

STOP! Proceed With Care: Gifts to Life Insurance Trusts in 2010

The first day of 2010 brought repeal of both the estate and generation-skipping transfer (GST) taxes. It was an occurrence that some celebrated, some bemoaned, and most expected would never occur. Aside from the obvious outcomes of no tax for deaths and generation-skipping transfers during 2010, there are two other important aspects of repeal. First, the repeal is only temporary and second, it isn't at all clear how decisions made during this period of repeal will "play out" in future years, and even in 2010 if there are legislative changes before the end of the year.

Under current law, both the estate and GST taxes are resurrected on January 1, 2011. When it returns, the GST tax exemption will be restated back to its level in the days before the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, otherwise known as EGTRRA. In 2011, the exemption is expected to be about \$1,340,000 (after many years of cost of living adjustments), and the tax rate will be 55%.

The scarier aspect is that it is not at all clear what the future ramifications of actions taken during repeal will be. In addition, Congress continues to consider making changes to the law during 2010 that may be retroactive to the beginning of the year. There are many estate tax-minimizing strategies that should be carefully and thoughtfully considered during the period of estate and generation-skipping tax repeal in 2010.

For this paper, we will focus on one, the irrevocable life insurance trust (ILIT), a widely used structure for purchasing life insurance policies for loved ones. We advise everyone to take special care before making the annual gifts to life insurance trusts that may have been on "auto-pilot" for years.

How does an ILIT work?

The parent or grandparent, the grantor, has an agreement drafted to create a trust for the benefit of children - or grandchildren - or possibly both. The agreement directs a third party, the trustee, to manage the trust assets for the benefit of these individuals, the beneficiaries. The terms of the agreement allow, but usually do not direct, the trustee to purchase life insurance on the life of the grantor, the grantor's spouse, or both. The trust is given assets by the grantor which the trustee uses to purchase the life insurance on the grantor's life. The trustee, on behalf of the trust, is the owner and beneficiary of the life insurance policy.

On the death of the insured/grantor, the trustee receives the life insurance proceeds to be held in trust for the beneficiaries. This is an estate tax-efficient way to provide the benefit of life insurance for heirs. It avoids the estate tax burden of having life insurance policies included in the estate of the insured person, which could increase the estate taxes due after death.

The ILIT can also be an efficient choice for maximizing the benefit of annual exclusion gifts (currently \$13,000 per donee per year) since the ILIT can be the recipient of annual exclusion gifts, as long as the individual beneficiaries of the trust are given the right to withdraw those gifts for a period of time.

Since 1976, though, planning for life insurance trusts that may benefit grandchildren has been complicated by the generation-skipping transfer tax. The GST tax is assessed on inter-generational transfers that “skip” a generation, for example, grandparent to grandchild. The basis of the GST tax is the belief that wealth transfers should be taxed at every generation. If a family has enough wealth that the grandparents can give to grandchildren because the children don’t need the gifts, the GST operates to insure that the family pays taxes as though the wealth did pass through the estates of the children - by paying a second transfer tax, the GST, whenever lifetime or at death transfers to grandchildren occur. The tax also applies to transfers to other, non-lineal donees if they are more than 37-1/2 years younger than the donor. These donees include all descendants of the donor’s siblings, i.e., nieces or nephews, great or otherwise, as well as unrelated individuals, such as the donor’s best friend’s grandchild. They also include trusts for the benefit of any of these individuals. The transferees to whom a transfer could generate a GST tax are called “skip persons.”

The GST tax is assessed when transfers exceeding a certain lifetime dollar amount per donor (the GST tax exemption) are made to “skip persons.” The tax code provides many fairly complicated rules that address assigning the exemption to specific gifts to minimize the risk that they might be the subject of a GST tax at the time of the gift or, in the case of trust gifts, in the future when the trust distributes or terminates. Often those rules are interpreted to favor assigning or allocating the exemption to all gifts to trusts when a grandchild is likely to be an income or remainder beneficiary. For trusts, if the total gifts to the trust have had equivalent amounts of exemption allocated to them, then subsequent transfers from the trust to one level of skip persons are exempt from GST tax. If gifts to the trust are more than the allocated GST tax exemption, then part of each future transfer from the trust to skip persons will be subject to the GST tax.

Back to today's uncertainty

The GST tax exemption amount was for many years \$1 million - adjusted for inflation. The EGTRRA legislation increased that exemption to the same amount as the estate tax exemption, which was \$3.5 million in 2009. In 2010, there is no GST tax and thus no GST exemption. However, as mentioned earlier, in 2011 the tax returns at the inflation-adjusted 2001 exemption and 55% tax rate. In addition, the law is unclear about what the future ramifications of a 2010 trust gift might be. Consider the following quandary many families are likely facing in various forms across the country this year:

The Smith Family irrevocable life insurance trust was created five years ago. Sarah Smith's three children and five grandchildren are all beneficiaries of the trust, which is intended to provide medical and educational support to all beneficiaries and their descendants. The trustee purchased a \$10 million life insurance policy on Sarah's life. The annual premiums are \$87,500. Each year Sarah makes a gift to the trust of \$92,000. Immediately after the \$92,000 gift, the trustee notifies each beneficiary of the right to withdraw a share of the gift for a period of 30 days. The \$92,000 gift qualifies for annual exclusion from gift tax. In 2010, the annual exclusion amount is \$13,000 per donee and this gift is only \$11,500 to each of eight donees. To date, no one has withdrawn the gift and the trustee has used the funds to pay insurance premiums as well as fees and expenses. Sarah's accountant has allocated GST exemption in the amount of \$92,000 to the trust gift each year on her gift tax return. At the end of 2009, the trust had about \$10,000 in its bank account. Sarah is preparing to send another \$92,000 to the trustee for 2010. The insurance premium is due in June.

Under GST tax repeal, there is technically no GST exemption to allocate to 2010 gifts because there is no GST tax for 2010. If a gift is made in 2010 and no exemption is allocated, it is possible that some time in the future, after Sarah has died and the life insurance proceeds have been received, the trust will make payments to grandchildren which could be found to be at least partially taxable as generation-skipping transfers since no exemption was allocated to the 2010 trust gift. At an expected tax rate of 55% in 2011 and subsequent years, the GST tax is very expensive. In addition, when a trust pays GST tax for a distribution to a beneficiary, the tax payment itself is also subject to GST since the tax is the beneficiary's obligation. These transfers can get very expensive. As an example, if a trust distributes \$1,000,000 to a grandchild and the trust is not exempt from GST, the GST tax on the distribution is \$550,000 and the GST tax on the tax if the trust pays it is \$302,500 – total tax of \$802,500 for a distribution to the beneficiary of \$1,000,000.

Guidance addressing this uncertainty for 2010 and future years has not been forthcoming from the Internal Revenue Service. Nor has there been any change in the law for 2010, although such a change has been predicted by some members of Congress and hoped for by attorneys and other tax professionals.

Alternatives we recommend

Before making a 2010 gift to a trust that includes grandchildren as beneficiaries, we recommend that a tax advisor be consulted. Alternatives for 2010 include loans instead of gifts or exploring utilizing the life insurance policy's cash surrender value, if any, to pay the 2010 premium. A loan provides flexibility for conversion to a gift during 2010 if the uncertainties discussed above are addressed legislatively or through guidance from the IRS before the end of the year, but does add some complexity for the trust in 2010 and possibly subsequent years. Utilizing an insurance policy's cash surrender value for the 2010 premium payment provides some certainty about GST because there would be no 2010 transfer that might have GST consequences, but it may affect future premium payments.

Obviously, everyone would prefer not to have a cloud of uncertainty hanging over 2010 transactions. At Laird Norton Tyee, we try to provide background to inform our clients' decisions and help them address uncertainty from a position of awareness and knowledge. Please contact your LNT Advisor if you have any questions about this or any other planning issues.

About the author

Kristi Mathisen serves as Laird Norton Tyee's in-house expert on tax and estate planning issues. She provides advice on philanthropic strategies to the firm's client service team and to clients directly. She is an attorney and CPA and has more than 20 years of finance-related experience, much of it in accounting.

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