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Life Insurance: An Estate Planning Tool

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Explains when life insurance should be part of a family's estate plan.

Many families find life insurance to be an important tool in an estate plan. Life insurance can help accomplish families' financial objectives by providing:

- Immediate cash for payments of debts, costs of the last illness, burial expenses, costs of administration, other settlement costs, and, if necessary, payment of federal estate taxes and elimination of the possibility of a forced sale of assets to generate needed cash.
- Funds for the surviving partner to buy the partnership interest of the deceased partner from the heirs. This enables the business to continue as an on-going enterprise.
- Cash when an heir has a contract to buy a family member's farm/ranch or other business at his/her death. The heir could insure the family member's life as a means of providing cash to purchase the business should the family member's death occur before the heir has built enough cash reserves.

Also,

- Some parents buy life insurance on an adult son or daughter who is in the process of taking over the farm/ranch or other business. Such action offers protection for parents so that the death of the adult child will not disrupt the business.
- Life insurance proceeds can be used to provide off-farm heirs with "equitable" treatment if the parents' desire is to pass the business intact to a farming/ranching son or daughter. Doing this can prevent the farm/ranch from being split into smaller units of uneconomical size to make an "equal" division among children. Leaving the business to the operating heir and life insurance proceeds to off-farm heirs prevents the operating heir from having to buy out the interests of other heirs when he/she may be unable to afford it.
- Life insurance can also be used to create an estate where one would not otherwise exist.

Tax Status

Many people are unaware that some life insurance proceeds are taxable. Life insurance proceeds are subject to federal estate taxes if the policy holder has "incidents of ownership" in the policies or if the proceeds are payable to the estate. Examples of "incidents of ownership" include the right to change beneficiaries, to borrow cash value, to select dividend options or to change premium payment schedules. If your objective is to avoid having the value of life insurance included in your gross estate for federal estate tax purposes, you must give up ownership of the policy. To accomplish this, all incidents of ownership must be surrendered or transferred to someone else, such as your spouse, child or to a trust.

Changing Ownership

To make sure beneficiaries fully benefit from each dollar of life insurance, the insured may find it advisable to establish ownership in someone else's name (spouse or children, for example) for all or some of their policies. If the insured does not retain "incidents of ownership" in the policies, life insurance proceeds will not be included in the gross estate for federal estate tax computation purposes.

A life insurance policy is considered a gift when transferred after the initial purchase. The value of the gift is the replacement cost of the policy at the time of the transfer. There may be federal gift tax consequences if the amount exceeds the federal gift tax annual exclusion of $11,000 per donee. Any premium payments made on a policy owned by another are also considered a gift for federal gift taxation purposes.

If your total estate, including life

insurance proceeds from policies owned by you, is less than the amount subject to federal estate taxes ($1 million in 2002 and 2003), the form of ownership of your life insurance policy may not be of concern to you. When your estate reaches $1 million, have professional advisors such as attorneys, certified public accountants or chartered life underwriters evaluate the federal estate and gift tax consequences of your ownership of any life insurance policies to ensure that your overall estate planning goals and objectives are accomplished.

Example: A father died without a spouse and left an estate valued at $1,000,000 to his daughter. He also had a $250,000 life insurance policy in which he had incidents of ownership. Upon his death, the value of the $250,000 life insurance was added to his other assets which increased the taxable value of his estate to $1,250,000. The federal estate tax due was $102,500.

If the father had transferred ownership of the life insurance policy to his daughter and then lived more than three years, the $250,000 proceeds would not have been included in the federal estate tax computation. The estate tax in this case would have been $0 instead of $102,500. The father's estate could have saved $102,500 in federal estate taxes by transferring the ownership of the policy to his daughter. As the new owner of the policy, the daughter should make the insurance premium payments. She can name herself as the beneficiary; the insured is the father.

Designation of Beneficiaries

Designation of beneficiaries of life insurance policies is a very important estate planning consideration. A life insurance policy is a legal and binding contract which directs the distribution of proceeds to designated beneficiaries. A will controls the disposition of life insurance proceeds ***only*** if the estate is designated as the beneficiary. Beneficiary designations on the policy contract should be consistent with overall estate planning goals and objectives.

Because situations and family conditions change, review your beneficiary designations periodically and change them when appropriate. Births, deaths and divorce are examples of occasions where a review of beneficiary designation is appropriate. If a change is needed, ask your insurance company to send you a change of beneficiary form to fill out and return. The company will attach the completed form to your policy and the change of beneficiaries is accomplished.

If you designate minor children as beneficiaries, the insurance company may require that a court-appointed conservator manage the funds until the child reaches the age of majority (18 in Montana). When children reach their 18th birthday, each receives his or her share of the life insurance proceeds, regardless of ability to manage it.

Parents may think their children are bright but not believe they are capable of managing $100,000 or $200,000 in life insurance proceeds while so young. Rather than leaving the proceeds directly to the children and nominating a conservator to manage them until the children reach age 18, parents can have the assets left in a "family" trust for the children's benefit. Their wills can indicate that insurance proceeds are to be paid into the trust if both parents die. The parents select and name a trustee to manage the assets. They prepare a trust agreement giving the trustee the power to manage the trust assets and use the income for the children's benefit. The trust agreement is effective upon the death of both parents. A trust can avoid the inflexibility of conservatorship which passes the assets to the children at age 18. The trust agreement can indicate any age at which the trust terminates and that age could be beyond 18.

Types of Life Insurance

The major types of life insurance are term, whole life, universal life, variable life and adjustable life.

Term Insurance provides financial protection for a limited, specified period of time. Since it provides temporary protection and does not generate a cash value, term insurance is the least expensive kind of protection. However, the premium for this protection will usually increase periodically, or the coverage will decrease. For example, a 30-year-old man buying $30,000 of coverage for one year renewable term insurance could pay a premium of $85 the first year. Here is how the premium would increase: for age 40: $98/one year renewable term. For age 50: $220/one year renewable term; for age 60: $497/one year renewable term

A "basic-level" term insurance policy provides a constant amount of insurance and annual premiums for a fixed time, usually 5 or 10 years. An annually renewable term policy has yearly increases in premiums for the same amount of coverage. This type of policy is commonly referred to as a "yearly renewable" term policy.

There are two other variations of term insurance: increasing and decreasing. With increasing term, the face value of the policy periodically grows. Increasing term insurance is frequently sold in a package with other policies. In decreasing term insurance, coverage declines in value from year to year or from month to month while premiums remain level. These policies are purchased for periods of time to match the period for which money will be needed. An example would be a policy that decreases as the mortgage on a home is paid.

Whole Life policies provide a death benefit for the entire life of the insured. They also provide for a tax-deferred build up of cash values. The cost of whole life insurance is usually greater than term insurance during the early years. Premiums are paid over the life of the policyholder or for a specific period of time. When premiums are paid over the lifetime of the insured, the contract is called a "straight whole life" policy. For example, suppose a 30-year-old man wants to buy $30,000 worth of coverage. He could pay an annual premium of $239 for a whole life policy with no policy dividends. Contracts with premiums paid over a shorter period, such as 20 years, are "limited-pay whole life" policies.

With whole life, you can borrow an amount from the insurance company up to the current cash value of the policy. You can repay the amount borrowed when you want, or not at all. But if you die before the loan is repaid, the amount previously borrowed is deducted from the death benefit provided to your beneficiaries.

Universal Life Insurance **and** ***Adjustable Life Insurance*** offer flexible premium payments, an adjustable death benefit and cash values that are often tied to current interest rates. Most contracts pay a current interest rate that competes well with other options available in the money market. However, these rates are not guaranteed over the life of the contract. Premiums are deposited in a special fund. From this fund, the company deducts its fee and the monthly costs for the protection that covers the life of the policy holder. After making these deductions, the company credits interest to the fund at the market rate.

Much of the appeal of universal life insurance stems from its tax treatment, which is the same as for other life insurance products that meet specific standards. Examples of this tax treatment include tax-deferred build-up of income and cash value and no income taxation of proceeds to the beneficiary.

Compare administrative costs of universal life insurance. Ask if the charges are front-loaded (deducted before the premium is credited to your cash value) or back-loaded (paid if you surrender the policy).

Variable Life Insurance has death benefits and cash values that fluctuate according to the investment experience of a separate account managed by the life insurance company. Thus, policyholders may obtain higher cash values and death benefits than with policies calculating benefits based on a fixed rate of return. Conversely, policyholders also assume the risk of negative investment performance.

Life insurance agents selling variable life must be registered representatives of a broker-dealer licensed by the National Association of Securities Dealers and registered with the Securities and Exchange Commission. If you are interested in this type of policy, be sure your agent gives you a prospectus that contains extensive disclosure about the variable life policy. Review the prospectus carefully so that you understand the potential risks associated with the investment.

Comparing Costs

The actual premium depends upon rates of a particular company, as well as other factors. Whether or not dividends are paid on the policy will affect net premium cost. Occupational classification and health status of the insured may also influence premium rates. Most companies also give rate discounts for policies of large size. Annual cost of insurance also depends, in part, upon whether premiums are paid on a weekly, monthly, quarterly, or annual basis.

One way to compare the costs of various term life insurance policies is to ask the agent for the interest-adjusted net cost index. That index represents the cost per thousand dollars of coverage during the term of the policy. The lower the index, the less expensive the policy will be over time. So a term policy with an index of 1.47 is a better buy than one with an index of 2.28.

If you want your insurance policy to also be a savings vehicle, expect to pay higher premiums than you would pay for term insurance. You can use the interest-adjusted net cost index to compare the costs of two cash value insurance policies. For cash value insurance, the index is frequently called a surrender index. It is most useful if cash values are of primary importance to you since it assumes that you will surrender the policy—cancel it and take the cash value—at some future time.

A second index, the net payment cost index, is helpful for comparing cash value insurance policies if your primary concern is the death benefit, not the cash value. With either index, the lower number indicates a lower cost policy.

Remember that cost comparisons should only be made between similar plans of life insurance. The index for a cash value policy can't be compared with that of a term policy. Compare index numbers for the actual policy (for your age) and the amount of insurance you intend to buy. Small differences in index numbers may be less important than other policy features or agent services. In addition to the cost index, consider also whether the policy meets your needs and if you can afford the premium.

Rating Insurance Companies

The financial health of insurance companies is evaluated by major rating companies such as A. M. Best, Phelps, Moody's, Standard & Poor's and Weiss Research. Ratings are available in libraries, from insurance agents or directly from the rating company. However, you should be aware that each company has different definitions and formulas for determining financial stability. To illustrate: An A+ is the top grade from A.M. Best, but fifth from the top on S&P's and Duff & Phelps's scales. A high rating does not guarantee safety, but it is one of the best means available to consumers to gauge an insurance company's financial health.

Settlement Options

Life insurance usually provides for payment of benefits in a lump sum. However, if a family wants to put some or all of its life insurance money away for future spending, a variety of settlement options are available. When a settlement option is chosen, the company keeps the stipulated sum and pays amounts to the beneficiary of the policy in the manner selected.

The policy owner can specify exactly how the life insurance proceeds are to be paid to the beneficiaries, or the choice can be left for the family to make after the insured dies. When one of these settlement options is used, a family knows exactly what its income from the policy will be and exactly how long this income will last.

Settlement options can be used by living policyholders, too. For a living policyholder, the cash value of a policy forms the basis of the settlement arrangement chosen. At retirement age, the policy holder can convert the policy's cash value into retirement income.

There are four basic settlement options:

Interest option—The company holds the life insurance proceeds and pays interest at a rate that is usually higher than the rate guaranteed in the policy. Arrangements can generally be made to withdraw part of the money if desired. The remaining money can be withdrawn later or left to someone named by the beneficiary of the policy.

Amount option—A regular monthly income of a desired amount is paid until the money and the interest it earns are depleted.

Time option—A regular monthly income is paid for the desired period of time. The amount of monthly income is determined by the money and interest available.

Lifetime income option—This plan is very different from the other options. It provides a monthly income for life. The amount received depends on (1) how much money you want to have coming to you, (2) the rate of interest guaranteed by your policy, and (3) how old you are at the death of the policy holder.

Presenting a Claim

When a death occurs, a beneficiary can start settlement proceedings by notifying the life insurance agent who will help file the claim. The company will send the beneficiaries a claimant's statement which must be returned with proof of death, usually a copy of the death certificate. The claimant's statement includes, among other things, an outline of how the proceeds are to be handled—that is, which of the settlement options should be used and how. With most claims, processing takes two to three weeks. However, it make take longer if there are complications such as questionable death circumstances.

Life Insurance for Me?

There are many insurance companies, agents and variations among life insurance policies. Shop around for the best policy at the least cost to satisfy your financial goals.

Before purchasing insurance or changing policies, ask yourself these questions:

- Do I need life insurance? For what purposes?
- If I need insurance for debts, mortgages, taxes or family income, how much do I need?
- How much can I afford to pay for annual premiums?
- What kind of life insurance should I buy—term, whole life, universal life, variable, adjustable?
- Which company provides the best policy for me at the lowest cost? Is it a financially sound company?
- Once I have purchased the insurance, should I ever consider increasing or decreasing the amount I own?
- When should I transfer ownership of my insurance policies to save on federal estate taxes?

Many of these questions can be answered by a qualified and experienced insurance agent.

Acknowledgement

This publication has been approved by representatives of the following organizations who recommend its reading by those using insurance as an estate planning tool: Business, Estates, Trusts, Tax and Real Property Law Section, State Bar of Montana; Montana Association of Life Underwriters; and the Montana Commissioner of Insurance. Appreciation is expressed to MSU Extension faculty who reviewed the MontGuide and made many helpful suggestions.

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