

## **Don't Skip GST Tax Planning: Doing So May Cost You Big Money in Estate Tax**

When you transfer assets directly to your grandchildren, the transfer may be subject to a flat 55% generation-skipping transfer (GST) tax. That's in addition to any applicable gift or estate tax -- which also can soar as high as 55%. Fortunately, you can exempt \$1.03 million -- adjusted each year for inflation -- of generation-skipping transfers. For married couples the exemption is \$2.06 million.

If you and your spouse wish to maximize the assets passing to your grandchildren or great-grandchildren, you can reduce or eliminate the amount of GST tax on such transfers in four ways.

### **1. Make Annual Exclusion Gifts**

The annual gift tax exclusion lets you give up to \$10,000 each year (\$20,000 for married couples) to each grandchild or other beneficiary without incurring gift tax. These gifts are also exempt from GST tax. But gifts you make by using irrevocable trusts may not qualify for the annual GST tax exclusion unless you file a gift tax return.

### **2. Pay Education or Healthcare Expenses**

Any payments you make toward your grandchildren's tuition or medical expenses -- provided you pay the school or healthcare provider directly -- are exempt from gift and GST tax. This approach also lets you use the payments as incentives for your grandchildren to attend college or quit smoking, for example.

### **3. Establish GST Gift Trusts**

Establish GST gift trusts for each of your children and contribute up to \$2.06 million to the trusts. Your children can use the trust funds -- including principal, interest and dividends -- during their lifetimes. The assets that remain in the trust at their deaths will pass to their children (your grandchildren) free of GST tax. By the time your grandchildren receive the remaining assets, their value -- and thus the amount you transferred GST tax free -- may have appreciated to dramatically exceed \$2.06 million.

### **4. Set Up A Dynasty Life Insurance Trust**

A more sophisticated strategy is to leverage the GST tax exemption using a dynasty life insurance trust -- otherwise known as an irrevocable life insurance trust with GST tax provisions. The underlying principle is that insurance proceeds are not subject to estate or GST tax as long as the policy is not part of the insured's estate. To establish a dynasty life insurance trust you must:

Insure your and your spouse's lives,

Hold the insurance policy in an irrevocable trust,

Name your grandchildren as the trust beneficiaries, and

Contribute enough money annually to the trust to pay the insurance premiums.

The IRS considers the yearly contributions as gifts to your grandchildren. As long as your total contributions do not exceed the applicable exclusion amount -- \$675,000 for the gift tax exclusion in 2000 -- you will not have to pay gift or GST tax on them. When you die, the insurance proceeds -- which will probably be substantially more than the cumulative premiums paid -- go to your grandchildren GST and estate tax free.

To gain a better understanding of how to use a dynasty life insurance trust, let's examine an example. Ralph and Lucy have set up a dynasty trust to benefit their four grandchildren. They buy \$6 million in joint-survivor life insurance, hold the policy in a trust and name their grandchildren as beneficiaries. The annual premiums are \$80,000. (The actual amount will vary according to the insureds' age and health.) Ralph and Lucy contribute \$80,000 a year to pay the premium. The \$80,000 gift is not subject to GST or gift tax because of the \$10,000 annual exclusion per spouse for each beneficiary -- assuming that the trust has Crummey powers, that you filed gift tax returns and that beneficiaries have a vested interest in the trust.

In addition, Ralph and Lucy are still free to allocate their \$2.06 million GST tax exemption for the benefit of other heirs. After Ralph and Lucy die, their grandchildren can collect \$6 million in insurance proceeds free of estate and GST tax.

If Ralph and Lucy had given their grandchildren an outright gift of \$6 million, \$3.94 million of it (\$6 million -- \$2.06 million exemption) would have been subject to a 55% GST tax, which equals a tax liability of \$2.167 million -- plus the applicable gift tax. In addition, Ralph and Lucy would have used up their entire GST tax exemption so that they could not have allocated it to other heirs.

This example is simplified, and the calculations in an actual case can be complex. But the savings magnitude is realistic.

### **Keep Your Options Open**

If you have grandchildren, don't wait too long to plan your generation-skipping strategies because your options may narrow as you get older. For example, you may not be able to buy life insurance at an affordable price. And complicated rules govern GST tax and dynasty trusts. Seek advice from knowledgeable financial and legal advisers. We would be happy to help you review your options and plan your strategies.