

Many persons believe that life insurance is tax-free. Generally, death benefits payable under a life insurance policy are income tax free. However, they may be subject to transfer taxes, that is, estate, gift and/or generation skipping taxes, depending upon the circumstances.

Estate Taxes

If you die owning any incidents of ownership in a policy on your life, such as the right to designate the beneficiary, to borrow against the policy's cash value or to surrender the policy, the death benefit will be included in your estate for federal estate tax purposes, even though someone else is designated as the beneficiary and receives the death proceeds. If your spouse is the designated beneficiary, your estate will be entitled to an offsetting marital deduction. However, upon your surviving spouse's death, any unconsumed life insurance proceeds would be included in the survivor's estate. If the survivor's estate, including the unconsumed proceeds, exceeds the survivor's available exemption amount (maximum of \$2,000,000 in 2008 rising to \$3,500,000 in 2009), estate taxes will be due based, in part, on such proceeds.

If you donate existing life insurance you own on your life to an irrevocable life insurance trust for the benefit of

your spouse

and/or children, the death proceeds will be excluded from your estate and your spouse's estate, provided you survive at least three years from the donation. If the trust initially purchases a policy on your life, there is no three-year waiting period, even though you may be providing the funds to pay the premiums.

It makes little sense for either you or your spouse to be the owner of insurance on both of your lives ("second-to-die" life insurance) and have it included in your estates, unless your access to cash values is important. An irrevocable life insurance trust can avoid estate taxes and insure that the proceeds from the second-to-die policy are not spent by the heirs before your death taxes are paid.

Gift Taxes

The donation of an existing policy or your future premium payments on a policy owned by a trust will have gift tax implications. You can gift up to \$12,000 per year, per donee, without having to file a federal or state gift tax return and without incurring gift taxes ("annual gift tax exclusion"). A married couple can donate up to \$24,000 per year, per donee. Only gifts of a "present" interest which the donee can immediately use and enjoy on an unrestricted basis qualify for the annual gift tax exclusion. A gift of a policy to a trust and future premium payments thereon normally do not qualify for the annual gift tax exclusion because the beneficiary's enjoyment is postponed to some future date.

One important exception is a trust which gives the beneficiary the right, for a limited period of time after timely notice, to withdraw all or a portion of each transfer to the trust, not to exceed the annual exclusion amount. This right is deemed to be a "present" interest in the gift which qualifies for the annual gift tax exclusion, even though the withdrawal right lapses after the stated withdrawal period and the property thereafter remains subject to the terms of the trust.

Other Considerations

In addition to being an important estate planning tool for decreasing death taxes, the irrevocable life insurance trust can provide for asset management and preservation, particularly if the beneficiaries are not mature enough to handle the insurance proceeds. Any proceeds paid to a child age 18 or over will be exclusively under the child's control. You can designate in a trust who will have control over investment and distribution decisions and at what ages or under what conditions the trust will terminate. However, the trust must be carefully drafted to avoid tax pitfalls and to accomplish your specific objectives. You should obtain competent legal counsel in this area.

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