Columbus Life Insurance Company

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Advanced Markets **Insights**

Life Insurance and the Triangle problem – An Unexpected Tax Liability

A tax-free death benefit is an important benefit of life insurance. However, if the life insurance policy is not properly structured unexpected tax consequences can occur. IRC Section 101(a) provides the general rule that the death benefit is received income tax free.

"Two of Three" Rule

There are a number of statutory exceptions to this general rule, including the "transfer for value" rule and employer owned life insurance policies. Sometimes overlooked is the non-statutory "triangle" rule that can result in the death benefit being subject to income or gift taxes. For death benefit tax purposes, there are three essential parties to an insurance contract — the owner, the insured and the beneficiary. The rule with respect to insurance contracts is that two of the three parties to the contract should be the same. In other words, if the owner and the insured are the same, then the beneficiary will be someone else. If the owner is not the insured, then the owner needs to be the beneficiary. It is the situation where the owner and insured are different that problems usually arise. The reason for this is simple — the owner of the life insurance contract has the power to name the beneficiary and if the owner names anyone other than the owner then they have made a transfer to the beneficiary.

When the three parties are different, the consequence is that the owner is treated as either making a gift to the beneficiary or the beneficiary receives taxable income, depending on the relationship between the parties. In a family situation the result will usually be gift tax consequences. In a business situation there will usually be an income tax consequence with the amount treated as compensation or a dividend.

Gift Tax

With the gift tax situation, the IRS has issued three Revenue Rulings in this area to illustrate the problem.

1. Wife purchases a life insurance policy on husband and names herself as the owner and the children as beneficiaries. At the death of husband, wife is treated as making a gift of the entire proceeds to the children. Rev. Rul. 73-207, 1963-1 CB 409.
2. Wife purchases policy on life of husband, naming a trust she created as the beneficiary. The trust provides that income from the trust is to be paid to husband for life and after his death trust assets are divided equally among the children. If husband dies first, the wife is deemed to have a gift of the proceeds to her children. Rev. Rul. 77-48, 1977-1 CB 292.

The "Triangle" Problem

The "Triangle" problem arises when each of the owner, the insured and the beneficiary are different parties. By making sure that two of the parties are the same, unexpected tax consequences when the death benefit is paid can be avoided.

3. Husband creates a revocable living trust. Income is payable to wife during her life and at her death, trust assets pass to the children. Wife purchases life insurance on husband and names his trust as the beneficiary. Upon husband's death wife is deemed to have made a gift of the proceeds to the children, less the present value of her income interest for life. Rev. Rul. 81-166, 1981-1 CB 477.

Another situation where this problem arises is where Mom wants to purchase a policy on her life with her three children as beneficiaries. Mom's attorney recommends an ILIT to keep the policy out of her estate for tax or other reasons. Mom wants the children to own the policy and not bother with the trust. However, she has three children, one of whom lives nearby and the other two live out of state. Producer suggests that the child who lives nearby be the owner and all three children be named as beneficiaries. At Mom's death each child will receive one-third of the death benefit. However, the child that is the owner of the policy will be treated as having made of a gift of one-third to each of the siblings.

These expensive mistakes in the family situation can be avoided by making the owner and the beneficiary the same. While joint owners of a policy may be permitted, it can lead to a different set of problems particularly if one of the children predeceases the insured. In most cases, the use of an ILIT will be a better solution.

Income Tax

The income tax situation usually arises in the business environment and is most commonly an issue when changing the beneficiary on an existing policy. A typical example is when a business purchases a key person policy on an executive, naming the business as the owner and beneficiary. At retirement, rather than distributing the policy to the executive, the business simply changes the beneficiary to the executive's spouse. When the executive dies, the death benefit will be income taxable to the spouse as compensation income because of the business relationship between the parties. This result could have been avoided with a split dollar arrangement, with the executive paying the economic benefit cost each year.

The problem can also arise when buy-sell arrangements are terminated after the owners are no longer involved in the business. If an entity redemption arrangement is being unwound, simply changing the beneficiary to the spouse gives the same result as above. If the arrangement was a cross purchase arrangement, the owner simply changes the life insurance beneficiary from himself to the other owner's spouse without transferring the policy to the other owner. The result is the same when the spouse receives the death benefit on the death of husband — taxable income because the owner and her deceased spouse were business partners.

Summary

The triangle problem is an issue to keep in mind when structuring life insurance contracts and when making changes. While the majority of cases never have this concern, it is important to keep this and other rules in mind. If two of three parties are the same when setting up or making changes to a life insurance policy, problems will be avoided.

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