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Generation-Skipping Transfer Tax Planning

There is both a Federal estate tax and a Massachusetts estate tax imposed on the estates of Massachusetts-domiciled decedents. In 2014, there is a Federal estate tax exclusion of \$5,340,000 (but note that large lifetime gifts can deplete this exclusion) and a Massachusetts estate tax exclusion of \$1,000,000. Assets exceeding those amounts will be taxed accordingly.

Generally, after parents pass away, the children receive their inheritance after the payment of estate taxes. Subsequently, when the children pass away, their estates are subject to another round of estate taxes before the remaining assets pass to their children, and so on. In other words, the taxing authorities get a “bite” with the passing of each generation.

For wealthier families, the obvious solution is to leave assets to lower generations, skipping the intervening generations that do not need the assets to maintain their standard of living. This is referred to as “generation skipping”, and the Federal government (not Massachusetts) imposes an additional tax on this type of transfer. This generation-skipping transfer tax (or “GST tax”) is an additional estate tax (at the highest marginal rate) imposed for skipping one or more generations.

For example, Grandfather leaves his \$10,000,000 estate to his grandchildren. There is an estate tax on all assets over the Federal exclusion, and another estate tax tacked on to that to represent the estate taxes that would have eventually been collected when Grandfather’s child passed away. Note that the GST tax is due from Grandfather’s estate; it is not delayed until child’s death.

The good news is that there is also a Federal GST tax exclusion in the same amount of the Federal estate tax exclusion that Grandfather can apply to his transfer to the grandchildren. Using the same example, Grandfather can instead leave \$5,340,000 to grandchildren, and the balance of his estate to his children (being no estate tax benefit – and actually an additional GST

tax detriment – to skipping them). The GST tax exclusion prevents the additional GST tax from being incurred.

Generation-skipping transfer tax planning – to the extent of the GST exclusion – enables a family to avoid estate taxes for one or more generations, getting the assets to lower generations with less “bites” by the taxing authorities.

But what if you don’t want to “disinherit” your children in case they need the assets at any point in the future? This is possible through the use of a GST Trust. In a typical GST Trust, assets are held for the benefit of the child for the child’s lifetime, but with restrictions on the child’s access to the assets. These restrictions are usually in the form of IRS-approved “ascertainable standards” – the child would be allowed access to the assets for his or her *health, education, maintenance and support*.

Although these are restrictions on a child’s access to the inheritance, they are interpreted with respect to the child’s customary standard of living. The child may not be “allowed” to replace the Mercedes with a Lamborghini, but he or she would never go hungry while assets remained in the GST Trust. It is important to note that the child can serve as his or her own trustee, and thus be the one to make distribution decisions.

As long as the child’s access is restricted, the assets in the GST Trust will not be taxed on the child’s death as part of the child’s estate. Of course, any assets that the child withdraws and does not spend will become part of the child’s estate and will be taxed. So, the child will be instructed by his or her tax advisor to preserve the assets in the GST Trust so that they continue to grow for the next generation, knowing they will not be taxed in the child’s estate.

This is the concept behind what is commonly referred to as a “dynasty” trust, which is a trust that goes on for many generations. Massachusetts does not allow perpetual trusts, so the maximum duration of a GST Trust under Massachusetts statute is approximately 90 years. Several other states do permit much longer durations and even perpetual trusts, which may be of interest to the very wealthy.

A GST Trust will also include provisions for the next generation(s). Commonly, a child will be granted a power of appointment over the assets in the child's GST Trust, which is a power to direct how the assets will be administered for the next generation. This enables a child to address circumstances that were unknown when the parent set up the GST Trust, such as the need for disability planning, spendthrift concerns, and the like. If the child does not exercise the power of appointment, then the GST Trust contains the necessary provisions to administer the assets for the next generation.