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Life Insurance in Estate Planning

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What is life insurance?

Life insurance , sometimes called liquidity insurance or a clean-up fund, is a contract under which one party (the insured and/or owner) makes payments (premiums) to another party (the insurer) for a specified term. In return, the insurer pays the insured's estate or a third party, called the beneficiary, an agreed amount in the event of death or some other occurrence. Life insurance is used for many estate planning purposes, but probably its most valuable purpose is to provide estate liquidity.

Estate liquidity refers to the ability of your estate to pay potential taxes and other costs that arise after your death using cash and cash alternatives. If your property is mostly nonliquid (generally consists of real estate and business interests, for example), your estate may be forced to sell assets to meet its obligations as they become due. This may result in an economic loss and/or the need for your family to sell assets that you intended for them to keep. Therefore, planning for estate liquidity should be one of your most important estate planning objectives. With life insurance, if you have correctly forecasted the liquidity needs of your estate, the necessary cash will be available precisely when it is needed. The four big questions that you should consider regarding life insurance are: (1) How much do you need? (2) What type of policy is right for you? (3) Who should be the owner and the beneficiaries? (4) Can you meet your other goals for your insurance policy while keeping the proceeds out of your estate?

Is it life insurance?

The Internal Revenue Code defines life insurance proceeds as:

- Death benefits paid under regular life insurance contracts
- Death benefits paid under an endowment policy where death occurs prior to maturity of the contract
- Death proceeds of group life
- Proceeds of National Service or U.S. Government Life Insurance
- Paid-up additions and term additions purchased with dividends paid on a policy
- Proceeds payable under a double indemnity provision
- Proceeds paid under an accident policy or accident and health policy

What is the role of life insurance in providing estate liquidity?

You complete arrangements before death

You, as the owner or the insured, do all the time-consuming work ahead of time. You contact your insurance agent, make the decisions, fill out the paperwork, undergo the medical exam (if necessary), and pay the premiums in advance of your death. There will not be too much red tape for your family to deal with when you die, which is going to be traumatic enough for them.

Proceeds available immediately upon death (or soon thereafter)

The proceeds of an insurance policy are paid immediately or soon after the insured dies. Probate, which can take months, is bypassed for the insurance proceeds. This way, estate bills get paid when due, and your family gets the money it needs for day-to-day living expenses. For business owners, it means that there are funds available to keep the business operations continuing.

How much do you need?

When thinking about life insurance to meet estate liquidity needs, the first thing to do is compute how much life insurance you should buy. You should consider your estate's immediate cash needs at death (to pay any bills you owe and costs incurred because of your death), as well as your family's long-range need for funds to pay daily living expenses and special obligations.

Group or individual?

Group life is an employment benefit

There has been growth recently in group life insurance, which is a benefit provided by an employer to an employee. Generally, the premium payer is the business, although some have the employee paying a portion. The beneficiary can be anyone designated by the employee. The main objective is to provide income to the employee's family. If your employer offers this benefit, you need to understand the tax ramifications before you decide to go this route or purchase an individual policy instead.

Proceeds may be includable in employee's estate for estate tax purposes

For estate tax purposes, proceeds of a group life policy may be includable in your estate, depending on the year in which you die. You can remove the proceeds from your estate with an absolute assignment of all "incidents of ownership" in the policy, provided that you do not directly or indirectly name your estate or personal representative as beneficiary of the policy. However, this assignment must occur at least three years before your death to be successful in removing the proceeds from your estate.

What type of insurance policy should you buy?

Life insurance that meets your goals

There are many types of life insurance policies so be prepared to invest some time to understand how they work or seek a life insurance professional for help. However, before you get bogged down in the details, it is good to have some sense of the big picture. Most permanent policies focus on the cash surrender value and how it increases at various performance rates. If you are primarily interested in death protection and less interested in investment performance, you may be better off with a term policy or one with minimal investment features.

Life insurance that fits

The particular type of policy you choose depends on many things--how large your estate is, what your current financial situation is, what your current age and physical condition are, and what the needs of your survivors will be. What follows is a very brief discussion of some of the policy types available.

Term

Term (or pure) life insurance is suitable when either: (1) your need for protection is purely temporary, or (2) your need for protection is permanent, but you cannot afford permanent insurance premiums. Term life provides protection for a specified period. At the end of that period, coverage terminates and the policy has no value. However, term life can span the gap between your need for permanent insurance and your financial ability to meet that need.

There are five types of term insurance:

- Annual renewable
- Convertible
- Decreasing
- Level
- Re-entry

Whole life

Whole life (or permanent) insurance offers lifetime coverage. The major advantage of whole life over term life is that whole life is a combination savings account and insurance. Principal types of whole life include the following:

- Ordinary level-- Ordinary level whole life is a policy with level premiums, meaning that the amount you pay will not increase. Your premium payment amount is calculated on the assumption that premiums will be paid over your entire life. In many cases, however, policy dividends can be used to pay up the premiums in a shorter period of time. Ordinary level whole life is also referred to as continuous premium whole life.
- Limited-pay-- Limited pay whole life insurance is a special form of whole life insurance. As such, the policy contains cash values that grow tax-deferred and a certain death benefit. This type of whole life policy has all the benefits of any other whole life insurance policy, with a shorter time frame for making premium payments. The policy is identified by either the number of

annual payments, (e.g., 7, 10, 20, or 30 annual payments) or the age at which it is paid up (at 60, 65, or 70).

- Single premium--A single premium policy is a type of limited-pay policy that involves the one-time payment of a lump-sum premium, as the name implies. Since single premium whole life represents a substantial amount of money being expended all at once, and since it is computed on the basis that there will be no return on any part of it in the event of your early death, there is only a limited appeal for this type of protection.

Variations of whole life

- Adjustable life-- Adjustable life is a special whole life policy with initial level premiums. The policy provides the same guarantees of death benefits and cash values as does a traditional whole life policy. What makes the adjustable life policy special is that, at specific intervals, the policy allows you to request upward or downward adjustments of premium, death benefit (face amount), or cash value. Increases in the death benefit above a certain percentage or amount usually require medical proof of insurability.
- Current assumption whole life-- Current assumption whole life is a variation of traditional whole life somewhere between adjustable life and universal life. A redetermination feature recasts the premium amount and death benefit in response to the most recent interval of experience or time frame. Current assumption whole life is appropriate for those who need the discipline of a fixed-premium design but want to participate, in part, in the positive investment returns beyond the policy's guaranteed interest rate.

Other types

- Endowment life--An endowment life policy provides death benefits and cash values that increase with duration so that the policy's cash value equals the death benefit at maturity. It also allows the purchaser to specify the maturity date. Full survivorship benefit is payable at a specified time or age. It also provides a death benefit during the accumulation period that is equal to the target accumulation amount. There is no tax-free buildup of a flexible premium endowment policy's cash value so sales of this type are typically limited.
- Variable life--A variable life policy provides no guarantees of interest rate or minimum dollar value. The policyowner is permitted to select among a limited number of investment portfolio choices with death benefits varying as a function of investment performance. Variable life is not a short-term investment vehicle because sales load, mortality charges, and surrender charges significantly reduce gains in the early years. ***Caution:*** *Variable life insurance policies are offered by prospectus, which you can obtain from your financial professional or the insurance company issuing the policy. The prospectus contains detailed information about investment objectives, risks, charges, and expenses. You should read the prospectus and consider this information carefully before purchasing a variable life insurance policy.*
- Universal life-- Universal life offers flexible premiums (such as additional premium payments, skipped premium payments, or below-target premiums). Aggregate payments must be adequate to cover the costs of maintaining the policy. The policyowner determines prefunding. The policyholder can make partial withdrawals from cash value without incurring indebtedness and also has a choice between a level death benefit and an increasing death benefit. With an increasing benefit, as cash value rises, so does the total death benefit. Payment is of both the stated face value and the cash value in return for higher premiums.
- Joint first to die--Joint first to die covers two or more individuals and pays a death benefit when the first death occurs. The policy may be either a term, universal, variable, or whole life policy. Generally, joint first to die is used by business partners to cover the life of each partner. On the death of the first partner, the surviving partners receive funds with which to purchase the deceased partner's partnership interest.
- Joint second to die (or survivorship)-- Joint second to die or survivorship policies insure two or more lives under one contract. The death benefit is paid at the second death. The policy may be either a term, universal, variable, or whole life policy.

Who should be the owner and beneficiaries (or, how do you keep the proceeds out of your estate for federal gift and estate tax purposes)?

Funds used for taxes do not reach your beneficiaries

Why is it important to understand the federal gift and estate tax ramifications of life insurance? Because funds used to pay taxes (your estate may also be subject to state death taxes) are funds that don't go to your beneficiaries. To get the most out of your dollar, it is often best to keep the proceeds from being subject to potential taxation.

Proceeds are generally subject to federal gift and estate tax

Life insurance may be includable in your gross estate for federal gift and estate tax purposes if: (1) the proceeds are payable to or for the benefit of your estate, or (2) you possessed "incidents of ownership" in the policy at the time of your death or at any time during the three years prior to your death, or (3) you transferred ownership of a policy within three years of your death, and (4) estate taxes are imposed in the year in which you die. In addition, the value of life insurance you own on another person's life at the time of your death may be includable in your gross estate for tax purposes.

Therefore, to avoid federal gift and estate tax, do not:

- Make the proceeds payable to your estate
- Make the proceeds payable to your personal representative (executor)
- Own the policy or any "incidents of ownership" in the policy
- Transfer an existing policy to a new owner within three years of your death (you may need a crystal ball for this one)
- Make the proceeds payable to a beneficiary to satisfy a debt
- Make the proceeds payable to a beneficiary under an agreement requiring the beneficiary to pay death taxes or other estate debts or expenses
- Make the proceeds payable to a beneficiary to pay alimony or support

Technical Note: *Incidents of ownership is a legal term. It means any right to benefit economically or control the policy, such as: (1) retaining the right to change beneficiaries, (2) retaining the right to borrow on its cash value or pledge it for a loan, (3) retaining the right to surrender or cancel the policy, (4) retaining the right to assign the policy, (5) retaining the right to elect or revoke a settlement option, (6) retaining the right to get the policy back, or (7) retaining the right to convert group coverage to an individual policy.*

Tip: *If the named* beneficiary *dies, be sure to name another so that the proceeds do not go to your estate.*

Tip: *The* owner *of the policy can be either another individual or a* trust .

Caution: *Your estate may also be subject to state death taxes.*

What about income taxes?

Proceeds are exempt from income taxes

Generally, proceeds are exempt from income taxes and are excludable from the gross income of the beneficiary (with a few exceptions). Only interest paid on proceeds retained by the insurer after your death is taxable to the beneficiaries, unless there has been a transfer for value of the policy. Therefore, you need not be too concerned about income taxes depleting the insurance funds.

Transfer-for-value rule

If you sell your life insurance policy to another owner, the proceeds will be taxable income to the new owner except to the extent of the new owner's investment in the contract. This rule does not apply to any of the following:

- Transfers to a partner
- Transfers to a partnership (in which you are a partner)
- Transfers to a corporation in which you are a shareholder or officer
- Transfers in which the basis is tacked

Technical Note: *The tacked-basis exception means that the transferee takes a carryover basis from you. It commonly applies when property is a gift.*

IMPORTANT DISCLOSURES

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