IF THE TRUST MAY BENEFIT generations lower than the grantor's children, the transferor must allocate a generation-skipping transfer exemption on a gift tax return.

ALLOCATION OF GST EXEMPTION TO CONTRIBUTIONS TO LIFE INSURANCE TRUSTS

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When the grantor of a life insurance trust transfers funds to the trust to pay insurance premiums, powers of withdrawal may be created in trust beneficiaries to qualify the transfers as annual exclusion gifts under IRC section 2503(b). *Crummey v. Comm'r* [397 F.2d 82 (9th Cir. 1968)] held that a power of withdrawal over contributions to a trust constituted a present interest for purposes of the annual gift tax exclusion.

To obtain an annual gift tax exclusion for property subject to a withdrawal power, Revenue Ruling 81-7 (1981-1 CB 474) requires that the powerholder must be given notice of the power and a reasonable time within which to exercise the power before it lapses. The IRS has ruled in TAM 9532001 that a beneficiary who waives notice of future rights of withdrawal will not be considered as having received adequate notice in subsequent years, with the result that any future gifts in trust will not qualify under *Crummey* for the annual gift tax exclusion. It is therefore essential for taxpayers to have evidence to satisfy the IRS that the beneficiaries knew of their withdrawal rights.

If the trust may benefit generations lower than the grantor's children (i.e., in trust for child for life, remainder to grandchildren in continuing trust), the transferor must allocate a generation-skipping transfer (GST) exemption on a gift tax return to prevent a GST tax on distributions to such beneficiaries, even if the filing is not required for gift tax purposes because the gifts are within the grantor's annual gift tax exclusions. A GST exemption must be allocated to all transfers to the trust, even with respect to those for which *Crummey* withdrawal powers are held by the grantor's children. Further, the practitioner may not rely on the "predeceased child exception" to the GST tax, notwithstanding that the grantor's child may predecease the grantor during the trust term, because that exception applies only where the grandchild's parent is dead at the time of the transfer.

Direct Skips in Trust

Under the GST provisions as originally enacted by the Tax Reform Act of 1986, gifts in trust that qualified for the annual $10,000 gift tax exclusion were also excluded for GST purposes. This GST exclusion was subsequently limited; after March 31, 1988, only certain transfers qualify for the GST tax annual exclusion in addition to the gift tax annual exclusion.

Under IRC section 2642(c), transfers in trust will qualify for the GST tax annual exclusion only if they are direct skip gifts in trust for the benefit of a single beneficiary in whose estate the trust property will be taxable either because the trust property is payable to the beneficiary's estate at death or because the beneficiary has a general power of appointment over it. In order for a trust to be fully GST exempt, a portion of the grantor's GST exemption must be allocated to every transfer to any trust from which distributions to grandchildren may be made (even if the gift tax annual exclusion may apply), unless the grandparent creates a separate insurance trust for the benefit of each grandchild, to the exclusion of the grantor's children.

Transferor

A lapse of a *Crummey* withdrawal power is a release of the holder's general power of appointment to the extent the lapsed withdrawal right exceeds the greater of $5,000 or five percent of the trust assets, per IRC section 2514(e). As a result, any amount that lapses in excess of this "5 & 5" amount will be deemed a current taxable gift from the powerholder to the beneficiaries of the trust. Such deemed gift will be ineligible for the annual gift tax exclusion, and the powerholder will become the "transferor" for GST tax purposes to the extent of this excess. Typically, insurance trusts are drawn such that there will be no lapse in excess of the 5 & 5 amount (by use of a "hanging" *Crummey* power), and the original grantor will remain as the transferor for GST tax purposes. If the *Crummey* powerholder dies while any hanging withdrawal rights are outstanding, the property subject to the power will be includable in the powerholder's gross estate.

Regulations section 26.2652-1(a)(5) Example 5, *Effect of Lapse of Withdrawal Right on Identity of Transferor*, illustrates this point:

T transfers $10,000 to a new trust providing that the trust income is to be paid to T's child, C, for C's life and, on the death of C, the trust principal is to be paid to T's grandchild, GC. The trustee has discretion to distribute principal for GC's benefit during C's lifetime. C has a right to withdraw $10,000 from the trust for a 60-day period following the transfer. Thereafter, the power lapses. C does not exercise the withdrawal right. The transfer by T is subject to Federal gift tax because a gift tax is imposed under IRC section 2501(a) (without regard to exemptions, exclusions, deductions, and credits) and, thus, T is treated as having transferred the entire $10,000 to the trust. On the lapse of the withdrawal right, C becomes a transferor to the extent C is treated as having made a completed transfer for purposes of chapter 12 [gift tax exclusion]. Therefore, except to the extent that the amount with respect to which the power of withdrawal lapses exceeds the greater of $5,000 or five percent of the value of the trust property, T remains the transferor of the trust property for purposes of chapter 13 [GST].

If a $10,000 transfer in trust is subject to a power of withdrawal the lapse of which is not limited to the greater of $5,000 or five percent of the value of the trust property, an over-allocation of the GST exemption may be necessary in order to obtain a zero inclusion ratio for the transfer. T must allocate $10,000 of GST exemption to the original transfer, and C must in turn allocate $5,000 of a GST exemption to the lapsed amount in excess of the 5 & 5 amount. If T makes a late allocation of GST exemption, only $5,000 of the GST exemption must be allocated, assuming no capital appreciation.

However, as noted above, careful drafting will prevent lapses each year in excess of the 5 & 5 amount, and the presence of the *Crummey* withdrawal power in the grantor's child will not change the identity of the transferor from the grandparent to the child. Distributions from the trust to grandchildren will be subject to GST tax, either as taxable distributions or taxable terminations, unless the grandparent-transferor had allocated GST exemption to each transfer to the trust on a gift tax return.

This result is confirmed by Richard Covey, Esq.:

> The trust is not a skip person, and powers of withdrawal in a C or GC are ignored for GST purposes unless a lapse of such a power is a taxable gift by the powerholder. Distributions from the trust to a skip person will be taxable distributions, except to the extent that 1) T allocates GST exemption to the trust or 2) the lapse of a power of withdrawal results in a taxable gift by the powerholder, thereby causing him to become T. With a discretionary trust, the lapse of a power of withdrawal will be a taxable gift by the holder [subject to the application of the exception in section 2514(e)], except to the extent his or her creditors may reach the lapsed amount (*Practical Drafting*, October 1996, chapter nine, section F, page 4657).

This conclusion was also reached in PLR 9541029, which stated the following:

The amount over which each beneficiary's power lapsed was less than $5,000 or five percent of the aggregate value of the assets out of which the exercise of the lapsed power could have been satisfied. Therefore, under section 2514(e), the lapse is not considered a transfer for gift tax purposes. Accordingly, the decedent remains the transferor of the property for generation-skipping transfer tax purposes. Accordingly, we conclude that the decedent is the transferor, for purposes of the generation-skipping transfer tax, of the entire trust. The personal representative of the decedent's estate may allocate the unused portion of the decedent's generation-skipping transfer tax exemption to the trust.

Allocation of GST Exemption

Even if the GST exemption was not allocated to transfers to an insurance trust on a timely filed gift tax return, if the trust will likely pass to grandchildren, the filing of a return should be considered now to make a late allocation that will fully protect the trust from GST tax. Of course, all contemplated transfers by the grantor should be examined to determine the most effective allocation of the grantor's GST exemption.

Regulations section 26.2632-1(b)(2)(i) describes the general procedure as follows:

> An allocation of a GST exemption to property transferred during the transferor's lifetime, other than in a direct skip, is made on Form 709. The allocation must clearly identify the trust to which the allocation is being made, the amount of GST exemption allocated to it, and if the allocation is late or if an inclusion ratio greater than zero is claimed, the value of the trust assets at the effective date of the allocation.... The allocation should also state the inclusion ratio of the trust after the allocation.

If the gift tax return is timely filed, the allocation of GST exemption is effective as of the date of original transfer. Even if no timely allocation of GST exemption was made, the regulations still provide a mechanism for late allocation of available GST exemption, based on the value of the gift on the date the gift tax return is filed rather than the date of original transfer:

> Except as otherwise provided, an allocation of GST exemption is effective as of the date of any transfer as to which the Form 709 on which it is made is a timely filed return (a timely allocation).... [A]n allocation to a trust made on a Form 709 filed after the due date for reporting a transfer to the trust (a late allocation) is effective on the date the Form 709 is filed and is deemed to precede in point of time any taxable event occurring on such date. For purposes of this paragraph (b)(2)(ii), the Form 709 is deemed filed on the date it is postmarked to the Internal Revenue Service Center [Regulations section 26.2632-1(b)(2)(ii)(A)(1)].

LATE ALLOCATION OF GST EXEMPTION to transfers to an insurance trust is often just as efficient as timely allocation.

The value of an existing insurance policy is not simply the cash surrender value; Regulations section 25.2512-6(a) provides that the value may be approximated by adding to the policy's interpolated terminal reserve at the date of the gift the proportionate part of the gross premium last paid before the date of the gift that covers the period extending beyond that date. The insurance agent might assist in obtaining this information. This method may not be available if the insured's health has deteriorated substantially.

In our experience, late allocation of GST exemption to transfers to an insurance trust is often just as efficient as timely allocation, because the asset in the trust (the insurance policy) would not have grown substantially. Many commentators suggest an intentional late allocation, particularly in the early years of the policy, when administrative costs, including commissions, are high, and the policy may actually be worth less than the sum of the premiums paid in. Of course, this course of action bears the risk of the insured's sickness or death, and should be pursued with caution. ❑