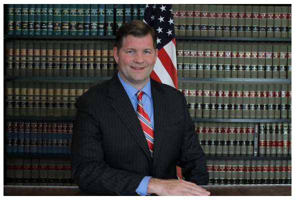

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Estate, Gift, and Generation-Skipping Transfer (GST) Taxation and Life Insurance: Estate Planning

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Don't let taxes steal your family's financial security

Life insurance can provide financial security for your family. However, if you don't plan appropriately, taxes can greatly reduce the life insurance benefits actually received by your family. Although life insurance proceeds are generally received by the beneficiaries free of income tax, you need to understand how life insurance policies and proceeds are taxed for estate, gift, and generation-skipping transfer tax (GSTT) purposes in order to realize maximum benefits from your insurance.

Tip: *Take steps now to keep the federal government from being the unintended beneficiary of your life insurance.*

How is life insurance taxed for estate tax purposes?

Life insurance policies owned by you on the life of another

If you own life insurance on the life of another (the insured), and you predecease the insured, the value of the policy on the date of your death is includable in your gross estate for estate tax purposes. For example, if you buy a policy on your spouse's life and you predecease your spouse, the value of that policy is includable in your gross estate and may be subject to estate taxes. The value of a policy for purposes of inclusion in the estate of a decedent who is not the insured is generally not its face value (i.e., the death benefit) and should be determined by the insurance company. If you die owning insurance policies on the life of another individual, your executor should contact the insurer and request Form 712, which is the form the insurers use to report the value of life insurance policies for tax purposes.

Caution: *Beware of the three-year rule, which causes the value of a policy originally owned by you but transferred to another owner within three years of your death to be included in your gross estate. So, if you're going to transfer ownership of a life insurance policy, do it now while you are in good health.*

Life insurance policies in which you hold "incidents of ownership"

Insurance policies in which you hold incidents of ownership at death are includable in your gross estate for estate tax purposes. Incidents of ownership is a legal term, which refers to the right of the insured to control the economic benefits of the policy. This definition encompasses more than outright ownership in that policy and includes the power: (1) to change the beneficiaries of the policy; (2) to pledge the policy for a loan; (3) to surrender or cancel the policy; (4) to assign the policy; or (5) to borrow against the surrender value of the policy. A reversionary interest in a life insurance policy is also treated as an incident of ownership in that policy and will result in inclusion of the value of the policy in the insured's estate if the value of the reversionary interest immediately before the insured's death exceeds 5 percent of the value of the policy. A reversionary interest in a life insurance policy includes the possibility that the policy or its proceeds may return to the insured or his estate or may be subject to power of disposition (e.g., a power of appointment) by the insured.

Caution: *The three-year rule applies here too, so even if you transfer away all incidents of ownership, the value of the policy will still be includable in your gross estate if you die within three years after the transfer takes place.*

Life insurance proceeds from policies on which you (the insured) paid premiums

If you purchase a policy on your own life, pay premiums on the policy, and then transfer the policy to another owner within 3 years of your death, a portion of the proceeds may be includable in your gross estate for estate tax purposes. The includable portion is calculated by dividing the premiums you paid by the total premiums paid and multiplying the proceeds by the resulting fraction.

Example(s): *You buy a $1 million policy on your own life and over 5 years, you pay $9,000 in premiums. After the fifth year, you transfer the policy to your daughter who takes over the payment of the premiums until your death 2 years later. Your daughter pays $18,000 in premiums. The amount of proceeds includable in your gross estate is roughly $333,333 ($1,000,000 x [$9,000 ÷ ($18,000 + $9,000)]).*

Proceeds payable to or for the benefit of your estate

Proceeds from policies owned by you or another and made payable directly to your estate are includable in your gross estate. Proceeds payable indirectly to your estate are also includable. Proceeds are considered paid indirectly to your estate if they are used to pay estate taxes, debts, or other expenses of your estate.

Tip: *The IRS generally follows state law if state law provides that life insurance proceeds received by an estate are treated as if received by the ultimate beneficiary (and therefore are not part of the decedent's gross estate). The proceeds in this case will not be included in the decedent's gross estate only if the decedent did not own the policy upon his or her death or within three years of his or her death or if the proceeds are directed by the decedent's will to a nontaxable beneficiary such as a charity or the decedent's spouse.*

Tip: *If you live in a community property state, only one-half of the proceeds of policies on your life which you own but which were paid for with community funds are includable in your gross estate.*

Proceeds payable to your executor

Proceeds made payable to your executor are generally deemed payable to your estate and are subject to estate taxes.

Tip: *Again, the IRS generally follows state law if the law dictates that life insurance proceeds received by an executor are treated as if received by the ultimate beneficiaries of the decedent's estate.*

Tip: *Again, if you live in a community property state, only one-half of the proceeds of policies on your life which you own but which were paid for with community funds are includable in your gross estate.*

Proceeds diverted to your estate

If your named beneficiary is barred from collecting the proceeds (e.g., because he or she has intentionally killed you) and you have not named a secondary or final beneficiary, the proceeds are payable to your estate.

Tip: *To avoid this result, you will want to name a secondary and/or a final beneficiary.*

Tip: *Once again, if you live in a community property state, only one-half of the proceeds of policies on your life which you own but which were paid for with community funds are includable in your gross estate.*

Proceeds payable to your spouse

The unlimited marital deduction allows your spouse to receive life insurance proceeds free of estate taxes even if you own the policy on your death. However, the proceeds will be subject to estate taxes in your spouse's estate at your spouse's death unless, of course, your spouse spends them all first or remarries and uses the unlimited marital deduction. If the proceeds of life insurance policies on your life are payable to your spouse, you will not necessarily avoid estate taxes, you may only postpone them.

Tip: *If you want the proceeds to eventually reach your children after benefitting your spouse during his or her remaining life if he or she survives you, you need to arrange to have the proceeds pass to a special type of trust known as a qualified terminable interest property (or QTIP) trust or, if your spouse is not a U.S. citizen, to a qualified domestic trust (or QDOT).*

Caution: *If you and your spouse die simultaneously, the Uniform Simultaneous Death Act (USDA) provides that the beneficiary (your spouse) will be presumed to have died first. This means that the unlimited marital deduction will not be applicable to shelter the proceeds from estate tax.*

Who is liable for estate taxes due?

Any person who receives proceeds is liable for any estate taxes that may be owed on such proceeds. The IRS can trace the proceeds as far as they go and collect from a beneficiary's other assets if the proceeds have already been spent.

Generally, the executor pays the estate taxes from the estate's probate assets. However, the executor has the right to recover any taxes resulting from inclusion of the proceeds in the decedent's estate from the beneficiaries who receive those proceeds. The decedent may direct the executor in his or her will to pay taxes from a specific share or group of assets or may waive the estate's right to recover taxes from a beneficiary. The taxes chargeable to the share of a particular beneficiary are proportionate to the beneficiary's share of the proceeds. In other words, if a beneficiary received one-half of the proceeds, he or she is only liable for one-half of the taxes associated with inclusion of the proceeds in the decedent's estate. A surviving spouse who receives proceeds that qualify for the unlimited marital deduction would be under no obligation to contribute toward the payment of taxes resulting from inclusion of the proceeds in the decedent's estate. This is because there are no taxes associated with inclusion of the proceeds in the decedent's estate if the proceeds pass tax free to the surviving spouse.

Tip: *You can direct how the tax burden will be apportioned in your will so that you can place it on the shoulders of those best able to carry it. The IRS will generally abide by these directions.*

How is life insurance taxed for gift tax purposes?

Outright gifts of life insurance policies

An outright gift of a life insurance policy to another individual is a taxable event, subject to gift taxes, as long as you do not retain any incidents of ownership. The gift is valued on the date of the transfer. The value of the gift is generally the interpolated terminal reserve or the cash value of the policy. The insurance company is the only reliable source of a policy's value and can provide on request Form 712, which states the value of the policy as of a particular date and can be used to verify the value for estate or gift tax purposes. The $16,000 (in 2022) annual gift tax exclusion is applicable to gifts of life insurance. Gifts from one spouse to another qualify for the unlimited marital deduction. A gift to a qualified charity qualifies for the charitable deduction.

Transfers to an irrevocable trust

Transfers of life insurance policies to an irrevocable trust and subsequent payments of premiums are both taxable gifts. The date of the taxable event is the date of transfer or payment. The value of the gift is either the replacement value of the policy or the sum of a proportionate part of the most recent premium paid prior to the gift and covering a period that extends beyond the gift, plus the policy's interpolated terminal reserve value (approximately the cash surrender value). Gifts made to an irrevocable trust qualify for the unlimited marital deduction if it is a QTIP trust. A charitable deduction may be allowed for the value of the charity's interest in an irrevocable split-interest trust. The annual gift tax exclusion is generally not applicable to gifts to a trust unless the trust includes a Crummey withdrawal provision. This is because in many cases, trusts create future interest in their beneficiaries and the annual gift tax exclusion can be applied only to gifts of present interest.

Transfers to a revocable trust

If the trust is revocable, the date of the taxable event is the date on which distributions are made to the beneficiaries because prior to this date, the gift is revocable and therefore not complete. The annual gift tax exclusion, the unlimited marital deduction, and the charitable deduction are generally not applicable to gifts to a revocable trust since the gift is incomplete for gift tax purposes and therefore not taxable. When the gift becomes complete (i.e., when a payment is made from the trust to a beneficiary), then various exclusions and deductions from the gift tax may be applicable.

Third-party gifts

If you own a policy on the life of someone other than yourself (the second party), the proceeds of which are payable to a beneficiary who is not yourself or the insured (the third party), you will have made a gift to the third party: (1) upon the death of the second party, or (2) upon making the beneficiary designation, if it is irrevocable. The value of the gift is determined as of the date that the gift is complete.

Payment of premiums on behalf of another

If you pay a premium on a policy owned by another, you have made a taxable gift to the owner. The amount of the gift is the amount of the premium paid.

If the owner of the policy is an ILIT, transfers you make to the ILIT to cover premiums on the policy are taxable gifts to the beneficiaries of the trust. If the ILIT is properly drafted, the annual exclusion will be applicable to transfers to an ILIT. If a beneficiary of an ILIT makes premium payments, he or she has made a taxable gift to the other beneficiaries of the ILIT. Again, if the ILIT is properly drafted, the annual exclusion will be applicable to such transfers.

Gift by lapse of power

If a primary beneficiary is entitled to receive proceeds under a settlement option but allows his or her power to withdraw the proceeds to lapse such that the secondary beneficiary becomes entitled to the proceeds, then the primary beneficiary has made a taxable gift to the secondary beneficiary.

Example(s): *Rob dies. Rob's life insurance policy names Lisa as primary beneficiary under a settlement option that gives Lisa the right to receive all the interest each year and to withdraw a stated amount of principal once a year. The settlement option also names secondary beneficiaries who will receive the remaining principal upon Lisa's death. The first year, Lisa receives the interest but does not exercise her right to withdraw principal. Her power to withdraw this stated amount of principal lapses and the lapse is a taxable gift to the secondary beneficiaries.*

Who is liable for gift taxes owed?

The donor (person making the gift) is responsible for payment of gift taxes on that gift. However, the donee (person receiving the gift) is liable for any taxes not paid by the donor. With a gift of life insurance, the donee's liability extends beyond the cash value of the policy (i.e., the IRS can go after any of the donee's assets). Where the donee pays taxes on a gift by the donor, it is called a net gift — the calculation of gift tax due on a net gift is very complicated but the net effect is to reduce the overall gift taxes due since the donee's actual gift is reduced by the gift taxes he or she paid on the gift (i.e., the donee is treated as having "bought" the gift for the price of the taxes) — no taxes are assessed against the portion of the gift paid for by the donee since this portion wasn't really a gift.

How is life insurance taxed for GSTT purposes?

A quick lesson on the GSTT

The GSTT is an excise tax levied when you transfer property either during life or at death to a skip person. A skip person is someone two or more generations below you (e.g., a grandchild or great-nephew). GSTT can be imposed on gifts to persons outside your family as well. Generations for non-family members are determined based on the number of years younger than the transferor the transferee is. The GSTT is imposed on transfers to skip persons at the highest federal gift and estate tax rate then in effect (40 percent for transfers made in 2013 and later years), in addition to any gift taxes or estate taxes assessed on the transfer.

Outright transfers to skip persons

Life insurance is generally treated the same as any other type of property for GSTT purposes. Thus, an outright gift of a life insurance policy to a skip person is a taxable event, subject to gift tax and GSTT, as long as you do not retain any incidents of ownership in the policy. The gift is valued on the date of the transfer and the value of the gift should be obtained from the insurer and can vary depending on the type of policy. In most cases, the annual gift tax exclusion can be applied to gifts to a skip person.

Transfers to a trust

When all trust beneficiaries are skip persons, transfers to the trust will be subject to the GSTT. The trust must meet certain requirements to qualify for the annual GSTT exclusion. Every individual has a limited lifetime exemption that can be applied to generation-skipping transfers. This exemption is $12,060,000 in 2022. If some or all of an individual's lifetime exemption is applied to a transfer to a trust (whether or not that trust currently has beneficiaries who are skip persons), a portion or all of the subsequent distributions from the trust to skip persons will not be subject to the GSTT. The exemption is automatically applied to direct skips (transfers by an individual directly to a skip person or to a trust who is a skip person).

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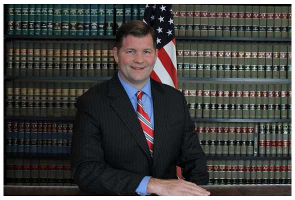

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