Indecent Proposal: Is the Biden Administration Courting the Life Insurance Industry?

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Last September, the House Ways and Means Committee released proposed funding details for the Democrats' $3.5 trillion Build Back Better Act social infrastructure package. The draft bill included tax provisions that would have considerably restricted a few popular and effective wealth transfer strategies, including grantor trusts, grantor retained annuity trusts (GRATs), and valuation discounts. Although that bill was short-lived, some of its tax proposals have been resurrected in the Biden Administration's FY2023 "greenbook,"[1] but with several curious differences—most significantly, the elimination of most of transfer tax changes in favor of more extensive income tax changes. A close study of the differences between the 2021 House bill and the more recent greenbook reveals something quite unexpected: Although traditional wealth transfer strategies with grantor trusts and GRATs would be severely curtailed if the Biden proposals were enacted, estate planning with life insurance would remain largely—perhaps completely—untouched. Why?

The strength of the insurance lobby is considerable, as became obvious when the House bill came under attack last fall. Notably, that bill would have imposed estate tax at the grantor's death on post-effective-date grantor trusts and on future "contributions" to existing grantor trusts. Because virtually every irrevocable life insurance trust (ILIT) is a grantor trust under Section 677(a)(3) of the Internal Revenue Code, contributions to fund future premium payments would have resulted in partial estate tax inclusion, essentially crippling the ILIT as an estate planning strategy. The insurance industry (among others) was having none of that, and the House bill quickly died on the vine.

These events apparently taught the Biden Administration an important lesson: Don't mess with the insurance industry. And the Administration's greenbook reflects that understanding. Consider the greenbook's updated approach to estate planning strategies:

- A donor or deceased owner of appreciated property (including property held by the owner's revocable living trust) would realize gain at the time of transfer.
- Sales of appreciated property to, and distributions of such property in kind from, a grantor trust (other than a revocable living trust) would trigger recognition of gain.
- Gain on unrealized appreciation also would be recognized by a trust, partnership, or other non-corporate entity if that property has not been subject to a recognition event within the prior 90 years.
- Valuation discounts would be disregarded in determining the amount of gain recognized.
- The "step-up" in income tax basis at death would be repealed, subject to a $5 million per transferor exclusion—although certain transfers to spouses, and dispositions of interests in those darlings of the Internal Revenue Code, family-owned businesses and farms, would be granted relief or deferral from many of the deemed recognition rules.
- The greenbook makes no mention of the House bill's proposal to subject post-enactment grantor trusts and contributions to existing grantor trusts to estate tax upon the grantor's death.
- GRATs would be subject to a minimum 25% remainder requirement and a 10-year minimum term, among other restrictions, effectively eliminating GRATs as a viable estate planning strategy.
- Payment of income tax by the deemed owner of a post-enactment-date grantor trust would be treated as a gift for gift tax purposes, legislatively repealing Revenue Ruling 2004-64.

Collectively, these proposals would gut perhaps 90 percent of lifetime transfer planning strategies currently used by ultra-high-net-worth families. But curiously, the greenbook would not touch planning with ILITs. Consider:

- In the United States, insurance premiums are payable only in cash, and a contribution of cash to any trust, including an ILIT, would not trigger recognition of gain under the proposals.
- Growth of cash value in a properly constructed life insurance policy is not includable in gross income; thus, the ILIT's deemed owner would pay no income tax on those cash value increases—and no gift tax on income taxes that otherwise would have been so payable.

- Will a policy's death benefit, to the extent that it exceeds premiums paid, be subject to gain recognition upon the insured's death? The greenbook is silent on this issue, but the plain language of Section 101(a)(1) of the Internal Revenue Code indicates that a policy's death benefit is excluded from gross income, subject to certain exceptions unrelated to the Administration's proposals. It seems likely that life insurance death benefits will be excluded from new rules that otherwise would require the recognition of gain.

Reality check: The Biden Administration's proposals seem unlikely to become law anytime soon, as unanimous Democratic consent in the Senate, and near-unanimous consent of House Democrats, currently is necessary for any tax bill to become law. But it's also unlikely that we have seen the last of these ideas, although they raise almost no meaningful revenue.[2] Indeed, these proposals will come up again and again as Congress and future administrations struggle to garner support for social and environmental programs, and to raise sufficient revenue to retire runaway government debt.

As argued herein, these proposals are not likely to meet strenuous opposition from the insurance lobby, which may leave the professional estate planning community without a powerful ally in its efforts to stop legislative initiatives that seem designed, not to raise revenue, but rather to punish wealthy families who are perceived to have benefitted disproportionately from the taxpayer-friendly provisions of the 2017 Tax Cuts and Jobs Act. Perhaps our country would be better served if tax policy were to focus on raising revenue and enforcing existing laws. In other words—and with apologies to Olivia Newton-John: "Let's get fiscal."

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[1] General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals, Treas. Dept. (March 2022).

[2] The estate planning provisions described in the greenbook are expected to raise less than two percent of the $2.5 trillion total revenue projected to be raised by the tax proposals collectively over the next 10 years, and only about 6.6 percent of the projected revenue of proposed personal income tax rate increases over that same period.