New Irrevocable Life Insurance Trusts (ILITs)
& Defective Grantor Trust (DGT) Status

On September 13th, the House Ways & Means Committee introduced new Code Sec. 2901. Pursuant to that Code section, post enactment gifts to a defective grantor trust (DGT) would taint the trust for gift and estate tax purposes. On October 28th, the House released a second version of proposed legislation. The good news is that the proposed laws affecting DGTs (Code Secs. 2901 and 1062) were notably absent. But it is possible the DGT provisions could be added back in by either the House or Senate.

For new ILITs, one reasonable approach is to simply address legislative changes when they actually become law. Another approach is to plan ahead. For example, is it best to make the trust defective or non-defective initially? Furthermore, can steps be taken now to allow DGT status to be easily changed to accommodate whatever law we end up with? For the following three scenarios, whether an ILIT is initially defective or not, including a trust protector who can toggle DGT status on and off is recommended. Consider the following common scenarios:

1. **New ILITs where premiums are funded with annual gifts only**
   The ILIT should not be a defective grantor trust from inception. Because the Trust will have little or no income, there is no compelling advantage to the ILIT being a defective grantor trust.

   On the other hand, if a new ILIT is defective from day one and the DGT legislation is passed, it will be possible to avoid negative gift and estate tax consequences by turning DGT status off before additional premium gifts are made – however, depending upon state law and the terms of the trust, it can get complicated (and expensive). It seems far simpler to make this ILIT non-defective from inception (with the ability to toggle DGT status on and off later).

2. **New ILIT is being funded with sales or loans of appreciated assets**
   The trust should be defective from inception so that gain is not triggered on the sale and interest due on the note is not taxable to the grantor. Even with a loan of cash, it may be desirable to make the trust defective from inception so that loan interest is not taxable. (In either case, providing the ability to toggle DGT status on and off.)

3. **New ILIT funded with a lump sum gift**
   Where substantial taxable trust income is expected, then it may be advisable to make the trust defective from inception. Where the taxable income will not be substantial or the client may just want the trust to pay its own income taxes, then making it non-defective from inception may be advisable. (In either case, providing the ability to toggle DGT status on and off.)

Each situation is unique. Over time, it is possible to manage DGT status to obtain the best possible outcome. This would include carefully considering trustees and their removal/replacement to account for the long reach of Code Sec. 677(a). Taking the time today to think through the possible outcomes can pay huge dividends in the future.