“Life insurance is a tool with the potential to help unmarried couples pass on money to each other in ways which may reduce the loss of the marital deduction.”

Creating a “Virtual” Marital Deduction with Life Insurance
It's no secret that the Internal Revenue Code legally discriminates in favor of married couples. Over the years Congress has created many tax preferences for married couples. One of the most valuable tax preferences is the marital deduction. The marital deduction permits spouses to make lifetime transfers of property to each other free of federal gift taxes (IRC Section 2523). Also, it allows transfers of property at death to be federal estate tax free under IRC Section 2056.*

The marital deduction can provide at least three valuable benefits: (1) federal estate taxes on transferred assets are postponed until the surviving spouse's death, (2) transferred assets can help the spouse take advantage of his/her applicable exemption amount, and (3) there is no ceiling on the marital deduction. It is available whether the amount transferred to the spouse is $100 or $100 billion dollars (although state estate/inheritance taxes may be assessed in some states).

In order to qualify for the marital deduction, the person transferring the assets must be legally married to the person who receives them. Property that passes to a loved one who is not married to the transferor at the time of the transfer doesn’t qualify for the marital deduction. The imposition of federal gift or estate taxes may significantly reduce the amount of property the partner receives. This is not a problem for unmarried couples who don’t have property in excess of the applicable exemption amount. However, it has the potential to be an expensive problem for unmarried couples with large net worths.

A “Virtual” Marital Deduction

Many unmarried couples with large estates who are in committed relationships are often surprised to learn how expensive federal gift and estate taxes can be. Once they understand how much they stand to lose to these taxes, they often become more interested in minimizing the financial impact of not qualifying for the marital deduction.

Life insurance is a tool with the potential to help unmarried couples pass on money to each other in ways which may reduce the loss of the marital deduction. A policy insuring

Example

Chris and Jess are in a committed long-term relationship; they desire to leave all their assets to each other. Chris has a current net worth of $7 million. They are not certain what the federal estate and gift tax laws will be in the future, but without a marital deduction they expect the impact on Chris’ estate will be in the neighborhood of 35% - over $2 million. Chris is willing to help Jess purchase a $2 million life insurance policy to offset this loss. Jess will be the beneficiary and have the responsibility of paying the premiums. Chris has the option of helping Jess pay some or all of the premiums by making gifts or loans.

Potential Concerns

Chris could potentially have one or two concerns with this simple ownership structure. First is loss of control. Since Jess owns the policy, Chris has no control over it. Only Jess can make decisions pertaining to it. If for some reason their relationship ends, Chris may not be able to terminate the policy or get it back.

A second concern is that Jess may not use the death benefits as Chris might desire. Is there any way for Chris to keep the death benefits from being squandered or used unwisely? If Jess owns the policy, Chris can’t control how the death benefits are used.

Establishing a Trust to Own the Policy

If Chris is concerned about either of these possible problems, a different ownership arrangement should be considered. Chris can establish an irrevocable life insurance trust (ILIT) to own the policy and name Jess as its primary beneficiary.

At Chris’ death the trust will receive the income tax free death benefits. The trustee will then distribute them to Jess as Chris has directed in the trust. Chris should not be the ILIT trustee because that would give Chris an incident of ownership in the policy. Still, Chris could maintain indirect control over the policy in two ways. First, Chris gets to place provisions in the trust to dictate how the death benefits may be used. These provisions can address particular situations that may concern Chris and tell the trustee how to deal with them.

* An unlimited marital deduction is currently not available for transfers to spouses who are not citizens of the United States (unless the transfer is made through a qualified domestic trust-QDOT). Transfers to non-citizen spouses are subject to gift or estate taxes when the total value of lifetime transfers (not qualifying for the gift tax annual exclusion) and/or transfers at death exceed the gift or estate tax exemptions.
one partner may be designed to pay death benefits directly to the surviving partner outside the federal estate tax system. The result can be a “virtual” marital deduction for the proceeds passing to the surviving partner. To achieve this favorable estate tax result, the insured partner should avoid owning the policy or possessing any “incident of ownership” in it. Under IRC Section 2042, when an insured possesses an incident of ownership in a policy within three years of death, the entire policy death benefit will be included in the insured’s taxable estate. Federal estate taxes may increase as a result.

The steps needed to obtain a “virtual” marital deduction with life insurance are relatively simple. The partner with the longest life expectancy is the one most likely to suffer the financial cost of not qualifying for the marital deduction. He/she may purchase a policy on the life of the other partner and name him/herself as the policy beneficiary. At the insured partner’s death, the surviving partner generally receives the proceeds federal income tax free under IRC Section 101. The proceeds should also be federal estate tax free if the insured does not have an incident of ownership in the policy.

Second, Chris selects the trustee and can name someone who is likely to follow the terms of the trust. Although Chris can’t force the trustee to take specific actions, while Chris is alive they can have conversations and discuss specific procedures and courses of action. Chris can make gifts or loans to the trust to help the trustee pay the premiums. As long as Chris doesn’t have an incident of ownership in the policy, the death benefits should avoid federal estate taxes at Chris’ death.

Avoiding Probate and Publicity

In addition to financial benefits, these two ownership strategies potentially provide another advantage—the ability to avoid publicity and probate. Because life insurance death benefits are paid directly to the policy beneficiary and because Chris never had an interest in the policy, the death benefits should be excluded from the probate of Chris’ estate. However, a party with standing (such as someone claiming he/she was an equitable beneficiary of the policy) could challenge the payment of the death benefits in a civil court.

Still, avoiding probate can be a big advantage. Property transfers at death to non-family members (especially a live-in non-spouse partner) sometimes trigger serious issues in the probate of an estate. Will contests and claims against the estate are not uncommon. Many months can pass before there is a resolution. The court costs and attorney’s fees eat away at the inheritance everyone ultimately receives. Using life insurance to provide a significant part of the inheritance for the non-spouse partner may avoid probate court conflicts and the unwanted publicity which often flows from them.

If Chris establishes an ILIT to own the policy, there may possibly be another layer of protection for the death benefits from outsiders’ claims. By going to the trouble and expense of creating a trust to own the policy and manage the death benefits, Chris is making a strong statement about how the death benefits should be used.

What If Estate Taxes Aren’t a Problem?

Many unmarried partners in committed relationships aren’t wealthy enough to be subject to the federal estate tax. For them, the inability to use the marital deduction isn’t a problem. But that doesn’t mean they don’t have the same estate planning objectives as wealthier Americans. They still want to maximize the value of their estates and divide them reasonably between their partner and other beloved family members.

If federal gift and estate taxes aren’t a concern, then another planning strategy can be used. The partner likely to die first can purchase and own the policy him/herself. As long as the policy death benefit isn’t large enough to increase the taxable estate to more than the applicable exemption amount, the policy may not need to be owned by the partner or by a trust. Instead, the insured can own it him/herself.

Personal ownership of the policy has several potential advantages.

1. The insured has total control of the policy. He/she could do anything desired with the policy (within the policy’s terms). The time and expense of creating a trust could be avoided.

2. The insured would have total privacy. The insured could purchase it without telling anyone. He/she could change the beneficiary or surrender the policy at any time without having to give anyone a notice or explanation.

3. The insured could pay premiums without having to worry about making any gifts. Since he/she owns the policy, the premiums paid would not be considered gifts.

4. As the policy owner, the insured partner owns and has unrestricted access to any cash values the policy could potentially produce.

5. Issues regarding insurable interests (the ability of an individual to purchase a policy on the life of a non-relative) should not apply. Personal ownership of the policy can make things much simpler.
Conclusion

People form many different types of committed relationships and many of them do not involve a marriage contract. The Internal Revenue Code prevents unmarried couples from benefitting from one of the valuable tax benefits in our tax system - the gift and estate tax marital deduction. However, with good health and thoughtful planning, unmarried couples may use life insurance to create a “virtual” marital deduction. Considering life insurance in this way may add new opportunities and flexibility to their wealth transfer planning.

For more information on creating a virtual marital deduction with life insurance, contact your Voya Financial™ professional.