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Key Considerations When Transferring Existing Life Insurance to an Irrevocable Life Insurance Trust (ILIT)

LEARN THE KEY ESTATE PLANNING, TAX, AND TRUST IMPLICATIONS OF MOVING AN EXISTING LIFE INSURANCE POLICY TO AN IRREVOCABLE LIFE INSURANCE TRUST (ILIT).

“One thing leads to another.” – The Fixx

When it comes to moving a life insurance policy into an irrevocable life insurance trust (ILIT), that lyric is surprisingly good estate planning advice. What may seem like a simple decision often sets off a chain reaction of other considerations. Gift the policy to the trust? Now you’re dealing with gift tax valuation and the three-year rule. Sell it to the trust? Then questions arise regarding trust taxation and transfer-for-value concerns.

One of the most common estate planning recommendations for affluent and ultra-affluent clients is the use of an ILIT. An ILIT can be an important tool for clients concerned about potential federal or state estate taxes because assets owned by the trust are generally removed from the client’s taxable estate. In addition, an ILIT can provide a framework for controlling distributions to beneficiaries, protecting assets from creditors, and facilitating an efficient transfer of wealth to future generations.

While most financial professionals are familiar with having an ILIT purchase a newly issued life insurance policy, a different set of considerations arises when a client already owns a permanent life insurance policy and wants to move that policy into an existing or newly created trust. Often, the policy contains significant cash value, favorable policy guarantees, or underwriting advantages that make replacing the coverage unattractive. In those situations, transferring the existing policy may be the preferred approach.

The challenge is that there is more than one way to accomplish that goal, and each path brings its own tax and planning consequences. Understanding how those decisions connect to one another is essential to ensuring that one planning step does not inadvertently create another problem down the road.

Let’s examine some of the major considerations when moving an existing permanent life insurance policy into an ILIT.

TWO PRIMARY TRANSFER OPTIONS:

Generally speaking, there are two overarching methods for moving an individually owned life insurance policy into an ILIT:

- Gifting the policy to the ILIT, or
- Selling the policy to the ILIT

Each method has advantages and disadvantages, and understanding these differences is critical before implementing the transaction.

GIFTING THE POLICY TO THE ILIT:

Under a gift-transfer strategy, the policy owner transfers ownership of the existing life insurance contract to the ILIT without receiving any consideration in return. Assuming the gift is treated as a completed gift, and the trust is properly drafted, the policy is generally removed from the insured's estate for estate tax purposes, subject to one important caveat: the three-year rule (see below).

The value of the transferred policy is considered a taxable gift. Depending on the policy's value, the gift may be sheltered by annual exclusion gifts¹ (if applicable),² the client's unused portion of their lifetime gift tax exemption,³ or a combination of both.

THE THREE-YEAR RULE:

When discussing gifted life insurance policies, there is one Internal Revenue Code provision that inevitably enters the conversation: IRC Section 2035.

Under Section 2035, if an insured transfers ownership of a life insurance policy and dies within three years of the transfer, the death benefit is generally pulled back into the insured's gross estate. Many practitioners simply refer to this as "the three-year rule."

The rule applies regardless of whether the transfer was made to an ILIT, family member, or another recipient. If the insured does not survive the three-year period, the primary estate tax objective may be defeated.

This does not mean that gifting a policy is ineffective. In fact, gifting remains a widely used strategy. However, clients and their advisors must understand that the three-year rule introduces mortality risk into the planning process.

The older the insured and the larger the estate tax exposure, the more important this consideration becomes.

SELLING THE POLICY TO THE ILIT:

Many sophisticated planners prefer a different approach: a sale. One main reason is that a sale generally avoids the three-year rule. Because the transaction is a bona fide sale for adequate consideration rather than a gift, Section 2035 typically does not apply in the same manner as it does with gratuitous transfers.

However, depending on the way the trust is drafted for income tax purposes, there can be vastly different tax outcomes and major considerations.

SALE TO A GRANTOR TRUST:

When an ILIT is drafted as a *grantor trust*, the grantor and the trust are generally treated as the same taxpayer for federal income tax purposes. As such, transactions between the grantor and the grantor trust are generally disregarded for income tax purposes.

This treatment creates some potential advantages in addition to avoiding the three-year rule. First, because the transaction is disregarded for income tax purposes, there is generally no recognition of gain on the sale.

Second, a properly structured bona fide sale may reduce or eliminate the need to use the gift tax exemption associated with transferring a highly valued policy.

¹The federal annual gift tax exclusion amount is \$19,000 per recipient in 2026.

²In order to utilize the annual exclusion, the trust must contain Crummey provisions, and those must be exercised.

³The federal lifetime gift and estate tax exemption amount is \$15,000,000 per individual in 2026.

The trust typically funds the purchase at Fair Market Value (FMV) through one of two methods:

- Existing trust assets; or
- A note issued by the trust to the grantor⁴

The result is that the policy becomes trust-owned while avoiding one of the more significant concerns associated with gifting.

For older insureds or clients with substantial estate tax exposure, a sale to a grantor trust is often viewed as one of the more attractive planning alternatives.

SALE TO A NON-GRANTOR TRUST:

While a sale to a grantor trust may be a great alternative to gifting, a sale to a non-grantor trust introduces an entirely different set of issues.

Unlike a grantor trust, a non-grantor trust is treated as a separate taxpayer. Therefore, transactions between the grantor and the trust are not ignored for income tax purposes. This can create potential gain recognition if the amount realized exceeds the owner's basis in the policy. Depending on the circumstances, significant income tax consequences may result. Additionally, advisors must carefully evaluate whether the transfer-for-value rule (TFV) may apply.

Generally speaking, life insurance death benefits are received income tax-free* under IRC Section 101(a). However, when a life insurance contract is transferred for valuable consideration, part or all of the death benefit may become subject to income taxation unless an exception applies.

One of the exceptions under TFV is a transfer to the insured (which is why it is not applicable to a sale to a grantor trust); however, since a non-grantor trust is treated as a separate taxpayer from the insured, another exception would have to apply to avoid the application of TFV.

POLICY VALUATION:

Another important consideration in the transfer of a policy to an ILIT is policy valuation.

For federal gift tax purposes, the FMV of a life insurance policy is generally going to be its replacement cost.⁵ In the case of a newly issued policy, the replacement cost is the total premiums paid. If a policy has been in force for more than one year and future premiums are payable, the replacement cost is not readily ascertainable, and therefore, the Interpolated Terminal Reserve (ITR) is the appropriate measure of the policy's value.

However, the IRS has indicated through various guidance that the FMV of a life insurance policy may exceed traditional reserve-based calculations, particularly when a contract contains significant economic benefits, favorable guarantees, or other unique features.

As a result, policy valuation has become a specialized area requiring careful analysis. Clients should consult their tax advisors on how best to value their policy, and for policies with substantial cash value, unusual features, advanced-age insureds, or significant death benefits, obtaining a professional valuation may be prudent.

FINAL THOUGHTS

Moving an existing permanent life insurance policy into an ILIT may be a necessary estate planning strategy for an affluent client. However, as we've seen, what may start as a simple ownership transfer often becomes a series of connected planning decisions. The choice between a gift and a sale, whether the trust is a grantor or non-grantor trust, the potential application of the three-year rule, and proper policy valuation can all impact the effectiveness of the strategy.

As The Fixx reminded us, *"one thing leads to another."* When it comes to transferring life insurance into an ILIT, that is certainly true. A single planning decision can create a series of tax and estate planning consequences, both positive and negative. Understanding how those pieces fit together can help ensure that one step forward doesn't inadvertently create a problem further down the road.

⁴Trust must still be "seeded" with sufficient funding (typically at least 10% of the purchase price) and should have income-producing assets to cover interest and principal.

⁵Treasury Regulation 25.2512-6

That's why successful implementation often requires coordination among the client's financial professional, attorney, CPA, and trustee. Taking the time to evaluate these issues before submitting a transfer form can help avoid unintended consequences and position the client and their family for a better long-term outcome.

As always, clients should consult their tax and legal advisors before implementing any life insurance trust strategy, but Penn Mutual's Advanced Sales team is here to help as well.⁶ Reach out to us to learn more.

⁶Penn Mutual and its representatives do not provide tax or legal advice.

⁷For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e. the transfer-for-value rule); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

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