Trusts and Estates Law
Life Insurance: A Survivor

by Hon. C. Raymond Radigan

I have been teaching estate planning as a special or adjunct professor at St. John's University School of Law and Hofstra University School of Law, and other law schools throughout the state since 1980.

When I first started teaching estate planning, I pointed out many devices that could be used in order to minimize estate taxes such as Crown loans, Clifford trusts, trust and leasebacks, estate freezes, and other like devices which I will address in future articles.

Congressional legislation and court rulings have greatly diminished the utilization of these devices to reduce estate taxes.

One survivor of the tools that estate planners utilize in order to reduce estate taxes is life insurance, which survives because of the social and economic benefits that the Congress attributes to life insurance as well as the successful lobbying by the life insurance industry.

Life Insurance Keys

Basically, life insurance is an arrangement under which many share the risk of death. Life insurance is acquired for many reasons, which include, among others, the following:

(i) to replace earnings of the breadwinner that are lost on death of the earner;

(ii) to pay outstanding debts or those arising at death;

(iii) to cover death taxes and other expenses relating to one's death;

(iv) to provide working capital for a business when a key person dies causing

an economic loss and that individual has to be replaced;

(v) to fund employee stock ownership plans and other employee benefit entities;

(vi) to fund a buy-sell agreement;

(vii) to pay income taxes on assets such as pensions and death benefits;

(viii) to provide assets and not force the sale of estate assets in order to cover estate obligations;

(ix) to build an estate for the surviving spouse and family members; and

(x) to substitute for an interest in a trust whereby the decedent derived income that ceases upon his death and the family would no longer have the benefit of those assets to provide for their necessary maintenance and support.

The foregoing and other reasons prompt individuals to include life insurance in their overall estate plan. It is a protection for dependents since ordinarily creditors cannot reach the insurance payments. Generally, the insurance proceeds are not subject to economic fluctuations other than inflation. Life insurance also provides immediate liquidity in an estate relieving the fiduciaries of the need to sell estate assets on unfavorable conditions at the time of death.

Another benefit of life insurance is that ordinarily the beneficiaries will not have any income tax liability on the proceeds especially if they are received in a lump sum. If they are taken by installment, part will be subject to income taxes. Therefore, unlike annuities, Internal Revenue Service (IRS)-qualified pension and death benefit plans, and like receipts, which are subject to income tax, generally insurance is not.

Initially, the test as to whether insurance proceeds were to be included in the insured estate was based on who paid the premiums. If the insured paid the premiums, the full recovery under the policy would be included in the insured's estate.

Under our present law, we look to incidents of ownership and not whether the insured paid the premiums. Under §2042 of the code, if the decedent has any incidents of ownership in the policy, it would be included in his estate, and of course if he named his estate as the beneficiary of the policy, it also would be included in his estate.

Practitioner in Estate Planning

In estate planning, the practitioner in order to avoid having insurance proceeds be included in the decedent's estate will attempt to have the incidents of ownership owned by others and not the insured. This can be accomplished by beneficiaries or others taking out insurance on the insured's life without the insured having any incidents of ownership or had the insured initially procured the insurance to have it effectively transferred so that it would not be included in his estate for estate tax purposes.

Prior to our uniform estate tax and gift tax system, gifts in contemplation of death would be includable in the decedent's estate if the transfers were made within three years of the decedent's death. When Congress eliminated the gifts in contemplation rule, it did retain, however, insurance, as an asset that would be subject to the old gift in contemplation of death rule. Therefore, if a decedent gave up whatever incidents of ownership that he or she had within three years of death, it would cause the insurance recovery to be included in his or her estate for estate tax purposes.

Some estate planners address this issue by transferring the insured's interest in a policy to a trust that provides that the beneficiary would be the surviving spouse if the insured died within three years, which by the way of the unlimited marital deduction, would avoid any estate tax on the insurance proceeds. The trust could further provide that if the decedent survived three years, then the proceeds would be paid to others and thus if he or she had no incidents of ownership at all when he died, the proceeds could go to his children or others without being subject to estate taxes.

The insured could transfer incidents of ownership outright to his children if that was his intent, however, he must survive three years to avoid the contemplation of death rule. Very often, the insured desires to transfer the incidents of ownership to a trust. One must be cautious when dealing with transfer to a trust. If an insured wishes to take out an insurance policy, goes to a broker, arranges for the procurement of the policy and names a trust as the beneficiary and then goes to his or her lawyer and creates the trust, the designation would be ineffectual and the assets from the policy would be included in the insured's estate. Life insurance can be paid to a trustee as beneficiary but only if the trustee was named under a trust agreement in existence at the time of the naming of the trustee as beneficiary, and the trust agreement is identified as the designated beneficiary. Therefore, the trust must be created before the insurance is taken out naming the trust as a beneficiary. *In re Stein*, 131 AD2d 68, 520 NYS2d 157 (2nd Dept. 1987).

A defensive position concerning transferring incidents of ownership within three years of death would be to have the beneficiary pay the premium on the policy for that period of time. If the decedent dies within three years and the beneficiary paid the premium during that three-year period of time, the pro rata portion of the insurance paid by the beneficiary will be excluded from the decedent's estate. It is not only the premiums that the beneficiary paid during that period of time, but the full pro rata portion of the insurance itself that will be excluded from the decedent's estate. *Liebmann v. Hassett,* 148 F2d 247; *Silverman v. U.S.,* 521 F2d 574.

A Crummey Power

If an insured wishes to transfer a policy to a trust, and wishes to avoid gift taxes on the transfer of the policy, he or she can accomplish this by what is called a Crummey Power (*Crummey v. Commissioner*, 397 F2d 82 Rev. Rule 73-405).

If insurance is transferred directly and not in trust, the annual exclusion could be used to offset any gift tax on the transfer and one can use the uniform transfer to minors act to transfer a policy on behalf of an infant. However, if the policy is gifted to a trust, then the gift would not be a present interest but a future interest and the annual exclusion would be allowed.

Under the Crummey Power, the trust instrument created by the insured or others would provide that the beneficiaries could withdraw the policy thereby converting what would have been a future interest into a present interest and the annual exclusion would be allowed to cover gift tax due. The beneficiary would let the power to lapse leaving the policy in the trust.

When there are multiple beneficiaries of an insurance trust, one must limit the Crummey Power to comport with the five and five rule of the Internal Revenue Code (IRC 2041(b)(2) and (e)) provisions in order for a beneficiary not to be treated as giving a gift to the other beneficiaries as a result of permitting the lapse. Therefore, practitioners dealing with multiple beneficiaries limit the power to take down the greater of $5,000 or 5 percent of the principal, which then would not result in a lapse of a general power of appointment benefiting the other beneficiaries.

In *Cristofani v. Commissioner,* 97 TC 74 1991, the IRS unsuccessfully argued that withdrawal powers given to grandchildren with only contingent remainder interests did not qualify for the annual exclusion since they were not primary beneficiaries. Nonetheless, one should be cautioned not to solely give a beneficiary a Crummey Power to withdraw without any further interest in the trust.

Once the policy is transferred outright, the insured can utilize his or her annual exclusion to provide funds for the payment of the premiums. If, however, the policy is transferred in trust, the insured can contribute assets to the trust for the purposes of the trust paying the insurance premiums. However, again, that would be a future interest and the way to convert the future interest into a present interest is to grant the beneficiaries the power to withdraw the premiums under a Crummey Power which they will let lapse, but again, one must be concerned with the five and five power.

If one wishes to disinherit a spouse, all of his or her assets could be utilized to purchase life insurance and a surviving spouse would not be entitled to an interest in the insurance proceeds as it does not constitute a testamentary substitute. For a detailed discussion of the legislative history concerning insurance, and why it is not a testamentary substitute, see *Matter of Boyd,* 161 Misc2d 191 613 N.Y.S.2d 330 (Surr. Court, Nassau Co. 1994).

The Future

In my next article I will cover additional estate planning as it relates to insurance.

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