Potential Tax Law Changes and Their Implications for Life Insurance Planning

ADVANCED MARKETS

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Wealth transfer plans will be affected if proposed tax code changes are signed into law. Some of the changes contained in The 99.5 Percent Act (proposed by Sen. Bernie Sanders) would have a dramatic effect on a foundational component of wealth transfer planning – the irrevocable life insurance trust (ILIT). Here's how.

POTENTIAL GRANTOR TRUST CHANGES

An ILIT is usually formed as a "grantor trust": The assets owned by the trust are considered owned by the grantor *for income tax purposes* while those same trust assets – including appreciation and accumulated income – are outside the grantor's estate *for estate tax purposes*. This dual-tax nature makes the grantor trust an extremely flexible, widely used tool in wealth transfer strategies. If the Sanders bill is enacted, the fair market value (FMV) of the assets owned by a grantor trust, less any gifts the trust receives, would be included in the grantor's estate. The new rules would apply to new trusts and new gifts to existing grantor trusts.

Example:

A client establishes a new ILIT as a grantor trust. Over the next 20 years, the client makes annual gifts of $50,000 to fund a $5 million life insurance policy. Upon the client's death, the trust receives $5 million of death benefit – but $4 million is subject to estate tax.

POTENTIAL LIFETIME GIFTING CHANGES

The Sanders bill also proposes changes to the gift and estate tax regimes. New limitations would be imposed on tax-free gifts made to trusts, including ILITs. Currently, the annual exclusion amount is $15,000 (the Sanders' bill reduces it to $10,000). Families with multiple children and grandchildren have significant capacity to make annual exclusion gifts. If the proposal is adopted, the number of annual exclusion gifts to trusts will be limited to two per donor.

Example:

Seven trust beneficiaries mean a grantor can gift $105,000 or both spouses can gift $210,000 to the trust. The new rules would limit the maximum annual exclusion gift to $30,000, or $60,000 for both spouses.

The bill would create a $3.5 million estate tax exemption. Of that, $1 million can be applied against lifetime taxable gifts. Taxable gifts exceeding $1 million would incur gift tax. In contrast, current law provides a "unified exemption" against gift tax and estate tax of $11.7 million for each person. (A decedent's estate tax exemption is reduced by the amount of lifetime gifts.)

IMPLICATIONS FOR EXISTING ILITS

Gifts made to an existing ILIT will expose some portion of the trust to estate tax inclusion—and reduce the net assets they have to meet tax obligations or other personal purposes. Thus, gifts made after enactment are self-defeating.

An ILIT trustee owning a life insurance policy requiring annual premium payments will be challenged if the flow of annual tax-free gifts is cut off (many trust-owned policies rely on ongoing gifts to make the annual premium payments). The result, at best, is that the duration of the policy coverage will be dramatically reduced. At worst, the policy may lapse immediately after the grace period expires for the next unpaid premium.

Advisors should meet with clients to discuss making a single lifetime exemption gift that's adequate to fund their ILIT's policy through life expectancy. If making a large lump sum gift is infeasible, they might explore making loans to the trust under a split dollar arrangement so that the trustee can make the annual premium payment. Alternatively, the they may be able to reduce the face amount of the policy to a level where no further premiums are required.

IMPLICATIONS FOR NEW ILITS

Prior to enactment. Wealth transfer opportunities will be dramatically reduced if the proposed rules are adopted. Advisors have no time to waste and should prioritize meeting with clients who haven't yet engaged in the planning process. You should discuss whether creating and funding a new grantor trust prior to enactment is appropriate. If so, prepare your clients to make the largest gift possible using their current lifetime exemption. Married couples may be uncomfortable with giving significant wealth to an irrevocable trust. Structuring the

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trust as a spousal lifetime access trust may alleviate such concerns. If the trust is intended to own life insurance, the amount gifted should be large enough to pay future required premiums.

After enactment. New trusts will have to be structured as non-grantor trusts so that they are effective in sheltering assets from the estate tax. Accordingly, working with ILITs will be different in the future.

Example:

If an existing policy is transferred to an ILIT as a gift and death occurs within three years, the policy proceeds are included in the taxable estate. Under current law, that exposure can be avoided by having the trust (a "grantor trust") buy the policy for its FMV. In the future, using a non-grantor trust, such a sale would likely qualify as a "transfer for value," resulting in the policy proceeds being subject to income tax.

Given the new cap on annual exclusion gifts to trusts coupled with the reduced lifetime gift tax exemption, wealthy clients face a much greater challenge funding large premiums for trust-owned policies in a tax-efficient manner. Planners need to evaluate alternative funding strategies for existing and new ILITs including but not limited to split dollar, premium financing or net taxable gifts. We may also see interest in having a limited liability partnership own the policy as an alternative to using a non-grantor trust.

Advisors' takeaway. Of course, we can't know which parts of the Sanders bill, if any, will be signed into law. Accordingly, advisors should encourage clients to meet with their estate planning attorney and other team members to discuss:

1. **the implications of these proposals on existing ILITs;**
2. **whether a new ILIT would be advantageous;**
3. **funding existing or new ILITs with a large lifetime gift before 12/31/2021; and**
4. **strategies for funding non-grantor ILITs after enactment.**

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