Counselor’s Corner

How Can I get a Life Insurance Policy Out of an Irrevocable Trust?

Situation: With the recent doubling of the estate tax exemption I’ve been asked, “Is it possible to get a life insurance policy out of an irrevocable trust (ILIT) when the terms of the trust no longer meet the needs of the grantor or the trust’s beneficiaries?” This *Counselor’s Corner* answers this question.

Solution: Yes, but there are a number of legal and tax issues. Often, I’ve needed to remind individuals that irrevocable does not necessarily mean unchangeable or inflexible. It is possible to include language in an ILIT to deal with changes in the grantors' and beneficiaries’ life circumstances. Unfortunately, these provisions are frequently omitted. So, what are the options for getting a policy out of, or to change the terms of, an irrevocable trust when the trust no longer meets the needs of the client?

Identify Options Available Under Trust Document & State Law. The first place to start is to have the client’s legal advisor review the trust document and the laws of the state to determine under what circumstances:

- The trust can be modified, or
- The trust assets can be distributed to the beneficiaries, or
- The trust assets can be transferred to, or merged into, a newly created trust.

If the trust document might contain trust protector language permitting modification or give a trustee the power to distribute to a beneficiary. A court may interpret this as giving the trustee the power to do something to a lesser extent, such as transfer to a further trust.

The laws of many states permit modification of trust provisions. For example, modifications are permitted in states that have adopted the Uniform Trust Code (UTC). In addition, several states have decanting statues that generally allow a trustee with discretionary distribution authority to pour over the assets of one trust to a new trust with modified terms and conditions.

Even where the trust provision or state law permits the distribution of the policy or modification of the trust, this capability may not meet the needs of the client. In those situations, the following options are worth considering.

Review Product Options. The financial professional should determine if there are any available product solutions. One simple product option is to stop premium payment to the problem trust, take a reduced paid-up policy, and establish a new insurance trust that would purchase a new insurance policy. However, this may not be a feasible solution due to policy acquisition costs or in a situation where the insured’s health has changed.

Determine Feasibility of Trustee Selling Policy. Another option is to have the trustee transfer the policy to another trust that contains more appropriate provisions. However, before transferring a policy, the trustee’s

fiduciary responsibilities must be considered. Additionally, close attention must be taken to avoid obstacles presented by the following two Internal Revenue Code sections:

- The **three-year inclusion rule** found in I.R.C. § 2035, is applicable when a **policy is transferred by gift** (for less than full value). Code Section 2035 provides that the proceeds of a life insurance policy transferred by gift from the insured are includible in the insured's estate if he/she dies within three years of the date of transfer.
- The **transfer-for-value rule** found in I.R.C. § 101(a)(2), is applicable to the **sale of a policy.** Unless an exception to this rule applies, the policy proceeds, less the total premiums paid by the transferee, will be included in the income of the beneficiary of the policy.

Let's see how these rules affect the transfer of a policy held by an ILIT.

#1: Sale to the insured followed by a gift to a new ILIT. With this approach, the insured purchases the policy from the existing ILIT and then gifts the policy to a new ILIT.

Fortunately, the purchase by the insured is an exception to the transfer-for-value rule. However, the subsequent gift of the policy to the new ILIT will present some problems.

First, the three-year inclusion rule will apply. If the insured dies within three years of the transfer date, the policy proceeds will be included in his/her estate and potentially subject to tax. The effect of the three-year inclusion rule may be lessened if the new ILIT pays premiums from sources other than funds contributed by the insured. If someone other than the insured pays part of the premiums during the three-year period, a proportionate share of the insurance proceeds may be excluded from the insured's gross estate under a technique often referred to as the "Silverman ratio."[1]

If the existing policy has significant value, the transfer to the new trust may raise a gift tax concern unless the value of the policy transferred is less than the annual and/or lifetime exclusion amounts. One method of reducing the value of the policy is for the trustee or insured to borrow against the cash value of the policy prior to its transfer. In addition to the practical disadvantage of burdening the new ILIT by debt, there are a number of potential tax issues concerning the transfer of a policy with a loan.[2]

An important side consideration that is raised by the purchase of the policy is the tax consequences within the original trust. Unless the trust is structured as a grantor trust, the trust will be forced to recognize the gain amount and pay tax.

The three-year inclusion rule does not apply to **a bona fide sale of a life insurance policy for full and adequate consideration.** So, if the insured sells the policy to the new ILIT for full and adequate consideration, then the policy proceeds will be immediately removed from his/her estate. Here again, to avoid disastrous income tax results on the sale to the trust, the trust must qualify as one of the exempt transferees under the transfer-for-value rule. Two frequently used options are as follows:

A. New ILIT is a partner in a partnership in which the insured is a partner. One approach is to structure the transaction so that the new ILIT and the insured are partners in a partnership. A transfer between partners in a common partnership is an exception to the transfer-for-value rule. If the insured is a partner in an existing partnership, he can gift a portion of his partnership interest to the new ILIT. If there is no existing partnership, the insured could make additional gifts to the new ILIT beyond those needed to pay policy premium. The new ILIT would then have the funds with which to purchase an interest in the partnership.

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[1] *Estate of Silverman, 61 T.C. 338 (1973)*

[2] *The transfer of a policy subject to a loan may cause the policy death proceeds to be subject to income tax under the transfer-for-value rule.*

A consideration that is raised by the sale of the policy to the trust is the income tax consequences to the insured. Unless the new trust is a grantor trust, the insured will be forced to recognize the gain amount and pay tax.[3]

B. New ILIT qualifies as a transfer to the insured under the grantor trust rules. Most legal advisors have believed that transactions between a grantor and a grantor trust, or between trust and a grantor trust, do not have tax consequences. The theory is that the transaction is the same as a sale to the insured, which is an exception to the transfer-for-value rule.

In 2007 the IRS confirmed this belief with the issuance of Revenue Ruling 2007-13.[4] This ruling involved two fact patterns. The first fact pattern involved a transfer of a life insurance policy between two grantor trusts, each of which was treated as being wholly owned by the same grantor. The second fact pattern involved a transfer from a nongrantor trust to a second trust, which was a grantor trust.

In the first fact pattern, the IRS held that the transfer-for-value rule did not apply to a transfer between two trusts wholly owned by the same grantor because there was no change in the owner (in effect there was no transfer). In the second situation, since the policy was transferred from a nongrantor trust to a grantor trust, the transaction was treated as a transfer-for-valuable consideration. But, here again, the IRS held that an exception to the transfer-for-value rule applied because the transfer to the grantor trust was deemed to be a transfer to the insured.

While the ruling provides good news, there are additional hurdles. First, to avoid estate inclusion the transfer must be for "full and adequate consideration." While the IRS has issued regulations and rulings on the valuation of life insurance, there remains a great deal of uncertainty as to what measure of value to use in many situations, including transfers subject to the three-year inclusion rule.[5] The variety of elements that make up an insurance product, the differences in the health of the insured and other circumstances mean the same type of life insurance policy may have different values.

Second, there are financial hurdles to selling the policy to the new ILIT. If the policy has significant cash value, funding the new ILIT may be a problem for the client. If cash gifts are made to the new ILIT gift tax could potentially result.

Another problem could arise if the IRS views the purchase from the old ILIT, the gifts to the new ILIT and the purchase by the new ILIT as one interdependent plan – a step transaction. This could lead to the argument that this transaction was simply a disguised gift of the policy by the insured to the new ILIT, invoking the three-year inclusion rule. Some advisors feel this risk is minimized by allowing a period of time to elapse between the sale to the insured and the sale to the trust.

#3: Sale from ILIT to New ILIT. A newly established ILIT drafted as a grantor trust could purchase the policy from the existing ILIT. There would be no three-year inclusion problem because the insured never had an incident of ownership. And, as discussed above, the transfer-for-value rule can be avoided by qualifying for the partnership exception or as a transfer to the insured under the grantor trust rules.

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[3] *There is some concern regarding how gain should be calculated since the IRS issued Revenue Rulings 2009-13 and 2009-14. In these ruling the IRS held that basis is calculated by subtracting the cost of insurance from the investment in the contract (generally premiums paid) when a policy is sold to an unrelated person who would suffer no economic loss on the death of the insured.*

[4] *Until 2007 the only authority that supported this position was Swanson v. Commissioner, 518 F.2d 59 (8th Cir. 1975) and a series of PLRs. See PLRs 200228019, 200247006, 200514001, 200514002, 200518061, 200606027 and 200636086.*

[5] *See Revenue Procedure 2005-25 for safe harbor valuation guidance for IRC §§ 402,79,83*

#4: Sale to the insured's spouse followed by a gift to a new ILIT. A married insured could have his or her spouse purchase the policy from the problem ILIT and then gift it to a new ILIT. Under this strategy the three-year inclusion rule does not apply since the insured never has an incident of ownership in the policy. Furthermore, under IRC § 1041(b)(1), the spouse, for federal income tax purposes, is treated as acquiring the policy by gift even though the transfer is cast in the form of a sale – therefore, the transfer-for-value rule should not apply.

This strategy has a couple of potential issues. First, it has the potential of being subject to the step-transaction doctrine in the same manner as the sale of a policy to an ILIT. More importantly, because the spouse would be the grantor of the new ILIT, the transfer would be subject to the retained interest provisions of IRC §§ 2036 to 2038 potentially causing the policy to be included in the spouse's estate where the spouse is a beneficiary of the new ILIT.

In conclusion, while there are many possible ways to get a policy out of an ILIT there are many legal and tax hurdles to overcome. Legal and tax counsel should always be consulted before such a transfer is undertaken.

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