

What are we waiting for?

We are seeing a recent trend of what we term “bad timing.” To understand, first we must define “ideal timing.” As it pertains to an irrevocable life insurance trust (ILIT) and life insurance, ideal timing is as follows:

1. After thoughtful and thorough consideration, planning team creates an estate or business plan that includes purchasing life insurance inside of an ILIT
2. Client’s counsel drafts a trust, then client executes and funds the trust
3. Client applies for life insurance and goes through an underwriting process
4. Life insurance is purchased within the ILIT

The reality seldom matches this timeline—underwriting can have twists and turns, clients may apply for life insurance before engaging an estate planning attorney, attorneys may be backlogged—there are exponential number of journeys. As a result, we find many policies approved in underwriting that are waiting for a trust to be drafted or for the client to fund.

Trusts are complex documents. They require difficult decisions on the client’s part, and competence and time on the attorney’s part. With the current high exemptions scheduled to sunset at the end of 2025, attorney availability will pose an even greater bottleneck.

Life insurance underwriting has its own complexities. When a formal offer is made for coverage, it is based on all the current medical information received by the company and remains open for a limited period. If a trust didn’t exist when the application was made, the client will have to submit another formal application with the trust as owner, signed by the trustee. Any change in health, visit to a doctor, or change in medication can cause the offer of coverage to be put on hold until new records are ordered, received, and reviewed by the underwriter, causing further delays. Any modifications to the product, features, benefits, or a change in age can cause the cost to be re-projected from the original proposal.



How can clients mitigate these risks and avoid additional delays? Put the approved policy in-force immediately with a premium payment. Once the policy is in-force, it can be transferred into a trust either by gift or sale.

Gift

This is the simplest approach; however, any transfer to a trust within three years of death is still included in the client's taxable estate. To protect against this risk, the client may consider purchasing a term policy to cover the additional tax that may be due or for survivorship policies, the estate preservation rider may be available, which is designed to provide additional death benefit for the first four policy years to offset some risk of estate tax inclusion at no additional charge.

Sale

The sale of a policy to an intentionally defective grantor trust avoids the three-year lookback.¹ Rather than transferring the policy into the trust, the client sells the policy for its fair market value to the trust (in cash or partly in cash and partly for a note).

Whether the client gifts or sells the policy into their trust, they will need to determine the "fair market value" of the policy at the time of the transfer. If the transfer is made within a year, the value is generally the premiums paid, (read [BYA: Policy valuation](#) for more information on this topic), particularly after the first year, and a gift tax return may also be required.

The "buy now, transfer later" approach also benefits the attorney—rather than rushing to finish a document before an offer expires, they can take the time required to craft a trust that matches the client's goals. The attorney may also be engaged to draft a sales agreement for the policy sale to the trust to avoid the three-year lookback. This way, a client can achieve their planning goals, even without ideal timing.

1. The IRS has determined that the transfer of assets between a grantor and their grantor trust will not be treated as a "sale" for income tax purposes. See Revenue Ruling 85-13.

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Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping tax). Failure to do so could result in adverse tax treatment of trust proceeds. There can be costs associated with drafting a trust.

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