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Basic Estate Planning Fact Sheet Series

Life Insurance

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The topic of this fact sheet is life insurance. Life insurance is a contract similar to property ownership with rights of survivorship, in that upon the death of the insured, a beneficiary receives a cash payment. Life insurance can be very useful in estate settlement. Life insurance is a contract between as many as four entities:

1. Company
2. Policy owner
3. Insured
4. Beneficiary

The first entity, the company, accepts money from the second entity, the owner of the contract. The policy owner determines who is insured. The owner of the policy has the authority to cancel the policy, to borrow against the policy, and to initially determine and change the beneficiary. When the insured

dies, a cash award is made to a beneficiary, the fourth entity.

The primary reason for a death benefit is to care for dependents who would have been cared for if the deceased were still alive. Ironically, we generally most need life insurance when we are least able to afford it, when debt is high, assets are low, and children are young and cannot take care of themselves. Then is when life insurance can create an estate in the event of the death of the breadwinner/caretaker. Life insurance is for most the only way to provide for the security for our loved ones to be cared for in the event of the worst.

Even if the deceased has no dependents, liquidity is needed upon one's death. Cash to pay settlement costs and/or debts can come from life insurance, from liquid assets in your estate or from liquidating fixed assets. Those

who do not wish assets to be sold or do not want heirs to have to borrow money because there are not sufficient liquid assets (savings accounts, CD's, etc.) to cover settlement costs, should consider life insurance.

Often fixed assets (house, farm, or business) make up a majority of the estate, and parents wish for only certain children to have them. At the same time, the parents often desire to give bequests of equitable value to all children. In addition, business associates may wish to be able to “buy out” others when the need arises. When this is the case, there is seldom enough cash. Life insurance is one of several tools that can be used to assist with the dilemma.

There are several ways to use life insurance. First, heirs not receiving equitable fixed assets may be designated as life insurance beneficiaries. Or, all heirs can be given equitable shares of all assets, including the fixed assets. Then one or more of the heirs can buy out the others' share with proceeds from a life insurance policy.

Life insurance may also be used to avert estate settlement costs, even if liquidity is not needed. Life insurance proceeds are not generally subject to any estate settlement costs, except federal estate tax, and not even federal estate tax as long as the insured is not the beneficiary or owner of the policy.

Because of special federal estate tax considerations mentioned above, those with estates of \$3,500,000 or more who own life insurance policies may wish to have someone other than the insured pay the premiums and own the policy. Trusts can also be owners and beneficiaries of life insurance policies, which

also averts settlement costs, including federal estate taxes, on the life insurance proceeds. **CAUTION:** Having spouses own life insurance policies on each other does not avert federal estate taxes because the surviving spouse now owns the proceeds. The survivor then needs to spend, gift, or otherwise allocate the proceeds, else estate settlement costs will be assessed on those proceeds upon his or her death. The surviving spouse also needs to change the beneficiary of his or her own policy if the deceased spouse was the only named beneficiary.

Most dividends paid on money deposited in a life insurance policy are not charged income tax. This is the case because the dividends are considered a refund of the policy owner's overpayment. If the policy is held properly, the proceeds may also be estate tax free as mentioned above. Money placed in a whole life insurance policy can have an “investment” component, so that the policy has a cash value from which the owner may borrow. However, investment returns from life insurance may not be as high as from alternative investments so the cost of the above tax protection may be high.

Life insurance cost varies by company, type of insurance, age, sex, and health of the insured. Term insurance is generally less expensive because it covers only a specified period of time, builds no cash value, the premium goes up over time, and many cannot be renewed beyond age 65 or 70. When the specified term is up, premium cost may be too high to renew.

Still, the lower initial cost of term insurance may allow families to be adequately insured when young and when many most need it.

Then later in life, income may be higher so that the relatively higher cost of term insurance will not be problematic. Also, the size of policy needed may be lower as the children become less dependent and the wealth of the family grows. Size of policy is most easily reduced with term insurance. If you purchase term insurance, it is important that there is a clause to assure renewal at the end of the term. Even if renewable, the premiums for the next term will likely be higher, as the insured's age will be higher.

Survivorship policies pay only when the last surviving spouse dies. Survivorship policies have lower rates, as the life expectancy for the last surviving spouse is longer than for either spouse. If the objective is to provide liquidity upon the death of the surviving spouse, survivorship policies may be appropriate.

Whole life insurance premiums are constant over the insured's life because the money saved by lower insurance costs early in the insured's life builds cash reserves that are used to pay the higher insurance costs later in life. Variable life insurance policies incorporate an investment factor into life insurance and their value varies with the ups and downs of a varying market such as stocks and bonds. However, they seldom perform as well as stocks or bonds.

The financial viability of the company is also important, as the federal government does not guarantee insurance policies as they do bank accounts. A.M. Best (A++), Standard and Poor's (AAA), Moody's Investors (Aaa), and Duff and Phelps (AAA) are some of the rating agencies that compare the financial health of insurance companies (best ratings are in parentheses). In general, companies

to be considered should have at least an A rating or higher. Competitive rates can be obtained with the highest rated companies. Additional information and an excellent life insurance shopping guide can be obtained from the State Insurance Commissioner, who may be contacted at: State of Ohio Insurance Department, 2100 Stella Court, Columbus, Ohio 43266, 1-800-686-1526.

One last note on life insurance. A contingent owner and contingent beneficiary should be designated in the policy. If a contingent owner or beneficiary is designated and the owner or beneficiary dies before the insured, the person previously designated as the contingent now becomes the new owner or beneficiary. For estate tax and other settlement cost purposes, the contingent beneficiary needs to end up being different than the insured. Otherwise the proceeds will be included in the estate of the insured and settlement costs will be assessed on the proceeds. This can be the case if spouses name each other as the beneficiary, but don't change beneficiary after the first spouse dies. When the second spouse dies, there is no beneficiary and the proceeds go into the estate. This can be averted by naming the children as contingent beneficiaries when both spouses are alive or by the use of a trust. If the policy is paid into a trust upon death, it will avoid Ohio estate tax at the death of both spouses; however, if the policy is paid to the surviving spouse, there will be Ohio estate tax on whatever portion of the proceeds remain at the second death.

It may not only be wise to name a contingent beneficiary, but also a contingent owner different than the spouse. For those with estates of \$3,500,000 or more that need to be con-

cerned about federal estate tax, it is important that the insured does not end up being the owner, so that the proceeds are not included on the federal estate tax form. If spouses own each other's policies, unless a contingent owner is designated (other than the surviving spouse) upon the death of the first spouse, the surviving spouse may become the owner and insured of the remaining policy. The proceeds of this policy are now included in federal estate tax calculations in the estate of the

second spouse to die. Careful consideration needs to be given to contingent beneficiaries and owners of life insurance policies. Remember, the owner of the policy has the power to cash in a policy, to change beneficiaries, and to assign the policy to someone else.

This concludes the discussion of life insurance. The next fact sheet will discuss the use of trusts as an estate planning and managing tool.

These fact sheets should in no manner be considered as a replacement for consulting with estate planning professionals, nor should the general principles in these fact sheets be applied to specific situations without consulting with an attorney.

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Your Response

Fact Sheet 6

1. Which one of the following is the least appropriate use of life insurance?
 - a. To provide for dependents in the event of premature death of a “breadwinner” or “care-giver”
 - b. To provide liquidity needed upon the death of the insured
 - c. As an investment vehicle

2. Joe owned and paid the premiums for a life insurance policy on himself. When Joe died, the company paid Mary, his daughter. For which of the following calculations are the life insurance premiums included?
 - a. Probate Court fee
 - b. Executor fee
 - c. Capital gain for income taxes
 - d. Ohio estate tax
 - e. Federal estate tax

3. Now assume Joe did not own the policy, but that Mary, his daughter owned the policy and paid the premiums. For Joe’s estate, for which, if any of the following calculations are the life insurance premiums included?
 - a. Probate Court fee
 - b. Executor Fee
 - c. Capital gain for income taxes
 - d. Ohio estate tax
 - e. Federal estate tax
 - f. None of the above

4. The money you give to a life insurance company is insured by the government.

True	False
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5. If you are shopping for life insurance, which of the following are important considerations?
 - a. cost per \$1000 of coverage, now and in the future
 - b. financial health of the company
 - c. familiarity with and trust worthiness of the agent
 - d. renewability of policy, for term policies
 - e. all of the above

6. Which of the following are cash needs that can be supplied by life insurance?
- a. provide for dependents in case of premature death
 - b. provide liquidity for estate settlement costs
 - c. if real estate or other non-liquid assets go to some heirs, life insurance proceeds can provide cash to other heirs to equalize inheritances
 - d. If policy is a whole life policy with “cash value,” one can borrow against the cash value while living.
 - e. all of the above

Answers

Fact Sheet 6

1. Which one of the following is the least appropriate use of life insurance?
- a. To provide for dependents in the event of premature death of a “breadwinner” or “care-giver”
 - b. To provide liquidity needed upon the death of the insured
 - c. As an investment vehicle

Yields of life insurance are generally lower than those available outside the life insurance industry. Be leery of life insurance policies sold solely on the basis of their return on investment.

2. Joe owned and paid the premiums for a life insurance policy on himself. When Joe died, the company paid Mary, his daughter. For which of the following calculations are the life insurance premiums included?
- a. Probate Court fee
 - b. Executor fee
 - c. Capital gain for income taxes
 - d. Ohio estate tax
 - e. Federal estate tax

The value of the life insurance policy is included in federal estate tax calculations. If Mary owned the policy on Joe, and Mary paid the premiums, the value of the life insurance would not have been included in even federal estate tax calculations.

3. Now assume Joe did not own the policy, but that Mary, his daughter owned the policy and paid the premiums. For Joe’s estate, for which, if any of the following calculations are the life insurance premiums included?
- a. Probate Court fee
 - b. Executor Fee
 - c. Capital gain for income taxes
 - d. Ohio estate tax
 - e. Federal estate tax
 - f. None of the above

As indicated in the answer above, when a person other than the insured and deceased owns the policy and pays the premiums, and a beneficiary is designated (so that the settlement does not go to the estate), life insurance proceeds are not subject to any estate settlement costs.

4. The money you give to a life insurance company is insured by the government.

True

False

Even though the government regulates and oversees life insurance companies, it does not insure them as it does most savings accounts and certificates of deposits.

5. If you are shopping for life insurance, which of the following are important considerations?

- a. cost per \$1000 of coverage, now and in the future
- b. financial health of the company
- c. familiarity with and trust worthiness of the agent
- d. renewability of policy

e. all of the above

All of the above are important considerations. Considering item “a,” term insurance has had the lowest cost, even over a lifetime, but the cost of term insurance will increase as one ages. Policies with a paid up provision or investment provision will have level or decreasing payments over one’s lifetime.

6. Which of the following are cash needs that can be supplied by life insurance?

- a. provide for dependents in case of premature death
- b. provide liquidity for estate settlement costs
- c. if real estate or other non-liquid assets go to some heirs, life insurance proceeds can provide cash to other heirs to equalize inheritances
- d. If policy is a whole life policy with “cash value,” one can borrow against the cash value while living.

e. all of the above

All of the above are possible uses for life insurance. However, if term insurance is used, no equity is available unless one dies within the term for which the premium is paid.