Life Insurance: A Flexible Asset

The composition of portfolio assets varies from person to person, but one almost universally accepted asset is life insurance. It is an unrivaled source of protection against economic loss suffered in the event of premature death, and it is commonly used to fulfill philanthropic objectives as well.

Life insurance protects so effectively because it is the only asset that guarantees funds will be available when needed most. Many people think of life insurance only as emergency funding, but it can be a much more flexible asset. This booklet explores the versatility of life insurance.

Adapting to Change

Life insurance companies continually create new products to meet changing needs and circumstances. Individuals, likewise, need to adjust their insurance programs as situations change. Marrying, having children, starting a business—all create special insurance needs. The approach of retirement is also the time to reexamine an insurance program. If your children are well established and you have sufficient liquidity, you may want to convert a policy to an annuity or surrender it and invest the cash value. Another possibility is to convert your insurance to paid-up policies, which reduces the face amount but eliminates premiums.

Life insurance industry statistics show that many people elect to continue their life insurance policies through retirement to provide cash for estate-settlement purposes. Life insurance is an excellent source of liquid funds for payment of state and federal estate taxes and other costs. For an estate with a large percentage of nonliquid assets, such as real estate, business interests, or works of art, life insurance may be the only practical way to provide needed liquidity.

An insurance policy originally purchased to protect the insured's family against loss can be used at probate to provide *estate conservation*, protecting the estate against shrinkage through lack of liquidity.

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Insurance Proceeds Generally Subject to Estate Taxes

Life insurance proceeds do not escape taxation entirely. Though generally exempt from income tax, they are includable in the insured's gross estate if he or she possesses any ownership rights (see below) in the policy or if the proceeds benefit the estate. This means only a portion of a policy's face value may be available to pay expenses and taxes.

Proceeds Payable to the Estate

If insurance proceeds benefit the insured's estate (or the estate's executor), generally they will be included in the estate regardless of who owned the policy or paid the premiums. This rule is somewhat broader than it may appear. For example, if a beneficiary other than the estate is under any legal obligation to use the proceeds for payment of the insured's estate taxes, debts, or other costs, the proceeds—or a portion of them—will be includable in the insured's estate.

If you are contemplating your estate as the beneficiary of insurance proceeds, there are certain disadvantages: Proceeds payable to your estate will be subject to the claims of your creditors and to administration costs.

In many states, insurance proceeds payable to an individual are fully or partially exempt from state death taxes; if payable to your estate, however, they become part of your estate and subject to taxes.

Ownership Rights

The incidents of ownership (ownership rights) in an insurance policy consist of a bundle of contractual rights over the policy and its benefits. These include the right to surrender or cancel the policy, to change the beneficiary, to assign the policy, to borrow against the cash value of the policy, and to choose a settlement option. If, at death, the insured possesses any one of these incidents of ownership in the policy, the full amount of the proceeds will be included in the insured's gross estate for federal estate-tax purposes.

Planning pointer: An insured can remove the proceeds from his or her gross estate by assigning all incidents of ownership to another person. The assignment must occur more than three years before the insured's death, or the proceeds will be included in the estate and taxed accordingly.

Gifts of Life Insurance to Family Members

After thoroughly reviewing and assessing your life insurance program, you may find that a policy can be a meaningful gift to a family member and can be given at low cost. A gift of a policy affords an opportunity to remove a potentially large asset from your estate and creates no gift-tax liability —provided each donee's interest in the cash value does not exceed the $12,000 annual gift-tax exclusion ($24,000 if you and your spouse agree to gift splitting). If future premium payments are to be made on the policy, generally the $12,000 annual exclusion will apply to such payments.

Planning pointer: If the removal of insurance proceeds from an estate is a primary objective, careful planning is necessary to avoid returning the policy to the insured by inheritance. For example, if a husband transfers a policy to his wife and she dies first, the policy will be returned to the husband as part of his wife's estate. To avoid this, it may be wise for the wife to specify in her will that the policy go to a family member other than the insured.

In some cases, a beneficiary designation by a policy owner creates unintended gift-tax consequences regarding the policy's proceeds. For example, if a wife owns a policy on her husband's life and names her children as beneficiaries, the proceeds paid to the children when the policy matures will be treated as a gift from the wife to the children.

A more costly result from a tax standpoint can occur when one spouse owns a policy on the life of

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the other and irrevocably elects the interest-only settlement option with principal payable to the children at the surviving spouse's death. At the time of the election, the spouse has made a gift to the children of the remainder interest in the principal. Additionally, since the spouse has retained the right to receive the interest, the principal will be included in his or her gross estate.

Gift-Tax Consequences

When you give an insurance policy to someone other than a spouse, the transfer will result in a gift-tax liability if the fair-market value of the policy exceeds the annual gift-tax exclusion. Even then, you will incur no out-of-pocket cost if your unused exemption equivalent is sufficient to cover any tax assessed on the gift.

Determination of the fair-market value depends on the type of policy transferred. If the policy is fully paid-up or is a single-premium policy, its fair-market value is the cost of replacing it with a comparable contract. For policies that have been in existence for some time and are not fully paid-up, the fair-market value will usually be slightly more than the cash value of the policy. For a newly issued policy, the value is the premium paid to bring the policy into force.

The Life Insurance Trust: An Integrated Plan

One way to enhance the effectiveness of your estate plan is to name a trust as the beneficiary of your life insurance proceeds. This may produce a number of advantages:

- Although insurance contracts generally offer several settlement options, with a trust you may be able to achieve more flexibility in providing for your beneficiaries—even place restrictions on trust distributions to protect your beneficiaries.
- You may give the trustee considerable latitude on investment decisions or restrict investment decision-making according to your objectives.
- A trust may be set up to house a number of diverse assets for a more orderly distribution of income and principal.
- With a trust it is possible to eliminate a second estate tax following the death of the surviving life beneficiary.

Life insurance trusts can be set up to satisfy a variety of objectives. They can be funded or unfunded, created during life or by will, and may be revocable or irrevocable. Naturally, when exploring the possible uses of a life insurance trust, you should seek the counsel of your legal and financial advisors and consult with your life insurance representative.

Charitable Gifts of Life Insurance

Contributing life insurance policies can fulfill an individual's philanthropic objectives and generate tax savings as well. What's more, a charitable contribution of a policy offers a number of practical advantages:

- Your gift can be made on the installment plan. For the annual cost of a whole-life policy premium, you can provide our organization with a substantial future benefit.
- As long as the premiums are paid, the benefit to us is guaranteed—a fixed amount not subject to fluctuations as are some other types of assets.
- Insurance proceeds are paid promptly, and they are not subject to the delays and costs of the probate process.
- A substantial gift can be made without impairing other assets intended for family members.

In addition to the nontax advantages for gifts of life insurance, you can, depending on the arrangement of your gift, realize considerable income- and estate-tax savings.

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Naming a Charity as Beneficiary

A donor can name a charity as the primary beneficiary of a life insurance policy.

The donor retains ownership of the policy and has access to the policy's cash value. Since he or she retains ownership, no charitable income-tax deduction is allowed. This is true whether the beneficiary designation is revocable or irrevocable.

However, if the charity receives the insurance proceeds at the death of the insured, the insured's estate will be allowed an estate-tax deduction equal to the amount of the proceeds. Although the face value of the policy will be includable in the donor's gross estate, no federal estate-tax liability will result from the inclusion of the policy because of the charitable deduction.

A donor can also name a charity as a successor beneficiary to receive the proceeds in the event the primary beneficiaries are no longer living. Once again, should the proceeds be paid to the charity, the donor's estate will be allowed a charitable estate-tax deduction.

Naming a Charity as Owner

If you wish to receive immediate tax benefits, you may want to make an irrevocable assignment of an insurance policy to our organization. Upon such an assignment, you are allowed an immediate charitable deduction for the lesser of the policy's fair-market value or the net premiums paid. Deductions for contributions to enable us to pay subsequent premiums are also allowed.

Example: *A number of years ago, Mrs. Coffman purchased a $25,000 whole-life policy to ensure funds for her children's education. The annual policy premium is $500. Her children have graduated and are financially independent. Her policy has a fair-market value of $11,000, and the net premiums paid equal $11,500.*

Mrs. Coffman assigns the policy to our organization and receives a charitable deduction of $11,000 that, given her 28% tax bracket, results in an immediate tax savings of $3,080. In future years, Mrs. Coffman contributes $500 a year to us, and in turn we pay the insurance premium. Mrs. Coffman realizes an annual income-tax savings of $140 for each contribution. If she paid the premiums directly to the insurance company, her tax savings would be the same.

To obtain a charitable deduction for an assignment of life insurance to a charitable organization, a donor cannot retain any rights (such as the right to change the beneficiary) in the policy.

Note: Under the insurance laws of some states, a charity does not have an insurable interest in the life of an individual donor, in which case the charitable deduction could be denied. Before assigning ownership of a policy, consult your own legal advisor about applicable laws in your state.

Contributions That Protect Survivors

Provision for a spouse: If insurance proceeds are needed to support a surviving spouse, they could be paid to a charitable remainder trust or QTIP trust. The spouse would be entitled to payments from the trust until death, when the remaining principal would be distributed to the charity.

This arrangement has several advantages. The insurance proceeds will be paid promptly to the trust, and the surviving spouse will start receiving payments immediately without waiting for probate to be concluded. The donor's estate can receive a federal estate-tax deduction for the full amount of the proceeds paid to the trust. Upon the surviving spouse's death, no federal estate tax will be payable on the property in the trust, which passes to the charitable organization.

Provision for children: Some people hesitate to make a major charitable gift because they do not want to diminish their children's legacy. One solution is to contribute property such as securities or real estate, then use the tax savings to purchase a life insurance policy,

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the proceeds of which are payable to the children. This kind of arrangement is called *wealth replacement* because the insurance proceeds replace for the children the asset that was donated.

Example: *Mr. Schwartz contributes securities valued at $300,000. This gift results in tax savings of $99,000, given his 33% tax bracket. He then purchases a $300,000 life insurance policy, assigns ownership to his two children, and during each of the next six years gives the children $15,000, drawing from the tax savings, and they use these gifts to pay the premiums. This particular policy is paid up after six years, and the death benefit may increase. He incurs no gift tax because the gift to each child is within the $12,000 annual exclusion; and if he lives more than three years, the proceeds of the policy will not be included in his gross estate for federal estate-tax purposes. Mr. Schwartz could have achieved the same result by creating an irrevocable life insurance trust that purchases the policy on his life. Each year he would transfer $15,000 to the trust for the premium payments.*

Final Note

Life insurance is an exceptionally versatile asset and can be used to meet a wide variety of financial- and estate-planning objectives. We have discussed a few of the planning opportunities in this booklet. If you would like to explore the options available for making a gift through your life insurance, please call or write us.

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