The Unintended Consequences of Transferring Existing Term Life Insurance to an ILIT

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High net-worth clients dodged a bullet with the removal of legislative changes under the "Neal Proposal" that could have had a dramatic effect on year end planning for life insurance. For example, the current Lifetime Gift, Estate and Generation Skipping Transfer Exemption of $11,700,000 per person is scheduled to reduce in 2026. The proposal would have moved the reduction up to 2022. Also, the "Neal Proposal" had a negative impact on irrevocable life insurance trusts (ILITs) that are grantor trusts. For example, the legislation could have resulted in a portion of the insurance proceeds being pulled back into the Grantor's estate and limited other Grantor Trust planning such as a sale of income producing property to an Intentionally Defective Grantor Trust (IDGT) and commonly used valuation discounts.

None the less, the anticipated proposed legislative changes created a flurry of estate planning activity, including the creation of new grantor trusts, major gifts to old and new grantor trusts, sales of income producing property to Intentionally Defective Grantor Trusts (IDGT's) and the transfer of personally owned life insurance to Irrevocable Life Insurance Trust (ILITS).

For those that are considering transferring existing life insurance to an ILIT, particularly term life insurance, we believe it is prudent to proceed carefully and to understand the ramifications of the transfer and what other options are available

HAZARDS:

Hazards of transferring a personally owned life term life insurance policy to an ILIT include:

- A gratuitous transfer of a policy to an ILIT is subject to the IRC Section 2035 three-year contemplation of death rule. If the insured dies with in 3 years after transferring a policy to an ILIT, the proceeds will still be included in the estate of the insured and possibly subject to estate tax. For a married couple it is possible to put a provision in the ILIT that qualified the proceeds for the unlimited marital deduction, however, the proceeds are then included in the surviving spouse's estate.

- Life insurance policy valuation is complicated. Some mistakenly believe that just because a term policy has no cash value that it has little or no value as a gift to an ILIT. Level premium term life insurance policies are valued by the issuing life insurance carriers based on combining the Interpolated Terminal Reserve (ITR) plus any unearned premium. Depending on the age of the insured and the face amount of the policy, this amount can be substantial and may require the use of some lifetime exemption. Furthermore, if the policy expires before it matures as a death claim, the insured has wasted their exemption.

SOLUTIONS:

A possible solution to the IRC Section 2035 contemplation of death rule is to sell the policy to an ILIT rather than making a gratuitous transfer. The same valuation technique applies. The insured could sell the policy to the ILIT for a note at the currently low Applicable Federal Rate (AFR) interest rate. It would be prudent for the trust to at least pay interest to the insured because the value of the note will be included in the insured's taxable estate. If loan interest is accrued, the note grows larger and more of the proceeds will be pulled back into the insured's estate. There is also the expense of setting up the note and the periodic administration.

There is also the issue of how the note will be repaid if the term coverage expires before the note is paid.

Probably the best answer is to simply start over again with a new term life insurance policy. The proceeds of a death claim are not subject to the IRC Section 2035 three-year contemplation of death rule because the ILIT is the original applicant, owner, and beneficiary of the policy. Additionally, there is only a gift for the premium and no waste of the lifetime exemption if the policy expires before death. Best of all, the proceeds are excluded from the taxable estate of the insured and spouse.

CASE STUDY:

Male age 55, owns a 20-year term life insurance with a face amount of $5 million and an annual premium of $8,500 per year. The ITR Value is $80,000 and the policy has 12 years left on the guarantee. The Long Term AFR is currently 2%. If the policy is sold to an ILIT and the grantor pays interest only on the note, the cost of owning the policy in the ILIT increases from $8,500 (premium only) to $10,100 (premium plus the loan interest), and the outstanding loan balance still remains included in the taxable estate. Worse, the ILIT still owes the debt even after the coverage expires.

CASE STUDY SOLUTION:

Purchase a new 10-year term life insurance policy (assuming the insured can qualify at the same underwriting rate), for $8,000 per year. There is no loan, no loan interest, and the entire proceeds are excluded from the insured's taxable estate. There is no risk of the coverage expiring before the note is repaid.

On the surface, the transfer of a term life insurance policy to an ILIT to reduce Federal and State Estate Tax exposure seems simple. However, starting over with a new policy often has a better result.

Questions? Please feel free to contact:

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