Tax & Business Alert – April 2022

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Abstract: Individuals who have a life insurance policy probably want to ensure that the benefits their families will receive after their deaths aren't included in their estates. That way, the benefits won't be subject to the federal estate tax. This article discusses the ins and outs of life insurance plans and estate taxes.

Shield your life insurance from federal estate tax

If you have a life insurance policy, be aware that the proceeds your beneficiary receives could be subject to federal estate tax. That is, unless you take steps to ensure that the policy isn't part of your estate.

What to do

Life insurance proceeds will be included in your taxable estate if:

- Your estate is the beneficiary of the insurance proceeds, or
- You possessed certain economic ownership rights (called "incidents of ownership") in the policy at your death (or within three years of your death).

The first situation is avoidable simply by making sure your estate isn't the designated beneficiary of the policy. The second situation is more complicated. If you possess any of the incidents of ownership of the policy, the proceeds will be included in your estate regardless of the beneficiary, even if someone else has legal title to the policy. To avoid that result, you must not retain the right to:

- Change beneficiaries,
- Assign the policy (or revoke an assignment),
- Borrow against the policy's cash surrender value,
- Pledge the policy as security for a loan, and
- Surrender or cancel the policy.

Note: Merely *having* any of the above powers will result in the proceeds being included in your estate, even if you never exercise the powers.

Possible solutions

To shield life insurance proceeds from estate tax, here are two options:

1. **Buy-sell agreement.** Life insurance may be purchased to fund a buy-sell agreement for a business interest under a “crosspurchase” arrangement. The proceeds won’t be taxed in your estate unless the estate is the beneficiary. Let’s say two business partners agree that the partnership interest of the first to die will be purchased by the survivor. To fund the obligation, each partner buys, pays all premiums for and retains all ownership rights on a policy on the life of the other partner. When the first partner dies, the insurance proceeds aren’t taxed in the estate of the deceased.
2. **Irrevocable life insurance trust (ILIT).** An ILIT can be established and be the owner of a life insurance policy, purchased with assets from the insured. As long as the insured has no rights of ownership in the policy, the proceeds of the policy won’t be taxed to his or her estate.

Three-year rule

If you’re considering establishing an ILIT or assigning away rights in a policy you own, we can help. However, unless you live for at least three years after taking these steps, the proceeds will be taxed in your estate. For policies in which you never held incidents of ownership, the three-year rule doesn’t apply. Don’t hesitate to contact us with any questions about your situation.