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What the Build Back Better Act Could Mean for Life Insurance Trusts

Planners have a window of opportunity to prevent potential calamity

Lawrence Brody, Senior Counsel, Harrison & Held, LLP
Charles L. Ratner, JD, CLU®, ChFC®, AEP® (Distinguished)

Yes, it's early October as we write this. And, true, no one can predict whether there will be a new tax law in the offing for next year and, if there is, how drastically it will alter the estate planning landscape. But the Sept. 13 release by the House Ways and Means Committee of its tax proposals under the Build Back Better Act (the Act) is a clarion call for estate planners to think seriously about how profoundly some of these proposals would affect clients' estate and liquidity planning.

There are myriad aspects of planning that would be affected by these proposals. However, it can make a lot of sense to focus on irrevocable life insurance trusts (ILITs), both existing and newly contemplated, as well as how they are or will be funded. If the conversation involves the word "irrevocable," it's going to involve the word "complications." And if it involves complications, then time is of the essence.
Consider at a high level what's on the table, which includes these provisions:

- An ILIT established on or after the date of enactment of the Act that's a grantor trust will be included in the grantor's estate.
- A gift on or after the date of enactment to an ILIT that's a grantor trust established before date of enactment will cause a portion the ILIT's assets to be included in the grantor/donor's estate
- A sale on or after date of enactment to an ILIT that's a grantor trust will be considered a sale to a third-party
- The estate and gift tax exemption is (reduced to) $5 million (indexed) after 2021.
- Capital gains tax rates for high income taxpayers are increased, effective for gains incurred after Sept. 13.

Notably not on the table, at least for now, is a proposal for carryover (rather than stepped-up) basis and recognition of capital gains at death.

It's impossible to know when the date of enactment will be. However, given all that remains to be done (and no doubt changed) before the Act becomes law, there should be sufficient time for planners to react and reach out to clients.

It goes without saying that, depending on what comes to pass, many clients will have to reassess the fundamental underpinnings of their estate plans, the continued viability of their wealth transfer vehicles and, of course, their liquidity position. Many will also have to review the performance and durability of their life insurance policies. This reassessment would be challenging enough if the "only" thing clients had to deal with were a reduction in the gift and estate tax exemptions. But the change in the treatment of grantor trusts will take the conversation into uncharted territory.

Like songwriters, planners will have to compose the lyrics to some targeted alerts and memoranda that they'll send to clients, urging them to talk or meet sooner rather than later. The challenge, of course, is to make a common sense case for why clients should

spend their time and money to talk about the potential implications of possible legislation. Perhaps for that reason, communications with clients should focus less on the principle of the thing than the money. If they can't see what's at stake in real dollar terms, they're a lot less likely to heed a call to action. And where applicable, let the client know that these proposals simply give them more reason to do now what they've been thinking about doing anyway.

Where to Begin?

It might make sense to start with the most proximate and problematic situations, meaning those that portend the most tax and financial harm, likely involve the most complications and require the most time to settle on and implement a course of action. A priority list might look something like this:

- Clients with existing ILITs that are grantor trusts that are being funded by some form of tax and/or economically leveraged technique.
- Clients funding grantor trust ILITs with gifts of cash. These gifts could be problematic after the date of enactment from both a gift and an estate tax perspective.
- Clients who once again have taxable estates…for now.
- Clients who would like to avoid a gift and the 3-year rule (Internal Revenue Code Section 2035) by selling their policy to a grantor trust ILIT.

ILITs Supported by a Leveraged Technique

Here we include ILITs involved in split-dollar and third-party premium financing arrangements. Split-dollar arrangements run the gamut from pre-final regulation collateral assignment equity plans (yes, there are still many of these out there) to post-final regulations non-equity collateral assignment plans under the economic benefit regime and collateral assignment plans under the loan regime. These plans can involve the client's company/employer as the party advancing the premiums and due repayment or the client as donor in that capacity.

Third-party premium financing arrangements can also involve several variations on the theme. For purposes of this discussion, the arrangements that matter are those that call for annual direct or indirect gifts to the ILIT to service the loan and/or those that will require a large direct or indirect gift to enable the ILIT to repay the loan and keep the policy more or less intact.

Why start here? Three reasons. First, many of those plans and programs of older vintage are in trouble, meaning they have no reasonable prospect of successfully completing their mission without a large direct taxable gift of cash or property or a large indirect gift. An example of an indirect gift would be employer's release for less than full consideration of the collateral assignment in termination of a compensatory split-dollar arrangement. Why are these plans in trouble? The usual suspects include an absence of an exit strategy, failure on the part of the client to follow through on the exit strategy that was planned from the outset and lagging policy performance after years of low interest rates. But the arrangements are where they are! Second, the solution to these problems will call for the input of several types of advisors and maybe the involvement of a client's company or employer and its advisors. The employer's involvement could present issues, especially if the employer is anxious to get out of the split-dollar arrangement now

and has no interest whatsoever in the income, gift or estate tax cost to the client of terminating the plan. All this can take a lot of meetings/calls and a lot of time, which is now of the essence. Third, the "You'd better take a serious look at this plan" song has been on the charts for years now. But when one overlays the proposals against the dwindling exit strategies that remain, the tax and economic results to the clients are even more draconian and far-reaching than planners have been warning about for years.

Memo to Clients

Depending on the type of arrangement in place, a memorandum to clients would describe in more or less detail:

- The arrangement, that is, the parties, the tax characteristics of the ILIT, the design/structure of the plan and, based on the most recent illustrations, its current and projected economic and tax implications under current law. If the arrangement is an economic benefit split-dollar plan that covers two individuals, then the projections should include the 1-year term rates after one insured passes away (or at least periodic examples of the differences between the 2-life rates and the single-life rates). This point is a great example of the motivational power of numbers over concepts. The concept that the rates increase when the first insured dies is nowhere near as clear and motivational a message as actually seeing the numbers!
- The impact of potential tax legislation on the arrangement, that is, if the client doesn't do something about this before the date of enactment, here's how the basic elements of the arrangement such as the annual gift of the economic benefit in a split-dollar plan could have seriously negative consequences.
- The steps that the client could consider to alleviate the situation or terminate it altogether on some kind of reasonable basis, as well as the comparative, all-inclusive tax implications of those steps if taken before or after the date of enactment. Depending on the type of arrangement, this might involve additional direct or deferred gifts of cash or property to the ILIT or forgiveness by the party advancing the premiums. It might involve a life settlement. Complicating factors here can include but not be limited to the income and gift tax implications of terminating pre-final regulations collateral assignment equity plans and, in some cases, IRC Section 409A .
- Information and input needed from the insurance professional and other advisors and a request for authority to get it and talk with those advisors. The insurance professional could include recommendations for an exchange of the current policy for one that requires no further premiums.

Existing ILITs Funded by Gifts of Cash and Property

These are obviously less complex situations than those just described. However, they may call for a line of inquiry that's every bit as nuanced as those "sophisticated" situations.

The problem is straightforward but still profound. If made to grantor trust ILITs, those gifts could trigger some element of estate inclusion of the insurance proceeds. Commentators have made the very sensible suggestion that clients buy time by funding these ILITs to the extent they can in 2021 or more specifically now, before the date of enactment. But some clients may not be in a position to do that or may be reluctant to use their exemption. An alternative to gifts is a loan, meaning split-dollar or, as the technique is popularly called, private premium financing. Ah, but there's a rub or two or three.

A memorandum for these situations would describe in more or less detail:

- The arrangement and its present-day tax implications.
- Based on the most recent information/illustrations, how many more years of premium gifts are required.
- Relevant tax characteristics of the ILIT
- The impact of potential legislation on the arrangement, including gift tax implications, potential estate inclusion attributable to post-date of enactment gifts to a grantor trust ILIT, etc.
- Alternatives to consider, including:
  - Large gifts of cash or income-producing property before date of enactment. The gift can pre-fund the ILIT for a certain number of years, but it uses exemption.
  - Private premium financing, whereby the client lends the funds to the ILIT. As long as the loan is at the applicable federal rate (AFR), a well-documented, properly maintained arrangement should be respected for what it purports to be, a split-dollar loan. As long as the ILIT is a grantor trust, there will be no income tax implications to the loan. As a side note, planners could discuss a non-equity collateral assignment plan with clients. However, with interest rates so low now, a loan regime plan is more attractive.
  - So what's the rub? if the ILIT is a grantor trust, there can be no margin for error in case, sometime post-date of enactment, the arrangement doesn't pass muster as a loan and any "delta" is considered a gift with the above-described complications. If the ILIT isn't a grantor trust, then the ILIT will be responsible for the tax on any income-producing property the client transfers to it to enable the ILIT to pay some premiums. In the loan context, if the ILIT isn't a grantor trust, the interest at the AFR whether paid or accrued will be taxable to the client. In either case, what's the endgame with the loan? Assuming the policy won't be able to finance the repayment of the loan for many years if ever, how will the loan be repaid? A big gift later in life? Not if the ILIT is a grantor trust! Forgiveness? No! Uh oh, it's split-dollar deja vu all over again.
- Information, input, illustrations and more that will be needed from the insurance professional and other advisors as well as the authority to get it. As noted above, the insurance professional could include recommendations for an exchange of the current policy for one that requires no further premiums.

It's reasonable to assume that, once clients absorb the above, they'll wonder whether their ILITs have "jumped the shark, that is, the clients don't feel they're needed any more or are just plain tired of the annual rigamarole. Perhaps the ILIT could distribute the policy to the adult children beneficiaries, and they can pay for it (with an occasional contribution from the client). Yes, the protection of the ILIT for the trust beneficiaries, including creditor protection, estate tax exclusion and spendthrift tenancies will be lost but so will the complexity. And the children's stewardship of the policy will be a good test of…whatever.

Hey Look, Our Estate Is Taxable…Again!

There's a significant group of clients for whom estate taxes became irrelevant and/or immaterial after the exemptions doubled a few years ago. Now, however, an "accelerated sunset" will bring a new dawn of estate tax exposure. But will clients care? Any couples in this group who don't have to deal with ILITs crying out for attention before

year-end might very well shrug off these latest developments. And why not? Their estate planning documents will still “work.” There’s no change to the marital deduction, so there will still be no tax when the first spouse passes away. Anyway, they’ve seen that the estate and gift tax laws have more turnover than a pancake griddle. Before you know it, the exemptions will be back up. So why bother?

However, for others, particularly those who won’t have the benefit of the marital deduction, the new law could cause a tectonic shift in their thinking. They may be concerned enough to prepare to move before the date of enactment if that’s required. And that move could certainly involve forming and funding new ILITs. It could also involve transferring (or selling) existing life policies to these new ILITs, again before date of enactment. There will obviously be a certain amount of redundancy between the planning discussions with this group and the prior group, as both have to concern themselves with trust design and long-term funding of the ILITs in a decidedly unfriendly transfer tax environment. Planners will probably also explore alternatives to ILITs altogether, such as partnerships.

Some clients will want to use split-dollar or other leveraged techniques to preserve their exemption or use someone else’s money to fund their ILITs. So that they prevent the past from being prologue, planners can work with the life insurance professionals to fashion approaches to the plans and the design and funding of the policies so that clients have more control and flexibility to manage the arrangements and reduce their risk than in the past. That should be interesting!

Clients who would like to avoid the 3-year rule by selling their policy to a grantor trust ILIT

This is a common situation that could be even more so in light of the proposal to accelerate the sunset and reduce the gift and estate tax exemptions. Say a client owns a large life insurance policy. They decide that now would be a good time to “do something” to remove the policy from their taxable estate. They could simply transfer the policy to an ILIT as a gift, but as they’ve been told more than three times, the policy will be pulled back into his estate if they dies within three years of the transfer. Besides, they’re reluctant to use more gift tax exemption. Their advisors have suggested, more than three times, that a properly designed sale of the policy to a grantor trust ILIT for full consideration won’t be a gift and will avoid the 3-year rule. What’s more, the sale won’t be a taxable transaction under Revenue Ruling 85-13, nor will it be a transfer for value under IRC Section 101(a). Under the new proposed rule however, a grantor trust ILIT will be considered a third-party, rendering the sale a taxable event and, absent another exception, a transfer for value. This result would obtain only if the sale occurs on or after the date of enactment to a trust created then, which means that there’s still time to sell the policy to an existing ILIT or establish a new one before date of enactment and then make the sale.

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