10 Frequent Life Insurance Mistakes in Estate Planning

February 12, 2024

Life Insurance in Estate Planning

01

Income Replacement

- Family Income Earner
- Family Objectives
- Maintaining Standard of Living

02

Estate Liquidity

- Taxable Estate
- Illiquid Assets
- Preserving Illiquid Assets by Providing Liquidity

03

Wealth Replacement

- Taxable Estate
- Estate Planning Strategy
- Replace Value of Estate Assets

Life Insurance Mistake #1 – Failure to Determine Need

Income Replacement

Term Insurance

Temporary Need

Calculation of Lost Income

Focus on What the Death Benefit Provides

Estate Tax Planning

Permanent Insurance

Permanent Need

Projection of Tax Liability

Moving Target

Life Insurance Mistake #2 – Failure to Review Performance

01

- Permanent life insurance policies have a hypothetical assumption that must be achieved to meet policy objectives.
- Due to several decades of declining interest rates, many policies are in jeopardy of underperformance, possibly to the point of lapsing.

02

- Permanent life insurance policy performance must be reviewed.
- In-force ledgers must be requested to project policy performance based on what's happened to this point.
- Results must be compared with current market options.

Life Insurance Mistake #3 – Personal Ownership

Personal Ownership

Includable in Taxable Estate

If a client has a taxable estate, 40% (or more) of their death benefit could be lost to estate taxes.

Third Party ownership

Not Includable in Taxable Estate

An irrevocable life insurance trust (ILIT) will keep the death benefit outside of the taxable estate.

Life Insurance Mistake #4 – Three Year Rule

- Discourages attempts to avoid estate taxes by transferring property when death is imminent.
- Applies to life insurance policies transferred within three years of death for less than full fair market value.
- Brings death benefit back into decedent's taxable estate.
- Avoid the three year rule by selling the policy instead of gifting it.
- For a sale to a trust, ILIT must be structured as a grantor trust to avoid transfer for value rule.

Life Insurance Mistake #5 – Ineffective Beneficiary Designations

01

Estate as Beneficiary

- Unintended beneficiaries could receive proceeds.
- Increased probate expenses.
- Insurance proceeds subject to creditors' claims.
- Consider naming individuals, trusts or custodians as beneficiary instead.

02

Minor Beneficiaries

- Court supervision of life insurance proceeds for minors.
- Increased costs and administrative burden.
- Consider naming a living trust or testamentary trust as beneficiary instead.
- Consider naming a custodian under UTMA instead.

03

No Contingent Beneficiary

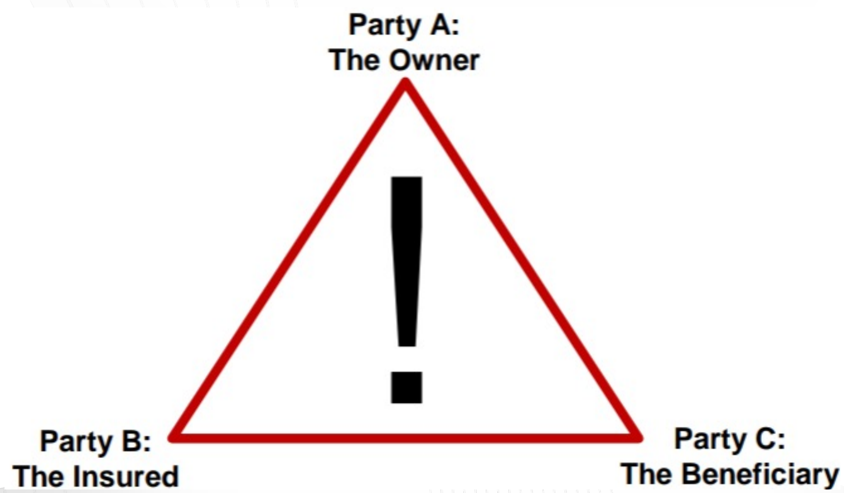
- Same as naming estate as beneficiary if primary beneficiary is not living.
- Consider naming a living trust or testamentary trust as contingent beneficiary instead.

Life Insurance Mistake #6 – The Unholy Trinity

Also known as the Goodman Triangle after the 1946 Tax Court case, Goodman v. Commissioner

The Problem

Party A owns a life insurance policy on the life of Party B and makes the proceeds payable to Party C. Upon B's death, Party A will be deemed to have made a taxable gift of the entire death benefit to C.



The Solution

If the insured is not the owner, then the owner and beneficiary should always be the same

Life Insurance Mistake #6 – The Unholy Trinity

Also known as the Goodman Triangle after the 1946 Tax Court case, Goodman v. Commissioner

Common "Unholy Trinity" Scenarios

	Owner	Insured	Beneficiary	Result Upon Insured's Death
Spouse Owns Policy	Spouse A	Spouse B	Children	Spouse A is considered to have made a **taxable gift of the death benefit** to children.
Child Owns Policy on Parent	Child A	Parent	Child A, Child B, & Child C	Child A is deemed to have made a **taxable gift of 1/3 of the death benefit** to Child B and **1/3 of the death benefit** to Child C.
Business Owns Policy on Owner	Business	Business Owner	Business Owner's Spouse	Death benefit will be **taxable as a dividend or compensation** to Business Owner's Spouse.
Business Owns Policy	Business	Non-Owner Key Employee	Key Employee's Spouse	Death benefit will be **taxed as compensation** to Key Employee's Spouse.

Life Insurance Mistake #7 – Transfer for Value

- When an interest in a life insurance contract, or the death benefit, has been transferred for "valuable consideration", the death benefit becomes subject to income taxation.
- Exceptions…transfers to:
  - The insured;
  - A partner of the insured;
  - A partnership in which the insured is a partner;
  - A corporation in which the insured is a shareholder or officer;
  - If transferee's basis in transferred policy is determined, in whole or in part, by the transferor's basis in the contract (carryover basis exception)

Life Insurance Mistake #8 – Employer Owned Life Insurance

- A policy owned by a person or entity engaged in a trade or business on the life of an employee and the person/entity is directly or indirectly a beneficiary of the policy. IRC §101(j)
- Failure to comply subjects the entire death benefit, less premiums paid, to income taxation!

01

Notice & Consent Required

Employer notifies employee in writing that they intend to insure employee's life, and employee consents.

02

IRS Form 8925 Filed Annually

Lists number of employees, number of EOLI policies, total EOLI death benefit, and number of policies with valid Notice & Consent on file.

03

Failure to Provide Notice & Consent

IRS Notice 2009-48 indicates it will not challenge failure to satisfy requirement so long as:

- Owner made good faith effort to comply;
- Failure to comply was inadvertent;
- Failure to comply was corrected no later than due date of the tax return for the tax year in which policy was issued.

04

Failure to Timely File Form 8925

IRS has not issued definitive guidance on penalty. Could be governed by IRC § 6723, which imposes a $50 penalty for each instance of a failure to comply with "a specific information reporting requirement."

Life Insurance Mistake #9 – No Crummey Withdrawal Notices

Gifts of a Future Interest

- If trust beneficiaries do not receive actual notice of gifts to an irrevocable trust, it's a gift of a future interest.
- Likely the death benefit for ILITs

Gifts of a Present Interest

- Crummey v. Commissioner
- Providing beneficiaries with a window in which they can withdraw gifts from the trust.
- Qualifies gifts as a present interest, frequently falling within annual gift tax exclusion.

Actual Notice Required!

Life Insurance Mistake #10 – Taxation in 1035 Exchanges

- **IRC §1035 provides that taxation of gain is deferred for policy owners who merely exchanged one insurance policy for another better suited to their needs.**
- **Through an exchange, if a policy owner receives other money or property in addition to the like-kind property, that additional money or property is considered "boot" and will be included in the policy owner's taxable income to the extent of gain.**

Withdrawing Basis Before Exchange

- Owner withdraws basis and only exchanges gain to the new policy.
- Step-transaction applies when basis withdrawn and subsequent 1035 exchange.
- Income recognized to the extent of gain and taxed at ordinary income tax rates.

Loan Extinguished in 1035 Exchange

- Repayment of the loan using cash values is considered the receipt of "other property or money".
- Treated as "boot" and owner recognizes tax to the extent of gain in the contract.

Loan Carried Over to New Contract

- Policy owner has NOT received "other property or money" thus no "boot" and no taxation triggered.
- Policy owner can also use outside funds, out of pocket, to extinguish the loan and no taxation is triggered.

Meeting Survey

- Click the QR Code to provide your feedback for today's meeting

- The Board appreciates your participation

11433 Old Cabin Road – Third Floor
(314) 392-2841
bseigel@buiusa.com
www.buiusa.com