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Managing Life Insurance Trusts
- by Neil E. Harl

Life insurance trusts continue to play an important role in farm estate and business planning although perhaps not to the extent that was the case several years ago. The expanded applicable exclusion amount for federal estate tax and gift tax purposes ($5,340,000 for deaths or gifts in 2014) and the availability of portability on a permanent basis (which can effectively double the applicable exclusion amount for married couples) lessens the pressure to distance one’s self from property to reduce or eliminate federal estate tax at death. Nonetheless, such trusts entered into over the past several years can pose significant tax problems for the trustor (or the estate or both), some of which can be minimized or avoided with careful planning.

A life insurance trust is a trust which becomes effective and receives life insurance proceeds at the insured’s death or holds life insurance policies during life in revocable or irrevocable form and receives the life insurance proceeds at the death of the insured. The focus in this article is on irrevocable life insurance trusts.

Setting up the trust

The establishment of an irrevocable life insurance trust and the conveyance of policies to the trust can have important gift tax consequences. If distributions to the trust beneficiaries are not set to begin until after the insured’s death, as is usually the case, and the transfer of policies to the trust amounts to a gift for federal gift tax purposes, the transfer of life insurance policies (and other income producing property) to the trust initially as well as any subsequent payment of premiums would be a gift of a future interest based on the cash value of the policies which would not be eligible for the federal gift tax annual exclusion to offset the gift. That would be the outcome if distributions to the beneficiaries are not set to begin until after the insured’s death, as is typically the case.

Federal estate tax consequences

Retention by the insured of any of the incidents of ownership of the policies subjects the proceeds to inclusion in the insured’s gross estate for federal estate tax purposes. The list of “incidents of ownership” includes the retained right to borrow against the policies, the right to change the beneficiaries, the right to a reversionary interest (if it exceeds five percent of the value of the policy) and the right to exercise a power of disposition.

Ordinarily, if the insured was not the owner or beneficiary of the policy or policies at death, and had not retained any incidents of ownership over the policies, the proceeds

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would not be included in the gross estate for federal estate tax purposes. However, if the policy proceeds, under the terms of the policy (or policies) “... are receivable by another beneficiary but are subject to an obligation, legally binding upon the other beneficiary, to pay taxes, debts and other charges ...” that are enforceable against the insured’s estate from the insurance proceeds required for payment of the obligation, and that are legally binding upon the beneficiary, the amount of the proceeds required for such payment of the obligation (or obligations) is includible in the insured’s gross estate to the extent of the retained interest.”

In Hooper v. Commissioner, life insurance proceeds transferred to the trust to pay debts were held to be includible in the gross estate where the trustee was required to use the insurance proceeds to liquidate debts and obligations of the estate. In Estate of Rohnert v. Commissioner, insurance placed in trust which was required to pay estate taxes made the proceeds taxable. In Pritchard v. United States, life insurance proceeds receivable by or for the benefit of the estate were included in the gross estate. In a slightly different set of facts, in Matthews v. Commissioner, a portion of the proceeds of an assigned policy payable to an assignee bank in satisfaction of the decedent’s debts was held to be included in the gross estate. Therefore, in every instance it is advisable to scrutinize carefully whether there is language in the trust that could result in inclusion in the gross estate of part (or all) of the proceeds from the policies at death.

As is reported in one current publication, “although attempts have frequently been made to provide an estate tax exemption for the proceeds of insurance that are used to pay estate taxes, none of the attempts in Congress have been successful. If the recipient of the proceeds is required to use them to pay taxes, the proceeds are includible in the gross estate as insurance receivable by the executor.”

**Simpler alternatives**

For those who prefer simpler alternatives, one possibility is for the insured to transfer the life insurance policies to the spouse without retaining any incidents of ownership which should keep the policy proceeds out of the insured’s gross estate. However, if the spouse then designates a child (or children) as beneficiaries, the death of the insured results in a gift of the policy proceeds from the policy owner (the spouse) to the children as beneficiaries. That comes as a shock to those who believed transfer of ownership to the spouse would avoid all transfer taxes.

The other major alternative is to use the life insurance trust approach but to avoid any language requiring the insurance proceeds to be used to pay “... taxes, debts and other charges. ...” which would result in inclusion of the amounts involved in the gross estate.

**ENDNOTES**

3 I.R.C. § 2010(c)(4).
4 I.R.C. § 2501(a).
7 I.R.C. § 2042(2).
9 I.R.C. § 2042(2).
10 See I.R.C. § 2042.
13 40 B.T.A. 1319 (1939).
17 See I.R.C. § 2042.