Generation-Skipping Transfer Tax Issues

OVERVIEW OF CHAPTER
This chapter discusses selected key generation-skipping transfer (GST) tax issues concerning life insurance.

The GST tax is one of the most complicated provisions of the federal transfer tax system, and probably one of the least understood by practitioners who do not practice in the GST tax area on a frequent basis. The application of the GST tax exemption to an ILIT is important because of the insured’s ability to leverage the transferor’s GST

1 The author gratefully acknowledges the contributions of Jon J. Gallo, Esq., of Greenberg, Glusker, Fields, Claman, Machtinger & Kinsella, LLP of Los Angeles, California, and Dennis M. Mitzel, Esq. of Berry Moorman, PC of Detroit, Michigan in the writing of this Chapter.

exemption through the use of life insurance. The amount of GST tax exemption that generally needs to be allocated to an ILIT is small in comparison to the huge reward that is reaped when the insured dies and the ILIT receives the policy death benefits. This makes the ILIT an attractive candidate for dynasty trust treatment. The GST tax also impacts a beneficiary’s right to withdraw gifts that are made to the ILIT. For example, if the beneficiary dies before the withdrawal right lapses, there may be a GST tax event, which could cause a conflict with the grantor’s structure of the trust for transfer tax purpose. This chapter discusses these potential beneficiary-caused GST tax traps and how to avoid them.

In the ILIT context, there are several key GST tax issues that the advisor should note:

• The fact that a Crummey withdrawal right gift may qualify for the gift tax annual exclusion does not mean that the gift is automatically GST tax exempt. Because there is a disconnect between the gift tax annual exclusion under IRC section 2503(b) and the GST rules, GST tax exemption may still need to be allocated to the ILIT.

• If the spouse is a beneficiary of an ILIT, the spouse’s Crummey withdrawal right should be limited to the five-by-five safe harbor amounts of IRC section 2514 and 2041, and the right of withdrawal must lapse no later than 60 days after the date of the transfer that creates the withdrawal right.

• Every ILIT is possibly subject to the indirect skip rules that came into existence under the 2001 Tax Act. A decision must be made to either opt in or opt out of those rules.

§5.1 BRIEF OVERVIEW OF THE GST TAX

Before the existence of the GST tax, many wealthy families transferred property to their descendants in trust rather than outright. At each subsequent death, the beneficiary’s life estate was not includable in the beneficiary’s gross estate, and for succeeding generations, the family’s wealth went untaxed. The GST tax was designed to stop this tax-free transmission of wealth. The GST tax was initially adopted in 1976 and then replaced in its entirety with a new set of GST tax rules in 1986. The 1976 version of the GST tax was overly complicated. A lack of understanding, inability by the IRS to devise appropriate GST tax reporting forms, and scattered compliance all led to the demise of the original version of the GST tax. The 1986 version of the GST tax (as
amended) is still in effect at this time (but will be repealed for calendar year 2010, and then reinstated on January 1, 2011). The GST tax is set forth in Chapter 13 of the Internal Revenue Code of 1986 (as amended), and is structured on a series of defined terms, many of which are discussed below. The purpose of the GST tax is to prevent the dynastic accumulation of inherited wealth that can occur when multiple generations of a transferor's family are benefited by property transfers that are not subject to additional estate taxation at each succeeding generation. Simply put, Congress wants to ensure that significant wealth transferred to a person's descendants (or transferees) is eventually taxed, even though the transferred wealth is insulated from successive estate or gift taxation. The imposition of the GST tax occurs at generations that are two or more below that of the transferor, such as the transferor's grandchildren or more remote descendants.

**Example:** An individual dies leaving a credit shelter trust for the surviving spouse. After the death of the surviving spouse, the balance of the credit shelter trust, which is not GST tax exempt, is payable outright to the transferor's descendants, per stirpes. Six months after the transferor's death, the transferor's son dies leaving surviving issue. Upon the death of the transferor's surviving spouse, the trust distribution to the deceased son's issue will be subject to the GST tax, as a taxable termination.

**Example:** After the surviving spouse's death, the balance of the credit shelter trust, which is not GST tax exempt, remains in trust for the benefit of the transferor's descendants for as long as is permitted under the rule against perpetuities. At the death of each descendant, as his or her interest passes to the next generation, that interest in the trust generally escapes estate tax, but is instead subject to the GST tax.

### §5.2 GENERATION-SKIPPING TRANSFER DEFINED

The following events constitute a generation-skipping transfer: (1) a taxable termination; (2) a taxable distribution; or (3) a direct skip. IRC section 2611(a). An outright transfer to an individual who is a skip person that qualifies for the gift tax annual exclusion under IRC section 2503(b) does not constitute a GST event. Also, a transfer under IRC section 2503(e) (concerning direct payment of medical expenses
and tuition) does not constitute a GST event; nor does any transfer:
(1) to the extent the property transferred was subject to a prior GST tax; (2) the transferee in the prior transfer was assigned to the same generation as (or a lower generation than) the generation assignment of the transferee in the current transfer; and (3) the current transfer does not have the effect of avoiding the GST tax with respect to any transfer. IRC section 2611(b).

**Practice Point:** Certain transfers from trusts or wills that were executed before a certain date are not subject to the GST tax. Treas. Reg. §26.2601-1. See, section 5.24, below. However, a modification of such instrument or an addition (including a constructive addition) to such trust may cause the trust to lose its GST grandfathered status. See, section 5.25, below.

**§5.3 TAXABLE TERMINATION DEFINED**

A taxable termination is the termination (by death, lapse of time, release of a power, or otherwise) of a beneficiary's interest in property held in a trust3 (such as a life estate) where immediately after the termination, there is no person who has an interest4 in the trust property

---

3 For GST tax purposes, “[t]he term ‘trust’ includes any arrangement (other than...[a probate] estate) which, although not a trust, has substantially the same effect as a trust.” IRC section 2652(b). For example, life insurance proceeds that are payable over time by the life insurance company constitute a trust arrangement. Treas. Reg. §26.2652-1(b)(1). Property held in a custodial arrangement (such as an UGMA or UTMA account) for the benefit of a skip person is a trust arrangement. Treas. Reg. §26.2652-1(b)(2), Example 1.

4 IRC section 2652(c) defines what constitutes an “interest” in trust property for GST tax purposes. It is important to know who holds an “interest” in a trust for purposes of determining whether the trust is a skip person, and for purposes of determining if a taxable termination has occurred. A taxable termination may be postponed if a non-skip person has an “interest” in the trust as long as possible. However, certain “interests” are disregarded for GST purposes, including certain discretionary interests of charitable beneficiaries, and interests that are used primarily to postpone or avoid the GST tax. IRC sections 2652(c).

A person has an interest in property held in trust (i) if the person has a present legal right to receive income or corpus from the trust, or (ii) if the person is a permissible current non-charitable recipient of income or corpus of a trust. IRC section 2652(c). IRC section 2651(f)(2) provides a “look through” rule where an estate, trust or other entity has an interest in the property.
other than a skip person, or after the termination, no distribution may
be made from the trust to a non-skip person. IRC section 2612(a). A
taxable termination does not occur if, at the time of the termination of
the beneficiary's interest, a transfer of the trust property occurs and that
transfer is subject to estate or gift tax (such as the trust property's being
includable in the beneficiary's gross estate because he or she has been
granted a testamentary general power of appointment over the non-
GST tax-exempt trust property). A taxable termination can occur only
from a trust (or a trust arrangement). A taxable termination cannot
occur from a probate estate. Thus, a taxable termination of a trust is
when all interests of non-skip persons come to an end. Because the
GST tax is levied on the termination of any interest in trust property,
a taxable termination can occur on more than one occasion.

For example, if T creates a trust to pay income for life to T's
child (C) for life, then to T's grandchild (GC) for life, with distribu-
tion of the remainder to T's great grandchild (GGC), two taxable
terminations will occur—one when C dies, and one when GC dies.
The severity of taxable terminations underscores the need for transferors to allocate GST tax exemption to trusts that are intended to
benefit skip persons.

**Practice Point:** A non-skip person's interest in a trust that is
used primarily to postpone or avoid any GST tax is disre-
garded for GST tax purposes. IRC section 2652(c)(2). An
interest is considered so used if a significant purpose for the
creation of the interest is to postpone or avoid the GST
tax. Treas. Reg. §26.2612-1(e)(2)(ii). The interest to be
disregarded does not have to be nominal.

**Practice Point:** A charity's interest in a trust will not avoid
a taxable termination if (i) the charity's interest is discre-
tionary, or (ii) the charity's interest is a separate share that
existed at all times from the creation of the trust (or results
from a qualified severance), or (iii) the charity's interest is
used primarily to postpone or avoid the GST tax. Treas.

---

1 *But see,* Treas. Reg. §26.2652-1(b)(2), Example 3, which takes the position that a
bequest payable under a transferor's will is treated as a "transfer in trust" if the identity
of the transferee is contingent upon the occurrence of an event (such as the trans-
ferree's survival) that will not necessarily occur within six months of the transferor's
death.