Maximizing the Estate Planning Value of Life Insurance

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What is maximizing the estate planning value of life insurance?

Simply put, maximizing the estate planning value of life insurance means getting the most bang for your buck. That is, it involves keeping as much of the proceeds as possible away from the IRS and in the hands of your beneficiaries. When you die, all your worldly goods (e.g., your money, house, car, stocks, bonds, as well as your life insurance proceeds) become a pie. The pie is then cut into slices and served. One slice goes to your heirs and beneficiaries, one slice to the federal government, one slice to your creditors and so on. The size of the slice that goes to the federal government can be as big as 40% (the rate for the estates of persons who die in 2013 and later years), and what goes to the federal government does not go to your heirs and beneficiaries. You need to plan now to make sure that the slice that goes to the federal government is as small as possible, leaving a bigger slice for your loved ones.

How is it done?

Understand how life insurance is taxed

If you want to reduce estate taxes, a good first step is to understand how the estate tax system works. Although this is a technical area best left to the experts, the basics can be grasped fairly easily and will give you some direction regarding how to make the wisest arrangements.

Arrange proper ownership of the policy

Who owns the policy and for how long can affect how life insurance is taxed for estate tax purposes. If you own a life insurance policy on your own life when you die, the proceeds of the policy are includable in your gross estate for estate tax purposes, regardless of who your designated beneficiaries are. If you own a policy and transfer it to another owner within three years of your death, the transfer is not recognized for estate tax purposes and the proceeds are therefore includable in your gross estate.

However, if you transfer ownership of the policy to someone else more than three years before your death, the transfer is recognized for estate tax purposes and the proceeds will therefore not be included in your estate. Since insurance that you own on your death (or within three years of your death) is included in your estate and therefore may be subject to estate tax, someone other than yourself (or your spouse in a community property state) should own the policy if you wish to avoid subjecting the proceeds to estate tax. The owner of the policy can be another individual or a trust, such as an irrevocable life insurance trust (ILIT).

Designate the right beneficiary

Who your beneficiaries are can also affect how life insurance is taxed for estate tax purposes. For example, if the designated beneficiary of a policy on your life is your estate, the proceeds are generally includable in your gross estate for estate tax purposes even if you do not own the policy on your death (or did not own it within three years of your death). If the designated beneficiary is your executor or your estate, the proceeds may be includable in your gross estate.

The primary reason for not naming your estate or your executors as beneficiaries of policies on your life is that doing so subjects the proceeds to the expense of probate and claims of creditors. If you own the policy and name a third party as a beneficiary, the proceeds will be included in your estate for estate tax purposes, but they will pass by operation of law outside of the probate process and will not be subject to the claims of creditors of your estate. Proceeds payable to your children are not subject to estate tax unless you own the policy on your death or within three years of your death. If you own the policy, the proceeds are includable in your estate (and therefore subject to the estate tax) regardless of who your beneficiaries are.

However, as noted above, if you name your children as beneficiaries, they will receive a greater benefit from the policy than if you named your estate as the beneficiary and then directed that the proceeds be distributed from your estate to your children, because proceeds paid to your estate will be reduced by probate expenses and claims of creditors while proceeds paid directly to your children will not.

IMPORTANT DISCLOSURES