EBNY Financial, LLC
Kevin Kautzmann, CFP®
Certified Financial Planner
80 Fifth Avenue #1403
New York, NY
212-269-2625
kevin@ebnyfinancial.com
www.ebnyfinancial.com

Life Insurance and Estate Planning

Life Insurance and Estate Planning

What is the connection between life insurance and estate planning?

Life insurance has come a long way since the days when it was called burial insurance. Today, life insurance is a crucial part of many estate plans. How does life insurance fit into an estate plan? In three basic ways:

1. It ensures that your loved ones get money quickly without going through the process of probate
2. It solves cash flow problems caused by your death (there usually are bills to pay)
3. It allows you to give money to your favorite charity

To accomplish these goals, you need to know how to maximize the value of your life insurance or how to keep the federal government's hands off the insurance proceeds, because if you don't, the insurance proceeds will increase the size of your estate and could be subject to estate taxes. Understanding the tax consequences of life insurance is no easy task, even for the most sophisticated estate planner. However, if you learn how to own the policy the right way, learn how to designate the proper beneficiaries, and understand the income tax ramifications of the settlement options available to the beneficiaries, you'll be halfway there.

What are the benefits?

Peace of mind

You believe your assets are going to increase, but you aren't rich. You want to protect your children in case something happens to you before you become wealthy. In this case, buy insurance and name your spouse or children as beneficiary(ies). Once you've bought your policy, you can stop worrying. In fact, your early years are probably the best time to buy insurance, since you are likely to be healthy enough to afford sufficient coverage to accomplish your goals.

Uses a few cents to get big bucks

Another nice aspect of insurance is that it allows you to use a few dollars to leave many dollars to your family. There are only two catches to this deal. The first is that you have to die before your beneficiaries get the proceeds. The second is that you must be able to pay the insurance premiums every year. Still, insurance is much less expensive and lets you create an instant estate.

Replaces wealth lost by estate shrinkage

Life insurance is probably the number one method of replacing wealth lost because of estate shrinkage (i.e., the costs and expenses associated with your death, like taxes, administration expenses, and funeral and burial costs).

Allows you to be generous to charity

Life insurance allows you to give to charity while enjoying the tax benefits that result.

- Income tax break: Generally, gifts to charity are deductible for income tax purposes
- Estate taxes or gift tax break: If properly structured, gifts to charity qualify for the charitable deduction and may reduce or eliminate estate taxes or gift tax

How do you own the policy the right way?

Not by you (the insured)

Depending on the year in which you die, proceeds from life insurance on your life may be includable in your estate for estate tax purposes if you own the policy outright or own any incidents of ownership in the policy at the time of your death or at any time within three years of your death.

> **Technical Note:** "Incidents of ownership" is a legal term. It means any right to the economic benefits of the policy, such as:
>
> 1. Retaining the right to change beneficiaries
> 2. Retaining the right to borrow on the policy's cash value or pledge the policy for a loan
> 3. Retaining the right to surrender or cancel the policy
> 4. Retaining the right to assign the policy
> 5. Retaining the right to elect or revoke a settlement option
> 6. Retaining the right to get the policy back
> 7. Retaining the right to convert group coverage to an individual policy

Not by your spouse if you live in a community property state

In general, community property states treat all types of property acquired during the marriage (except by gift or inheritance), including life insurance, as being owned one-half by each spouse. Thus, one-half of the life insurance policy owned by your spouse may be includable in your estate for estate tax purposes, depending on the year in which you die.

By another individual

One person can own a policy insuring the life of another. Proceeds of such a policy will not be includable in the insured's estate for estate tax purposes.

Premiums should be paid by the owner but not from joint assets or community property belonging to the insured.

By an irrevocable trust

An irrevocable life insurance trust (ILIT) is a type of trust used to keep proceeds out of the insured's taxable estate. The trust is the owner of the policy and the beneficiary of the proceeds, which are then distributed to the beneficiaries of the ILIT according to the terms of the trust agreement.

> **Caution:** An ILIT is a complex estate planning tool. It must be properly created to be effective.

How do you designate the proper beneficiary?

Don't name your estate or your executor

Life insurance proceeds will be includable in your estate for estate tax purposes if any one of the following is true:

1. The proceeds are payable to, or for the benefit of, your estate
2. You possessed any incidents of ownership in the policy at the time of your death or at any time during the three years prior to your death
3. You transferred ownership of a policy within three years of your death

Therefore, you should not name your estate or your executor as the beneficiary.

Tip: Some states have laws providing that proceeds payable to an estate or executor are treated as if they are paid to the ultimate beneficiary. The IRS honors state law in these cases.

Don't name a beneficiary to satisfy a debt

Naming a beneficiary to receive proceeds in payment of a debt will be considered to be for the benefit of your estate, and the proceeds may be includable in your estate for estate tax purposes.

Don't name a beneficiary to pay death taxes or other estate debts or expenses

Naming a beneficiary to receive proceeds under an agreement requiring him or her to pay your estate's debts or expenses will be considered to be for the benefit of your estate, and the proceeds may be includable in your estate, depending on the year in which you die.

Don't name a beneficiary to pay alimony or support

Naming a beneficiary to receive proceeds to pay alimony or support will be considered by the IRS to be for the benefit of your estate, and the proceeds may be includable in your estate for estate tax purposes, depending on the year in which you die.

What are the tax consequences of settlement options?

Lump sum generally exempt from income tax

Generally, life insurance proceeds payable in a lump sum are received by the beneficiary free of income tax.

Caution: There are some exceptions to this general rule:

- Transfer-for-value rule: Under the transfer-for-value rule, death proceeds of a life insurance policy that has been transferred in exchange for consideration (i.e., money or something of value) are subject to income tax to the extent that such proceeds exceed the dollar value of the consideration, premiums, and other amounts paid by the transferee for the policy
- Qualified retirement plan: Proceeds received by the beneficiary under a qualified annuity plan or employee benefit trust are taxable as ordinary income to the extent that the proceeds equal the cash surrender value of the policy at the time of the insured's death
- Dividends/compensation: If the proceeds are considered dividends or compensation because the employer paid the premiums and the insured was a stockholder/employee, they are taxable to the beneficiary as ordinary income

Interest earned on installment payments taxable at ordinary rates

When payments of interest are received by the beneficiary under an installment option, the interest (but not the proceeds) is subject to income tax. Generally, interest is taxable as soon as it is credited to the beneficiary, even if the beneficiary does not actually receive it on that date.

Tip: Interest received by the beneficiary under a government life insurance policy is exempt from income tax.

IMPORTANT DISCLOSURES

Broadridge Investor Communication Solutions, Inc. does not provide investment, tax, or legal advice. The information presented here is not specific to any individual's personal circumstances.

To the extent that this material concerns tax matters, it is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding penalties that may be imposed by law. Each taxpayer should seek independent advice from a tax professional based on his or her individual circumstances.

These materials are provided for general information and educational purposes based upon publicly available information from sources believed to be reliable—we cannot assure the accuracy or completeness of these materials. The information in these materials may change at any time and without notice.

EBNY Financial, LLC
Kevin Kautzmann, CFP®
Certified Financial Planner
80 Fifth Avenue #1403
New York, NY
212-269-2625
kevin@ebnyfinancial.com
www.ebnyfinancial.com