To help avoid inadvertently losing generation-skipping transfer (GST) tax exemption benefits, the tax code provides for the exemption to be allocated automatically to certain transfers unless you affirmatively opt out. This includes direct skips as well as transfers to certain trusts that have the potential to benefit skip persons in the future.

Despite Congress's good intentions, the automatic allocation rules don't always work in your best interest. In the example in the main article, half of Jake's exemption would automatically be allocated to the direct skip to his grandson, even though he's better off allocating his entire exemption to the trust. In this case, Jake would be wise to file an election to opt out of the automatic allocation rules.

Whenever you make gifts that will (or may) benefit your grandchildren or more remote generations, it's a good idea to consult your estate planning advisor to be sure you allocate your exemption in the most tax-efficient manner.

Here's an example: In 2011, Jake makes an outright gift of \$2.5 million to his grandson, Jeff. Later, Jake transfers \$5 million to an irrevocable trust that provides his daughter, Betty, with income for life and leaves the remaining trust assets to her children. Jake allocates \$2.5 million of his GST tax exemption to the direct skip gift to Jeff and the other \$2.5 million to the trust.

The trust has an "inclusion ratio" of 0.5 — which is the portion of the transfer (\$2.5 million/\$5 million) that's not protected by Jake's GST tax exemption. Later, the inclusion ratio determines the portion of any taxable distribution or termination that's subject to GST tax.

Suppose, for example, that Betty dies 10 years later and the trust assets, which have grown to \$10 million, are distributed to her children. Based on the trust's inclusion ratio, half of that amount, or \$5 million, is subject to GST tax.

If, instead, Jake had allocated his entire exemption to the trust, the direct skip to Jeff would have been subject to GST tax. But the trust's inclusion ratio would have been zero, shielding the entire \$10 million in trust assets from GST tax. In other words, this strategy would have cut the taxable amount in half, from \$5 million to \$2.5 million.

One of the most effective tools for leveraging the GST tax exemption is an irrevocable life insurance trust (ILIT). You need allocate only enough of your exemption to cover contributions for premium payments to shield the death benefit, and any appreciation in other trust assets, from GST tax.

To implement the most tax-efficient GST tax strategy, be sure you understand the automatic allocation rules. (See “Taking control of the GST tax exemption” on page 3.)

### CREATING A DYNASTY

Strategic allocation of your GST tax exemption to one or more trusts allows you to minimize GST taxes and maximize future growth. A carefully designed GST trust can even serve as a “dynasty trust” that benefits not only your grandchildren, but also future generations for decades to come. ❀



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## ESTATE PLANNING ISN'T JUST ABOUT TAXES

Last year the estate tax exemption amount was increased to \$5 million. If your net worth is under this threshold, can you put off estate planning? From a tax-planning perspective, the increased exemption amount takes some of the pressure off. But estate taxes are only one piece of the estate planning puzzle. In fact, there are critical nontax issues you need to think about.

### APPOINTING A GUARDIAN

If you have minor children, appointing a guardian for them in your will may be the single most important estate planning decision you'll make. If you don't name a guardian, then in the event of your untimely death a court will make the decision for

you. Consider both family and nonfamily members, based on a variety of criteria — from religious beliefs and educational values to age and financial security.

Be sure to discuss your wishes with potential guardians to be sure they want the job. And once you make a decision, name at least one backup guardian in the event your first choice dies, becomes disabled or simply changes his or her mind.

### AVOIDING PROBATE

Estate planning can also help you avoid probate. Probate is a court-supervised proceeding for establishing the validity of your will, valuing your estate, paying certain expenses and distributing your assets

to your heirs. Not only can probate be expensive and time consuming, but it also exposes your financial affairs to public scrutiny.

You can avoid probate by using a revocable “living” trust — except in certain limited circumstances. Further, use of beneficiary designations and other techniques that allow assets to be transferred directly to your heirs outside your will can eliminate the necessity of a probate estate.

## PROTECTING YOUR ASSETS

Many estate planning techniques can protect your assets against creditors’ claims (both your creditors and those of your family members). Asset protection is important regardless of the potential for estate tax liability.

Simple asset-protection techniques include transferring assets to family members, titling property in a manner that avoids certain claims, and making contributions to qualified retirement plans. More sophisticated techniques include domestic or offshore asset-protection trusts and family limited partnerships.

(To learn about a strategy to protect assets from your heirs’ creditors, see “Are your loved ones’ inheritances protected?” on page 6.)

## SHAPING YOUR LEGACY

Money can be a powerful motivator. Regardless of your estate tax situation, you may want to share



your values with your heirs and influence their behavior. For example, you can design a trust that provides your child with a financial safety net but also offers incentives to lead a responsible, productive life.

You can condition trust distributions on virtually any criteria you wish, such as graduating from college, staying gainfully employed, or simply reaching a certain age. One common technique is to link trust distributions to beneficiaries’ earnings — the more money they make on their own, the more they receive from the trust.

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Keep in mind, however, that this approach can penalize heirs who make less money yet lead lives you’d be proud of. One possible solution is to outline general criteria — both financial and nonfinancial — for distributing trust funds and let the trustee determine whether your heirs have met them.

## PLAN NOW

The \$5 million exemption may make estate taxes seem like a remote possibility. But keep in mind that, unless Congress intervenes, the exemption amount will drop to \$1 million beginning in 2013. So you need to be prepared for that contingency.

Even if you’re confident that Congress will make the \$5 million exemption permanent, however, the nontax issues are at least as important as — and perhaps more important than — reducing taxes. ❖

# ARE YOUR LOVED ONES' INHERITANCES PROTECTED?

## ADD SPENDTHRIFT LANGUAGE TO A TRUST TO SAFEGUARD ASSETS

Protecting assets from creditors is a critical aspect of estate planning, but you need to think about more than just your own creditors: You also need to consider your heirs' creditors. Adding spendthrift language to a trust benefiting your heirs can help safeguard assets.

### SPENDTHRIFT LANGUAGE EXPLAINED

Despite its name, the purpose of a spendthrift trust isn't just to protect profligate heirs from themselves. Although that's one use for this trust type, even the most financially responsible heirs can be exposed to frivolous lawsuits, dishonest business partners or unscrupulous creditors. A properly designed spendthrift trust can protect assets against such attacks.

It can also protect your loved ones in the event of relationship changes. If one of your children divorces, your child's spouse generally can't claim a share of the trust property in the divorce settlement.

Also, if your child predeceases his or her spouse, the spouse generally is entitled by law to a significant portion of your child's estate, including property you left the child outright. In some cases, that may be a desirable outcome. But in others, such as second marriages when there are children from a prior marriage, a spendthrift trust can prevent your child's inheritance from ending up in the hands of his or her spouse rather than in those of your grandchildren.

*Despite its name, the purpose of a spendthrift trust isn't just to protect profligate heirs from themselves.*

A variety of trusts can be spendthrift trusts. It's just a matter of including a spendthrift clause, which restricts a beneficiary's ability to assign or transfer his or her interest in the trust and restricts the rights of creditors to reach the trust assets.

### ADDITIONAL CONSIDERATIONS

It's important to recognize that the protection offered by a spendthrift trust isn't absolute. Depending on applicable law, it may be possible for government agencies to reach the trust assets — to satisfy a tax obligation, for example.

Generally, the more discretion you give the trustee over distributions from the trust, the greater the protection against creditors' claims. If the trust requires



the trustee to make distributions for a beneficiary's support, for example, a court may rule that a creditor can reach the trust assets to satisfy support-related debts. For increased protection, it's preferable to give the trustee full discretion over whether and when to make distributions.

Finally, keep in mind that in most states you can't create a spendthrift trust that provides for your

own benefit, though a few states permit so-called "self-settled spendthrift trusts."

## PROTECT WEALTH AFTER TRANSFER

Protecting your wealth after you've transferred it to your family is just as important as reducing tax liability on the transfer. One such strategy is including spendthrift language in a trust. ❀

### ESTATE PLANNING RED FLAG

## You haven't planned for incapacity

Estate planning is often associated with death. But it's just as important for your plan to address incapacity associated with illness, injury, advanced age or other circumstances.

Unless you specify how financial and health care decisions will be made in the event you become incapacitated, there's no guarantee that your wishes will be carried out. Plus, without a plan, your loved ones will be saddled with the difficult task of seeking a court-appointed guardian.



On the financial side, planning tools you should consider include:

**A revocable living trust.** You transfer your assets to the trust, retaining control over your financial affairs by serving as trustee. In the event you become incapacitated, your chosen representative takes over as trustee.

**A durable power of attorney.** This document authorizes your representative to manage your financial affairs and control your assets, subject to limitations you establish.

**Joint ownership.** Holding title to property jointly with another person allows him or her to manage the property in the event you become incapacitated. It's a simple, inexpensive strategy. But it produces two results that may or may not be desirable: 1) It provides your co-owner with immediate, unrestricted access to the property, and 2) the property will pass to him or her when you die. Joint ownership also may trigger negative tax consequences.

On the health care side, planning tools you should consider include:

**A health care power of attorney.** Also referred to as a durable medical power of attorney or health care proxy, this document appoints a representative to make medical decisions for you in the event you can't make them yourself.

**A living will.** Permitted in most states, a living will communicates your preferences for life-sustaining medical intervention — such as artificial nutrition or hydration — under specified, life-threatening circumstances.



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