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TOPIC: It Can Really Last Forever: Irrevocable Life Insurance Trusts & the Generation-Skipping Transfer Tax – 4 Things to Know.

MARKET TREND: Impending tax reform and questions regarding the future of the estate and GST tax create substantial incentives for acquiring life insurance as a means of creating certainty and stability for a long-term trust plan. While tax law changes may come and go, the family legacy remains protected. Ensuring proper treatment of the trust for generation skipping transfer ("GST") tax purposes, however, is critical to fulfilling these long-term legacy planning objectives.

SYNOPSIS: The GST tax generally applies to transfers to irrevocable life insurance trusts ("ILITs") that benefit both "skip persons" (e.g., grandchildren and more remote descendants) and non-skip persons (e.g., children). The annual GST tax exclusion and GST tax exemption are available to apply to ILITs, but the rules regarding their application are complex. While most contributions to ILITs will qualify for the annual gift tax exclusion if the trust beneficiaries hold withdrawal powers, they will not simultaneously qualify for the annual GST tax exclusion. This is one of the most common oversights made in GST planning with ILITs. Further, the rules automatically allocating GST tax exemption to gifts to certain trusts may not always provide a fail-safe. Understanding the application of the GST tax to ILITs and proper allocation of the GST tax exemption to ILIT gifts can ensure far more security in legacy planning by preventing unanticipated GST taxation on future trust distributions.

TAKE AWAY: When planning for GST-exempt ILITs, best practices suggest filing a gift tax return to ensure proper allocation of the GST tax exemption and to formally document the annual allocation of GST exemption, rather than relying on the hopes of automatic allocation. Successful planning with a GST-exempt ILIT depends on proper communication and coordination between the ILIT's creator and his or her advisory team as well as clear implementation and administration of the plan.

1. THE BASICS: GST TAX APPLIES TO MOST ILITS UNLESS MADE GST- EXEMPT

The GST tax applies to transfers of assets to "**skip persons**," which are individuals more than one generation below the transferor (*e.g.*, grandchildren and more remote descendants), or trusts where all current beneficiaries are skip persons individuals.[1] The tax applies at a rate equal to the highest federal estate tax rate - 40%.

A typical ILIT usually benefits the children and later descendants of the trust creator ("**grantor**"), meaning both skip persons and non-skip persons[2] are beneficiaries. In such a case, a GST tax generally applies upon a taxable distribution or taxable termination of the ILIT:[3]

- A **taxable distribution** occurs when distributions are made to a skip person (i.e., a grandchild) from a trust that has both non-skip and skip beneficiaries.

  Example: Eric created an ILIT that allows distributions to his descendants. Assume Eric had only one child David, and David has two children, Sarah and Emily. The ILIT will have a taxable distribution each time the trustee makes a distribution to or for Sarah or Emily.

- A **taxable termination** occurs when all beneficial interests in a trust held by non-skip persons (such as the grantor's children) terminate, leaving only skip persons as beneficiaries.

  Example: Using the facts from above, a taxable termination of the ILIT would occur upon David's passing, as he is the only non-skip beneficiary.

Given these facts, it is critical to ensure that the ILIT is fully GST-exempt by ensuring that all asset transfers to the ILIT are exempt from GST tax. Each taxpayer has an exemption from the GST tax currently equal to the federal estate tax exemption of $5.49 million (annually indexed for inflation), which can be allocated to asset transfers at lifetime or at passing.[4] In addition, there is an annual exclusion from GST tax of $14,000 per recipient for qualifying transfers. As noted below, however, the annual GST tax exclusion is rarely available for transfers to a typical ILIT.

2. THE TRAP: THE ANNUAL GST TAX EXLUSION IS NOT AVAILABLE FOR MOST ILIT CONTRIBUTONS

Many grantors rely on the annual gift tax exclusion (currently $14,000 per donee per year) to fund at least some portion of their ILITs with non-taxable gifts. As long as the ILIT beneficiaries have a present interest in the gift (*e.g.*, the beneficiaries are given so-called Crummey withdrawal powers of the ILIT contribution), the gift qualifies for the annual gift tax exclusion. For the annual GST tax exclusion to apply, however, the trust receiving the annual exclusion gift must (1) benefit only one individual during his or her life (who is a skip person for GST tax purposes (*e.g.*, a grandchild)) and (2) must require that the trust assets be paid to that individual during life or otherwise result in inclusion in his or her his gross estate at death.[5]

Accordingly, despite what most people think, annual exclusion gifts to ILITs often will **not** qualify for the annual GST tax exclusion because most ILITs have multiple beneficiaries and are drafted to prevent inclusion of the trust assets in a beneficiary's estate. If gifts to an ILIT are not otherwise made fully GST-exempt through the allocation of GST tax exemption, then GST tax will apply to taxable termination and taxable distributions of the ILITs.

3. THE IMPERFECT FIX: AUTOMATIC ALLOCATION RULES MAY NOT SOLVE ALLOCATION PROBLEMS

Because the annual GST tax exclusion is not available for transfers to typical ILITs, a grantor will need to rely on allocation of his or her GST tax exemption to gifts to the ILIT to ensure fully GST-exempt status. The so-called "automatic allocation" rules may apply here, as they automatically allocate GST exemption to any contribution made to a qualified "GST trust."[6] Most ILITs may qualify for GST automatic allocation treatment and/or can elect to be treated as a GST trust for purposes of transfers to the ILIT. Allocation of the GST tax exemption to a GST trust is automatic and becomes irrevocable unless the transferor elects out of automatic allocation on a timely-filed gift tax return.

These automatic allocation rules were designed in part as a backup measure for inadvertent failures to allocate GST tax exemption to gifts the transferor most likely intended to be GST-exempt. The rules, however, are exceedingly complex and generally only apply to contributions made after 2000.

Example: Matt and Nancy created a dynasty ILIT for their descendants in 1996 and funded it annually for 20 years with $40,000 in annual exclusion gifts to pay premiums on a survivorship policy. The trustee has provided *Crummey* withdrawal notices to the required beneficiaries, but Matt and Nancy have not filed any gift tax returns allocating GST tax exemption. Since the GST exemption automatic allocation rules only applied to their gifts from 2001 and after, no GST exemption has been applied to their gifts from 1996 through 2000.

Currently, the ILIT's applicable fraction for GST tax purposes is .75 ($600,000 (amount of GST exemption allocated to the trust) over $800,000 (value of the assets transferred to the trust)). The inclusion ratio is .25 (1 − .75). The applicable GST tax rate to the taxable distribution is .10 (40% top federal estate tax rate x .25). Assume after their deaths and the deaths of their children, a taxable termination occurs on $12 million of trust value. The GST tax would be $1.2 million ($12,000,000 x .10).

In addition, when relying on automatic allocation, the transferor must independently and properly track the GST exemption automatically allocated each year to the ILIT to ensure an accurate calculation of his or her GST tax exemption remaining for future transfers.

Improper GST allocation is one of the most common and expensive-to-fix trouble spots in ILIT planning and may require the filing of amended gift and GST tax returns and/or a qualified GST severance of the partially-exempt ILIT (see *WRMarketplace No. 16-18* for a discussion of qualified severances). ***Simply put, relying on the automatic allocation rules for ILIT transfers is not the ideal approach.*** Best practices suggest filing a gift tax return to report the gift and formally allocating the GST tax exemption to the gift. This reporting will ensure proper allocation of the exemption, confirm the ILIT's GST-exempt status and provide a formal record of the GST tax exemption allocated each year (and the remaining amount available for future gifts). When grantors and trustees attempt to manage this process without post-implementation advisory support, however, the results can be disappointing and costly.

4. THE BETTER SOLUTION: TRACKING AND TEAMWORK CAN HELP ENSURE PROPER REPORTING AND ALLOCATION

The solution is to appreciate that legacy planning with an ILIT is not an episodic event, but proceeds along a continuum from formation through post-implementation. For optimum results, grantors and trustees need the on-going support of advisors at every level, from drafting the trust, to funding it and acquiring the policy, to reporting the contributions and allocating exemption, and to ensuring proper ILIT reporting and administration so the trust achieves its intended goals.

For example, maintaining an ILIT's fully GST-exempt status over the long-term requires communication among the grantor's insurance, legal, and tax advisors to help coordinate the grantor's gifts and generation-skipping transfers with respect to all his or her planning, not just the ILIT. If the grantor makes annual other gifts or GST transfers apart from those to the ILIT that are not reported, insufficient GST exemption may be allocated, resulting in GST tax exposure. Thus, each advisor should have a clear understanding of his or her role during and post-ILIT implementation. The accountant should be advised of his role in calculating and reporting gifts and GST exemption allocations, the insurance advisor should provide information on future contribution requirements to support the ILIT's policy, and the attorney should coordinate this information with the ILIT grantor's other planning and provide support to the ILIT trustee for proper administration of the ILIT. The key is communication and cooperation. When viewed in the overall context, it's not hard to see how grantors and trustees who may take a "DIY" approach to ILIT funding and administration in hopes of minimizing advisor fees and expenses can easily fall prey to mistakes that will cost far more to fix.

TAKE AWAYS

When planning for GST-exempt ILITs, best practices suggest filing a gift tax return to ensure proper allocation of the GST tax exemption and to formally document the annual allocation of GST exemption, rather than relying on the hopes of automatic allocation. Successful planning with a GST-exempt ILIT depends on proper communication and coordination between the ILIT's creator and his or her advisory team as well as clear implementation and administration of the plan.

NOTES

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[1] See, IRC §§ 2613(a), 2651. For purposes of the GST tax, a "skip person" is (i) a natural person assigned to a generation which is 2 or more generations below the transferor (*e.g.*, a grandchild or more remote descendant of the transferor or an unrelated individual who was born 37 1/2 years or more after the birth of the transferor), or (ii) a trust for the benefit of such persons as long as no other persons (that is, "non-skip persons") hold an interest in the trust and at no time after such transfer may a distribution (including distributions on termination) be made from such trust to a non-skip person.

[2] A "non-skip person" means any person who is not a skip person. See, IRC § 2613(b).

[3] Another type of GST tax transfer is a "**direct skip**," which occurs when assets are transferred solely to a skip person. For example, the transfer of a life insurance policy outright to a grandchild or to an ILIT where all of the beneficial interests are held by grandchildren or more remote descendants would be a direct skip. With a direct skip, the GST tax is imposed on the value of the assets transferred (less any portion of the gift that may be sheltered by the GSTT annual exclusion discussed below) and is paid by the transferor. Transfers to a typical ILIT or other irrevocable dynasty trust generally will not qualify as direct skips because they will have non-skip beneficiaries. See Treas. Regs. § 26.2612-1(d)(2), providing that a trust will be treated as a skip person for GST tax purposes if (1) all interests in the

trust are held by skip persons, or (2) no person holds an interest in the trust and no distributions, other than a distribution the probability of which occurring is so remote as to be negligible (e.g., there is less than a 5% probability that the distribution will occur), may be made after the transfer to a person other than a skip person. See also IRC §2603.

[4] Note that, unlike the estate tax exemption, the GST tax exemption is not "portable" from a predeceased spouse to a surviving spouse. Accordingly, any GST tax exemption not used by an individual will be lost when he or she passes.

[5] IRC §2642(c)(2).

[6] A GST trust is any trust that could have a taxable distribution or taxable termination, unless the trust: (1) provides that more than 25% of the trust must be distributed to or may be withdrawn by one or more non-skip individuals (a) before the non-skip individual attains age 46, (b) on or before dates specified in the trust that will occur before the individual attains age 46, or (c) upon the occurrence of an event that may reasonably be expected to occur before the date the individual attains age 46; (2) provides that more than 25% of the trust principal must be distributed to or may be withdrawn by one or more non-skip individuals who are living on the death of another person identified in the trust who is more than 10 years older than these non-skip individuals; (3) provides that if one or more individuals who are non-skip persons die on or before a date or event described above, more than 25% of the trust corpus must be distributed to the estate or estates of one or more of such individuals or is subject to a general power of appointment exercisable by one or more of such individuals; or (4) would result in inclusion of the trust assets in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer. *See* Treas. Reg. §26.2632-1; IRC § 2632(c)(3)(B). Automatic allocation of the GST tax exemption also will not apply to a charitable lead annuity trust, charitable remainder annuity trust, charitable remainder unitrust, or a charitable lead unitrust that is required to pay principal to a non-skip person if such person is alive at the end of the trust's charitable term.