

That's Rich

Life Insurance May Create Tax Problem

By Judon Fambrough

President Clinton is considering ways to reduce the federal deficit. Although many advocate the reduction in spending, in all probability taxes will rise.

Tax hikes generally are associated with federal income taxes. However, a movement is underway to increase the lesser known federal gift and estate taxes.

Federal gift and estate taxes (referred to here as *taxes*) are designed to tax each generation of "rich people." The intent is to redistribute the wealth by taxing large estates. The problem lies with defining a large or wealthy estate.

During the 1940s, only estates exceeding \$60,000 were subject to the tax. The gift tax was separate.

Because of the inflationary spiral during the 1970s, a \$60,000 estate was no longer associated with the rich. Consequently, the tax was restructured in 1976, gradually raising the taxable estate to \$600,000.

After several legislative refinements and adjustments, the current structure emerged. Here is a brief sketch.

- Gift taxes and estate taxes are combined and no longer administered separately.
- A person giving away more than \$10,000 per year per donee must file a quarterly gift tax return with the Internal Revenue Service.

- All taxable gifts (the amount in excess of \$10,000 per year per donee) reduce the \$600,000 lifetime exemption given each donor.
- When the taxable gift or gifts plus the deceased's taxable estate exceed \$600,000, the tax must be paid.
- Tax rates are progressive, beginning at 37 percent and ending at 50 percent.
- All property passing between spouses, either by gift or will, is free of the tax. This is known as the *unlimited marital deduction*.
- Unpaid taxes create a lien on the deceased's property. The Texas homestead law can not prevent a valid federal lien from being placed on homes.

In 1992, two attempts to change the tax were unsuccessful. One measure attempted to lower the taxable estate to \$200,000. With the new administration trying to raise revenue, no doubt the present tax structure will be re-evaluated.

The major problem created by the tax is finding sufficient liquidity to pay it. People with large homes, farms or ranches may have an enviable net worth but a small cash flow. For this reason, life insurance, if affordable, becomes an apparent solution.

Life insurance, however, may increase or even create a tax problem. If not handled properly, the face value of the policy is included in the deceased's

estate. This can cause an otherwise nontaxable estate to exceed \$600,000. Also, it will increase the burden on an estate already subject to the tax.

Four key players are associated with life insurance: the insurer (the company), the insured (the person whose death will trigger payment), the owner (generally the one paying the premiums) and the beneficiary (the one receiving the value of the policy upon the insured's death). The problems occur when the insured or the insured's estate is either the owner or beneficiary of the policy.

Here is a brief synopsis of the tax rules. The face value of any insurance policy is included in the deceased's estate for purposes of the tax whenever:

- the deceased's executor (or administrator) or the deceased's estate is the beneficiary or recipient,
- the deceased holds any "incidents of ownership" at death or
- the deceased transferred the incidents of ownership in "contemplation of death."

The phrase "contemplation of death" generally means within three years of death. The phrase "incidents of ownership" means having the power to:

- change the beneficiary,
- surrender or cancel the policy,
- assign the policy,
- revoke an assignment,

- obtain a loan from the insurer against the policy's surrender value.

Texas residents do have some relief. If the policy was purchased with community property funds, and not with the deceased's separate property, only half the value of the policy is included in the deceased's estate.

To keep the policy from being included in the deceased's estate, two rules should be followed. First, never make the deceased's executor (or administrator) or the deceased's estate

the beneficiary or recipient. Second, the insured should never purchase the policy nor pay the premiums. This should be done by the beneficiaries, generally the insured's children. If the children have insufficient cash, the insured may give them the amount using the \$10,000 per year per donee exemption.

If the insured already has purchased a policy and named the estate as the beneficiary or retained the incidents of ownership, swift measures should be initiated if a tax problem is apparent.

The insured should contact the insurer to change the beneficiary and assign the incidents of ownership. The insured must then live three years. If not, the value of the policy may be included in the deceased's estate because of the contemplation-of-death rule mentioned earlier.

This article is for information only and is not a substitute for legal counsel. ☐

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