CHAPTER I

Introduction

1.1 THE ROLE OF LIFE INSURANCE IN ESTATE PLANNING

Before turning to the specific transfer taxation issues arising in connection with life insurance, it is important to consider the place of life insurance in estate planning to minimize transfer taxation. That planning primarily involves lifetime gifts of life insurance policies in order to remove the death proceeds from the insured's gross estate for federal estate tax purposes. In larger estates, the planning will also include techniques to pass life insurance proceeds to or for the benefit of skip persons with no or minimal generation-skipping transfer tax implications.

1.1.1 Transfer Tax Leverage

The reasons for making a gift of a life insurance policy are the same as for any other kind of property. The fundamental tax reason for making lifetime gifts, since the unification of the gift and estate taxes in the Tax Reform Act of 1976,[1] is to avoid transfer taxation of the potential appreciation in value of the donated property between the date of the gift and the donor's death. In the case of a life insurance policy, the appreciation is more than "potential." To qualify as life insurance for federal tax purposes, a policy must have at least a specified amount of pure insurance protection—that is, a death benefit in excess of the policy's cash surrender value.[2] This pure insurance element represents built-in appreciation in a life insurance contract and makes life insurance a uniquely attractive candidate for transfer tax planning.

If the gift of an insurance policy qualifies as a "present interest," the gift tax annual exclusion will reduce the amount of the taxable gift. To the extent the gift tax value of the policy (and of subsequent gifts to pay premiums) exceeds the available annual exclusions, the gift will result in use of the donor's unified credit against gift and estate taxes or in the payment of gift tax if the donor has insufficient unused unified credit to eliminate the gift tax. However, assuming that the policy proceeds are not includible in the donor's gross estate for federal estate tax purposes, only the value of the policy at the date of the gift will constitute part of "adjusted taxable gifts" included in the estate tax base.[3] Thus, the amount subject to transfer taxation will be the value of the policy at the date of the gift, and the excess of the death proceeds over that amount will pass to the beneficiary free of gift or estate taxes.

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[1] Pub. L. No. 94-455.

[2] IRC § 7702. All references to the "IRC" or to the "Code" are to the Internal Revenue Code of 1986, as amended and all references to section numbers in the text are to sections of that Code.

[3] IRC § 2001(b).

This concept of applying the gift tax annual exclusion or unified credit, or paying gift tax, based on the current gift tax value of a life insurance policy, in order to avoid estate taxation of the (larger) death benefit under the policy, is commonly referred to as “leverage.” Leverage is the key to transfer tax planning with life insurance.

1.1.2 Other Transfer Tax Benefits

In addition to avoiding transfer taxation of the difference between the death proceeds and the gift tax value of the policy, a gift of a life insurance policy may have other tax benefits. For example, if the gift results in payment of a gift tax, the amount of the gift tax paid will avoid gift and estate taxation, because the gift tax is computed on a tax-exclusive basis, whereas the estate tax is computed on a tax-inclusive basis. In other words, there is an estate tax imposed on the assets used to pay the estate tax, but no gift tax is imposed on the assets used to pay the gift tax. The donor must, however, survive for more than three years after the gift to achieve this result.[4] In addition, there may be state transfer tax benefits from the gift of a life insurance policy. In states imposing no gift tax, a lifetime gift can be made without the payment of any state gift tax, and the policy proceeds can entirely avoid state death taxation.

Life insurance may also be an attractive candidate for generation-skipping transfer (GST) tax planning. The application of the gift tax annual exclusion (in some cases) or the GST exemption to values at the time of the gift can result in the ultimate transfer of a much greater amount (the death proceeds) to skip persons, free of generation-skipping tax. That is, the annual exclusion or GST exemption can be leveraged against current gift tax values, in order to avoid generation-skipping taxation of the policy proceeds.

1.2 CONSIDERATIONS IN SELECTING A LIFE INSURANCE POLICY TO GIVE AWAY

Unlike gifts of other property, gifts of life insurance do not normally reduce the donor’s income or the assets available to provide for the donor’s financial security, except for loss of access to the cash values of permanent types of policies. This feature argues against considering policies with potentially large lifetime values as the subject of a gift. The ideal policy for a gift would be a policy that has a high death benefit in relation to lifetime cash values—typically some form of permanent policy with as small a lifetime value as possible or a pure term policy (although the high premiums for term life insurance at older ages must also be considered).

Gifts of life insurance (other than single-premium or paid-up policies) are also unlike gifts of most other kinds of property in that unless the donee has the means to pay premiums due after the gift, the donor must make continuing gifts to keep the policy in force. Consequently, a gift of insurance can often be viewed as a series of yearly gifts, which might be designed to fit within the gift tax annual exclusion. The ideal policy from this point of view would be a policy with premiums that fit the available annual exclusions, or perhaps insurance provided under a

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[4] IRC § 2035(c).

split-dollar arrangement, which can reduce the deemed gift to keep it within the available exclusions. Because additional future gifts will in most cases be required to support the gifted policy, the insured's ability to make, withhold or vary those future gifts adds some flexibility to an otherwise irrevocable gift. The possible importance of keeping the annual gifts within the available annual exclusions, because of the impact of the generation-skipping transfer tax, is discussed in Chapter IV.

In summary, the best candidates for gifts of life insurance appear to be universal life or variable universal life (in which premiums can be varied and outlays therefore minimized), some forms of whole life under which premiums in later years are projected to be payable from nonguaranteed values (recognizing the risk inherent in any such projections), any permanent form of insurance using a split-dollar or premium loan arrangement (to reduce the value of gifting premiums to the trust, recognizing the risk that these arrangements become less tax-efficient as time goes on), or pure term or group term insurance (recognizing the risk that, unless converted, it will not likely be available at or beyond life expectancy). Conversely, the least attractive policies would be single premium or any other heavily investment-oriented type of policy. The spread between the policy's death benefit and its lifetime values will be the most critical variable in choosing the form of policy for gifting; the greater the spread, the better.

1.3 ORGANIZATION AND CONTENT OF THIS BOOK

1.3.1 Organization

This book addresses the federal transfer tax aspects of life insurance. Chapter II deals with the gift tax and considers when a gift occurs with respect to a life insurance policy, the valuation of the gift, and the availability of the gift tax annual exclusion and the gift tax charitable or marital deduction. Chapter III discusses the estate taxation of life insurance, with emphasis on the two IRC sections that have particular application to life insurance: Sections 2035 and 2042. Chapter IV is a discussion of the generation-skipping transfer tax and its application to life insurance and irrevocable life insurance trusts. The final chapter, Chapter V, specifically addresses community property considerations.

1.3.2 Other Books in the Insurance Counselor Series

One of the most common instruments used to remove life insurance from the insured's gross estate is the irrevocable life insurance trust. Another book in the *INSURANCE COUNSELOR* series includes annotated forms for irrevocable life insurance trusts.[5] The authors hope that this book will serve as a useful companion for lawyers who use the annotated forms in that book.

1.3.3 A Note about Letter Rulings and Technical Advice Memoranda

This book includes numerous citations to letter rulings and technical advice memoranda issued by the Internal Revenue Service. The reader should bear in mind that neither a letter

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[5] LAWRENCE BRODY AND DONALD JANSEN, ABA Insurance Counselor Primer #6, THE IRREVOCABLE LIFE INSURANCE TRUST: FORMS WITH DRAFTING NOTES (3d ed. 2010).

ruling nor a technical advice memorandum may be used or cited as precedent.[6] These documents may therefore offer helpful insight into the thinking of the Service on a particular issue, but they do not have precedential value in other cases. Consequently, and because letter rulings and technical advice memoranda do not receive the same level of review within the Service as do published Revenue Rulings, one should not put too much emphasis on a favorable result, nor be overly alarmed by an unfavorable result, in a letter ruling or technical advice memorandum.

1.3.4 A Note about Life Insurance Terminology—"Vanishing" Premiums Versus Projected Payment of Premiums from Nonguaranteed Values

The term "vanishing premiums" has been widely used in the life insurance industry. Unfortunately, this terminology was not always adequately explained and proved misleading to some consumers.

> Many illustrations are sold on the basis that the policy will be self-supporting after a given number of annual premiums are paid, *based on current assumptions for interest and mortality*. *If these assumptions are validated* during this initial period, then the premiums will "vanish"; the values that the policy has built up in this initial period will be sufficient to cover all future projected charges *based on the continuation of those assumptions*. *Should experience worsen after vanish, then further premiums would have to be paid* in order for the policy to deliver the full benefits that were forecast at vanish.[7]

This definition makes clear that when a policy is sold, the time at which premiums may be discontinued is not a fixed point in time, but a *projection* based on current assumptions about the future economic performance of the policy. Further, this definition makes clear that even after premiums have "vanished," they may, like Marley's ghost, reappear to haunt the policy owner.

Most (if not all) life insurance companies have already required their agents and brokers to cease using the term "vanish." As a result, the authors avoid the use of the term "vanish" in this book, and use the somewhat more awkward but more self-explanatory phrase that future premiums may be "projected to be payable from nonguaranteed values."

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[6] IRC § 6610(j)(3).

[7] RICHARD A. SCHWARTZ AND CATHERINE R. TURNER, ABA Insurance Counselor Primer #1, LIFE INSURANCE DUE CARE: CARRIERS, PRODUCTS, AND ILLUSTRATIONS § 359 (2d ed. 1994), emphasis added.