

CHAPTER 13

Life Insurance

Reasons for acquiring life insurance:

- 1) Funding decedent/insured's final expenses (funeral and estate administration).**
- 2) Provide minimum survivors' benefits (spouse and minor children).**
- 3) Enable liquidity to fund buyouts by surviving owners of decedent's business interests and jointly held assets.**

Insurance is often a non-testamentary asset (i.e., assets paid directly to a designated beneficiary).

What is the Governing Law?

- 1) The specific insurance contract.
- 2) Contractual matters – state law; state insurance regulatory agencies & estates code.
- 3) Possible preemption where insurance policy governed by federal law; see Hillman case (fn., p. 3) re federal law preemption re non-effectiveness of a possible revocation of ex-wife's beneficiary designation.
- 4) Federal income tax (§101 & §264) & transfer tax (§2042 & § 2035) applicability. *Next slide*

Life Insurance and Federal Tax Issues

p.4

- 1) Income during the policy value accrual period (prior to insured's death)?
- 2) Income tax effects upon the transfer of policy prior to death – gift, sale?
- 3) Income at maturity – actuarial gain & investment gain? What if a deferred payout?
- 4) Gift tax effects when transferring an existing policy? Low value at gift? Cf., face value.
- 5) Estate tax inclusion upon maturity of policy at death of insured? Objective: no inclusion.

Considering Life Insurance Purchases p.4

- 1) How much insurance is appropriate for an individual? Cf., other investments.
- 2) What type of insurance should be chosen (p.5):
 - a) whole life
 - b) term
 - c) variable - flexible premiums
 - d) universal life & variable universal
 - e) endowment? P.4-5

Considering Life Insurance Purchases p.4

- 3) How evaluate the life insurance company, the product, etc.? Use an independent life insurance financial analyst?
- 4) How consider the recommendation for more insurance by the life insurance salesperson?
- 5) Who is to be the designated beneficiary?
Individual(s)?
An existing trust?

Other Life Insurance

Terminology

p.5

What is “cash surrender value”?

What is “interpolated terminal reserve value”?

What is the purpose of a “waiver of premium” feature in a life insurance policy?

What is a “double indemnity” feature/purpose?

What is the objective of a “two-life” policy (payment at death of the surviving spouse)?

Does a need for liquidity arise at that time?

Use an irrevocable life insurance trust “ILIT”?

Insurance & Investment Considerations p.6-7

Term or whole life insurance?

“Vanishing” premiums? Use paid-up additions?

What is the internal investment return on the policy? Is current return better than money market funds? Plus, “income” is tax-exempt)?

Consider the necessity for the policy owner to have an “insurable interest” on the life of insured, i.e., where the policy owner and the insured are different persons.

Pre-death Federal Income Tax Considerations p.8

Is life insurance a “tax shelter” because of the exclusion of the policy’s current internal buildup from gross income?

The real cost is the front-end load – how can this be reduced?

Are the benefits provided under life insurance policies “tax expenditures”? See fn.13.

Other Federal Income Tax Considerations

p.8

What is the income tax treatment to the insured under group term insurance coverage provided by an employer? See Code §79. P.9.

What is the FIT treatment of policy borrowings by the insured? (P.10)

Is any deduction permitted for the interest expense paid? (P.10) See §264. Cf., Code §265 (re tax-exempt bonds & borrowings to acquire).

Income Tax on Proceeds at Death **p.11**

Code §101(a) provides for GI exclusion of proceeds received at death.

Code §101(a)(2) provides for GI inclusion when the policy is transferred for value (ordinary income or capital gain)?

See Code §101(a)(2) exceptions from this GI inclusion for:

- (1) §101(a)(2)(A) – transferred basis;
- (2) §101(a)(2)(B) – transfer to a business partner, etc. Note PLR 9701026, p. 12.

See TCJA-2017 limit, p. 11, fn.16.

Rev. Rul. 2007-13

p.14 Policy Transfers

1) Transfer of life insurance contract from G's Grantor Trust 2 to G's Grantor Trust 1: not a transfer for §101(a)(2) purposes.

2) Transfer of life insurance contract from G's Non-grantor Trust 2 to G's Grantor Trust 1: transfer for §101(a)(2) purposes, but transfer to the insured (Grantor Trust), and an exception is available.

Note: Defective insurance trust situations where the grantor trusts are (1) irrevocable & (2) not-includible for federal estate tax purposes.

Defining “Life Insurance” for Estate Tax p.16

Note Code §7702 defining insurance contracts (and, e.g., not an interest in a mutual fund).

Noel case, p. 16, specifying that “accident insurance” (an “evitable event”) providing for death benefits is life insurance for Code §2042 purposes. How purchase “flight insurance”? Who purchases this insurance?

Use of a credit card?

What is the estate tax treatment of an “office pool” payment received after death (i.e., is this “life insurance”)? P.18.

Code §2042(1) – Executor Receives Policy Proceeds

Inclusion in insured's gross estate? P.18

What if proceeds receivable by an estate “administrator” rather than an executor (e.g., when an intestate estate)?

What if paid under a “creditor life insurance policy”? Example: this policy might be mandated by the lender upon making (1) a home loan or (2) a car loan, with policy proceeds payable directly to the lender (to the extent of the loan balance at the time of death).

“Incidents of Ownership” Inclusion - §2042(2).

What are “incidents of ownership”? P.18-19

See Reg. §20.2042-1(c)(2), including power to:

- 1) change the beneficiary,
- 2) surrender the policy, &
- 3) borrow against the policy.

See Noel case (II), p. 19: he held “incidents of ownership” – he had not assigned his interest to her (at the airport). The ownership assignment needed to be in writing. Why?

Rev. Rul. 84-179 p.21

Insured as trustee

Code §2042(2) incidents of ownership issue:

D purchased policy; transfers policy to spouse. Spouse dies, with residuary trust (& D as trustee holding policy for child).

D is designated as substitute trustee and as the trustee holds the policy on D's life. Trustee has broad discretionary powers (& for the policy).

Holding: No §2042(2) inclusion since D did not transfer the policy into the trust. Is this the correct result? §2042(2) specifies "possessed."

Indirect Holding of “Incidents”

p.23

PLR 9348028. Insured is employee, director and shareholder (less than 50%) in a bank.

Bank is trustee of insured’s insurance trust, but the insured is not on the trust committee & holds no other fiduciary powers re the policies.

Restriction on officers re §2042(2) power.

Here “split dollar” policies purchased by the bank & never owned by the insured.

Held: No incidents of ownership to the insured.

Partnerships & “incidents of ownership”? P.26

What treatment to partner when the partnership owns policy on life of the partner?

Planning: Specify in the partnership agreement that the insured partner has no capacity re the partnership’s policy on that partner’s life?

This inquiry relevant for those partnerships having entity purchase buyouts needing to be funded with life insurance proceeds?

Corporations & “incidents of ownership”?

What treatment where corporation is the beneficiary of the insurance policy on the life of a shareholder?

Inclusion of the proceeds (received by the corporation) in the value of the stock owner by the shareholder (and, then, no double gross estate inclusion by reason of §2042(2)).

Reg. §20.2042-1(c)(6). But, see §2035 discussion below.

Gift Tax & Life Insurance Policy Transfers p.27

- 1) What is the federal gift tax value of a gifted life insurance policy? How determine the “fair market value” of the policy? The “interpolated terminal reserve value” – see Reg. 25.2512-6(a). What is this? The “in-place” value.
- 2) Is the annual donee exclusion available for a gift of a life insurance policy (or is this a “future interest” for §2503(b) purposes)? Query: Can the donee “cash in” the policy?

Estate Tax & Transfers within Three Years p.28

§2035(a) requires gross estate inclusion for policies transferred within three years of death. Why? What about inclusion for annually renewable term policies? P.28.

How deflect the initial policy ownership to either (1) children or (2) irrevocable insurance trust (as beneficiaries)? See Perry case, p. 29. Rejecting *Bel* case “beamed transfer” analysis.

Can beneficiaries apply for insurance on another’s life? How pay the subsequent annual premiums (if the insured provides the funds)?

Reg § 20.2042-1(c)(6)

p.32 Corporate Owner

Corporation is the owner of the insurance policy on the life of the majority shareholder.

Who is the beneficiary under the policy?

1) The corporation? Proceeds enhance value of stock at death.

2) Another beneficiary? Then incidents of ownership to the shareholder?

§2035(a) Transfers?

Controlling (50%+) shareholder:

- 1) Within three years of the death of the controlling shareholder (a) the corporation assigns policy on life of shareholder, and (b) then insured loses control (50%+) of the corp.
- 2) Within three years of death stockholder loses control of stock with corporation owning policy on his life (gift of stock to child/also ins. bene).

Note: Inclusion under §2035 in both situations - proceeds are not payable to the corp.

Group Term Insurance Coverage and “Incidents”

What is “group term” life insurance? P.35.

What are the ownership rights of the employee?

Gross income inclusion? But, Code §79.

Is the termination of employment possibility an “incident of ownership” for estate tax purposes?

Gift tax if rights under policy are transferred?

PLR 9436036, p. 36, re change of insurers after assignment of a policy to an insurance trust – no §2035(a) applicability.

Estate Tax Liability for Insurance Inclusion

1) See Code §2206 (p. 38) re estate tax payment from insurance proceeds if includible in gross estate: (1) proportionate allocation (i.e., not “stacking”), and (2) “unless the decedent directs otherwise in his will.”

2) What about no gross estate inclusion for the policy proceeds when received by an irrevocable trust – but the trust (a) can “loan” these funds to the probate estate to pay taxes, etc. or (b) can buy illiquid assets from the probate estate?

Delayed Receipt of Insurance Proceeds p.40

What options for paying insurance proceeds on a delayed basis: *Interest only* until later date, level payments, life or two lives annuity? See Code §101(c) & (d).

Who specifies this payout regime – the insured?

Why might the insured want to do this?

What if deferral of the receipt of insurance proceeds by beneficiary election? What estate tax risks for the beneficiary (e.g., §2036)?

Life Insurance Trusts

p.41

Options for creating life insurance trusts:
revocable - irrevocable; funded - unfunded?

1) Gift tax considerations? Annual donee exclusion for annual premium payments?

Crummey power availability for gift tax?

2) Income tax/Subpart E? §677(a)(3). P.42.

3) Estate tax planning considerations? Permit insurance funds use for paying taxes, loaning money to estate, buying assets from the estate?

Split dollar insurance

p. 44-53

What is the concept of “split dollar” life insurance?

What are the types of structures for the ownership of the split dollar insurance policy? Employer or the employee? Donor or donee?

What are the various tax risks?

- 1) Income tax**
- 2) Gift tax**
- 3) Estate tax.**

Community Property Policies

p.54

Who can designate the beneficiaries of a community property life insurance policy?

How determine if a policy is a “community property” policy? State law (Bosch case).

If a community property policy exists, how allocate a portion of the proceeds to the surviving spouse (if not the beneficiary)?

See Parson case, p. 55 (policies were initiated in a separate property jurisdiction).

“Inception of title” (TX) or “proportionality”?

Community Property Policies, cont.

Rev. Rul. 2003-40, p. 57:

Decedent purchased policy on decedent's life with community funds (spouse as beneficiary).

Decedent named as owner, but only actual $\frac{1}{2}$ ownership by the decedent (under state law).

Only one-half of the proceeds are includible in the insured's gross estate. Remainder belongs to surviving spouse (assume community prop.).

Note "duty of consistency," p. 59 (e.g., where non-insured spouse dies first & no inclusion).

Insurance on the Life of Another p.60

Example: Wife owns a policy on life of husband and wife (non-insured owner) dies (& not community property; cf., Rev. Rul. 2003-40).

See Reg. §20.2031-8(a).

Inclusion of the (unmatured) value of the policy in the policy owner's gross estate.

Community property policy: $\frac{1}{2}$ of the unmatured policy is includible in the deceased spouse's estate.

Life Insurance and Charitable Gift Planning

P. 61.

Can a charity own a policy on the life of an individual (e.g., a large donor)?

Depends on state law re whether a charity can have an “insurable interest”? Alternatively, insured initiates policy and transfers policy.

See §170(f)(10) re limit on charitable deduction when split dollar life insurance.

Viatical Settlement Arrangements p.62

§101(g) re viatical settlements.

Issue concerns amounts received for policy before death when amount received exceeds income tax basis in the policy not includible in gross income for income tax purposes.

Why this specialized treatment?

If §101(g) not applicable what income tax treatment for amount received for insurance policy sale during lifetime?

Long term care insurance

p.62

Not life insurance – but insurance to cover costs of continuing to live.

Insurance to cover the long term costs of the last illness and similar additional costs of the client.