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The Nongrantor ILIT: A Discussion

MARKET TREND: As Congress and the Biden administration continue to consider the grantor trust rules, some practitioners have turned their attention to the little-used nongrantor irrevocable life insurance trust ("ILIT") as a planning alternative.

SYNOPSIS: The ILIT, one of the most commonly used legacy management tools, is typically established as a grantor trust for income tax purposes for many reasons but the most important being the ability to use the trust income to pay life insurance premiums.

TAKE AWAYS: The nongrantor ILIT is possible but not ideal. In most situations, the grantor ILIT will remain the preferred structure. However, it is possible to structure the ILIT as a grantor trust from the outset and allow for a future toggling-off of grantor trust status to manage possible changes in the law.

MAJOR REFERENCES: Internal Revenue Code § 677(a)(3).

The Lingering Threat to Grantor Trusts

Recent legislative proposals, specifically the failed Build Back Better Act of 2021, sought to change the treatment of grantor trusts by including the trust assets in the taxable estate of the grantor and treating transactions between the trust and grantor as recognition events for income tax purposes. While the Build Back Better Act did not pass, the Biden administration has kept these proposed changes to the grantor trust rules alive in the 2023 Greenbook.[1]

This possible threat to the beneficial treatment of grantor trust status plays a huge role in the ILIT space because the vast majority of ILITs are established as grantor trusts so the trustee can use the trust income to satisfy the on-going premium requirements of the life insurance policy. In addition, the grantor ILIT allows for other flexibilities, such as the ability to engage in split-dollar premium financing or the ability to avoid the transfer-for-value rules on the sale of a life insurance policy.

[1] General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals.

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The potential for a change in the treatment of grantor trusts has led to the question: can an ILIT be structured, instead, as a nongrantor trust? This article explores the grantor trust rules and focuses on Internal Revenue Code ("**IRC**") Section 677(a)(3) and the possibility of structuring an ILIT as a nongrantor trust.

Background – Grantor Trust Rules

A grantor trust is a type of trust where the person creating the trust (the "**grantor**") remains the owner of the trust assets for income tax purposes. Grantor trust status occurs when the grantor or other party (such as the trustee or a beneficiary) holds certain rights to the income or principal of the trust or certain powers over the disposition of income and principal. As a consequence, the trust is not treated as a separate entity from the grantor for income tax purposes, and the grantor must include all income generated by the trust on his individual tax returns.

Benefits of Grantor Trust Status

Structuring an ILIT as a grantor trust adds flexibility and comes with many advantages, including:

- A gift of an existing policy to an ILIT will generally be included in the insured's estate if the insured passes within three-years of the gift. The sale of a policy to a grantor ILIT may avoid the three-year issue if the sale is for "adequate and full consideration in money or money's worth."
- A grantor ILIT can purchase appreciating or income producing assets from the grantor in return for a promissory note (a so-called installment sale to a grantor trust). The ILIT can then use income generated by the trust assets to pay insurance premiums which eliminates the need for future gifts to the trust. The transaction will be disregarded for income tax purposes, so the sale will not trigger capital gain for the grantor, and interest paid on the promissory note will not be taxable to the grantor.
- A grantor ILIT can engage in split-dollar premium financing.
- If, over time, the terms of an existing ILIT become unsuitable for the current circumstances of the beneficiaries, the trustee of the existing ILIT may consider a sale of the policies to a new ILIT with more desirable terms.
- If the grantor ILIT provides the grantor with a nonfiduciary power to substitute assets, the grantor could, if appropriate, reacquire the policies in the ILIT by substituting assets of equivalent value.

The key to allowing these benefits is a mismatch between the transfer tax system and the income tax system such that a transfer of assets to an irrevocable trust can be a completed gift for gift tax purposes (and consequently removed from the grantor's estate for estate tax purposes) while the grantor can still be treated as the owner of the assets for income tax purposes. This mismatch allows for the creation of a grantor ILIT.

Grantor Trust Rules – Creating a Grantor Trust

The so-called "grantor trust rules," found at IRC §§ 671-679, set out the rights and powers that will result in grantor trust status. Common rights and powers used in irrevocable trusts to intentionally obtain grantor trust status include:

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- The power, without the approval or consent of an adverse party (such as a beneficiary of the trust) to use trust income to pay premiums for insurance on the life of the grantor or grantor's spouse (the "**premium paying power**").

- The power, without the approval or consent of an adverse party, to distribute trust income to a grantor's spouse.

- The power, exercisable by the grantor in a non-fiduciary capacity, which enables the grantor to borrow the income or principal of the trust without adequate interest or security (unless the trustee is authorized under a general lending power to make loans to any person without regard to interest or security (the "**lending power**")).

- The power exercisable by the grantor or nonadverse party, in a nonfiduciary capacity, without the approval or consent of any person in a fiduciary capacity, to reacquire trust assets by substituting other assets of equivalent value (the "**swap power**").

Grantor ILITs typically employ several rights or powers listed above to ensure grantor trust status for the ILIT.

Can we Create a Nongrantor ILIT?

The short answer is "yes." To structure an ILIT as a nongrantor trust, the typical grantor trust powers, such as the swap power, lending power, and the ability to distribute income to the grantor's spouse are easily eliminated, but what about the premium paying power?

The answer is not entirely clear. What is clear is that pursuing a nongrantor structure injects uncertainty into an otherwise conservative legacy planning tool.

The Premium Paying Power – IRC § 677(a)(3)

The premium paying power, found at IRC § 677(a)(3), provides that "the grantor shall be treated as the owner of any portion of a trust . . . whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or nonadverse party, or both, may be applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse . . ."

The boundaries of what falls into IRC § 677(a)(3) are fuzzy, and guidance is scarce. Part of the challenge in purposely avoiding the application of IRC § 677(a)(3) is the on-going need to fund annual, recurring premium payments for life insurance on the life of the grantor or the grantor's spouse. This section will take a close look at the statutory language and explore possible options to work around its application.

Breaking it Down – Adverse Party Option

The first part of IRC § 677(a)(3), the "adverse party" option, reads, in pertinent part, "the grantor shall be treated as the owner of any portion of a trust . . . whose income *without the approval or consent of any adverse party* is . . . applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse" (emphasis added).

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Easy enough. One way to purposely avoid triggering grantor trust status under IRC § 677(a)(3) is to require the consent of an adverse party to use income to pay the premiums on life insurance. The difficulty is in the definition of an adverse party. An adverse party is defined in the grantor trust rules to mean any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercised of the power which he possesses.

The regulations provide a seemingly simplified definition, providing that "ordinarily, a beneficiary will be an adverse party."[2] Some practitioners are comfortable with relying on this regulation, and would consider a trust which does not allow the trustee to pay the premiums of life insurance on the grantor or grantor's spouse without consent of the beneficiaries a nongrantor trust (if no other grantor trust powers were included in the trust agreement).

Some practitioners, however, question whether an income *and* remainder beneficiary would be deemed an adverse party in this context. To be adversely affected by the payment of the premium, the beneficiary ostensibly must lose out on the benefit of the eventual payout, shifting the beneficial interest away from such beneficiary. Using this definition of adverse party, the prototypical ILIT may not have an adverse party available.

There is a lack of guidance on this point.

Breaking it Down – Disallowance Option

The second part of IRC § 677(a)(3) provides "the grantor shall be treated as the owner of any portion of a trust . . . whose *income* in the discretion of the grantor or a nonadverse party, or both, *may be applied* to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse" (emphasis added).

This "may be applied" language is very broad, and presumably can only be restricted by forbidding the use of income to pay such premiums. If premiums are still required on a life insurance policy, a potential solution is to require such premiums to be paid from trust corpus (not income). Caution must be had with this approach however, in a private letter ruling involving an ILIT which prohibited applying "trust income" to the payments of premiums, the IRS found the ILIT was a grantor trust because the IRS construed the document as referring to accounting income and not taxable income.[3] It appears the IRS is not too keen on drawing distinctions here.

Possible Solution(s) to IRC § 677(a)(3)

Because of the broad "may be applied" language in the statute, it is advisable to explicitly disallow the use of trust income (taxable not fiduciary) to pay life insurance premiums on the life of the grantor or grantor's spouse. Possibly the best solution to avoid the application of IRC § 677(a)(3) would be to create an ILIT prohibiting the use of income to pay premiums, and then: (1) fund the ILIT and keep the funds in a non-interest bearing account for future use paying premiums; or (2) have the grantor pay the premiums directly to the insurer (which is a deemed gift to the ILIT but does not implicate IRC § 677(a)(3)).

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[2] Treas. Reg. § 1.672(a)-1(b)
[3] PLR 8839008.

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Getting Practical – When Nongrantor ILIT Planning Makes Sense

Given the uncertainty and risk surrounding the use of a nongrantor ILIT, we would likely see most practitioners steering clear of their use. Rather nongrantor ILITs would be a prophylactic measure – if the laws changed making the use of a grantor ILIT impossible, the grantor would in effect convert the grantor trust to a nongrantor trust to salvage the transaction, by toggling-off grantor trust status.

TAKE AWAYS

The nongrantor ILIT is possible but not ideal. In most situations, the grantor ILIT will remain the preferred structure. However, it is possible to structure the ILIT as a grantor trust from the outset and allow for a future toggling-off of grantor trust status to manage possible changes in the law.

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