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Protect Against The Generation Skipping Transfer Tax

If some or all of your estate bypasses your children and goes directly to a grandchild when you die, your estate might have to pay a tax called the generation skipping transfer (GST) tax. This is a very expensive tax. It is equal to the highest federal estate tax rate in effect at the time, and is *in addition to* the federal estate tax.

"Skipping a generation," and incurring this tax, can happen in three ways. It can happen intentionally, for example if you "skip" the living parent (your child) and leave an inheritance directly to your grandchildren. It can also happen unintentionally. For example, if the inheritance is in a trust for your child, he or she dies after you but before receiving the full amount in the trust and your grandchildren will receive their parent's remaining inheritance under the terms of the trust, it could then be subject to the GST tax. This tax also applies if you leave assets to a non-relative who is more than 37 1/2 years younger than you.

Why do we even have this tax? Well, in the past, generation skipping trusts were common, especially among the wealthy. The grandfather would set up a trust that distributed only income (no principal) to his children. The trust principal would be distributed later to his grandchildren and future generations. This allowed the trust assets to grow estate tax-free and appreciate in value. And it avoided the heavy taxation that would have occurred if each generation had been taxed on the full inheritance. The Rockefellers are one family who used this concept to great advantage, building (and retaining) considerable wealth for several generations.

Eventually, of course, Uncle Sam decided he wanted his share of taxes, just as if each generation had received its inheritance and paid estate taxes on it. So, if you leave substantial assets to your grandchildren and future generations - bypassing your children's generation -- these assets may be subject to the GST tax.

The good news is that everyone has an exemption from this tax. In 2016, each person has a $5.45 million exemption (the amount adjusts annually for inflation). So, you and your spouse together could leave up to $10.9 million to your grandchildren and future generations without having to pay the generation skipping transfer tax. This amount is expected to increase as the exemption is adjusted for inflation. Just like the federal estate tax exemption, you have to plan ahead so you don't waste your GST tax exemptions. Unlike the estate tax, there is no “portability” or transferability for the GST tax exemption from one spouse to another, so a trust of some kind is almost always necessary.

One way to do this is with an A-B-C living trust. When one spouse dies, the estate can be divided in half. The deceased spouse's GST tax exemption can be applied to his/her half (Trust B + Trust C). And when the surviving spouse dies, his/her GST tax exemption can be applied to Trust A. This arrangement makes full use of both exemptions. Of course, this same planning can also be done in a will, but you would not enjoy the many benefits of a revocable living trust.