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# Avoiding a GSTT Asteroid[1]

## *Revisiting a Dangerous Adversary: The Generation Skipping Transfer Tax*

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***"It hit with the force of 10,000 nuclear weapons. A trillion tons of dirt and rock hurtled into the atmosphere, creating a suffocating blanket of dust the sun was powerless to penetrate for a thousand years. It happened before. It will happen again. It's just a question of when."***

*—From Armageddon (1998), a motion picture starring Bruce Willis, in which an asteroid heads toward planet Earth.*[2]

The odds that an estate will run afoul of the generation skipping transfer tax (GSTT) may be rather slim nowadays, but estate planners must never let down their guard against this virulent adversary.

The GSTT sneaks up without warning and packs a powerful punch. Just the convoluted process of calculating this tax can send an estate planning professional into a black hole of despair.

Let us review GSTT rules and strategies. But first, to set the GSTT in proper context, we must travel back through the time-space continuum to a more innocent time, before the GSTT existed, when the estate tax was the primary opponent for estate planning.

### The Kennedy Fortune

Joseph P. Kennedy (1888-1969) was the president of a bank at age 25. He boldly invested during the Roaring Twenties and was a master of stock market manipulation and insider trading before such practices were regulated. He became a millionaire by age 30 and had the instinct to sell his stocks before the Great Crash of 1929. He then used short sales to make huge profits during the Great Depression. Ironically, Kennedy later became the first Chairman of the Securities and Exchange Commission.

Other fortunes were made in Hollywood and in real estate. There are rumors that Kennedy had a bootlegging operation, but this may be exaggerated considering Kennedy's foresight in cornering the market on importing legitimate pre-Prohibition alcohol.

The net result was one of America's great fortunes. By 1935, he had amassed $180 million, the equivalent of $2.8 billion today.

### Pre-GSTT Planning

During the years of Joseph Kennedy's peak wealth until his death in 1969, the estate tax had a top rate of 70% or 77%. It was a harsh gatekeeper that applied to every generation. From 1941 on, the 77% top rate applied to assets exceeding $10 million. If taxed at that rate at Joseph Kennedy's death, and then again only one generation later, the Kennedy fortune would have been erased.

Kennedy saw the wisdom of avoiding a 77% tax. By passing wealth directly to his grandchildren, he skipped an entire layer of estate taxation.

For example, trusts that Joseph Kennedy established for John F. Kennedy provided JFK with income for life, as well as the right to withdraw up to 5% of principal in any year. During the Kennedy administration, the President's trust funds were said to be paying him $500,000 in annual income. Because Joseph Kennedy gave only a life estate to his son, the assets were not subject to estate tax at JFK's death. Thus, the government taxed the assets only once, in Joseph P. Kennedy's estate, before those assets reached Joseph's grandchildren, John F. Kennedy, Jr., and Caroline Kennedy Schlossberg.

The Kennedy estate plan shows that when assets are unencumbered by transfer taxes or the need to benefit one particular generation, the family can productively invest those assets in long-term pursuits. The Kennedy trusts held assets ranging from businesses to real estate. The family holding company, Joseph P. Kennedy Enterprises, contained the Merchandise Mart in Chicago, which Joseph Kennedy purchased in 1945 for $13 million and which was eventually sold for $625 million.

## The Next Generation: Camelot

At the time of his assassination in 1963, President John F. Kennedy left a 1954 will that made no provision for his children. Had he lived, he might have adopted a multigenerational trust approach in the same manner as his father.

For the same reasons, it made sense for the President's widow, Jacqueline Kennedy Onassis, to direct her wealth to her grandchildren. She coordinated her GSTT strategy with a charitable lead trust (CLT) that would have reduced taxes and maintained privacy.

Ironically, the public identified the Onassis estate with the use of CLTs, even though the estate's executors ultimately decided not to fund the trusts, demonstrating the flexibility of the Onassis estate plan. One reason for the change may have been the size of the estate, which fell short of the $100-$200 million amounts noted in the press, even with $34.4 million from a 1996 Sotheby's auction of the Kennedy family's personal property. On the other hand, the acclaimed CLT/GSTT arrangement may have resulted in too much GSTT after all.

## Deep Impact: The First GSTT

An entire generation of estate planners has never known a time when the GSTT did not exist. Travel back 35 years to a pre-GSTT age of innocence when Congress first began to sow the seeds of change.

The summer of 1976 was a bicentennial time of tall ships and fireworks. In North Carolina, 5'8" Larry Jordan was beating his little brother Michael in one-on-one in the backyard. On Wall Street, the formation of Kohlberg Kravis Roberts and Drexel Burnham Lambert presaged a future era of hostile takeovers and junk bond deals. Silicon Valley did not yet exist. Steve Jobs, a 21-year-old college dropout, had just started Apple Computers in a garage, one year after 19-year-old college dropout Bill Gates founded Microsoft.

A typical estate planning lawyer might have spent the summer of 1976 musing over the latest Clifford trust techniques and pecking out letters on an IBM Selectric typewriter.

Suddenly, a screaming comes across the sky.[3] It is October, and the Tax Reform Act of 1976 has reached President Gerald Ford's desk. A meteor shower of tax changes unifies estate and gift taxes, increases the marital deduction, provides throwback rules for accumulation distributions from trusts, and makes other profound changes in the transfer tax system including the birth of a new tax, the first GSTT.

## A Fallible Authority

Congress makes mistakes. Tax experiments go awry. Lawyers take for granted the stepped-up basis for assets held at death under Code §1014. Nevertheless, in 1976, Congress attempted to impose carryover basis at death, only to postpone it and ultimately retroactively repeal it (and with quite a low profile) in the Crude Oil Windfall Profit Tax Act of 1980. It was as if the whole messy chapter was just erased, like the 1985 bad-dream season of Dallas. Forgetting this lesson, Congress dabbled with the carryover basis in 2010 and once again cleaned up the mess with a retroactive wipe down of its fingerprints.

Likewise, problems soon became apparent with the first GSTT. For example, instead of a flat tax rate of 55%, Congress imposed the tax at the tax rate of the deemed transferor—the grantor's child or some other member of the generation that was skipped. To calculate the tax rate, the tax return preparer needed to know the size of the deemed transferor's taxable estate, including prior adjusted taxable gifts. This proved to be highly infeasible.

Due to this and numerous other problems, Congress first postponed the 1976 GSTT, amended it three times, and ultimately repealed it retroactively 10 years after the fact. In 1986, Congress provided an entirely new GSTT law. Codes §§ 2601-2663 comprise the 1986 GSTT. Here are five key points about that version of the GSTT.

1. The GSTT did not have a progressive rate schedule. Rather, Congress imposed the tax on nonexempt property at a flat 55% rate.

2. Each person had a GSTT exemption of $1 million, subject to adjustment for inflation.

3. A gift or bequest skips a generation when assets pass to an individual who is two or more generations below the transferor.

4. In the case of unrelated individuals, a transfer generation skips under Code § 2651(d)(2) if assets pass to an individual who is more than 37.5 years younger than the transferor.

5. Each generation is considered to be 25 years.

The current version of the GSTT is similar but has an exemption of $5 million and a tax rate of 35%. If only it were this simple.

## The X Files

Just to keep things interesting, there are several distinct types of generation-skipping transfers subject to the GSTT, each with its own horrendous and paranormal tax implications. A transfer in trust may not result in immediate GSTT. As circumstances unfold, however, a taxable termination or distribution in the future may involve skip persons and may trigger GSTT without triggering additional gift or estate taxes. By comparison, direct skips arise in a more straightforward fashion, i.e., when a direct transfer to a skip person triggers gift or estate taxes, as well as GSTT.

* **Taxable terminations.** Assume that a testamentary trust provides a life interest for Son with the remainder to Grandchild. At Son's death, his intervening trust interest ends and the only remaining trust beneficiary is a skip person, Grandchild. This results in GSTT liability to be paid by the trustee out of the transferred assets. See Code §2612(a)(1) and Code §2603(a)(2). Considering the 35% estate tax that Grandparent's estate paid, the additional GSTT on the remaining assets brings the effective tax rate on the gift to Grandchild up to about 58%.

* **Taxable distributions.** A testamentary trustee's discretionary distribution from a spray trust to a skip person results in GSTT liability to be paid by the skip person and effectively reduces the transferred amount. Code §2603(a)(1). Treas. Reg. §26.2612-1(C)(1) treats the trustee's payment of GSTT as a taxable transfer subject to additional GSTT. What happens if the transferor pays that tax as well? Will there be a gift tax on a GSTT tax after an initial estate tax? With higher rates in the past, this resulted in confiscatory tax rates exceeding 100%. Nowadays, with lower rates, the impact is merely brutal, exceeding 75%.

* **Direct skips with tax payment.** Grandma makes a direct transfer to Grandson. It is a taxable gift with no exclusions. Grandma pays the gift tax. Grandma also pays the GSTT. Grandma's payment of the GSTT is treated as an additional taxable gift. One transfer, three tax hits.

* **Adding to GSTT-exempt trusts.** Never, never do this. A trust that is otherwise exempt from GSTT consequences can become exposed to GSTT consequences if it receives a generation skipping transfer. Separating trusts into GSTT-exempt and non-exempt is an effective strategy, however.

## GSTT Strategies

Reverse QTIPs. Clients and their lawyers should not overlook the grantor's GSTT exemption by transferring all assets to a surviving spouse. If a "reverse" QTIP election is made under Code § 2652, those assets will remain in the deceased spouse's estate for purposes of claiming the $5 million GSTT exemption. Because that election applies to an entire QTIP, a client should use two separate QTIP trusts to make the reverse QTIP election for one of the trusts and use the grantor's GSTT exemption, while the other QTIP remains in the surviving spouse's estate for GSTT purposes. That way, the surviving spouse's GSTT exemption can also be used. The resulting alignment of three trusts looks like this:

**Trust #1:** A credit shelter trust to which the grantor's executor allocates GSTT exemption.

**Trust #2:** A separate QTIP trust to which the grantor's executor allocates the grantor's GSTT exemption remaining after allocation of the exemption to the credit shelter trust and with respect to which the executor makes a reverse QTIP election.

**Trust #3:** Remaining assets in a standard QTIP trust to which the surviving spouse's GSTT exemption will be allocated at his or her death.

* **Anti-GSTT approaches.** A client should use intervening generations when appropriate. If the client exhausts his or her GSTT exemption and plans to skip a generation by leaving assets to a grandchild, this will actually produce a higher tax. The client should consider the alternative of not skipping a generation and leaving assets to a child, in whose hands the assets will be taxed. This may result in a lower overall transfer tax rate. For future flexibility, clients should consider a power of appointment that will allow the child to treat a transfer to a skip person as a taxable gift rather than a distribution subject to the GSTT.

* **Leveraging.** The most effective estate planning is implemented long before death. This is especially true of multigenerational living trusts. A client can apply his or her $5- million GSTT exemption to assets that appreciate by 100% by the time of death, thereby being as valuable as two exemptions. When a client pursues a lifetime generation-skipping gift, he or she should use assets that are most likely to appreciate rapidly.

* **Disclaimer trusts.** When a client plans outright gifts to his or her children, the client can establish unfunded multigenerational trusts that will be activated only if the children, seeing an opportunity to take advantage

of unused GSTT exemption, disclaim inherited assets or powers of appointment and thereby fund the trusts.

### Let's All Skip

As long as a client skips one generation, why not skip more for the price of one? Taking Kennedy's estate plan concept to its logical conclusion, a client could create a trust that is a perpetual source of revenue that would avoid transfer taxes forever and would serve as a family bank to finance his or her descendants.

Although the common law rule against perpetuities imposes a time limit—a life in being plus 21 years can reach about 100 to 120 years—true dynasty trusts can be established, with various limitations, in a growing number of perpetuity havens: Delaware, Idaho, Ohio, New Hampshire, South Dakota, Utah, and Wisconsin now permit perpetual trusts, while Alaska, Colorado, and Wyoming provide for 1,000-year trusts. Nevada and Florida also provide trusts lasting 365 years and 360 years, respectively.[4]

Skipping additional generations does not add to the GSTT bill for direct skips—that is, outright transfers—but see Code § 2653 for multiple skips held in trust.

### The GSTT's Third Incarnation

With its fate tied to the Federal estate tax, the GSTT had a $3.5 million exemption and a 45% top rate in 2009. It was then terminated in 2010 but was then reinstated retroactively for 2010 with a zero tax rate and a $5-million exemption. Why an exemption for a zero tax rate? Avoiding a paradox in the event of chronosynclastic infindibular time travel has not yet been confirmed as the intent of Congress, but the truth is out there.

For the moment, the GSTT will have a 35% top rate and a $5-million exemption for 2011 and 2012 and will likely ride along with the reunited estate and gift tax when it is revised in the next major wave of tax reforms.

No GSTT Portability: It should be noted that the new estate tax exclusion's portability rule for married couples does not apply to the GSTT. Example: Rocky leaves his $10 million estate to his wife, Ramona, and Rocky's timely estate tax return elects to transfer his unused estate tax exclusion to Ramona. At Ramona's death, she has her full $5 million exclusion available, as well as the $5 million from Rocky. Ramona leaves $10 million to her grandson. Her $10 million exclusion shields her estate from estate tax on that transfer, but only $5 million of the transfer is exempt for generation skipping transfer tax purposes.

### Conclusion

GSTT isn't quite the nightmare it once was with combined taxes exceeding 100%. But even with $5 million in exclusions and a 35% tax rate, the combined impact is still a force to be reckoned with that will rock an estate backwards. With care and planning, a lawyer can avoid a GSTT asteroid. Keep watching the night skies, and may the force be with you.

### TECHNICAL REFERENCES

1. "Avoiding a GSTT Asteroid," was originally published as the August 1998 issue of The Estate Analyst. About one-third of that issue consisted of footnotes due to the author's youthful infatuation with trivia. This article was then rewritten and published in the March/April 1999 issue of the ABA's Property & Probate journal. This new version is produced with updates for inclusion in a textbook by Professor Gerry Beyer.

2. On April 13, 2029, the asteroid Apophis, which is the size of a 25-story building, will swing past Earth and has a 1 in 45,000 chance of hitting our planet. Reminder: Party like it's 2028.

3. Opening sentence of Gravity's Rainbow, (1973) by Thomas Pyncheon.

4. Any arrangements like these can skip a lot of generational transfer taxation. Arizona, Illinois, Maine, New Jersey, Rhode Island, and Virginia have also abrogated their perpetuity rules. Most of these states joined the trend in or after 1994. Other states have also included modifications by adopting the Uniform Statutory Rule Against Perpetuities. This approach extends the waiting period to 90 years after creation of the interest. There is some uncertainty, however, about how the GSTT would apply to statutory perpetuity periods that have simply been extended, as opposed to those in jurisdictions in which the rule has simply been abrogated or where exceptions are created for certain types of trusts.

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