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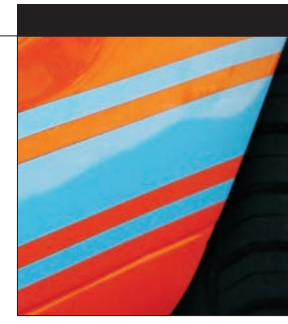

Life Insurance in Light of Democratic Tax Proposals

An analysis of potential planning moves in light of proposed legislation.

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Estate planners and their clients anxiously await learning what changes may be made to the Internal Revenue Code that will impact estate planning. Numerous proposals have been made recently, including reducing the current $10 million (inflation adjusted to $11.7 million for 2021) wealth transfer (estate, gift, and generation-skipping transfer) tax exemption[1] to $3.5 million (or less), effectively "outlawing" grantor retained annuity trusts (GRATs),[2] eliminating certain discounts in valuation for wealth transfer tax purposes, reducing the time property may remain free of transfer taxes by limiting how long a trust may remain exempt from generation-skipping transfer (GST) tax, curbing the use of gift tax annual exclusions for transfers in trust, curbing the use of grantor trusts (which are the foundation of many estate planning arrangements) by causing them to be included in the gross estates of their settlors, and eliminating the income tax free adjustment (typically referred to as a step-up) in basis under Section 1014 for assets included in the gross estate of a decedent.[3]

On March 25, 2021, Senator Bernie Sanders (I-VT) and Senator Sheldon Whitehouse (D-R.I.), and joined by Senators Chris Van Hollen (D-MD.), Jack Reed (D-R.I.) and Kirsten Gillibrand (D-N.Y.) introduced a bill entitled "For the 99.5 Percent Act." Senator Sanders reported that "companion estate tax legislation will be introduced [in the House of Representatives] by Rep. Jimmy Gomez (D-Calif.)." It would make, among others, many of the estate, gift, and GST tax changes recited above. Senator Van Hollen has introduced a bill, entitled "Sensible Taxation and Equity Promotion Act of 2021," ("STEP") which would largely end the income tax free change in basis under Section 1014 by treating property which is transferred by gift, in trust, or upon death as sold for its fair market value to the transferee on the date of such gift, death, or transfer. This could have a dramatic impact on planning. Property in trust would be treated, in general, as sold every 21 years including for assets already in trust as early as 21 years after 2005. The Sanders' bill would have various effective dates but, generally, not before date of enactment or before 2022. The Van Hollen bill would be effective at the beginning of this year. These proposed effective dates have profound implications to planning. For example, while some have focused on the Sanders bill effective date of January 1, 2022 for the reduction in the exemption, the

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grantor trust changes are effective upon enactment of the bill. Thus, clients may need to have completed critical planning before enactment, not just before the end of 2021.

Needless to say, these changes would have extremely far-reaching effects to estate plans. Commentators have recommended specific action for individuals to take with respect to the wealth transfer tax proposals, especially using the exemptions before the Sanders' proposals become effective, if they are enacted, which is not a certainty. Little has been written on planning in light of the Van Hollen proposal which, on account of its proposed retroactive effective date of January 1, 2021, is, perhaps, surprising. Previous legislation which essentially eliminated the step-up in basis under Section 1014 provided many exceptions and special rules, virtually none of which is contained in Senator Van Hollen's bill.[4] Canada repealed its estate tax system for people dying after 1971 and imposed a deemed sale of their assets but it applies only to property acquired after December 31, 1971.[5] Because of the retroactivity, severity, and lack of exclusions, it is certain there will be challenges to the Van Hollen proposal before it could be enacted and probably more if it is enacted.[6] In any case, practitioners should be mindful that some variant of it could be passed.

One asset class that has historically been favorably treated for estate and inherited basis purposes has been proceeds of life insurance paid upon the death of an insured. This article will discuss insurance in the context of the foregoing legislative proposals and make some recommendations for consideration.

Brief Overview of Life Insurance

Life insurance is a contract between the holder of a policy and an insurance company under which the company agrees, in return for premium payments, to pay a specified sum (the face value or maturity value of the policy) to a designated beneficiary upon the death of the insured. In its most basic form, life insurance works the same way that all insurance works. When someone buys, for example, household insurance, the premium is for a fixed term, such as one year. If the event insured against occurs (such as the theft of property from the home), the insurance company will pay the benefit provided for under the policy. If the event does not occur, the insurance company keeps the premiums and the coverage ends. Of course, the insured and insurer may decide to continue the coverage for another year.

In most cases, the insurance contract is for a term of one year. Term life insurance works the same way. For a premium, the insurance company promises to pay a predetermined amount if the event insured against (in this case, death) occurs during the term. In general, most term insurance (such as fire insurance) is renewed for another term (usually a year). A life insurance company may refuse to renew the policy because the insured's health has deteriorated. In addition, although some types of insurance (such as automobile accident insurance) will have premiums decline each year if the experience indicates that the risk which the policy covers (e.g., an accident) declines, premiums for life insurance will increase every year because the insured is older and, except for the first year of life, the probability of death in any year increases for each additional year the insured lives. At extreme ages (e.g., over 80), the probability of death becomes so great that the cost of life insurance appears to be prohibitively expensive.

1 Currently, there is no estate or gift tax exemption per se. Rather, a credit against estate or gift tax is allowed under Section 2010 and 2505 respectively, which is often "converted" into an exemption.

2 A grantor retained annuity trust refers to one described in Reg. 25.2702-3 which pays an annuity that constitutes a qualified interest within the meaning of Section 2702(b) which avoids having the interest being deemed to have a zero value under Section 2702(a)(2)(A). See, generally, Blattmachr, Slade & Zeydel, Bloomberg Tax Management Portfolio 836 (all editions) "Partial Interests - GRATs, GRUTs, QPRTs, (Section 2702)."

3 Dealing with some of these possibilities is discussed in Blattmachr & McCaffrey, "The Estate Planning Tsunami of 2020", 47 ETPL 3 (Nov. 2020), and in Keebler, Matak, Blattmachr & Shenkman, "Sanders & Van Hollen Tax Proposals—Analysis & Suggestions for Immediate Action," Leimberg Estate Planning Newsletter #2876 (Apr. 5, 2021).

4 Section 1023 (now repealed) under the Tax Reform Act of 1976, which in general provided for the decedent's basis in inherited property to be carried over to the successors of the decedent's estate, provided for a "fresh start" basis as of December 31, 1976 and several other adjustments. Section 1022 (now repealed) provided for a carryover basis for inherited assets acquired by someone who died in 2010 and did not elect into the estate tax system. It contained some adjustments but no fresh start basis.

5 See https://www.mileiq.com/en-ca/blog/inheritance-tax-rules-laws/

6 See Gans, Hess Lecture (Oct. 2020), "Exploring Constitutional Viability of Various Progressive Tax Measures Given Conservative Make-Up of the Supreme Court," New York City Bar Association, available at https://www.nycbar.org/media-listing/media/detail/the-2020-mortimer-h-hess-memorial-lecture-progressive-taxation-and-a-conservative-supreme-court-and-related-issues

7 See Section 2042.

8 See, generally, Slade, Bloomberg Tax Management Portfolio 807 "Personal Life Insurance Trusts."

9 See discussion in Gans & Blattmachr, "Life Insurance and Some Common 2035/2036 Problems: A Suggested Remedy," 139 Trusts & Estates 58 (May 2000), republished in 26 ACTEC Notes 39 (Summer 2000).

10 See Slade, supra.

11 See Zeydel, "Gift-Splitting: A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules." 107 J. Tax'n 334 (Jun. 2007).

12 There are eight non-spouse beneficiaries (consisting of the two children, the two children-in-law and four grandchildren) for which $30,000 each could be transferred if the donor's spouse agreed to gift split, totaling $240,000 in annual exclusions. Plus, the insured could transfer $15,000 for his or her spouse under the exclusion which, when added to the $240,000, would total $255,000. Properly structured, the family need not worry about property being diverted to former children-in-law in the event of divorce or the death of the child to whom the in-law was married. See Blattmachr & Graham, "Extra Crummey Trust sm: Maybe the Best Annual Exclusion Vehicle Around," 22 Probate & Property 43 (Jul./Aug. 2008).

On account of that (and for other reasons), in addition to the term component (or what may be viewed as pure insurance), cash (or investment) value is substituted for part of the death benefit. This investment component effectively creates a reserve to cover a portion of the costs of coverage in later years when the premiums would otherwise be too high for the insured to be willing to pay or to be able to afford to pay.

Taxation of Life Insurance

The cash (or investment) value of the policy does not stay stable. It is invested either directly in selected investments or, in effect, by the insurance company in its own investments. Income, profits, and losses are allocated to the cash or investment component of the policy. There are various ways in which the return on the investment "inside" the policy is allocated. However, the "good" news is that the growth or income earned on the cash (or investment) component is not (usually) subject to income taxation. That may be viewed as similar to an investment in an individual retirement account (IRA) or qualified pension plan (such as a so-called Section 401(k) plan). Income or growth experienced inside the policy may be subject to income tax if distributed during the lifetime of the insured. However, under Section 101(a)(1), neither the pure death benefit nor any cash (or investment) component under the policy paid upon the death of the insured is included in the recipient's gross income even to the extent the proceeds paid at death consist of previously untaxed income, as a general rule.

Most assets owned at death are subject to estate tax to the extent their value exceeds the allowable exemption and they do not qualify for the marital or charitable deduction. The estate taxation of life insurance proceeds is somewhat different. The proceeds will be taxed as part of the estate of the insured, along with other assets he or she owns at death (or otherwise are included in his or her gross estate), not only if the insured owns the policy at death but if he or she then holds any "incident of ownership" in it.[7] Unlike most other property (whether a home or an income producing asset), the insured rarely needs or wants to benefit from a policy of insurance on his or her life during his or her lifetime. Therefore, arranging for some other person (such as a family member or a trust) to own the policy is quite common so the insured will neither own the policy nor hold any incident of ownership at death which would trigger estate tax inclusion of the proceeds paid at death. A very common arrangement is to have the policy owned by what is often called an Irrevocable Life Insurance Trust (ILIT).[8] Under current law, a major benefit of using an ILIT to own the policy is generally to have the proceeds excluded from the insured's gross estate for federal estate tax purposes. This fundamental foundation of traditional estate planning may change if the Sanders' bill is enacted.

If the Sanders bill is enacted, post-enactment funding will create a blended trust such that a portion of the insurance proceeds will be included in the settlor's estate, assuming the ILIT is a grantor trust for income tax purposes as almost all such trusts are.

Care and Feeding of ILITs

As a general rule, the policy of insurance is either acquired directly by the ILIT upon issuance from the insurance carrier, or the policy is transferred to the ILIT long before the insured dies, because, if the policy is owned by the insured at (or typically within three years of) death, the proceeds usually will be included in the gross estate of the insured and potentially be subject to estate tax.[9] The payment of premiums by the insured (or anyone else) on a policy owned by another will constitute a gift to the ILIT. To have the gift of premium payments qualify for the gift tax annual exclusion under Section 2503(b), the trust is structured as a so-called "Crummey Trust."[10]

For many individuals, the entire premium payment on policies owned by the ILIT can be covered by annual exclusions (avoiding the use of the lifetime gift tax exemption under Section 2505 and without the payment of any gift tax even if the entire lifetime exemption has been used). With the current annual gift tax exclusion of $15,000, an insured could give that amount to the trust under the exclusions for each trust beneficiary, and twice that amount if the insured were married and his or her spouse would agree to "split" the gifts as permitted under Section 2513 (other than for gifts to or for the donor's spouse).[11] For, by way of example, if the insured is married and has two children, two children-in-law and four grandchildren, he or she could transfer $255,000 to the trust (directly or by way of payment of premiums on policies owned by the ILIT) under the current gift tax annual exclusions.[12] This may largely end if the Sanders bill is enacted.

Prefunding Using the Lifetime Exclusion. The Sanders' bill would limit total annual exclusions for transfers to trusts to just $30,000 each year.[13]

Under Sec. 10(d) of the bill, this limitation would be effective as of the date of enactment of the bill. In order to avoid using the lifetime exemption for the payment of gift tax if annual premiums exceed $30,000, some individuals need to take alternative action to relying on annual payment of premiums. One possibility is to use a portion of the unused $11.7 million annual exclusion by a significant transfer to the ILIT directly or by prepayment of premiums. Many, if not most, insureds will not have alternative plans to use their entire wealth transfer exemptions and "pre-funding" the ILIT using the available exemption before the exemption amount is reduced may make sense. If the Sanders bill is enacted, the gift exemption may be reduced to $1 million and that may preclude many clients from being able to use the exemption to fund an ILIT gift tax free. Thus, for some clients, funding ILITs now with available lifetime exemption may be a simple and beneficial step.

Whatever quantum of life insurance coverage a client currently has may not be sufficient to address the post-enactment estate tax reality.

Also note that, if the Sanders bill is enacted, post-enactment funding will create a blended trust such that a portion of the insurance proceeds will be included in the settlor's estate, assuming the ILIT is a grantor trust for income tax purposes as almost all such trusts are. Although under the Sanders' bill pre-existing grantor trusts would not automatically be included in the gross estates of their grantors, they would be included to the extent of additions after the bill is enacted. The only way to avoid that result would be to ensure the trust is not a grantor trust. Under Section 677(a)(3), a trust is a grantor trust if the trust may use its income (including capital gain) to pay premiums on a policy insuring the life of the grantor or the grantor's spouse unless that payment may be made only with the consent of an adverse party. Hence, to avoid grantor trust status (and, therefore, avoid estate tax inclusion with respect to additions to the trust), the trust would have to prohibit the use of income (including capital gain) to pay such premiums or to permit the payment only with the consent of an adverse party. Also, Section 677(a)(1) and (2) will make it a grantor trust if distributions of income can be made to the grantor or the grantor's spouse unless they may be made only with the consent of an adverse party. Hence, no distribution to either the grantor or the grantor's spouse should be permitted, or should be permitted only with the consent of an adverse party. As mentioned earlier, most ILITs are grantor trusts. To avoid estate tax inclusion with respect to additions, any such trust would have to be modified by a decanting or otherwise.[14] Consider the impact of the Van Hollen bill if that is also enacted.

Pre-Funding Using Annual Outright Gifts or Alternative Structures. If such pre-funding is not an option, the insured could make annual exclusion non-trust gifts to family members (such as the insured's children who are beneficiaries of the ILIT) who could pool the gifts by forming, for example, an LLC or a multi-member grantor trust for themselves and have the entity own the policies and pay the premiums. Perhaps, they would simply pay the premiums even though the ILIT owns the policies. This could permit the family members to use their own annual exclusions. However, this may cause a portion of the trusts to be included in the beneficiaries' gross estates if they are trust beneficiaries. That might be acceptable if it allows the premiums to be paid and allows the proceeds to be kept out of the gross estate of the insured. It likely will be complicated if a pre-existing ILIT owns part of the policy (having paid premiums in prior years) and the multi-member entity (such as an LLC) or multiple party non-grantor trust owns the balance.[15] It might prove simpler to have the ILIT distribute the policies to the beneficiaries or to their multi-member entity or trust. Of course, consideration must be given to complications if one or more of the beneficiaries refuses to participate in the payment of the premiums or if there is a death of a beneficiary before the death of the insured. Although some of the traditional benefits of a trust (such as asset protection and protection from a claim of a spouse) may be more difficult to achieve, creative planning may help accomplish some of these, such as by creating a multi-grantor self-settled trust in a so-called domestic asset protection jurisdiction.[16]

Pre-Funding Pre-Enactment with Laddered GRATs. Another option that may be useful before enactment, but which will be precluded by the Sanders bill as proposed, is using grantor retained annuity trusts ("GRATs") to fund the ILIT. This might be a helpful one-time technique to use now for those clients who have exhausted their exemptions but face large future premiums for policies held in an ILIT. This may be only a one-time step because, as noted above, the Sanders bill would emasculate GRATs (requiring, among other conditions, that the value of the remainder be at least

25% of the contribution to the GRAT). In light of that limitation on using GRATs only before enactment, clients might choose now to create a tier or ladder of GRATs (e.g., 2, 3, 4, 5, 6, 7, 8, 9, and 10 year GRATs) whose remainder beneficiaries are the ILIT. So, if the GRATs are successful in transferring property to the remainder beneficiary (the ILIT), assets would be available over the years to pay premiums on the policies the ILIT owns. It seems that the remainder in a GRAT cannot be made GST exempt by the allocation of GST exemption to it (by reason of the so-called "ETIP" rule of Section 2642(f)(3)), so the property coming from GRATs and transferred to the ILIT will make the ILIT at least partly subject to the GST tax rules, unless the grantor of the GRATs allocates sufficient GST exemption to the additions coming from the GRATs once each ends, keeping in mind that the GST exemption also would be reduced under the Sanders' bill.

Third Party Premium Financing. An alternative to gifting funds to an ILIT is to use an arrangement known as "premium financing." It is an arrangement in which the insured borrows money from a lender, such as a bank, and uses the borrowed funds to pay premiums, typically pledging the policy as security together with a personal guarantee and/or other assets.[17] Although the borrower (traditionally, the insured) is not out-of-pocket for the premium cost, the plan will still face the potential of limitations on annual exclusions under the Sanders' bill. The alternative is to have the trust borrow the money directly from the lender, with the insured (or some other interested person, such as one or more of the beneficiaries) guaranteeing the loan. The loan itself does not result in a gift where the loan is from a third party and it seems likely that the provision of a guarantee by a trust beneficiary would not be a gift although, no doubt, some will suggest a fee be paid by the trust for the guarantee. The *Bradford* court found that a beneficiary was protecting his or her interest in the trust by making a guarantee on behalf of the trust, and, therefore, indicated that a guarantee fee was not necessary.[18]

An alternative form of premium financing is where the insured (or some other interested party) loans funds to the ILIT to pay the premiums. In several cases, the IRS has sought to "recast" a transaction labelled by the family as a loan as a gift.[19] However, there appears to be a safe harbor by using a "split-dollar" loan. So, there are two broad options for a loan: a "traditional" loan and a "split-dollar" loan.

Family or Private Financing (Not Split-Dollar) Loans. The client/settlor, another family member, or family trust may simply loan funds to an ILIT post-enactment of the Sanders bill to fund premiums. This may be necessary given the limitations on annual gifts and more so because of the harsh rules affecting post-enactment gifts to new grantor trusts or additions to old grantor trusts (namely that a portion of the trust will be included in the settlor's estate). These loans might be structured as split-dollar loans as discussed below, or in some instances as "regular" (i.e., not split-dollar) loans. If the funding is by loan, the transaction will have to pass muster as a real loan. In *Miller*,[20] the Tax Court weighed each of the following factors to determine if the transaction was, in fact, a loan. These are not the exclusive factors but alert practitioners to many of the considerations involved:

- Written promissory note evidencing the debt.
- Demand for repayment is made if a default occurred.
- Required payments were actually made on the note.
- The transaction was reported for federal tax purposes consistent with it being a loan.
- The note has a fixed maturity date.
- Borrowers have reasonable ability to repay the loan.
- Books and records of the lender and borrower reflect the transfers as loans.
- Interest is charged on the note.
- Reasonable security or collateral is provided for the note.

Family or Private Premium Financing: Split-Dollar Loans. If the restrictions on annual gifts and grantor trusts contained in the Sanders bill are enacted, split-dollar loans may become a common approach to financing the payment of premiums on trust owned life insurance. For

13 Although Sec. 10 of the Sanders' bill references $10,000 per donee (with a limit for trust transfer to two of these), it seems the inflation adjustment built into annual exclusion under Section 2503(b)(2) would apply making the total $15,000 per donee, as it does now, times two or $30,000 in total. Note that this annual limitation would apply not just to transfer in trust but also to a transfer of an interest in a pass-through entity, a transfer of an interest subject to a prohibition on sale, and any other transfer of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee.

14 See Zeydel & Blattmachr, "Tax Effects of Decanting - Obtaining and Preserving the Benefits," 111 J. Tax'n 288 (Nov. 2009).

15 It should be noted, as indicated above, that any multi-party grantor trust will be included in the estates of the grantors. Of course, this may not be a problem because the grantors were intended to be the beneficiaries of the original ILIT. If that would be a problem, then the trust should be structured as a non-grantor trust as discussed above.

16 See Twelfth ACTEC Comparison of the Domestic Asset Protection Trust Statutes, updated through August 2019. Available at http://www.shaftellaw.com/

17 See https://bankingtruths.com/premium-financing-life-insurance/?gclid= Cj0KCQjwgtWDBhDZARIsADEKwgNOjhZ2VEXGkIc0IsHgiRRHy04xB_0tPYE3VPvO03aaGqy4VafuseIaAj5eEALw_wcB#flowcharts for an illustration.

18 *Bradford v. Commissioner*, 34 TC 1059 (1960), acq. 1961-2 C.B. 4.

19 *Miller v. Commissioner*, TC Memo 1996-3.

20 Id.

practitioners that had avoided split-dollar planning in the past, viewing it as something esoteric for large or complex plans only, this may become as standard a planning tool as the ILIT itself.

A split-dollar insurance arrangement is not a type of policy. Rather, it is a way in which the proceeds paid on the death of the insured are divided or split. In addition, in some cases, the premiums paid on the policy are also divided or split.

After issuing several revenue rulings, private letter rulings, and other announcements about split-dollar arrangements over several decades, the Treasury Department in 2003 issued final regulations dealing with them. The split-dollar regulations set out two detailed mutually exclusive regimes: (1) economic benefit (traditional) split-dollar, similar to what is described in Rev. Rul. 64-328[21] and its progeny (including the first family split-dollar ruling, PLR 9636033, which, under Section 6110(k)(3), cannot be cited or used as precedent); and (2) split-dollar loan regime, essentially governed by the principles of Section 7872. If a taxpayer follows one of the regimes "to the letter," it seems that the taxpayer should be able rely on getting the tax treatment as set forth in the regulations.

For example, if the taxpayer enters a family split-dollar arrangement with an ILIT under the economic benefit regime (the tax effects of which are set forth in Reg.1.61-22(d)) under which the taxpayer will get back, when the insured dies, the greater of premiums the taxpayer has paid or the policy's cash value at that time, then each year it seems the taxpayer should be deemed in most cases to have made a gift of the one year cost of the term insurance component that would be paid if the insured died that year (that is, a gift equal to the IRS Table 2001 rate or whatever other rate may apply to measure the value of that term insurance component), or no gift should be deemed made if the ILIT is required to and does reimburse the taxpayer in that amount each year. That seems not only to be expressly provided for under the split-dollar regulations but is expressed stated essentially as an example in the preamble to the proposed split-dollar regulations (which were not changed in that regard in the final regulations).

With respect to a private or family split-dollar arrangement between a family member and a family trust (such as a traditional ILIT), it seems one may either "opt" into the economic benefit regime by having the donor own the policy or by having the family trust own the policy but limiting the trust's interest to pure term insurance protection (and no part of the cash value) only. Alternatively, the client or can "opt" into the loan regime by having the family trust own the policy and receive something more than just term insurance protection (for example, even apparently a de minimus amount of cash value it does not pay for). If the trust is limited to term (pure) insurance protection only, then the cash value sponsor is treated as the owner even if the trust in fact owns the policy, and that will cause the arrangement to be under the economic benefit regime under Reg. 1.61-22(b)(3) and Reg. 1.61-22(c)(1)(ii)(A)(2).

Under the split-dollar loan regime, the taxpayer may make a loan that will be "governed" by Section 7872 (dealing with below market loans and related matters). Although several regulations under Section 7872 have been proposed, only those issued with respect to the split-dollar loan regime have been made final. Generally, the split-dollar loan regime regulations appear consistent with the general rules of Section 7872 which provide, in general and in the gift context (such as a loan between family members), that the lender will be treated as making a gift to the extent the interest provided for under the loan is less than the applicable federal rate (AFR). For example, if the family trust must pay (or accrue) at least AFR interest, then no gift will be imputed even, apparently, if it is a term loan.[22] However, the lender would have gross income each year equal to the AFR whether the interest is paid or foregone. But, if the ILIT is the borrower under a split dollar loan and it is a grantor trust with respect to the lender, then there should be no gross income. Note, that if the Sanders bill is enacted, non-grantor ILITs may be used, and, if so, this will not be the result.

There may be differences with respect to the split-dollar loan regime than other loans covered by Section 7872. The amount of interest imputed under Section 7872 is based, as indicated above, upon the AFR determined under Section 1274(d). In fact, there are three AFRs: short term (payable on demand loans to term loans out to three years), midterm (loans over three years but payable within nine years), and long term (loans payable in more than nine years). Under the split-dollar loan regime, the loan need not be made

[21] 1964-2 CB 11.

[22] See Section 7872(a) and Rev. Rul. 55-713, 1955-2 CB 23.

[23] See, e.g., Rev. Rul. 85-13, 1985-1 CB 184.

[24] See, e.g., Reg. 1.7872-15(e)(5)(i).

[25] See Blattmachr & Pasquale, "Buying Life Insurance to Fund Estate Taxes," 151 Trusts & Estates 27 (Jul. 2012), for a discussion of similar matters.

[26] See McGrath & Blattmachr, *Carryover Basis under the 1976 Tax Reform Act*, Chapter 15 "New Life for Life Insurance" (J. Tax'n 1977).

[27] Lipkind & Blattmachr, "Income Tax Aspects of Variable Life Insurance Policies," 71 J. Tax'n 52 (Feb. 2015); Blattmachr & Keenen, "*Webber* and the Investor Control Doctrine," Tax Notes 683 (Aug. 1, 2016).

[28] See Section 7702(a) and (g)(2).

[29] Several aspects of the Van Hollen proposal are uncertain including how it may impact the transfer for value sale of Section 101(a)(2).

repayable at the end of a particular period of time (e.g., 2 years or 20 years) but when the insured, whose life is insured under the policy the proceeds of which then could be used to repay the loan, dies. Unless the insured is extremely old, the long- term rate will apply if the loan is to be repaid when the insured dies. There is no indication that any other type of loan under Section 7872 could be made payable upon such a "contingency."

Rather than making one or more large premium payments which likely will be gifts where the policy is owned by another (such as an ILIT), the "cash value sponsor" (that is, the person providing the funds to pay premiums who often will be the insured) instead may make a split-dollar loan to the taxpayer (e.g., an ILIT) that will be used by the borrower to acquire the policy or pay premiums. As long as the borrower is a disregarded entity as to the lender, the accrued interest will not be included in the gross income of any taxpayer.[23] Hence, a pre-existing ILIT that is a grantor trust could be the borrower in a split-dollar loan arrangement without income tax or estate tax inclusion effects.

The bottom line is that success of premium financing, whether from a third party or within the family, really turns on the actual out of pocket costs to the lender of interest due on the loan from a third party or the amount of imputed benefit under a private economic benefit regime or the AFR interest under a split-dollar loan. One benefit for a split-dollar loan is that the AFR interest rate can be "locked in" at current low AFR rates. The appropriate AFR is dependent upon the life expectancy of the insured if the loan is to be repaid upon his or her death, which is permitted under the split-dollar loan regime regulations.[24] For any person with a life expectancy of more than nine years, it will be the long-term rate which for May 2021 was 2.16%. As long as the policy value grows at that or a greater rate (which cannot be guaranteed but may be anticipated), the financing arrangement should work regardless of how long the insured lives. However, if the plan is to make a split-dollar loan each time a premium is due, then the parties may face much higher AFRs which exceed the growth in value of the policy. The success will also turn, as returns on life insurance policies always do, on when the insured dies. Perhaps, it would be wise not to attempt to use premium financing when the policy will expire at some age (as some policies do) or its cash value will not increase.[25]

Conclusion. It seems, as a practical matter, if premiums on insurance policies will exceed $30,000 a year (inflation adjusted) or whatever exemptions are available for contributions to trusts, then either gifts to family members who can pay the premiums or who can pool their resources (such as through a multiple settlor grantor/revocable trust created and funded by all of them) or by a split-dollar loan will be a useful tool. Perhaps more important, given that a portion of the grantor trust funded with post-enactment gifts would be included in the settlor's estate under the Sanders' bill, loan options may be preferable to gifts and may become as common for funding premiums as Crummey powers are today. Practitioners should be cautious in that focus of the IRS in audits may well change. Instead of focusing on Crummey powers, the IRS audits of ILITs may focus on recharacterizing purported loans as gifts to trigger the estate inclusion rules for grantor trusts.

GST Exemption and ILITs

Many existing ILITs were not structured to be GST Exempt Trusts and have not had GST exemption allocated to them. For ILITs owning only term life insurance, since only a very small percentage of term policies pay off, it may not have been efficient to allocate GST exemption to the ILIT when the trust was created or premiums paid, or the estate may have been too small to be concerned. However, with the prospect of a $3.5 million exemption that may not be inflation adjusted, the allocation of GST exemption to ILITs that might otherwise have no or insufficient GST exemption protection, if the Sanders bill is enacted, may be prudent. Many old ILITs still have provisions mandating payouts to beneficiaries at specified ages, e.g., 25 or 30. So, for these ILITs, practitioners might advise clients to act before a law change by decanting the ILIT into long-term trusts and allocating GST exemption to them after the trusts' durations are extended. Even if this is done, the 50-year GST exemption limitation rule in the Sanders bill would still affect the ILIT. So, 50 years after enactment, the ILIT GST inclusion ratio under Section 2642 would be set to 1 (meaning full GST taxation on gen-

eration-skipping transfers from the trust). Note, that could still provide a 50-year period of avoiding transfer tax. When the inclusion ratio is set to 1, as it would be under the Sanders bill (meaning full GST taxation), the ILIT could pay into a non-GST exempt trust at that juncture, retain some assets for payment to non-skip persons (which would not trigger GST tax), and, perhaps, some assets could be used for health and educational expenses of skip persons, which are exempted from GST tax under Section 2611(b), at least under current law. So, now may be a prudent time to review all existing ILITs, not only to consider pre-law change funding as discussed above, but also strategic restructure to enhance the results of the ILIT even if those results may be limited by the Sanders bill.

Gains on Death and Life Insurance

As mentioned above, twice since 1976, the automatic change in income tax basis under Section 1014 of inherited assets has been eliminated temporarily by having the decedent's basis in the assets carry over to the inheritors in a manner somewhat similar to the carryover of basis for property transferred by lifetime gift. Neither of these regimes apparently resulted in the taxation of life insurance proceeds paid upon the death of the insured which, in general, are excluded from gross income pursuant to Section 101(a)(1).

Nothing in the Van Hollen proposal would seem to change that result. It could mean that life insurance will become ever more popular as an estate planning tool.[26] As explained earlier, the proceeds paid at death may include not just the true death benefit (that is, the portion paid from the insurance company's own assets, commonly called the "net amount at risk" for it is the part for which the insurance company is personally liable for) but also the cash (or investment) value.

The cash value, as also indicated above, may represent the earnings of the policy's investments. These may include almost all traditional investments, from publicly traded stocks and bonds to mutual funds to commodity funds to hedge funds. There are limitations on investments made through policies of insurance, income earned may be currently subject to income tax when withdrawn (even by loan) or if the mysterious investor control doctrine is violated,[27] but the entire proceeds paid at death may be excluded from the gross income of the recipient, even if the policy does not meet the statutory definition of life insurance.[28] Accordingly, it can be anticipated that the Van Hollen proposal, if enacted, will result in a huge shift in investing from personal investments to investments structured through life insurance products to capture the income tax advantages that may be afforded by them.[29]

Evaluating the Adequacy of Life Insurance Coverage

The last topic to address is, perhaps, so obvious that it need not be specifically stated. If the estate tax rates increase from 40% to 65% and higher, discounts are severely restricted and, in some instances, eliminated, corpus of post-act grantor trusts (and pre-act trusts receiving post-act gratuitous transfers) included in the estates of grantors, and perhaps most obviously a reduction in exemption amount, many clients will benefit from reviewing the adequacy of their life insurance plan. Simply put, whatever quantum of life insurance coverage a client currently has may not be sufficient to address the post-enactment estate tax reality. What makes the Sanders proposal so important to plan for now is that, if the insurance plan is structured post-enactment, a grantor trust structure may not be feasible to create and a non-grantor trust or entity structure to own the life insurance coverage may have to be used. Further, it may require, as discussed in detail above, very different funding techniques for the purchase of the insurance coverage. For many clients, if it is feasible, the insurance plan structure, and funding transfers, may be much more advantageous to implement before the passage of the Sanders bill (or any Sanders-like bill). The results may be different if the Van Hollen bill is enacted, so caution is in order.

Summary and Conclusions

It is uncertain which, if any, of the proposals made in the Sanders bill or in the Van Hollen bill will become law. Either would have an enormous impact in the world of estate planning. Together they would represent a change that is hard to grasp. Life insurance will continue to be an important tool in planning. Although challenges in using trusts to avoid estate taxation of proceeds at death and to obtain the traditional benefits of trusts will arise if the Sanders proposal on limitation on the amount allowed for annual gift tax exclusion for transfers in trust is passed, split-dollar arrangements are likely to come to the recuse. If the Van Hollen gains at death proposal becomes law and contains, as it seems to, a complete avoidance of income taxation of proceeds paid at death, it is certain life insurance will become an even more preferred method of investing than it has been in the past. ■