

Issues When Transferring an Existing Life Policy to a New Irrevocable Life Insurance Trust

Avoiding the Three-Year Rule Under Section 2035

When a Client does not wish to purchase (or cannot qualify for) a new life insurance policy, an existing policy may be transferred to an irrevocable life insurance trust by gift. The Client will submit an absolute assignment of ownership form, which is obtained from the insurance agent. This will transfer all of the Client's rights in the policy to the trust. The trust will then become the owner and should immediately name itself beneficiary of the insurance policy. There should be no charge for this transaction from either the insurance company or the agent.

Under Code Section 2035, the insured Client must survive for three years after the insurance is transferred, beginning on the date of the transfer. Otherwise, the policy proceeds will be included in the Client's estate and taxed at the Client's highest federal estate tax bracket. Thus, the Client's effort and expense to establish the life insurance trust would be wasted.

The most favored option to avoid application of Section 2035 is to sell an existing policy to a life insurance trust. Because the transfer is by sale rather than by gift, Section 2035 does not apply.

Transfer for Value Rule

Life insurance death benefit proceeds are generally excluded from the definition of income under the tax code. However, there is an arcane exception called the Transfer-for-Value rule. If a life insurance policy is transferred for value, i.e., sold to a life insurance trust, then the amount by which the death proceeds exceed the amount of consideration paid are income taxable to the recipient.

In order to avoid triggering the Transfer-for-Value rule, the life insurance trust should be drafted as a grantor trust for income tax purposes. The IRS will disregard a grantor trust for income tax purposes and basically treat the Client as the owner.

Thus, if the Client sells an existing policy to a life insurance trust, which is intentionally designed as a grantor trust, the transfer is treated as a sale from the Client to the Client. For income tax purposes, the buyer and seller of the insurance policy are the same and the Transfer-for-Value rule is avoided.

Valuation of the Policy

For transfers by gift or sale, the Client's tax preparer will need to know the fair market value of the life insurance policy. The Client's insurance agent should request Form 712, Life Insurance Statement from the insurance company. The value is generally determined to be the policy's "interpolated terminal reserve" at the date of the gift plus any unused premium plus dividends accumulated minus any policy loans. In other words, the value is approximately equal to the policy's cash surrender value.

Gift-Over Issue

Most people are aware that a person may transfer \$12,000 per year to any number of donees without using any of the donor's lifetime estate and gift tax credits. Many then infer that the donor may contribute \$12,000 for every withdrawal right beneficiary of an irrevocable trust. There is another issue to consider, however.

[Note: Technically, gifts to a life insurance trust are gifts of a future interest and do not qualify for the gift tax annual exclusion. Thus, gifts are usually accompanied by a 30 day demand right for each beneficiary of the trust. The beneficiary may withdraw his or her portion of the gift. This *Crummey* power qualifies the gift as a present interest.]

Code Section 2514 provides that the exercise *or release* of a general power of appointment shall be deemed to be a transfer of property by the individual possessing such power. Allowing a *Crummey* withdrawal right to expire, unexercised, constitutes the release of a general power of appointment to the extent that the lapsed withdrawal right exceeds the greater of \$5,000 or 5% of the value of the trust property. Stated another way, when a donee fails to exercise a *Crummey* withdrawal power, for gift tax purposes the donee actually makes a gift to the other trust beneficiaries of that amount in excess of \$5,000 or 5% of the contributed trust property.

By utilizing "hanging" *Crummey* powers, the grantor will be able to make full use of the entire \$12,000 annual gift tax exclusion amount for each donee. Under the terms of the trust, the amount that lapses is limited to the 5 and 5 safe harbor amount each year. The amount contributed for that donee in excess of the safe harbor amount remains subject to the beneficiary's withdrawal right, or "hangs," until it lapses at some future date.

A hanging power may not be granted to the grantor's spouse, so the spouse's annual demand right is strictly limited to \$5,000.

Summary: Gift or Sale?

The simpler option is to gift the policy into the life insurance trust. However, this will trigger the 3 year rule under Section 2035. Of course, the actuarial odds of anyone dying within 3 years is low, so this issue may be of small concern to the Client. Thus, assuming full disclosure, if the Client is not concerned about the 3 year rule, then a gift of the policy is a simpler choice.

The other option is to sell the policy into the life insurance trust. This process involves gifting cash from another source to the life insurance trust. The trustee then uses the cash to buy the policy from the Client. Thus, the Client has no out-of-pocket cost, but the Client may still have to use some unified credit to make the initial gift. Also, the Client may be unable or unwilling to temporarily part with a large cash amount.

The taxable gift amount is the same either way. The difference is solely logistical. For both techniques, the transfer is a taxable gift (using up some of the Client's unified credit) to the extent *Crummey* powers do not cover the value of the policy. For example, if the value of the policy is \$100,000 and there are four *Crummey* beneficiaries, only \$48,000 is covered by the gift tax annual exclusion. The balance will reduce the Client's unified credit when reported on Form 709 to the IRS.

Logistics of Selling an Existing Policy to an ILIT

1. Client signs ILIT created as a grantor trust.
2. Life insurance company provides written statement of policy value.
3. Client gifts money to ILIT at least equal to stated value of existing policy.
4. Trustee sends out *Crummey* demand notices to beneficiaries.
4. Trustee purchases life insurance policy from client/insured.
5. Insured gives trustee "Bill of Sale" or other receipt evidencing transfer.
6. Trustee submits policy change of ownership form, registering trustee as owner.
7. Trustee submits beneficiary designation form naming ILIT as beneficiary.
8. Client reports any taxable gifts to IRS on Form 709.