Transfer of Insurance Policy Held in a Grantor Trust

By James F. McDonough, Jr. on April 9th, 2012

One of the most common estate planning techniques is the use of a trust to hold a life insurance policy, sometimes referred to as an ILIT. An ILIT, containing the proceeds of life insurance (that is, the death benefit), will not be included in a decedent's estate if it is properly structured. The ability to exclude the death benefit from the taxable estate is of immeasurable benefit not only because of the tax savings but also because it creates a certain level of creditor protection. The ILIT may also provide the estate with liquidity by loaning it money or purchasing assets. Finally, the ILIT may provide an inheritance for those heirs who are not involved in and will not inherit the family business.

One assumes all will continue to be right with the world after the ILIT is created. Unfortunately, plans change as couples divorce and businesses fail or are sold. When plans change, advisors are often asked to adapt the plan to the change in circumstances, and sometimes that means unlocking the ILIT. The very provisions that prevented inclusion of the proceeds in the estate of the insured also limit what the insured can do to control or transfer the policy. Proper design precludes the insured from holding any *incidence of ownership* over life insurance causing inclusion under IRC §2042, such as the ability to change beneficiaries. Proper design prevents an insured or spouse from having a *retained power* of enjoyment over the policy causing inclusion under IRC §2036 or IRC §2038.

There are also income tax rules which, if violated, convert the death benefit that is otherwise tax-free into ordinary income. How then does one unlock the policy from the ILIT and avoid creating income in the face of these rules?

One of the most useful tools in the tax toolbox is the grantor trust. A transaction between a grantor and his or her grantor trust are ignored for income tax purposes. These rules, if properly used, prevent the conversion of a tax-free death benefit into ordinary income. The other part of the problem is resolved by Rev. Rul. 2011-28 which permits the insured to substitute assets of equivalent value in exchange for the life insurance policy. Mere possession of such a power will not cause inclusion of the ILIT in the insured's estate.

There are a number of design (drafting) issues that are not discussed but the ruling is helpful in that it approves what practitioners believe to be reasonable and possible.