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Possibly the Best Way to Pass Assets to Your Children or Other Loved Ones: GST Planning - Part One

By Richard M. Morgan & Loraine M. DiSalvo

Eventually, we all pass on. At that point, assuming we didn't die broke, we will usually leave some form of inheritance to people who survive us. Some of us also may also want to make gifts to our loved ones before we die. Proper estate planning allows you to control who will receive a gift or inheritance from you, and to decide how the recipients will benefit from the assets. Proper estate planning can also allow you to provide your beneficiaries with additional benefits, beyond the economic value of the assets they receive. These benefits may include creditor and predator protection, divorce protection, and estate tax protection, among others. Most of our clients over the years have used a technique we generally refer to as "GST planning" to help them maximize the benefits their loved ones will receive from any gift or inheritance. However, we usually have to first explain to the client what GST planning is, how it works, and the benefits it can provide. This month's article is intended to provide an introduction to the concept of GST planning, and how we use it to help our estate planning clients provide for and protect their loved ones. It is set up in an informal, question and answer format. Next month's article will explain things you should consider in setting up a GST planning based estate plan, including considering various factors and selecting an attorney.

Why do you call it "GST Planning"? The "GST" in "GST planning" refers to the "Generation-Skipping Transfer" tax. The Generation-Skipping Transfer tax is one of three federal "transfer" taxes which may apply anytime assets move from one person to another person in a non-purely-business context. Those three taxes are the gift tax, which applies to gifts made during the giver's lifetime, the estate tax, which applies to transfers made at a person's death, and the GST tax, which can apply to either lifetime or at-death transfers. The GST tax essentially applies any time assets pass by gift or inheritance in a manner which skips a generation for gift and estate tax purposes, and it serves to help ensure that the federal government gets a chance to apply a transfer tax at each generational level. The clearest example of a generation-skipping transfer would be a direct gift from a grandparent to a grandchild, which causes the gifted property to avoid being subject to either gift or estate tax in the child's level (the child being the grandchild's parent). Please note, however, that the GST tax is not limited to transfers between family members: for unrelated parties, it is based on the age difference between the transferor and transferee. Like the gift and estate taxes, the federal government also provides an exemption from the GST tax: for 2011, the GST tax exemption can be as high as $5,000,000. This means that an individual who wants to transfer assets during 2011 may be able to transfer up to $5,000,000 worth of assets without generating any GST tax liability. The exemption can also be used to make trusts exempt from the GST tax on a long-term basis, to protect against the possibility that the GST tax will apply if there are trust beneficiaries who are considered to be more than one generation below the trust's creator.

We use "GST planning" as a shorthand way to refer to long-term trust based planning, because the planning uses a client's GST tax exemption to help improve the benefits available to the client's desired beneficiaries. Most of our clients do not actually skip over their children when using GST planning. Instead, their GST exemptions are used to make the trusts which will benefit their children (or other loved ones) exempt from the GST tax on a long-term basis. This helps allow the trusts to last for as long as possible, without repeated estate tax hits to the trust assets. Long-term trusts offer many potential advantages over outright distributions to beneficiaries.

If I don't do GST planning, what would I do? Your options are essentially to do "regular," more common, estate planning, or to do GST planning. In order to contrast regular estate planning with GST planning in the simplest possible context, assume for now that you are an unmarried person (either divorced or widowed), with no significant other, but with three children. You are meeting with an estate planning attorney to have a Will prepared. You intend to ensure that, in the event of your death, your children's inheritance can be taken care of for them during any period where they are very young or immature, and that any assets they inherit from you eventually benefit the children equally. In setting up your Will and determining how your children will receive their eventual inheritance from you, you have two basic options:

1. **Outright distributions**, **either immediately or deferred for some period of time after your death**. This type of plan would generally provide that, upon your death, your remaining assets are distributed into equal shares, one for each of your children. Each share is the child's inheritance from you. The simplest way to have your children receive their inheritances is to provide that, after your death, each child will receive his or her share of your assets outright. If your children are minors, or if they are adults but still young enough that you fear they may not be ready to handle their own finances wisely if your death occurs in the near future, then you can defer the outright distribution for some period of time. Deferring an outright distribution allows you to have a trustee hold and manage the assets for each child who has not yet attained a certain stage of maturity. Generally, for ease of administration purposes in a non-GST plan, deferring the outright distribution means that a trust will be held until the child reaches certain ages. For example, one-half (1/2) of a child's trust could be distributed to the child when he or she turns 25, and the rest could be distributed when the child turns 30. The distribution of the child's trust could also be made contingent upon the occurrence of a specified event, such as a child's graduation from college or a child's marriage. However, it should be noted that such contingencies can create a number of unexpected trust administration-related and drafting complications. Eventually, however, the goal is to get the children's inheritances to them outright, and to have any trusts created be fairly short-term in nature.

2. **GST Planning: long-term trusts for your children's benefit.** As in Option 1, GST planning still has each child receive a separate share of your remaining assets after your death. However, instead of a child's share being distributed to the child outright, either immediately or at some later date, the children's shares are held in trusts, one for each child. These trusts are intended to exist throughout the children's lifetimes. Having the trusts last

throughout the children's lifetimes allows the children to maximize the many potential benefits which can come along with a trust which was created for your benefit by someone else. The trusts can be made very flexible, and the children can each be allowed to control their own trust shares to the greatest extent possible without eliminating the benefits of having the trusts. Or, if you, as the ultimate creator of the trusts, prefer, you can restrict your children's ability to control and demand access to their trusts to some degree. You can also select the default distribution for any assets which remain in trust for the child at the child's death (for example, a child's trust could divide into equal shares for the child's children, if any). You can allow your child to have the ability to pick a different distribution after the child's death, and you can make the range of permissible changes to the distribution as wide or as narrow as you like.

Okay; you say long-term trusts can create potential benefits. So what are all these potential benefits? The potential benefits of having a trust created for you by someone else (such as a parent, significant other, or other person who loves you and wants to provide for you) are many. One such benefit is **creditor protection for the beneficiary**. If I create a trust for another person's benefit, the beneficiary of the trust I create may have creditors. Creditors can include credit card companies, mortgage lenders, and medical care providers. Even the most responsible and level-headed beneficiary can end up having hard times, due to an illness or injury and related expenses not fully covered by insurance, a divorce, a job loss, difficult economic conditions, a failed business venture, or simple bad luck. A person's creditors can, subject to a number of different and complex rules, generally reach assets which that person owns in his or her own name, even if the assets are inherited or received as a gift from another person. However, Georgia, and most other states, allow a person who creates a trust for the benefit of another person to include a "spendthrift" provision in the trust. The spendthrift provision essentially states that the trust assets are not intended to be available to the beneficiary's creditors. Different states may provide different exceptions, such as child support creditors and sometimes tort judgement or criminal restitution creditors, but in general the creditor protection is relatively strong. A beneficiary generally cannot achieve this level of creditor protection for his or her own assets without significant expense and complication, if at all, since most states do not allow you to create a trust for your own benefit with this kind of creditor protection. However, you can provide this protection for your own loved ones quite easily, and at relatively low expense.

Another potential benefit to having assets pass to a beneficiary in a trust is that **the trust may help protect the assets against "predators"** who may seek to take advantage of or steal from the beneficiary. A "predator" could be a beneficiary's significant other, who seeks to use the beneficiary's romantic inclinations to garner gifts or bequests from the beneficiary. A predator could also be a caregiver for a disabled or elderly beneficiary, who seeks to use the beneficiary's dependence on and trust in the caregiver for the caregiver's improper personal benefit. A predator could also simply be someone who befriends the beneficiary and then uses that friendship to gain gifts or bequests. The predator protection provided by a trust will be strongest if the beneficiary is not his or her own trustee, so you may want to name a third party trustee or co-trustee for a beneficiary you feel maybe exceptionally susceptible to predators. However, because the trust spells

out the potential direct beneficiaries, even a beneficiary who is serving as his or her own trustee will have to take deliberate action to allow a predator to receive significant benefits from the trust. In addition, because there will nearly always be someone other than the primary beneficiary who has an interest in the trust (the "remainder" beneficiaries, who will receive assets if the beneficiary dies without making a different provision), there are usually others who will watch over the trust and may object to distributions which improperly benefit a predator. Finally, the trust can limit the potential recipients of trust assets at the beneficiary's death, which can make it unlikely that a predator could receive bequests from the trust assets.

A third potential benefit is **divorce protection**. Assets which a person receives as part of a gift or inheritance are generally considered "separate" property if that person gets divorced, even if there is no premarital agreement in place. However, even if the gift or inheritance begins as separate property, if the person receives the gift or inheritance outright it is extremely easy for the person to accidentally convert those assets to "marital" property which is subject to division in a divorce (or to community property for those beneficiaries who live in community property states). For example, if the beneficiary uses his or her inheritance to purchase a house with his or her spouse, the inheritance which was used to make the purchase is now likely to be considered marital property. The conversion could even occur from something as simple as the beneficiary placing the gift or inheritance into a jointly held bank or brokerage account. If a beneficiary's gift or inheritance is held in a separate trust, however, the beneficiary can simply leave assets in the trust except to the extent they are really needed. By doing so, the beneficiary helps preserve the separate property status of the trust assets. The beneficiary also has to deliberately take assets out of the trust to use them in ways which would result in a potential conversion to marital property, and so has an extra opportunity to think about and consider the possible result of their actions. If a third-party trustee or co-trustee is in place, this protection can be even stronger. Many of our clients have been sold on the benefits of GST planning because of benefit alone, as they often fear that the assets they worked and saved to accumulate may end up with a beneficiary's spouse, rather than remaining available for the beneficiary and the beneficiary's descendants. After all, the divorce rate in the U.S. has hovered around the 50% level for several decades now, and there seems to be no sign that the divorce rate will improve in the future.

A fourth potential benefit to having assets pass to a beneficiary in trust, rather than outright, is that the **trust may be able to avoid estate taxes at the beneficiary's death**, even though the beneficiary was able to benefit from and manage the trust during his or her lifetime, and even though the beneficiary could direct how the remaining trust assets passed at his or her death. This benefit can be provided to the extent that the beneficiary's trust was made exempt from the GST tax through the use of the trust creator's GST tax exemption. While a non-GST exempt trust can still be set up to last throughout a beneficiary's lifetime, if the ultimate beneficiaries of the trust assets after the primary beneficiary's death may include persons who are considered to be more than one generation beneath the trust's creator (such as grandchildren or great-grandchildren), the trust will potentially generate a GST tax at the primary beneficiary's death. Generally, in order to avoid the potential for GST tax, the non-GST exempt trust's assets are simply made includible in the primary beneficiary's estate for estate tax purposes (essentially because the GST tax has typically been a flat tax, while the

estate tax has generally been a bracketed tax, and because the beneficiary's estate tax exemption may be able to cover a significant portion of the assets if they are taxable in the beneficiary's estate). This can be accomplished in many ways, but it's usually preferable to avoid both the GST tax and the estate tax to the furthest extent possible.

So tell me, who gets to decide how these long-term trusts operate? The person who creates the Will or trust which uses the GST planning is the one who gets to decide how the long-term trusts for the beneficiaries are designed. As the client, you can, if desired, require a third-party trustee or co-trustee for a child who you feel may need additional help or guidance. You can limit the people and/or entities to whom your child can have trust property distributed. You can also set forth the default rules which will apply at the child's death if the child does not exercise the power to change the trust's default distribution. You can require certain distributions (although this weakens the protective benefits of the trusts), or you can limit permissible distributions (for example, you can allow distributions to be made only from the trust's net income, you can prevent a beneficiary from distributing trust assets to his or her spouse, or you can limit distributions to "safety net" type expenses such as medical bills). In short, you can call the shots, but to the extent you want to do so, you can let your primary intended beneficiaries make their own decisions. GST planning can be as flexible or as restrictive as you want to make it.

I have a lot of assets in IRAs and qualified plans. Can I use GST planning and still let my beneficiaries get the benefits of continued income tax deferral on those IRA and qualified plan assets? For clients who want to use GST planning but have a lot of assets in IRAs or qualified plans ("tax-deferred retirement accounts"), it is possible to balance the income tax deferral which may be available to beneficiaries with the protective benefits of the GST trusts. In general, the IRS does not consider a trust or an estate to be a proper "designated beneficiary." This can mean that naming a trust as beneficiary of tax-deferred retirement account assets will mean that the account assets have to be withdrawn within as few as five years after the original account owner's death. However, the IRS has rules which allow it to "see through" a trust if the trust meets certain requirements. If a "see through" trust is named as the beneficiary of a tax-deferred retirement account, the IRS will generally use the life expectancy of the trust's oldest living beneficiary as the basis for determining the minimum required distributions which must be taken out of the trust each year after the original account owner dies. Through the use of careful drafting, it is generally possible to structure the long-term trusts so that they will be considered "see through" trusts by the IRS. It may not be a perfect balance, because one option for complying with the "see through" trust requirements restricts potential beneficiaries of tax-deferred assets in unusual ways, while another option will require any amounts actually withdrawn from a tax-deferred account to be distributed outright to the beneficiary immediately, rather than held in the trust. However, the trustee, not necessarily the beneficiary, gets to determine what amounts, if any, are withdrawn from the tax deferred account in addition to the minimum required distributions. For a young, immature, or spendthrift beneficiary, having the trustee stand between the beneficiary and the tax-deferred account can be a great thing. In addition, the inherited tax-deferred account assets which are still in the account receive much stronger protection, for creditor, predator, and estate tax protection purposes,

from the trust's ownership of the account than they would if the beneficiary owned the account directly. So it is still possible to get many of the benefits of GST planning even if many assets are held in tax-deferred accounts.

How do I get started? Contact us at (678) 720-0750 or sollila@morgandisalvo.com to set up an estate planning consultation with either Richard Morgan or Loraine DiSalvo. You can discuss GST planning and find out what benefits it can offer you and your loved ones. If you're not ready for a consultation right now, then watch for our next newsletter for a discussion of the issues you should consider when setting up a GST planning based estate plan.