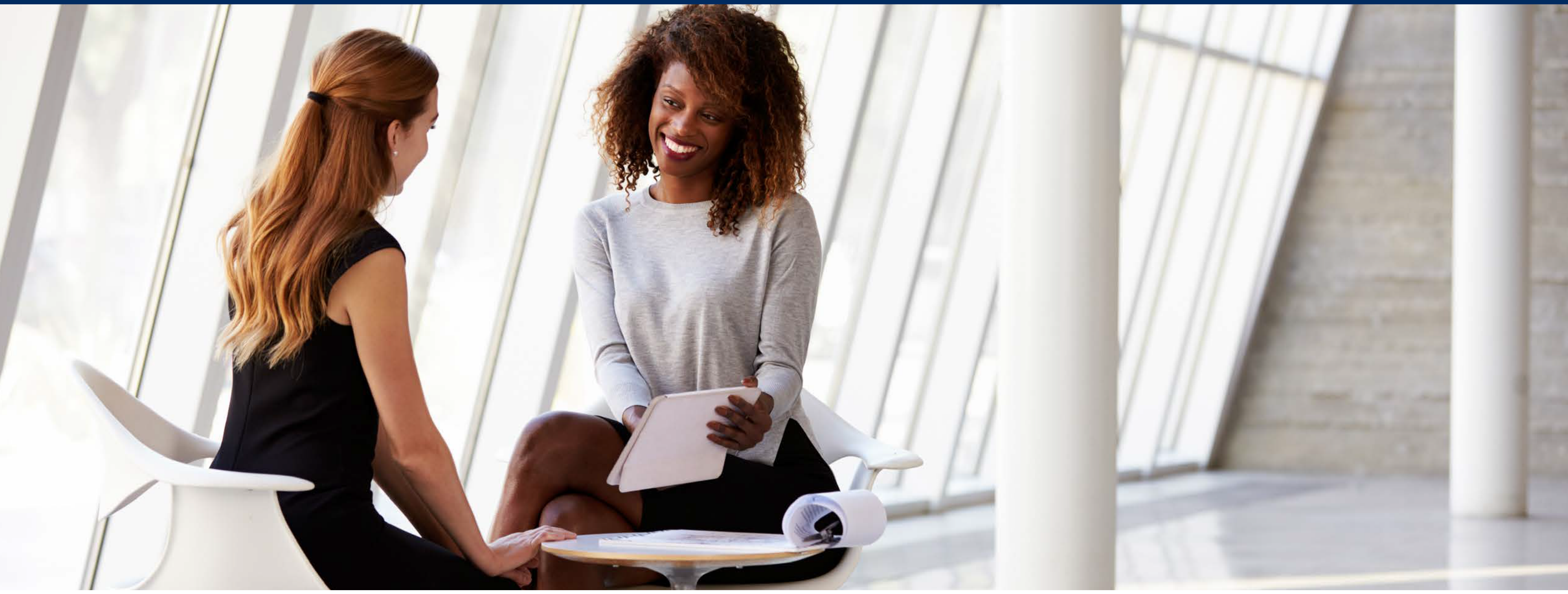

Proposed Legislative Changes Would Impact Use of ILITs in Estate Planning

Advanced Market Insights

This paper discusses proposed legislation that would impact current life insurance and estate planning practices incorporating trusts taxed as grantor trusts for Federal income tax purposes. We expect that the legislation as proposed is not in its final form and will change. FINSECA is working diligently to seek guidance and shape policy.

Introduction

On September 13, 2021, Chairman Richard Neal (D-MA) of the House Ways and Means Committee introduced an amendment to the Committee's recommendations advancing a number of proposed tax Code1 changes including increasing individual and corporate tax rates, accelerating expiration of the temporarily increased estate and gift tax exemption amount, certain limitations to large IRAs, and critically, changes affecting established planning with irrevocable grantor trusts.

This proposal could be voted on in the U.S. House of Representatives as soon as this week. The Senate is expected to take its own approach. It remains to be seen which previously discussed "Senate ideas" (e.g., stock buy-back provisions, elimination of "stepped-up basis") will be proposed. The proposed grantor trust rules are raising concerns over the future of planning with irrevocable life insurance trusts (ILITs). If enacted "as is," the proposals will change how ILITs are drafted, funded, and administered. But it is not the death knell for ILIT planning. ILITs will remain a viable—and perhaps critical–planning technique for clients, now and in the future.

UNDER THE CURRENT PROPOSAL

Grantor trusts as we know them today will no longer be a viable planning option.

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[1] Unless otherwise indicated, all mentions of the Code or "IRC" are references to the Internal Revenue Code of 1986.

Proposed IRC Sec.2901 effectively unifies the income tax and transfer tax treatment of grantor trusts. Under current law, an irrevocable trust can be drafted to intentionally be a grantor trust for income tax purposes while allowing the trust assets to be excluded in determining the value of the grantor's gross estate for transfer tax purposes.

Proposed IRC Sec.2901 states that if the grantor is deemed to own trust assets for income tax purposes, they are also owned for transfer tax purposes and are part of the grantor's gross estate. Consequently, to remove assets from the grantor's estate, the trust must be carefully drafted, funded, and administered to be a non-grantor trust.

Grantor trusts established prior to the proposed statute's effective date will be "grandfathered."[2] That is, they may retain their grantor trust status without estate tax inclusion. However, if certain subsequent circumstances occur, such as making a future gift, a prorated amount of trust assets (including life insurance death benefits) will be pulled back into the calculation of the grantor's gross estate at death for transfer tax purposes.

How the Tax Proposals Will Affect ILITs Treated as Grantor Trusts

Most ILITs are drafted as grantor trusts. Under IRC Sec. 677(a)(3), grantor trust status results if the trustee may—without the consent of an adverse party[3]—apply trust income to pay any portion of a life insurance premium on a policy insuring the life of the grantor and/or their spouse. Other common provisions found in ILITs such as the spousal rights provisions (IRC 677(a)(1)), so-called "substitution powers" and other administrative powers (IRC 675), or other certain rights retained by the grantor alone would also cause an ILIT to be a grantor trust.

Treatment of Existing ILITs

For existing ILITs, it will be critical that clients, and their legal and life insurance professionals review the trust document and the underlying life insurance policies prior to enactment (as soon as possible) to ensure that any potential future action or gift will not jeopardize the existing ILIT's grandfathered status.

Qualified legal counsel should review the trust to determine whether the trust is indeed a grantor trust.

An experienced insurance professional should be consulted to review any trust-owned life insurance policies to determine if additional premium is required.

For trusts requiring further gifts to pay life insurance premium, consider the following:

- Review the underlying policy and determine if a face amount reduction will eliminate the need for future premiums without endangering the policy. Assuming no further premiums need to be paid, this reduction may eliminate the need for additional gifts. A supplemental, non-grantor ILIT may be established to receive future gifts and purchase a new policy[4] to make up any shortfall in death benefit created by reducing the face amount on the older policy.

- If possible, the client may make additional gifts to an existing grantor trust prior to the effective date. By pre-funding the trust with additional gifts, it may allow the trustee to continue to pay premium on trust-owned life insurance policies without the need for gifts made after the effective date. Assuming no such gifts are made, the grantor trust should remain grandfathered. A premium deposit account (PDA), which pays premiums automatically, can provide a convenient repository for future premiums and an investment return generated by the interest rate set by the carrier. It is important to determine if the carrier offers a PDA.

- An initial reading of the proposal suggests that loans to grandfathered grantor trusts should be a viable alternative. However, present negotiations have created ambiguity. If lending between the grantor and their

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[2] As drafted, the effective date for this proposal will be the date of enactment of the statute.
[3] IRC Section 677(a).
[4] This assumes the proposed insureds are insurable.

grandfathered grantor trust is determined to still be viable, consider making bona fide premium loans to the trust that are fully compliant with IRC 7872 and the related regulations in lieu of gifts. At issue presently is whether a loan in exchange for a promissory note might be an exchange of value that results in a new contribution. A broadly written and interpreted statute could disrupt the option to make loans to a grandfathered grantor trust.

- Consider commercial premium finance. Commercial premium finance lenders may lend funds to the trustee to support the premium payment obligations. Note that commercial premium finance is complex and carries its own unique risks.

- Consider converting a grandfathered grantor trust to a post-enactment, non-grantor trust. This could apply to situations where premiums are still required after the grantor trust is grandfathered and there is insufficient principal or trust income to pay policy premiums. Some grantor trusts will have a provision permitting the trustee or trust protector to remove, or "toggle off", grantor trust status.

Once "toggled off," gifts to a non-grantor trust will not cause a prorated inclusion of trust assets in the grantor's estate. The "off switch" must completely disable any provision which could cause the Service to view the trust as a grantor trust. It is not enough for the grantor to avoid using the power.

- Consider whether decanting the grantor trust into a compliant non-grantor trust is possible, and if so decanted, continue to make gifts as previously planned.

Go-Forward Strategy: Avoid Grantor Trust Status On New ILITs

Even if the recent tax proposals are passed, ILITs will remain a valid trust design and option for planners.

It is critical that newly drafted ILITs maintain non-grantor trust status by avoiding inclusion of any of the powers described in IRC Secs 671-678. Specific to ILITs, care must be taken to avoid application of IRC Sec. 677(a)(3). This may be accomplished by any of the following methods (separately or combined):

- Use a restriction in the new ILIT that only permits trust principal to be applied towards life insurance premium on the life of the grantor or the spouse. The trust should require an annual distribution of all income to the income beneficiaries.[5]

- Require that the consent of an adverse party (other non-spouse income beneficiary or person having an income interest in the trust) be obtained prior to any application of trust income towards life insurance premium on the life of the grantor or their spouse.

- Design the trust so that the trustee could apply for life insurance on the life of someone other than the grantor or their spouse such as a downstream generation, taking into consideration insurable interest concerns.

Gifts to properly drafted non-grantor ILITs drafted after the statute's effective date will not cause inclusion in the grantor's estate.

To Be Determined...

The contents of this paper constitute our thoughts and understanding of the tax proposal's impact as of the date of drafting. Given the uncertainty around whether the tax proposals will be passed as drafted, and in what form, as well as their potential application if passed, these positions are subject to change. We will continue to monitor the status of these proposals and analyze the impact to our clients and the broader planning community.

[5] It is worth noting that the law around IRC 677(a)(3) has been evolving since enactment in 1954. The Service and courts may still have more to say.

Contact HORAN at 800.544.8306 if you have questions about the proposed legislative changes.

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