TRENDS 360

Leveraging Generation-Skipping-Transfer Exemption in Life Insurance Planning

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BACKGROUND

The **generation-skipping-transfer (GST) tax** is a federal transfer tax that can apply when wealth is transferred to a beneficiary who is two or more generations below the transferor (like a grandchild), whether the transfer is made outright or through a trust. In general, the GST tax is imposed in addition to the federal estate-or-gift tax, and is designed to prevent families from avoiding transfer tax at each generational level by skipping a generation. The GST tax rate is equal to the highest federal estate tax rate (currently 40%). This penalty is not inconsequential to successful families as it can change the trajectory of success between generations.

THE CONTEXT

Planning for the GST is often overlooked because the rules are hyper-technical, and the tax consequences remain latent. Exposure most commonly arises in long-term, multigenerational trusts that attempt to make distributions to a "skip person." If the trust hasn't had a GST exemption allocated to (long ago), the GST tax will exact its toll.

Dynasty trusts solve this issue by ensuring the GST exemption is proactively allocated at inception. This allocation acts as a powerful shield, allowing trust assets to move freely across generations without incurring GST tax. This so-called leveraging of the GST exemption over future appreciation allows the family resources to grow and compound on a larger base of assets between generations. Tax mitigation may provide benefits over long periods of time.

To ensure the GST exemption is properly allocated, it's important to make a deliberate election, typically by filing a gift tax return (Form 709). By reporting the transfer on Form 709 and affirmatively selecting the allocation of a GST exemption, the trust's protected status is documented and confirmed. This intentional allocation helps avoid ambiguity and maintains the trust's multigenerational benefits, safeguarding assets from GST tax as they're distributed to succeeding generations.

Exercise caution – the effectiveness of any life insurance strategy hinges on the choice of product. Product design is critical. If a term insurance policy is used as the funding vehicle, allocating a GST exemption may squander its potential, since term products are far more likely to lapse before a benefit is realized wasting the possible GST exemption.

The Strategies – Optimizing

Life insurance can optimize the GST exemption. Life insurance alone delivers unparalleled leverage (especially in the split-dollar context), and a level of predictability relative to other asset classes. Sure, other appreciating assets might offer the same GST-leveraging effect, but the key is might. However, a family has no control over two important variables – mortality (time horizon) and asset performance. Life insurance acts as a hedge against mortality and asset performance. It is designed to provide leverage. And when split dollar is used, the leverage may be more pronounced compared to other approaches, as split dollar offers the only IRS-approved discounting option.

IRREVOCABLE LIFE INSURANCE TRUST

Put simply, a traditional life insurance trust can leverage the GST exemption using several funding methods. You can directly use your gift-tax exemption, make annual exclusion gifts (like "Crummey gifts"), or even employ split-dollar arrangements – which supercharge the leverage by minimizing the taxable gift.

To explain briefly: Exemption use involves assigning the GST exemption to specific assets or trusts, protecting them from GST taxes and allowing wealth to move efficiently to later generations. Crummey gifts are contributions made to a trust where beneficiaries are given a short-term right to withdraw the funds, which lets the gifts qualify for the annual gift-tax exclusion. This helps families fund trusts and maximize exemption benefits by leaving them untapped.

Split-dollar arrangements share the costs and advantages of a life insurance policy between the grantor and the trust, sometimes using the economic benefit regime. The only trust-based gift is the value of the insurance protection afforded (the mortality charge), so the GST exemption can be applied gradually, ultimately shielding a larger death benefit from GST tax.

Example: Split dollar for a young couple. Consider a 40-year-old married couple, Alex and Taylor, who want to maximize their legacy through GST-efficient planning. They establish a dynasty trust and implement a private split-dollar arrangement using the economic benefit regime. The trust owns a life insurance policy with a $10 million face amount on Alex and Taylor, while they pay annual premiums totaling $50,000. Under the economic benefit approach, only the annual value of the life insurance protection (the economic benefit) – say, $8,000 per year – is treated as a gift to the trust, and thus subject to a GST exemption allocation.

Each year, Alex and Taylor allocate a GST exemption equal to the economic benefit amount ($8,000), not the full premium or policy value. Over 20 years, they merely use $160,000 in total GST exemption. Appendix A (below), illustrates the comparative leverage of this split-dollar design against a traditional gift-and-purchase insurance structure and a gift-and-invest approach over the same 20-year period.

When both insureds pass, the dynasty trust receives the entire $10 million, fully protected from GST tax. If the GST exemption had not been allocated, the trust would owe up to $4 million in GST tax (at a 40% rate) on the proceeds eroding their family balance sheet and the future compounding thereon.

TRADITIONAL PLANS: FAMILY AND MARITAL TRUST STRUCTURES

In more conventional legacy plans, assets frequently divide at the first spouse's passing between a family (or bypass) trust and a marital trust. The primary purpose of the bypass trust is to use (or capture) the remaining federal estate tax exemption available to the deceased spouse.

As an added benefit, planners often allocate any remaining federal GST exemption to the family trust as well. This dual allocation strategy not only shields the trust assets from estate tax, but also helps preserve them from GST tax exposure.

GRANTOR RETAINED ANNUITY TRUSTS

A grantor retained annuity trust (GRAT) is a specialized legacy planning tool designed to transfer future asset appreciation to heirs at minimal gift tax cost. In a GRAT, the grantor places assets into a trust and receives fixed annuity payments for a predetermined period. The annuity is calculated so that, if the assets only grow at the IRS's assumed rate (known as the Section 7520 rate), the value returned to the grantor will equal the value contributed – meaning little or no taxable gift is made.

However, if the trust assets outperform the IRS rate, the excess appreciation at the end of the term passes to the remainder beneficiaries (often children or grandchildren) or to a continuing trust, with little or no gift tax liability.

It's important to understand that because the grantor retains an interest in the trust during the annuity term, a GRAT generally isn't eligible for a GST exemption allocation at inception. The GST planning opportunity emerges at the end of the GRAT's term, once the grantor's retained interest ends.

If the grantor survives the GRAT term, any remaining assets are transferred to a continuing trust for descendants. At this point, a GST exemption can be allocated to the continuing trust, effectively shielding those assets from GST tax as they pass to future generations

Planning idea: The continuing trust can then acquire life insurance, amplifying the benefit. A relatively modest allocation of a GST exemption can protect a much larger pool of assets – including life insurance proceeds – from GST tax, preserving family wealth over the long term. This approach combines the advantages of GRATs (tax-efficient asset transfer using possibly a marginal amount of the family's gift-tax exemption) with the multigenerational protection of GST-exempt trusts, maximizing the family's legacy.

This planning opportunity highlights the importance of collaborating with allied professionals. Partnering with both an experienced estate planning attorney and a knowledgeable accountant is essential to ensure that GST exemption allocations are properly executed.

PARTING THOUGHTS

1. The GST exemption can easily be missed unless allied professionals coordinate their efforts to produce a better outcome.

2. Life insurance can act as an accelerator for GST maximization.

3. Failure to allocate which creates a non-GST exempt trust carries a material risk: Future law changes can negatively alter the economics of future transfers.

> **Example:** Consider a long-term trust that isn't fully GST exempt, and 15 years from now, distributes $5 million to grandchildren after significant growth. If the GST tax rate at that time were ten percentage points higher than today, the incremental tax cost on that single distribution could be $500,000 – driven solely by the rate change, not by any change in the family's planning objectives.

4. In 2025, the IRS issued two Private Letter Rulings (202507005 and 202531005) laying the groundwork for stricter scrutiny of GST planning.

REVIEW CURRENT ARRANGEMENTS

Properly leveraging the GST exemption isn't just a technical exercise – it's a can have a significant impact on a family's balance sheet. By thoughtfully allocating the exemption and optimizing with life insurance strategies, families may enhance the ability for wealth to transfer across generations. Results will vary.

It's worth taking a fresh look at existing arrangements with your advisor. Reviewing how life insurance is currently owned or whether it should be acquired, how related trusts are structured, and whether key elections have been made, can all help ensure the plan is aligned with long-term objectives.

APPENDIX A

		Split Dollar	No Split Dollar	No Insurance
Year 1	**Asset Value**	$10,000,000 life insurance policy	$10,000,000 life insurance policy	$50,000 account value
Year 1	**GST Exemption Allocated**	$8,000	$50,000	$50,000
Year 1	**Leverage per $1**	$1,250	$200	$1
Year 20	**Value**	$10,000,000 life insurance policy	$10,000,000 life insurance policy	$1,579,757 account value (6% ROR)
Year 20	**Cumulative GST Allocated**	$160,000	$1,000,000	$1,000,000
Year 20	**Leverage per $1**	$62.50	$10	$1.58

In this hypothetical example, a split-dollar life insurance arrangement produced higher projected outcomes than the other illustrated approaches. For a mere $160,000 GST allocation, the couple transferred $10,000,000 through multiple (maybe endless) generations, reducing potential GST tax exposure. Other strategies may produce different outcomes.

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