

Estate Planning

Technical Guide

GENERATION SKIPPING TRANSFER TAX



The Prudential Insurance Company of America

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Generation Skipping Transfer Tax and Its Impact on Life Insurance Trusts

Estate planning techniques are used in an effort to transfer an individual's assets during life or at death in an orderly and tax efficient manner. Frequently, these assets are either transferred to the individual's surviving spouse or to the individual's children as part of a natural succession plan. However, it is not uncommon for larger estates to employ techniques that are designed to maximize the amounts left to future generations and eliminate or minimize the assets left to the spouse and children. Understanding and using the generation skipping transfer (GST) tax to its full potential is key to such an approach.

Generation skipping tax planning, however, is not just for large estates. It may also apply to your moderately wealthy clients. For example, a very typical arrangement is to have a life insurance policy pass into an irrevocable trust for the benefit of the surviving spouse, with a provision that income and principal is to be paid out at the death of the surviving spouse to the children at various ages. If the income and principal are paid out to the children, there is no application of GST tax. However, there may be application of the GST tax if the arrangement provides that in a situation where a child dies before the final payment is made, the property should be distributed to that child's children. This is the case even though no estate or gift tax has been incurred. Consequently, understanding the application of the generation skipping transfer tax is becoming increasingly important.

The GST tax is one of the more complicated tax concepts. This guide provides general information on the GST tax and outlines various life insurance trust planning techniques used when dealing with the tax.

Background Generation Skipping Transfer Taxes

Overview

The underlying premise of the federal transfer tax system has been that property should be taxed each time it passes from one generation to the next. Under this system, when an individual transfers property to another, either during life or at death, the property is subject to a transfer tax – gift or estate tax. Transfers to a trust are also subject to gift or estate tax when an individual irrevocably transfers the assets to the trust. Generally, subsequent transfers by trust beneficiaries who have control over the assets can result in gift or estate tax.



A trust may be structured in a way to limit the trust beneficiaries' control or ownership so that they have the benefit of the trust but not ownership of trust assets. In the past, by giving the trust beneficiaries limited rights, it was possible to benefit remote descendants and avoid transfer tax at each generation. Likewise, clients could bypass or "skip" their children and transfer their assets directly to their grandchildren. In both of these situations, the federal government would lose taxes that it would have otherwise collected on the transferred assets had they been owned by the successor generation (the children) at their deaths.

The federal government established the generation skipping transfer (GST) tax in 1976 to prevent this "avoidance" of transfer taxes. As part of the Tax Reform Act of 1986 and subsequently the Economic Growth and Tax Relief Reconciliation Act of 2001 (the 2001 Act), the GST tax was modified to give us the GST tax that is in place today.¹ In general, today's GST tax applies to generation skipping transfers both during life and at death if those transfers occur after September 25, 1985.²

The 2001 Act repeals estate and generation skipping transfer taxes in year 2010 but reinstates both in their pre-Act form in 2011. If the estate and generation skipping taxes are repealed, even if for one year, dynasty trusts may become the centerpiece of advanced estate planning for high-net-worth clients because transfers to dynasty trusts during this time period should be immune to any future return of the tax.

Objective of the Tax

The GST tax was enacted as a substitute for the estate and gift tax in situations where wealth is passed to a grandchild or other party two or more generations below that of the transferor without having passed through taxable ownership of the intervening generation (i.e., the generation of the donor's children). The GST tax is imposed on transfers that involve such "skips." The GST tax rate is a flat rate equal to the highest federal estate tax rate at the time of the transfer.

Similar to gift and estate transfer taxes, each transferor has an exemption amount that can be allocated during lifetime. Any unused balance is allocated when the transferor dies. The mechanics of the imposition of the GST tax and the allocation of the GST exemption involve a series of calculations to determine the tax effect. The taxable amount and the person responsible for the tax varies according to the type of transfer made.

¹ IRC §§ 2601-2663.

² Generally, irrevocable trusts created prior to this date are exempt from GST tax. Nevertheless, if any property is added to such a "grandfathered" trust, the trust is tainted, and a portion of the trust becomes subject to GST tax.



Generation Skipping Transfer Tax in General

Parties Involved in the Transfer

A generation skipping transfer is defined as a transfer by a “transferor” to at least one “skip person.”

Transferor

The transferor is the person with respect to whom the property was most recently subject to estate or gift tax. The transferor will change if property is included in the estate of someone other than the original transferor or if someone other than the original transferor is considered to have made a gift.

***Life Insurance Pointer:** The lapse of a Crummey power can result in a change in the identity of the transferor. If the lapse is entirely within the lapse-protected amount (the greater of \$5,000 or 5% of the trust assets) there is no taxable gift and no change in the transferor. However, to the extent the lapse exceeds the lapse-protected amount, the holder of the Crummey power becomes the transferor, but only to the extent the lapse is a taxable gift. When portions of a trust are attributable to a different transferor they are treated as separate trusts for GST tax purposes.*

Skip Person

The definition of a “skip person” is essential to the determination of whether a generation skipping transfer has occurred and whether a tax will be imposed.

A “skip” person is either (1) a natural person assigned to a generation that is two or more generations below the transferor’s generation or (2) a trust for such person or persons.³ The identification of a skip person is made by reference to the transferor and is controlled by the generation assignments found in IRC § 2651.

(1) Natural Persons.

- *Recipients Who Are Related Parties.* If the recipient is an individual who is a related party to the transferor, the generation assignment is based on the family tree, regardless of the ages of the individuals involved.

A relative two or more generations below the transferor’s generation, such as a grandchild or great-grandchild, is a skip person. Adoptive and half-blood relationships are treated as full-blooded relationships. Moreover, relatives of a transferor’s spouse are treated as relatives of the transferor.⁴

³ IRC§ 2613(a).

⁴ IRC §§ 2613(a)(1), 2651(b), 2651(c).



- *Generation Step-Up Rule.* Sometimes referred to as the “predeceased parent (or ancestor) exception,” this rule “steps up” the generation of an individual (or the descendant of an individual) with a deceased parent, as long as that deceased parent is a descendant of the transferor’s parent.⁴

Prior to the enactment of the Taxpayer Relief Act of 1997 (TRA 97), this rule provided that, for the purposes of determining whether a transfer is a direct skip, if the parent of the transferor’s grandchild is deceased, the grandchild is treated as the child of the transferor for purposes of determining whether a transfer is a direct skip.⁵

TRA 97 retained this predeceased parent exception but amended the rule and extended the exception to collateral relatives if the transferor has no living lineal descendants at the time of the transfer.⁶

Example: A transfer to a daughter of the transferor’s niece (a grandniece of the transferor) is not a direct skip if, at the time of the transfer, the transferor has no living lineal descendants and the transferor’s niece, who is the parent of the grandniece, is deceased.

TRA 97 also extended this exception to taxable terminations and taxable distributions if the parent of the relevant beneficiary was dead at the earliest time when the transfer was subject to gift or estate tax.

- *Recipients Who Are Not Related Parties.* When transfers are made outside the family, generations are measured in years, using the transferor’s age. Persons who are more than thirty-seven and one-half years younger than the transferor are skip persons.⁷

(2) *Interests in Trust*

A skip person includes a trust if all interests are held by skip persons or if no person has an interest in the trust at the time of transfer and future distributions can be made only to skip persons.⁸

Non-Skip Person

A non-skip person is a person who is not a skip person.⁹

⁴ IRC §§ 2613(a)(1), 2651(b), 2651(c).

⁵ IRC § 2612(c)(2).

⁶ IRC § 2651(e), as amended by TRA 97 § 511(a).

⁷ IRC § 2651(d), 2651(e).

⁸ IRC § 2613(a)(2).

⁹ IRC § 2613(b).



Transfers Subject to Generation Skipping Transfer Tax

Three types of transfers to skip persons trigger the GST tax: direct skips, taxable distributions, and taxable terminations. The taxable amount and the person responsible for the tax varies according to the type of transfer made.

Direct Skips

A direct skip is a transfer that is subject to either gift or estate tax and is made to a skip person.¹⁰ A direct skip may be either an outright gift to an individual or a gift made in trust. (See previous discussion for when a trust is a skip person.)

Example: Either the outright gift of cash from grandmother to grandchild or the transfer of cash by a grandparent to a trust with the grandchild as the only beneficiary is a direct skip.

The GST tax is imposed only on the value of the property received by the transferee (i.e., the taxable amount (tax base) does not include the GST tax paid). Like the gift tax, it is calculated on a “tax exclusive” basis.¹¹

The donor/transferor generally pays any GST tax imposed on direct skips.¹² In the case of a lifetime direct skip, the GST tax paid by the transferor is treated as an additional gift for purposes of calculating the transferor’s gift tax.¹³

Example: A donor transfers \$1,000,000 to a granddaughter. Assume the GST tax on this transfer is \$500,000 (50% of \$1,000,000) that is paid by the donor. The donor has made a taxable gift to the granddaughter of \$1,500,000 (\$1,000,000 transfer plus the GST tax of \$500,000). Assuming the 50% gift tax bracket, the tax on the overall gift is \$750,000. Thus, it will cost the donor \$1,250,000 (\$750,000 gift tax plus \$500,000 GST tax) to transfer \$1,000,000 to the granddaughter.

Taxable Terminations

A taxable termination is any termination (by death, time, release or otherwise) of an interest in trust property such that only skip persons have interests in the trust after the termination event.¹⁴

Example: Grandfather creates an irrevocable trust worth \$1,000,000 for the benefit of his daughter for life, with the remainder to his granddaughter. At his daughter’s death, the only living beneficiary (the granddaughter) is a skip person. This transfer results in a taxable termination.

¹⁰ IRC § 2612(c)(1).

¹¹ IRC § 2623.

¹² IRC § 2603(a)(3).

¹³ IRC § 2615.

¹⁴ IRC § 2612(a).



The GST tax is imposed on the value of the property to which the terminations have occurred. Expenses described in IRC § 2053 reduce the value of the property.¹⁵ GST tax on taxable terminations is calculated on a “tax inclusive” basis. Similar to the estate tax, the dollars used to pay the tax are included in the base on which the tax is calculated. In the case of a taxable termination, the trustee pays any GST tax.¹⁶ The GST tax is usually taken from the property transferred but does not reduce the amount subject to the GST tax.

Example: Assume the trust remainder value is \$1,000,000 at the daughter’s death. Assuming an inclusion ratio of 1, the trustee will pay GST tax of \$500,000 (50% of \$1,000,000) and the granddaughter will receive the \$500,000 balance. (See discussion of inclusion ratio on page 14.)

Taxable Distributions

Taxable distributions are any distributions of income or principal from a trust made to a skip person – other than a taxable termination or a direct skip.¹⁷ Taxable distributions can only be distributions from a trust or a trust equivalent.

Example: Grandmother creates a trust with her son and grandchildren as discretionary income beneficiaries and her grandchildren as remainder beneficiaries. The initial transfer to the trust is not a GST transfer because the trust is not by definition a skip person. A taxable distribution occurs when the trustee distributes the income interest to the grandchildren.

The GST tax is imposed on the value of the property received by the skip person. Specific tax-related expenses incurred by the transferee reduce the value of the property received.¹⁸ As with taxable terminations, the GST tax on taxable distributions is calculated on a “tax inclusive” basis. Similar to the estate tax, the dollars used to pay the tax are included in the base on which the tax is calculated. The transferee pays the GST tax resulting from a taxable distribution.¹⁹

Example: Assume the irrevocable trust established above distributes \$200,000 to a grandchild while the son is living. The grandchild will pay \$100,000 (50% of \$200,000) and net \$100,000 from the original transfer.

If the trustee pays the tax, the amount paid will be considered an additional taxable distribution.²⁰

¹⁵ IRC §§ 2622(a)(1), 2622(b).

¹⁶ IRC § 2603(a)(2).

¹⁷ IRC § 2612(b).

¹⁸ IRC § 2621(a).

¹⁹ IRC § 2603(a)(1).

²⁰ IRC § 2621(b).



Exemptions and Exclusions from the GST Tax

Several exemptions and exclusions are allowed with respect to the GST tax.

Medical, Educational and Charitable Exclusion

Payments made directly to the providers of medical care or educational services, if made under circumstances that would otherwise incur generation skipping transfer, qualify for the exclusion from taxable gifts.²¹ Transfers to a charity are also exempt from GST tax. However, in case of a split interest trust (e.g., charitable remainder trust), a taxable termination or distribution could occur as a distribution of property to a skip person subject to GST tax.

GST Annual Exclusion

A gift qualifying for the present interest gift tax annual exclusion under IRC § 2503(b), including the portion covered by gift splitting with a spouse, may be treated as a non-taxable gift for GST tax purposes. The availability of the GST annual exclusion (\$12,000 in 2008, indexed for inflation) is dependent on whether the transfer is an outright gift or made to a trust.

- (1) *Outright Gifts*. If the transfer qualifies as a present interest in property and is made directly to a skip individual, the transferor can shelter \$12,000 per donee (\$24,000 for split gifts) from GST tax.²²
- (2) *Gifts Made to a Trust (IRC § 2642(c)(2) requirements)*. If the gift is in trust, the annual exclusion is available for transfers after March 31, 1988, only if the following requirements are met:
 - The trust can have only one individual as a beneficiary,
 - During the life of the beneficiary, no other person may benefit from the trust income or principal, and
 - On the death of the beneficiary prior to the trust termination, the trust assets must be includable in such beneficiary's estate.²³

Life Insurance Pointer: *Most irrevocable life insurance trusts will not meet the requirements of IRC § 2642(c) since they generally have multiple beneficiaries that include not just one of the transferor's grandchildren but the transferor's spouse, children and other grandchildren. Consequently, while use of the Crummey power may qualify the premium payment for the gift tax annual exclusion of the grantor/transferor, it will not qualify for the GST annual exclusion. In general, to protect the insurance death proceeds from GST tax it may be necessary to file a gift tax return and allocate part of the GST exemption to the gifts of the premium payment.*

²¹ IRC § 2611(b)(1).

²² IRC § 2642(c)(3)(A).

²³ IRC § 2642(c)(2).



Because of the existence of Crummey provisions, many individuals have not filed gift tax returns allocating the GST tax exemption. In practical terms, this means many existing life insurance trusts should be reviewed.

For a more complete discussion of GST issues with irrevocable life insurance trusts see the section entitled: “GST Techniques: Focus on Life Insurance Trust Applications.”

GST Exemption

In addition to the estate and gift tax applicable exclusion amount, which shelters an individual’s property from estate and gift taxes, every individual is allowed an exemption from the GST tax.²⁴ The GST exemption is the same amount as the estate tax applicable exclusion amount.

Unlike the applicable exclusion amount, which is automatically used when available, an individual will generally need to allocate the GST exemption. An individual may choose to allocate the exemption against either lifetime transfers or transfers occurring at death. In the case of a lifetime transfer, the allocation is made on the gift tax return. In the case of transfers taking place at the transferor’s death, the allocation is on the estate tax return. Once made, any allocation is irrevocable.²⁵ *(The specifics of the allocation rules are discussed in the next section, “Timing of the Allocation of the GST Exemption.” Many of the opportunities under the GST tax involve the proper allocation of the exemption and the proper timing of the allocation.)*

Transfer Tax Rates and Exemption Amounts after the 2001 Act

Calendar Year	Estate Applicable Exclusion Amount	GST Applicable Exclusion Amount	Gift Tax Applicable Exclusion Amount	Highest Estate and Gift Tax Rates
2007	\$2,000,000	\$2,000,000	\$1,000,000	45%
2008	\$2,000,000	\$2,000,000	\$1,000,000	45%
2009	\$3,500,000	\$3,500,000	\$1,000,000	45%
2010	N/A	N/A	\$1,000,000	35% (gift tax only)
2011	\$1,000,000	\$1,000,000 Adjusted for inflation between 2001 and 2011 (2003 amount was \$1,120,00)	\$1,000,000	55%

²⁴ IRC § 2631(a).

²⁵ IRC § 2631(b).



Timing of the Allocation of the GST Exemption

Since the allocation of part or all of an individual's GST exemption to a transfer is irrevocable, proper allocation is critical.²⁶ The timing of the allocation of the GST exemption is important because the valuation of the transferred property for purposes of computing the inclusion ratio is made at the time the GST exemption allocation becomes effective. Early allocation of the GST exemption to appreciating assets is beneficial since it will result in the GST exemption effectively shielding any future appreciation of the assets from taxation.

However, before recommending the allocation of the GST exemption to a transfer, consideration should be given as to whether the allocation is an efficient use of the exemption. If the transfer might, but probably will not, involve a generation skipping transfer, it may not be advisable to allocate the GST exemption. In contrast, if the transfer is designed to last as long as possible through multiple generations, the allocation of the GST exemption to shelter the transfer from taxation is probably a good use of the exemption.

General Rule for Allocating GST Exemption to Lifetime Transfers

In general, for lifetime transfers, the exemption can be allocated by the transferor on or before the transferor's death. If the allocation is made on a timely filed gift tax return, the allocation is effective as of the date of the transfer and the exemption is allocated to the transferred property based on the value for gift tax purposes.²⁷

If the allocation is not made on a timely filed gift tax return, the allocation is based on the property's value as of the first day of the month that the allocation is filed. In some situations, deferring the allocation of the GST exemption to a later date may provide additional leverage.

Life Insurance Pointer: *In the case of a life insurance trust, because the cash value of a policy will typically be less than the premiums paid during the first few years, it may be possible to increase the leverage of the GST exemption through a carefully timed late allocation. As long as the insured is alive at the date of the late allocation, Regulation §26.2642-2(a)(2) provides that a donor may use the value of the property on the first day of the month in which the late filing occurs. However, if the client dies before the late allocation is filed, the allocation will include the entire policy death benefit. The client must be willing to take the risk that he or she will not die between the date of the gift tax return and the time of filing of the late allocation of the GST exemption.*

There are several exceptions to the general rule for allocating GST exemption to lifetime transfers.

²⁶ IRC § 2631(b).

²⁷ IRC § 2642(b)(1).



Automatic Allocation to Lifetime Direct Skips. The first exception applies to lifetime direct skips. If any individual makes a direct skip to a skip person or trust during his/her lifetime, any unused portion of his/her GST exemption will be automatically allocated to the transferred property to the extent necessary to bring the inclusion ratio for that transfer to zero²⁸ unless the transferor makes an election not to allocate the GST exemption to the transfer. If the amount of the direct skip exceeds the unused portion of the GST exemption, any remaining exemption is allocated to the transfer.²⁹

- *Election not to allocate to direct skip.* The transferor can prevent an automatic allocation by payment of the tax and timely filing a federal gift tax return (Form 709: U.S. Gift and Generation Skipping Transfer Tax Return) indicating the extent to which the automatic allocation is not to apply.³⁰ Either the automatic allocation or the election to prevent the allocation becomes irrevocable after the due date of Form 709.

Automatic Allocation to Lifetime Indirect Skips to “GST Trust”. The second exception applies to lifetime indirect skips to a “GST Trust.” Prior to the 2001 Act, for lifetime transfers made to a trust that were not direct skips, the transferor had to allocate the GST exemption. The allocation was not automatic. For transfers made after December 31, 2000, if an individual makes an indirect skip to a “GST Trust” during his/her lifetime, any unused portion of his/her GST exemption is automatically allocated to the property transferred to the extent necessary to make the inclusion ratio for the property zero. If the amount of the indirect skip exceeds the unused portion of GST exemption, any remaining exemption is allocated to the transfer.³¹

- *Indirect Skip Defined.* An indirect skip is defined as any lifetime transfer of property (other than a direct skip), which is subject to gift tax and is made to a “GST trust.”³²

²⁸ IRC § 2632(b)(1).

²⁹ IRC § 2632(b)(2).

³⁰ IRC § 2632(b)(3) and Reg. § 26.2632-1(b)(1)(I).

³¹ IRC § 2632(c)(1).

³² IRC § 2632(c)(3)(A).



- *GST Trust defined.* A “GST Trust” is a trust that could have a generation skipping transfer (i.e., a taxable termination or taxable distribution) with respect to the transferor.³³ In general, transfers to trusts that provide that at least 75 percent of the corpus is to be distributed to a skip person will be classified as a GST trust. In contrast, if the trust provides that more than 25 percent of the trust corpus must be distributed to, or may be withdrawn by, a non-skip person (e.g., transferor’s child) before the non-skip person attains age 46, the trust is not a “GST Trust” and will not have the GST exemption automatically allocated. The intent of this rule is to avoid application of this automatic allocation rule where the trust is not intended to be a generation skipping trust.

Life Insurance Pointers: *Many life insurance trusts have provisions requiring distribution of at least 25 percent of the trust to children prior to age 46. However, in many cases, children of the insured transferor may reach age 46 prior to the death of the insured without any distribution having occurred. It is not clear whether 25 percent of the trust must be distributed before the non-skip person reaches age 46 to avoid application of this automatic allocation rule. As indicated earlier, there is a need to examine existing life insurance trusts to determine whether it is necessary or desirable to allocate the GST exemption or to opt out of automatic allocation rules.*

- *Election not to allocate to an indirect skip.* An individual may elect not to have the automatic allocation rules apply to an indirect skip.³⁴

Effect of the Estate Tax Inclusions Period (ETIP) on Allocation. The third exception applies to transfers where, if the transferor had died immediately after making the lifetime transfer, the transferred property would be included in his/her gross estate (under any section other than IRC § 2035). For example, this exception would apply to grantor retained trusts because, if the grantor dies during the term of the trust, the trust is included in the grantor’s gross estate.

In this case, a special rule prevents the allocation of GST exemption to transferred property before the close of the estate tax inclusion period (ETIP) for such property.³⁵ The ETIP is the period during which the transferred property would be includable in the transferor’s (or the transferor’s spouse’s) estate if the transferor were to die during that period. If any part of a trust is subject to an ETIP, the entire trust is subject to an ETIP.³⁶

³³ IRC § 2632(c)(3)(B).

³⁴ IRC § 2632(c)(5)(A)(i)(I).

³⁵ Reg. § 26.2632-1(c)(1).

³⁶ Reg. § 26.2632-1(c)(1).



If a transfer is deemed to be subject to the ETIP delayed allocation rule, then the allocation is made based on either the value of the property at the close of the ETIP or the estate tax value of the property, if the property is actually included in the transferor's gross estate³⁷.

Pointer: *Since GST trusts are generally funded with assets that are expected to appreciate, the fair market value of these assets may be significant at the end of an ETIP period. This can result in GST tax if the grantor does not have sufficient GST exemption at that time to allocate to the assets where a skip person is a beneficiary. A grantor should consider avoiding skip persons as beneficiaries for trusts that may be subject to ETIP.*

Retroactive Allocation of GST Exemption. The final exemption permits a retroactive allocation of GST in cases involving an unexpected order of death. In many cases, a transferor may fail to allocate the GST exemption to a trust that the transferor expects will benefit only non-skip persons, such as children of the transferor. This expectation may be upset if a death occurs out-of-order. For example, if a transferor's child dies unexpectedly before the transferor and the trust terminates in favor of the grandchild, a taxable termination occurs and GST tax will be due since no exemption allocation was made.

The 2001 Act added a new "step-up" rule for generation assignment, granting GST tax relief to cases involving an unnatural order of death. This section applies to deaths of non-skip persons after December 31, 2000. Under this rule, a transferor can elect to make a retroactive allocation of his or her unused GST exemption to a previous transfer in a trust, where the beneficiary of the trust (1) is a non-skip person, and (2) is a lineal descendant of the transferor's grandparent (or a grandparent of the transferor's spouse or former spouse), (3) is assigned to a generation younger than the generation of the transferor, and (4) dies before the transferor.³⁸ This allocation would be made on a timely filed gift tax return for the year of the non-skip person's death. The allocation would be effective immediately before death of the non-skip person and be determined by the gift tax value – as though it had been a timely allocation.

Allocations of the GST Exemption after the Transferor's Death

At the death of the transferor, the transferor's executor may make allocations of the remaining GST exemption.³⁹ Allocation of the GST exemption to property transferred at death is based on estate tax values.⁴⁰

Any portion of an individual's GST exemption that hasn't been allocated on or before the estate tax return filing date, will be deemed allocated:

³⁷ IRC § 2632(c)(4).

³⁸ IRC § 2632(d)(1).

³⁹ IRC § 2632(a)(1).

⁴⁰ IRC § 2642(b)(2)(A).



- first, to property subject to a direct skip occurring at the transferor's death, and
- second, to trusts for which the individual is the transferor and from which a taxable distribution or taxable termination might occur at or after the transferor's death.

Segregated Trusts

For planning purposes, particularly with larger estates, to avoid the inefficient use or wasting of an individual's GST election, it may be important to create segregated or separate trusts between either GST and non-GST trusts or trusts for non-skip persons (children) and trusts for skip persons (grandchildren, etc.). However, prior to the 2001 Act, a severance of a trust was not permitted unless it was included in the transferor's gross estate or was a testamentary trust. Under the 2001 Act, the rules regarding severance became less burdensome.

The 2001 Act and regulations permit any trust to be severed at any time if the severance occurs on a fractional basis and if, in the aggregate, the terms of the new trusts provide for the same succession of interests of beneficiaries as in the original trust.⁴¹ These rules took effect after December 31, 2000.

Computation of the GST Tax

Before discussing how the GST tax is calculated, it may be helpful to understand the main principle on which GST tax planning is based:

If there is a possibility that a skip person will receive benefits, and the transfer does not qualify for one of the non-taxable exemptions, sufficient GST exemption should be allocated to the transfer to result in an inclusion ratio of zero. In general, if the inclusion ratio is zero (0) there will be no GST tax on the transfer. If no GST exemption is allocated to a transfer subject to GST tax, the inclusion ratio is generally one (1) and the transfer is taxed at the maximum federal estate tax rate. If only part of a transfer is exempt, then the inclusion ratio will be a fraction greater than zero (0) and less than one (1) that, when multiplied against the maximum federal estate tax rate, yields the "applicable rate" of tax to be imposed on the generation skipping transfer.

⁴¹ IRC § 2642(a)(3).



Tax Rate

Unlike some other taxes, the GST tax does not have its own independent rate schedule. Instead, it relies on the maximum rate of the federal estate tax schedule.⁴² For generation skipping transfers occurring in 2008, the maximum rate is 45 percent. The 2001 Act provides for the gradual phase-out of the GST tax by 2010 with reinstatement in 2011. (See prior table under GST Exemption)

The Inclusion Ratio

Although the GST tax is a flat rate equal to the highest federal estate tax rate at the time of the transfer, the tax is actually calculated using an inclusion ratio. The inclusion ratio reflects the relationship between the amount of the GST exemption allocated to the property and the total value of the property.⁴³ The inclusion ratio is equal to one (1) minus an “applicable fraction”, where the numerator of the fraction is the allocated GST exemption amount and the denominator is the value of the property (reduced by any federal or state death taxes paid out of the transfer and reduced by any charitable deduction allowed with respect to the property).

The inclusion ratio is determined when the transfer is made even though the actual GST transfer may occur some time later. Once an inclusion ratio is determined for a trust, it applies to all later distributions and terminations respecting that trust.

Although an inclusion ratio may yield a lower applicable GST tax rate on the entire transfer, the tax rate on the taxable amount of a transfer should equal the maximum estate tax rate under the Internal Revenue Code.

Example: In 2002, your client transferred \$2,000,000 in stock to his granddaughter. He/she allocated \$1,000,000 of his GST exemption amount. The GST tax is calculated as follows:

Applicable Fraction	=	$\frac{\text{GST exemption allocated}}{\text{Value of property transferred}}$	=	$\frac{\$1,000,000}{\$2,000,000}$	=	0.50
Inclusion Ratio	=	1 - Applicable fraction	=	1 - 0.50	=	0.50
Applicable Rate	=	GST rate X Inclusion ratio	=	0.50 X 0.50	=	0.25
GST Tax Due	=	Value of Property Transferred X Application Rate	=	\$2,000,000 X 0.25	=	\$500,000

Since the exemption was applied, only \$1,000,000 of the transfer is subject to the GST tax. The \$500,000 tax is 50% of the taxable \$1,000,000. So, the GST tax attributed to the taxable amount of the transfer is still equal to the maximum estate tax rate.

⁴² IRC § 2641(a).

⁴³ IRC § 2642(a).



GST Techniques: Focus on Life Insurance Trust Applications

Most of the GST techniques involve leveraging the GST exemption. Every strategy requires thorough knowledge of the tax rules, exemptions, exclusions and proper implementation. GST tax is one of the most complex areas of tax law and contains tax traps for the unwary. The section that follows discusses some of the more common GST tax techniques with a focus on issues involved with irrevocable life insurance trusts.

Maximize the Use of the “Qualified Exclusions”

Direct payment of a grandchild’s tuition to an educational institution and/or the direct payment of a grandchild’s medical expense to a health care provider (including health insurance premiums paid directly to an insurance carrier) can be made in unlimited amounts, avoiding the imposition of both gift and GST tax.

Maximize the Use of the GST Annual Exclusions – Section 2642(c)(2) Trust

Use the gift tax annual exclusion and GST annual exclusions by making non-taxable gifts to a skip person or Section 2642(c)(2) trust. Outright gifts to a skip person will qualify for both the gift tax annual exclusion and the GST annual exclusion (\$12,000 for 2008, indexed for inflation) and do not reduce the transferor’s GST exemption.

Although the gift tax annual exclusion and the GST annual exclusion can work hand-in-hand, there are certain situations where the gift tax annual exclusion will apply but the GST annual exclusion will not. As indicated earlier, one situation where a transfer may qualify for the gift tax annual exclusion, but not the GST annual exclusion, is when a transfer is made to a trust

Example: Grandmother creates and implements a trust transferring \$12,000 of cash to pay the premiums on a life insurance policy owned by the trust. The trust provides that income is to be paid to her son for his life and, at his death, the trust principal is to be distributed to her grandchildren. The trust gives her son and two grandchildren Crummey withdrawal powers [note in this situation the transfer is within the beneficiaries’ “lapse protected amount” (see page 21)]. Assuming the Crummey powers have been properly structured and implemented, the grandmother’s transfer of cash to the trust should qualify for the gift tax annual exclusion; however, the transfer will not qualify for the GST annual exclusion because the trust benefits multiple beneficiaries including a non-skip person.



A transfer to a trust can be structured to qualify for both the gift tax annual exclusion and the GST annual exclusion. As indicated earlier, in order for transfers made to a trust after March 31, 1988 to qualify for the GST annual exclusion, Section 2642(c)(2) requires that:

- the trust can have only one skip person as its beneficiary;
- during the life of the beneficiary, no other person may benefit from the trust income or principal; and
- on the death of the beneficiary prior to termination of the trust, the trust assets must be includable in such beneficiary's gross estate.

It's possible to draft a life insurance trust to qualify for both annual exclusions; however, the trust would be restricted to benefiting one skip person and would be subject to transfer taxes at the beneficiary's death. From a practical point of view, the use of the Section 2642(c)(2) rules prevents trusts from stretching the benefit of the trust assets to more than one generation and maximizing the power of tax deferral.

Since most life insurance trusts have multiple beneficiaries (which include not just one of the transferor's grandchildren, but the transferor's spouse, children and other grandchildren), most life insurance trusts will not qualify for the GST annual exclusion. Consequently, in the above example, while the \$12,000 transfer qualifies for the gift tax annual exclusion, it does not qualify for the GST annual exclusion. The only practical way to protect trust-owned life insurance proceeds through multiple generations is to allocate enough GST exemption to the premium payment to maintain an inclusion ratio of zero. (See *discussion below "Maximize the GST Exemption – The Life Insurance Funded Dynasty Trust"*).

The most important point to be gleaned from the above discussion is that many existing life insurance trusts should be reviewed to see if prior allocation of the GST exemption was neglected and determine if future allocation of GST is necessary or desirable. In addition, new trusts should be monitored to see that the GST exemption is being efficiently allocated where necessary or desired.

Maximize the GST Exemption – The Life Insurance Funded Dynasty Trust

One of the most effective benefits of lifetime giving is the elimination of transfer taxation on the future appreciation of lifetime gifts. Likewise, an important objective of GST strategies is the allocation of the GST exemption to property having a low value at the time of exemption allocation when compared with its likely future value. If the GST exemption is allocated to property that will increase in value, the exemption has been "leveraged."



When multiple generations are included in the trust, the results can be astounding. By placing property in a trust to which the GST exemption has been properly allocated, the GST tax can be permanently avoided with respect to all benefits derived by succeeding generations. Two examples may help to demonstrate the power of this technique.

Example 1: Assume a father's will leaves \$1 million to his son. The son invests the cash earning a 7% after-tax return. In year twenty, the son dies leaving the investment, now worth \$3.6 million, to the granddaughter. After estate taxes are paid, the granddaughter has \$2.3 million left in the 7% fund. If the granddaughter lives twenty years, there will be \$8.4 million in the 7% fund at her death. After paying estate taxes, \$4.5 million will pass to the next generation.

Example 2: Assume the same situation except the father transfers the \$1 million to a trust. Distributions from the trust may be made to his son and granddaughter. The GST exemption is allocated to the trust, resulting in an inclusion ratio of zero. Assuming that the \$1 million continues to earn a 7% after-tax return until the son dies in 20 years, there will be \$3.6 million in the trust. In contrast to the above example, since the daughter does not own the investment fund – it is not subject to estate tax. If the granddaughter lives another 20 years and the \$3.6 million continues to earn a 7% after-tax return, there will be \$13 million in the trust for the next generation.

In the second example, the establishment of a GST exempt trust creates an additional \$8.5 million of wealth that will pass to family members within just two generations. Consider the potential to maximize the goal of keeping wealth within the family unit if the GST exempt trust could be designed to grow rapidly and avoid transfer taxes for several generations – preferably into perpetuity.

In its purest form, a GST exempt trust is designed to allow the assets in the trust to be held perpetually without imposition of any estate, gift or other transfer tax liability. The assets of the trust are protected from transfer tax because the beneficiaries of the trust are never given sufficient ownership and control over the assets to trigger the imposition of the transfer tax. However, income taxes with respect to any income generated within the trust are paid in the same manner as any income generated by an irrevocable trust. If the trustee invests in assets that maximize growth and minimize income, significant sums could be passed to future generations. The term “dynasty” is often used to describe such a trust created for the benefit of multiple generations.

In actuality, while a dynasty trust may be designed to be perpetual, most families establish GST exempt trusts that continue for several generations. In addition, most dynasty trusts are controlled by state imposed restrictions on the length of time property may be held in trust.



- *The Rule Against Perpetuities.* The rule against perpetuities is an English common law rule designed to prohibit a grantor from controlling the disposition of property from the grave for long periods of time. It requires property to vest not later than twenty-one years after the death of “some life in being at the creation of the interest.” Many states still apply this rule or have developed similar rules that restrict the length of time during which property may be controlled beyond the transfer by the original owner. In these states, a perpetual dynasty trust is not possible.

However, some states have eliminated their rules against perpetuities (or limited their reach to interests in real property only) reasoning that there is no justification for limiting the term of a trust that restricts the disposition of personal property only. In order to establish a perpetual dynasty trust, it is necessary to establish the trust in these states or to establish a connection with a jurisdiction that will allow the continuance of the trust on a perpetual basis.

Because a dynasty trust may be permitted to exist forever, it cannot be created without considerable thought and expert drafting by legal counsel. Trusts must be drafted to be irrevocable – not inflexible. Through proper drafting, a perpetual plan that manages the impact of future wealth for future generations can be designed and implemented.

As its name implies, a dynasty trust is intended to provide maximum security for several generations of beneficiaries, providing them with use and enjoyment of trust assets, yet insulating the trust funds from federal and state, estate, and generation skipping transfer taxes. A second purpose of a dynasty trust is to protect trust funds from the claims of the beneficiaries’ creditors, including former spouses.⁴⁴ Because transfer taxes are not imposed at each successive generation, a dynasty trust funded with highly appreciating assets presents a unique opportunity for significant leverage.

Allocating the GST Exemption to the Life Insurance Funded Dynasty Trust. The key to the success of the dynasty trust is to leverage the GST exemption. Life insurance owned by a dynasty trust is one of the most efficient financial vehicles because, where the GST exemption is applied to the premiums, the death proceeds are removed from GST tax.

Because the death proceeds often exceed the sum of premiums paid several times over, life insurance owned by a dynasty trust operates synergistically to provide leverage to the GST exemption.

Example 3: Assume that the trustee of the GST exempt trust created in Example 2 by grandfather, and funded by a one-time cash contribution of \$1 million, chooses to purchase a life insurance policy on grandfather. Grandfather uses his applicable exclusion amount to avoid gift tax and allocates his GST exemption against the transfer. If grandfather dies ten years later, the trust will receive a \$3.49 million death benefit free of income tax.⁴⁵

⁴⁴ Dynasty trusts are usually drafted to be spendthrift trusts. A spendthrift trust is a trust in which the claims of creditors of the beneficiaries are restricted.

⁴⁵ Illustration assumptions are as follows: Product: PruLife® Universal Protector; Premium: \$1 million single pay; Male A65; Underwriting: preferred best. Availability and rates will vary based on company underwriting criteria.



If the policy proceeds are invested in a fund earning a 7% after-tax return, the trust will be worth \$8.3 million at the son's death in twenty years. Assuming the granddaughter's death twenty years later and the continued after-tax return during that time of 7%, the sum available to the heirs will have grown to over \$32 million.

If the grantor's spouse consents, the GST tax exemption can be maximized further through the use of gift splitting. In addition, in those situations where the transferor wants to allocate the GST exemption or where the GST exemption is not enough with respect to the size of the transfer, the transferor could establish a split dollar arrangement to further maximize death benefit proceeds in relation to premium expense. Rather than equaling the full amount of the policy premium, the annual gifts under the traditional non-equity split dollar arrangement are limited to the amount of economic benefit. Consequently, a smaller amount of GST exemption is necessary to fully exempt the trust from the GST tax. (Note: The Sarbanes Oxley Act makes it a crime for publicly traded companies to, directly or indirectly, enter into a loan with certain directors and executive officers. It is unclear whether the Act applies to split dollar arrangements. Clients should consult their tax or legal advisors for the most recent developments.)

As previously noted, for life insurance trusts that benefit multiple generations, it will generally be necessary for the transferor (and his/her spouse in the case of split gifts) to allocate the GST exemption to the trust. To avoid undesirable GST tax consequences, trust instruments that benefit multiple generations are generally drafted using one of the following techniques:

- Use transferor's gift tax applicable exclusion
- Limit Crummey powers to the lapse protected amount (see page 20)
- Establish separate trusts or trust shares with a power of appointment for each Crummey power holder
- Use "hanging powers"

Dynasty Trust Using the Transferor's Gift Applicable Exclusion. The simplest approach to establishing a dynasty insurance trust is to have the transferor make taxable gifts to the trust (not use Crummey powers). Because the gifts to the trust do not qualify for the gift tax annual exclusion, the transferor will use his or her gift tax applicable exclusion, or pay gift taxes if the gift tax applicable exclusion has been exhausted. In this situation, the allocation of the GST exemption is relatively straightforward. So long as sufficient GST exemption is allocated to the premiums transferred to the trust, the trust inclusion ratio will be zero and the trust will be fully exempt from GST tax.



Prior to the Economic Growth and Tax Recovery Relief Act of 2001, the transferor had to file a gift tax return in order to allocate the GST exemption. Because the automatic allocation of the GST exemption was extended by the 2001 Act to include indirect skips to a “GST Trust,” the GST exemption may automatically be allocated to transfers made to life insurance trusts after December 31, 2000.

As previously indicated, the automatic allocation of the GST exemption to “GST Trusts” may provide relief to transfers where the allocation is inadvertently neglected. Advisors should still consider whether allocation of the GST exemption to the particular trust involved is an efficient use of the exemption.

Dynasty Trust Using Crummey Powers Limited to the Lapse Protected Amount. The allocation of GST exemption to life insurance trusts with Crummey provisions raises a number of complex issues involving the interplay of withdrawal rights and the effect of lapses of these powers. Because of that, great care should be exercised when these trusts are written.

The lapse or non-exercise of the Crummey demand right by a beneficiary (the typical scenario in an insurance trust) will be treated as a taxable gift to the other beneficiaries of the trust to the extent that the lapsed withdrawal rights exceed the greater of \$5,000 or 5% of the trust asset (the “five-and-five safe harbor”).⁴⁶

Example: Grandmother creates and transfers \$12,000 to a Crummey trust. The trust provides that income is to be paid to her son and, at his death, the trust principal is to be distributed to her only grandchild. Grandmother makes a timely allocation of her GST exemption for the transfer to the trust. The son does not exercise his Crummey withdrawal right with respect to the \$12,000 transfer and the power lapses after 30 days.

Results: The failure to withdraw the \$12,000 results in a taxable lapse of \$7,000 (the amount beyond the “five-and-five safe harbor”) and the son has made a transfer for gift tax purposes.

The GST regulations essentially provide that, upon the lapse of the withdrawal power, the holder of the Crummey power becomes the transferor of the lapsed amount for GST purposes (the amount in excess of the greater of \$5,000 or 5%).⁴⁷ To the extent the lapse of the Crummey power makes the power holder (the son in the above example) the transferor, and if the trust benefits skip persons with respect to the power holder, then the property subject to the power in excess of the safe harbor will not be exempt from GST as a result of the transferor’s (grandmother’s in the above example) allocation of the GST exemption. This is because the transferor (grandmother) is no longer considered the transferor of that portion of the trust for GST purposes. In order to maintain the trust’s zero inclusion ratio, it will be necessary for the Crummey power holder son to allocate part of his GST exemption to the trust. Basically, it is as if the trust is treated as two trusts for GST purposes.⁴⁸

⁴⁶ IRC §§ 2514(b), 2514(e).

⁴⁷ Reg. § 26.2652-1(a)(5), Example 5.

⁴⁸ IRC § 2652(b)(1) and Reg. § 26.2654-1(a)(2) require that portions of a trust attributable to different transferors must be treated as separate trusts.



To further complicate this analysis, under the ETIP rules, the transferor may not be able to allocate the GST exemption until the close of the estate tax inclusion period if the transferor's spouse has an interest in, or a power over, the trust that would cause inclusion in his estate (such as an income interest, or a power of appointment). Fortunately, by limiting the spouse's withdrawal right to no more than the greater of \$5,000 or 5% of the trust corpus, and having the spouse's withdrawal right terminate no later than 60 days after the transfer to the trust, it's possible to avoid application of the ETIP to the transferor's spouse.⁴⁹

On the other hand, the regulations provide that, to the extent the Crummey power holder's lapse is fully within the five-and-five lapse-protected safe harbor amount, the creator of the power (grandmother in the example) remains the transferor for GST tax purposes.⁵⁰ Therefore, to avoid the complicated tax issues of determining who the transferor is for GST tax purposes, and whose GST exemption can and should be allocated to the trust, trust instruments that benefit multiple generations are often drafted to limit the Crummey demand right to the "five-and-five safe harbor."

If the power holder has more than a five-and-five power, there are two techniques for potentially avoiding the problems caused by the lapse of the excess Crummey amount. One involves dividing the trust into separate trusts or shares for each Crummey power holder and giving each power holder a power of appointment over his or her trust share. The other involves structuring the Crummey withdrawal rights as "hanging powers."

Dynasty Trust Using Separate Trusts with Power of Appointment for Each Crummey Power Holder. To avoid the problems caused by lapsing Crummey withdrawal rights, practitioners may draft the trust to provide for separate trusts or shares for each Crummey power holder and give each power holder a power of appointment over his or her trust. In this situation, the lapse of a Crummey power in excess of the five-and-five amount will not be a completed gift because the "donor" of the gift (Crummey power holder) has retained control as long as the power of appointment has not been exercised.⁵¹ Because the lapse of the power in excess of the five-and-five amount will not be a taxable event, the lapse will not cause the power holder to become the transferor. Thus, the transferor can allocate his or her exemption in order to maintain a zero exclusion ratio for the trust. However, at the power holder's death, the gift will be complete and a proportionate share of the trust will be included in his or her gross estate and, to that extent, the allocation of the transferor's GST exemption will have been wasted.⁵²

Dynasty Trust Using "Hanging Powers." To avoid the problems caused by lapsing Crummey withdrawal rights, practitioners may include "hanging powers" in their generation skipping trust documents. A hanging power is a power to withdraw contributions to a trust that lapses only to the extent protected by the five-and-five amount.

⁴⁹ Reg. § 26.2632-1(c)(2).

⁵⁰ Reg. § 26.2601-1(b)(1)(v)(a).

⁵¹ Reg. § 25.2511-2.

⁵² IRC § 2041(a)(2).



Any amount in excess of the five-and-five limitation does not lapse but instead “hangs” and remains subject to the withdrawal power. The withdrawal right remains operative and is carried forward subject to lapse only to the extent of the five-and-five amount in each succeeding calendar year until the entire “hanging” amount is fully lapsed (if ever). Because a hanging power will not lapse in any year in excess of the five-and-five limits, there should be no shift of transferors for GST purposes. Thus, the transferor should be able to maintain the trust’s exempt status by simply allocating his or her GST exemption to transfers to the trust.

Hanging powers present two significant problems. First, if the power holder dies prior to the lapse of any amount subject to the hanging power, the un-lapsed amount is included in the power-holder’s gross estate. To that extent, the allocation of the transferor’s GST exemption will have been wasted.⁵³ Second, the Service has indicated that, at least in some circumstances, hanging powers do not work for gift tax purposes.⁵⁴ To the extent that hanging powers are ineffective for gift tax purposes, the GST tax consequences are unclear but may be the same as for Crummey powers that lapse in excess of the five-and-five limitation.

Summary

Although the generation skipping transfer taxes are complex, with careful planning and allocation of the GST exemption, family wealth can be transferred to grandchildren and future generations in ways that minimize transfer taxes and maximize family wealth. The GST Tax heightens the importance and usefulness of life insurance as a vehicle for multi-generational transfers of family wealth.

⁵³ IRC § 2041(a)(2).

⁵⁴ TAM 8901004 The Service relied on the principle of Proctor [142 F2d 824 (4th Cir.) cert. denied, 323 US 756 (1944)] where a transfer was made subject to a condition subsequent. The TAM might be inapplicable in the case of a hanging power drafted so that the determination of the extent to which the withdrawal right does not lapse and is carried forward is keyed to a mechanical numerical formula without the use of language that conditions it specifically on potential tax consequences.

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