Take a Bite Out of the Estate Tax: Estate Planning with Life Insurance

June 10, 2011

In the movie The Pink Panther Strikes Again, Inspector Clouseau asks a hotel clerk standing near a dog whether his dog bites. The clerk says no. Clouseau reaches down to pet the dog. The dog bites his hand. Taken aback, Clouseau says, "I thought that you said that your dog does not bite!" The clerk responds, "That is not my dog."

Recent changes in the control of Congress have rendered unlikely both the repeal of the estate tax and the hope that the estate tax will not bite. Addressing life insurance in an estate plan is one technique that not only can reduce significantly the potential for estate tax but also provide solutions to other estate planning problems. This article focuses on planning with life insurance to help take a bite out of the estate tax.

Why Focus on Estate Planning with Life Insurance?

Although it is commonly known that a beneficiary receives insurance proceeds free of income tax, it is less understood that the value of insurance proceeds may be subject to estate tax. With proper planning, estate tax on insurance proceeds can be avoided. Moreover, the ability to pass insurance proceeds free of estate tax provides the opportunity to create liquidity or replace value used to pay the tax.

What Is the Law?

Section 2042 of the Internal Revenue Code provides that life insurance proceeds are taxable in the estate of the insured if (1) the proceeds are paid to the insured's estate or (2) the insured retained any "incidents of ownership" in the policy. Outright ownership is an "incident of ownership." Certain rights less significant than ownership also can result in estate taxation. For example, the rights to change the beneficiary of a policy and to borrow against a for the purpose of paying premiums are "incidents of ownership."

How Can Estate Tax on Life Insurance Proceeds Be Avoided?

The keys to preventing estate tax on life insurance proceeds are avoidance of (1) payment to the insured's estate and (2) "incidents of ownership." Planning techniques to accomplish these goals include:

1. Having another person or entity apply for and purchase a new policy on an insured's life; and
2. Transferring all "incidents of ownership" in an existing policy to another person or entity.

If the insured never owns a policy, then the proceeds typically will not be taxed in the insured's estate, even if the insured dies shortly after the policy is acquired. With the transfer of all "incidents of ownership" in an existing policy, however, the insured must survive three years from the date of transfer to avoid estate tax on the proceeds.

As a result, anyone with a taxable estate (presently, more than $2,000,000 for an individual or $4,000,000 for a married couple with appropriate estate tax planning built into their wills) should consider avoiding the purchase or continued ownership of life insurance on their own life. Possibilities for alternative ownership include children, irrevocable trusts, limited partnerships, or limited liability companies. Planning with life insurance in this manner can produce dramatic estate tax savings.

Example of Estate Tax Savings

Assume that a Taxpayer owns a life insurance policy with proceeds of $2,000,000. His daughter is the beneficiary. He owns other assets with a total value of $2,000,000. His will leaves all of his assets to his daughter. If he dies in the year 2007, what are the estate tax consequences of his policy ownership? What would be the impact of appropriate estate planning with the policy?

	Insured Owns Policy	Insured Does Not Own Policy
1. Total Assets	$4,000,000	$4,000,000
2. Taxable Estate	$4,000,000	$2,000,000
3. Approximate Estate Tax Owed	$ 900,000	$ 0
4. Remaining Assets	**$3,100,000**	**$4,000,000**

With appropriate estate planning for his insurance policy, the Taxpayer could avoid **$900,000** of estate taxes. This would be a significant bite out of the potential estate tax and a significant benefit to the Taxpayer's daughter.

What Are Additional Estate Planning Opportunities With Life Insurance?

The ability to pass life insurance proceeds free of estate tax also provides other planning opportunities. These include (1) creating estate liquidity and (2) providing wealth replacement.

If an estate has estate tax liability, the tax typically must be paid *in cash* within nine months after the decedent's death. Many people own assets that are difficult or costly to convert to cash within a nine-month period, such as a closely-held business interest, real estate, or an IRA. The removal of cash from an IRA can result in significant income tax liability in addition to the estate tax liability. Life insurance, however, can create cash at the time the estate tax is due. The cash then can be used to pay the tax, thereby leaving the decedent's assets available to his or her beneficiaries. Even if liquidity is not a problem, life insurance proceeds could replace cash used to pay the estate tax. Careful estate planning can ensure that insurance purchased for liquidity or wealth replacement purposes solves the concerns without adding to the estate tax.

Life insurance offers significant estate planning opportunities. The critical steps are to recognize the opportunities, analyze the potential benefits, and implement appropriate estate tax avoidance techniques. This can result both in reduction of estate tax liability and resolution of other problems potentially caused by the estate tax. Careful planning with life insurance can help take a bite out of the estate tax.

For further information regarding the issues described above, please contact a member of the Trusts & Estates practice.

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