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LIFE INSURANCE: A TAX PLANNING TOOL TO ENSURE THAT THE WEALTHY RETAIN THEIR WEALTH

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Despite the rhetoric that the estate tax is an unfair tax burden on the American people, in reality the estate tax only affects .14% of Americans.¹ Furthermore, for those individuals who have a taxable estate, the average tax rate is only 16.6%, which is well below the highest estate tax rate of 40% for 2014.² For 2013, the estimate for total revenue generated through the estate tax is only \$14.2 billion.³

Part of the reason the estate tax only affects such a small portion of the population and generates little revenue is due to the increasing levels of exclusions and exemptions. However, another reason is the tax planning strategies that wealthy individuals take advantage of to minimize their taxable estate. Planning with life insurance is one of the strategies employed by the wealthy to avoid the estate tax and pass their wealth to their heirs.

I. INCOME TAX TREATMENT OF LIFE INSURANCE

Ever since the Revenue Act of 1913, Congress has excluded life insurance death benefits from income tax, which reflected the important social role life insurance filled “from providing support for widows and orphans following the loss of a family breadwinner, to providing solutions to various liquidity needs of the business taxpayer.”⁴ However, life insurance was not defined in the Internal Revenue Code (Code) until 1984 when section 7702 was included.⁵

Individuals purchase life insurance for a number of reasons, but one of the principal benefits of life insurance is that it provides tax-free income to the beneficiaries. Generally, proceeds of life insurance contracts

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1. *Estate Tax Returns and Liability Under Current Law and Various Reform Proposals, 2011-2022*, TAX POLICY CTR., URBAN INST. & BROOKINGS INST. (Jan. 9, 2013), <http://www.taxpolicycenter.org/numbers/Content/PDF/T13-0019.pdf> (Calculated using the projected number of deaths and number of taxable returns for 2013).

2. *Current Law Distribution of Gross Estate and Net Estate Tax by Size of Gross Estate, 2013*, TAX POLICY CTR., URBAN INST. & BROOKINGS INST. (Jan. 9, 2013), <http://www.taxpolicycenter.org/numbers/Content/PDF/T13-0020.pdf>.

3. *Id.*

4. CHRISTIAN J. DESROCHERS ET AL., LIFE INSURANCE AND MODIFIED ENDOWMENTS UNDER INTERNAL REVENUE CODE SECTIONS 7702 AND 7702A 205 (1st ed. 2004).

5. 26 U.S.C. § 7702 (2012).

payable by reason of death are excluded from gross income.⁶ The preferential income tax treatment of life insurance is available to both wealthy and less wealthy policyholders. In the last two decades the average face amount of individual life insurance policies purchased has doubled from \$78,000 in 1992 to \$163,000 in 2012.⁷ A 2010 study found that ownership of individual life insurance was at a fifty-year low and that only 44% of households had individual life insurance.⁸ This data suggests that while many Americans are foregoing life insurance, the wealthy are buying even more life insurance coverage in order to not only replace lost income, but also to take advantage of the tax benefits.

One type of life insurance favored by wealthy individuals is a whole life policy that will cover an insured for life. The premiums are usually more expensive than a term life insurance policy but the whole life policy can receive dividends that may be reinvested in the policy, which will grow tax-free.

II. ESTATE TAXATION OF LIFE INSURANCE

If life insurance proceeds are subjected to any tax at all, they will most likely be subject to the estate tax. Sections 2042 and 2035 of the Code can work to pull proceeds of life insurance into the gross estate. Section 2042 provides for the inclusion in the gross estate of life insurance proceeds where those amounts are receivable by the executor.⁹ Additionally, section 2042 includes life insurance proceeds in the gross estate if receivable by other beneficiaries but only if the decedent “possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person.”¹⁰

Even though section 2042 specifically includes only a reversionary interest as an incident of ownership, the Regulations denote that an incident of ownership is not limited to ownership of the policy. It includes “power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc.”¹¹

6. *Id.* at § 101(a).

7. THE AM. COUNCIL OF LIFE INSURERS, LIFE INSURERS FACT BOOK 2013 67 (2013), available at https://www.acli.com/Tools/Industry%20Facts/Life%20Insurers%20Fact%20Book/Documents/FB13%20Chapter%207_LI.pdf.

8. *Ownership of Individual Life Insurance Falls to 50-Year Low*, LIMRA Reports, LIMRA (Aug. 30, 2010), http://www.limra.com/Posts/PR/News_Releases/Ownership_of_Individual_Life_Insurance_Falls_to_50-Year_Low_LIMRA_Reports.aspx.

9. 26 U.S.C. § 2042(1) (2012).

10. *Id.* at § 2042(2).

11. 26 C.F.R. § 20.2042-1(c)(2) (2013).

Although the scope of section 2035 is not as broad as it was in the past, it still has the effect of including some life insurance policies in the gross estate. If an insured gifts a life insurance policy, or some other interest in the policy, within three years of the insured's death, the life insurance proceeds will be included in the insured's gross estate.¹²

III. RECENT TRANSFER TAX LAW CHANGES THAT AFFECT THE USE OF LIFE INSURANCE

Relatively recent developments in transfer tax law have encouraged wealthy individuals to use life insurance more predominantly in their financial planning. Some of these changes include: increasing the annual exclusion, reducing the scope of section 2035, adjustments to the marital deduction, and the creation of the generation skipping transfer tax.¹³

Before 1982, the annual exclusion from gift tax was \$3,000 and there were no exclusions for gifts of tuition and medical costs.¹⁴ But starting in 1982, Congress raised the gift tax exclusion to \$10,000 and it has slowly increased to the current exclusion of \$14,000 starting in 2013.¹⁵ These exclusions permit individuals to gift a higher dollar amount of life insurance premiums that will be excluded from gift tax.

Section 2035 was modified in 1982 to exclude life insurance proceeds from the estate of an insured when the policy was purchased and held by a third party within three years of the insured's death, and where the insured had never possessed an incident of ownership.¹⁶

In 1981, Congress removed the limit on the marital deduction, which at that time was capped at \$250,000 or 50% of the value of the adjusted gross estate.¹⁷ As a result, all property can now be left to a surviving spouse and no estate tax will be due until the surviving spouse dies. This permits an individual to own a large life insurance policy without worrying that it will increase the estate tax liability when the insured dies. As the Code evolved, insurance companies made adjustments, such as promoting more joint and survivor policies, to meet the financial planning needs of their wealthy clients.¹⁸

Congress also created a generation-skipping transfer tax in order to tax wealth transfers at each generation. Moreover, just as they did with the other transfer taxes, Congress provided an exemption amount, which

12. 26 U.S.C. § 2035(a) (2013).

13. Robert B. Smith, *Reconsidering the Taxation of Life Insurance Proceeds Through the Lens of Current Estate Planning*, 15 VA. TAX REV. 283, 319–21 (1995) [hereinafter *Reconsidering*].

14. *Id.* at 319.

15. 26 U.S.C. § 2503(b) (2012) (originally enacted as Act of Aug. 16, 1954, ch. 736, 68A Stat. 404); Rev. Proc. 2013-35, 2013-47 I.R.B. 537.

16. *Reconsidering*, *supra* note 13, at 319–20.

17. 26 U.S.C. § 2056 (2012) (originally enacted as Act of Aug. 16, 1954, ch. 736, 68A Stat. 392).

18. *See Reconsidering*, *supra* note 13, at 320–21.

for 2014 is 5.34 million dollars.¹⁹ This tax has forced wealthy individuals to look for clever ways to keep wealth in their family while minimizing or avoiding additional taxes.

IV. LIFE INSURANCE TRUSTS AS A TOOL TO MINIMIZE TAXES

One example of life insurance as an estate-planning tool used by wealthy individuals to minimize their taxable estate is an irrevocable life insurance trust, also known as an ILIT. To create an ILIT, a grantor must create a trust and choose a trustee to manage the trust. The grantor also selects the beneficiaries of the trust. The trust purchases a life insurance policy on the life of the grantor that is paid into the trust once the grantor dies. After the insured's death, these funds can be used by the trustee to pay any expenses or estate taxes, and then the remaining funds can be distributed to the beneficiaries.

Minimizing taxes through the use of an ILIT can be complicated; however, it might be worth the trouble in order to maximize the amount of money that can be passed on to loved ones. The grantor can make annual exclusion gifts of up to \$14,000 (in 2014) to fund the trust and the trustee can use those funds to purchase life insurance and pay the premiums. For example, an individual can create a trust and name all six children as beneficiaries. Then, each year the grantor can make gifts to the trust for each beneficiary that equal the annual gift exclusion of \$14,000. Among other things, the beneficiaries must be given a right to withdraw this money in order for the money to be eligible for the annual gift tax exclusion. The trustee will then use the \$84,000 to pay for life insurance, and this method will be used each year to add funds to the trust and pay for life insurance. After the grantor dies, the life insurance proceeds will be paid to the trust, which can distribute it to the beneficiaries all while avoiding any estate tax. The technique in this example allows the taxpayer to remove \$84,000 each year from his estate through completed gifts. Notwithstanding the many omitted rules and complexities that can apply to this tax strategy, this simple example demonstrates how life insurance can be used in conjunction with a trust to minimize estate taxes.

V. CONCLUSION

Life insurance is frequently used as a financial planning tool for the wealthy rather than merely a safety net. Congress intended to capture life insurance in the estate tax when they passed sections 2035 and 2042. However, it appears less likely that many life insurance proceeds will be subject to the estate tax because subsequent legislation raised the exemption amounts to immense levels. Instead, by using life insurance, the wealthy have a tool that can help prevent the dissipation of their wealth.

19. 26 U.S.C. § 2631 (2012); Rev. Proc. 2013-35, 2013-47 I.R.B. 537.