SPECAL PLANNING UPDATE: Consider Reevaluating Your Life Insurance Trust (ILIT) Before Year End

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By Brian Luster

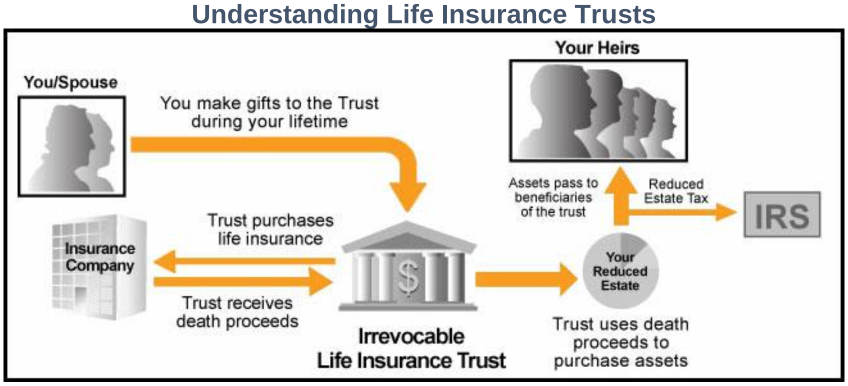
As many expected, on October 7 the Senate passed a bill extending the debt ceiling limit by $480 billion, essentially allowing the US government to continue operating through early December, while avoiding a default on its $28 Trillion of debt obligations. While this issue is hardly resolved, it does suggest that Congress will spend the next two months focused on paring down the original $3.5 Trillion reconciliation bill (more commonly known as the Build Back Better Act or H.R. 5376) in order to reach a compromise amongst Democratic leaders. One such section we do not expect to change (Section 2901) concerns grantor trusts, and thus has potentially severe tax and estate planning implications for clients that have created Irrevocable Life Insurance Trusts (ILIT) with the hope that their death benefit will transfer to heirs free and clear of estate taxes. If you have a Life Insurance Trust, it may be prudent to sit down with your attorney before year end to explore your options.

WHY THE HURRY?

The House budget reconciliation bill, H.R. 5376, proposes sweeping changes to tax rules that apply to both individuals and trusts, with far-reaching implications for estate planning.

Under the proposed bill, contributions made to grantor trusts after the date of enactment of H.R. 5376 will cause some portion (or possibly all) of the property in such trusts to be includible in the grantor's estate for estate tax purposes. For those with an Irrevocable Life Insurance Trust, this should be concerning.

Understanding Life Insurance Trusts



Source: https://drdisabilityquotes.com/understanding-life-insurance-trusts/

As a reminder, an Irrevocable Life Insurance Trust, is a trust that owns a Life Insurance Policy for the benefit of the heirs of the insured. The primary purpose of establishing this type of trust is to exclude the value of the death benefit of the life insurance policy from estate taxes.

In practice, the grantor (typically the insured) makes annual gifts of cash to the trust that the trustee then uses to pay the annual life insurance premium on the policy due to the Life Insurance Company. Under the proposed rules, these annual gifts can cause some or all of the death benefit to become includible in the gross estate of the insured, thus creating an unintended estate tax liability. Families with an existing Life Insurance Trust, that expect to continue to make annual payments to their trust to keep their insurance policy in force, may need to rethink their plans, as these future gifts/payments now risk causing all or part of the death benefit to be includible in their gross estate.

A Simple (But Not Necessarily Palatable) Solution

One way to possibly avoid this issue would be to make a very large cash contribution to the ILIT this year in order to cover all future premiums through the end of the life of the insurance policy. This is known as pre-funding a Life Insurance Trust. Unfortunately, the logic behind creating such a trust in the first place is often due to a lack of liquidity from a concentration of wealth in a business, real estate, or other illiquid asset. Other options may include allowing the policy to lapse, surrendering the policy, converting the policy to a paid-up policy, engaging in a split-dollar arrangement, unwinding the trust, or even engaging in a life settlement sale.

Given both the legislative uncertainty around H.R. 5376, and the complexity around which option may be best for you, we are highly recommending that families with Life Insurance Trusts that own policies that are not fully paid-up consider scheduling a call with their attorney before Congress enacts any changes through the reconciliation bill to explore all their available options.

ABOUT THE AUTHOR

BRIAN LUSTER is a Principal and Chief Investment Officer of Collective Family Office located in York, Pennsylvania. With over 20 years of Wealth Management experience, Mr. Luster has previously served as Founder and CEO of a boutique Multi Family Office in New York City, as the Managing Member and Portfolio Manager of a long/short US event-driven value-oriented hedge fund in New York, and as a Senior Wealth Manager for BNY Mellon Wealth Management in Central Pennsylvania.

An avid thought leader, he has authored over 60 articles covering investing, tax, trust & estate planning, family governance, and next generation education, featured in such publications as Forbes, Barron's, The Wall Street Journal, Private Asset Management Magazine, Family Office Elite, and The Huffington Post.

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