What to Do with Irrevocable Life Insurance Trusts in Light of Proposed Tax Reform

October 18, 2021

Since the House Ways and Means Committee released its initial draft of proposed tax increases on 9/13/2021, many taxpayers and advisors have been expressing concern about the impact on and future of Irrevocable Life Insurance Trusts (referred to hereinafter as "ILITs") and asking what actions they should consider taking or recommending regarding existing ILITs or those to be created.

The cause of this concern is a proposed change to the tax treatment of irrevocable grantor trusts (referred to hereinafter as an "IGTs," "grantor trusts" or "grantor-ILITs") that could inadvertently affect ILITs. Below is a summary of these proposed changes as well as some planning insights to consider ***assuming the House's proposal were to be enacted as initially drafted.***

Proposed Changes to the Transfer Tax Treatment of Irrevocable Grantor Trusts

The initial Ways and Means proposal contained a new Internal Revenue Code (IRC) section, **IRC § 2901**, which would make significant changes to current estate and gift tax treatment of IGTs and is the primary concern regarding ILITs.

The key aspect in this new Code section that could impact new and certain existing ILITs is § 2901(a)(1) which states (paraphrasing):

In the case of any portion of a trust for which the grantor is the deemed owner for income tax purposes (i.e. a "grantor trust" under IRC §§ 671-679), the value of the deceased deemed owner's gross estate shall include the value of all assets attributable to that portion at such owner's death.

This proposed new Code section is effective for:

- ✓ Any trusts created on or after the date of enactment and any portion of a trust established before enactment which is attributable to a new contribution (term to be defined, but many presume it to mean gifts) made on or after such date.

Impact of the Proposed IRC § 2901 on Irrevocable Life Insurance Trusts

If the insured is treated as the deemed owner of an ILIT for income tax purposes, a portion or all the death benefit payable to the ILIT could be includible in such owner's gross estate and subject to estate tax at his or her death.

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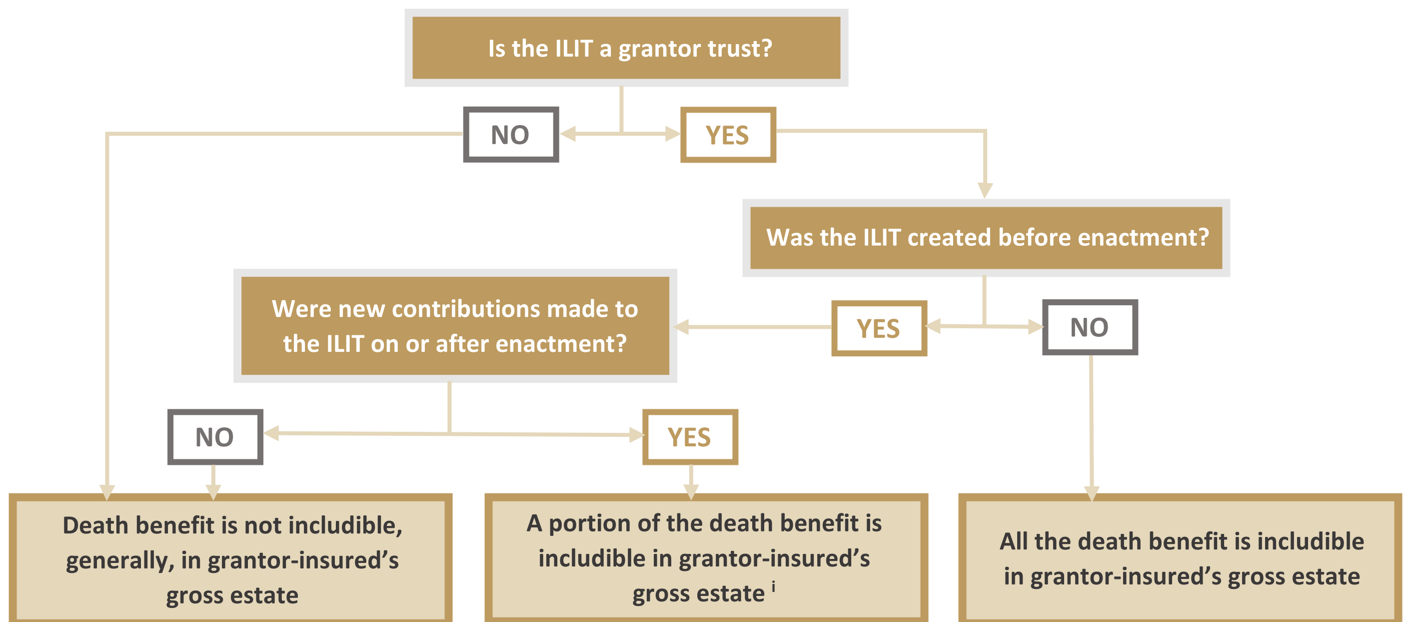
Determining the Includability of ILIT Death Benefits in the Grantor-Insured's Gross Estate

Should IRC § 2901 go into effect as initially drafted, the key considerations in determining § 2901 includability would include whether the ILIT is a grantor trust, when the ILIT was created and whether any new contributions were made to the ILIT on or after enactment. Below is a flow chart illustrating these considerations:



How an Irrevocable Life Insurance Trust Can Become a Grantor Trust

Below are the more common retained powers under the grantor trust statutes (IRC §§ 671-679) that are often found in, or may apply to, ILITs causing the grantor to be treated as the deemed owner for income tax purposes. The below comments are not an exhaustive discussion of all the ways in which a trust can be treated as a grantor trust.

IRC § 677(a)(3)

Income that is or may be used to pay premiums on policies insuring the grantor or grantor's spouse:

The grantor shall be treated as the deemed owner of any portion of a trust the income from which is or may be used to pay premiums on life insurance policies insuring the grantor or grantor's spouse without the approval or consent of an adverse party unless the policy proceeds are irrevocably payable for a charitable purpose.

Relevance to ILITs: Trust income is often used as a source of premium payments in ILITs, which are generally designed to own life insurance on the grantor, causing the grantor to be treated as the deemed owner of all or a portion of the trust. "Income" refers to any income for tax purposes even if added to principal in the current year and used for this purpose in a subsequent year. It can even include interest income in a bank account set up by the trustee to hold cash gifted by the grantor to pay premium. This statute has generally been interpreted to treat the grantor as the deemed owner of only such portion whose income is actually used to pay premiums on actual policies insuring the grantor or grantor's spouse.[ii]

IRC §§ 677(a)(1) and (2)

Income that is or may distributed to the grantor or grantor's spouse:

The grantor shall be treated as the deemed owner of any portion of a trust the income (for tax purposes) from which is or may be distributed, or held or accumulated for future distribution, to the grantor or grantor's spouse without the approval or consent or an adverse party.

Relevance to ILITs: Adding the grantor's spouse as an income beneficiary is often done to give the spouse the flexibility to access trust distributions during life causing the grantor to be treated as the deemed owner. Even adding the grantor's spouse as a beneficiary with respect to principal only could cause the grantor to be treated as the deemed owner if the trustee has the power to add income to principal for accounting purposes.

IRC §§ 675(2), (3) and (4)

Administrative powers

The grantor shall be treated as the deemed owner of any portion of a trust in respect of which – (2) the grantor has retained the power to borrow from the trust without adequate interest or security; (3) the grantor or grantor's spouse has borrowed from the trust and not fully repaid the loan before the beginning of the taxable year (unless such loan provides for adequate interest and security and was not made by a related or subordinate trustee subservient to the grantor); and (4) a power to reacquire trust principal by substituting other property of equivalent value exists and is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity.

Relevance to ILITs: One or more of these powers are often included in the ILIT instrument to provide administrative flexibility with respect to the trust which cause the grantor to be treated as the deemed owner of such portion.

IRC § 674

Beneficial enjoyment of principal or income subject to a power of disposition held by a nonadverse party:

In general, the grantor shall be treated as the deemed owner of any portion of a trust in respect of which the beneficial enjoyment of principal or income is subject to a power of disposition held by the grantor or a nonadverse party, beyond specified limits and exceptions, without the approval or consent of an adverse party. The power can be in the form of a trustee power, power of appointment or any other power.

Relevance to ILITs: IRC § 674 is a complicated statute but it can commonly apply due to trustee selection and the powers given thereto, absent an eligible exception. For example, the grantor could be treated as the deemed owner if more than half of the trustees are related to the grantor and have discretionary powers over distributions to beneficiaries that are not limited by a reasonably definite standard, or if an independent nonadverse trustee with such powers is coupled with a nonadverse person who can add additional beneficiaries other than descendants of existing beneficiaries.

What to Do with New or Existing Irrevocable Life Insurance Trusts

Below are some planning considerations regarding administering existing, or structuring new, ILITs assuming § 2901 were to be enacted as initially proposed by the House Ways and Means Committee. Note, any reference below to the payment of premiums pertains to a policy insuring the grantor or grantor's spouse.

Existing grantor-ILITs with funding for annual policy premiums required post enactment

- ✓ **Prefund the ILIT with a large gift:** The insured can consider making a large gift prior to enactment (allocating his or her lifetime exclusion amount to avoid gift taxes) to provide cash and/or income to fund future premiums. Doing so can help avoid the need to make ongoing gifts that could cause inclusion under the proposed § 2901.

- ✓ **Terminate grantor trust status:** Can the ILIT be easily converted to a non-grantor trust through rescinding the applicable grantor trust powers or decanting? If so, it could help prevent inclusion under the proposed § 2901 from ongoing gifts.

- ✓ **Use split dollar loans to fund premiums:** If ongoing premiums are due, transfers are required to fund them and the above two options are not feasible in full, then consider funding premiums via split dollar loans with interest accrued, or payable from existing trust assets, at an adequate interest rate to avoid future gifts.[iii] Doing so could avoid gifts after enactment that could cause inclusion under the proposed § 2901. The policy and ILIT should be reviewed first to determine adequacy to support such a strategy.

New ILITs established in anticipation of, or after, enactment

- ✓ **Create a non-grantor ILIT and gift cash only**: The insured can consider creating a non-grantor ILIT which could avoid § 2901 but may require careful administration to avoid the generation and use of trust income to pay premiums that could trigger grantor trust status under § 677(a)(3). Accordingly, it may limit the type of gifts to the trust to cash only in the exact amount of premium due, require the trustee to hold cash earmarked for premiums, or other trust expenses, in a non-interest-bearing bank account, or require the grantor to pay premiums directly to the insurance carrier which can be akin to cash-only gifts. Split dollar loans could also be used to help reduce future gift tax exposure associated with significant-sized premiums, although the interest paid or accrued on the loans would be recognized as taxable income by the lender due to non-grantor trust status (possibly a moot point relative to grantor trusts considering the proposed IRC § 1062 discussed below).

- ✓ **Create a non-grantor ILIT by requiring adverse party consent to pay premiums with trust income:** If it is desired to make gifts to the trust that will or could generate income, it could be possible to avoid grantor trust status under § 677(a)(3) by requiring the majority of the beneficiaries having a substantial interest in the trust to consent to using trust income for the payment of premiums.

- ✓ **Create a grantor-ILIT with the ability to convert to a non-grantor ILIT:** The insured can consider creating a grantor-ILIT carefully drafted with the ability to rescind the applicable grantor trust powers and convert to a non-grantor trust if § 2901 is enacted as proposed and ongoing gifts are required. If the tax treatment of grantor-ILITs under current law is preserved with any final legislation, then the trust can remain a grantor-ILIT and enjoy the related administrative and tax benefits. It may be necessary to avoid generating and using any trust income to pay premiums to avoid § 677(a)(3) as described above until it is known how ILITs and life insurance may be affected by any final legislation.
- ✓ **Use a partnership instead of an ILIT:** The insured can consider creating a family limited liability company (FLLC) to own the life insurance on his or her life, make capital contributions thereto and gifts of non-managing member interests therein to their beneficiaries. FLLCs could help keep a proportional amount of the death benefit proceeds payable thereto out of the insured-member's gross estate equal to the proportional interest held by members other than the insured, while providing for flexible administration and management of the underlying assets. For example, if the insured retained a 1% FLLC interest and gifted the 99% interest to their beneficiaries, 99% of the death benefit of a policy owned by and payable to the FLLC could be kept out of his or her gross estate.[iv]

But Wait, There's More! Proposed IRC § 1062

The Ways and Means proposal also contained another new Code section, **IRC § 1062**, which would cause sales and other transfers or dispositions between an IGT and the person who is the deemed owner thereof to be recognized for income tax purposes. This new section would effectively revoke Revenue Ruling 85-13, the preeminent source of authority for the current disregarded treatment of transactions between grantors and their IGTs for income tax purposes.

The key aspect in this new Code section that could impact any ILITs is § 1062(a) which states (paraphrasing):

In the case of any transfer of property between a trust and the person who is the deemed owner of the trust (or portion thereof), such treatment of the person as the owner shall be disregarded in determining whether a transfer is a sale or exchange for income tax purposes.[v]

This proposed new Code section is effective for:

- ✓ Any sale or other disposition that occurs on or after the date of enactment between any trust and the deemed owner of the trust (or portion thereof) regardless of when the trust was created.

Impact of the Proposed IRC § 1062 on Irrevocable Life Insurance Trusts

Should this law go into effect as initially drafted, interest received on loans made to the trust, including split dollar loans, could be recognized as taxable income annually by the insured-lender if the insured is treated as the deemed owner of an ILIT for income tax purposes. Accrued interest is generally treated as Original Issue Discount (OID) income and recognized annually by the lender as well.[vi] Accordingly, it may be advisable to structure a new ILIT as a non-grantor trust if ongoing split dollar loans will be made to fund premiums since the income tax treatment of the loans would be the same as with any grantor trust, but inclusion under the proposed § 2901 would not be triggered by gifting money or property to the non-grantor trust to help it pay interest and limit future taxable income. For preexisting grantor-ILITs where future split dollar loans will be made to fund premiums, it may be advisable to make as big of a gift as possible to the trust prior to enactment to provide a source of future interest payments to the lender to limit taxable income and avoid having to make future contributions that could trigger § 2901.

Additionally, the sale of income-producing, appreciated property to a grantor-ILIT to provide a source of cash flow for ongoing premiums and the repayment of debt obligations in kind with interests in appreciated property would cause recognition of taxable gain in such property. Therefore, if transfers exceeding the grantor-insured's available lifetime gift tax exclusion amount are needed to fund premiums, split dollar loans with non-grantor-ILITs may become preferable to minimize taxable income and § 2901 inclusion risk. For outstanding debt obligations of existing grantor-ILITs where repayment may be made in kind with interests in appreciated property, it may be advisable to proceed with such repayment prior to enactment, if possible, and consider future split dollar loans, if needed and feasible.

Additional Thoughts

It must be underscored that these potential tax law changes are still just proposals. As of the publishing of this document, the House has yet to vote on any legislation and the Senate has yet to release any proposed tax law changes of its own. Therefore, the situation is fluid and likely to change in the coming weeks as proposed legislation continues to make its way through committee and members of each chamber of Congress continue internal negotiations. Moreover, Finseca, the leading organization that advocates to Congress for tax policy affecting the life insurance and financial security industry, is keenly aware of the concerns discussed herein and has been actively educating members of Congress on the importance of preserving the favorable tax treatment of life insurance owned in trust for the purposes of providing liquidity to help taxpayers address their financial security goals.

However, it is impossible to predict what any final legislation will look like and nothing is final until the President signs the bill. Feedback from those with knowledge of the situation indicates that the Democrats are endeavoring to pass something by end of November 2021. Accordingly, it is critical for taxpayers to rely on the guidance of tax and legal professionals regarding the potential impact of proposed tax law changes on their individual situations and guidance for actions to take in anticipation thereof.

Depending on individual circumstances, it may be advisable to closely monitor the situation for developments and hold off on acting until it becomes clear what any final legislation may include. That said, it may also be prudent to take what steps are necessary in the meantime (such as drafting trust documents, preparing business entity interests, obtaining qualified appraisals, etc.) to be ready and able to implement any desired estate planning decisions quickly and effectively in anticipation of final legislation when the time comes. Reviewing existing ILITs and underlying policies should be done to determine to what extent the proposed laws may apply and what options could be considered in response going forward. Flexibility will be crucial, especially during times of uncertainty.

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[i] Although it is not defined in the current proposal and may require additional regulatory guidance or an IRS pronouncement for clarification, some commentators estimate that the method for determining the portion of a preexisting grantor trust includible in the grantor gross estate due to new contributions made on or after enactment could be comparable to that which is used for determining the Generation Skipping Transfer (GST) Inclusion Ratio.

[ii] That is, the mere possibility or express power contained in the trust instrument that income *could be* used to pay premiums on a policy that *could be* purchased by the trustee may not cause the grantor to be treated as the deemed owner for income tax purposes under IRC §677(a)(3). For example, if the trust has income for tax purposes (interest, capital gains, dividends, earnings, etc.) and the premium payment exceeds the amount of such income, then the grantor could be treated as the deemed owner of the entire trust. If the premium payment is less than the trust's taxable income then the grantor could be treated as the deemed owner of a portion of the trust (it is uncertain how such portion would be calculated when a trust has excess income not used to pay premiums). Note, a trust instrument expressly prohibiting the use of income to pay premiums generally does not negate IRC § 677(a)(3) if trust income is actually applied for such use. See Revenue Ruling 66-313 and PLRs 5603015410A, 6406221750A, 8007080, 8014078 and 8839008. Private Letter Rulings (PLRs) provide binding precedent only for the taxpayer to whom they are issued but can provide insight into how the IRS may interpret and apply the tax laws under similar facts and circumstances.

[iii] Note, the split dollar loan receivable repaid would be includible in the insured's gross estate. An analysis should therefore be conducted to determine which option would cause greater inclusion – making new gifts after enactment or split dollar loans. With existing ILITs, the policy should be reviewed for adequacy within a split dollar loan arrangement. If the insured is still sufficiently insurable and a new policy is needed, a § 1035 tax-free exchange can be considered to acquire a new policy designed accordingly. Split dollar loans are payments to the owner of a policy from a non-owner to fund premiums, the repayment of which is to be made from or secured by the policy's cash value, death benefit or both. There must be a reasonable expectation of repayment and the loans can be fully non-recourse if structured properly. If interest is not paid or accrued on each loan advance at a rate equal to or more than the Applicable Federal Rate (AFR) in effect the month the loan is made then transfers are imputed between the lender and the borrower to account for the insufficient interest for gift and income tax purposes. See Treasury Regulation § 1.7872-15.

[iv] Partnerships are subject to numerous statutes and regulations. Much attention must be given to the formalities when forming and administering these entities to ensure the senior family member achieves the desired outcome for transfer tax purposes and the risk of inclusion of the partnership's assets in his or her gross estate, for example under IRC §§ 2036 or 2038, is minimized.

[v] The proposal also amends IRC § 267(b) to expand the definition of a related party to include an IGT and its deemed owner and disallow recognition of losses on sales or other dispositions between such persons.

[vi] The difference between the stated redemption price at maturity, which includes accrued interest, and the issue price is OID. The holder of a debt instrument (lender) must include in gross income the sum of daily portions of OID (interest accrued) throughout the taxable year in which the instrument was held. Daily portions of OID are determined by allocating to each day during an accrual period the ratable portion of the increase in the adjusted issue price (interest accrued in the current period). The adjusted issue price at the beginning of any accrual period is the sum of the issue price (original loan) plus all adjustments made in prior accrual periods (prior accrued interest recognized). See IRC §§ 1272 and 1273.

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