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Subject: **Planning For Transfers to GST-Exempt Life Insurance Trusts During 2010**

Prior AALU Washington Reports: 10-14; 10-12; 09-141; 08-69; 03-01; 02-124; 02-92

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THE CONCLUSION OF THIS WASHINGTON REPORT.**

As discussed in our previous Washington Reports on estate tax repeal (see, e.g., our Bulletins Nos. 10-12 and 09-141, as the result of changes adopted in the Economic Growth And Tax Relief Reconciliation Act of 2001 ("EGTRRA," P.L. 107-16), both the federal estate tax and the generation-skipping transfer (GST) tax (but not the gift tax) are repealed during 2010. Because the GST tax is repealed, the ability to allocate GST exemption to existing trusts, including life insurance trusts to which continuing gifts of premium amounts are necessary, also is theoretically repealed during 2010.

As explained in our Bulletin No. 10-14, most life insurance trusts rely on the dual availability of § 2503(b) of the Internal Revenue Code (the "Code") for the gift tax exemption and § 2642(c) of the Code for the GST exemption when making gifts to irrevocable life insurance trusts - usually through the use of "Crummey" demand rights. The GST tax is not applicable in 2010 (although it may be retroactively restored) and thus no allocation of GST exemption may be made, leaving open the question of whether the inclusion ratio of such trusts may not be zero in 2011 with respect to gifts made during 2010.

A number of solutions have been suggested to address these concerns, which may be summarized as follows:

1. **Loans to Pay Premiums.** We advised in Bulletin No. 10-14, that, while the allocation issue may turn out to be only a theoretical annoyance, it may be wise to consider making premium payments through loans (from either the grantor or the policy), as opposed to gifts, to the trust, until this issue is

resolved. Such loans, if funded by the grantor, probably would fall within the definition of a “split-dollar arrangement,” and therefore care should be taken to charge an interest rate at least equal to the “applicable federal rate” for the month in which the transfer is made, and all other provisions of the split-dollar regulations should be followed. (The split-dollar implications obviously need not be considered if the loans can be made from policy values.)

2. Avoid 2010 Contributions. Depending on a policy’s past funding levels and investment performance, it may be possible to skip the premium payment or defer it until 2011. Alternatively, the trust may use existing trust assets to pay the 2010 premium (e.g., by applying the policy’s existing cash value to the 2010 premium).

3. Late Allocations. Another option would be to wait until the ability to make an allocation of GST exemption to the trust is restored (as we assume will happen at some point) and make a “late allocation” of GST exemption - under Code § 2642(g) - to the trust for amounts contributed during 2010. In Notice 2001-50, 2001-2 C.B. 189, released on August 1, 2001, the Internal Revenue Service announced that taxpayers may seek an extension of time to make a late allocation of GST exemption (or an election out of the deemed allocation of that exemption in certain circumstances) under the provisions of Reg. Section 301.9100-3. Generally, relief would be granted under this regulation if the taxpayer acted reasonably and in good faith and if granting relief won’t prejudice the government’s interests. Taxpayers requesting relief were directed to follow the procedures for requesting a private letter ruling under reg. section 301.9100. As reported in our Bulletins Nos. 02-92, 02-124 and 03-1, the Revenue Service has been generous in granting ruling requests for “Section 9100”-type” relief with respect to late allocations of GST exemption. In 2008, the IRS issued proposed regulations updating the circumstances in which late allocation relief would be granted, including lists of some of the factors that would be considered by the IRS in determining whether to grant relief. (See our Bulletin No. 08-69.)

This approach assumes that GST exemption is available to allocate under the reinstated GST laws, and it would not be effective should the insured die in the meantime. Further, the ability to make a late allocation at values at the time of the gift would not be available should the generation-skipping transfer tax revert to its pre-2001 provisions, since the § 2642(g) relief provision was added by EGTRRA and would not be effective unless the EGTRRA GST reforms are reinstated.

4. New “Mirror” Trust. Yet a fourth option (which is making the rounds of estate planning blogs and appears to be originally based on a presentation at the 44th Annual Heckerling Institute on Estate Planning in January 2010) is not to waste annual exclusion, but to make gifts in such a way that, when the uncertainty is over, the gifts can be added to the existing GST-exempt insurance trust. This technique involves several steps, as follows:

Step 1: Create a new ILIT (funded with 2010’s available annual exclusion amount), the beneficiary of which is the old ILIT; Step 2: To pay the premiums, client lends money to the original ILIT trust to make the payments; and Step 3: Once the legislative uncertainty is over, if there is available GST exemption, the trustee of the new trust can contribute the assets of the new ILIT to the old trust (presumably after an allocation of that exemption to the contributed assets), and the old ILIT can then repay the debt.

This technique may be viewed as cumbersome and doubtless would be expensive, although the expense would be mitigated to the extent that the original trust could be “cloned,” and simply merged with the original trust after an allocation of GST exemption is made to the new trust. It has the advantage, however, of preserving the client’s 2010 annual exclusion amount, while retaining the ability to allocate GST exemption at a later date.

We thank AALU’s Business, Insurance and Estate Planning (BIEP) Committee for their suggestion to address this issue and for their input to this Washington Report.

As always, we again emphasize that any suggestions made in this and other Washington Reports should be undertaken only with the advice and judgment of legal counsel. We are not offering drafting or legal advice; we are merely attempting to give an appropriate background to help you think through your clients needs for ultimate referral to legal counsel.

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