Avoiding the Tax Hazards of Life Insurance Policies

By: John L. Pritchard, Esq.

Reprinted from the New Jersey Law Journal, March 3, 1997, p. 32, 147 N.J.L.J. 1016.

Attorneys reviewing a client's estate planning often encounter existing life insurance policies which are held in an inappropriate manner. A policy may be owned by the client himself, by a spouse, by a former business partner, by the client's children or by an improperly-drafted life insurance trust. Depending upon the circumstances, any of these forms of ownership may cause adverse tax consequences or other problems.

The ownership of a policy may be changed simply by executing a form provided by the insurance company, but there are at least three tax problems which could be triggered by the transfer itself. An approach which avoids one problem will commonly result in another. Policy transfers can therefore require the same degree of care as bomb disposal work. No transfer, by gift or otherwise, of an existing life insurance policy should be made until each of the tax hazards have been considered.

Background. The person whose death causes the payment on the policy is the 'insured', but by no means is this person necessarily the owner of the policy. The 'beneficiary' is the person designated by the owner to receive the policy proceeds on the death of the insured. In most cases, the name of the beneficiary can be changed at any time by the owner, but the rights of the beneficiary become irrevocable upon the death of the insured.

The Transfer for Value Problem. The death proceeds on a life insurance policy are ordinarily free of income tax. If the owner received the policy not from the issuing company, but from a third party, then the proceeds may be entirely subject to income tax. This will not be a problem if there is a pure gift of the policy. However, if there was a 'transfer for value' of the policy for almost any form of actual or imputed consideration, then there is a potential for an income tax on the death proceeds. This is in addition to any estate or gift tax problem. The transfer for value problem can be avoided if the policy is sold to the insured himself, to a partnership of which he is a member, or even to a trust of which he is considered the owner for income tax purposes. IRC 101(a)(2).

Estate and Gift Taxes. While the death proceeds are usually free of income taxes, if the insured himself owns the policy, and therefore has the right to name or change the beneficiary, then the proceeds will be subject to estate tax. For this reason, it is commonly advisable to transfer a policy to the insured's children, or to an irrevocable trust which is not includible in the insured's taxable estate. If a person has any 'incidents of ownership' of a policy, then the death proceeds will be includible in his estate, even if he does not actually own the policy.

Therefore the right to borrow against the policy, to pledge the policy as security for a loan, or to change the beneficiary, will each trigger estate tax inclusion. If the spouse of the insured owns the policy and is the beneficiary, then the death of the insured will not cause an estate tax. However, the proceeds will then be in the hands of the widow or widower, and will later be exposed to estate or gift taxes, unless it is spent. If the insured owns the policy and names his or her spouse as beneficiary, there also will be no estate tax due. The reason is that while the policy is includible in the taxable estate, the unlimited marital deduction for transfers to a spouse prevents a tax from being imposed. The problem, again, is that this will leave the proceeds exposed to a later estate tax on the death of the widow or widower.

If the spouse of the insured owns the policy, and has named a child as a beneficiary, then the death of the insured causes the beneficiary designation to become irrevocable, and triggers a potential gift tax on the imputed transfer of the death proceeds from the spouse to the child. Goodman v. Commissioner, 156 F.2d 218 (2nd Cir. 1946). This 'family triangle' problem can be avoided through a transfer of ownership of the policy to the child or to a trust while the insured is still alive.

A gift of a policy while the insured is alive may merely result in using up part of the $10,000.00 per year per recipient annual gift tax exclusion, or in using up part of the donor's $600,000.00 unified credit equivalent. Either is clearly more favorable than exposing the entire death proceeds to the estate tax. However, a gift is not always the answer. Sometimes a sale of the policy may be more beneficial.

An estate tax will also be due if the insured gives away an existing policy, and then dies within three years. IRC 2035(d)(2). This 'three-year rule' must be considered when a client is considering the purchase of a new policy, or when an existing policy is transferred.

Once a policy passes into the hands of the insured, a subsequent gift by the insured leaves the taint on the policy for three years. This will poses for a client in ill health, and even a healthy insured will be taking a gamble when if he gifts a policy. A sale transaction into a life insurance trust may be better, but then the transfer for value rule must be considered, along with a possible capital gain.

Capital Gains Tax. If a policy is sold for consideration, there is a potential for a capital gains tax. Such a tax is rare, since the actual value of a policy on a healthy insured is usually less than the amount of the premiums previously paid. A capital loss can not be taken on the sale of a life insurance policy.

If the insured is very ill, the likelihood of death in the near future will increase the fair market value of the policy. When a terminally-ill insured sells his or her life insurance policy, the proceeds are subject to a capital gains tax. PLR 9443020. A limited exemption was recently granted under the Small Business Job Protection Act of 1996 for insureds who can document their condition as 'terminal' or 'chronic', and who make a sale to a qualified viatical settlement firm. IRC 101(g). 'Business-related' policies do not qualify for the exemption.

The sale of an existing policy may also be appropriate where the co-owners of a business have held policies on each other, and wish to discontinue the arrangement. Cross-owned life insurance policies are commonly used to fund a buy-sell agreement between two or more partners or shareholders. An attempt to 'uncross' such policies may trigger a host of tax problems.

In such a situation, a tax-free exchange of policies under IRC 1035 can be useful. The Internal Revenue Service has taken the position that IRC 1035 only applies to exchanges involving the company issuing the policy. There is no support for this in the statute, however, and only limited support in the regulations. Unlike other tax-free exchanges, a taxpayer claiming the benefit of IRC 1035 is not required to report the transaction on his income tax return.

When co-owners of a business wish to transfer the policies on each other, it is better for each of them to make a gift of the policies to their own life insurance trusts, and then to have the trusts exchange the policies. Doing an exchange of the policies first will trigger the three-year rule as the policies pass through the hands of the insureds en route to the life insurance trusts.

Paths through the Maze. Advisors must tread carefully in avoiding each of the three tax hazards. One helpful tool is a particular type of life insurance trust known as a 'defective trust'. Such a trust is irrevocable, and is designed to be outside the grantor's taxable estate for the estate tax, but the trust is intentionally caused to be taxed to the grantor for income tax purposes. Such a trust is commonly referred to as a 'defective trust', since the income tax inclusion is sometimes considered a drafting error.

Because the trust is considered to be owned by the grantor for income tax purposes, the purchase of an existing policy by such a trust is the same as a purchase of the policy by the grantor-insured, and therefore should not trigger the transfer for value rule. The Internal Revenue Service has avoided ruling on this technique, PLR 9413045, though there is clear support for it. See Rev. Rul. 85-13, 85-1 C.B. 184. Cf. PLR 9451056.

A purchase by such a trust from the grantor/insured is preferable to a gift of the policy, since a gift will trigger the three-year rule problem for estate tax purposes, while a purchase will not.

As an alternative approach for avoiding the transfer for value rule, an existing policy can be purchased by a partnership of which the insured is a partner. While this will avoid the transfer for value rule, IRC 101(a)(2)(B), a portion of the policy will be includible in the insured's taxable estate to the extent of his interest in the partnership when he or she dies.

There are several options for drafting a defective trust. The safest means of triggering income tax inclusion, without estate tax inclusion, is to specifically allow or require the trustee to use income earned on trust assets to pay for premiums on the life of the grantor. IRC 677(a)(3). As an alternative, a non-adverse party may be named as trustee. IRC 672(a),(b), 674(a). There are difficulties in determining when a potential trustee will be ‘adverse’ or ‘non-adverse’, and so this may cause a careful drafter to avoid this approach.

At the same time, care should be taken to make sure that the life insurance trust is not includible for purposes of the grantor's estate tax, though this is the easier of the two drafting tasks.

Conclusion. The complexity of the tax issues causes many clients and their attorneys to avoid resolving the proper treatment of the policies. This delay is the enemy of good planning. Once the transfers are made, the running of the three-year rule will start, if necessary, and the policy will be properly situated to await the time when a claim on it is made.