Why you should keep life insurance out of your estate

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If you have a life insurance policy, you probably want to make sure that the life insurance benefits your family will receive after your death won't be included in your estate. That way, the benefits won't be subject to the federal estate tax.

Under the estate tax rules, life insurance will be included in your taxable estate if either:

- 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 easy to avoid. You can just make sure your estate isn't designated as beneficiary of the policy.

The second situation is more complicated. It's clear that if you're the owner of the policy, the proceeds will be included in your estate regardless of the beneficiary. However, simply having someone else possess legal title to the policy won't prevent this result if you keep so-called "incidents of ownership" in the policy. If held by you, the rights that will cause the proceeds to be taxed in your estate include:

- The right to change beneficiaries;
- The right to assign the policy (or revoke an assignment);
- The right to borrow against the policy's cash surrender value;
- The right to pledge the policy as security for a loan; and
- The right to surrender or cancel the policy.

Merely *having* any of the above powers will cause the proceeds to be taxed in your estate even if you never exercise the power.

Buy-sell agreements

If life insurance is obtained to fund a buy-sell agreement for a business interest under a "cross-purchase" arrangement, it won't be taxed in your estate (unless the estate is named as beneficiary). For example, say Andrew and Bob are partners who agree that the partnership interest of the first of them to die will be bought by the surviving partner. To fund these obligations, Andrew buys a life insurance policy on Bob's life. Andrew pays all the premiums, retains all incidents of ownership, and names himself as beneficiary. Bob does the same regarding Andrew. When the first partner dies, the insurance proceeds aren't taxed in the first partner's estate.

Life insurance trusts

An irrevocable life insurance trust ("ILIT") is an effective vehicle that can be set up to keep life insurance proceeds from being taxed in the insured's estate. Typically, the policy is transferred to the ILIT along with assets that can be used to pay future premiums. Alternatively, the ILIT buys the insurance with funds contributed by the insured person. So long as the trust agreement gives the insured person none of the ownership rights described above, the proceeds won't be included in his or her estate.

The three-year rule

If you're considering setting up a life insurance trust with a policy you own now or you just want to assign away your ownership rights in a policy, please contact us to help you make these moves. Unless you live for at least three years after these steps are taken, 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.

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