

Shielding Your Insurance from Estate Taxes

Life insurance can help provide for your heirs, and act as an important estate planning tool. It can offer protection to loved ones when they need it most, and help ensure financial obligations will be fulfilled. One thing that many people do not realize is that life insurance can add a significant amount of wealth to their overall estates, and can possibly cause assets to surpass the applicable exclusion amount of \$2,000,000 (in 2006), the amount that can be sheltered from estate taxes. However, with proper guidance, it is possible to keep your life insurance policy proceeds out of your estate, as well as provide immediate funding for short-term financial needs.

You may already know that life insurance policy benefits are contingent upon incidents of ownership. In general, an incident of ownership is the right to exercise control over the policy, or to receive an economic benefit from the policy. When planning estate conservation, it is important to know that policy proceeds cannot be shielded from estate taxation if you have held any incidents of ownership in the policy during the three-year period preceding your death.

Incidents of ownership in life insurance include 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. Incidents of ownership also applies to any power to act as a fiduciary of a trust that holds insurance on your life if you established the trust, you transferred the policy or consideration for the policy to the trust, or if you can exercise any fiduciary power over the trust for your own benefit. However, your estate will not include your life insurance proceeds merely because you initiated its purchase or paid its premiums within three years prior to your death.

Entire policy benefits will be included in your estate unless all incidents of ownership are transferred more than three years before your death. In practice, application of this rule is not always clear. In some circumstances, life insurance policy proceeds may be included in an insured's taxable estate even though the insured was never named as the policy owner.

Steps You Can Take

For new life insurance policies, 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 and owner of the policy, and when the insured never possesses an incident of ownership in the policy.

If you want to keep life insurance proceeds out of your estate on existing policies, you will need to transfer any incidents of ownership in the policy to another person at least three years before your death. In addition, you must 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.

A Plan of Action

The above guidelines can help you develop a plan of action for keeping your life insurance proceeds out of your estate. However, before you take any action that might affect your policies, consider all of the alternatives, and seek professional counsel on how to best achieve your specific objectives.

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