Chapter 10

Life Insurance

Role of Life Insurance

Insurance Program

A life insurance program should be an integral part of the overall estate plan. The estate planner should review all of the forest owner’s policies, inventory the provisions and benefits, and make estimates of needed insurance changes over time in conjunction with other estate assets.

There are two primary reasons for buying life insurance: (1) to replace income foregone at the death of the principal breadwinner, and (2) to provide liquidity. The first reason obviously is to meet the needs of the surviving family for living expenses. The second is to prevent shrinkage from forced liquidation of estate assets under unfavorable terms, to cover the cost of estate administration, and to pay any estate taxes.

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 the last child (see fig. 10.1). Insurance can provide an instant estate for the surviving spouse in the event the primary breadwinner dies prematurely. Over time, the family’s insurance needs generally decline with the move to self-sufficiency of the children and the accumulation of capital assets such as homes, timberland, and retirement benefits.

There are alternatives to insurance for liquidity purposes such as government and corporate bonds, and publicly traded securities. These investments fluctuate in value, and there always is the risk that one or all could be at a low point in their cycle when cash is needed. Many life insurance policies carry an investment component with highly-rated companies, which is relatively safe. Insurance firms are highly regulated and well diversified; a minimum return usually is guaranteed with policies that have an investment component. A policyholder should be cautious, however, in relying on projected returns since they are projections and usually not guaranteed.

Insurance payable to a named beneficiary is exempt from death taxes in most States. Life insurance also receives favorable tax treatment under the Federal estate tax laws. Insurance proceeds payable to beneficiaries other than the insured’s estate are exempt from tax if the decedent retained no incidents of ownership in the policy for the 3 years prior to death and no beneficiary is required to use any of the proceeds for the benefit of the estate; life insurance proceeds, therefore, may be paid to an executor if the executor can keep the proceeds for his (her) own benefit. Insurance also is treated favorably for income tax purposes at the Federal level and in most States. In addition to favorable tax treatment, insurance benefits can include the flexibility of different settlement options, financial security for survivors, and the convenience of low-interest cash value loans should the policyholder need them.

Life insurance contract—Perhaps, the most important provision of the insurance policy is that of ownership. The policy owner exercises control over the insurance contract. The owner can name one or more beneficiaries, including contingent beneficiaries; in addition, the owner can control the payment options depending on the needs of the beneficiaries (although the procedural rules of the policy should be followed carefully). In most cases, the insured is the policy owner which results in the proceeds of the policy entering his (her) estate at death. If, however, the owner divests himself (herself) of all incidents of ownership for at least the last 3 years of life (see below for more discussion of this rule) and names a beneficiary other than his (her) estate, the proceeds will not be included in the estate.

The insurance contract lists the cash value schedule, if any, over time. 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 generally is not the preferred method for adjusting coverage. 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 if the insured contracts a terminal illness. In effect, the insured draws on the death benefits during his (her) life to cover living expenses associated with the 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 interest rate that usually is lower than the rate charged by commercial lenders. There also are various options for loan repayment, as well as provisions for premium payment with loan proceeds.

**Definition of life insurance**—Life insurance is defined for the purposes of income, gift, and estate taxes in section 7702 of the Internal Revenue Code (IRC). The applicable test basically is a distinction between contracts for 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 and qualifies for the income tax exclusion, while the cash surrender component is treated separately with the income being taxable to the insured. In this context, income is defined as the amount by which the net surrender value, less the cost of insurance, exceeds the premiums paid, less any dividends credited. This means that all accumulated earnings—not just those for the current year—are included in the policyholder’s gross income each year and taxed as ordinary income.

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 insurance are described below.

**Estate’s Needs**

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

**Uses**

Insurance may provide equity for absentee heir(s) who have chosen to live and work away from the forest land. Insurance can provide liquidity to pay estate or other debts, protect a dependent’s income stream, and perhaps accumulate funds for the forest landowner’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 protection and investment. Term insurance (pure protection) is the least expensive and provides the greatest protection per dollar invested in the short run; however, it may not be the best vehicle over time because the rates increase with the age of the insured and a person may eventually become uninsurable. Term insurance is a means of deferring risk until the owner can afford a higher-cost policy with an investment component. The ultimate choice of pure insurance versus insurance with an investment component depends on the opportunity for sound outside investments, the tax effect (including both the rates and whether the investment component gets tax-free buildup), the premium cost and amount of cash buildup—and finally, the probability of the insured dying with the policy in force. A policy that provides cash buildup generally will provide a lower death benefit than a policy purchased at the same price with no cash buildup. A cash buildup policy, however, increases the pool of funds against which the insured can borrow at a favored rate for any purpose.

**Term Insurance**

The primary characteristic of term insurance is low-cost protection, making it most suitable for insureds such as young married couples with children, who need a large amount of coverage for a relatively short period of time. Policy premiums are related directly to the probability of death. Some policies may be converted to whole life (see below) without a physical examination, which guards against the problem of uninsurability. Term insurance is sold either in fixed benefit policies with increasing premiums or in decreasing term policies with fixed payments. It can be a good idea to use a decreasing term policy in conjunction with mortgage redemption, installment contracts, or short-term loan repayments.
Whole Life Insurance

Whole life (sometimes called ordinary life) insurance combines the pure protection feature of term insurance with an accumulating cash value. Whole life is the most common type of insurance; the cash value feature provides a ready source of emergency funds for insureds such as young single people and newly-married couples. The premiums and death benefit generally are fixed with a whole life policy, as are the maturity date and the buildup of cash value. The rate at which cash value accumulates under a policy should be compared with alternative saving and investment opportunities.

Other Insurance

Numerous insurance options are available to meet specialized needs, but all should be compared with alternatives. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA; Public Law 100-647) not only changed the definition of insurance, but also instituted income tax changes for policies that fail a seven-payment premium test. TAMRA created a modified endowment contract (MEC). An MEC satisfies the life insurance test but fails the premium test. That is, the cumulative amount paid for the policy exceeds the sum of the premiums that would have been paid if the policy contact 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 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 designed primarily 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 decedent’s will.

Universal life, limited payment life, and single premium life policies with high investment components have been restricted by changes in the definition of life insurance under 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 additional premiums are required or the death benefit is reduced. These policies are most attractive to high-income individuals who want the tax-free buildup.

Spousal or second-to-die insurance is used primarily to pay the estate tax liability of the surviving spouse. It often is used in conjunction with a charitable remainder trust (see chapter 8) to replace the principal that went into the charitable trust. First-to-die insurance often is used in buy-sell agreements to balance the interest of the heirs who choose to live in other areas with those who choose to live on the forest land 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 the decedent retained “incidents of ownership” in the policy or if the proceeds are payable to the estate. Transfer of policy ownership within 3 years of the decedent’s death also will result in the proceeds being included in the decedent’s estate, together with any gift tax paid, as discussed in chapter 8.

Example 10.1. After careful planning, the taxable estate of a forest landowner was exactly $2 million. Unfortunately, the owner forgot about a life insurance policy for $200,000 that he owned and which was payable to his estate. At his death, the policy was includable in his estate, and the $200,000 that he had intended for the heirs’ benefit was reduced to $110,000 since it was subject to Federal estate tax at 45 percent. Also, depending on the State of residence, State death taxes may be due.

To avoid the problem illustrated above, all “incidents of ownership” should be divested 3 years or more prior to an insured’s death. Incidents of ownership include the power to: (1) change the beneficiaries of the policy, (2) cancel the policy, (3) assign the policy, (4) pledge the policy for a loan, or (5) borrow against the policy’s cash value. Reversionary interests, by which the insured may regain one or more of these rights in the event a beneficiary predeceases the insured, or if certain other contingencies occur, should not be held. Additionally, the insured should not pay the premiums on the policy 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.

Transfer of Ownership

A transfer of insurance policy ownership results in a gift. The value of a gift of insurance is the cost of replacing the policy—the cash surrender value. The insurance company will provide this value on request; it generally is much smaller than the face amount of the policy.
Premiums paid by the insured for a policy owned by the beneficiaries constitute a taxable gift even though the donee’s rights are conditional on their surviving the insured. The $12,000 annual gift tax exclusion (2008, as indexed) is available for the transfer of the insurance policy and for making gifts of the premium payments; the allowable $1 million lifetime gift tax credit also can be used. If a gift is made to cover premium payments for insurance held by a trust, the gift is treated as a future interest and the annual exclusion is not available unless the Crummey power (see chapter 9) is included. If the donor makes a split gift of insurance or premiums within 3 years of death, the value of the gift reverts to the donor’s estate [IRC section 2035(c)(3)].

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 this value.

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 a beneficiary nor should a policy be subject to a loan; both situations cause problems.

Choice of Primary and Contingent Beneficiaries

Tax Liability

Beneficiary designation is important in determining whether 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 established by the insured, or one or more individuals?

If the proceeds are made payable to the estate, they are includable in probate. They also may increase administration costs, and be subject to estate tax. 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

Insurance beneficiary designation is an extremely important part of the overall estate plan—particularly with regard to distribution of assets—and should be coordinated with all other parts of the plan.

Naming as beneficiary a responsible family member who can be trusted to make the proceeds available to meet the estate’s liquidity needs is an important consideration. Normally, the spouse is named the beneficiary, with the children listed as contingent beneficiaries. Doing so will avoid probate and, generally, State death taxes. If minor children receive policy proceeds, however, a guardian will have to be appointed for each child, with added expense and complications.

If the owner does not have an individual in whom he (she) has confidence, a trust should be considered.

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, and 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 also is the ability to put restrictions and limitations on the 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 the most important attributes and must be balanced against the costs—broadly defined—of using a trust.

An irrevocable insurance trust—The advantages are avoidance of estate taxes, avoidance of probate, and possibly, avoidance of State death taxes. 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 9—loss of control and the gift tax liability in establishing the trust. These are complex problems and should be considered in consultation with 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—fixed payments for a specific period after which the balance is payable under some other option, or (4) life income—an annuity for life. The choice basically is
a gamble, and once made, involves rigidity not present in a
trust. An insurance specialist should be consulted to arrive at
the choice best for meeting the individual’s objectives.

**Replacing Policies in Force**

Replacing policies in force rarely is advisable due to
new acquisition costs, policy value increases with age, a
contestable period, unequal dividends, unequal cash value,
and replacement by policies of a different type. Especially
if the amounts involved are substantial, an insurance
consultant—whose fee is dependent on the service provided,
not the sale of a particular insurance product—should be
consulted.

**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. Rules of thumb such as the 10-times-earning
rule should be avoided.

**Income Producer**

Insurance should be concentrated on the person who
generates the family income, since it is this income stream
that needs to be replaced if the person dies prematurely.
First, information about the family assets and liabilities
and the family estate plan should be assembled—that is,
an inventory of family resources. What are the family
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 years, since anything over 10 years is pure
guesswork. The effects of the untimely death of the primary
breadwinner should be calculated considering factors such
as family income needs due to the loss of his (her) salary
and leadership, estate taxes, administrative costs, and funeral
expenses.

The status of liquid funds needed to maintain the family’s
expected standard of living should be evaluated. For
example, will the family have to cash saving accounts
or harvest timber to meet deficits? What are the family’s
goals for shelter, college, retirement, and recreation? With
regard to the continuity of business, do family goals involve
acquiring more forest land or better management of what
already is owned?

The process of determining the needs of the immediate
family is illustrated conceptually in figure 10.1. How much
insurance is needed to protect the family if the primary
breadwinner should die before family goals are met? The
answer depends on where the family is on the time line. If
the available resources are insufficient to meet the goals,
there are three basic courses of action: (1) increase earnings,
(2) reduce costs, or (3) redefine goals. Insurance can fill
some of the gaps.

**Periodic Review**

Life insurance policies should be reviewed periodically to
evaluate whether they are providing adequate coverage at
affordable cost. The concerns outlined above also should be
revisited periodically: What are the resources? What are the
goals? Can the resources (forest land, timber growing stock,
and capital) be increased to produce the income (growth)
that is needed to meet family goals? Insurance is one
alternative to bring income protection up to the minimum
level desired to assure a particular standard of living.