

# CHAPTER 8



## LIFE INSURANCE

### *Introduction*

Though not immediately obvious as part of the estate planning process, life insurance is a very important component of many estate plans. This is often true because the client anticipates that a substantial amount of the value of his or her estate will be in the form of proceeds from life insurance payable following a death. In other circumstances, the insurance may play an important part in providing security to a surviving spouse and family or to provide a simple means by which the estate may pay the taxes owed at the time of the insured's death.

### *Basic definitions and types of life insurance*

Before reviewing the importance of life insurance in the estate planning process, a review of the basic terminology and types of life insurance is important. What follows is not intended to be comprehensive but merely an overview of important definitions and basic forms of insurance. Armed with this basic information, the reader should be able to navigate the estate planning process as it applies to life insurance policies.

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| <b>Insured</b> | The insured identifies the person whose life is being insured under the policy. In some cases, two lives may be insured under the same policy (see definition for Second-to-Die Insurance below).   |
| <b>Owner</b>   | The owner of the policy is most often the insured. However, in some circumstances the policy may be owned by a different person than the insured. This may occur where the policy is owned by a trust (see the Irrevocable Life Insurance Trust discussion below), or a corporation or other business entity, or a charity.                             |
| <b>Policy</b>  | The policy is the legal contract between the owner of the policy and the issuing insurance company. Most of the rights and responsibilities of the parties to the policy will be contained within the policy document itself. Applicable state and federal law will also control certain aspects of the relationship between the parties to the policy. |

**Beneficiary** As the term implies, the beneficiary is the person, trust or entity (such as a business or charity) that is entitled to receive the death benefit at the time of the insured's death.

**Premium** The premium is the amount of money that must be paid to maintain the policy in force. Premiums are commonly paid on a periodic basis (such as monthly or annually). Sometimes the premium is paid at the time of the acquisition of the policy or at a later date so that no additional premiums are payable. Premiums may increase over time as the insured ages or may be for a fixed amount.

**Incidents of Ownership** The owner of the policy holds the incidents of ownership in the policy. These incidents are defined in the Internal Revenue Code and include such powers as the right to designate the beneficiary of the policy, the power to borrow against the cash value of the policy, the power to transfer ownership in the policy, the power to terminate the policy and the like. Where the policy is owned by an individual, it is the possession of these incidents of ownership that will result in the inclusion of the policy value or the death benefit proceeds in the owner's estate for estate tax purposes.

**Term Insurance** This form of insurance is often referred to as pure insurance in that it is nothing more than a policy of insurance on the life of an individual for a specific death benefit. So long as the premium is paid, the death benefit will be payable at the insured's death. There are no investment or savings opportunities available with this form of insurance.

**Group Term Insurance** This form of insurance is simply term insurance provided to the insured as a result of his or her association with a group, such as an employer. So long as the insured is associated with the group, the insurance is available and remains in force. On occasion, the policy will provide that if the insured disassociates from the group (such as retiring from employment) the policy may be converted to term or other form of insurance.

**Permanent Insurance** There are many forms of permanent insurance, including whole life, variable life and universal life. Though these insurance policies differ in many important respects, they all have one factor in common: the policy is designed to include not merely a life insurance component (such as is the case with term insurance) but also an investment component. The investment component may be in the form of the cash value of the policy,

investment in mutual funds (owning stocks, bonds and other investments) that the owner of the policy may manage, or other investments.

**Second-to-Die Insurance** Second-to-die (also known as survivorship) insurance is a specific form of insurance that insures the lives of two individuals, such as a husband and wife. The death benefit is not payable until after both insureds have died. These policies are acquired primarily for the purpose of providing funds to pay estate taxes. Since married couples' estate planning can be designed to avoid estate tax at the first death, the insurance death benefit is not necessary for the payment of estate tax until the survivor's death. The policy may be designed as permanent or term insurance.

### *Taxes and life insurance*

There are a myriad of tax rules that apply to life insurance. With regard to the estate planning process, the primary issues concern the income taxability of the death benefit on the insured's death and the application of estate taxes to the insurance policy.

Although there are some important exceptions to this rule, life insurance proceeds received by a beneficiary will not be subject to income tax payable by the beneficiary or the insured's estate.

A lesser known rule is that the insurance, though not subject to income tax, is subject to estate tax. At the time of the death of the owner of the policy, the value of the policy or the proceeds from the policy will be included in the decedent's estate for purposes of calculating the estate tax payable.

Note that the estate tax implications are determined based on whether the decedent held any incidents of ownership in the policy; merely being the insured is not enough to trigger an estate tax at death. For example, if the insured is also the owner (and, therefore, holds incidents of ownership at death) the full death benefit will be included in the estate of the insured at death for purposes of determining the estate tax owned.

On the other hand, if the owner of a life insurance policy dies (and is not the insured), only the value of the policy as of the date of death will be included in the taxable estate. This may be only a small amount (such as the cash value of the policy) compared to the death benefit.

## *The irrevocable life insurance trust*

As indicated in the proceeding section of this chapter, the proceeds of a life insurance policy will be subject to estate tax at a person's death if the insured is also the owner of the policy. As a consequence, even though there may be no income tax to pay, there may be substantial estate taxes payable on the death of the insured.

One approach to reduce the estate tax liability associated with the ownership of insurance policies is to purchase the policy as owned by, or transfer an existing policy to, the trustee of an Irrevocable Life Insurance Trust (also known by the acronym "ILIT"). If the policy is owned by the trustee of a properly drafted ILIT, the insurance proceeds will not be subject to estate tax at the owner-insured's death. Therefore, the entire death benefit will pass to the insured's intended beneficiaries (such as children) free from any estate tax liability.

The drafting and implementation of an ILIT is complex and proper structuring and management of the ILIT is necessary if the objective of saving estate tax is to be achieved. The insured of the policy held in the ILIT should never serve as the trustee of the ILIT since it is quite likely that the trustee will hold incidents of ownership as trustee which, in turn, will cause the insurance proceeds to be subject to estate tax.

In addition, there are significant gift tax consequences when contributions are made to the ILIT so that it will have the resources necessary to pay the life insurance premiums. Gift tax issues are also present when an existing policy is transferred to the ILIT. These gift tax considerations must be properly managed to achieve the most favorable tax consequences.

Even with the complexities associated with the ILIT, it remains one of the most effective and efficient estate planning strategies available to reduce estate taxes and to provide liquidity which may be needed to transition the family assets to the next generation. An ILIT may also provide benefits to the decedent's spouse and/or other family members in a trust that will be free from the claims of the beneficiaries' creditors.

## *Conclusion*

Understanding the role of insurance as part of estate planning is very important. It is recommended that these issues be discussed with an estate planning attorney and life insurance professional. Please review Chapter 3 for a more detailed discussion regarding the proper designation of beneficiaries on life insurance policies, retirement benefits and other assets that are distributed at death by beneficiary designation in order to maximize the effectiveness of your estate plan.