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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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Dear :

This responds to your inquiry on October 21, 2004, requesting our views on a draft opinion prepared by your office regarding the applicability of the generation-skipping transfer (GST) tax to certain group life insurance program benefits provided by the Department of Veterans Affairs (VA).

On November 1, 2000, Congress amended 38 U.S.C. § 1967 and increased the maximum amount for which a person may be insured under the VA's Servicemembers' Group Life Insurance (SGLI) and Veterans' Group Life Insurance (VGLI) programs to \$250,000. The Prudential Insurance Company of America (Prudential), the primary insurer under the SGLI and VGLI programs, is concerned that this change in the law may have GST tax implications. Specifically, if an individual is insured under SGLI or VGLI for the maximum amount of \$250,000 and designates a skip person as their beneficiary, Prudential is concerned that they would be liable for the GST tax and would be required to withhold the amount of GST tax due from the insurance proceeds payable to the beneficiary upon the insured's death. The draft opinion prepared by your office concludes that 38 U.S.C. § 1970(g) exempts SGLI and VGLI proceeds from the GST tax and, therefore, Prudential is not required to withhold a portion of the proceeds for payment of the tax.

The GST tax is imposed upon transfers of interests in property to a skip person. A skip person is a person assigned to a generation that is two or more generations below the generation of the transferor (generally a grandchild or great grandchild). A trust is also a skip person if all of the beneficiaries are skip persons. 26 U.S.C. §§ 2601, 2613.

The tax imposed on a GST is charged to the property constituting such transfer. 26 U.S.C. § 2603(b). GST transfers include, among other transfers, any distribution to a

skip person under a trust arrangement. 26 U.S.C. §§ 2611-12. A trust arrangement includes any arrangement, such as a contract for life insurance that has substantially the same effect as an explicit trust. 26 U.S.C. § 2652(b); 26 C.F.R. §§ 26.2652-1(b)(1); 26.2662-1(c)(2)(ii).

For transfers before 2004, each individual is allowed a GST exemption of \$1,000,000 that may be allocated by the transferor during his lifetime or his executor to any property with respect to which that individual is the transferor. 26 U.S.C. § 2631. This amount is indexed for inflation for transfers made after 1998 and before 2004. For transfers made after 2003, the GST exemption amount is equal to the applicable exclusion amount under 26 U.S.C. § 2010(c) for that particular year. Thus, for example, the GST exemption amount is for 2005 is \$1,500,000.

An allocation of an individual's GST exemption may be made at any time (during life or at death) on or before the date prescribed for filing the estate tax return for that individual's estate. 26 U.S.C. § 2632(a). Generally, any portion of an individual's GST exemption that has not been allocated is deemed to be allocated to property that is the subject of a direct skip occurring at that individual's death. 26 U.S.C. § 2632(e). If the value of the transferred property exceeds the amount of GST exemption allocated to that property, the GST tax is applied to the excess value at the highest estate tax rate. 26 U.S.C. §§ 2602, 2641-42.

In the event an insured individual designates a skip person as the beneficiary of the insurance policy, upon the insured individual's death, the payment of the proceeds to the beneficiary constitutes a direct skip from a trust arrangement. If the insured individual does not have a sufficient amount of GST exemption available to exempt the transfer from the GST tax, all or a portion of the transfer will be subject to GST tax. The executor of the insured individual's estate is liable for the GST tax imposed on that direct skip if the value of the property involved in the direct skip is less than \$250,000. 26 C.F.R. § 26.2662-1(c)(2)(iii). If the total value of the property involved in the direct skip is \$250,000 or more, the trustee of the trust arrangement (the insurer) is liable for the GST tax. See 26 C.F.R. § 26.2662-1(c)(2)(vi), Example 2. Thus, an insurer distributing policy proceeds of \$250,000 or more to a skip person beneficiary generally deducts the amount of GST tax from the policy proceeds prior to distribution to the beneficiary.

With respect to the payment of SGLI or VGLI benefits, however, 38 U.S.C. § 1970(g) provides that

[a]ny payments due or to become due under SGLI or VGLI made to, or on account of, an insured or a beneficiary shall be exempt from taxation, shall be exempt from the claims of creditors, and shall not be liable to attachment, levy, or seizure by or under any legal or equitable process whatever, either before or after receipt by the beneficiary. The preceding sentence shall not apply to: (1) collection of amounts not deducted from the member's pay, or collected from him by the Secretary concerned under § 1969(a) of this title, (2) levy under subchapter D of chapter 64 of the Internal Revenue Code of 1986 (26 U.S.C. § 6331 et seq.) (relating to the seizure of property for collection of taxes), and (3) the taxation of any property purchased in part or wholly out of such payments.

Congress plainly intended to protect VA insurance benefits so they could be put to use for the maintenance and support of the insured's beneficiaries and, thus, with certain exceptions, exempted these benefits from taxation, levy, and seizure. With respect to the GST tax, the statute specifically provides, that "any payments due or to become due under SGLI or VGLI made to, or on account of, an insured or a beneficiary shall be exempt from taxation. . . ." Exempting SGLI and VGLI proceeds from the GST tax is consistent the statute. Moreover, we note that in drafting 38 U.S.C. § 1970(g), Congress clearly chose to include three exceptions to the general rule that SGLI and VGLI proceeds be exempt from taxation, attachment, levy, or seizure. Had Congress intended SGLI and VGLI proceeds to be subject to GST tax, they could have specifically provided such an exception. Thus, we concur with your conclusion that 38 U.S.C. § 1970(g) exempts SGLI and VGLI proceeds from the GST tax. Accordingly, we believe that Prudential and other insurers under these programs are not required to withhold a portion of the proceeds to satisfy a GST tax liability.

This conclusion is not binding on any taxpayer and may not be cited as precedent. If you have any questions or require further assistance, please do not hesitate to contact [redacted] at [redacted].

Sincerely,

Heather C. Maloy
Associate Chief Counsel
(Passthroughs & Special Industries)