Chapter 11.

Life Insurance

ROLE OF LIFE INSURANCE

Insurance Program

The life insurance program must be part of the overall evaluation of the estate plan. The estate planner should review all of the landowner's policies, inventory the provisions and benefits, and make projections of needed insurance changes over time in conjunction with other estate assets.

There are two primary reasons for buying life insurance: (1) to replace the foregone income of the principal breadwinner and (2) to provide liquidity. The liquidity is needed to prevent shrinkage from forced liquidations of estate assets under unfavorable terms, to cover the cost of estate administration, and to pay estate taxes, if any.

For a young family with limited assets and heavy financial commitments, insurance protection is a necessary expenditure. Many observers have noted that the family's greatest insurance needs peak immediately following the birth of their last child. Insurance can provide an instant estate for the surviving spouse in the event of a primary bread-winner's premature death. Over time, the family's insurance needs generally decline with the self-sufficiency of the children and with the accumulation of capital assets, such as timberland and other retirement benefits.

There are also alternatives to insurance for liquidity purposes, such as government and corporate bonds, and publicly traded securities. These invest-ments fluctuate in value, and there is always the risk that one or all could be at a low ebb in their cycle when cash is needed. However, the risk-return trade-off is the nature of the investment choice. Most life insurance carries an investment component, which is relatively safe with highly rated companies. Insurance firms are highly regulated, well diver-sified, and professionally managed. A minimum return is usually guaranteed, but a policyholder should be cautious in believing the projected returns because they are just that--projections--and, thus, subject to error.

Life insurance receives favorable tax treatment under the Federal estate tax laws. Insurance payable to the named beneficiary is tax exempt in many States. The Federal estate tax exempts insurance proceeds payable to beneficiaries other than the executor of the insured's estate, if the decedent retained no incidents of ownership in the policy at death. Insurance is also favorably treated for income tax purposes at the Federal level and in most States. In addition to favorable tax treatment, insurance benefits include the flexibility of different settlement options, financial security for survivors, and the convenience of low-interest, cash value loans when the policyholder may need them.

Life Insurance Contract.--Perhaps, the most important provision of the policy is that of ownership. The insured is usually the owner, but he (she) may divest himself (herself) of incidents of ownership and make the proceeds payable to someone other than to the insured's estate. With no incidents of ownership and with proceeds payable to a named beneficiary other than the estate, the value will not be included in the decedent's estate. Because the policyholder exercises control over the insurance contract, he (she) can name one or more beneficiaries including contingent beneficiaries. The owner controls the payment options depending on the needs of the beneficiaries, but the procedural rules of the policy should be followed carefully.

The insurance contract lists the schedule of cash value over time, if any. The cash value is a close approximation of the policy's gift tax value. If a policy is a participating type, it will stipulate how the dividends--the nontaxable return of excess premiums--will be paid. It describes the various options that are available for dividends, such as cash payments, paid-up additions, retention of premiums with interest, and others.

In the event that premiums are not paid in a timely manner, most permanent insurance provides for a period of extended coverage as term insurance. This is generally not the preferred method. If the owner decides to stop paying the premiums on the policy, paid-up insurance can be obtained instead of cash.

The insurance policy will spell out the procedural rules for making an assignment of the policy. This normally must be done in writing and must be received by the company to be effective. Many newer policies have special provisions for so-called "living benefits" that are available when the insured contracts a terminal illness. In effect, the insured draws on the death benefit during his (her) life to cover living

expenses associated with the final illness.

Permanent insurance (as compared to term) permits the policy owner to borrow a specified proportion of the policy's cash value. The contract has a guaranteed rate that is available to the policyholder and is normally below the rate charged by commercial lenders. There are also various options for loan repayment, as well as provisions for premium payment with loan proceeds.

Definition of Life Insurance.--Life insurance is defined for tax purposes--estate, gift, and income--in Internal Revenue Code (IRC) Section 7702. The applicable test is basically the distinction between contracts of life insurance and thinly veiled investment vehicles. If an insurance policy fails to meet the test, the pure insurance component--the difference between the cash surrender value and the death benefit--is treated as term insurance for tax purposes. The cash surrender part is treated separately with the income being taxable to the insured. More importantly, all income--not only that from the current year but also that earned in prior years--will be included in gross income and taxed to the policyholder at ordinary rates. Income is defined in this context as the amount by which the net surrender value less the cost of insurance exceeds the premiums paid less dividends credited, if any. If a policy is disqualified, the pure insurance portion--the excess of the death benefits over the net surrender value--will qualify for the income tax exclusion. Thus, buying an investment contract disguised as an insurance policy carries the added risk of disqualification by the Internal Revenue Service (IRS). If life insurance is needed, a forest landowner should buy an appropriate policy. The types of policies are described below.

Estate's Needs

The estate's needs should be considered, the alternatives for meeting family needs should be evaluated, and the economy of meeting these needs with insurance should be considered.

Uses

Insurance may provide equity for absentee heir(s) who have chosen to live and work away from the timberland. Insurance can provide liquidity to pay estate or other debts, protect a dependent's income stream, and perhaps accumulate funds for the parent's retirement. For young couples, insurance can create an instant estate for the surviving spouse and children in the case of untimely death.

TYPES OF INSURANCE

Insurance comes in many combinations of pure protection (term) and types of investment. Term insurance is the cheapest and provides the greatest protection per dollar invested in the short run. It may not be the best vehicle over time because the rates increase with the age of the insured and a person may become uninsurable. Term insurance is a means of deferring risk until the owner can afford higher cost, investment component policies. The ultimate choice of pure insurance versus insurance with an invest-ment component depends on the opportunity for sound outside investments, the tax effects (including both the rates and whether the investment component gets tax-free buildup), the premium cost and amount of cash build-up, and finally, the probability of the insured dying with the policy in force. Cash buildup in a policy reduces the actual death benefit, but at the same time, it increases the pool of funds against which the insured can borrow at a low, favored rate for any purpose.

Term Insurance

Term insurance is purchased for pure protection. Policy premiums are related directly to probability of death. It is sold in fixed-benefit policies with increasing premiums or decreasing term policies with fixed premium payments. Some policies may be converted to whole life (see below) without a physical examination, which guards against the problem of insurability. The primary characteristic of term insurance is low-cost protection, and it is most suitable for an insured who needs large amounts of coverage for short periods of time--for example, a young, married couple who have young children. Reducing term policies are often a good idea in conjunction with mortgage redemption, installment contracts, or other short-term loan repayments.

Whole Life Insurance

Whole life combines a cash value with pure protection. Payments in early years exceed the cost of pure protection. The saving-investment element of

insurance found with whole life policies should be compared with alternative saving opportunities. With ordinary life policies, the insured pays a fixed premium for life. Generally, the death benefits are fixed, there is a fixed maturity date, fixed premiums, and a fixed buildup of cash values. This is the most common type of policy, because it provides protection, some investment, and a source of emergency funds for young, single persons and newly married couples.

Other Insurance

Numerous options are available for specialized needs, but all should be compared with alternatives. The Technical and Miscellaneous Revenue Act (TAMRA) of 1988 not only changed the definition of insurance, but it also instituted income tax changes for policies that fail a seven-payment premium test. The Act created a new category of policy called a modified endowment contract (MEC). An MEC satisfies the life insurance test but fails the premium test. That is, the cumulative amount paid on the policy exceeds the sum of the net level premiums that would have been paid if the policy contract had provided for paid-up future benefits after the payment of seven level premiums. Loans and partial withdrawals are taxed on a last-in, first-out (LIFO) accounting basis. Earnings are treated first and are taxable. In addition the insured has a 10-percent, early withdrawal penalty for withdrawals made before age 59 1/2. This penalty also applies to insurance policy terminations.

Single premium policies were hit hard by TAMRA because they were primarily designed for the investment component. They are attractive to investors for the tax-free buildup and estate-tax-free transfer of assets. They also avoid probate and challenges to the decedents's will. Universal life, limited payment life, and single premium life policies with a high investment component have similarly been restricted by changes in the definition of life insurance under TAMRA (IRC Section 7702). Universal life and variable life policies separate the cash value and term protection elements of whole life. The investment option will cover the term insurance portion of the premium. If the investment side of the policy fails to earn enough for the insurance portion, then addi-tional premiums are required or the death benefit is reduced. These are most attractive to high-income individuals who want the tax-free buildup.

Spousal or second-to-die insurance is used to pay the estate tax liability of the surviving spouse. It is often used in conjunction with charitable remainder trusts (see example 8.7) to replace the principal that went into the charitable trust. First-to-die insurance is often used in buy-sell agreements to balance the interests of the heirs who choose to live in other areas with those who choose to live on the tree farm and continue to help with the day-to-day management.

ESTATE AND GIFT TAX CONSIDERATIONS

Proceeds

As noted above, life insurance proceeds are included in the gross estate if payable to the estate or, if payable to others, from policies in which the decedent retained "incidents of ownership." Transfer of policy ownership within 3 years of the decedent's death, as discussed in chapter 8, will also result in a policy being included in the decedent's estate, together with any gift tax paid.

Example 10.1. The taxable estate of a landowner was exactly $600,000 after careful estate planning. Unfortunately, the decedent forgot about an insurance policy of $100,000 that he owned and which was payable to the estate to take care of beneficiaries' needs. The policy was includable in the decedent's estate, and the $100,000 that the decedent had intended for the heirs' benefit actually amounted to $63,000. This difference accounts for Federal estate tax only, and additional State death tax may be due. To avoid this problem all "incidents of ownership" must be transferred out of the insured's control more than 3 years before the date of death. The recipient must not be under any obligation to the estate for the proceeds or they will be drawn back into the estate. The term "incidents of ownership" is emphasized because it is defined to include the power to change the beneficiaries, cancel the policy, assign it, pledge the policy for a loan, or borrow against the cash value. The insured should not pay the premiums on the policy within 3 years of death after giving up ownership. Gifts of cash or income-producing property to the policyholder on the insured's life should not be in amounts or timed so as to have the appearance that the insured is supplying funds for the premiums.

Transfers of Ownership

A transfer of insurance policy ownership results in a gift roughly equal to the cash value of the policy. The value of the gift of insurance is the cost of replacing the policy--the cash surrender value. The insurance company will supply the amount on request. This amount is generally much smaller than the face amount of the policy when it endows (that is, becomes paid up).

Premiums paid by the insured on his (her) life for a policy owned by the beneficiaries constitutes a taxable gift even though the donee's rights are conditioned on their surviving the insured. The $10,000 annual gift tax exclusion is available for the transfer of the insurance policy and for making gifts of the premium payments. If the payment is for premiums of insurance held by a trust, the gift is treated as a future interest and the annual exclusion is not available. The unified credit can be used to cover the gift and premium payments. If the donor makes a split gift of insurance or premiums within 3 years of death, there is an exception that expressly exempts the transfer of life insurance [IRC Section 2035(b)(2)].

If the policyholder dies before the insured, the value of the unmatured policy is included in the policyholder's estate. The value is the interpolated term reserve; the insurance company will provide the amount.

To avoid problems of inclusion, a younger family member should be made the owner, or the insurance should be put in trust. The trustee of a revocable trust should not be designated as beneficiary nor should a policy be subject to a loan. Both situations cause problems.

CHOICE OF BENEFICIARIES (INCLUDING CONTINGENCIES)

Tax Lability

Beneficiary designation is especially important in determining if policy proceeds are subject to Federal estate tax. The policy owner has nearly complete freedom in naming a beneficiary. Should it be the spouse, the estate, the executor of the insured, the trustee of either a lifetime trust or a testamentary trust set up by the insured, or one or more individuals?

If proceeds are made payable to the executor of the estate, they are includable in probate and increase administration cost, and estate tax, if taxable. This action will not hurt tax wise if the estate tax is deferred by virtue of the marital deduction. But, there is a better way.

Beneficiary Designation

Beneficiary designation is extremely important in determining the overall plan for the distribution of assets. It should be coordinated with the will, any trusts established, and the overall plan.

A responsible individual (family member), who can be trusted to make the proceeds available to meet the estate's liquidity needs, will keep the proceeds out of probate. If the owner does not have an individual in whom he (she) has confidence, a trust should be considered.

Normally, the spouse is named the beneficiary with the children listed as contingent beneficiaries. Doing so will avoid probate and, generally, State death taxes. However, if the children are minors, a guardian will have to be appointed for each with added expense and complications.

Insurance Trusts

An insurance trust can combine the flexibility of trusts with the protection advantages of insurance. It may be funded or unfunded, revocable or irrevocable; testamentary trusts are possible. The key advantage of naming a trust as beneficiary is greater flexibility in distributing the proceeds to meet the needs of the family. There is also the ability to put restrictions and limitations on use of funds for beneficiaries under other settlement options. The need for guardians for minor beneficiaries can be eliminated in most cases, subject to State law. The trust can eliminate the second estate tax for life insurance beneficiaries. Depending on the goals of the grantor, the trustee can be authorized to accumulate income and have broad investment discretion for the benefit of the family. The flexibility and use of restrictions are perhaps most important and must be balanced against the costs, broadly defined, of using a trust.

An Irrevocable Insurance Trust.--The advantages to be gained are avoidance of estate taxes, avoidance of probate, and possibly avoiding State death tax. The reasons noted above for choosing a trust also apply. An irrevocable trust has two big problems for the

grantor that were discussed in chapter 10--loss of control and the gift tax liability in establishing the trust. These are complex problems and should be considered with the expert advice of an estate planner who is familiar with both trusts and insurance.

OTHER CONSIDERATIONS

Settlement Options

Life insurance proceeds may be received under four basic options: (1) interest--paid for a limited time and then another option is selected, (2) fixed period--equal installments paid for a fixed period at a guaranteed rate, (3) fixed income--amount is fixed for a specific period after which the balance is pay-able under some other option, and (4) life income--an annuity for life. The choice is basically a gamble and, once made, involves rigidity not present in a trust. An insurance specialist should be consulted in arriving at the best choice for meeting the individual's objectives.

Replacing Policies in Force

Replacing policies in force is rarely advisable due to new acquisition costs, policy value increases with age, a contestable period, unequal dividends, unequal cash values, and replacement by policies of a different type.

HOW MUCH INSURANCE IS ENOUGH?

The choice of how much insurance to purchase is highly subjective, but there are some guidelines that can be followed in reaching a logical, affordable, and common sense decision. Avoid rules of thumb such as the 10-times-earnings rule.

Income Producer

The insurance should be concentrated on the person who generates the family income. This is the income stream that requires replacement if the generator dies prematurely. First, information about the family assets and liabilities and the family estate plan should be assembled. What are the family's goals and aspirations? Then, the net value of the assets and liabilities should be projected for a reasonable planning horizon. A 5-year horizon should be sufficient, but not more than 10 because anything more than 10 years is pure guesswork. The effects of an untimely death of the primary breadwinner should be calculated--such as estate taxes, administration costs, funeral expenses, and family income needs due to the loss of his (her) salary and leadership. The status of the liquid funds needed to maintain the family's standard of living should be evaluated. That is, will the family have to cash in principal in the form of savings accounts or harvest timber to meet the deficits? What are the family's goals for shelter, college, retirement, recreation, more timberland, or better management of what is owned?

If the primary income producer should happen to die before the family goals are met through hard work, how much and what kind of insurance is needed to protect the family? There are two basic courses of action if the resources are not sufficient to meet the goals--increase earnings or reduce costs and goals. Insurance can fill some of the gaps.

Periodic Review

The policies should be reviewed periodically so that adequate coverage will continue to be provided at affordable cost. Also, the steps that are outlined above should be reviewed periodically. What are the resources? What are the goals? Can the resources (timberland, growing stock, and capital) be increased to produce the income (growth) that is needed to meet the family's goals?

Minimum Standard

Use insurance to bring income protection up to the minimum level desired to assure a particular standard of living.