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TAX & TRANSACTIONS BULLETIN

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- Families are subject to Estate Tax at each successive generation.
- A solution is for Mom and Dad to establish a Generation-Skipping Exempt Trust for Child.
- The GST Exempt Trust allows Child to have lifetime access to Trust assets, but avoids transfer tax on those assets upon Child's death.
- Thus, the Trust provides financial security to successive generations of Family Members while permanently avoiding transfer tax.
- A favorable rule permits Child to be both Beneficiary and sole Trustee of his own Trust, and avoid Estate Tax and GST Tax.

Inside this Volume:

GENERATION–SKIPPING TAX PLANNING CAN INCREASE FAMILY WEALTH

Many U.S. Families have accumulated significant wealth. People often desire to keep this wealth within their Family. Typically, a married couple distributes assets for each other during their joint lifetimes, and then distributes assets to younger generations. These distributions are subject to 3 transfer taxes: Gift Tax, Estate Tax, and Generation-Skipping Tax.[1] These 3 taxes are interrelated, and apply to all transfers of wealth from one individual to another.

Each tax has its own Credit.[2] The Credit reduces tax on a dollar-for-dollar basis.[3] A Credit thus permits tax-free transfers of Family wealth. The Credits assist a married couple in providing for each other during their joint lifetimes, and then distributing property to their children and grandchildren. Careful planning with Credits can maximize Family tax savings.

Families are subject to Estate Tax at each successive generation.[4] For instance, if Mom and Dad transfer assets to Child, there may be an Estate Tax on Child's assets. A solution is for Mom and Dad to establish a Generation-Skipping Exempt Trust for Child. The GST Exempt Trust allows Child to have lifetime access[5] to Trust assets, but avoids transfer tax on those assets upon

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[1]The phrase "Generation-Skipping" may be abbreviated as "GST".
[2]The GST Credit is also referred to as the GST "Exemption". The federal GST Exemption is currently $2 million, increasing to $3.5 million on January 1, 2009.
[3]The GST Tax equals the value of the transferred property *multiplied by* 45% *multiplied by* the Inclusion Ratio. The "Inclusion Ratio" equals one (1) *minus* {the GST Exemption Allocated *divided by* the value of the property when transferred/gifted/bequeathed.} The fraction represented by {the GST Exemption Allocated *divided by* the value of the property when transferred/gifted/bequeathed} is referred to as the "Applicable Fraction".
[4]The GST Tax is in addition to any estate or gift tax on a transfer. For example, an outright bequest to Grandchild is subject to two (2) transfer taxes: (1) Estate Tax; and (2) GST Tax. Absent proper planning, the total transfer tax may be larger than the value of the property transferred. Careful planning is therefore essential. [Note: The purpose of the GST Tax is to collect or fill-in for the missing estate/gift tax, where property is distributed to a beneficiary two (2) or more generations below the Grantor in a manner that fails to trigger a 2nd estate/gift tax.]
[5]Child can be sole Trustee of his own Trust and avoid Estate Tax and GST Tax. See PLR 200450033; PLR 200637021. See also Revenue Ruling 78-398 which states: "…a power of appointment that is measurable in terms of a beneficiary's needs for health, education, support, or maintenance is not regarded as a general power of appointment even though the power is possessed by the beneficiary as [sole] trustee of the property subject to the power."

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Child's death.[6] After Child's death, the GST Exempt Trust continues on for Grandchildren, then for Great-grandchildren, and so on.[7]

The GST Exempt Trust has three (3) main advantages. First, it eliminates Estate Tax on all subsequent Trust transfers.[8] Second, it eliminates GST Tax on all subsequent Trust transfers.[9] Third, it eliminates GST Tax on the entire Trust value including all future appreciation, thus eliminating tax on amounts far greater than the original gift to the Trust.[10]

The GST Exempt Trust is designed to provide Family Members with maximum access to assets while nevertheless avoiding transfer tax. The Trust may continue for many generations. Thus, the Trust provides financial security to successive generations of Family Members while permanently avoiding transfer tax.[11]

Mom and Dad can designate Child as sole Trustee of his GST Exempt Trust and still avoid Estate Tax and GST Tax. A favorable rule permits Child to be both Beneficiary and sole Trustee of his own Trust, and avoid Estate Tax and GST Tax. This rule allows Families to keep control and ownership of Trust assets within the Family and obtain tax savings. A major benefit of the GST Exempt Trust is the Family's ability to retain control and ownership of Trust assets consistent with tax savings.

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[6]The GST Exempt Trust avoids estate tax since the beneficiary does not hold a general power of appointment. See PLR 200450033; PLR 200637021; Revenue Ruling 78-398. The GST Exempt Trust also avoids generation-skipping tax provided the Grantor allocates sufficient GST Exemption to the Trust.

[7]At each successive generation, the GST Exempt Trust allows a Family Member to have lifetime access to Trust assets, but avoids transfer tax on those assets upon the Family Member's death.

[8]See PLR 200450033; PLR 200637021; Revenue Ruling 78-398. The Trust should be outside the taxable estate of each beneficiary, even where the beneficiary is sole Trustee of his own Trust. Also, the Trust can be designed to continue for many generations as an Illinois Qualified Perpetual Trust, thus continuing to benefit the Family for many generations to come. [See 765 ILCS 305/3(a-5), (the rule against perpetuities shall not apply).]

[9]In contrast, an allocation of GST exemption to an outright gift or bequest only eliminates one (1) GST Tax.

[10]The GST Exempt Trust eliminates GST Tax on the entire Trust value including all future appreciation. Elimination of GST Tax on all future appreciation of the Trust is an important benefit. [See IRS Regulation §26.2642-4(a) which states: "The nontax portion of a trust is determined by multiplying the value of the trust assets, determined immediately prior to the event, by the then Applicable Fraction."]

[11]The GST Tax applies to three (3) types of transfers: (1) Direct Skips; (2) Taxable Terminations; and (3) Taxable Distributions. A "Direct Skip" is an outright gift or bequest to an individual who is 2 or more generations below the transferor, or a transfer to a Trust all of whose beneficiaries are 2 or more generations below the transferor. A "Taxable Termination" occurs at the first instant moment when all interests in a Trust are held by individuals who are 2 or more generations below the transferor. A "Taxable Distribution" is a Trust distribution to a beneficiary who is 2 or more generations below the transferor (unless the beneficiary's interest was previously taxed as a Direct Skip or a Taxable Termination).

The following Example illustrates the benefits of a GST Exempt Trust:

Dad bequeaths $2 million to an Irrevocable Trust which pays mandatory income and discretionary principal[12] to Child for life, then to Grandchild for life, then to Great-grandchild for life, and so on.[13] Child is sole Trustee.[14] Dad allocates his entire $2 million GST Exemption to the Trust.[15] The Trust is a qualified perpetual trust under Illinois law.[16] Although a Taxable Termination occurs on the death of Child, and on the death of Grandchild, and on the death of Great-grandchild, the GST Tax for all three (3) Taxable Terminations is zero (0.00). The GST Tax remains at zero (0.00) even though the Trust assets appreciate in value over time. Dad's initial allocation which made the Trust GST Exempt results in the elimination of GST Tax on all subsequent generation-skipping transfers of Trust principal plus all appreciation. If the value of the Trust increases to $10 million, the entire $10 million is exempt from GST Tax and Estate Tax.

[12]The Trustee may distribute principal for the "support" of a beneficiary. [**Note:** under Code Section 2041(b)(1)(A), a power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent is not a general power of appointment. See Revenue Ruling 78-398.]
[13]Child is sole Trustee during his lifetime; then Grandchild is Trustee; then Great-grandchild is Trustee.
[14]Grandchild and Great-grandchild are Successor Trustees.
[15]This allocation of GST Exemption results in an Inclusion Ratio of zero (0.00). Technically, it is Dad's Executor who makes the allocation.
[16]The Trust can be designed to continue for many generations as an Illinois Qualified Perpetual Trust. See 765 ILCS 305/3(a-5).

IRS ISSUES FIRST RULING APPROVING SERIES LLCs

The IRS has issued its first Ruling approving the use of a "Series Limited Liability Company."[1] A Series LLC is a single Master LLC entity with separate and distinct underlying business lines. Each separate underlying business line is referred to as a separate Series. Each Series functions as a separate LLC with its own distinct business objectives, earnings, taxable income, assets and liabilities, owners, creditors, voting, and management. Effectively, each Series functions as a separate limited liability entity.[2]

A primary benefit of a Series LLC is reduced administrative costs, since the owners merely need to file one (1) Master LLC organizing document with the State. This one (1) Master LLC can initially authorize multiple Series, and may permit subsequent creation of additional Series without additional State filings.

[1]See PLR 200803004 (IRC Sec(s). 7701, 01/18/2008). A Series Limited Liability Company is also known as a "Series LLC".
[2]Illinois authorizes the creation of a Series LLC. See 805 ILCS 180/37-40.

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In PLR 200803004 the IRS ruled that a single Master LLC may create separate Series which are respected for tax purposes. Each separate Series has the following characteristics:[3]

- Each separate Series may be classified for federal tax purposes as a single-member disregarded entity, a partnership, or a corporation, depending on its own characteristics.
- Allocations of taxable income, gain, loss, deductions and credits of each Series classified as a partnership for federal income tax purposes are made in accordance with Sections 704(b) and 704(c). Generally, each member's allocable share of such Series' income or loss will be comprised of a proportionate share of each item of income or loss of such Series.
- Each Series will consist of a separate pool of assets, liabilities and stream of earnings.
- The members of a Series may share in the income only of that Series.
- The ownership interest of the members of a Series will be limited to the assets of that Series upon redemption, liquidation, or termination of such Series.
- The payment of the expenses, charges and liabilities of a Series will be limited to that Series' assets.
- The creditors of a Series are limited to the assets of that Series for recovery of expenses, charges, and liabilities.
- Each Series will have its own investment objectives, policies and restrictions.
- Votes of members may be conducted by each Series separately with respect to matters that affect only that particular Series.

The IRS effectively ruled that each LLC Series is itself a separate entity for both tax and business purposes. Thus, each LLC Series may be structured as a single-member disregarded entity, as a partnership, or as a corporation. This tax treatment is consistent with the choices currently available to a "regular" LLC. Although this Ruling provides some guidance, there likely remain many unanswered questions about Series LLCs.[4]

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[3] PLR200803004.

[4] At least some practitioners remain hesitant to use Series LLCs since (1) not all States recognize them which may create inter-State issues, and (2) some business owners may encounter practical difficulties in attempting to properly segregate assets, earnings, and ownership for each distinct Series.

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