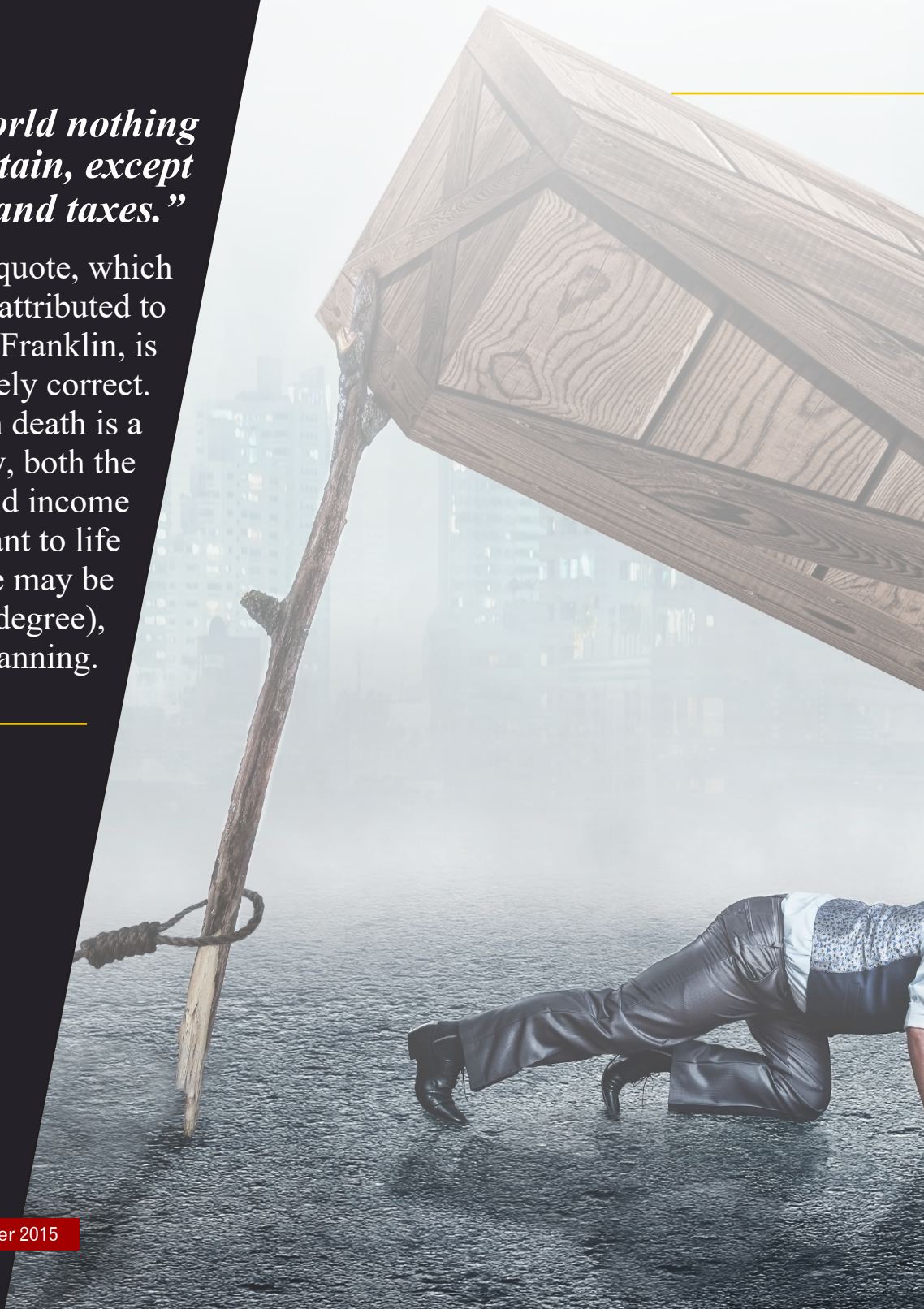
AVOIDING



"In this world nothing can be certain, except death and taxes."

This famous quote, which has been attributed to Benjamin Franklin, is not absolutely correct. Although death is a certainty, both the estate taxes and income taxes attendant to life insurance may be avoided (to a degree), with careful planning.

LIFE INSURANCE TAX TRAPS

BY A. COLLINS HUNSAKER, ESQ. AND JASON C. WALKER, ESQ.

Avoiding Estate Taxes through an Irrevocable Life Insurance Trust

Pursuant to the general rule, the death benefit received by a beneficiary is not includable in calculating the beneficiary's gross income for federal tax purposes.[1] However, life insurance proceeds may be subject to estate tax if deemed includable in the insured's estate.[2] The Internal Revenue Code (IRC) outlines the following situations in which the proceeds of life insurance are includable in the insured's estate:

- The proceeds are payable to the insured's estate, or are receivable for the benefit of the insured's estate.
- The proceeds are payable to a beneficiary other than the insured's estate, but the insured possessed one or more incidents of ownership in the policy at the time of the insured's death, whether exercisable by the insured alone or

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only in conjunction with another person.

- The insured has made a gift of the policy on his or her life within three years before his or her death.[3]

To ensure that proceeds of life insurance remain outside of the insured's taxable estate, it is often recommended that a life insurance policy be purchased and owned by what is commonly referred to as an irrevocable life insurance trust (ILIT). An ILIT is a complex trust agreement that must be carefully drafted and administered to achieve its intended objectives. For instance, the ILIT should clearly identify the beneficiary, and it should avoid any indication that the beneficiary has an obligation to pay taxes, debts or other charges that are enforceable against the estate.[4] Further, the insured should not act as the trustee of the ILIT, and the ILIT should vest all incidents of ownership in the trustee.

The term incidents of ownership may include any of the following:

- The power to change the beneficiary;[5]
- The power to surrender or cancel the policy, assign the policy, to revoke an assignment, to pledge the policy for a loan or to obtain from the insurer a loan against the surrender value of the policy;[6] or
- The power to change the beneficial ownership in the policy, or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust.[7]

The administration of an ILIT and the life insurance owned therein should also require the ILIT to be sufficiently funded to allow for the life insurance premiums to be paid as they become due. Generally, the insured will make gifts to the ILIT that are designed to be treated as excludable under what is generally known as the "annual exclusion."[8] This may be a tedious task, as the rules require the gift to an ILIT to be a transfer of a present interest to qualify for the annual exclusion. A present interest implies that the beneficiary can utilize the gift immediately. In *Crummey v. Commissioner*, the court established that a gift qualifies as a present interest if a beneficiary has received notice of the gift and has a present right to withdraw all or a portion of the gift made to the ILIT. 397 F.2d 82 (9th Cir. 1968). Typically this notice is sent as a letter informing the beneficiary of his or her right to withdraw the gift for a limited period of time.

Using Life Insurance in Business Planning

When advising business owners regarding their estate planning, life insurance can be very useful tool for funding buy-sell agreements. The issue presented is: "How will the surviving partner(s) purchase the interest of a deceased partner?" Generally, business partners do not want to be in a continued partnership with a deceased partner's spouse or children, thus, life insurance purchased by the business or the other partners on the life of the deceased partner may provide the needed liquidity to purchase the deceased partner's interest from his or her estate. Partners also gain comfort in knowing that their estate will quickly receive cash payment in exchange for the business interest when they die. Further, if the deceased partner plays a key role in the business, making it difficult to immediately replace the partner, life insurance can also provide the business with a much needed liquidity to assist with recruiting costs or the cost of training and developing a new employee or partner.

Life insurance funded buy-sell agreements usually take one of the following forms:

Cross-Purchase

Each partner will purchase life insurance on all of the other partners, naming himself or herself as the beneficiary of the policy, thereby providing the liquidity allowing the surviving partners to purchase the shares of the deceased partner. Complexities exist with this method if multiple policies are needed for each partner, or if the relative health and insurability of each partner is not

equivalent. For example, a business with four partners will require 12 life insurance policies. And if one of the four partners is significantly older or is not as insurable, then the cost for each of the other three partners will be greater than it is for the less-insurable partner.

Redemption

When there are multiple partners in the business, sometimes a redemption technique makes sense. This method would require the business itself to own the life insurance on each partner and, upon the death of a partner, the business itself redeems the deceased partner's interest from the estate of the deceased partner.

Hybrid

There are also different hybrid techniques that utilize trusts or business entities to hold the life insurance in an effort to provide the benefits of both of the above methods, while minimizing the negative aspects.

Business owners should take caution and seek the advice of insurance and tax experts whenever purchasing life insurance and engaging in business planning in anticipation of buy-sell agreements. Due to a fairly recent income tax law, life insurance proceeds received by a business entity may be partially taxable if the policy is classified as Employer Owned Life Insurance (EOLI).[9] Although a thorough discussion of the definition an EOLI policy is outside the scope of this article, it is easy to fall into the EOLI tax trap, as it easily encompasses most small business

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situations in which a business owns life insurance on one of the partners. An exception to this rule, however, allows for avoidance of the EOLI tax. This exception requires the following:

- The employee is notified in writing that the insurance policyholder intends to insure the life of the employee along with notice of the maximum face amount for which the employee could be insured when the contract was purchased;
- The employee provides written consent to being insured and that the insurance coverage may continue even after employment ends;
- The employee is informed, in writing, that the policyholder will be a beneficiary of any proceeds from the policy upon the death of the employee.[10]

With careful planning, life insurance traps can be avoided. For instance, through the use of an ILIT, life insurance proceeds may not be includable in the insured's estate, if it is carefully implemented and administered. Further, life insurance proceeds may play a powerful role in business planning if careful attention is given to estate and income tax laws. When faced with life insurance and tax planning, clients should seek the advice of an attorney or tax advisor familiar with both the income and estate tax laws surrounding life insurance. **NL**

1. I.R.C. §101(a)(1) (2014).
2. The federal estate tax provides a lifetime exemption amount of $5,430,000 for 2015 and a tax rate of 40 percent for value in excess of the exemption amount.
3. I.R.C. §§ 2042 and 2038. Life insurance could also be included in the transferor's estate under I.R.C. § 2043 if a policy was transferred for less than adequate and full consideration under §§2035, 2036, 2037, 2038 or 2041.
4. Treas. Reg. § 20.2042-1(b).
5. Treas. Reg. § 20.2042-1(c)(2).
6. *Id.*
7. Treas. Reg. § 20.2042-1(c)(4).
8. I.R.C. §2503(b)(1). The annual exclusion is $14,000 for tax year 2015 and is occasionally adjusted.
9. I.R.C. § 101(j) (2014).
10. I.R.C. § 101(j)(4)(A) through (C).

COLLINS HUNSAKER is an attorney with Jeffrey Burr, Ltd., practicing in the areas of estate planning, asset protection and taxation. Hunsaker obtained his J.D. and his LL.M. in taxation from the Chapman University School of Law. He can be reached at (702) 254-4455 or collins@jeffreyburr.com.

JASON C. WALKER is a partner with Jeffrey Burr, Ltd., practicing in the areas of estate planning, asset protection and taxation. He has been with the firm since 2007. Walker is licensed in Nevada and Utah and has a Master's Degree in accounting from Weber State University, a Juris Doctorate from the University of Wyoming and an LL.M. in taxation from the University of Florida. He can be reached at (702) 433-4455 or jason@jeffreyburr.com.