Florida Law Review

Volume 30 | Issue 3 Article 4

April 1978

Application of the New Generation-Skipping Tax to Life Insurance Proceeds: A Headache for Everyone Involved

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NOTES

APPLICATION OF THE NEW GENERATION-SKIPPING TAX TO LIFE INSURANCE PROCEEDS: A HEADACHE FOR EVERYONE INVOLVED*

INTRODUCTION

In its continuing effort to redistribute wealth and to get its finger in the pie, the federal government has recently enacted the new tax on generation-skipping transfers – Chapter 13 of the Internal Revenue Code.[1] One purpose of the tax is to extract a fair share for government and to discourage wealth accumulation in arrangements that transfer wealth from generation to generation and that under past law have escaped transfer taxes.[2] The purpose stated in committee reports is to equalize tax treatment among the economic classes of Americans through elimination of the generation-skipping trust which allowed wealthier individuals to escape estate taxes.[3] While such trusts were theoretically available to all individuals, only those with substantial wealth would have the requisite funds to establish a trust providing benefits to more than one generation of beneficiaries. Hence, the wealthy were able to escape several generations of estate taxes while other economic classes were subject to these taxes each generation. The motivation that runs throughout the chapter is that wealth should be taxed once for each generation that has enjoyed its benefit.[4] Under current estate and gift tax law, the corpus of a trust which provides for a life interest in a son with remainder to his children will be taxed once upon the establishment of the trust and then not again until the death of the son's children. At the death of the son no estate tax will be imposed since there was no interest in the son's estate to be taxed.[5] The son's generation of wealth

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EDITOR'S NOTE: This note was awarded the *Gertrude Brick Law Review Apprentice Prize* as the outstanding note submitted by a Senior Candidate in the Winter 1978 quarter.

1. I.R.C. §§2601-2622.

2. *See* Stephens & Calfee, *Skip to M'Loo*, 32 TAX. L. REV. 443, 448 (1977) [hereinafter cited as Stephens & Calfee] for a discussion of the federal government's continuing effort to tax wealth transfers.

3. Although the tax advantages of generation-skipping trusts are available to all, it is only the wealthy who may practically take advantage of them since they are the only ones whose wealth will create enough interest income to make a generation-skipping trust worthwhile. Recognizing the inequities in application of the tax advantage and also recognizing that the effect of escaping tax for a generation defeats the progressive nature of federal taxes for which Congress strives, legislators felt a change of law was warranted. H.R. REP. NO. 94-1380, 94th Cong., 2d Sess. 47, *reprinted in* 1976-3 C.B. 735 [herinafter cited as H.R. REP.].

4. "The tax is to be substantially equivalent to the estate tax which would have been imposed if the property had been actually transferred outright to each successive generation." *Id.*

5. "[T]he mere termination of a person's interest in property, if he never had an interest other than that which terminated, was invariably viewed as a tax nullity, even though the termination was accompanied by a shift of a present interest to another." Stephens & Calfee, *supra* note 2, at 449. When the life tenant dies his interest is extinguished leaving nothing to

enjoyment escapes taxation through the use of the trust.[6] Such an arrangement is the simplest form of generation-skipping trusts addressed by the new taxing statute. Under the new law, a generation-skipping tax may be imposed at the death of the son.

The new transfer tax[7] is designed to apply to all generation-skipping trusts[8] including "trust equivalents."[9] Life insurance and annuities are examples of arrangements that are specifically included within the statute's trust equivalent definition.[10] This note will examine the kinds of life insurance and annuity contracts that may be classified as trust equivalents. In addition, an examination will be made of how the tax may be applied in those cases.

Following an analysis of the new law, the types of insurance arrangements that are most likely to be affected by the tax will be examined. Special emphasis will be placed on those problems that will likely be encountered in trying to administer the new tax from the viewpoint of both the insurance company and the beneficiary.

THE NEW GENERATION-SKIPPING LAW

Before applicability of the new law to insurance arrangements can be understood, an overview is essential. As indicated above, the new taxing scheme applies only to generation-skipping trusts and trust equivalents. Since in-

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pass as part of his estate. The interest of the remainderman is deemed to pass from the grantor of the trust itself. *See, e.g.*, Keeter v. United States, 323 F. Supp. 1093, 1971-1 U.S. Tax Cas. ¶12,759 (N.D. Fla. 1971), *rev'd on other grounds*, 461 F.2d 714, 1972-1 U.S. Tax Cas. ¶12,759 (5th Cir. 1972); Estate of Wittman v. Commissioner, 11 T.C.M. (CCH) ¶19,054 (1952); Estate of Schwartz v. Commissioner, 6 T.C.M. (CCH) ¶15,621 (1947).

6. If the trust vehicle had not been used, the assets would have passed to the son outright. The assets would then be included in the son's gross estate to whatever extent they were not consumed during his life. *See* I.R.C. §2033.

7. "A tax is . . . imposed on every generation-skipping transfer." I.R.C. §2601. "The amount of the tax imposed . . . shall be the excess of —

(1) a tentative tax computed in accordance with the rate schedule set forth in section 2001(c) (as in effect on the date of transfer) on the sum of —

(A) the fair market value of the property transferred determined as of the date of transfer (or in the case of an election under subsection (d), as of the applicable valuation date prescribed by section 2032),

(B) the aggregate fair market value (determined for purposes of this chapter) of all prior transfers of the deemed transferor to which this chapter applied,

(C) the amount of the adjusted taxable gifts (within the meaning of section 2001(b)) made by the deemed transferor before this transfer, and

(D) if the deemed transferor has died at the same time as, or before, this transfer, the taxable estate of the deemed transferor, over

(2) a tenative tax (similarly computed) on the sum of the amounts determined under subparagraphs (B), (C), and (D) of paragraph (1)." I.R.C. §2602.

8. "The term 'generation-skipping trust' means any trust having younger generation beneficiaries . . . who are assigned to more than one generation." I.R.C. §2611(b). See text accompanying notes 11-14 *infra*.

9. I.R.C. §2611(d)(1) defines trust equivalents as arrangements which "although not a trust, [have] substantially the same effect as a generation-skipping trust."

10. "Arrangements to be taken into account . . . include (but are not limited to) arrangements involving life estates and remainders, estates for years, insurance and annuities, and split interests." I.R.C. §2611(d)(2). See note 58 *infra*.

surance will only qualify as a trust equivalent when it has substantially the same effect as a generation-skipping trust, it is essential that the basic term be understood. The law itself defines a generation-skipping trust as "any trust having younger generation beneficiaries . . . who are assigned to more than one generation."[11] Anyone who possesses a present or future interest[12] in a generation-skipping trust is a younger generation beneficiary if he is assigned to a generation that is at least one generation younger[13] than the grantor.[14] For example, a trust in which the grantor's son has a life estate with the remainder going to the grantor's grandchildren would have as younger generation beneficiaries both the son and grandchildren. Each is in younger generations than the grantor and each has a present or future interest in the trust. Once it is determined that a generation-skipping trust or trust equivalent is involved, it becomes necessary to examine the events that will trigger a tax. There are two such events listed in the statute: the taxable distribution,[15] and the taxable termination.[16]

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11. I.R.C. §2611(b). For example, a trust in which the only two beneficiaries are the son and grandson of the grantor would meet this younger generation beneficiary test; each beneficiary belongs to a different generation that is younger than that of the grantor.

12. "The term 'beneficiary' means any person who has a present or future interest or power in the trust." I.R.C. §2613(c)(3). The statute defines a person having an interest as either a person who has the "right to receive income or corpus from the trust" or "a permismisible recipient of such income or corpus." *Id.* §2613(d)(1). A power is described as the ability to "establish or alter beneficial enjoyment of the corpus or income of the trust." *Id.* §2613(d)(2).

13. I.R.C. §2613(c)(1). A beneficiary is assigned a generation by virtue of his family relationship to the grantor. H.R. REP., *supra* note 3, at 48. The basic rule for related beneficiaries, whether related by the half blood (I.R.C. §2611(c)(3)) or by legal adoption (I.R.C. §2611(c)(4)), is to look to the natural family generation pattern. "[A]n individual who is a lineal descendant of a grandparent of the grantor shall be assigned to that generation which results from comparing the number of generations between the grandparent and such individual with the number of generations between the grandparent and the grantor." I.R.C. §2611(c)(1). Grandparents, parents, brothers and sisters and first cousins of the grantor will never belong to a generation younger than the grantor so they could never be younger generation beneficiaries. Spouses are assigned to the same generation as their related spouse, regardless of age, so spouses of the above named persons would also never be younger generation beneficiaries. Children, nephews and second cousins of the grantor would be in the first generation of younger generation beneficiaries while grandchildren, grand nephews, and third cousins would be second younger generation.

For beneficiaries outside the family, the generation level changes every twenty-five years. The first set of younger generation beneficiaries are those who are more than twelve and a half years younger than the grantor but not more than thirty-seven and a half years younger. *See* I.R.C. §2611(c)(5).

14. Nowhere in the statute is the term "grantor" defined. The house report gives some guidance in stating that "a 'grantor' of the trust would include any person contributing or adding property to the trust." H.R. REP., *supra* note 3, at 48. This would seem to be the person who controls the original fund or adds to it. See text accompanying notes 75-94 *infra*.

15. Under I.R.C. §2601 a tax is imposed on generation-skipping transfers which are defined as "any taxable distribution or taxable termination with respect to a generation-skipping trust or trust equivalent." I.R.C. §2611(a). For a discussion of what constitutes a taxable distribution see text accompanying notes 17-19 *infra*.

16. For a discussion of what constitutes a taxable termination see text accompanying notes 22-24 *infra*.

A taxable distribution[17] occurs whenever trust funds other than income are distributed to a younger generation beneficiary who is assigned to a generation younger than that of another younger generation beneficiary with a present interest or power.[18] For instance, consider a trust to the grantor's son and grandson. If during the son's life amounts out of the corpus of the trust are paid to the grandson, a taxable distribution occurs at the time the payments are made. Both the son and the grandson, who are members of different younger generations, would be receiving present benefits in the same year and amounts in excess of the trust income would have been paid out in that year. Note, however, that section 2613(b)(6) of the code excepts from the generation-skipping tax any transfer to grandchildren of the grantor up to $250,000 per deemed transferor. The exception applies to both taxable terminations and taxable distributions. For the purposes of this note, it will be assumed that the grandchild exclusion is not applicable. As the above example indicates, in order for a distribution to be taxable there must always be younger generation beneficiaries in at least two different generation levels, both of which have present interests in the year of the distribution. The amount taxable as a distribution will only be those amounts paid to the member of the younger beneficiary level that exceed trust income for the year.[19] Whenever a taxable distribution occurs, the distributee is liable for the tax imposed[20] to the extent of the fair market value of the distribution.[21]

The other event that triggers imposition of the tax is a "taxable termination."[22] A "taxable termination" occurs whenever there is a termination of the present interest or power of a younger generation beneficiary. The termination will be taxable if the beneficiary whose interest has terminated is assigned to a

17. See text accompanying notes 112-131 *infra*.

18. I.R.C. §2613(a)(1).

19. Under §2613(a)(2), whenever distributions in any year are out of both income and trust assets and two different generation levels of younger generation beneficiaries are receiving benefits, the income distributions, which are not a part of taxable distributions, will be presumed to go first to the older level of beneficiaries. This provision prevents arbitrary assignment of labels to the distributions from being assigned to the older beneficiary; by designating the grandson's benefit as being from income and the son's benefit as being from income and corpus, the taxable distribution would be avoided altogether. *See also* text accompanying note 104 *infra*.

20. I.R.C. §2603(a)(1)(B). The liability of the distributee arises "[i]f the tax . . . is not paid, when due." This wording suggests the possibility that someone else is primarily liable to pay the tax. It may be expected in this situation that the trustee would withhold funds from the distribution and pay the tax for the distributee. However, it should be noted that if the trustee pays the tax out of the trust itself, the payment would constitute another taxable distribution. *See* I.R.C. §2613(a)(3).

21. I.R.C. §2603(a)(3). The fair market value is determined at the date of distribution. *Id.* Until the tax is paid, a lien is placed upon the transferred property. I.R.C. §2603(b). In addition to paying the tax, the distributee has the duty of filing the tax return in the taxable distribution. I.R.C. §2621(c)(1)(A).

22. In the event of a taxable termination and a taxable distribution resulting from the same transaction, the statute creates a preference for taxable terminations. I.R.C. §2613(b)(7)(A). For example, if property were distributed to a remainderman due to the termination of the preceding life estate, the taxable distribuion will be ignored and the taxable termination will be the taxable event. See text accompanying notes 165-175 *infra*.

generation level higher than some other younger generation beneficiary.[23] An example would be the termination of the son's life estate when there are grandchildren with either present or future interests in the trust.[24] The tax in a taxable termination is the personal responsibility of the trustee.[25]

The computation of the tax on all generation-skipping transfers is based upon the fiction of a transfer of property from a deemed transferor.[26] The deemed transferor is frequently either the person whose interest has just terminated or the parent of the transferee.[27] Occasionally, however, the person designated as the deemed transferor will be someone who never had any interest in the trust at all.[28] The law creates the fiction that the deemed transferor participated in the transfer. This is done in order to obtain the maximum possible tax on the transfer through use of the deemed transferor's estate and gift tax history. A tax on the distribution or termination amount alone might pro-

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23. I.R.C. §2613(b)(1).

24. There are several statutory exceptions to the statutory definition of taxable terminations. Two of these deal with the situation when there is more than one current younger generation beneficiary receiving benefits under the generation-skipping trust. If the beneficiaries are assigned to different generation levels and the younger generation beneficiary dies first, the taxable termination will be postponed until the interests of the older generation beneficiaries also terminate. I.R.C. §2613(b)(2)(C). At the death of the older beneficiary or at the termination of his interest, two taxes will be imposed.

If the beneficiaries are assigned to the same generation level, the taxable termination of each beneficiary's interest will be postponed until the termination of the last interest held by a beneficiary on that generation level. I.R.C. §2613(b)(2)(A); H.R. REP., *supra* note 3, at 37. *See also* H.R. REP., *supra* note 3, at 50, 53. An exception to this second exception might occur if the beneficiaries assigned to the same generation were deemed to have separate shares. See text accompanying notes 97-106 *infra*.

25. I.R.C. §2603(a)(1)(B). Failure to pay the tax subjects the trustee to personal liability. Once again, however, the statute phrases the trustee's liability as arising if the tax "is not paid, when due." This raises the question of who is primarily liable to pay the tax. One would assume that the trustee is expected to pay the tax out of trust assets. A possible problem arises, however, if the trustee has distributed the assets to a beneficiary before an audit or reassessment determines that additional tax is due. Such an additional tax could arise when a deemed transferor dies within three years of the generation-skipping transfer. I.R.C. §2602(e). See note 32 *infra*. Since a lien for the tax is also imposed upon property transferred in a taxable termination (§2603(b)), it is conceivable that this additional liability will follow the property (and not the trustee) when he no longer has possession of it.

The statute also limits the liability of the trustee by permitting him to ask for and rely on rates from the Secretary. I.R.C. §2603(a)(2). See text accompanying notes 184-190 *infra*.

26. *See* Stephens & Calfee, *supra* note 2, at 510. "The deemed transferor is what it's all about. In Cole Porter's words, he's 'The Top.' He is all over the place in Chapter 13. He has proved it is not necessary to be a Baptist to be reborn; when physically dead he is fiscally vigorous. Even when lacking in ectoplasm, he is more colorful than a mere Chapter 11 decedent or Chapter 12 donor. And, despite zero growth advocates, he is usually a parent—a parent of a transferee—all as must now be told." *Id.* at 509. *See also* I.R.C. §§2602, 2621.

27. "Almost invariably, the deemed transferor in a taxable distribution or taxable termination is the parent of the transferee, and the parent more closely related to the grantor of the trust than is the transferee's other parent. If neither parent is related to the grantor, the deemed transferor is the parent who has the closer affinity to the grantor." Stephens & Calfee, *supra* note 2, at 509, 510. *See* I.R.C. §2612.

28. I.R.C. §2612. *See also* Stephens & Calfee, *supra* note 2, at 511-13 for a discussion of various unexpected possibilities and problems in identifying the deemed transferor.

duce little or no tax at all since the tax rates are progressive and exempt from tax the first $175,000 of the taxpayer's transfers.[29] Therefore, a deemed transferor is presumed to have made the transfer being considered. This permits a tax to be calculated on all the deemed transferor's estate and gift transfers.[30] Following this, another tax is figured using the sum of his estate and gift transfers and the generation-skipping transfer. The difference between these two taxes is the amount of tax imposed on the generation-skipping transfer.[31] Thus, to compute the tax on a generation-skipping transfer it is necessary to determine not only who the deemed transferor is but also his tax history.[32]

Finally, before it can be determined that a generation-skipping trust equivalent exists in a life insurance or annuity contract, the effective dates and grandfathering provisions of the tax must be examined. In general, the tax will apply to any generation-skipping transfer made after April 30, 1976.[33] This rule is modified by several exceptions, including one that excepts transfers from trusts that were irrevocable on April 30, 1976,[34] and another that excepts, until 1982, transfers from revocable trusts that were in existence on April 30, 1976. As to revocable trusts, however, if they are amended after April 30, 1976, in any manner that creates or increases a generation-skipping transfer, the tax will be invoked.[35] As to any trust to which corpus is added after April 30, 1976, the amount of a generation-skipping transfer that is produced by added corpus will be taxed.[36]

CHAPTER 13 APPLICATION TO INSURANCE

Insurance Arrangements as Trust Equivalents

In order for an insurance arrangement to be a generation-skipping trust equivalent, there must be payments to two or more levels of younger generation beneficiaries.[37] In order for this to happen, practically speaking, the pro-

29. For decedents dying in 1977 through 1980 the statutory amounts are $120,000, $134,000, $147,000, and $161,000 respectively. For decedents dying after 1980, returns will only be required of estates in excess of $175,000.

30. I.R.C. §2602(a). See note 7 *supra*. Computation of the tax also incorporates deductions and credits for the deemed transferor's unused unified credit, marital deduction, charitable deductions, etc. *See* I.R.C. §2602(c).

31. This method allows the generation-skipping transfer to be taxed at the maximum possible rate on the progressive rate table. The actual rate applied will be the rate at which the deemed transferor's taxable transfers will be taxed.

32. I.R.C. §2602. In addition, in the case of a live deemed transferor, it will be necessary to observe his health for three years after the transfer. If he dies within that period, the transfer tax will be subject to recalculation. I.R.C. §2602(e). See text accompanying notes 169-170 and 191 *infra*.

Although the statute provides detailed description of the method of calculating the tax rate, it also limits the liability of trustees who rely on rates furnished by the Secretary. I.R.C. §2603(a)(2). See text accompanying notes 184-188 *infra* for a discussion of conceivable conflicts that may arise in this area.

33. Tax Reform Act of 1976, Pub. L. No. 94-455, Tit. XX, §2006(c)(1), 90 Stat. 1520.

34. *Id.* §2006(c)(2)(A).

35. *Id.* §2006(c)(2)(B).

36. *Id.* §2006(c)(2). See text accompanying notes 65-68 *infra*.

37. See text accompanying notes 11-14 *supra*.

ceeds to be received from the insurance policy will necessarily be large.[38] Otherwise, the insured or beneficiary probably would not choose the delayed payout method. Whenever the amount of the proceeds is substantial the bargaining power of the grantor with the insurance company naturally increases.[39] In addition, when a grantor must choose a method of payment of large amounts of insurance proceeds and he feels the present value of those proceeds exceeds the needs of the first beneficiary he is likely to choose an ar-

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38. For example, under typical settlement option rates, beneficiaries would receive the following monthly benefits:

	Policy Proceeds		
	$50,000	$100,000	$250,000
a) Interest only at 2-1/2%	104/per mo.	208/per mo.	520/per mo.
Interest only at 5%	208	416	1042
b) Life income 15 year certain*			
Male age 55	238	477	1192
Male age 45	200	401	1002
c) Life income 20 year certain*			
Male age 55	223	447	1117
Male age 45	195	390	975
d) 50% Joint & Survivor**			
Male 55 & Female 35	306	613	1532
Male 45 & Female 25	279	558	1396
e) 100% Joint & Survivor**			
Male 55 & Female 35	264	528	1322
Male 45 & Female 25	255	509	1273

*Assumptions used: 1937 Standard Annuity Table — calculated at 2-1/2% interest.

**Assumptions used: 1974 George B. Buck Mortality Table calculated at 6% Interest. Table can be found in Toussaint and Driscoll, *Note on a New Mortality Table For Use in Pension Plans*, 24 PROCEEDINGS OF THE CONFERENCE OF ACTUARIES IN PUBLIC PRACTICE 320 (1974).

39. *See generally*, R. RIEGEL & J. MILLER, INSURANCE PRINCIPLES AND PRACTICES (5th ed. 1966) [hereinafter cited as RIEGEL]; D. MCGILL, THE BENEFICIARY IN LIFE INSURANCE (rev. ed. 1956) [hereinafter cited as MCGILL]. Riegel points out that insurance companies are usually more willing to tailor-make settlement plans for the insured than for the beneficiary. RIEGEL at 185. McGill feels that companies will tailor-make any plan within reason but that they generally limit the duration of the plan to the life of the widow and the maturity of the children. In the non-family situation McGill states that companies tend to limit duration of plans to the lives of the primary beneficiary and first contingent beneficiary. The method of payment to the second contingent beneficiary will often be limited to a lump sum payout. MCGILL at 133. "Most life insurance companies will, in addition to the optional modes of settlement offered in the contract, permit the election by the policyholder in advance of his death, or by the beneficiary thereafter, of any reasonable and sound mode of settlement. Many companies, further, will write special settlement agreements which they will attach to make a part of the policy contract." R. MEHR & R. OSLER, MODERN LIFE INSURANCE 219 (3d ed. 1969) [hereinafter cited as MEHR]. "[I]t is the practice of some companies to provide in special settlement agreements that the options selected under them shall be the options, not in the policy, but those in use by the company at the time the option goes into effect. A number of observers question the ethics of this provision . . . [and] in at least some instances, counsel of companies following the practice doubt not only the ethics of it but also the legality." MEHR at 219 n. 33.

rangement whereby payments will be spread out over more than one beneficiary, or even over more than one generation of beneficiaries. Due to the substantial bargaining power of this type of grantor, insurance companies have been more receptive to tailor-made settlement arrangements or the use of standard options that fulfill the particular grantor's desires. Under these circumstances, it is possible that several arrangements currently exist in insurance files which will fall within the generation-skipping trust equivalent category. Equally likely is that some of these payout arrangements have been created after April 30, 1976, the effective date of the new tax, since it is doubtful that companies have changed their practices in the short time since its passage. The result is that these policies may fall squarely within the ambit of the new tax and the companies and beneficiaries may be forced to make appropriate adjustments.

Settlement Options

Trust equivalents arise most frequently from the various standard settlement options used in life insurance and annuity plans.[40] A choice between these options is often guaranteed to the insured and the beneficiaries in the policy itself. Therefore, in many instances companies now cannot alter existing policies in any manner that will prevent exercise of the trust-creating options.[41]

In order to understand how settlement options may create a trust equivalent situation, it is necessary to examine the various options commonly offered. A brief summary of the basic options is offered below.[42] The reader should keep in mind that companies offer a wide variety of variations and combinations of these basic alternatives.

There are five commonly offered settlement options available in most

40. A portion of payments under settlement options is currently taxed as gross income to the recipient under I.R.C. §101(c) & (d). *See* 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION §7.04 (1974 & Supp. 1977) and W. MEYER, LIFE AND HEALTH INSURANCE LAW §25:2 (1972 & Supp. 1976) [hereinafter cited as MEYER] for a discussion of the application of I.R.C. §101(c) & (d).

41. While current figures on the percentage of policies electing distribution under settlement options are not readily available, past estimates place the percentage of ordinary life policies electing delayed payment options at 18 to 25% of all policies. The largest percentage of these appear to select the interest option. The following estimates have been published:

Method	MEHR	RIEGEL
Lump sum	75%	82%
Life income	no estimate	3%
Annuity certain	7%	6%
Held at interest	11%	8%
Others	no estimate	1%

See MEHR, *supra* note 39, at 212-217; RIEGEL, *supra* note 39, at 185.

42. The descriptions presented are summarized from MCGILL, *supra* note 39, at 116-118 and MEYER, *supra* note 40, at 384. See text accompanying notes 49-56 *infra*.

policies:[43] the lump sum,[44] interest,[45] life income,[46] time certain[47] and joint and survivor options.[48] As the name of the lump sum option implies, all proceeds under that alternative are distributed at one time.[49] Under an interest option all proceeds of the policy are left with the insurance company and a guaranteed rate of interest is paid to the beneficiary. In addition, the company may declare additional interest each year in excess of the guaranteed rate.[50] Under the interest option the beneficiary may also have the power to withdraw principal in whole or in part.[51] At the death of the primary beneficiary,[52] the principal is paid to a secondary beneficiary either in a lump sum or in any other optional payment arrangement.[53]

Under the life income option, equal installments are paid periodically to the beneficiary for life. The payments consist of part principal and part interest. Death of the beneficiary terminates all payments.[54]

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43. For sample language used in policies offering settlement options see S. HUEBNER & K. BLACK, LIFE INSURANCE app. A, at 824 (8th ed. 1972) [hereinafter cited as HUEBNER]; MEHR, *supra* note 39, at 212.

44. See text accompanying note 49 *infra.*

45. An examination of the interest option reveals a close resemblance to the life-estate-plus-remainder situation which the statute specifically includes as a possible generation-skipping trust equivalent. *See* I.R.C. §2611(d)(1). This is especially true if the interest and limited withdrawals are to be paid to one beneficiary while the remaining principal is to be paid to a second one. Given this analogy, it is probable that these arrangements will be dealt with as generation-skipping trust equivalents whenever there are two or more levels of younger generation beneficiaries involved. See text accompanying notes 50-53 *infra.*

46. See text accompanying note 54 *infra.*

47. The time certain option is also known as a term certain. A common variation similar to the time certain option is the annuity certain option. *See generally* RIEGEL, *supra* note 39, at 183. See text accompanying note 55 *infra.*

48. See text accompanying note 57 *infra.*

49. When all proceeds are distributed at once, there would be no monies left in the possession of the company and hence no possibility of periodic or delayed payments. Since there are no delayed payments to younger generation beneficiaries, there can be no generation-skipping trust equivalent based upon this method of payment alone. See text accompanying notes 11-14 *supra.*

50. MEHR, *supra* note 39, at 214. Current policies guarantee only 2 to 2 1/2% interest but are actually paying 3 to 3 1/2%. For an example of policy paying excess interest over the guarantee, see *In re* Harper's Estate, 124 Mont. 52, 218 P.2d 927 (1950).

51. MCGILL, *supra* note 39, at 118. The ability to withdraw principal provides flexibility for the beneficiary.

52. The primary beneficiary is the person named by the insured to first take the proceeds upon the insured's death. The insured "may name several successive beneficiaries in the order in which they are to take priority should the primary beneficiary not survive the insured or not live to collect the full amount of the proceeds guaranteed under a settlement option. These successive beneficiaries are known as 'contingent' or 'secondary', 'tertiary', etc." MEHR, *supra* note 39, at 184. *See also* MEYER, *supra* note 40, at 384.

53. The optional arrangement may be prearranged by either the insured, the primary or the secondary beneficiary. There is a growing trend in companies toward letting secondary beneficiaries select their own settlement option instead of taking a lump sum distribution. Those selections are not granted until the secondary beneficiary is due to start receiving proceeds. MCGILL, *supra* note 39, at 137.

54. The amount of the payments depend upon the beneficiary's life expectancy, interest rates used by the company and the amount of principal to be paid out. This option may provide differing income for different time periods, such as greater payments until eligibility for

The time certain option provides that proceeds are paid in installments for the life of the primary beneficiary. If the primary beneficiary dies before the end of the time period designated in the option, the payments will be continued to a secondary beneficiary or to the primary beneficiary's estate until the end of the period.[55] The time certain periods offered usually range from five to twenty years.[56]

Under the joint and survivor options, proceeds are paid in installments until the death of the last surviving beneficiary. Payments may be level throughout or may be reduced upon the death of the first beneficiary to die.[57]

It appears that a generation-skipping trust equivalent could never exist in the case of lump sum or straight life income settlements since these never involve delayed payments to more than one beneficiary. However, it is possible to imagine situations in which the interest option, the time certain option and the joint and survivor options could create generation-skipping trust equivalents since each of these options involve the possibility of payments over a period of time to two or more individuals who could be in different generations each younger than that of the grantor. For example, if the insured chooses the interest option under which interest or interest plus limited withdrawal rights is to be paid to the primary beneficiary and the first contingent beneficiary with distribution of remaining principal to the third beneficiary, the arrangement would be a generation-skipping trust equivalent if the beneficiaries are assigned to two different generation levels that are both younger than that of the insured.[58] Another arrangement[59] under interest options that would probably

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social security benefits with decreased benefits thereafter. This option is often found in combination with the annuity certain option. *See generally* MEHR, *supra* note 39, at 217; MEYER, *supra* note 40; RIEGEL, *supra* note 39, at 184.

55. HUEBNER, *supra* note 43, at 227. For an example of a policy paying the remaining proceeds to the primary beneficiary's estate when payments were under a fixed time period, see *In re* Walker's Estate Tax, 79 N.Y.S.2d 377 (Sur. Ct. 1948).

56. This option may also direct payment of the remaining principal at the death of the first beneficiary in a lump sum. A similar option is the refund annuity under which payments continue to the second beneficiary until the original proceeds are exhausted. This option may also be designed for payments to end after a time certain. *See* RIEGEL, *supra* note 39, at 184.

57. This option may be combined with a time certain period or a refund feature. Such a combination would create the possibility of a third beneficiary in addition to the two primary beneficiaries. *See generally* RIEGEL, *supra* note 39, at 185.

58. See text accompanying notes 11-14 *supra*. An example of a generation-skipping trust equivalent would be an option to pay interest to the insured's wife and son with principal going to the grandchildren. Such an arrangement involves interests and powers in two or more younger generation beneficiaries assigned to more than one generation lower than that of the insured. Therefore, it seems certain that a trust equivalent would be deemed to exist under that arrangement.

59. For an example of a case where an insured selected an interest option that might be classified as a generation-skipping trust equivalent today, see *In re* Loewenstein's Estate, 37 Cal. 2d 843, 236 P.2d 566 (1951). In that case the insured contracted with the insurance company to hold the proceeds of the policy upon his death, with interest payable to his niece and her husband. At the death of the niece, interest payments were to continue to her son and at his death the proceeds would be paid to his surviving spouse or children or, if none, to a charitable organization. The court held that since the niece had the power to withdraw principal in whole or in part, the entire amount of proceeds were includable in her gross

create a trust equivalent would be the payment of interest with or without a power to withdraw principal to two younger generation beneficiaries at the same time with the remaining principal at their deaths to be distributed to a third younger generation beneficiary who is assigned to a generation younger than the interest recipients (i.e. from sons to grandchildren).[60]

The second standard option that could create a generation-skipping arrangement is the time-certain option.[61] If the proceeds are to be paid to a beneficiary assigned to a generation younger than the insured and he dies before the end of the time certain period, the payments must continue to a second beneficiary or to the first beneficiary's estate. If the second beneficiary is assigned to an even younger generation than the first beneficiary, then a generation-skipping trust equivalent has been created.[62]

The joint and survivor annuity[63] also runs the risk of classification as a trust equivalent. For example, if the insured left a joint and survivor annuity to his son and grandson, this would certainly be a generation-skipping arrangement because the son and grandson would be younger generation beneficiaries in two different generations both younger than that of the insured. Since this option is often combined with the time certain option, the possibility of a third beneficiary being involved only increases the possibility that it may be classified as a trust equivalent. It may be that this is the option that will most frequently be deemed a trust equivalent since it always involves at least two beneficiaries.

In view of the likelihood that three of the various settlement options might easily be classified as trust equivalents,[64] it seems certain that both insurance companies and beneficiaries must soon deal with the complicated provisions of this new law. Of course, policies created after effective date are covered by the new law. It may be, however, that policies created before the effective date may also be affected. The applicability of the tax to that latter category is examined next.

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estate. This arrangement would very likely be classified as a generation-skipping trust equivalent under the statute today.

60. Indeed, it is an accepted practice in insurance policies to name a class as beneficiary under the policy. McGILL, *supra* note 39, at 18-19. Problems can arise in designating classes as beneficiaries. The insurance company may have difficulty determining the members of the class and locating those persons. For those reasons, class designations are usually not accepted by insurance companies if the relationship to the insured is too remote. *Id.* at 19.

For a discussion of the possible effects of separate share rules on class beneficiaries, see text accompanying notes 97-106 *infra.*

61. See text accompanying notes 55-56 *supra.*

62. For an example of an arrangement that would probably be classified a trust equivalent under the time certain option see Estate of Minotto v. Commissioner, 9 T.C.M. (CCH) ¶17,752 (1950). In *Minotto,* a father/insured chose a settlement option paying the proceeds to his daughter in thirty equal installments. If she died before receiving all thirty installments, the payments were to continue to her two children until exhausted. The daughter died after seven payments. The court held the remaining twenty-three payments were not part of the daughter's gross estate.

63. See text accompanying note 57 *supra.*

64. See text accompanying notes 58-63 *supra.*

POLICIES IN FORCE BEFORE APRIL 30, 1976

Since the Chapter 13 tax applies only to generation-skipping trusts created after April 30, 1976, or to corpus added to those trusts after that date,[65] it would seem that those policies in force before that date would not be affected by the new tax. However, this is not necessarily true. First, even if the settlement option[66] had been irrevocably selected by the insured before the effective date, there remains the possibility that the corpus[67] of the trust equivalent may be considered to have been increased by premium payments after the effective date. If so, transfers made out of the additions to corpus may be subject to the tax.

The argument in favor of such a view is that a discontinuance of premium payments would cause the policy to lapse, thereby destroying the trust equivalent. Therefore, the continuing premium payments must be considered to increase the fund in some manner. The difficulty is how to quantify the increase. One method would be to compute the ratio of post-effective date premiums paid to total premiums paid with the resulting ratio being the percentage of the fund that is due to increases to corpus after the effective date. This would require insurance companies to separately account for pre- and post-effective date premium payments of all pre-effective date policies. Another method would be to compare the cash surrender value at death of the insured with the cash surrender value on April 30, 1976. Any difference would be the increase to corpus added after the effective date of the tax.[68]

In support of the view that post-effective date premiums do not go to increase corpus is the fact that the amount of proceeds of the policy has not changed between the Chapter 13 effective date and the insured's date of death. If the insured had died May 1, 1976, the beneficiary would have received exactly the same amount as he would receive if death occurred ten years later. Thus, it can be argued that no additions to the actual trust corpus have been made and the policy should not be subject to the tax.

Pre-effective date insurance policies that are likely to be subject to the tax are those policies in which the settlement option has been selected, but the selection is revocable.[69] If the insured dies before January 1, 1982, without having revoked his election and without having increased the amount of the generation-skipping transfer,[70] the arrangement will escape tax.[71] Again the

65. See text accompanying notes 33-36 *supra*.

66. Discussion of settlement options after this point will presume the option is one that may become a generation-skipping trust equivalent.

67. Although there is technically no corpus as such in an insurance policy, one must presume that the policy proceeds will be used to fill this role in the generation-skipping trust equivalent calculations of taxable distributions and taxable terminations.

68. Another proposal would be to compare the value of the death proceeds with the cash surrender value on the effective date. This proposal does not seem logical, however, since the comparison would be like comparing apples with oranges.

69. This situation would fall clearly within §2006(c)(2)(B) of the Tax Reform Act of 1976 dealing with revocable trusts. See text accompanying notes 33-36 *supra*.

70. For a discussion of what constitutes a generation-skipping transfer see text accompanying notes 15-24 *supra*.

71. See text accompanying note 35 *supra*.

question arises as to whether the payment of premiums after the effective date has increased the amount of the generation-skipping transfer.[72] If the insured changes his election or if he survives until January 1, 1982, and is not under a mental disability,[73] the policy proceeds will create a generation-skipping trust equivalent.[74]

Any option selection by the insured after the effective date that creates a generation-skipping ararngement with respect to pre-effective date policies should certainly subject those policies to the tax since the actual generation-skipping arrangement has been created after the effective date. Those policies should be treated no differently than policies that are written after April 30, 1976.

Once it is determined that a policy is subject to the tax, there are likely to be problems interpreting the new law in its application to the policy. Each of these problems will have to be resolved before an orderly method for taxing life insurance trust equivalents can be established.

PROBLEMS OF INTERPRETATION

Identifying the Grantor

One problem that will require resolution is the determination of the identity of the grantor of the trust. In the statute itself the term "grantor" is not defined. The committee reports refer to the grantor as the person who contributes or adds property to the trust.[75] In an insurance context, three choices are available: the owner of the policy,[76] the insured, or the beneficiary.

In cases where the non-beneficiary owner or insured has designated the option to be followed and has named the various beneficiaries or classes of beneficiaries, it seems appropriate that he will be the grantor of the trust. In such a situation, the owner or insured has contributed the property by funding the policy and has designated the insurance proceeds to be used in the specified option. It could be said that he is the creator of the trust. His role in the generation-skipping trust would seem to fit comfortably within the coverage of the grantor concept.

If no settlement option has been selected before death,[77] the proceeds will

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72. See text accompanying notes 67-68 *supra*.

73. If the insured was mentally incompetent on April 30, 1976, and could, therefore, not change his revocable election, the trust equivalent would not be subject to the generation-skipping tax until two years after he regains mental competency or January 1, 1982, whichever is later. Tax Reform Act of 1976, Pub. L. No. 94-455, tit. xx, §2006(c)(2), 90 Stat. 1520.

74. *Id.* §2006(c)(2)(B).

75. H.R. REP., *supra* note 3, at 48. See note 14 *supra*.

76. The owner of the policy may be a different person than either the insured or the beneficiary. He is usually the person who initially contracted for the insurance. The owner of the policy usually pays the premiums, has rights to the cash surrender value and has power to designate beneficiaries. In most cases ownership is in either the insured or beneficiary. *See generally* D. MCGILL, LIFE INSURANCE 592 (rev. ed. 1967).

77. This is probably the more usual case since few insured wish to create inflexibility for the beneficiary. However, if substantial wealth is involved as would usually be the case in policies designated as trust equivalents, insureds may be more willing to delineate the exact manner of distribution of policy proceeds. *See generally* HUEBNER, *supra* note 43, at 233-236.

be paid out in a lump sum.[78] Rather than taking all the proceeds at once, the beneficiary is usually given the opportunity to choose any of the options available under the policy.[79] In that situation it is possible that either the insured/owner or the beneficiary may be deemed to be the grantor. An argument can be made that since the insured created the fund by purchasing the insurance and keeping it in force, he should be the grantor. If that view were followed, it would take only a primary beneficiary in a generation younger than the insured and one other younger generation beneficiary assigned to a generation younger than the primary beneficiary to have a generation-skipping trust equivalent.[80] However, if the primary beneficiary has the power to take distribution in a lump sum but elects an option instead, perhaps the beneficiary should be considered the grantor.[81] It may be contended that in reality the beneficiary is the person creating the trust by contributing the proceeds that were to be paid to him in a lump sum. Several analogous situations may be used to support the contention that the primary beneficiary is the grantor. In the estate tax area, Congress has determined that property subject to a general power of appointment[82] by a decedent will be included in his gross estate.[83] The reasoning behind this policy is the realization that holding a general power of appointment is tantamount to outright ownership of property.[84] Since in the insurance area under discussion the beneficiary can either take the proceeds himself or leave them to be distributed according to his option designation, he also can be deemed to have outright ownership of the property.[85]

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78. *Id.* at 226.

79. *Id.* at 226-227.

80. See text accompanying notes 11-14 *supra.*

81. If the beneficiary is deemed to be the grantor, the possibility of creating a generation-skipping trust equivalent will be greatly diminished. For a generation-skipping trust to be created, when the beneficiary is deemed to be the grantor, there will have to be at least two beneficiaries named in his chosen settlement option that are in different generation levels, both younger than the grantor/beneficiary. While this might occur if the proceeds are large enough to give the beneficiary considerable bargaining power, it will not be the usual case since companies are more restrictive as to the flexibility and duration of options chosen by beneficiaries. *See* HUEBNER, *supra* note 43, at 227. See note 39 *supra.*

82. I.R.C. §2041.

83. The generation-skipping tax statute specifically exempts from tax transfers that have been subjected to estate or gift taxes. *Id.* §2613(a)(4)(B) & §2613(b)(5)(B).

84. *See* Stephens & Calfee, *supra* note 2, at 449; R. STEPHENS, G. MAXFIELD & S. LIND, FEDERAL ESTATE & GIFT TAXATION 4-202 (3d ed. 1974 & Supp. 1977). *But see* note 94 *infra.*

85. Under I.R.C. §2039(a) a decedent's gross estate includes "the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent under any form of contract or agreement entered into after March 3, 1931 . . . if, under such contract or agreement, an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such annuity or payment, either alone or in conjunction with another for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death." The amounts are includable to the extent that the decedent contributed to the purchase price of the annuity. Although there are no cases applying this section to elections of options by beneficiaries, it is conceivable that the requisite ownership of proceeds could be found such that the beneficiary would be deemed to have purchased the settlement annuity with policy proceeds. Under such an interpretation the payments remaining at the beneficiary's death would be included in his gross estate under §2039(b).

Thus, it is really the beneficiary who is contributing the property to the trust and designating the manner of its disposition.[86]

A second analogy that can be drawn to insurance contracts under which the beneficiary controls settlement options is in the area of insurance trusts. On some occasions a beneficiary may have manifested his intention to hold funds in trust for a second beneficiary when it was his belief that that was the desire of the insured. When courts have found that the insured did not create the trust, some courts have gone further to find that the beneficiary, by his manifestation and acts, has created a trust even though the insured did not do so.[87] Those courts have further held that it is the beneficiary who is the settlor of the trust.[88] In the instant situation the beneficiary may have manifested the requisite intention through choosing the option and designating beneficiaries. Perhaps the courts will agree that in this case he is the grantor. However, the case for the beneficiary as grantor may not in fact prevail. In a recent decision the Tax Court took a position that seemingly contradicts the argument that the beneficiary has ownership through his power to control the proceeds. *Estate of Haggett v. Commissioner*[89] dealt with a refund annuity[90] purchased with funds from the estate of decedent's husband. Under the annuity the beneficiary had the right to surrender the contract for its cash value[91] and to designate the beneficiaries of the remainder interest.[92] The court held that no part of the value of the annuity was includable in the beneficiary's gross estate.[93] It seems reasonable that if the court had agreed that the above powers gave the beneficiary ownership of the entire annuity value, it would have included that value

86. In Equitable Trust Co. of N.Y. v. Commissioner, 31 BTA 329 (1934), *rev'd on other grounds sub nom*, Commissioner v. Chase Nat'l Bank of N.Y., 82 F.2d 157, 36-1 U.S. Tax Cas. ¶9154 (2d Cir. 1936), *cert. denied*, 299 U.S. 552 (1936) the court held that when a decedent had the right to direct what should be done with certain annuity-like payments payable to her estate after her death, the commuted value of the payments would be includable in her estate. (The commuted value is the lump sum amount that represents the present value of remaining installment payments. *See* D. McGILL, LIFE INSURANCE, *supra* note 76, at 646.) The court apparently belived the decedent had a sufficient inter vivos interest in the post-death payments to warrant inclusion in her estate. Applying this reasoning to the beneficiary/grantor question, a similar interest appears. This case supports the idea of the trust equivalent property being contributed by the beneficiary rather than the insured. *But see* Estate of Haggett v. Commissioner, 14 T.C. 325 (1950); Estate of Wittmann v. Commissioner, 11 T.C.M. (CCH) ¶19,054 (1952).

87. "If . . . after the death of the insured, the beneficiary manifests his intent to hold the funds in trust for a proper purpose, the trust will be created, but it is the beneficiary who is the settlor of the trust." A. SMITH, PERSONAL LIFE INSURANCE TRUSTS 29 (1950). SMITH cites the following cases as authority: Devries' Estate v. Hawkins, 70 Neb. 656, 97 N.W. 792 (1903); Gribbel v. Gribbel, 341 Pa. 11, 17 A.2d 892 (1941); *In re* Free's Estate, 327 Pa. 362, 194 A. 492 (1937); Pugh v. Gaines, 156 Pa. Super. Ct. 613, 41 A.2d 287 (1944).

88. *Id.*

89. 14 T.C. 325 (1950).

90. For a description of the refund annuity see note 56 *supra*.

91. The cash value would be the commuted value of remaining payments due at any particular time. For a definition of commuted value see note 86 *supra*.

92. The remainder interest is the right to whatever payments have not yet been paid at the primary beneficiary's death. If the policy had previously been surrendered for its cash value, there would be no remainder interest.

93. *Accord*, Estate of Wittmann v. Commissioner, 11 T.C.M. (CCH) ¶19,054 (1952).

in her estate. Apparently, the court felt that less than full ownership was present. Because the powers of the beneficiary in *Haggett* are very similar to the powers of a beneficiary in the situation here, it is possible that the beneficiary would not be deemed the grantor.[94]

Payments to an Estate

A second problem in interpreting the law concerns the effect of payments made to a beneficiary's estate. Since the statute specifically exempts from the tax any transfer that has been subject to estate or gift taxes,[95] any payments to an estate that are deemed part of the estate for tax purposes will fall out of the generation-skipping problem.[96]

Separate Shares

Whenever a policy is designed to make simultaneous payments to two or more younger generation beneficiaries, the arrangement should be examined closely for potential applicability of the separate share rules[97] before any taxable termination or taxable distributions are declared or postponed. Depending on regulations yet to be proposed,[98] a finding of separate shares in a trust

94. Consider also the fact that the statute defines a beneficiary as someone with an interest or power in the trust. I.R.C. §2613(c)(3). A power is defined as "any power to establish or alter beneficial enjoyment of the corpus or income of the trust." *Id.* §2613(d)(2). This definition covers both special and general powers of appointment. *See, e.g.*, Stephens & Calfee, *supra* note 2, at 566. Although the transfer from a beneficiary with a general power of appointment would be excluded from tax, since it is subject to estate or gift tax, (see note 83 *supra*) he is still recognized by the statute as a beneficiary. The statute does not name him a grantor because of his ownership through the general power of appointment. If the statute did not intend for a person with a general power of appointment to be the grantor, then it is possible the beneficiary who selects a settlement option may also escape that designation.

95. See note 83 *supra*.

96. In the unlikely event that some payments were deemed to be not within the beneficiary's estate in this situation, it will become necessary to determine the generation level of the estate as compared with the grantor. The statute specifically provides for veil piercing whenever a beneficiary in a generation-skipping trust is an estate. I.R.C. §2611(c)(7). In such circumstances anyone "having an indirect interest or power in the trust through [the estate] shall be treated as a beneficiary of the trust and shall be assigned to a generation. . . ." *Id.* It seems unlikely that the decedent beneficiary would designate a person in his will to take the remainder of his insurance proceeds. If he was so inclined, he probably would have done so directly with the insurance company. Assuming he has not, the question becomes whether all beneficiaries to the estate will be deemed to have an indirect interest, and thus be assigned generations, or whether the residuary legatee would be the only person so deemed. The answer to this question may be affected by the size of the estate and the amount that the residuary legatee will ultimately receive. Assuming that the commuted value under the policy is less than the total residuary fund to be taken by the residuary beneficiary, the better rule would make him the sole beneficiary with an indirect interest in the policy proceeds since all of the proceeds are for his benefit. Thus, the residuary legatee would be the only person assigned to a generation for trust equivalent purposes and the total number of beneficiaries involved will be kept to a minimum. Either way, though, the risk is present that a generation-skipping trust equivalent will be found since it is possible that both the residuary legatee and other beneficiaries of the estate are assigned to generations younger than the deceased payee.

97. See text accompanying note 24 *supra*.

98. Under the statute, the Secretary is directed to prescribe regulations dealing with the

equivalent may do one of two things. First, in taxable terminations when the taxable event would normally be postponed, a trust with separate shares would eliminate the postponement thereby invoking an unexpected taxable event. On the other hand, in a taxable distribution, taxable events may be eliminated altogether by a finding of separate shares.

Looking first at taxable terminations, the statute provides that whenever there are two or more younger generation beneficiaries on the same generation level taking benefits at the same time, taxable terminations will be postponed until the termination of the last such beneficiary's interest.[99] However, if those same beneficiaries are found to have separate shares, that is that they "are nominally beneficiaries under the same trust, [but] actually have interests which are identifiable and separate from those of other beneficiaries"[100] then the taxable event will no longer be postponed.[101] Thus, upon a finding of separate shares the taxable termination will be triggered with accompanying filing and tax requirements.

In the taxable distribution situation a finding of separate shares may have the opposite effect, possibly eliminating taxable events altogether. Although the commentators[102] and committee reports do not refer to separate share treatment in taxable distributions, application of the principle to distributions is nowhere precluded. The result of application would be the elimination of taxable distributions when simultaneous beneficiaries on two or more generation levels were found to possess separate shares.[103] Considering the great injustice created by the source rule[104] in annuity situations, the application of separate share rules to sever these distributions would be particularly appropri-

treatment of separate shares. I.R.C. §2622. It may be presumed these regulations will bear some resemblance to the separate shares guidelines in Section 663(c) which concentrate on "whether distributions of the trust are to be made in substantially the same manner as if separate trust had been created." Treas. Reg. §1.663(c)-3(a) (1956). *See, e.g.*, S. CONF. REP. NO. 94-1236, 94th Cong., 2d Sess 618, *reprinted in* 1976-3 C.B. 807 [hereinafter cited as CONF. REP.]; Stephens & Calfee, *supra* note 2, at 456-57.

99. I.R.C. §2613(b)(2)(A). *See also* §2613(b)(2)(D).

100. The committee reports state that "there are certain instances where several individuals, who are nominally beneficiaries under the same trust, actually have interests that are identifiable and separate from those of other beneficiaries. Under the committee bill, these interests are to be treated as interests in separate trusts, in accordance with 'separate share' rules to be prescribed in regulations."

"For example, assume that the grantor establishes a trust for the benefit of his two children, A and B. Under the terms of the trust, 50 percent of the income must be allocated to each of the two children and, upon the death of either child, 50 percent of the corpus of the trust is to be distributed to that child's grandchildren. Under these circumstances, the separate shares rules would apply, and there would be a taxable termination upon the death of either A or B with respect to that child's share of the trust." H.R. Rep., *supra* note 3, at 51.

101. *See generally* Stephens & Calfee, *supra* note 2, at 456-57, 528; R. COVEY, GENERATION-SKIPPING TRANSFERS IN TRUST 44-45 (1976) [hereinafter cited COVEY].

102. *Id.*

103. Essentially separate trusts would be found to exist, therefore, there would be no older generation younger generation beneficiary in the same trust so by definition there could be no taxable distribution. See text accompanying notes 17-19 *supra*.

104. The source rule requires that all corpus be allocated first to the younger generation

ate. An alternative result of application of separate share rules to annuity trust equivalent distributions would be to tax each younger generation beneficiary on the portion of corpus received in each annuity payment regardless of generation level. This would not eliminate the taxable distribution but would spread the tax liability more evenly over those who in reality benefit from the annuity.

In the insurance context, separate shares would probably be created in many cases. Simultaneous payments are usually entirely independent of each other and are predetermined as to both size and duration of payments.[105] They should, therefore, qualify as separate shares since they are being made essentially as if they were in separate trusts. The only time when one share would be affected by another in most cases is when a member of a class dies and his portion is used to increase payments to the surviving class members. At least one commentator believes that even this situation would qualify for separate share treatment.[106] Until regulations are promulgated, many questions will remain in this area.

Valuing the Generation-Skipping Transfer in a Taxable Termination

Whenever a taxable termination occurs, a tax will have to be paid on the amount of the corpus transferred to the succeeding generation. To do this, it is essential to know the amount of corpus being held by the insurance company. Since insurers do not maintain a traditional trust corpus,[107] some method must be used to obtain a value for the proceeds to be paid out to future beneficiaries.

If a lump sum payment is made, there will be no problem since the amount of the lump sum will be the value of the generation-skipping transfer. On the other hand, if periodic payments are to continue to future beneficiaries, some other method will have to be used.

One approach to value the amount of the transfer would be to use the present value of the remaining payouts. This figure could be calculated by use of individual company actuarial assumptions,[108] or by standardized assumptions published in regulations.[109]

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of simultaneous benefit recipients when two or more levels of younger generation beneficiaries receive benefits in the same year. See note 21 *supra*. *See also* Stephens & Calfee, *supra* note 2, at 528. This rule seems to create a particularly unjust situation in annuities in which benefits to each beneficiary are normally independent of each other and not the result of trustee discretion or trust earnings. The result created is that younger beneficiaries bear the entire burden of taxable distributions when their benefits are not related to benefits of older beneficiaries as they are in a traditional trust.

105. See, McGILL, LIFE INSURANCE, *supra* note 80, at 579-80.

106. "[S]eparate share treatment may exist even though upon the death of a beneficiary his share will be added to shares of other beneficiaries." COVEY, *supra* note 101, at 44.

107. There is no segregated fund supporting each policy and payments are not dependent on individual corpus earnings. See text accompanyin gnotes 146-148 *infra*.

108. Each company, in setting up the settlement option rates for each policy, used certain actuarial assumptions, (i.e., interest, mortality, etc.) to determine the amount of periodic payment it would offer per dollar of policy proceeds under each selection. HUEBNER, *supra* note 43, at 330-45; MEHR, *supra* note 39, at 502-30. These same assumptions could be used to figure the present value of the remaining payments.

109. Standardized assumptions published in regulations would have the advantage of

Another approach would be to use the cost of purchasing annuities of like amount for the younger generation beneficiaries at the time of the taxable termination. This is the approach used in estate tax contexts for valuing annuity contracts.[110] It would have the advantage of simplicity and familiarity since it is already in use.[111]

Valuing the Generation-Skipping Transfer in a Taxable Distribution

A more difficult calculation will be involved when taxable distributions occur. Except in the case of a pure interest option,[112] all payments to insurance beneficiaries will involve at least a partial taxable distribution of corpus[113] since payments consist of part proceeds and part interest.[114] The problem is how to segregate corpus from income in the insurance payouts, since only the portion of distributions that represents corpus is taxed under the generation-skipping statute. The valuation alternatives are more numerous here than in the taxable termination situation.

Looking first to the statute for guidance, one finds a definition of trust income in Section 643(b) of the Code.[115] In that section, trust income is defined as "the amount of income of the estate or trust for the taxable year[116] determined under the terms of the governing instrument and applicable local law."[117] This definition, when applied to insurance policies, is of little help.[118]

Governing instruments of policies rarely, if ever, set forth any means of determining income in periodic payout situations. Local laws do not deal with

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uniformity when compared with the wide variation in assumptions used by companies. One short term drawback, however, would be the delay created while waiting for official tables to be published by the Treasury.

110. "The value of a contract for the payment of an annuity or an insurance policy on the life of a person other than the decedent, issued by a company regularly engaged in the selling of contracts of that character is established through the sale by that company of comparable contracts." TREAS. REG. §20.2031-8(a)(1) (1958). *See, e.g.*, Mearkle's Estate v. Commissioner, 129 F.2d 386, 1942-2 U.S. Tax Cas. ¶10,193 (3d Cir. 1942); United States Trust Co. v. Higgins, 56 F. Supp. 997, 1942-2 U.S. Tax Cas. ¶10,199 (D.C.N.Y. 1942); Estate of Pruyn v. Commissioner, 12 T.C. 754 (1949). Each of the above cases held that the value to be included in the primary annuitant's gross estate was the cost of purchasing replacement annuities of like amount for the remaining beneficiary at the date of decedent's death.

111. Each of the suggested methods would reach a different result. It is doubtful that any regularity can be achieved until regulations are published.

112. A pure interest option would distribute only interest on the proceeds held by the insurance company. See text accompanying notes 50-53 *supra*.

113. This assumes that the original proceeds of the policy are considered the corpus.

114. The principle of periodic payments to a beneficiary assumes the gradual liquidation of the proceeds over time coupled with interest on whatever amounts are still in the possession of the insurance company. See text accompanying notes 54-57 *supra* for a discussion of the types of periodic payments to which this principle applies. *See* MEHR, *supra* note 39, at 214-18.

115. This is the definition specifically referred to in Chapter 13 when trust income is discussed. *See* I.R.C. §2613(a)(1).

116. See text accompanying notes 132-138 *infra* for a discussion of the problems in determining the taxable year of an insurance trust equivalent.

117. I.R.C. §643(b).

118. *See* Stephens & Calfee, *supra* note 2, at 525-26.

the subject at all. Thirty-six states[119] have adopted, with minor modification, either the 1962 or 1931 version of the Uniform Principal and Income Act. However, nowhere in the Act is the subject of insurance proceeds directly addressed and there appears little hope of indirectly applying its terms to insurance. As might be expected, the Uniform Principal and Income Act is addressed to the traditional trust situation in which principal has been set aside[120] and income is derived from its use and paid to beneficiaries. Allocation of expenses and revenues between principal and income is the major purpose of the Act.[121] This allocation has no practical relevance in the insurance agreement context since the entire relationship is controlled by contract and no segregation of funds exists. Indeed, in the Uniform Principal and Income Act the only mention of annuities is to classify them entirely as allocated to the income of the trust.[122] It is doubtful that the Internal Revenue Service will accept the argument that local law makes all annuity payments income. If this were the case, all taxable distributions from insurance proceeds and annuities would be eliminated.

Assuming that taxable distributions do exist in an annuity situation, an approach for their valuation must be found. One method would be to rely entirely on insurance company actuaries to supply figures derived from their own actuarial assumptions used in setting up the particular payment schedules. They might consider all assumptions originally used[123] when they first determined the payments to be made or they might limit their calculations to the interest rate assumed in the payment determinations.[124] The result of using individual company assumptions would be considerable variation in the taxable amounts from company to company for identical distributions. However, this may not be considered a disadvantage by Service officials, since the current approach used in valuing annuities for estate tax purposes involves an equal amount of variation.[125]

A second valuation possibility is to adopt the method used to calculate the portion of annuities includable in gross income.[126] Section 72 of the Code provides an exclusion from gross income for the portion of annuity payments that represent return of the cost of the annuity. Each year, the amount received as an annuity is multiplied by the ratio of the annuity's cost to expected return to determine the excluded amount. The expected return is determined by the

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119. *Preface* to UNIFORM PRINCIPAL AND INCOME ACT at 633, 657 (1970 & Supp. 1977).

120. Section 3 of the 1962 Revised Act reads: "(a) Income is the return in money or property derived from the use of principal . . . (b) Principal is the property which has been set aside by the owner or the person legally empowered so that it is held in trust eventually to be delivered to a remainderman while the return or use of the principal is in the meantime taken or received by or held for accumulation for an income beneficiary."

121. *See Preface* to UNIFORM PRINCIPAL AND INCOME ACT (1970 & Supp. 1977).

122. *Id.* §4.

123. See text accompanying note 108 *supra.*

124. *Id.*

125. See note 110 *supra.*

126. I.R.C. §72. The same basic approach is also used by §101(d) in determining the amount included in gross income from life insurance proceeds paid out through settlement options other than interest options.

expected duration of payments. If the duration of payments is contingent on the life of the beneficiary,[127] an average life expectancy is obtained from standard mortality tables published in regulations.[128] This same method could be used to determine the portion of each taxable distribution that is return of proceeds for purchase cost since in settlement options it is the proceeds that in effect purchase the settlement annuity. Since this method is currently in use in the annuity area its application would be readily understood by practitioners. In addition, with tables already published for use, it would be easy to implement in the generation-skipping context.[129]

Under either of the proposed methods, the total amount of corpus distributed, once determined, will be reassigned to the younger generation of the recipient beneficiaries, through application of the statutory presumption.[130] The result will be large distributions each year to younger beneficiaries while older beneficiaries have either pure income or greatly reduced distributions. This result seems harsh and will hopefully be eliminated by separate share rules.[131]

Taxable Year of the Trust

Whenever a taxable generation-skipping transfer occurs, the distributee or trustee must file a return and pay the tax.[132] The time for filing the return in the case of a live deemed transferor[133] is ". . . on or before the 90th day after the close of the taxable year of the trust . . . ."[134] Thus, it becomes necessary to identify the taxable year of trust in order to enable the distributee or trustee to file a return within the required time.[135] Several alternatives suggest themselves in the insurance context. Among the alternatives are the taxable year of the

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127. *See* TREAS. REG. §§1.72-1 to -19 (1956). These regulations also contain standard actuarial tables for calculating the expected return when other contingencies are involved.

128. *Id.* §1.72-9, Table 1.

129. A third approach would be to treat payments whose duration depend on one or more lifetimes as open ended transactions. Under this approach an analogy could be drawn to the Burnet v. Logan, 283 U.S. 404 (1931), open transaction in the capital gains area in which the amount realized is not calculable. In *Burnet* it was determined that period payments would first go to reduce basis until all basis was recovered and amounts received thereafter would be capital gain. This approach seems inequitable since early beneficiaries will bear the entire burden of the tax while later beneficiaries will receive nontaxable income.

130. See text accompanying note 19 *supra.*

131. See text accompanying notes 97-106 *supra.*

132. I.R.C. §2621(c)(1)(B).

133. When the deemed transferor is dead at the time of a generation-skipping transfer, the return must be filed on or before the 90th day after the last day for filing the estate tax return of the deemed transferor. If that date has passed, the return is due nine months after the transfer. I.R.C. §2621(c)(1)(B)(ii).

134. I.R.C. §2621(c)(1)(B)(i).

135. A second situation in which knowledge of the trust's taxable year is needed is in determining income for the trust under the statutory definition of income used to determine amounts not out of income which will be taxable distributions if distributed. See text accompanying notes 112-129 *supra.* Since this definition of income does not seem easily applicable to the insurance arrangement, it might be wise to dispense with it in income calcaulations, thus eliminating in that context the need for a taxable year date.

insurance company itself,[136] the policy year of the original policy of insurance,[137] and the yearly period beginning with either the death of the insured or the commencement of settlement payments.[138]

PAYMENT OF THE TAX

When a taxable distribution occurs, the distributee is liable for the tax.[139] Imposition of this liability on the distributee makes practical sense because he holds the distributed property and thus has a ready fund out of which the tax can be satisfied.[140] When a taxable termination occurs, the trustee pays the tax.[141] In the traditional trust situation in which the trustee continues to hold the principal, this arrangement also makes sense since ultimately, the tax is paid out of principal.[142] In the insurance context, however, the fairness and practicality of placing the tax burden on the trustee in the taxable termination situation disappears. Insurance companies may face problems recovering the tax from insurance proceeds[143] and may face unrecoverable liability when deemed transferors die within three years of the transfer.[144] In addition, the government may face obstacles in trying to collect the tax from the insurance company.[145]

Reimbursement for the Tax

Unlike the traditional trust setting, an insurance company does not hold a segregated fund for each policy upon which income is earned.[146] Expenses are not charged to the funds of a policy and payments do not generally vary with the investment experience or expense history of the insurance company.[147] In-

136. As taxable entities, each insurance company will have its own taxable year.

137. Each policy has a policy year for purposes of premium payments. The beginning and ending dates are determined by the yearly periods commencing with the original effective date of the policy.

138. *See generally* Stephens & Calfee, *supra* note 2, at 527. There are probably other suggestions that are equally viable. Regulations will hopefully deal with this problem.

139. I.R.C. §2603(a)(1)(B).

140. *Id.* The distributee's liability is limited to the fair market value of the distribution as of the date of transfer.

141. I.R.C. §2603(a)(1)(A).

142. The tax attributable to a taxable termination would be paid out of the principal in the traditional trust, thereby decreasing the principal. The decrease in principal will also decrease the income earnings on the trust in most cases.

143. See text accompanying notes 146-159 *infra.*

144. See text accompanying notes 169 & 170 *infra.*

145. See text accompanying notes 160-164 *infra.*

146. *See* 2 INSURANCE LAW AND PRACTICE §882 (J. Appleman ed. 1941 & Supp. 1977); HUEBNER, *supra* note 43, at 242; SMITH, *supra* note 87, at 13.

147. The exception to this statement arises with the interest option and with variable annuities. In the interest option, the company often pays interest in excess of the rate guaranteed in the policy. This additional interest is dependent on company earnings experience. See text accompanying notes 50-53 *supra.* In variable annuities, investment risk is assumed by the annuitant instead of the company. The investment dollars are used to purchase annuity units that vary in price with the investment experience of all units. As payments are due from the annuity, the units are liquidated and the current value of the fixed

stead, the entire relationship between beneficiary and insurance company is controlled by the policy contract.[148] The company has agreed to make certain payments for a specified time period and the beneficiary or insured has agreed to pay the contract price by way of premium payments or proceeds retention by the company. Under the terms of the contract, any variation from the agreement would be a breach.[149] Only those policies that provide for recovery of extraordinary expenses or taxes that might occur in the future would be able to recover generation-skipping taxes under the express policy provisions. Whether such provisions are common in existing policies is unknown. In those policies without such provisions the insurance company is to pay the taxes in generation-skipping transfers, but has no express provision under which to be reimbursed from the trust equivalent property. Surely, Congress did not intend these taxes to be paid out of company profits,[150] but the law provides no means of reimbursement. The only portion of the statute that lends possible support to an argument for reimbursement is the fact that in a taxable termination a lien is placed upon property transferred until the tax is paid.[151] This seems to indicate that legislative intent was that the tax is to be paid out of the specific property involved.[152]

Without statutory authorization to charge the tax liability against policy proceeds or benefits, companies are left in the position of arguing implied authorization[153] to offset the tax due on generation-skipping transfers, against policy proceeds. Such an implied authorization could only arise from either the generation-skipping law itself or the contract. The equities in such an argument for pre-effective date policies would seem to be on the side of the insurance company since it could not, at the time of contract formation, have anticipated that such a tax would be imposed. It would be unjust to require the taxes to be paid without any contribution from the generation-skipping trust equivalent. As to post-effective date policies, proponents might point to the naturally slow process required to put into effect changes in policy lan-

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number of payment units due is paid to the annuitant. The principle of the variable annuity is very similar to the purchase of units in mutual funds. *See* HUEBNER, *supra* note 43, at 125-27.

148. *See* HUERNER, *supra* note 43, at 242; 2 INSURANCE LAW AND PRACTICE, *supra* note 146, at §881; SMITH, *supra* note 87, at 13.

149. *Id.*

150. "Generally, it is anticipated that the tax will be paid out of the proceeds of the trust property." H.R. REP., *supra* note 3, at 57. Other than this statement, legislative committee reports give no indication of any thought given to this matter. *See also* Stephens & Calfee, *supra* note 2, at 506-07.

151. I.R.C. §2603(b).

152. H.R. REP., *supra* note 3, at 57.

153. "Reformation of an insurance contract is equitable in nature, and therefore controlled by equitable principles." 17 COUCH ON INSURANCE 2D §66.8 (2d ed. 1967 & Supp. 1976). "Equity in a proper case may reform a written contract which, due to mutual mistake, does not express the intention of the parties, but it can do so only to the extent of making the contract speak the actual agreement. It cannot make a new and different contract for the parties, . . . reformation will not add a term as to which the parties have never reached any agreement, for in such case the court would be making a new contract for the parties." *Id.* §66.9.

guage[154] as a justification for policy offsets of the tax without express policy authorization. Without allowance of some method of reimbursement the potential windfall to beneficiaries will be enormous. The development of judicial views differing from state to state in regard to the right of reimbursement may pose a serious problem for insurance companies.[155] Moreover, the costs of litigating the problem in many different states may become excessive.

An analogous situation to the instant problem of obtaining a means of reimbursement to the insurance companies is presented in cases dealing with the collection of estate taxes apportioned to insurance companies holding proceeds under delayed settlement options.[156] Although few states have addressed the question,[157] the courts of New York, in ruling that the taxes may be collected from the insurance company, have protected the insurance companies by allowing the companies to reduce their liability under the policies.[158] If partial liquidation of proceeds through payments had already begun, the companies were required to pay the taxes but were then allowed to recover from beneficiaries the amounts attributable to already disbursed funds.[159] The

154. Anytime a change in policy language is desired, the change must go through an unusually cumbersome process before an actual "new" policy can be issued. The change must not only be written and approved by company attorneys, it must also be filed and/or approved by state insurance departments in every state where the policy is expected to be written. The requirements of each state differ widely and each one may cause a considerable delay before the policy may be written in that state. *See* MEYER, *supra* note 40, §§26.12-.13.

155. Each state may interpret the policy differently under their respective insurance laws. A conflicts of laws question could also arise between states but discussion of any question in that area is beyond the scope of this note. For more information about conflicts of laws see MEYER, *supra* note 40, ch. 24; W. REESE AND M. ROSENBERG CONFLICTS OF LAW 466-78 (7th ed. 1978).

156. *See generally* Note, *Insurance Proceeds and Estate Tax Apportionment: The Florida Dilemma*, 29 U. FLA. L. REV. 468 (1977) [hereinafter cited as *Estate Tax Apportionment*].

157. Only four states have confronted the problems inherent in an action by executors against insurance companies for apportioned taxes. Those states are Florida, New Jersey, New York and Pennsylvania. *Id.* at 476.

158. "If the insured has retained all the proceeds, it appears settled that the insurer is required to pay the apportioned taxes from the proceeds and may reduce the proceeds payable to the beneficiary accordingly. The courts have protected the insurance companies in these circumstances by requiring the beneficiary to return his certificates of interest in order to record the amounts paid by the insurance companies and properly indicate the reduction in the insurer's liability under the policy." *Id.* at 477-78. *See also In re* Scott's Estate, 158 Misc. 481, 286 N.Y.S. 138 (Sur. Ct. 1936), *aff'd*, 249 App. Div. 542, 293 N.Y.S. 126 (1937), *aff'd*, 274 N.Y. 538, 10 N.E.2d 538, *cert. denied sub nom.*, Northwestern Mut. Life Ins. Co. v. Central Hanover Bank & Trust Co., 302 U.S. 721 (1938); *In re* Estate of Singer v. Commissioner, 80 Misc. 2d 1006, 363 N.Y.S.2d 746 (Sur. Ct. 1975); *In re* Estate of Klauber, 22 Misc. 2d 879, 195 N.Y.S.2d 1005 (Sur. Ct. 1959); *In re* Stempler's Estate, 20 Misc. 2d 797, 192 N.Y.S.2d (Sur. Ct. 1959).

159. If the insurer has distributed part of the proceeds through a fixed payout settlement option, the courts, while holding the insurer liable for taxes apportioned to the proceeds, permit the taxes to be paid by the company from proceeds it holds, thereby reducing the company's liability pro rata for each of the remaining payments, and to payments already distributed. Taxes paid by the company that are attributable to payments already dispersed may be recovered from the respective beneficiaries through cooperative beneficiaries or through court action or the beneficiary may be primarily liable to pay those taxes himself. *Estate Tax Apportionment*, *supra* note 156, at 479. *See also In re* Shea's Will, 63 Misc. 2d 741, 313

approach of New York seems to be sound and will hopefully be applied to the context of generation-skipping taxes. However, in view of the litigation costs and potential for disparity of results between the states, statutory authorization, either express or implied, would be preferable.

Collecting the Tax

The above discussion presumes that there is no prohibition against collecting the tax from the insurance company itself. Although collection of tax from insurance companies has not been addressed in the generation-skipping area, it has been in the estate tax area by some jurisdictions. In that area section 2206 of the Code specifically authorizes executors to collect taxes from life insurance beneficiaries attributable to policy proceeds included in decedents' gross estates.[160] However, when these proceeds are held by insurance companies under settlement agreements, the problem becomes whether the taxes may be recovered from the insurance company.[161] Section 2206 of the Code is not applicable to collection of apportioned taxes from insurance companies.[162]

Although few states have considered the question either legislatively or judicially, of those that have only New York has firmly allowed recovery from the company.[163] Of the others that have considered the problem, Florida and Massachusetts have statutorily prohibited collection, Oklahoma, Pennsylvania and District of Columbia have judicially prohibited collection and Kentucky and New Jersey are unsettled.[164] If collection of the estate tax is found to be analogous to collecting the generation-skipping tax, collection of tax from the insurance company may present problems. One plausible argument in favor of collection would be that the generation-skipping statute places personal liability on the trustee, who in the insurance trust equivalent is presumably the insurance company, whereas in the estate tax statute, the insurance company itself is never mentioned or even impliedly referred to.

Taxes Due After Proceeds Liquidation

Occasionally, insurance companies may be faced with taxable terminations at a time when they are scheduled to make a lump sum distribution to the new beneficiary.[165] In that situation, the statute states a preference for terminations

N.Y.S.2d 600 (Sur. Ct. 1970); *In re* Estate of Lipshie, 30 Misc. 2d 306, 213 N.Y.S.2d 280 (Sur. Ct. 1961); *In re* Estate of Klauber, 22 Misc. 2d 879, 195 N.Y.S.2d 1005 (Sur. Ct. 1959).

160. I.R.C. §2206.

161. *Estate Tax Apportionment, supra* note 156, at 468.

162. John Hancock Mut. Life Ins. Co. v. Helvering, 128 F.2d 745 (D.C. Cir. 1942).

163. *Estate Tax Apportionment, supra* note 156, at 470.

164. *Id.*

165. For example, an option paying interest to the grantor's son for his life and at his death providing for distribution of the policy proceeds to grandchildren, would constitute a lump sum distribution at the son's death. This incident triggers both a taxable termination due to the termination of the son's interest and a taxable distribution because the corpus is released to the grandchildren in the same year in which the son had been receiving income benefits. In this situation only the taxable termination would be taxed as a generation-skipping transfer. Other instances in which this might also occur would be upon the early

over distributions.[166] As a result, at the time that the insurance company is expected to release all funds and remove itself from the beneficiary's financial affairs, the company must determine and pay a tax as well as file the federal return. As a result, most companies will delay payment until their liability has been determined,[167] which may be a potentially lengthy process.[168] While this delay to the beneficiary may be unwelcome, it is only a small part of the problem for the company-trustee. Under the statute, the tax imposed may be subject to recalculation at a later date if the deemed transferor dies within three years of the transfer.[169] Such a recalculation will likely lead to an increase in tax.[170] Given this possibility of future liability, few companies will be willing to release funds for up to three years after a transfer. This amount of delay will certainly be protested by beneficiaries and may be deemed unreasonable by courts.[171] One must wonder whether a company that has released all funds is intended to be held liable at some future date for a tax on proceeds it no longer holds. It is arguable that since the statute provides a lien on the transferred property, this was not the intent of Congress.[172] Instead, it would seem reasonable to assume that the liability was to follow the assets.

In the estate tax apportionment area, at least one state would hold that the company would not be liable once it has released all of the policy proceeds. The Court of Appeals of New York held in *In re Zahn's Estate*[173] that an insurance company would not be liable for estate taxes attributable to proceeds that had been distributed three years before approtionment was sought.[174] The

death of a beneficiary under a time option in which the contingent beneficiary is scheduled to take the commuted value (see note 86 *supra*) of remaining payments for the period instead of periodic distributions. See text accompanying notes 49-54 *supra*.

166. I.R.C. §2613(b)(7)(A). See text accompanying note 22 *supra*.

167. In the estate tax apportionment setting this delay is one argument against holding the insurer liable for the tax. The reasoning is that such a delay defeats "one of the primary advantages of life insurance — rapid liquidity for the beneficiary." *Estate Tax Apportionment, supra* note 156, at 477.

168. See text accompanying notes 176-192 *infra* for a discussion of the variety of duties placed upon the insurer/trustee that may cause prolonged delays.

169. I.R.C. §2602(e). See text accompanying note 32 *supra*.

170. If a deemed transferor dies after the transfer, forcing a recalculation under I.R.C. §2602(e), the tax liability, if any, is likely to increase since the tax rate is based on the deemed transferor's lifetime gifts and estate rather than on his lifetime gifts alone. *Id.* §2602(a). Unless the deemed transferor's estate had no property at his death, the total amount possibly subject to tax will be greater when the estate property is added.

171. Most states provide a penalty to be applied against insurance companies who wrongfully withhold payment of claims. Whether the potential tax liability would be considered sufficient reason for delay in payment cannot be answered. For examples of typical statutes addressing the penalties, see ARK. STAT. ANN. §66-3238 (1966); FLA. STAT. §627.427, .428 (1977); GA. CODE ANN. §56-1206 (1977); KAN. STAT. §40-256 (1977).

172. See text accompanyin gnotes 151 & 152 *supra*.

173. 300 N.Y. 1, 87 N.E.2d 558 (1949).

174. In *Zahn*, apportionment was not sought until three years after distribution of the proceeds when a reaudit of the estate included the proceeds in the estate for the first tax. The executor paid the taxes and sued the insurance company for reimbursement upon finding no hope of recovery from the beneficiary who had died in the interim in a destitute financial condition. The duty of the insurance company in *Zahn* may be distinguishable from the duty of an insurance company in a generation-skipping arrangement in that in the latter case the

same principle of law might be applied in generation-skipping cases to allow the tax liability to follow the proceeds in any situation in which the proceeds have been released in good faith.[175]

Administrative Duties

When a taxable generation-skipping transfer is found to have occurred, the taxes to be paid are the most visible of costs involved. However, in addition to the tax burden, the insurer must perform other duties including: (1) identifying and monitoring actual and possible generation-skipping arrangements for the taxable events; (2) identifying deemed transferors and determining their tax histories; (3) computation of the amount of the transfers and resultant tax; (4) filing information returns.[176] The cost of performing these administrative duties is potentially very large.

Identification and Monitoring

The first task that must be undertaken by both insurance companies and beneficiaries is to examine all existing settlement elections and supplementary contracts[177] to determine if they involve generation-skipping trust equivalents. For beneficiaries, this task is not overly burdensome since they are usually involved in only one or two contracts. On the other hand, for companies this task will be more substantial. In order to identify these trust equivalents, the company must have on hand the following information: (1) Name and age of the insured; (2) Age and relationship to insured of the first primary beneficiary; (3) Age and relationship to insured and to the first beneficiary of any second beneficiaries, third beneficiaries, etc. Some of this information will be available in company files.[178] Other information, such as the ages and relationships of contingent beneficiaries may not be readily available. Many policies will have the potential for becoming a trust equivalent but will not as yet constitute one.[179] Thus, even after present policies are examined, the company must establish a system to monitor present and incoming policies and settlement selections. Policies will have to be examined for both their present status as trust

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insurer is in the position of a trustee. As holder under the estate tax apportionment statutes, the company did not have any duty to find out if the policy was includable in the estate or to make sure the taxes were paid. As a trustee in a generation-skipping context, the company not only has the duty to see if the payout constitutes a termination, but it also has the duty to pay the tax due and is personally liable for any tax not paid.

175. This could be applied to both simultaneous distribution-terminations and post-transfer deemed transferor death situations. *See also* Stephens & Calfee, *supra* note 2, at 493-96.

176. See text accompanying notes 177-192 *infra*.

177. Supplementary contracts are entered into by an insurance company when a departure from the standard settlement option is agreed upon. *See generally* HUEBNER, *supra* note 43, at 232; MEHR, *supra* note 39, at 219.

178. Companies will often have ages of beneficiaries on record since it is an essential ingredient in determining the life expectancy of the beneficiary. The life expectancy is then used to determine the amount that will be paid as periodic payments. See note 108 *supra*.

179. Any policy with a guaranteed choice of settlement options not subject to company approval will have such a potential. See text accompanying note 64 *supra*.

equivalents and the occurrence of taxable events.[180] The administrative costs involved in such a system will undoubtedly be large.

The Deemed Transferor

Whenever taxable events do occur, the identity of the deemed transferor and his tax history must be ascertained in order to determine the applicable tax.[181] This information might be readily available to the beneficiary in the case of a taxable distribution since he will usually be related to the deemed transferor in some manner.[182] On the other hand, this information will not necessarily be readily available to the insurance company. Additionally, assuming that the identity of the deemed transferor can be determined with a minimum of effort,[183] a major problem might still be presented in ascertaining the tax history of that person. In the statute a trustee is specifically authorized to ask for and rely upon rates furnished by the Secretary.[184] If the deemed transferor is deceased and his estate filed a return with the Secretary or if the deemed transferor is alive,[185] it is reasonable to assume the Secretary will be able to furnish the desired rates. However, if the deemed transferor has died and his estate did not file a return,[186] the Secretary will not have the rates to supply. Perhaps the statute will be interpreted as placing the burden on the Secretary to prepare an estimate. If not, insurance company/trustees will be faced with collecting tax history for that category of deemed transferors on its own.[187] The costs of such an endeavor and the conceivable obstacles, such as the potential refusal of executors and deemed transferors to cooperate,[188] impose a considerable burden on insurers.

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180. In addition to monitoring policy transactions, companies may be charged as trustees with the duty of notifying beneficiaries whenever taxable distributions occur. This would seem reasonable since the company has a better view of the overall transaction than isolated beneficiaries and may be better informed of the amount of distribution.

181. See text accompanying notes 26-32 *supra*.

182. See text accompanying notes 26 & 27 *supra*.

183. See text accompanying notes 27 & 28 *supra*.

184. I.R.C. §2603(a)(2). See text accompanying note 25 *supra*.

185. Under I.R.C. §6019 a taxpayer must file a gift tax return in any year that he makes a gratuitous transfer in excess of $3,000 per transferee per year (I.R.C. §2503(b)), other than a qualified charitable transfer. As a result, the Secretary will be able to obtain a summary of all the taxable gifts made by the deemed transferor.

186. I.R.C. §6018 only requires returns to be filed if an estate exceeds the statutory amount. For decedents dying in 1977 through 1980, the statutory amounts are $120,000, $134,000, $147,000, and $161,000, respectively. For decedents dying after 1980, returns will only be required of estates in excess of $175,000.

187. It seems distributees who encounter uncooperative deemed transferors may be faced with this problem even more since they are not authorized to request or rely on rates from the Secretary.

188. The statute does not give any legal rights against the deemed transferor or his representatives to those who need tax history of the deemed transferor. Thus, he may refuse to cooperate with no penalty against him and no recourse to the trustee or distributee who needs the information.

Calculating and Paying the Tax

Once the tax rate is determined and the taxable event has transpired, the last steps of the administrative process can begin; the value of the transfer must be determined[189] and the actual tax calculated.[190] A return must then be prepared and, together with the tax payment, filed with the Internal Revenue Service. Lastly, the deemed transferor must be observed for three years after the transfer so that the tax may be recalculated and a new return filed in the event of his death during that period.[191] At this point there are no more requirements imposed on the distributee-beneficiary. But for the trustee/insurance company, the costs of litigation to obtain reimbursement for the tax may still lie ahead. This may involve claims for reduction of the company liability under the policy, recovery from beneficiaries for overpayments, both, or neither.[192]

CONCLUSION

In view of the additional administrative and legal responsibilities created by the new tax on generation-skipping transfers, it is reasonable to expect that the costs of administration will be great. Certainly the costs will be far in excess of what was contemplated by the parties when they executed the insurance contract. It seems an argument could be made for reformation of the policy contracts to allow a reduction for these additional administrative costs[193] over and above reimbursement for the tax itself.

Even when companies are allowed to adjust policies to offset these additional costs, the question still remains as to how they should be allocated. Conceivably, there are four levels of costs. The first involves monitoring all policies that may become trust equivalents.[194] The second includes the costs of monitoring those policies that actually become trust equivalents for possible taxable events.[195] Another arises in the actual administrative and legal work required when the taxable event occurs.[196] And finally there is the tax itself.[197] All policies with a guaranteed choice of settlement options carry the risk of becoming trust equivalents, but the vast majority of these will never become such. Thus, instead of charging the first level of costs to all policies with the potential of

189. See text accompanying notes 107-131 *supra* for a discussion of alternative methods of valuing transfers.

190. See text accompanying notes 30-32 *supra* for an explanation of how to compute the tax.

191. See text accompanying note 169 *supra*.

192. See text accompanying notes 146-159 *supra*.

193. See text accompanying note 153 *supra*.

194. See text accompanying notes 177-179 *supra*.

195. See text accompanying note 180 *supra*.

196. This would include determining if separate shares exist (see text accompanying notes 97-106 *supra*), who the grantor is (see text accompanying notes 75-94 *supra*), the amount of the transfer (see text accompanying notes 107-131 *supra*), the taxable year of the trust (see text accompanying notes 132-138 *supra*), the identity of the deemed transferor (see text accompanying notes 26-28 *supra*), the tax rate to be applied (see text accompanying note 30 *supra*), the tax due, and preparation and filing of the return (see text accompanying notes 30, 132 & 133 *supra*).