GENERATION-SKIPPING TRUSTS

DEFINITION

A generation-skipping trust is an estate planning tool in which the assets contributed to the trust are passed down to the grantor's grandchildren, not the grantor's children. The grantor's children skip the opportunity to receive the assets in order to avoid the estate taxes that would be applicable if the assets were transferred to them. This type of trust can also be used to avoid exposure to children's financial debt, failed businesses, or divorces.

HOW THEY WORK

TAX BENEFITS

When an individual dies, their assets are subject to an estate tax. If a couple were to pass their assets to their children, those assets would first be reduced by the amount of the estate tax. If the assets were then passed to the grandchildren upon the children's death, those assets would be reduced again by the amount of the estate tax. In situations where the children are already financially independent, the grandparents may want to provide for their grandchildren and great-grandchildren instead of gifting all of their assets to their surviving children. Such a transfer would be subject to a "generation-skipping transfer tax (GSTT)." A generation-skipping trust allows the assets to escape the GSTT. It provides for all descendants to benefit from assets held in the trust without estate tax being imposed when the children die, and subsequently when the grandchildren pass away.

NON-TAX BENEFITS

There are also other benefits to setting up a generation-skipping trust and is not just utilized by the super wealthy. These include the ability to restrict a child's access to the assets which can also mean restricting that child's obligations from the assets. If a child has gone through a divorce, a failed business, had gambling debt obligations, or any other potentially devastating event, those debtors do not have access to the assets in this type of trust. Since the assets never legally belong to the child, they are not accessible to pay their obligations.

TRUST INCOME

Even though the beneficiary does not have access to the trust's assets, he or she does have access to the income it generates. This can also help in the case of a spendthrift child. The child does not have control over the timing or distributions of those assets. The income generated by the trust's assets, such as dividends, can be made available to the children while preserving the assets for a future generation.