Getting a Life Insurance Policy Out of an ILIT

Rather than a knee-jerk reaction that the ILIT is no longer necessary, you should engage qualified professionals, including your Guardian Financial Representative, to conduct a thorough analysis not only of the policy but also of your family's general planning objectives and intentions. The analysis is required because the ILIT is an irrevocable trust that provides many benefits beyond liquidity for estate taxes such as for the creation of a legacy; management of the death proceeds; control over distributions to beneficiaries; creditor protection of the proceeds; providing a permission slip to spend down assets; acting as a "family bank" or dynasty trust; and more.

In addition, so much time and ink has been spent in the popular media and press on the federal estate tax exemption. However, they have basically ignored the fact that nearly 40% of the states have a state estate and/or inheritance tax where an ILIT still makes sense from the estate tax planning perspective. Do you live in one of those states? Let's also not forget that the $5 million federal exemption is only as permanent as the next Congress or President. No one knows what the future holds.

Upon completion of the analysis, however, it may well be determined that having the policy out of the ILIT is the right thing for you. Note that we're assuming retention of the policy and keeping it in force is still desired. If so, how do you get the policy out? The only way to figure that out is to look to the trust document. Your attorney can help you do a thorough legal review of the trust document but your Guardian Financial Representative may be able to provide you with some general guidance before engaging the attorney.

There are basically three methods that may be possible. The first is to determine if there is a provision that allows for the substitution of assets. It may be possible for the grantor of the trust (i.e., the grantor is the person creating the trust which is probably you if you're reading this) to substitute assets of equivalent value into the trust in exchange for the policy based upon the policy's fair market value. Unfortunately, for many older trusts, you're probably not going to find this provision. Prior to 2011, there was always the fear that such a provision would cause the life insurance death proceeds to be included in the estate. As you should know, the value of the death proceeds of an individually owned life insurance policy is included in the calculation of what constitutes a person's gross estate for estate tax purposes. The ILIT was designed to exclude the death proceeds from the estate. However, the IRS issued Revenue Ruling 2011-28 that basically stated that an asset substitution power, on its own, would not cause the value of the life insurance to be included in the gross estate. Thus, more recently drafted ILITs will probably include this power of substitution.

The second method is to determine if the policy can be purchased out of the trust. It may be possible to buy out the policy from the trust for fair market value. Note, however, that the trustee has a fiduciary responsibility to ensure that the sale of the policy is actually in the best interests of the beneficiary, and NOT the grantor of the trust. What constitutes the best interests of the beneficiary involves many factors and considerations, the discussion of which is beyond the scope of this article. Clearly, however, you should seek out the advice of a knowledgeable estate planning attorney.

Another consideration in whether or not to purchase a policy out of a trust is the transfer-for-value (TFV) rules. The TFV rules state that if a policy is transferred for valuable consideration, then the death proceeds may be taxable income, rather than income tax-free, unless an exception to the TFV rule applies. Obviously, this is a major consideration since most people believe and expect that life insurance death proceeds would be received income tax-free. Fortunately, if you are the grantor and the individual interested in purchasing the insurance from the ILIT, and the insurance was on your life, one of the key exceptions to the TFV rule would be met – a transfer of a policy to the insured is an exception. Your Guardian Financial Representative and your legal counsel can help you to determine if the TFV rule may be avoided in other situations.

Lastly, the third method is to determine if the policy can be distributed out of the trust. Often, a trustee of an ILIT is given broad discretion to distribute trust income and principal to the beneficiaries of the trust. If the trustee has the power to make discretionary distributions, the policy may be distributed out of the trust to the trust beneficiaries who may, in turn, be able to gift the policy back to you. Of course, this strategy presumes that the trust beneficiaries would be willing to transfer the policy back to you because the transfer would be considered a gift and would have gift tax consequences to the beneficiaries making the gift.

Each of the methods has its pros and cons and each method is going to be subject to your overall planning objectives. If you think this might be the correct strategy for you, first consult with your Guardian Financial Representative and your estate planning attorney to review your overall planning objectives and intentions. You placed the insurance in the ILIT for a reason in the first place. That reason may resurface in the future, even if it doesn't exist today. If you still believe that you are better off having the insurance policy outside of the trust, have your attorney review the trust to see if it is possible to have the policy removed from the trust. Your Guardian Financial Representative can guide you in this process.

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

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