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Issue Contents

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Managing Life Insurance Policies

-by Neil E. Harl*

With the increase in valuation in recent years of many farm and ranch estates, one would reasonably expect that life insurance policies would receive at least as much planning attention as in prior years but that appears not to have been the case.[1] In one instance, recently, an estate planner advised an 87-year old client to "get rid of" a $50,000 policy with an income tax basis of just over $11,000, setting the stage for gain of $44,000 on redemption of the policy. Even though investments in farm and ranch land have elevated many farm and ranch estates to record levels well beyond the wildest expectations of the families involved, management of life insurance policies remains an important part of the overall estate planning process.

Federal estate tax rules for life insurance proceeds

The federal estate tax gross estate includes life insurance proceeds payable to the estate *and policy proceeds in which the decedent (the insured) retained "incidents of ownership in the policy*.[2] Thus, if father takes out a $100,000 policy, makes his three sons beneficiary but retains the "incidents of ownership," the proceeds at death would be included in the father's gross estate. What if the father, more than three years before death, transfers ownership to the three sons equally? The proceeds would escape inclusion in the father's gross estate but the gift to the three sons would be a gift, subject to federal gift tax.[3]

What if the father transfers ownership of the policy to mother (to get the policy proceeds out of his estate) while the named beneficiaries were the two sons? At the father's death, the mother makes a gift of the policy proceeds to the two sons.[4]

Valuing the gift. For a life insurance policy paid up at the time of an assignment, the gift is the value that would be charged for a single premium policy of the same amount on the life of a person of the same age as the insured.[5] For a policy that is not paid up, the amount of the gift is based upon the interpolated terminal reserve accumulated at the time of the gift plus a proportionate part of the last premium paid before the gift.[6]

Present or future interest? Is the policy a gift of a present interest or a future interest? If the donee's ownership is outright, the donor is normally entitled to the federal gift tax annual exclusion ($14,000 in 2013) as a gift of a present interest.[7] However, if the transfer is to two or more owners jointly, the transfer may not qualify for the gift tax annual exclusion because no donee could immediately possess and enjoy the property inasmuch as each donee's rights are dependent upon the consent of the others.[8] One solution is to request that the policy be severed into a separate policy for each done and then the transfer should be that of a present interest.[9]

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Transfer of policy ownership within three years of death

Transfer of policy ownership within three years of death by the insured continues to make the policy proceeds includible in the insured's gross estate.[10]

If a policy was not transferred by the insured within three years of death, and the policy was not owned by the decedent at death, is any amount included in the insured's estate (in addition to premium amounts paid by the insured)? The question is whether payment of premiums within three years of death would cause a proportionate part of the insurance collected at death to be included in the insured's gross estate. IRS ruled, in 1967,[11] that a proportionate part of the policy proceeds would have to be included in the insured's gross estate. However, that position was abandoned in 1971 with the result that only the premiums paid within three years of death would be included of forfeiture.[12] This assumes the original policy was transferred more than three years before death. IRS maintains the former position for accidental death policies and for whole life policies taken out or transferred within the three year period.[13]

Redemption of the policy during life

Remember, the payment of life insurance proceeds *after the death of the insured* does not result in the proceeds being subject to income tax.[14] But if a life insurance policy is surrendered to the insurer for the available cash value, to the extent the fair market value of the life insurance policy exceeds the policy's income tax basis (based on the premiums paid), the amount of the proceeds over which the taxpayer-insured has control or receives an economic benefit otherwise, is subject to income tax as ordinary income.[145]

ENDNOTES

[1] See Duffy, "Farmland Value Reaches Historic $8,296 Statewide Average," Iowa State University Extension, December 11, 2012. See generally 5 Harl, *Agricultural Law* § 43,02[8] (2013); Harl, *Agricultural Law Manual* § 5.02[5] (2013). See also Harl, "Watch Transfers of Life Insurance Policies," 21 *Agric. L. Dig*. 105 (2010).

[2] I.R.C. § 2042. See Salyer v. United states, 194 F.3d 1313 (6th Cir. 1999) (life insurance policy proceeds included in gross estate but not eligible for the marital deduction).

[3] Treas. Reg. § 25.2511-1(h)(8).

[4] Rev. Rul. 81-166, 81-1 C.B. 477 (gift by policy owner to beneficiaries at death of insured).

[5] Treas. Reg. § 25.2512-6(a). If the particular kind of policy is not then available, the value may be established by the replacement cost of comparable policies.

[6] Treas. Reg. § 25.2512-6(a). For each policy of life insurance given to a donee or donees during a calendar year, the donor is to obtain a statement by the insurance company on Form 712, Life Insurance Statement, and file it with the Internal Revenue Service Office with whom the gift tax return is filed.

[7] I.R.C. § 2503(b).

[8] Skouras v. Comm'r, 188 F.2d 831 (2d Cir. 1951).

[9] Some policies may be worded to avoid this problem.

[10] I.R.C. § 2035(a)(2). See I.R.C. § 2042 (proceeds of life insurance). That is one of only four instances where a gift within three years of death causes inclusion of the value in the donor's gross estate. The others are retained life estates, I.R.C. § 2036; transfers taking effect at death, I.R.C. § 2037; and revocable transfers, I.R.C. § 2038.

[11] Rev. Rul. 67-463, 1967-2 C.B. 327.

[12] Rev. Rul. 67-463, 1967-2 C.B. 329.

[13] See Bel v. United States, 452 F.2d 683 (5th Cir. 1971), *cert. denied,* 406 U.S. 919 (1972) (payment of premium on accidental death policy was deemed an act of "transfer"); Estate of Silverman v. Comm'r, 61 T.C. 338 (1973), *aff'd,* 521 F.2d 574 (2d Cir. 1975) (amount included in decedent's estate was portion of face value equal to ratio of premiums paid by decedent to total premiums where policy was transferred six months before death).

[14] I.R.C. § 101(a). The so-called "viatical settlements" whereby amounts are received under a life insurance contract on the life of the insured who is "terminally ill" or "chronically ill" are treated as paid by reason of the death of the insured with no income tax imposed. I.R.C. § 101(g)(1)(B).

[15] See Freedman v. Comm'r, 346 F.2d 526 (6th Cir. 1965), *aff'g,* 41 T.C. 428 (1963). See also Gluckman v. Comm'r, T.C. Memo. 2012-329 (life insurance policy benefits required to be included in gross income; taxpayer's employer withdrew from benefit plan, resulting in no risk of forfeiture); Scott v. White, T.C. Summary Op. 2012-108 (termination of life insurance policy resulted in constructive receipt of income).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

ANIMALS

HORSES. The plaintiff was riding a horse on a public highway when the defendant approached from the rear with the defendant's child in a stroller and two dogs. The plaintiff's horse bolted and threw the plaintiff who sustained injuries. The defendant asserted the defense of assumption of risk in that the spooking of the horse was within the normal risks of equestrian activities. The court noted that the doctrine of assumption of risk in New york required that the equestrian activity be "sponsored or otherwise supported by the defendant;" therefore, the doctrine could not be used as a defense in this case. The court held that the defendant was entitled to summary judgment on the negligence claim because actions for injuries caused by domestic animals are available only in strict liability which must be established by "evidence that the animal's owner had notice of its vicious propensities." The court noted that there was no evidence that the defendant's dogs directly caused the spooking of the plaintiff's horse or that the defendant had any knowledge that the dogs would cause the horse to spook. **Filer v. Adams, 2013 N.Y. App. Div. LEXIS 3831 (N.Y. Sup. Ct. 2013)**.