Transfer taxation of life insurance

In brief

TRANSFER TAX OVERVIEW

The Internal Revenue Code (I.R.C.) imposes transfer taxes – gift tax, estate tax, generation skipping transfer tax or a combination – on money or property transferred for less than adequate consideration (i.e., where the transferor received nothing in exchange, or perhaps received something of lower value than what was transferred). Lifetime transfers trigger a gift tax, and transfers at death trigger an estate tax. Either might trigger an additional generation skipping transfer tax.

Gift tax generally

Gifts of money or property generate a gift tax only if they exceed the lifetime exemption amount, after taking into account the applicable annual exclusion amount and any deductions permitted. The gift tax rate is 40%, and is imposed on the donor.

The annual exclusion

Gifts to each person (donee) up to the annual exclusion amount in a calendar year are excluded from gift tax. The annual exclusion amount is $15,000 in 2019 and is indexed for inflation in $1,000 increments. I.R.C. § 2503(b). To qualify for the annual exclusion, the gift must be a gift of a "present interest," which means the donee has an unrestricted right to immediately use, possess or enjoy the property (or its income). Treas. Reg. § 25.2503-3(b). A donor's spouse can join in a gift – called "gift splitting" – allowing the use of both spouses' annual exclusions, so that the donor can give $30,000 per year to each donee. I.R.C. § 2513.

Other tax free gifts

The following also are not taxable gifts and don't impact the gift tax exemption:

- **Educational and medical expense exclusion.** Gifts on behalf of any individual to pay tuition or medical expenses are unlimited if the payments are made directly to the educational institution or care provider. I.R.C. § 2503(e).

- **Gift tax marital deduction.** A donor can give unlimited amounts to the donor's U.S. citizen spouse. I.R.C. §§ 2523(a) and 2523(i). If the donee spouse is not a U.S. citizen, there is a "super" annual exclusion that is $155,000 in 2019.*

- **Gift tax charitable deduction.** A donor can give unlimited amounts to charity. I.R.C. § 2522.

The lifetime gift tax exemption

Gifts that do not fall within exclusions or deductions are called "taxable gifts." These trigger an out-of-pocket gift tax only when they exceed the donor's lifetime gift tax exemption. The lifetime gift tax exemption is $11.4 million in 2019, indexed for inflation. Married couples can effectively give away $22.8 million without paying gift tax.

* Indexed annually for inflation.

Gift tax and life insurance

The following events involving life insurance are considered gifts, if done for less than full and adequate consideration. The timing of the gift (i.e., currently or upon the death of the insured) will depend on the type of event.

- **Owner of policy that insures someone else designates a third person as beneficiary.** Consider this example. Daughter owns a $600,000 life insurance policy on mother's life. Daughter and her brother are equal beneficiaries. Upon death benefit being paid, daughter has made a $300,000 gift to her brother (half the death benefit).

- **Payment by one party of a premium on a policy owned by another party.** The value is the amount of the premium paid. Treas. Reg. § 25.2512-6(a), Ex. 1; and 25.2503-3(c), Ex. 6. This occurs when an individual pays the premium for a life insurance policy owned by someone else, such as an irrevocable trust. To qualify a gift to a trust as a gift of a present interest to the beneficiaries of the trust, making the annual exclusion available, the trust should allow trust beneficiaries to immediately withdraw each gift made to the trust for a specified period of time (e.g., 30 days). This withdrawal right is often called a "Crummey power" (named after a famous court case).

- **Transfer of policy ownership (sometimes called an absolute assignment).** The value of the gift is the fair market value of the policy, which is established either through the sale of the particular contract or comparable contracts sold by the insurance company. Treas. Reg. § 25.2512-6(a). Since those values are not always easy to determine, Treasury Regulations provide formulas.

  - If a policy is purchased for the benefit of another, the value is generally the premium that was paid. Treas. Reg. § 25.2512-6(a), Ex. 1 (some interpret this as applying whenever a policy is transferred in its first year).

  - With a paid-up or single premium policy, the value is the amount the insurer would charge for a single premium policy of the same amount on a person the insured's age.

  - In the case of an existing policy with future premium requirements, the value is the interpolated terminal reserve value plus the unearned portion of the last premium.

  - For many policies, the above formulas often provide a result close to "accumulated value" (especially with traditional whole life policies), but accumulated value can also understate the gift tax value, particularly with universal life policies that have a guaranteed death benefit.

  - For term policies, the value is generally the unearned portion of the last premium. *See* Rev. Rul. 76-490 and Rev. Rul. 2009-13. However for level term policies, the value can be higher as they generally have a reserve.

  - The above methods cannot be used if they fail to reflect the policy's full value (e.g., terminally ill insured). *See* Pritchard v. Comm'r, 4 T.C. 204 (1944).

  - Changing the beneficiary is not considered a gift, as the owner of the policy controls it and may change the beneficiary in the future.

  - **Loans on the policy reduce the value of the gift.** See I.R.S. Form 712, Life Insurance Statement. The transfer of a policy with a loan is equivalent to selling it for the loan amount, and making a gift of its net value (part gift / part sale). If the loan exceeds the donor's basis in the policy, the donor recognizes income. It is also a "transfer for value" that could make the death benefit taxable (unless an exception is met).

Estate tax generally

Property owned at death – the gross estate – is subject to estate tax. The gross estate includes all property owned by a person or his revocable trust at death, whether probate or non-probate property. This includes, for example, the home, personal property, investments, business interests, retirement assets, and life insurance. There are deductions and an exemption that reduce estate tax liability. Additionally, any prior taxable gifts made during lifetime will reduce the estate tax exemption available at death. The estate tax rate is 40%. Similar to the gift tax, estate tax is imposed when the decedent's gross estate exceeds the estate tax exemption.

Marital deduction

Property passing to a spouse who is a U.S. citizen qualifies for the unlimited estate tax marital deduction. No estate tax is owed on property that qualifies for the estate tax marital deduction.

Charitable deduction

Property passing to charity qualifies for the unlimited estate tax charitable deduction. No estate tax is owed on property that qualifies for the estate tax charitable deduction.

Estate tax exemption

In addition to the marital and charitable deductions, each person has an estate tax exemption – an amount that can be passed at death to anyone without any estate taxes. In 2019, the estate tax exemption is $11.4 million.* Because of a feature known as portability, a surviving spouse might use a deceased spouse's unused estate tax exemption.

Transfer tax summary chart (2019)

	Estate	Gift	GST
Exemption*	$11.4 million	$11.4 million	$11.4 million
Tax rate	40%	40%	40%
Portability	Yes	Yes	No
Annual exclusion*	N/A	$15,000	$15,000

* Indexed annually for inflation through 2025.

Estate tax and life insurance

Life insurance is included in the gross estate in the following situations:

- **Amounts receivable by the executor.** The amount receivable by or for the benefit of the insured's estate is included in the gross estate. I.R.C. § 2042(1).
- **Amounts receivable by others – incidents of ownership.** "If an insured dies with "incidents of ownership" in a policy, the death proceeds are included in the gross estate. I.R.C. § 2042(2).
  - "Incidents of ownership" is defined broadly and is not limited to technical ownership, but also includes the power to: change the beneficiary, surrender or cancel the policy, assign the policy, revoke an assignment, pledge the policy for a loan, or obtain a policy loan. Treas. Reg. § 20.2042-1(c)(2).
  - If an individual dies within three years of gifting a policy on his life (or gratuitously releasing any incidents of ownership), the death proceeds are included in the gross estate. I.R.C. §§ 2035 and 2042.
- **Life insurance on a third party.** If an individual dies owning a policy that insures someone else (who is still alive), the policy's fair market value – not its death benefit – is included in the owner's gross estate (presumably valued under the gift tax formulas described earlier). The "3-year rule" of I.R.C. §§ 2035 and 2042 does not apply if the donor dies within three years of gifting a policy on the life of someone other than the donor.
- **Business-Owned Life Insurance.**
  - When a business holds incidents of ownership in a policy insuring the life of one of the business owners,
    - death proceeds that **are not paid** to the business are in the insured's gross estate if:
      - the business is a corporation and the insured is a majority shareholder. Treas. Reg. § 20.2042-1(c)(6).
      - the business is a partnership, and the insured is a general partner or otherwise controls the business (even if not majority owner). *See* Rev. Rul. 83-147.
    - death proceeds that **are paid** to the business can increase the value of the business, and in turn increase the value of the portion of the business that is owned by, and included in the estate of, the deceased insured. In this situation, however, if there is an entity buy/sell agreement, the redemption liability may offset some if not all of the increase in the value of the business. *See* Estate of Blount v. Comm'r, 428 F.3d 1338 (11th Cir. 2005).
  - The "3 year rule" of I.R.C. §§ 2035 and 2042 can also apply when the business holds incidents of ownership and transfers the policy for less than full or adequate consideration and the insured dies within three years of transfer. Rev. Rul. 82-141.

Generation Skipping Transfer (GST) tax generally

Overview

The generation skipping transfer (GST) tax is generally imposed on the donor on gratuitous transfers to persons who are more than one generation younger than the transferor (transfers to a skip person).

- GST tax applies to both lifetime gifts and transfers at death and is in addition to any gift or estate tax.
- Similar to gift and estate tax rules, transfers that fall within certain exclusions or deductions are exempt from GST tax; those that do not, trigger an out-of-pocket GST tax once they exceed the GST exemption.

GST tax exclusions

- Gifts made directly to a skip person that qualify for the gift tax annual exclusion are also excluded from GST tax. I.R.C. § 2642(c). This amount is $15,000 in 2019 and is indexed for inflation in $1,000 increments.
- If a gift to a trust qualifies for the gift tax annual exclusion, the trust must meet additional requirements for the gift to also qualify for the GST annual exclusion:
  - During the life of the trust beneficiary (e.g., donor's grandchild), any distributions from the trust must go only to that beneficiary, and
  - If the beneficiary dies while the trust exists, the trust's assets must be included in that beneficiary's gross estate. I.R.C. § 2642(c).
  - Generally this means that, in order for gifts to a trust to fall within the GST annual exclusion, there will need to be a separate trust or trust share for each beneficiary.
- Amounts excluded from gift tax because of the educational and medical expense exclusion are also excluded from GST tax.
- Generally, if a donor allocates his GST exemption to all gifts he makes to an irrevocable trust, the GST tax will not apply to the trust's assets or its later distributions, regardless of how large they are.
- Given that the GST exemption for 2019 is $11.4 million per person, a married couple could give $22.8 million to an irrevocable trust that could use those funds to pay premiums for a life insurance policy (e.g., joint life second-to-die), and the death proceeds would be exempt from GST tax when paid to grandchildren or later generations.

GST tax exemption and rate

- In 2019, the GST tax exemption is $11.4 million.*
- Portability does not apply to the GST tax exemption.
- The top GST tax rate is 40%.

Types of Generation Skipping Transfers

Generation skipping transfers fall into one of three categories. See I.R.C. § 2612.

- **Direct skip.** A transfer directly to a "skip person" is a "direct skip." A skip person is (i) a person two or more generations below the transferor, or (ii) a trust with only skip persons as beneficiaries. I.R.C. §§ 2612(c) and 2613. If the transferor's child is already deceased, however, the "predeceased ancestor exception" provides that skip persons move up a generation (e.g., grandchild would be treated as donor's child and not as a skip person). I.R.C. § 2651(e).
- **Taxable termination.** A property interest in a trust that terminates in favor of a skip person is a "taxable termination."
- **Taxable distribution.** A "taxable distribution" means a distribution from a trust to a skip person that is neither a direct skip nor a taxable termination. I.R.C. § 2612(b).

* Indexed annually for inflation through 2025.

This publication is not intended as legal or tax advice. This information was compiled by The Northwestern Mutual Life Insurance Company. It is intended solely for the information and education of Northwestern Mutual's financial representatives, their customers, and the legal and tax advisors of those customers. It must not be used as a basis for legal or tax advice, and is not intended to be used and cannot be used to avoid any penalties that may be imposed on a taxpayer. Northwestern Mutual and its financial representatives do not give legal or tax advice. Taxpayers should seek advice regarding their particular circumstances from an independent legal, accounting, or tax advisor. Tax and other planning developments after the original date of publication may affect these discussions.

Copyright © 2019 by The Northwestern Mutual Life Insurance Company, Milwaukee, Wisconsin

Northwestern Mutual is the marketing name for The Northwestern Mutual Life Insurance Company (NM), Milwaukee, WI (life and disability insurance, annuities) and its subsidiaries. Further information on NM can be found at www.northwesternmutual.com.