Twelve Life Insurance Mistakes that Aren't "Cheaper by the Dozen"

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Situation: Children vs Trust As Owner

- Situation:
  - Client wants to avoid estate tax inclusion of policy proceeds, but wants to avoid complexity and cost of ILIT
- Frequently Proposed Solution:
  - Adult children as policy owners

Situation: Children vs Trust As Owner

- Consequences of Children as Owners:
  - Loss of “control” over policy proceeds
  - No creditor protection for the children
  - Gift issues if insured pays premiums directly to insurer
  - Adds to the children’s estate
  - Successor ownership issues if a child/owner predeceases the insured – unintended disinheritance
- In effort to overcome consequences of having children as owners, Mistake #1 often occurs

Mistake #1: The “Unholy Trinity”

- Problem: “Three on a policy” creates a gift tax issue at the death of the insured.
  - Owner: B (wife)
  - Insured: A (husband)
  - Beneficiary: C (children)

Gift made at A’s death

- Solutions:
  - If the insured is not the owner, the owner (third-party owner) and beneficiary must be the same to avoid the “unholy trinity” tax problem
  - But if the third-party owner is an individual, avoid making Mistake #2

Mistake #2: No Successor Owner

- Problem: Where an individual other than the insured is the owner of a policy (third-party owner) there is the possibility that the third-party owner may predecease the insured.
  - Policy is accessible to owner's creditors
  - Adds to the owner's estate
  - Potential unintended new successor owner
    - Who becomes successor owner? policy contract provisions, estate documents, state law
    - Potential estate inclusion if ownership passes to insured

Mistake #2: No Successor Owner

- Solution: To avoid having the policy pass to unintended owners, name a successor owner anytime the policy is owned by an individual other than the insured.
- Additional Caveats:
  - Third-party owner controls policy consequently he/she can transfer policy to new owner and change beneficiaries.
  - Potential gift tax issues depending on identity of individual third-party owner (i.e., multiple children, noncitizen spouse)

Mistake #3: Estate as Beneficiary

- Problem: Where a beneficiary predeceases the insured and the policy does not name successor beneficiaries, the proceeds will be paid to the insured's estate
  - Subject to creditor claims
  - Subject to probate and potentially more taxes
- Solutions:
  - Name contingent beneficiaries
  - Beneficiary designations should be checked periodically to see that named individuals or entities are consistent with current life circumstances and will not result in unwanted consequences.

Situation: Business Dollars for Personal Insurance

- Situation:
  - Business owner client wants to use business earnings to purchase insurance to benefit his/her family
  - Often wants to avoid being taxed on the premiums
- Frequently Proposed Solution:
  - Policy structured as follows, resulting in Mistake #4
    - Owner: Corporation
    - Insured: Business owner
    - Beneficiary: Spouse or other family member

Mistake #4: Three-Party Corporate Problem

- Problem: "Three on a policy" – where a business is the owner – creates tax either for the business owner or the beneficiary.
  - Owner: (B) Corporation
  - Insured: (A) Business owner
  - Beneficiary: (C) Spouse or other family member

Dividend/Compensation at A's death

- Solutions: Where you want to use business dollars to provide for personal benefits, explore
  - Executive bonus arrangements
  - Split dollar arrangements

Mistake #4: Three-Party Corporate Problem

- Additional Caveats:
  - Consider business entity form. Owners of LLCs, partnerships, and S Corporations do not avoid tax burden when business pays insurance premiums on a policy owned by the business.
  - The identity of the individuals involved (i.e., majority owner, minority owner, employee, independent contractor, director, highly compensated) will make a difference in how the arrangement is structured.
  - “Employer-owned contracts” issued after August 17, 2006, must comply with IRC §101(j). Failure to comply results in Mistake #5.

Mistake #5: Failing to Comply with IRC §101(j)

- Problem: "Employer-owned contracts" issued after August 17, 2006, that fail to comply with the requirements in IRC §101(j) will result in a portion of the death proceeds being subject to income tax.
  - The only way to correct the mistake is to start over.

Mistake #5: Failing to Comply with IRC §101(j)

- Solution: For employer-owned contracts make sure that prior to policy issue the IRC §101(j)
  - notice and consent requirements are met <u>and</u>
  - that one of the exceptions applies
- Devil is in the details

Mistake #5: Failing to Comply with IRC §101(j)

- What is an employer-owned contract?
  - Owned by a person engaged in a trade or business – the "applicable policyholder"
  - Under which, such person or "related person" is directly or indirectly a beneficiary, and
  - Where the insured is an employee of the trade or business of the applicable policyholder on the date the policy is issued
- Examples of employer-owned contracts:
  - Key person coverage, nonqualified deferred compensation arrangements, split dollar arrangements, buy-sell arrangements

Mistake #5: Failing to Comply with IRC §101(j)

- What notice and consent is required?
  - Must be completed prior to contract "issue"
  - The applicable policyholder must give written notification to the employee
    - Of the intention to insure the employee's life,
    - Specifying the maximum face amount of the intended coverage at the time of issue, and
    - Specifying that the applicable policyholder will be the beneficiary of any death benefits paid.
  - The employee must give written consent
    - Indicating awareness of the coverage, and that such coverage may extend beyond the termination of his or her employment.

Mistake #5: Failing to Comply with IRC §101(j)

- What are the exceptions?
  - Exception based on insured's status
    - Was an employee at any time during the 12-month period before the insured's death, or
    - Was a director, a highly compensated employee, or a highly compensated individual at the time the contract was issued.
  - Exception based on who receives the death benefit
    - A family member or estate of the insured
    - An individual who is the designated beneficiary of the insured (other than an applicable policyholder)
    - A trust established for the benefit of any such member of the family or designated beneficiary
    - Where policy proceeds are used to purchase an equity interest in the applicable policyholder

Situation: Transfers of Personally Owned Insurance

- Situation:
  - Client owns a life insurance policy on his/her life. He/she wants to avoid estate inclusion of proceeds.
  - IRC §2042 requires a decedent to include in his/her estate insurance proceeds on his/her life to the extent he/she possesses an “incident of ownership” in the policy (personal, fiduciary, business) at death.
    - IRC §2042 also requires estate inclusion of insurance directly or indirectly receivable by the estate, regardless of ownership.
- Frequently Proposed Solution:
  - Transfer policy ownership to ILIT or third party, but when doing the transfer, be aware of the following Mistakes #6 & 7

Mistake #6: Failing to Consider the 3-Year Estate Tax Inclusion Rule

- Problem: When an insured gives away a personally owned policy on his/her life, it's not out of his/her taxable estate for 3 years from the date of transfer.
  - 3-year rule does not apply to a transfer that qualifies as a "bona fide sale for adequate and full consideration."
  - But, what is full consideration?
    - Cash value, replacement cost, ITR, PERC, death benefit, some other value?
    - Does the value change if the client is ill… terminally ill?
  - Also watch out for Mistake #7.

Mistake #7: Violating the Transfer-for-Value Rule

- Problem: A transfer of a policy in exchange for value will result in a portion of the death proceeds being subject to ordinary income tax – except where the transfer is to one of five statutory exceptions
- Solution: Structure the sale as a transfer
  - To the insured, to a partner of the insured, to a partnership in which the insured is a partner, to a corporation in which the insured is an officer or shareholder, or
  - Where transferee's basis is determined in whole or in part by the transferor's basis (i.e., gift).

Mistake #7: Violating the Transfer-for-Value Rule

- Additional Caveats:
  - Transfer-for-value rule applies to term insurance.
  - Transfer is broadly defined to include any transfer of a right to receive all, or any part, of a life insurance policy. A transfer of the ownership of a policy does not have to occur for a transfer to take place. A transfer can be triggered by naming someone as the beneficiary.
  - Consideration is also broadly defined. It’s not limited to cash or property. It includes a mutual or reciprocal promise. (i.e., transfer to a co-shareholders)

Mistake #8: Gift of a Policy Where the Loan Amount Exceeds Basis

- Problem: A gift of a policy with an outstanding loan may cause the death benefit to be taxable as a violation of the transfer-for-value rule.
  - The carryover basis exception only applies when the transferor's basis exceeds the amount paid by the transferee, including the amount the transferee is deemed to have paid by relieving the transferor of the obligation to pay a policy loan.
- Solution: Structure the transaction so that the loan amount does <u>not</u> exceed policy basis at the time the gift is made.

Situation: Policy Transactions

- Situation:
  - Client has a policy with which he wishes to do any of the following transactions:
    - Exchange for a new policy
    - Assign
    - Take withdrawals
- Caveats:
  - Many of the common policy transactions can result in unintended tax consequences as illustrated in the following Mistakes #9, 10, and 11.

Mistake # 9: 1035 Exchanges and Policy Loans

- Problem: Deferral of gain is lost if a policy exchange is not structured properly.
  - IRC §1035 permits deferral of gain when an old policy is exchanged for a new policy; however, if money or property that is not of a "like-kind" is received, gain is recognized to the extent of the cash or other property received.
- Solutions:
  - Carry the loan over to the new policy
  - Pay off the loan with "outside funds" before exchanging the policy (not with a withdrawal from the policy)

Mistake #10 : Pledging a MEC

- Problem: Pledging a MEC (modified endowment contract) results in instant taxation of gain.
  - MECs are those that are entered into or materially changed after June 21, 1988 in which the cumulative premiums paid in the first 7 years fail the "7-pay test."
  - Lifetime distributions of MECs are taxed differently:
    - Distributions include loans, assignments, withdrawals
    - Ordinary income to the extent of gain first
    - Subject to 10% penalty on lifetime distribution except where taxpayer is at least 59½, disabled, or is receiving a series of equal periodic payments

Mistake #10 : Pledging a MEC

- Solution:
  - Clients should pledge other assets.
- Additional Caveats:
  - Once a MEC always a MEC.
  - Death benefit reductions on a single life policy within first 7 years results in recalculation as if the policy were originally issued with the lower face. In the case of survivorship policies the recalculation is required even if the reduction is done after the 7 years. If policy is determined to be a MEC based on recalculated numbers, the MEC tax rules apply to distributions 2 years prior to the failure as well as to subsequent distributions.

Mistake # 11 : Withdrawals Within the First 15 Years from Issue

- Problem: For non-MECs issued after 1984, any time there is a distribution accompanied by a reduction in the death benefit in the first 15 years of a “cash rich” policy, the policy must be tested to determine if it should be subject to tax.
  - The cash rich test is performed when there is a withdrawal, face amount reduction, partial surrender or a lapse of a policy with a loan.
- Solutions:
  - Take loans rather than withdrawals.
  - Wait and withdraw after the 15th year.

Mistake # 12: Failing to Conduct Reviews and Educating Clients

- Problem: Clients often don't "truly" understand what they are buying.
  - Product
  - Riders
  - Guarantees and how they work
  - The effect of interest rate changes, skipping a premium, or not paying premiums on time
  - Etc.
- Solution:
  - Highlight the positives and the negatives.
  - Circumstances change. Conduct regular reviews.

Questions