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Life Insurance and Estate Planning

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Introduction:

Life insurance can provide needed funds for survivors upon the death of the insured. For most families, the need for life insurance is greatest early in life. Children are young and the financial burden of supporting the family are the greatest and create the need for life insurance. Ironically, families with the greatest need also are those who probably can least afford the life insurance premiums. The need for life insurance usually decreases as family's age and accumulate more assets and net worth.

Types of Insurance:

There are two major types of life insurance. They are term insurance and whole or universal life insurance.

Term insurance is purchased on an annual basis and usually increases in cost as a person gets older. Term insurance pays out at death if kept in force by paying the premiums until death. All premiums are used to pay for the cost of the insurance and no cash value accumulates as a result of having the policy. You pay a year's premium for a year's coverage. Several varieties of term insurance are available including declining death benefits for a fixed annual premium and fixed benefits with a rising premium. Term insurance is much like fire, wind, auto, and medical insurance - you pay purely for the protection with no cash value accumulation.

Whole or universal life insurance is term insurance with an accompanying savings plan built in. There are many varieties of whole life insurance, all of which combine a savings plan along with the insurance protection. The cash "savings" value buildup can be borrowed at a rate of interest specified in the policy or taken out if the policy is terminated.

Premium payments are obviously higher for a given amount of whole life insurance compared to term insurance, since a portion of the premium is allocated to purchase a savings plan.

Uses of Life Insurance in Estate Planning:

Life insurance can be used for many functions in estate planning.

1. Life insurance can be purchased on an individual to provide funds for the surviving spouse or children when death occurs.
2. Whole life insurance can be purchased to provide income to the parents at retirement. This can occur by converting the policy to an annuity or by withdrawing the cash value.
3. Insurance can provide dollars that can be passed as an inheritance to the non-farm heirs. That allows farm assets to flow to farming heirs. The insurance dollars offset the farm assets and therefore all family members receive something from the estate while preserving the farm or business intact.
4. Life insurance can be used to provide funds for the payment of estate taxes, estate settlement costs or debt obligations of the deceased.
5. Insurance can be purchased by the farming heir/heirs on their farming parents. It will provide income, at the time of the parent's death, for the buyout of land, machinery or operating assets from other heirs, if the parents have distributed their farm assets equally among all their children.

   Note: a critical factor here is that the farm or business heir owns the policy and makes all the premium payments. The farming parent or parents are the insured. The policy beneficiaries are the farm or business heirs. Using this format will insure the death benefits go to the intended people.
6. Farming partners often buy insurance on each other. This process provides funds for buying out the deceased partner's assets if a premature death occurs. The end result is that it enables the living partner to keep the farm or business intact.
7. Life insurance can be used to create or enhance an estate. It can be an estate building plan providing money to heirs.
8. There are new life insurance choices that enable people to draw on the death benefit to cover long-term health care costs. This can be beneficial for someone who may not qualify for long-term care insurance but would qualify for life insurance. Check with your insurance agent.

Who Should Own Your Policy?

Ownership of the policy is sometimes treated lightly but is an important consideration, particularly in large estates. Generally, death benefits from life insurance are included in the estate of the owner of the policy, regardless of who is paying the insurance premium or who is named beneficiary. A change in ownership of a life insurance policy is a complex matter. One should review ownership provisions with an expert estate planner or insurance agent.

For example, even though you transfer ownership of a life insurance policy, if done within 3 years of death, the death benefits will most likely be included in the estate value of the original owner. In addition, the new owner can change the beneficiary, borrow on the policy or surrender or cancel the policy. Care should be taken in changing ownership if relationships are unstable or if there is any question about competency or intention of the new owner.

Establishing Beneficiaries:

Beneficiaries are the people who will get the death benefit proceeds of your life insurance.

If your estate is the beneficiary of your life insurance, the plan established in your Will or trust determines the distribution of death benefits.

Most husbands designate their spouse as the beneficiary if she survives him. If she doesn't, it goes to a trust for the children or directly to the children. Wives similarly often name the husband as beneficiary with the children as secondary beneficiaries. The final beneficiary designee may be the estate if no immediate family member survives. A potential problem with this strategy is the insurance death benefit amount can increase the estate to a value above the Applicable Exclusion Exemption amount for state and federal estate taxes. That causes an estate tax problem. This issue can be avoided if you place the life insurance in an Irrevocable Life Insurance Trust (ILIT). The trust owns the policy but you are the insured. Because you do not own it, the death benefit is not included in your estate value but you have the protection of the insurance. This is a complex area so consult your attorney and insurance agent.

Keep in mind that the insurance company makes ONE tax free payment of benefits. If the payment is to a trust and then later to a spouse or to children, that second payment becomes a taxable event, **if** there has been growth or income.

Note:

1) The entire amount of the benefit paid out to your beneficiaries or estate is included in your gross estate value for estate tax purposes **if you are the owner of the policy.** Many individuals create a taxable estate through purchasing life insurance that they did not realize will be included in their estate at death.

2) Life insurance proceeds paid to beneficiaries is not considered income to them for tax purposes.

Irrevocable Life Insurance Trust (ILTI):

An ILIT can be of use in two ways. First, to avoid having to include the death benefit amount of a life insurance policy you own in your estate net worth, the insurance policy can be placed into an ILIT. The trust owns the policy and therefore the value is not included in your estate value. Second, if your business entity purchases life insurance for the owner/operators of the entity the insurance can also be placed into an ILIT. That prevents an individual who chooses to leave the entity from taking some of the insurance cash value with them. The ILIT preserves the insurance intact for those who remain in the entity.

There are rules that need to be followed. The ILIT must be titled John & Jane Smith, Irrevocable Life Insurance Trust dated 1-12-14, Junior Smith, Trustee. The ILIT must have its own checking account and the address on the policy must be that of the trustee

In-Force Illustration:

If you own a whole or universal life insurance policy purchased a number of years ago, it would be advisable to contact your insurance agent and request an in-force illustration. This process will help you assess how long the insurance policy will remain in-force. Is it going to be available at your death or has the cash value declined to a point where the insurance lapses? This is a critical issue if the insurance was purchased a number of years ago and is a key part of your estate plan.

Conclusion:

Life insurance can play a vital role in estate planning. It is important to coordinate all aspects of life insurance with your overall estate plan. Carefully analyze all factors before purchasing life insurance. Continue to evaluate your life insurance as family, estate and business needs change throughout your lifetime.

Caution: This publication is offered as educational information. It does not offer legal advice. If you have questions on this information, contact an attorney.