Preserving Tax Shelter for Life Insurance

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It's well known that the beneficiaries of a life insurance policy do not have to pay federal income tax on the proceeds. But what about other taxes? As a general rule, payouts under a life insurance policy are subject to federal estate tax.

Possible Solution

Consider the use of a "life insurance trust." If the trust is set up properly, the insurance proceeds are not included in your taxable estate. So this amount can pass to the designated beneficiaries without any estate-tax erosion. That's true even if you give the trust the funds to pay the policy premiums each year.

This tax break is available if the policy is not issued to you as the owner and you do not retain any other "incidents of ownership." This includes the right to borrow against the policy or change the designated beneficiaries.

Caution

Life insurance trusts are not for everyone. Besides the aforementioned restrictions, there are costs and other factors to consider. Whether or not you should use a trust depends upon your particular situation. For example, to achieve the desired tax results, the trust must be irrevocable. If your family's financial condition changes significantly, you cannot recover the policy or other trust assets.

Suppose that your spouse is well provided for and your adult children, whose judgment is sound, are the intended beneficiaries of your insurance policy. You could give cash to your children, and they could take out a policy on your life naming themselves as beneficiaries. If you have an existing policy, you can transfer it and all powers over it to them. The proceeds are not included in your taxable estate and don't have to pass through probate (but proceeds are subject to estate tax if you die within three years of transferring the policy).

What about gift tax on the cash gifts that go toward the premium payments? The transfers may be sheltered by the annual gift-tax exclusion. For 2009, transfers of up to $13,000 per year per recipient are exempt from gift tax ($26,000 for joint gifts by a married couple). To take advantage of the annual gift-tax exclusion for a transfer to a trust, the children must have a limited right to withdraw the funds from the trust. With a straight cash gift to your children, there are no such problems.

Other estate-planning techniques may be more suitable for your situation. So when is creating a life insurance trust the "right thing" for someone to do? It may be particularly appropriate when insurance needs are high (e.g., a business interest makes up a large part of an estate) or additional assets are needed to provide support for a surviving spouse and minor children.

This is just a brief overview. Consult with your experienced Henry & Horne, LLP estate planner regarding your personal situation.

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