

Avoiding GST Tax

When a Trust Beneficiary Dies Early

Now that the generation-skipping transfer (GST) tax has been with us more than 10 years, we have observed a problem that is occurring more frequently. When a trust beneficiary who is a child of the trust grantor dies before the grantor, and the child's own children become the beneficiaries, the GST tax may be invoked.

GST Tax Basics

Before you can clearly understand the problem and the potential solutions, you must become familiar with a few GST tax planning basics:

- **GST tax exemption.** Each individual is entitled to a \$1 million GST tax exemption.
- **Skip person.** GST tax applies to taxable transfers to anyone more than one generation below you, such as a grandchild or an unrelated person more than 37 years younger than you.

- **Annual exclusion gifts.** Outright gifts to skip persons that qualify for the \$10,000 gift tax annual exclusion are exempt from GST tax.
- **Predeceased child exception.** A gift or bequest to a grandchild whose parent has died before the transfer is not treated as a GST.

The Problem

Say you have created an irrevocable life insurance trust (ILIT) and have designated your children as co-beneficiaries. You have given the trustee authority to distribute income and principal among your descendants at his or her discretion during your lifetime. At your death, the ILIT will divide into separate, equal trusts for each living child and for the descendants of any deceased child.

Distributions to your children after your death will not be subject to GST tax because they are not skip persons. However, if no

portion of your GST tax exemption is allocated to the ILIT, then all distributions to your grandchildren will be subject to the 55% GST tax.

In the unfortunate event that one of your children dies before you, if the child leaves descendants, a GST taxable termination will occur on your death for the share of the insurance proceeds that otherwise would have gone to the deceased child. This problem potentially exists for many trusts to which the grantor's GST tax exemption has not been allocated because the predeceased child exception is not applicable.

With your estate planning advisor, review the impact of the early death on your general estate plan and, in particular, on the ILIT. Then you can choose the best GST tax avoidance strategy for your situation.

Solution 1: Apply Any Available GST Tax Exemption

The first tool to consider is the GST tax exemption. If you have not already used your GST tax exemption elsewhere, now would be an appropriate time to re-examine the situation and consider making a late allocation.

If this is possible, consider whether the ILIT could be split into separate shares and the late allocation made only to the deceased child's share. This way you won't have to waste any of your GST tax exemption on transfers that won't be subject to GST tax. The ILIT would have to be split pursuant to an enabling power in the trust agreement, under state law or pursuant to court reformation.

Solution 2: Distribute The Policy Out of the Trust

Another possibility is for the trustee to exercise discretion and distribute the policy out of the trust to your living children. While this would provide a potentially unequal benefit to your children, in your estate plan you could make a compensating provision for your deceased child's children to minimize the imposition of the GST tax.

An alternative to the trustee's discretion, where available, is the exercise of a special power of appointment if the power is held by someone other than one of your children.

***Solution 3: Let the Policy Lapse
And Create a New Trust***

Another option involves allowing the current policy to lapse and creating a new insurance trust structured to minimize the GST tax problem. The new trust would acquire a new policy on your life.

Or, you could purchase the existing policy from the ILIT and contribute it to a new insurance trust or trusts. In this case, you need to consider the transfer-within-three-years-of-death issue.

***Don't Forget About
The GST Tax Possibility***

Many ILITs and other gift trusts are initially intended to benefit just the next generation. Because of the possibility that a beneficiary from the next generation may not survive and may leave children, special care in planning is necessary. Take such care both at the drafting stage and on the beneficiary's death to avoid or minimize the impact of the GST tax.