

Chapter 9.

Generation-skipping Transfers

A detailed discussion of generation-skipping transfers and the associated generation-skipping tax imposed by chapter 13 of the Internal Revenue Code (IRC) is beyond the scope of this book. The procedures involved are complex in nature and often hazardous to implement.

Nevertheless, generation-skipping transfers, if properly planned, can be used to provide income free of Federal estate and gift taxes to one or more generations of direct heirs. The property itself eventually passes to a person or persons two or more generations down the line. The forest estate planner should therefore be alert to the benefits of generation-skipping transfers while at the same time understanding the disadvantages.

GENERAL PROVISIONS

Every individual has a \$1 million generation-skipping transfer exemption which he (she) can allocate during life by gift or at death by will to any number of generation-skipping transfers. An allocation, once made, is irrevocable. Married couples can elect to split the use of the exemptions, thus raising the amount to \$2 million, much like the case of split gifts discussed in chapter 8.

The generation-skipping transfer tax is imposed at the time the property is eventually transferred. Unlike the estate and gift tax, which has a progressive rate structure, the generation-skipping tax is imposed at a flat rate equal to the maximum Federal estate tax rate in effect at the time of the eventual transfer--currently 55 percent plus a possible surtax.

A generation-skipping transfer involves use of a granted life estate that can either be held in trust or created outside of a trust. Life estates not held in trust are referred to as legal life estates. The disclaimer provisions of Federal law discussed in chapter 7 apply for generation-skipping transfer purposes (see IRS Letter Rulings 8815034 and 8907028).

Advantages

If the family goal is to preserve the woodland operation intact through more than one generation,

minimization of the estate tax in the estates of the children of the current generation is critical. Preserving the operating property for the lifetime of the children is consistent with such a family goal, and thus a generation-skipping transfer may be an ideal arrangement.

Example 9.1. A grandparent (A) might leave by will a tract of timber property valued at \$500,000 to his child (C) for life, with a remainder interest to a grandchild (G). C, the life tenant, would be entitled to the income from the property for life. At C's death, title to the property would pass to G. Under current law, an exemption from Federal tax of \$1 million per transferor, as discussed above, is provided. This means that the property in question would be subject to Federal estate tax in the estate of A but not again until the death of G. At G's death, the transfer would be subject to a flat rate of 55 percent under current law. The same rule would apply if the transfer by A had been made by deed during his lifetime rather than by will at his death, with the normal \$1 million exemption.

Strategic use of the \$1 million exemption will permit particularly large sums to escape taxation. Assets with the greatest potential for appreciation should be used to fund generation-skipping transfers.

Disadvantages

A number of disadvantages apply to generation-skipping transfers. In specific instances, these may offset the potential benefits. A careful analysis of each particular situation is critical in order to avoid costly mistakes.

Special use valuation as discussed in chapter 13 applies only to generation-skipping transfer property as included in the transferor's gross estate, not to the property as included in the eventual transferee's estate. The same rule applies to the installment payment of estate tax under Section 6166 of the IRC as discussed in chapter 14. As mentioned above, the property will be taxed in the transferee's estate at the maximum rate then in effect, and without benefit of the unified credit. The credit for previously taxed property (see page 22) also is not allowed. With respect to life-time generation-skipping transfers, the

\$10,000 gift tax annual exclusion is not available if the transfer is not of a present interest. (See chapter 8 for a discussion of the annual exclusion.)

Special Problems with Timber Properties

Problems may arise with legal life estates over the question of how far the life tenant can go with respect to certain actions involving the property in question. This is particularly important with timber-land.

For example, what constitutes income from a timber property? Will harvesting be restricted to cutting only timber volumes equal to the growth that occurs

after creation of the life estate? Or can additional harvesting be done if part of a professional forest management plan? What rights do the life tenant have with respect to making changes on the property where an expenditure of funds would be needed to return the land to its previous condition? What about minerals? State law in many instances controls the answers to these questions. In some cases, however, depending on the State in question, there are no clear guidelines. For these reasons and more, a trust with carefully drafted powers for the trustee can provide a more flexible management structure than could a transfer outside of trust. (See chapter 10 for a more detailed discussion of trusts.)