



How to Avoid the 3-Year Rule on a Transfer of an Existing Life Insurance Policy to an ILIT

Do you have prospects or clients who want to transfer policies they own on their lives to irrevocable life insurance trusts (ILITs) and who wish to avoid or minimize the application of the three-year rule?

Facts: Bob owns a \$1,000,000 policy on his life. The policy is five years old. He no longer needs the policy for family income, but he would like to use it to fund his increasing estate tax liability. Accordingly, he would like to transfer the policy to a trust and remove it from his estate. His health has taken a turn for the worse since he purchased the policy. He has been diagnosed with an illness that would cause him to be rated if he were to purchase a new policy, but the disease is not immediately life threatening. His attorney has informed him that if he gives the policy to a trust, he must live for three years after the completion of the gift before the policy will be removed from his estate. He asks you if there is another way that it might be immediately removed from his estate.

Solution: The 3-year rule does not apply to property that is transferred in a “bona fide sale for full and adequate consideration.” In other words, if Bob is able to sell the policy for adequate and full consideration, the policy will immediately be removed from his estate. To effectuate this transaction, several actions must be taken.

First, prior to the sale, the attorney must establish an irrevocable trust that will avoid the negative tax consequence of the transfer-for-value rule. Although the transfer for full and adequate consideration is an exception to the 3-year pullback rule, transferring a life insurance policy for consideration can subject the policy to another tax dilemma – the transfer-for-value rule. The transfer-for-value rule states that, if a life insurance policy is transferred for valuable consideration, the net amount at risk will be subject to income tax. Fortunately, this result can be avoided if the sale is structured to fall within one of the exceptions to the transfer-for-value rule. For example, if the ILIT is made a partner in a partnership in which the insured is a partner, the negative tax consequences of the transfer-for-value rule will be avoided.

Next, the policy must be valued as of the date of transfer. In general, for gift tax purposes, the regulations provide

that the value of an unmatured life insurance policy that has been in force for some time and on which premiums are still being paid is the interpolated terminal reserve plus unearned premium. The insurer can tell you what the interpolated terminal reserve on the transfer date will be.

It should be noted that it does not necessarily follow that the gift tax regulations will be used when reviewing the adequacy of consideration for the “bona fide sale” exception. The position taken by the IRS in private letter rulings has been inconsistent. However, its most recent rulings appear to acknowledge use of the gift tax value. (Caution: It should be noted that if the insured is nearing death, the gift tax value might not be determinative of its value.)

Next, the trust will need to be seeded with sufficient funds to purchase the policy. This can be done through annual exclusion gifts or by use of the gift tax applicable exclusion amount. Following the expiration of the Crummey notice time period, the trustee will purchase the policy from Bob by writing a check from the trust checking account.

The transfer-within-three-year rule, the transfer-for-value rule and the incidents-of-ownership rule can present hurdles in a situation where an individual has purchased a policy on his/her life and retained ownership, causing it to be includable in the individual’s gross estate. Fortunately, with careful planning, strategies exist for undoing the error. For a more detailed discussion, see Prudential’s *Frequently Asked Questions IFS-A068383 Avoiding the “3-Year Rule” for Transfers of an Existing Life Insurance Policy*.

A list of common situations follows.

This training material has been prepared to assist our licensed financial professionals. It is designed to provide general information in regard to the subject matter covered. It should be used with the understanding that Prudential is not rendering legal, accounting or tax advice. Such services should be provided by the client’s own advisors.

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751 Broad Street, Newark, NJ 07102-3777
IFS-A070156 Ed.11/07 Exp.12/09



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Is a Life Insurance Policy Included in the Insured's Estate in the Following Situations?

<i>Questions</i>	Yes	No
Will a policy an insured owns on his/her life be included in his/her estate if he/she transfers the policy to another for less than adequate and full consideration, continues to pay the premiums, and dies within 3 years after the transfer? IRC § 2035.	X	
Will a policy an insured owns on his/her life be included in his/her estate if he/she transfers the policy to another for less than adequate and full consideration, and dies within 3 years after the transfer, but the donee pays the premiums payable after the transfer out of the donee's own funds? <i>Estate of Silverman</i> , 61 T.C. 338 (1973).	X partial	
Will a policy an insured owns on his/her life be included in his/her estate if he/she transfers the policy to another for less than adequate and full consideration and dies more than 3 years after the transfer of the policy? IRC § 2035.		X
Will a policy be included in an insured's estate if the insured gives cash to a third party (e.g., an ILIT) and the third party uses the cash to purchase a policy on the donor/insured's life and the donor/insured dies within 3 years of the gift? <i>Estate of Leder v. Commissioner</i> , 893 F.2d 253 (10 th Cir. 1989), <i>affirming</i> 89 T.C. 235 (1987).		X
Will a policy an insured owns on his/her life be included in his/her estate if he/she transfers the policy to another for full and adequate consideration, continues to pay the premiums, and dies within 3 years after the transfer? IRC § 2035 (d).		X
Will a policy owned by a third party (e.g., spouse) on another person's life be included in the third party's estate if he/she transfers the policy and dies within 3 years after the transfer?		X
Will a policy owned by a controlled corporation (one where the insured owns more than 50%) on the life of the controlling shareholder/insured be included in the shareholder/insured's estate if the proceeds are paid to the corporation? Reg. § 20.2042-1(c)(6).		X
Will a policy owned by a controlled corporation on a controlling shareholder/insured's life be included in the shareholder/insured's estate if the proceeds are paid to a third party? Reg. § 20.2042-1(c)(6).	X	
Will a policy owned by a controlled corporation on a controlling shareholder/insured's life be included in the shareholder/insured's estate, where the proceeds are paid to a third party, if the corporation gifts the policy to another for less than adequate and full consideration and the shareholder dies within 3 years of the policy transfer? Rev. Rul. 82-141, 1982-2 C.B. 209.	X	
Will a policy owned by a controlled corporation on a controlling shareholder/insured's life be included in the shareholder/insured's estate, where the proceeds are paid to a third party, if the shareholder gives his business interest so he no longer has a controlling interest and dies within 3 years of the transfer? Rev. Rul. 90-21, 1990-1 C.B. 172.	X	