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GENERATION SKIPPING—PLANNING PRINCIPLES

— by **Neil E. Harl***

For may farm and ranch families, generation skipping is not part of their estate plans. However, for those wishing to limit the right of one or more succeeding generations to manage the property or the right to dispose of the property, generation skipping may figure into the estate planning effort. For the latter group, several additional guidelines or planning principles should be considered.

Planning principles. Although there may be exceptions in particular situations, several generalized guidelines or planning principles may be stated —

• Perhaps the most important guideline or planning principle is the importance of preserving for skip persons the benefits of trusts or funds to which the $1 million exemption has been allocated and avoid making distributions to spouses, children and other non-skip persons.

Example: A property owner with $1.6 million in farm assets specifies that $1 million is to be set aside in a generation skipping trust with income payable to the three children for life, remainder interest to the grandchildren. The $1 million exemption is allocated to the trust, producing an inclusion ratio of zero. Once that is done, it is well to avoid dissipating the exemption by authorizing distributions to non-skip persons from that trust, if possible.

• In general, allocate the generation skipping exemption to longer term trusts (trusts that are multi-generational, up to the limits imposed by the rule against perpetuities) as opposed to allocation to short-term trusts.

Example: Grandmother, with $2 million in farmland, sets aside $1 million in a trust (trust A) with income payable to the children for life, remainder interest to grandchildren. At the same time, she sets aside the rest of the farmland to another trust (trust B) with income payable to the children for life, then to the grandchildren for life, with the remainder interest held by the great grandchildren.

The $1 million exemption could have greater long term value if allocated to trust B.

• Direct skips are taxed on a tax-exclusive basis with the generation skipping tax paid by the donor or estate not includible in the taxable amount.[1] By contrast, taxable distributions and taxable terminations are taxed on a tax-inclusive basis meaning the amount includes the generation skipping transfer tax paid on it.[2] In general, it is preferable to allocate the generation skipping transfer tax exemption to taxable distributions and taxable terminations as opposed to allocation to direct skips which are tax exclusive.

• In general, GSTT trusts should be designed to have an inclusion ratio of one (which means the trust is fully subject to the GSTT at the maximum rate) or zero (not subject to GSTT). Keep in mind that distributions of income and principal to children and other persons one generation below the transferor can be made without GSTT consequences from a trust with an inclusion ratio of one. Distributions to grandchildren and others in generations two or more below the transferor can be made without GSTT consequences from the trust with a zero inclusion ratio.

Basic planning models

Several different planning approaches may be used to minimize the GSTT (where generation skipping is desired) and at the same time to minimize federal estate tax.

Spousal planning. The $1 million exemption is not freely transferable. If a spouse dies, without fully utilizing the exemption, the unused portion does not pass to the surviving spouse. Thus, careful planning is required to make full and effective use of the marital deduction and at the same time to plan with generation skipping in mind.

A special opportunity exists to make a "reverse QTIP election." After the death of a spouse creating terminable interest property (QTIP), the beneficiary spouse becomes the transferor.[3] However, a transferor creating a QTIP marital trust may elect to treat the QTIP property *as if no QTIP election had been made* for purposes of a generation skipping transfer tax.[4] The effect of the election is to make the spouse creating the QTIP the transferor with respect to the remainder interest. Thus, the spouse creating the QTIP can allocate a part of the exemption to the remainder interest, thus exempting all or part of the QTIP remainder interest that will pass under that trust on the death of the spouse.[5] A reverse QTIP election may be made with respect to a pecuniary bequest formula using date of distribution values, if desired.[6]

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The election must be made with respect to all of the property in the QTIP trust.[7] No partial reverse QTIP elections may be made. IRS has indicated that the regulations will provide, "at a minimum, a form of transitory relief by permitting post-mortem trust severance reformations to enable the estate" of an individual "to conform the QTIP trust to the entire-trust requirement."[8]

Two-trust planning. For an estate in the $1 million range, a workable plan might involve creation of unified credit trust ($600,000 in amount) in the will or revocable trust with the balance in a QTIP trust for which an election is made for the transferor spouse to be treated as the transferor of the entire QTIP (a reverse QTIP election).

The $1 million exemption of the first spouse to die would be used with $400,000 allocated to the QTIP and $600,000 to the unified credit trust.

Three-trust planning. For estates of substantially more than $1 million, the will or revocable trust could create a unified credit trust ($600,000 in amount), a QTIP trust in the amount of $400,000 for which an election is made for the transferor spouse to be treated as the transferor of the entire QTIP (a reverse QTIP election) with the balance outright to the spouse (or in any other form qualifying for the marital deduction).

The $1 million exemption of the first spouse to die would be used with $600,000 allocated to the unified credit trust and $400,000 allocated to the QTIP.

Income tax deduction. An income tax deduction is allowed for the amount of generation skipping transfer tax imposed on income distributions.[9]

FOOTNOTES

1 See I.R.C. § 2623.

2 I.R.C. §§ 2621, 2622.

3 See Ltr. Rul. 8944009, July 31, 1989.

4 I.R.C. § 2652(a)(3). See Ltr. Rul. 9050022, Sept. 14, 1990 (QTIP election for federal estate tax purposes and reverse QTIP election for GSTT purposes); Ltr. Rul. 9101013, Oct. 5, 1990 (same).

5 *Id.*

6 Ltr. Rul. 9125043, no date given.

7 I.R.C. § 2652(a)(3).

8 Ltr. Rul. 9028005, no date given. See Ltr. Rul. 9122071, March 6, 1991 (single trust could be divided into two separate QTIP trusts in conjunction with reverse QTIP election as to one of trusts).

9 I.R.C. § 164(a)(5). See Ann. 91-43, I.R.B. 1991-11, 29.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKING

LIABILITY. After the plaintiffs were not paid for potatoes shipped to a potato broker, the plaintiffs sued the broker's bank, alleging fraud, constructive trust and violation of the Perishable Agricultural Commodities Act (PACA). The fraud action was based on the assertion that the bank's previous honoring of checks written by the broker when the account had insufficient funds was a fraudulent representation that the broker was solvent and had money in the account. The court held that the honoring of such checks was not a representation. The court also held that the bank account was not held as a constructive trust in that the account had no funds to be held and the bank did not use any funds from the account to offset loans to the broker. The court also held that the bank was not an agricultural commodities dealer subject to PACA. **Val-Land Farms, Inc. v. Third Nat'l Bank, 937 F.2d 1110 (6th Cir. 1991)**.

BANKRUPTCY

GENERAL

ESTATE PROPERTY. Under the debtor's Chapter 13 plan, the debtor's debt for a motor vehicle was reduced to the fair market value of the vehicle and the creditor would receive that amount plus 10 percent of the unsecured portion of the debt. After confirmation of the plan, the debtor died and an insurance company paid the creditor the full amount due on the loan, under the debtor's credit life insurance policy. The debtor's estate sought return of the insurance proceeds in excess of the amount to be paid under the plan. The court held that the insurance proceeds were estate property subject to disbursement through the plan. **Matter of McAteer, 130 B.R. 724 (Bankr. D. N.J. 1991)**.

EXEMPTIONS. The debtor claimed an exemption in an IRA, an ERISA qualified pension plan, life insurance policies, annuities and property held with a nondebtor spouse as tenants by the entireties but subject to several joint debts. The court held that the IRA was exempt and that ERISA did not preempt the Florida exemption for interests in ERISA qualified pension plans. The court also held that the entireties property was exempt only to the extent the value of the debtor's interest in the property exceeded the amount of the joint claims against the property. The debtor had purchased a life insurance policy and an annuity using exempt and nonexempt assets. The court held that the policy and annuity were exempt because the debtor made the purchases as part of continuing financial planning and not with the intent to defraud creditors. ***In re* Kimmel, 131 B.R. 223 (Bankr. S.D. Fla. 1991)**.

JURISDICTION. The debtor was an agricultural cooperative which had filed a Chapter 7 case. The plaintiffs were patrons of the cooperative who had purchased supplies from the cooperative which were stored at the cooperative. The defendant was a secured creditor of the debtor which had taken control of the debtor prior to bankruptcy. The plaintiffs alleged that the defendant seized the supplies purchased by the plaintiffs and stored by the defendant and charged additional amounts for the release of these supplies. The plaintiffs brought suit in a state court alleging conversion, fraud,