How to Avoid Taxation on Life Insurance Proceeds

By Brian Beers

Wouldn't it be nice if you could pass on your entire estate free of taxation? While this scenario is highly unlikely, there are some smart decisions that you can make to avoid future tax consequences.

One poor decision that investors seem to frequently make is the naming of "payable to my estate" as the beneficiary of a contractual agreement, such as an IRA account, an annuity, or a life insurance policy. However, when you name the estate as your beneficiary, you take away the contractual advantage of naming a real person and subject the financial product to the probate process. Leaving items to your estate also increases the estate's value, and it could subject your heirs to exceptionally high estate taxes.

Here, we show you some of the ways that you can reduce the taxes on your estate and ensure that your heirs will benefit from it as much as possible.

How Life Insurance Death Benefits May Be Taxed

One of the benefits of owning life insurance is the ability to generate a large sum of money payable to your heirs upon your death. An even greater advantage is the federal income-tax-free benefit that life insurance proceeds receive when they are paid to your beneficiary. However, while the proceeds are income-tax-free, they may still be included as part of your taxable estate for estate tax purposes.

Section 2042 of the Internal Revenue Code states that the value of life insurance proceeds insuring your life are included in your gross estate if the proceeds are payable: (1) to your estate, either directly or indirectly or (2) to named beneficiaries if you possessed any incidents of ownership in the policy at the time of your death.1

In 2011, Congress and the president extended the Economic Growth and Tax Relief Reconciliation Act of 2001 through 2011 and 2012.2 Whereas the federal tax exclusion amount was increased to $5 million per person with an estate tax rate of 35% in 2011 and 2012. On January 1, 2013, the exemption and rate were scheduled to revert to the 2002 figures of a $1 million exemption and a 55% estate tax rate. However, on Jan. 1, 2013, the American Taxpayer Relief Act of 2012 established a $5 million estate tax exclusion and a 40% maximum rate that would index slightly higher for several years. 3

i.e., the gift and estate tax exemption

Thanks to the Tax Cuts and Jobs Act of 2017, however, the exemption amount doubled to $11.18 million in 2018, reached $11.4 million in 2019, and stands at $11.58 million for 2020, while maintaining the top rate of 40%.4

Using an Ownership Transfer to Avoid Taxation

For those estates that will owe taxes, whether life insurance proceeds are included as part of the taxable estate depends on the ownership of the policy at the time of the insured's death. If you want your life insurance proceeds to avoid federal taxation, you'll need to transfer ownership of your policy to another person or entity.

Here are a few guidelines to remember when considering an ownership transfer:

1. Choose a competent adult/entity to be the new owner (it may be the policy beneficiary), then call your insurance company for the proper assignment, or transfer of ownership, forms.

2. New owners *must* pay the premiums on the policy. However, you can gift up to $15,000 per person in 2020, so the recipient could use some of this gift to pay premiums.5
3. You will give up all rights to make changes to this policy in the future. However, if a child, family member or friend is named the new owner, changes can be made by the new owner at your request.
4. Because ownership transfer is an irrevocable event, beware of divorce situations when planning to name the new owner.
5. Obtain written confirmation from your insurance company as proof of the ownership change.

Using Life Insurance Trusts to Avoid Taxation

A second way to remove life insurance proceeds from your taxable estate is to create an irrevocable life insurance trust (ILIT). To complete an ownership transfer, you cannot be the trustee of the trust and you may not retain any rights to revoke the trust. In this case, the policy is held in trust and you will no longer be considered the owner. Therefore, the proceeds are not included as part of your estate.

Why choose trust ownership rather than transferring ownership to another person? One reason might be that you still wish to maintain some legal control over the policy. Or perhaps you are afraid that an individual owner may fail to pay premiums, whereas in the trust you can ensure that all premiums are paid promptly. If the beneficiaries of the proceeds are minor children from a previous marriage, an ILIT will allow you to name a trusted family member as trustee to handle the money for the children under the terms of the trust document.

Regulations on Life Insurance Policy Ownership

The IRS has developed rules that help to determine who owns a life insurance policy when an insured person dies. The primary regulation overseeing proper ownership is known in the financial world as the three-year rule, which states that any gifts of life insurance policies made within three years of death are still subject to federal estate tax. This applies to both a transfer of ownership to another individual and the establishment of an ILIT. So, if you die within three years of the transfer, the full amount of the proceeds is included in your estate as though you still owned the policy.6

The IRS will also look for any incidents of ownership by the person who transfers the policy. In transferring the policy, the original owner must forfeit any legal rights to change beneficiaries, borrow against the policy, surrender, or cancel the policy or select beneficiary payment options. Furthermore, the original owner must not pay the premiums to keep the policy in force. These actions are considered to be a part of the ownership of the assets and if any of them are carried out, they can negate the tax advantage of transferring them.

However, even if a policy transfer meets all of the requirements, some of the transferred assets may still be subject to taxation. If the current cash value of the policy exceeds the $15,000 gift tax exclusion, gift taxes will be assessed and will be due at the time of the original policyholder's death.

The Bottom Line

It's not uncommon for individuals to be insured under a life insurance policy for $500,000 to several million in death benefits. Once you add in the value of your home, your retirement accounts, savings, and other belongings, you may be surprised by the size of your estate. If you factor in more years of growth, some of us may be facing an estate tax issue.

A viable solution to this is to maximize your gifting potential and to transfer policy ownership whenever possible at little or no gift-tax cost. As long as you live another three years after the transfer, your estate could save a significant amount of tax.