

Make Sure Your Life Insurance Provides Protection — Not Tax Headaches

Life insurance provides much needed protection for your family. With careful planning, this protection can be doubled. In the right situation, giving an insurance policy on your life to your children or to a trust for the benefit of your children and your spouse can result in the full amount of the proceeds passing estate-tax free to them.

How Insurance Is Taxed

There are two tax exposures for life insurance proceeds: (1) income tax, if there has been a transfer of value, and (2) gift and estate tax.

Generally, if you take out a life insurance policy and don't do any estate planning with it, your beneficiaries won't have to pay income tax on the proceeds. For federal estate tax purposes, however, life insurance is included in your gross estate. Therefore, the proceeds are subject to an estate tax as high as 55% if: (1) the proceeds are payable to your estate, or (2) you possessed any incidents of ownership over the policy.

Transfer for Value

The Internal Revenue Code provides that life insurance proceeds are excluded from the recipient's gross income unless there has been a transfer for value. For example, if you sell the policy to your children, the excess of the proceeds over the amount they paid for the policy and any future premium paid is taxable income when your children receive the proceeds. If you give the policy to your children, the proceeds are income-tax free at your death, but you will have made a taxable gift of the value of the policy (generally, the cash value plus unexpired insurance premium).

Exemptions from the transfer-for-value rule are transfers to: (1) the insured, (2) a partner of the insured, (3) a partnership in which the insured is a partner, (4) a corporation in which the insured is an officer or shareholder, or (5) if the basis for determining gain or loss is determined in

whole or in part by reference to the transferor's basis.

Avoiding Income, Gift And Estate Taxes

Avoiding ownership altogether is the most obvious way to avoid estate tax. For example, your children could buy the policy on your life (subject to transfer for value considerations) or you could gift them an existing policy or gift them the premiums each year to buy a new policy. However, this strategy has disadvantages: The proceeds will be subject to spousal or creditor claims against your children and will be included in your children's taxable estates.

If you want your children to own the policy but you don't want to give it to them because the gift will be substantial, consider forming a partnership with them and selling the policy to the partnership, which fits within one of the exceptions to the transfer for value rule. Only your proportionate share of the partnership (and therefore your proportionate share of the proceeds) will be included in your estate. The partnership must have a legitimate business purpose, such as handling any investments on behalf of your children.

Another option is to give the policy (or cash to buy a policy) to an irrevocable life insurance trust and gift the premiums to the trust. This trust is specifically designed to hold an insurance policy. However, you still have to take care to avoid incidents of ownership.

You, as the insured, must have virtually no rights in the trust. For example, you cannot be the trustee because in that capacity you would have two important incidents of ownership: the ability to change the beneficiary of the policy and the right to borrow against the cash value of the policy. You cannot terminate the trust or access the cash value of the policy.

The advantage of an irrevocable life insurance trust is that the proceeds will not be subject to federal estate tax at your death if arranged properly. Your contributions to the trust are taxable gifts, but if you give your children a right to withdraw all or a part of the amount you give to the trust for an unlimited time period, the gifts may qualify for the \$10,000 annual gift tax exclusion. This right of withdrawal is sometimes called a "Crummey right," after the person who successfully argued against the Internal Revenue Service that such contributions qualified for the annual exclusion.

Irrevocable Life Insurance Disadvantages

The disadvantage of these trusts is that they can't be easily changed. If you provide that on your death the property in the trust passes equally to your children, and later you decide you would like to exclude one of them, you may not have that option. You cannot directly change the beneficiaries of the insurance policy after you sign the trust agreement because that would be an incident of ownership.

One solution to a change of heart is to stop funding the trust, causing the policy to lapse. You could then take out a new policy in a new trust with changed provisions. The drawbacks are that you must still be insurable and the new premiums will be based on your current age, not your age at the time you took out the old policy. Any cash value in the old policy is locked into the old trust, the provisions of which you may be unable to change.

Transferring an existing policy, either to a trust or an individual, creates an additional consideration. If you die within three years of transferring the policy, the policy proceeds are included in your gross estate even if you don't have any incidents of ownership at death. This rule is designed to curb deathbed transfers.

Planning Is Key

Contributing insurance to an irrevocable life insurance trust (or better yet, having the trust purchase a new policy) is a decision that deserves careful consideration. Please call us for assistance in determining the best insurance for your situation. We can help you structure a policy that meets the needs of you and your heirs.