LIFE INSURANCE CAN BE PART OF YOUR ESTATE PLAN

Even if you have a relatively modest estate, life insurance can be an important aspect of estate planning for the obvious reason that it can substantially increase the value of your estate. Where the death of a person is premature and a young family is in need of support, life insurance may be the primary means for the family's financial survival.

Even in larger estates, life insurance can be useful by providing the liquidity necessary to pay estate taxes and expenses without the necessity of selling off assets that a family would prefer to keep intact. Additionally, life insurance, unlike many other assets, does not have to go through a time-consuming administrative process before it becomes available to beneficiaries. Therefore, life insurance can be an immediate source of funds for a surviving family.

Estate Taxes and Life Insurance

As is true of any aspect of estate planning, one objective is to minimize the federal estate tax effect that life insurance can have. The primary tax issue that arises is whether the insurance proceeds are included in the estate for federal estate tax purposes. Including the proceeds could generate additional estate tax liability and reduce the amount of the proceeds that are available to the decedent's heirs.

The fundamental rule is that the gross estate will include the value of life insurance proceeds if (1) the proceeds are payable to the decedent's estate and are thus receivable by the executor, or (2) the proceeds are payable to other beneficiaries, but the decedent possessed at his or her death any of the “incidents of ownership” with respect to any policy.

The term “incidents of ownership” is defined more broadly than to be limited to the legal ownership of the policy. The term includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy or pledge it for a loan, and to obtain a loan from the insurer against the surrender value of the policy. There are other indirect ways that the decedent can be found to possess incidents of ownership. For instance, if the decedent is the controlling shareholder of a corporation that possesses an incident of ownership, such possession is attributed to the decedent.

Another scenario that will result in the inclusion of life insurance proceeds in the decedent's estate arises under certain circumstances where the decedent was the initial owner of the policy but transferred such ownership to another person or entity within three years of his or her death. Thus, even where the decedent has rid himself or herself of all incidents of ownership in the policy, there is still the possibility of inclusion under this three-year rule.

Keeping Life Insurance Proceeds Out of Your Estate

A common device for handling the life insurance aspect of an estate plan is the life insurance trust. Typically, a person would initiate the life insurance coverage by acquiring the policy. He or she would then transfer all incidents of ownership of the policy to a previously created irrevocable trust, which would be the named beneficiary on the policy. Assuming that the person survived until at least one day more than three years after the transfer of the policy to the trust, there would be no inclusion of the proceeds in the settlor's estate. If a policy is transferred within three years of death, the proceeds are included in the estate.

If the trust itself acquired the policy, the person would never be the owner and the three-year rule would not apply. The problem would be that the person could neither direct nor require the trust's acquisition of the policy without risking the possibility that he or she would be regarded as the original owner of the policy for purposes of applying the three-year rule. Therefore, it is important that the trustee be completely independent of the decedent.

An insurance trust can also have the practical effect of serving as a means of coordinating the collection, investment, and distribution of the proceeds of several policies. An insurance trust can hold other assets that the decedent transferred to it during his or her life. The trust can also receive assets “poured over” to it by the decedent's will.

If life insurance is to be an element of your estate plan, it should be carefully integrated with the other aspects of the plan. Be sure to seek the guidance of a qualified professional to assist you.