Life insurance and an estate plan may not always mix well

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A life insurance policy can be an important part of an estate plan. The tax benefits are twofold: The policy can provide a source of wealth for your family income-tax-free, and it can supply funds to pay estate taxes and other expenses.

However, if you *own* your policy, rather than having, for example, an irrevocable life insurance trust ("ILIT") own it, you'll have to take extra steps to keep the policy's proceeds out of your taxable estate.

3-year rule explained

If you already own an insurance policy on your life, you can remove it from your taxable estate by transferring it to a family member or to an ILIT. However, there's a caveat.

If you transfer a life insurance policy and don't survive for at least 3 years, the tax code requires the proceeds to be pulled back into your estate. Accordingly, the proceeds may be subject to estate taxes.

Fortunately, there's an exception to the 3-year rule for life insurance (or other property) you transfer as part of a "bona fide sale for adequate consideration." For example, let's say you wanted to transfer your policy to your daughter. You could do so without triggering the 3-year rule as long as your daughter paid adequate consideration for the policy (i.e., a sale of the policy - and not a gift of the policy - to your daughter).

Determining adequate consideration isn't an exact science. One definition is fair market value, which is essentially the price on which a willing seller and a willing buyer would agree.

Triggering the transfer-for-value rule

The problem with the bona fide sale exception is that, when life insurance is involved, it may trigger another, equally devastating, rule: the transfer-for-value rule. Under this rule, a transferee who gives valuable consideration for a life insurance policy will have gross income taxed at ordinary income tax rates on the amount by which the proceeds exceed the consideration and premiums the transferee paid.

So, in the previous example, even if your daughter purchased the policy for the appropriate amount to avoid the three-year rule, she could be subject to some income tax when she receives the proceeds.

However, several key exceptions to the transfer-for value rule exist, such as the transfer of the policy is to the insured, to a partner (or member) of the insured, to a partnership (or limited liability company) in which the insured is a partner (or member), or to a corporation in which the insured is a shareholder or officer. It is critical to ensure that the transfer of the policy falls into an exception to the transfer-for-value rules to avoid subjecting the policy proceeds to income tax upon the insured's death.

Recipe for success: Selling to a trust

It may be possible to avoid the three-year rule — without running afoul of the transfer-for-value rule — by selling an existing life insurance policy for adequate consideration to an irrevocable grantor trust. A grantor trust is a trust structured so that you, the grantor, are the owner for *income* tax purposes but not for *estate* tax purposes. An ILIT can be structured as a grantor trust, in which case a sale by you to the ILIT for adequate consideration will avoid both the 3-year rule (via a sale for adequate consideration) and the transfer-for value rule (via the transfer of the policy to the insured exception - you, as insured, are transferring the policy to you, the insured, by being treated as the owner of the trust for income tax purposes under the grantor trust rules).

Of course, the best approach would be for the ILIT to be the owner and beneficiary of the insurance policy on your life from the inception of the policy. Because no policy transfer is involved in such situation, the 3-year rule and transfer-for-value rule never come into play.

While there's been talk of an estate tax repeal, it's still uncertain if and when that will happen. If your estate is large enough that federal and/or state estate taxes could be an issue, it's best to continue to factor that into your planning. Please contact us if you have questions about how you should address your life insurance policy in your estate plan.

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