Generation Skipping Trusts

In the natural order of things, parents tend to leave their assets to their children. The children, in turn, leave assets to their children. When this happens, assets may be subject to gift or estate tax at every generation. This, of course, is exactly what the IRS wants. With the use of a generation skipping trust, however, this result can be avoided.

Example
Assume that a mother dies in 2002 leaving an estate of $1,000,000 to her only son. The mother's estate pays no estate taxes and the son receives the entire $1,000,000. If the son has $2,000,000 of his own and continues to own the inherited assets until he dies in 2006, his estate pays about $460,000 of taxes on the inherited assets and his children receive only about $540,000 out of the original $1,000,000.

By contrast, the estate tax could have been avoided with the use of a generation skipping trust. Instead of making an outright bequest to her son, the mother could have created a trust which pays all of its income to her son during his lifetime and authorizes distributions of principal to him if needed. The mother's estate would still pay no estate tax, and the trust would receive $1,000,000. Because the son does not own the trust assets, they are not subject to tax when the son dies. Instead, the entire $1,000,000, plus any appreciation on those assets, can be distributed to his children without being subject to estate tax. In this example, estate taxes are reduced by $460,000 or more.

Prior to 1986, wealthy families often used generation skipping trusts to avoid the estate tax. As might be expected, Congress and the IRS viewed this technique as a tax "loophole". Their response was to impose another tax known as the generation skipping tax. This tax, which is in addition to the federal gift tax and the federal estate tax, is imposed at the maximum estate tax rate (currently 50%). In general, when assets are transferred to someone more than one generation younger, the transfer can be subject to both gift or estate tax and to generation skipping tax. The generation skipping tax can make transfers to grandchildren or more remote descendants very expensive.

Fortunately, the tax law originally granted each taxpayer a $1,000,000 personal exemption from the generation skipping tax. The exemption is indexed for inflation and currently stands at $1,100,000. This means that any person can give up to $1,100,000 to grandchildren or to a generation skipping trust without worrying about the generation skipping tax. Married couples can give up to $2, 200,000 before the generation skipping tax applies.

Under the 2001 Tax Act, the generation skipping tax exemption is scheduled to increase to $1,500,000 in 2004, to $2,000,000 in 2006 and to $3,500,000 in 2009. These increases mirror the scheduled increase in the estate tax exemption. In 2010, the estate tax and the generation skipping tax are both repealed, but then they are both reinstated with a $1,000,000 exemption (as adjusted for inflation) in 2011. There are proposals to make the repeal permanent, but given projected federal budget deficits, many consider this unlikely. It is possible that both taxes will remain in force, perhaps with an increased exemption amount.

Not all transfers to grandchildren are subject to the generation skipping tax. For instance, there is a special rule that exempts transfers to grandchildren when their parent who was a child of the donor is deceased. In that situation, the grandchildren are deemed to "move up" one generation, so there is no generation skipping transfer and no tax applies. Also, outright gifts which qualify for the $11,000 annual gift tax exclusion are exempt from the generation skipping tax. Annual gifts provide another effective technique for avoiding the generation skipping tax, especially when a gifting program is begun early. Finally, direct payments of education and medical expenses which are exempt from gift tax are also exempt from generation skipping tax.

For taxpayers whose estates are smaller than the exemption amount, the generation skipping tax is not a cause for concern. However, even when a person's estate is less than the exemption and no estate or generation skipping tax will be due, the exemption presents planning opportunities. Many parents have worked and sacrificed to ensure that their children will be financially better off than they were. We frequently encounter situations where a child has done so well financially that estate planning for the child has become necessary in order to minimize estate taxes. In these cases, receiving an inheritance from a parent will only add to the child's estate tax problem. Since it is unlikely that the child will actually need the additional assets, in such cases we often recommend that parents change their estate plan to create a generation skipping trust rather than giving assets outright to the child. Because the trust can pay income to the child for life and distribute principal if needed, the child will have the financial benefit of the assets. The child can also be named as trustee, so the child can have investment and administrative control of the assets. However, because the child does not actually own the assets, the assets will not be included in the child's taxable estate and, upon the child's death, can pass to grandchildren without any estate tax.

If you have a child who is financially successful and unlikely to need the assets you might leave, you may wish to consider revising your estate plan to include a generation skipping trust. Likewise, if you are in a situation where estate taxes are a concern and you anticipate an inheritance from your parents, you may wish to discuss this technique with them and suggest the use of a generation skipping trust in order to reduce taxes in your estate.

While most generation skipping planning involves skipping a single generation, it should be noted that Wisconsin and Illinois law offer a special opportunity for multi-generational planning. Most states have a law, known as a rule against perpetuities, which is designed to limit the period of time during which a trust can exist. In Wisconsin and Illinois, the rule against perpetuities generally does not apply. Thus, it is possible to create a trust that will span several generations or even continue in perpetuity. While a gift or estate tax may be payable upon the creation of the trust, once it is established, the trust can continue for the benefit of successive generations of your family without ever being subject to estate or gift tax again.