Shielding Your Insurance from Estate Taxes

The rules are very stringent, but your financial advisor can help navigate

Life insurance, which can help to provide for your heirs in the event of your death, can be an important estate planning tool. It can provide funds to loved ones when they need it most and help meet your family's financial obligations.

One issue overlooked by many people, however, is that life insurance can add significant wealth to an overall estate, potentially causing assets to exceed the 2021 applicable exclusion amount of $11.7 million (per individual), the amount that can be sheltered from estate taxes. Fortunately, with proper guidance, it is possible to keep your life insurance policy proceeds out of your estate and to also provide immediate funding for short-term financial needs.

Know the Rules

You may already know that the inclusion of life insurance policy benefits in your taxable estate is contingent partly on incidents of ownership. Policy proceeds cannot be excluded from estate taxation if you have held any incidents of ownership on the policy during the three-year period preceding your death.

In general terms, an incident of ownership is the right to exercise control over the policy or to receive an economic benefit from the policy, including any powers to surrender the policy, to pledge the policy as collateral, or to assign the policy and any reversionary interest equal to 5% or more of the value of the policy before death. An incident of ownership also exists on a policy if you have any power to act as a fiduciary of a trust that holds insurance on your life if you established the trust, if you transferred the policy or consideration for the policy to the trust, or if you could have exercised any fiduciary power over the trust for your own benefit. However, your estate may not include your life insurance proceeds merely because you planned to purchase the insurance or gifted money used to pay premiums within three years prior to your death.

Again, entire policy benefits may be included in your estate unless all incidents of ownership are transferred more than three years before your death. In practice, the application of this rule is not always clear. Therefore, it is important to consult with your tax and legal advisors to ensure that your actions are consistent with your desired objectives.

A Plan of Action

Here is some additional information that you may want to discuss in detail with your advisor: for new life insurance policies, insurance proceeds are not included in the estate of the insured when another person (often an adult child or an irrevocable trust created by the insured) is the initial applicant on, and owner of, the policy, or when the insured never possessed an incident of ownership on the policy.

If you want to keep life insurance proceeds on existing policies out of your estate, you need to transfer any incidents of ownership on the policy to another person at least three years before your death. In addition, make sure that your estate is not the beneficiary of the policy and that the policy beneficiary is not required to use policy proceeds to pay estate claims and expenses.

Keep the above in mind as you develop a plan for keeping your life insurance proceeds out of your estate. Remember, before you take any action that might affect your policies, consider carefully all of the alternatives and seek professional counsel on how to best achieve your specific objectives.