

Costly Life Insurance Mistakes (Part 2)

THREE-YEAR LOOK-BACK RULE

When an insured gives away a personally owned policy on their life, it is not out of their estate for three years from the date of transfer. If the insured should pass within those three years, the policy proceeds will be included in the insured's estate. The three-year rule does not apply to a transfer that qualifies as a "bona fide sale for adequate and full consideration." *Reference: 26 U.S.C. § 101(a)(2)*

THE THREE-PARTY CORPORATE PROBLEM

Business owners want to use business earnings to purchase life insurance to benefit their family. Often they want to avoid taxes on the premium and propose the corporation own the policy, with the business owner as the insured and the spouse/family as the beneficiary. This leads to the Three-Party Corporate Problem, which creates a tax either for the business owner or beneficiary. **Solution:** Explore the use of Executive Bonus Arrangements or Split Dollar Arrangements. *Reference: TAM 8144001; Ducros v. Comm'r, 272 F (2d) 49 (1959)*

ESTATE AS BENEFICIARY

When a beneficiary dies before the insured and the policy does not name a successor beneficiary, the proceeds will be paid to the insured's estate. In turn, the proceeds would now be subject to creditor claims, probate, and potentially more taxes.

GIFT OF A POLICY WHERE THE LOAN AMOUNT EXCEEDS BASIS

A gift of a policy with an outstanding loan may cause the benefit to become taxable as a violation of the Transfer for Value Rule. **Solution:** Structure the transaction so that the loan amount does not exceed policy basis at the time the gift is made. *Reference: 26 U.S.C. § 101(a)(2)*

1035 EXCHANGE AND POLICY LOANS

The deferral of gains is lost if a policy exchange is not structured properly. The policy needs to be either transferred to a new policy with the loan, the loan could be taken care of out-of-pocket before the transfer or the policy owner could pay off the loan in the second year of the new policy with internal policy values. *Reference: 26 U.S.C. § 101(a)(2); Section 1031(b)*

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