

# Alphabet Soup: ILITs and the GST

With federal estate taxes designed to tax assets transferred from one estate to another, planning to preserve wealth for your children, grandchildren and future generations can be challenging. In 2006, the federal estate and gift tax rates reach as high as 46%; therefore, wealthy individuals, as well as those of modest means, need to carefully formulate their financial and estate plans in order to help minimize taxes and maximize their financial legacies. As a result, the irrevocable life insurance trust (ILIT) has become recognized as a straightforward mechanism for funding future estate tax liabilities and creating the potential for leveraged gifts to family or charity. However, in such cases, estate planners should also be aware of the implications of generation-skipping transfer (GST) taxes and take special care to ensure this additional transfer tax is not incurred.

Annual gifts by a donor to an ILIT are typically used to make premium payments on a life insurance policy insuring the life of the donor(s). The size of the gift will determine the amount of insurance the ILIT will be able to purchase. Thus, it is not uncommon for grandchildren to be included as ILIT beneficiaries in order to maximize the use of the donor's annual gift exclusion (\$12,000 annually per donee and \$24,000 for gifts made by husband and wife) and Crummey withdrawal powers.<sup>1</sup> The proceeds of a properly executed ILIT will not be included in the estate of the donor(s).

The GST tax is an additional tax imposed on all transfers (during one's lifetime or at death), either outright or in trust, to a skip person, where the transferred assets are not subject to estate taxes in the gross estate of the skipped generation. A skip person is an individual at least two generations removed from the generation of the transferor. For example, if a grandparent is a transferor, a grandchild qualifies as a skip person. The GST tax rate is currently equal to the maximum 46% federal estate tax rate and is applied to the entire transferred amount. In addition, every individual has a generation-skipping exemption (\$2 million in 2006) for transfers while living, as well as those at death, and the generation-skipping exemption cannot be transferred between spouses. It should be noted that the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) has amended the GST tax exemption amount in any calendar year to equal the estate tax applicable exclusion amount in effect for such calendar year. This change to the GST tax exemption amount becomes effective for the estates of decedents dying-and GST transfers made-after December 31, 2003.

## Dotting the "i" and Crossing the "t"

When properly drafted and implemented, an ILIT can be a creative tool for passing wealth to future generations while avoiding GST taxes. In many instances, this can be achieved without utilizing the donor's generation-skipping exemption. "Nontaxable gifts," such as those made under the annual gift exclusion, are excluded from the GST tax.<sup>2</sup> However, when nontaxable gifts are made to a trust, two additional vesting requirements must be met for the trust to be exempt from GST taxes.<sup>3</sup> First, the distribution of trust income and principal must be limited solely to the trust beneficiaries. Second, if a beneficiary predeceases the life of the trust, the deceased beneficiary's interest in the trust must be includable in his or her gross estate.

The use of ILITs is fairly commonplace in today's estate planning arena. However, the GST tax is typically underestimated as an issue. Thus, great care should be taken to help ensure generation-skipping transfer taxes do not undermine the benefits of an ILIT.

<sup>1</sup> Crummey v. Comm., 397 F.2d 82 (9th Cir. 1968).

<sup>2</sup> IRC Sec. 2642(c)(3).

<sup>3</sup> IRC Secs. 2642(c)(2) and 2652(c)(3).

The information provided is not written or intended as tax or legal advice and may not be relied on for purposes of avoiding any Federal tax penalties. MassMutual, its employees and representatives are not authorized to give tax or legal advice. Individuals are encouraged to seek advice from their own tax or legal counsel.

Copyright © 2006 Liberty Publishing, Inc. All Rights Reserved.

