This Finseca Report Marketplace was prepared exclusively for Finseca Influencer members by **Mary Ann Mancini, Partner and Ashley B. Sawyer, Senior Counsel of Loeb & Loeb, LLP**.

First do no harm - Estate planning for an unknown future

There is an adage in the medical field that applies to planning for insurance trusts right now, namely: “First do no harm”. What is particularly difficult for estate and tax practitioners today is they are being asked to plan for previously proposed legislation that, while currently out of the legislative debate, might resurface and pass in the future. Given this situation, what can we do to position our clients so that we are helping them in the event that the now shelved legislation reenters the debate and is passed, while simultaneously not hurting them if the laws do not change?

There are two sets of previously proposed legislation that practitioners should build a familiarity with now. First is parts of a previous version of the “Build Back Better Act”, which was introduced in September of this year and contains Section 2901 and Section 1062. The second is the Wyden Bill, which was recently introduced and is referred to as the Billionaires’ tax bill. This bill does have provisions that are similar to Section 2901 with respect to grantor trusts, but with different tax consequences. The Wyden Bill would only affects tax payers who have an “applicable” AGI of $100,000,000 or own assets worth $100,000,000 (adjusted downward if married and based on certain valuation rules set forth in the Wyden Bill).

What is in the previously proposed legislation?

Proposed Section 2901

The prior proposed legislation includes a new Internal Revenue Code (“IRC”) section, Section 2901, which, in short,

(1) includes in a decedent’s taxable estate any portion of a grantor trust’s assets of which the decedent was the grantor for grantor trust purposes during the decedent’s lifetime,

(2) treats a distribution made from a grantor trust as a gift made by the grantor, unless (a) the distribution is made to a grantor's spouse, or (b) the distribution discharges an obligation of the grantor, and

(3) treats the termination of grantor trust status during the grantor's lifetime as gift of the assets in the trust made by the grantor at the time of the termination.

Section 2901, as drafted, has a disproportionate effect on life insurance trusts, the traditional method of holding life insurance policies for estate and tax planning purposes, due to IRC Section 677(a)(3). This grantor trust provision results in grantor trust status for life insurance trusts that provides for premium payments on policies held in the trust made from the "income" of the trust. The word "income" is in quotes because many practitioners have questioned whether the word "income" as used in Section 677(a)(3) refers to fiduciary income (interest and dividends and other income allocable to the income portion of the trust) or taxable income which refers not only to fiduciary income but also to income earned in the principal portion of the trust, such as capital gains, redemptions, and partnership distributions that carry out taxable income and are added to the principal of the trust. This raises the issue of whether a life insurance trust can be anything other than a grantor trust, even if the Trustee is prohibited from paying premiums from the income of the trust.

The technical interpretation of "income" under Section 677(a)(3) has not created much concern in the past because of the preference that the trust be a grantor trust, but now, in light of the proposed Section 2901, it has become a very important issue.

The Wyden Bill

In the Wyden Bill, if a taxpayer is subject to the rules of the legislation and is a grantor of a grantor trust, then assets transferred in any of the below manors would be deemed an "applicable transfer."

(i) from the grantor to a grantor trust (other than wholly revocable trust),

(ii) (ii) from a grantor trust to anyone but grantor or grantor's spouse (which presumably would include a deemed transfer to a non-grantor trust or

(iii) (iii) from a grantor trust in such a way that results in the transferred assets being excluded from the grantor's estate.

An applicable transfer is a recognition event, and the transfer is treated as a taxable sale or exchange.

What are alternative planning strategies?

Potential options for changing income tax status of life insurance trusts

One clear way to avoid grantor trust status, even if income may be used to pay these premiums, is to insert an "adverse" party, as defined in IRC Section 672(a), who has the power to prevent the trustee from making the decision to pay such premiums out of the trust income. Trust agreements should be reviewed to determine whether an adverse party can be added under the existing trust provisions with the requisite power over the trustee; through a trust amendment by a trust protector or independent trustee; or by way of a trust decanting, and if so, can be done prior to the enactment of Section 2901. If Section 2901 were to be enacted, the change in status from a grantor trust to a non-grantor trust is a deemed gift by the grantor. If the Wyden Bill is enacted, the change in status will result in a taxable sale or exchange. Further, it is important to note that whether or not either legislation is enacted, such a change in status has the potential to cause gain recognition under certain circumstances.

If such a change from grantor trust to non-grantor trust is advisable (and remember, Section 2901 and the Wyden Bill may not be enacted, so it should be considered whether it is advisable regardless of whether the tax laws change) and the terms of the applicable trust agreement do not provide a clear mechanism to convert the trust, then another alternative may be to appoint a trustee who is an adverse party (provided that the person making the appointment is not "related or subordinate" within the meaning of Code Section 672(c) to the adverse party being appointed as a trustee), which will also except the trust from the provisions of Section 677. However, it may not be readily apparent who qualifies as an adverse party for this purpose, and it may not be advisable (particularly if neither legislation is enacted) to put someone who is adverse to the grantor or grantor's spouse in such a position of authority.

Alternatives for Holding Life Insurance Policies

We use irrevocable trusts to hold life insurance policies for many reasons. If drafted and administered correctly, the trust keeps the policy out of the estate of the insured, since the insured (and the insured's estate) is not considered to own or have the use of the insurance policy or death benefit under IRC Section 2042.

However, there are other ways to hold life insurance which have the potential to yield to the same result. For example, the intended beneficiary or beneficiaries of the policy could own the life insurance policy themselves, with the same estate tax result. A corporation or partnership also could hold life the insurance policy with the same estate and gift tax result so long as the insured has no control over the policy due to the insured's role in the entity (such as being general partner of the partnership or majority owner of the corporation, for example.)

In addition the Wyden Bill has provisions that also address the taxpayer's entity ownership which would need to be addressed if the taxpayer is subject to this Bill. The insured doesn't need to be an owner of the entity, but for purposes of the transfer for value rules of IRC Section 101, the insured's role or ownership in the entity must be considered. In the case of a partnership, the insured should own a small interest in the limited partnership as a limited partner. If a corporation holds the policy, the insured should act as an officer or director of the corporation (although with no control over the policy itself, directly or indirectly). Owning a limited partnership interest in a partnership that holds the insurance policy will result in a small percentage of the policy death benefit being included in the insured's estate, but it is well worth that price to allow the entity holding the policy to sell or otherwise convey the policy without consideration without triggering the transfer for value rules which cause the death benefit to be subject to income tax (minus the transferee's cost basis in the policy).

However, a trust is still a preferred avenue to hold a life insurance policy for many reasons, namely, if a beneficiary dies with the policy in the trust, the death benefit will be paid out to as the settlor of the trust provided. If the beneficiary holds the policy outright, then the beneficiary's estate planning documents, creditors, or spouse will determine how the beneficiary's ownership interest in the policy will pass. If the policy is held in a newly created partnership, there remains an issue as to whether the partnership will be valid; something the IRS has called into question if the sole purpose of the partnership is to hold insurance policies, and for which the IRS isn't issuing any rulings. Holding a policy in a corporation is even more problematical since, depending on whether the corporation is an S corporation or C corporation and the insured's status within the corporation, the distribution of the death benefit could be characterized as return of basis, compensation, or a dividend, particularly if the tax-free death benefit under Section 101 is lost.

Payment of Future Premiums when a Policy is held in a Grantor Trust

If the client decides to hold or retain the policy in an insurance trust, and either or both sets of previously proposed legislation one day become law, the issue then becomes how to pay future premiums.

Additional assets

One planning suggestion is to fill the trust with as many assets as possible, using discounts (something we may lose as well under previously proposed legislation), using the client's remaining gift tax exemption and the client's annual exclusion, before the law changes. This is a good estate planning move, even if the law doesn't change, as we have always recommended funding an insurance trust with a "side fund" to meet premium payments and to move assets out of the estate while avoiding a multitude of trusts to do so. However, there is a concern wherein if the trust is considered a grantor trust after the law changes, that the income tax earned by the assets held in the insurance trust, payable by the grantor under the grantor trust rules, would result in a gift or deemed contribution by the grantor when he or she pays those taxes. There are varying opinions on this possibility, but trusts created prior to the enactment of the previously proposed legislation could also be grandfathered from this consequence. But no one knows the answer with absolute certainty.

To address this issue, the assets transferred to the trust could be invested in such a way as to avoid earning any taxable income, such as non-income bearing accounts, deferring recognition of capital gains, offsetting taxable income with deductions, and investing in stock that does not pay dividends.

Alternatively, the trust's assets other than the policy itself, could be moved to a subtrust and if drafted and administered correctly, could treat the trust as a non-grantor trust and a separate taxable entity. If the trust then loans money to the insurance portion of the trust to fund premiums, and if the beneficiaries of both trusts are similar, then the loans (and interest paid on the loans) would be for the ultimate benefit of the same beneficiaries who receive the death benefit of the policy. The non-grantor trust could possibly make distributions to the trust holding the policy to pay premiums, but there is a concern that such a power to make distributions to the trust which are used to pay that trust's premiums might cause the non-grantor trust to be considered a grantor trust as well.

Loans

Loans may also be a good method to avoid Section 2901 (we think) since a loan is not a gift or contribution to the trust, since loans must be repaid, and loans are already a common means of paying premiums. It could be the easiest answer to the issue of paying premiums, and the lender could be another family trust, a third party lender, even the insured him or herself. The split dollar loan rules should be reviewed if this is done, but those rules are not onerous and can be easily addressed.

Economic benefit split dollar, however, which treats the grantor as having transferred to the trust the economic benefit of the insurance policy each year, is going to be a problem under either set of proposed legislation. Unless the transaction is terminated prior to the time Section 2901 or the Wyden Bill is enacted, each year, the grantor will be considered to have made a gift to the trust, and if the trust is a grantor trust, the gift, under Section 2901, would result in estate inclusion of a portion of that trust, and under the Wyden Bill the transfer to the trust would be a taxable transaction. If the economic benefit is to be continued, then the trust must become a non-grantor trust.

If the parties are open to amending the economic benefit arrangement, conversion to a loan arrangement should be considered if non-grantor trust status is not desirable. However, such a conversion should take place prior to the enactment of the new legislation, because the conversion may be considered a sale or change of the policy if not structured carefully, and Section 1062 (discussed below), Section 2901 or the Wyden Bill provisions may apply. As there are a host of other issues that arise upon termination of an economic benefit split dollar arrangement, the last thing a practitioner or client should want to do is have to address those issues when subject to such legislation if enacted.

Additional premiums

Finally, instead of taking any of these steps to avoid section 2901 or the Wyden Bill in order to pay future premiums, additional funds could be transferred into the policy itself, if permitted under the policy terms. U.S. private placement life insurance should be considered due to its ability to hold investment assets that grow tax free and can pay the premiums within the policy. Even non-private placement policies that have cash value accounts that can grow when invested will achieve the same goals. However, the Wyden Bill provisions that address private placement life insurance, particularly in the context of taking withdrawals from the policy, should be reviewed.

Annual exclusion gifts

If the insured has no other way to address these premiums, annual exclusion gifts should be considered even after either set of legislation is enacted. Many practitioners believe (to the extent they can draw conclusions about the previously proposed legislation) that gifts that qualify for the annual exclusion should not trigger estate inclusion of any portion of the trust under Section 2901, or a taxable transaction under the Wyden Bill because the gifts are technically made by the holder of the withdrawal right when the withdrawal right lapses who is not treated as the grantor of the trust. The original settlor of the trust is treated as the grantor under Section 678 so long as grantor trust powers are in effect with respect to the original settlor.. So, in effect, persons who are not grantors would be making gifts to the trust.

If Section 678 did not apply, however, withdrawal rights would cause a problem for those beneficiaries who held those withdrawal rights under either set of previously proposed legislation, as they would then be treated as grantors with respect to a portion of the trust, potentially risking estate inclusion under Section 2901 in the beneficiary's estate or a taxable transaction under the Wyden Bill. If the deemed grantor under Section 678 dies, the holder of the original withdrawal rights then becomes the grantor, since Section 678 no longer applies. In the case of an insurance trust, the death benefit will be paid to the insurance trust at that time, which should then become a grantor trust with the holders of the withdrawal rights becoming the new grantors. This may cause estate tax inclusion in those holder's estates, or a taxable transaction under the Wyden Bill, if the trust continues on after the deemed grantor's death and is not managed carefully.

Right now, however, while Section 2901 and the Wyden Bill are only shelved proposals, the annual exclusion should be used to the greatest extent possible to fund insurance premiums and the trust itself, while we have the protection of the existing law. Remember, the Tax Court held in a series of cases - *Christofani* and the *Estate of Turner* - to name two such cases, that even remote or other beneficiaries could have a valid withdrawal rights that would be eligible for the annual exclusion, even though the IRS disagrees. This could potentially allow for significant funding of a life insurance trust with only annual exclusion gifts.

Annual exclusion gifts from other parties

Another way of funding a grantor trust holding an insurance policy on the life of the grantor or grantor's spouse, if previously proposed legislation is enacted, may be to allow those who are not grantors to use their exemptions to gift funds to the trust to enable it to pay premiums. If the funds are quickly used to pay the premiums and not allowed to earn income when in the trust, the issue of the grantor paying the tax on the trust' s income being a possible gift, will not arise.

Proposed Section 1062

So far, this article has addressed planning for enactment of the proposed Section 2901 and the Wyden Bill, but it is also important to consider planning prior to the potential enactment of Section 1062. Section 1062 provides that whenever there is a transfer of property between a trust and its grantor, the transfer will be treated the same as a taxable transfer between the trust and any related party. Which is how the Wyden Bill also treats such transfers. As a deemed sale or exchange, (which would include substituting property in the trust for other replacement property), then gain (but not loss) will be recognized.

Other considerations when looking forward

So, what should be considered now that any of these legislative proposals could always be reintroduced?

Clients should be taking a hard look at the assets in any trust if there is a right of substitution under the trust terms. The grantor could consider substituting a life insurance policy held in the trust for other assets in the grantor's personal estate. This would not be a taxable transfer if done prior to the enactment of the previously proposed legislation. This is an important consideration given that even if the mere power to pay premiums from the income of the trust will cause grantor trust status under Section 677. But, in order for Section 677 to apply, presumably, there actually needs to be a policy in the trust on which to pay premiums. However, once the policy is removed from the trust, Section 677 may not apply and if all grantor trust powers are terminated, then the trust would become a non-grantor trust. But if the policy is then owned by the grantor/insured, it would be includible in the insured's estate under Section 2042, and the three-year rule under Section 2035 would apply, if gifted to another party by the insured. However, if no such legislation is enacted, the insured could sell the policy to a new grantor trust without recognition of income and the sale would be exempt from the transfer for value rules.

With respect to promissory notes between a grantor and grantor trust that arose due to a sale of assets to the grantor trust, the disposition of the notes must be carefully considered. The termination of grantor trust status is considered a sale or exchange to the resultant non-grantor trust, whether Section 1062 or the Wyden Bill is enacted. If the trust is funded with sufficient assets, the client should consider paying off the note, prior to the enactment of any new legislation, which may be good planning under either regime. The existence of the note itself could cause gain recognition under Section 1062 or the Wyden Bill as a sale transaction between related parties upon date of enactment, for which gain is not deferred since there was no installment sale election made. Or the note and transaction could be grandfathered and there would be no recognition of gain under any new legislation. However, the grandfathering may or may not extend to protect payments of principal on the note from gain recognition.

These are ideas that center on insurance policy planning, all of which may become unnecessary if the previously proposed legislation is not included in a final bill, but none of which should be ignored now that they've been part of the conversation. Either way, it's going to be a complicated year-end for clients and advisors alike.