Life Insurance a Big Part of Estate Plans

Life insurance is a unique estate planning tool, because you pay relatively little up front and your beneficiaries get much more when you die. When you name beneficiaries other than your estate, the money passes to them directly, without probate. Unlike money tied up in non-liquid assets like your company or real estate, life insurance gets cash into your beneficiaries' hands without their having to resort to a fire sale of other assets.

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Though procedures vary by company, usually the beneficiaries receive their insurance proceeds promptly. Generally, the beneficiary informs the company in writing of the death, sends a copy of the death certificate, and receives a check, often within a few weeks.

Three Ways to Distribute Proceeds

If you own life insurance on your own life, you can have the proceeds distributed in three ways.

1. **To beneficiaries.** The company pays the proceeds directly to one or more beneficiaries named in your policy. This is the quickest way to get the money to your survivors, and the proceeds typically pass free of income tax. However, your estate may be liable for federal and state estate taxes if the proceeds, when added to the other assets in the estate, total more than the $1.5 million threshold at which the federal estate tax presently kicks in.

2. **To your probate estate.** If you choose this route, the proceeds will be distributed along with your other assets according to the terms of your will. (If you die without a will, your state's intestate succession laws will determine where the proceeds go.) However, they will be tied up in the probate process, will add to the cost of probate by making the estate larger, and will be subject to creditors' claims. In addition, they may be subject to estate tax. You should do this only if your estate won't otherwise have enough money to pay debts and taxes.

3. **To a trust.** If you make the proceeds payable to a trust—either one set up in your will or created during your lifetime—they will be distributed like the other trust assets. Paying the proceeds to such a life insurance trust has several advantages:

- In many jurisdictions, your creditors can't get at them.
- If the trust is for the benefit of your minor children or anyone else who needs your protection, you can avoid the expense and court involvement of having a guardian manage this property. By having the proceeds paid to a trust, the trustee will have control over it.
- Generally, an estate tax will not have to be paid on the proceeds if certain rules are met (see below).

> Life insurance trusts can help avoid estate taxes on insurance proceeds.

Who Should Own the Policy?

As noted above, if you own the policy, the proceeds payable on death will be included in your estate for estate tax purposes. If your insurance is payable to your spouse, it won't matter in the short run if it pushes the value of your estate above $1.5 million—gifts of any size between U.S. citizen spouses pass tax-free. The problem comes in when your spouse dies—then his or her estate is liable for taxes on anything over the threshold, so in effect that estate is paying a delayed tax on the insurance proceeds.

To escape estate taxes on the proceeds, you must see that the policy is not owned by you or your estate. **Life insurance trusts** are a popular way of accomplishing this. Here's how they work. Let's say you set up an irrevocable life insurance trust in which the trustee owns the policy on your life—not you. The trustee can buy a policy on your life, or you can transfer ownership of an existing policy to the trustee (though in the case of a transfer, you would have to live at least three years for the proceeds to escape estate taxation). Each year, you pay the premiums so the policy stays in effect. When you die, the policy pays death benefits to the trust, and these benefits are free of estate taxes. Your family, including your spouse, can live off the income from the trust and have certain rights regarding the principal. Upon your spouse's death, depending on how the trust is written, the trust can continue and benefit your children and grandchildren for many years, or the trust can terminate and the children take the principal remaining. This principal passes free of estate taxes, even if the estate were otherwise large enough to trigger taxes.

Life insurance trusts are only one example of using irrevocable trusts to create a tax-free estate. Your lawyer can explain many other options.