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ADVANCED SALES COMMENT

How to Deal With Loans When Gifting a Policy to a Trust

Catrina Smith owns a $1 million life insurance policy. She intends to transfer it to her daughter, Kristen. The policy has a cost basis of $100,000 and a total cash value of $210,000. The policy also has a loan of $110,000, which results in a net cash value of $100,000.

Problems:

This seemingly innocuous situation has a whole host of income tax problems. The key is to recognize that the Internal Revenue Service (IRS) deems this transfer as a part gift/part sale. The part sale stems from the fact that Catrina's loan obligation is assumed by Kristen (the part gift is the net value of the contract being transferred). As a result, a transfer-for-value (TFV) has occurred.

Whether or not there will be a loss of the income tax-free death benefit depends upon the value of the loan in comparison to the value of the transferor's basis. This is due to the following exception to the TFV rule: The basis for determining gain or loss in the hands of the transferee is determined in whole or in part by reference to the basis of the transferor. Any time, such as in Catrina's situation above, where the loan ($110,000) exceeds the transferor's basis ($100,000), then this basis exception will be inapplicable and a TFV problem will still exist. This is because the transferee's basis here will be the greater of (a) the transferor's basis or (b) the amount of the loan (i.e., the cost basis effectively paid to acquire the policy).

So, Kristen's new basis would be $110,000 (the value of the loan). If you cannot use the transferor's basis, then you cannot use the exception. If TFV is triggered, then the amount of the death benefit in excess of the total amount paid for the contract would be subject to ordinary income tax.

The second problem is that since Catrina's loan obligation has effectively been discharged and the value exceeds her basis in the policy, the transferor currently has taxable gain (ordinary income) equal to the difference ($10,000).

The third problem is that the three-year rule of IRC § 2035 would cause the death benefit to be includible in Catrina's estate if she were to die within three years of the date of transfer. The three-year rule does not apply to transfers for full and adequate consideration. However, since this was partially a gift, the transfer was for less than full and adequate consideration.

Possible Solutions:

- Pay back enough of the loan prior to the transfer, so that the loan would be less than the transferor's basis. For example, if Catrina put in $12,000 to reduce the loan, the loan would now be $98,000. Now the basis exception to the TFV rule would apply since Catrina's carryover basis is now greater than the loan at the time of the gift. In addition, there would be no taxable gain since the transferor's basis would exceed the value of the assumed loan.
- Another possible solution would be to gift the policy to an irrevocable grantor trust ("defective" ILIT) for the benefit of Kristen rather than gifting the policy directly to her. Under the grantor trust rules, there is no recognition for federal income tax purposes of any transaction between the grantor and the grantor trust. Therefore, at least for income tax purposes, Catrina is not deemed to have transferred the policy at all. No transfer, no TFV. (Rev. Rul. 2007-13).

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