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Moving life insurance to an irrevocable trust

One of the time-honored ways to plan for a death tax[1] is to establish an irrevocable trust, and have it purchase life insurance on the grantor.[2] An irrevocable life insurance trust (ILIT) can use cash from a death benefit to purchase assets from the estate, so that estate taxes (generally due within nine months after death) can be paid. This can help the estate avoid having to rush to sell assets, like real estate or a business, to pay the taxes. Also, a properly designed ILIT keeps the policy out of the grantor's estate, so that it doesn't exacerbate the estate tax problem.

But, what happens if the grantor has a personally owned policy that is no longer needed and wants to put it into an ILIT? Can an existing policy that's no longer needed for its original purpose be moved to an ILIT? The answer is yes, but with certain considerations.

> ***Example***: *Walt Ritter sold his manufacturing business for $10 million. As part of the payout, he received a cash value life insurance policy on himself that had been owned by the company. Walt already has sufficient life insurance for his family needs, so he wants to put it into an ILIT. His attorney explains that if he makes a gift of the policy to his ILIT and then passes away within three years, the policy will be pulled back into his estate.[3] So, his attorney suggests selling the policy to the trust.*
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> *Walt's ILIT is designed to be a grantor trust, meaning that trust contains certain provisions that make the income of the trust taxable to Walt.[4] As a result, the trust's purchase of the policy from him does not trigger a transfer for value.[5]*
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> *Walt's financial professional obtains a fair market value of the policy from the insurance company: first, a current value for planning purpose, then a specific value for the actual date of the transfer.[6] Walt makes a gift of cash to the trust, to provide funds for a down payment, according to his attorney's recommendations. Walt's attorney draws up a memorandum of sale to document the terms and date of the sale. Walt transfers the policy to the trust in exchange for a down payment and an interest-bearing installment note. Walt then uses annual exclusion gifts to the trust to help provide the funds for the trust to make the payments required by the note and pay premiums on the policy. If needed, the memorandum of sale and the cancelled checks from the trust to Walt provide documentation that a sale took place.*

Paying the premiums

Once the policy is inside the ILIT, the trust typically needs a source of funds to pay premiums (unless the policy is paid up or self-sustaining). Planning for payment of premiums is also very common when a term policy is sold to the grantor's ILIT and then converted into a permanent policy. The most frequently-used strategy is for the grantor to make annual exclusion gifts to the trust. However, if the amount available with annual exclusion gifts is insufficient to pay the note and the premiums on the policy, or if the grantor prefers to use them for other purposes, further planning might be necessary. One option is a gift of income-producing property to the trust.

> ***Example:*** *Walt's trust needs $40,000 annually for policy premiums and $20,000 annually to pay the installment note. If Walt were married, he could split gifts with his spouse (doubling the available gift tax exclusion amounts), and if there were additional beneficiaries, like grandchildren, annual gifts could be made for them. However, Walt is widowed and has only two trust beneficiaries, his two adult children. The annual gift tax exclusion gifts alone will not be sufficient to pay for the premiums and the note.*
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> *Walt still owns a $3 million office building that is leased to an unrelated company. The company pays rent of $60,000 annually. His attorney suggests gifting the building to the trust, so that rent from the building lease would be paid to the trust instead of to Walt. This would also mean that Walt could use the annual exclusion gift amounts for other purposes, such as cash to help his adult children. The value of the building will use up $3 million of Walt's lifetime exemption amount, but it will help assure that the trust can pay the premiums for as long as needed.*

Other alternatives for getting cash into the trust could include loaning premiums to the trust, entering into a split dollar agreement with it, or premium financing. Any of these could continue for a period of time, but as a best practice, each of these strategies requires an exit plan that eventually terminates the loan or agreement and repays the loan, without relying on Walt's death to generate the needed funds.

Considerations

A sale of an existing policy to an ILIT can remove the policy from the grantor's estate and provide funding for estate liquidity. However, careful planning and documentation is necessary, to help assure that the transaction is viewed as an arm's length sale. Subsequent gifts to the trust can be planned according to the premiums needed to maintain the policy.

Additional Resources

ILIT Funding Strategies (BB11629)

ILIT Overview (BB9616)

ILIT and Gifting Sample Proposal (BB12101)

Considering ILIT Changes (BB12115)

Building ILIT flexibility with a SLAT (Spousal Lifetime Access Trust) (BB12606)

[1] This includes state inheritance taxes and/or Federal estate tax. In 2024, individuals with an estate exceeding $13,610,000 or married couples with an estate exceeding $27,220,000 are subject to a federal estate tax of 40% on amounts in excess of these lifetime exclusion limits. However, the limits are scheduled to drop by half beginning January 1, 2026, potentially exposing many more people to the estate tax. State thresholds can be much lower.
[2] The "grantor" is the person who establishes the trust.
[3] See Internal Revenue Code (IRC) Sec. 2035.
[4] A sale to a trust that is a grantor trust with respect to the insured does not trigger a transfer for value. See Rev. Rul. 2007-13, 2007-11 IRB 684. Note that "grantor trust" is a term of art, referring to certain trust designs described in IRC Sections 671-679. The fact that a trust was established by a grantor (as all are) does not make the trust a *grantor trust*.
[5] The transfer for value rule is found at IRC Sec. 101(a)(2).
[6] If Walt were terminally ill, the value of the policy could be higher. In that situation, an appraisal of the policy value might be necessary to substantiate its fair market value.