

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

Written By **Jennifer V. Boyer** (jvboyer@wardandsmith.com)

February 8, 2023



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."

With the looming sunset of the federal estate tax exemption amount – dropping from historic highs of \$12,920,000 per person in 2023 to approximately \$6,000,000 in 2026 – some high net worth families may soon feel an unexpected estate tax bite. While decreases in the estate tax exemption are quite rare historically, the increase in the exemption implemented in the Tax Cuts and Jobs Act of 2017 was crafted to be only temporary. Analysts had speculated its changes would eventually be made permanent, but that appears less likely in today's political climate. Planners are now returning to various techniques, including the life insurance planning discussed in this article, which can take some of the sting out of that estate tax bite.

Why Life Insurance?

Most people understand that insurance proceeds received by a beneficiary are not subject to *income* tax. Many are not aware, however, that the value of those insurance proceeds may be subject to *estate* tax in the estate of an insured. With proper planning, however, estate tax on insurance proceeds can be avoided by ensuring that the policy is not includible in a decedent's taxable estate. Moreover, the ability to pass insurance proceeds free of estate tax provides the opportunity to create liquidity or replace value used to pay other estate tax obligations.

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 policy for the purpose of paying premiums are "incidents of ownership."

How Can Estate Tax on Life Insurance Proceeds Be Avoided?

To prevent estate tax on life insurance proceeds, an insured must avoid (1) payment to the insured's estate and (2) "incidents of ownership." There are two primary techniques to accomplish those goals:

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.

The first approach will work well if a policy is not already in place. 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.

When an existing policy is already in place in the name of the insured, the second approach becomes necessary to avoid estate tax: Transferring all "incidents of ownership" in the existing policy. Congress, however, has codified a claw-back with respect to transfers of existing life insurance policies. To avoid the claw-back and the estate tax on insurance proceeds, the insured must survive three years from the date of the policy transfer.

In light of the above, anyone with a taxable estate should consider avoiding the purchase or continued ownership of life insurance on their own life. While that taxable estate threshold remains high today (\$12,920,000 per person for tax year 2023), it looks fairly certain to dip lower in the coming years. Without legislative action, in 2026, anyone with more than roughly \$6,000,000 (or \$12,000,000 for a married couple with appropriate estate tax planning built into their wills) will find themselves on the undesirable side of that taxable threshold. Insurance policy payouts that seemed perfectly reasonable under our currently-high estate tax thresholds may now push taxpayers over the lower limits set to take effect in 2026. If alternative ownership can be arranged, for instance, by using irrevocable trusts, limited partnerships, limited liability companies, or direct ownership by children, taxpayers can realize dramatic estate tax savings.

What Are The 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 \$6,000,000. His will leaves all of his assets to his daughter. If he dies in the year 2026 after the exemption has fallen back down to (approximately) \$6,000,000, what are the estate tax consequences of his policy ownership?

	<u>Insured Owns Policy</u>	<u>Insured Does Not Own Policy</u>
1. Total Assets	\$8,000,000	\$8,000,000
2. Taxable Estate	\$8,000,000	\$6,000,000
3. Estate Tax Owed	\$ 800,000	\$ 0
4. Daughter's Inheritance:	\$7,200,000	\$8,000,000

With appropriate estate planning for his insurance policy, the Taxpayer could avoid \$800,000 of estate taxes (and, in this particular example, avoid the tax altogether). This would be a significant benefit to the Taxpayer's daughter.

What Additional Planning Opportunities Can Life Insurance Provide?

Unburdening life insurance proceeds from potential estate tax can (1) create estate liquidity and (2) provide wealth replacement.

If an estate has an estate tax liability, the tax typically must be paid *in cash* within nine months after the decedent's death. This poses a significant hurdle for many people owning 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 add an income tax bite to an already-painful estate tax one.

Life insurance, however, can create cash at the time the estate tax is due. The cash 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, replenishing some of the inheritance going to beneficiaries. Careful estate planning can ensure that insurance purchased for liquidity or wealth replacement purposes solves these concerns *without* adding to the estate tax burden.

Summary

Because of its unique treatment in the Internal Revenue Code, life insurance offers distinctive estate planning opportunities. If these opportunities are recognized, and the appropriate techniques are implemented, significant estate tax savings can be realized, and other related burdens can be eased. Families can, indeed, bite back against a more-painful estate tax.

For further information about planning with insurance, please contact our Trusts and Estates team.

--

© 2024 Ward and Smith, P.A. For further information regarding the issues described above, please contact Jennifer V. Boyer.

This article is not intended to give, and should not be relied upon for, legal advice in any particular circumstance or fact situation. No action should be taken in reliance upon the information contained in this article without obtaining the advice of an attorney.

We are your established legal network with offices in Asheville, Greenville, New Bern, Raleigh, and Wilmington, NC.