Insurance on your life will be included in your taxable estate if either:

(1) Your estate is the beneficiary of the insurance proceeds, or
(2) You possessed certain economic ownership rights ("incidents of ownership") in the policy at your death (or within three years of your death).

Avoiding the first situation is easy: just make sure your estate is not designated as beneficiary of the policy.

The second rule is more complex. Clearly, if you are the owner of the policy, the proceeds are included in your estate regardless of who the beneficiary is. However, simply having someone else possess legal title to the policy will not prevent this result if you keep so-called "incidents of ownership" in the policy. Rights that, if held by you, will cause the proceeds to be taxed in your estate include:

- the right to change beneficiaries,
- the right to assign the policy (or to revoke an assignment),
- the right to pledge the policy as security for a loan,
- the right to borrow against the policy's cash surrender value, and
- the right to surrender or cancel the policy.

Keep in mind that merely *having* any of the above powers will cause the proceeds to be taxed in your estate even if you never exercise the power.

Buy-sell agreements. Life insurance obtained to fund a buy-sell agreement for a business interest under a "cross-purchase" arrangement will not be taxed in your estate (unless the estate is named as beneficiary). For example, say A and B are partners who agree that the partnership interest of the first of them to die will be bought by the surviving partner. To fund these obligations, A buys a life insurance policy on B's life. A pays all the premiums, retains all incidents of ownership, and names himself beneficiary. B does the same regarding A. When the first partner dies, the insurance proceeds are not taxed in his estate.

Life insurance trusts. A life insurance trust is an effective vehicle that can be set up to keep life insurance proceeds from being taxed in the insured's estate. Typically, the policy is transferred to the trust along with assets that can be used to pay future premiums. Alternatively, the trust buys the insurance itself with funds contributed by the insured. As long as the trust agreement gives the insured none of the ownership rights described above, the proceeds will not be included in his estate.

The three-year rule. If you are considering setting up a life insurance trust with a policy you own currently or simply assigning away your ownership rights in such a policy, please call me as soon as you reasonably can to effect these moves. Unless you live for at least three years after these steps are taken, the proceeds will be taxed in your estate. For policies in which you never held incidents of ownership, the three-year rule doesn't apply.