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Life Insurance as an Estate Planning Tool

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> This is one in a series of **NebFacts** providing information on the use of estate planning "tools" — mechanisms that can be used in attaining desired estate planning outcomes. Titles in the series are listed following the last narrative section of each document. Reading the documents in this series will improve your understanding of estate planning tools and alternatives, and make it easier to communicate with your attorney, accountant, and other helpers when your estate plan is prepared.
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> **Your need for legal and tax advice:** While the information contained in this document is thought to be accurate, it should not be used as a substitute for legal advice on matters related to business organization, taxation, estate planning, gifting of assets, life insurance, or other business and financial management matters. Consult with your legal and tax advisers before making decisions.

Life insurance can be an important estate planning tool. As long as insurability requirements are met and premium payments are made, life insurance creates an estate — possibly a sizeable estate — not limited by the insured's net worth or the nature or value of other assets. With few exceptions, the life-insurance-provided liquidity is not subject to income tax for the person (beneficiary) who receives it. Under appropriate arrangements, the face value of life insurance is not subject to estate, inheritance, or gift taxes. Thus, there are tax incentives for including life insurance in your estate plan.

As might be expected with these tax attributes, life insurance use in estate planning occurs within a framework set by many laws, regulations, and Internal Revenue Service rulings, a framework determining the tax status of life insurance proceeds in each situation or set of circumstances. This publication discusses aspects of life insurance and its use as an estate planning tool, aspects frequently mentioned in discussion periods of estate planning meetings. Since this discussion can provide only partial information on a very complex topic, be sure to secure professional advice before making decisions.

Using Life Insurance in Estate Planning

The death benefit from a life insurance settlement has many potential uses. It can pay taxes and related estate settlement expenses, allow fulfillment of business agreements, pay operating expenses during the transition after a family member's death, provide funds for survivors' living expenses, and provide needed liquidity. In family and business situations where the death of a family member could cause financial crisis, life insurance proceeds can support transitions to new work and living arrangements.

Life insurance also can be used to provide the equivalent of a bequest to children or grandchildren who do not inherit other personal or business assets — they often have moved to locations away from the parents' or grandparents' home or business. As life insurance beneficiaries, they receive or share in the death benefit. Other survivors, typically those active in a family business or other aspects of family life, receive tangible and intangible assets important to their future well-being. Family conflicts over ownership and control of income-generating assets often can be minimized or avoided.

Premium costs are balanced against the benefits of life insurance when making decisions about life insurance purchases. If the life insurance premium is to be paid each year until the insured dies, the insurance decision interacts with all other spending and savings decisions. Careful planning and feasibility projections are advised.

Life Insurance

A life insurance policy is a contract between the issuing company and the policy owner. In return for premiums received, the insurer agrees to pay a specified death benefit if the insured dies while the insurance is in effect. At any given time, life insurance companies offer to customers a variety of policies (often referred to as "products" by persons selling life insurance). Priority aspects of life insurance as an estate planning tool include:

- for the insurable person able to pay the premium(s), life insurance can provide an "instant estate" of almost any desired size;
- the policy owner must have an "insurable interest" in the life of the insured;
- the policy owner can be, but need not be, the insured;
- upon the death of the insured, the death benefit is paid by the insurance company to a beneficiary or beneficiaries identified in the policy and/or its endorsements;
- the owner has the right to change the beneficiary(ies) at any time prior to the death of the insured;
- for federal or state income tax purposes, the death benefit is not taxable income;
- if the insured possesses any "incident of ownership" (described under "Estate planning considerations," below) during the three years prior to death, the face value of the policy is included in the insured's estate;
- when a life insurance policy's face value is included in the insured's estate, it is taxable for estate tax purposes on the same basis as other assets;
- when the ownership of a policy is transferred from one owner to another, its value for gift tax purposes is approximately its cash surrender value on the transfer date. The exact gift value can be, and should be, obtained from the insurer.

Types of Life Insurance

The wide variety of policies offered at any given time by insurance companies makes it difficult for the typical person to compare policies. Despite the apparent complexity of insurance offerings, policies belong to one of these types:

Term Insurance:

This is insurance payable upon the death of the insured when death occurs within a specified period, the "term," of the insurance policy. Term insurance premiums reflect the actuarial risk of the insured's death occurring within the term of the policy. It accumulates no cash or surrender value. When the term ends or the premium is unpaid, the insurance lapses with no remainder value.

When the policy term ends, most policies are renewable for an additional term at the premium cost for similar persons of the insured's age at the time of renewal. With constant face value term insurance, the insurance coverage remains constant and the premium increases at each renewal. With decreasing term insurance, the premium remains constant and the insurance coverage is reduced at each renewal. Some term insurance policies are convertible to other forms of life insurance. Depending on the policy terms, evidence of insurability may or may not be required prior to a conversion.

For a given age and face value, term insurance when first issued usually has the lowest premium of the types of life insurance. If the level of coverage remains constant and the insurance goes through several renewals, the premium cost will increase until it is greater than the premium for other types of insurance. Term life insurance usually ends when the insured attains a specified age.

For younger persons and families, term insurance is a relatively inexpensive way to create an estate and provide reasonable security for survivors in the event of the untimely death of the insured. The cost advantage is lost as time passes. If the insured lives beyond the ending age, term insurance will lapse and will not provide the intended liquidity for estate settlement and/or survivors.

Ordinary life insurance:

As long as premiums are paid when due, this is permanent insurance with a death benefit payable upon the insured's death. Premium payments continue until the insured dies and the death benefit is received by beneficiaries. This form of insurance also is called "Whole Life Insurance."

In the level premium form, the premium is unchanged during the insured's life. During the initial years, the premium is greater than the amount required to fund the actuarial risk. Part or all of the excess accumulates as a reserve cash value that can be withdrawn if the policy is surrendered, or can be used for other purposes identified in the policy. (Those purposes usually include conversion to a smaller face value paid-up policy.) Depending on the policy provisions, the cash value at the time of death of the insured may be, or may not be, paid to the policy beneficiary with the death benefit.

In the flexible premium form, the premium periodically is adjusted for changes in the return on insurance company investments and for mortality rate changes. If premium increases are not paid, the face value and cash value will be reduced. Usually the policy will lapse when the cash value is depleted.

As long as the insurance does not lapse, ordinary life insurance ensures that a known amount of liquidity will be paid to the beneficiaries at the time the insured dies. This payment is made regardless of the insured's age at death. As the least expensive form of permanent insurance, ordinary life is used frequently in estate planning.

Limited pay life insurance:

This is a form of permanent life insurance with level or flexible premiums. Limited pay life insurance is very similar to ordinary life insurance except the premiums are greater for any given face value and are payable for a specified number of years. The number of premium payments can be as few as one (single-payment life insurance), though annual or more frequent premium payments typically are made over a period of 5, 10, 15, 20, or more years. This form of permanent life insurance is especially attractive if the insured post-retirement income is expected to be less than pre-retirement income and the payments can be completed prior to the expected time of retirement.

Endowment life insurance:

This is a form of limited pay life insurance with level or flexible premium payments. For any given face value, the premium cost is greater than for limited pay life insurance. The difference supports more rapid accumulation of cash value. At the end of the payment period, the accumulated cash value will equal the face value of the policy and the policy matures with payment of the face value to the insured. An endowment policy often is described as a combination of life insurance and a savings plan. Sources outside the insurance industry generally advise using other means of accumulating savings.

Joint survivorship life insurance:

This form of life insurance has become popular in recent years. A joint survivorship life insurance policy is written on the lives of two persons, typically husband and wife. No death benefit is paid at the time of first death though, if the insurance is to be maintained, the premium payments continue throughout the remaining life span of the survivor. The death benefit payment is made following the death of the second to die. Premium rates are based on the joint life expectancy of the two persons, and for a given face value the premium rate is lower than it would be for either person individually. In some instances, only one person must be insurable for both to qualify for a joint survivorship policy. This type of life insurance may be especially useful in estate planning by families where one person has serious health problems.

Life Insurance "Products"

Among terms used in the life insurance industry, "product" often is used to denote a specific life insurance policy or a named combination of life insurance and a form of savings sold by company representatives. Life insurance products change frequently as does the terminology used in describing them.

Some products offered by life insurance brokers combine two or more of the types of life insurance, and others may combine life insurance with annuities or other forms of savings or investment. These combinations may be offered in one contract, or as two or more related contracts. The large number of products offered and the terms used can cause confusion. It is very important that you ask questions and discuss the products offered by your life insurance representative until you clearly understand the terminology being used. Be sure you do clearly understand before making decisions.

Estate Planning Considerations

Internal Revenue Service regulations and rulings define circumstances in which the value of a life insurance death benefit is **excluded** from the insured's estate. These regulations and rulings are detailed and very complex. This discussion provides only information on the most frequently identified decision-making considerations in estate planning. Be sure to secure expert advice specific to your individual situation while keeping these considerations in mind:

- Life insurance proceeds are included in the estate of the insured if the insured owns the policy, pays policy premiums, or the death benefit is payable to the insured or to the insured's estate. However, the proceeds are not subject to Nebraska Inheritance Tax unless paid to the executor or administrator of the estate.

- "Incidents of ownership" is a term used by IRS to indicate aspects of the insured's control over a life insurance policy and/or the payment of its proceeds that cause the proceeds to be included in the insured's estate. These attributes go beyond policy ownership, paying premiums, or the death benefit being payable to the insured's estate. They include powers such as the right to influence or determine the economic benefit of the policy, including:

    - the right to determine or to change the beneficiary(ies) of the policy;
    - the right to surrender or cancel the policy;
    - the right to assign the policy or to revoke an assignment;
    - the right to borrow against the policy's cash value or to pledge the policy as security for a loan;
    - the right to change the payment procedures used in paying the death benefit;
    - the holding of a 5 percent or more revisionary interest in the policy (an interest that could result in the policy or its proceeds reverting to the insured);
    - the insured serving as trustee of a trust that owns the policy;
    - the insured being the owner of stock in a corporation that owns a policy payable to the corporation for what is called a "noncorporate purpose";
    - other circumstances specific to the insured's life circumstances.

- Transfer of ownership of the policy to a trust or to a person other than the insured within three years of the death of the insured will not remove the policy proceeds from the estate of the insured even if the insured has no "incident of ownership" at the time of death, has not paid premiums subsequent to the transfer, and the estate is not a beneficiary of the policy.

- Transfer of ownership of a policy with a named beneficiary other than the insured or the insured's estate to another person who pays the premiums usually will result in the policy proceeds being excluded from the insured's estate when the transfer is accomplished more than three years prior to the death of the insured **if** no "incident of ownership" is present after the transfer.

- When a life insurance policy is to be owned by a trust or an individual other than the insured it may be easier (and exclusion from the estate of the insured may be more certain), if a new policy is purchased rather than transferring ownership of an existing life insurance policy. Surrender of an existing policy with cash value in order to replace it with a new policy may have important income tax consequences for the owner of the surrendered policy. Before making any decision to surrender an existing life insurance policy be sure you know what the income tax consequences will be.

Life insurance companies and experts providing assistance and advice in estate planning can provide additional insights about the use of life insurance as an estate planning tool. Be sure to secure advice specific to your situation from your legal, accounting, and insurance advisers prior to making decisions about the role of life insurance in your estate plan.

Documents in This Series:

- NF 95-236, *Nebraska Inheritance and Estate Taxes*
- NF 96-291, *Intestate Succession As An Estate Planning Tool*
- NF 96-292, *A Will As An Estate Planning Tool*
- NF 96-293, *Joint Tenancy As An Estate Planning Tool*

- NF 96-294, *Tenants In Common Ownership As An Estate Planning Tool*
- NF 96-295, *A Trust As An Estate Planning Tool*
- NF 96-296, *Gifting As An Estate Planning Tool*
- NF 96-298, *Charitable Remainder Trusts and Charitable Annuities As Estate Planning Tools*
- NF 96-299, *Estate Planning Glossary*

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