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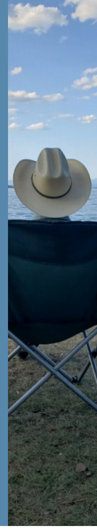

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FAMILY FINANCIAL MANAGEMENT

MT199211HR, REVISED 03/25

Life Insurance: An Estate Planning Tool

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Explains how life insurance can meet a variety of estate planning goals, provides hints about designation of beneficiaries, and describes the types of life insurance.

MANY FAMILIES FIND LIFE INSURANCE TO BE A VALUABLE tool in an estate plan. Life insurance can help accomplish families' financial objectives by providing:

- Immediate cash for payments of debts, costs of the last illness, burial expenses, costs of probate, other settlement costs, and, if necessary, payment of federal estate taxes and elimination of the possibility of a forced sale of assets to generate needed cash.
- Funds for the surviving partner to buy the partnership interest of the deceased partner from the heirs. This enables a business to continue as an ongoing enterprise.
- Cash when an heir has a contract to buy a family member's farm/ranch or other business at their death. The heir could insure the family member's life as a means of providing cash to purchase the business should the family member's death occur before the heir has built enough cash reserves.
- Income replacement for surviving spouse and children.

There are also other ways life insurance can meet a family's estate planning goals.

- Some parents buy life insurance on an adult son or daughter who is in the process of taking over the farm/ranch or other business. Such action offers protection for parents so that the death of an adult child will not disrupt the business.
- Life insurance proceeds can be used to provide off-farm heirs with "equitable" treatment if a parent's desire is to pass the business intact to a farming or ranching son or daughter. Doing this can prevent the farm or ranch from being split into smaller units of uneconomical size to make an "equal" division among children. Leaving the business to the operating heir and life insurance proceeds to off-farm heirs prevents the operating heir from having to buy out the interests of other heirs when they may be unable to afford it.
- Life insurance can also be used to create an estate where one would not otherwise exist.

Tax status

In general, life insurance proceeds pass to the beneficiary tax-free. Many people are unaware that life insurance proceeds can be subject to the federal estate tax under certain circumstances. Life insurance proceeds are subject to federal estate taxes if the policyholder has "incidents of ownership" in the policies or if the proceeds are payable to the estate. Examples of "incidents of ownership" include the policyholder's right to change beneficiaries, to borrow the cash value, to select dividend options, or to change premium payment schedules.

If a person's objective is to avoid having the value of life insurance included in their gross estate for federal estate tax purposes, they must give up ownership of the policy. To accomplish this, all incidents of ownership must be surrendered or transferred to someone else, such as a spouse, child, or to a trust.

Changing ownership

To make sure beneficiaries fully benefit from each dollar of life insurance, the insured may find it advisable to establish ownership in someone else's name (spouse or children, for example) for all or some of their policies. If the insured does not retain "incidents of ownership" in the policies, life insurance proceeds will not be included in the gross estate for federal estate tax computation purposes.

A life insurance policy is considered a gift when transferred after the initial purchase. The value of the gift is the ***interpolated terminal reserve*** in the policy at the time of the transfer. This amount can be provided by the life insurance company. There may be federal gift tax consequences if the amount exceeds the federal gift tax annual exclusion of $19,000 per donee (2025). For more information, see *Gifting: A Property Transfer Tool of Estate Planning* (MT199105HR).

If your total estate, including life insurance proceeds from policies owned by you, is less than the amount subject to federal estate taxes ($13,990,000 for a single person; $27,980,000 for a married couple in 2025), the form of ownership of your life insurance policy may not be of concern. When your estate reaches the taxable limits, have a professional advisor who specializes in estate planning such as an attorney, a certified public accountant, or a life insurance agent evaluate the federal estate and gift tax consequences of your ownership of any life insurance policies to ensure that overall estate planning goals and objectives are accomplished.

Designation of beneficiaries

Designation of beneficiaries of life insurance policies is a particularly important estate planning consideration. A life insurance policy is a legal and binding contract that directs the distribution of proceeds to designated beneficiaries. ***A will controls who receives life insurance proceeds only if the estate is designated as the beneficiary on the beneficiary designation form.*** If a father's Will names his son as the beneficiary of his life insurance proceeds but he later designates his daughter as the beneficiary on the life insurance forms, his daughter is the one who receives the proceeds. A Will cannot undo a beneficiary designation.

Beneficiary designations on the policy contract should be consistent with a person's overall estate planning goals and objectives. Because situations and family conditions change, a person should review their beneficiary designations periodically and change them when appropriate. Births, deaths, and divorce are examples of occasions for a review of life insurance beneficiary designations.

If a change is needed, a person should ask their insurance company to send a change of beneficiary form to fill out and return or complete the form online. The company will attach the complete form to the policy. If a person designates minor children as beneficiaries and they inherit more than $5,000, Montana Law requires that a court-appointed conservator manage the funds until the child reaches the age of majority (18 in Montana). When children reach their 18th birthday, each receives their share of the life insurance proceeds, regardless of their ability to manage it.

Parents may think their children are bright but do not believe they can manage $100,000 or $200,000 in life insurance proceeds while young. Rather than leaving the proceeds directly to the children and nominating a conservator to manage them until the children reach age 18, parents can leave assets in a "family" trust for the children's benefit.

Their Wills can indicate that insurance proceeds are to be paid into a testamentary trust if both parents die. Parents can select and name a trustee to manage the assets. They prepare a trust agreement giving the trustee the power to manage the trust assets and use income for the children's benefit. The trust agreement is effective upon the death of both parents. The trust can avoid the inflexibility of conservatorship that passes the assets to the children at age 18. The trust agreement can indicate any age at which the trust terminates, and that age could be beyond 18. For more information about Testamentary trusts, see MSU Extension MontGuide: montana.edu/estateplanning/pdf/MT202113HR.pdf.

Divorced couples

The Montana legislature passed a law (Mont. Code Ann. §72- 2-814) providing that a marriage dissolution (divorce) revokes any ***revocable disposition*** to a former spouse in a governing instrument that was executed before the divorce. Examples of governing instruments included in the law are life insurance policies, annuity policies, and IRAs.

Couples should examine their beneficiary designations on contractual arrangements during and after the divorce to ensure that the individuals they want to receive proceeds are designated as beneficiaries. A person can expressly provide for a former spouse to receive the assets if noted in a contract or on a beneficiary designation signed and dated after the marriage dissolution decree.

> ***Example:*** Montana residents Donna and Ron were divorced on April 1, 2023. In January 2024, Ron still had Donna listed as the beneficiary on his life insurance policy. If Ron had died, the proceeds would pass as though Donna had disclaimed the proceeds. In other words, the treatment would be the same as if Donna had predeceased Ron, and the life insurance proceeds would then pass to his heirs – Ron and Donna's two children. If Ron's preference is for his former wife, Donna, to receive the life insurance proceeds, then he must complete a new beneficiary designation form that is dated and signed after the marriage dissolution decree that was dated April 1, 2023.

Types of life insurance

The major types of life insurance are term, whole life, universal life, variable life, and adjustable life.

Term Insurance provides financial protection for a limited, specified period. Since it provides temporary protection and does not generate a cash value, term insurance is the least expensive kind of protection. However, the premium for this protection will usually increase with age. For example, a 35-year-old man buying $250,000 of coverage for 10 years of renewable term insurance could pay a premium of $156 the first year. The premium would increase to $450 for a 40-year-old man, $1,494 for a 50-year-old man, and $3,294 for a 60-year-old man.

A "basic level" term insurance policy provides a constant amount of insurance and annual premiums for a fixed time, usually five or 10 years. An annual renewable term policy has yearly increases in premiums for the same amount of coverage. This policy type is commonly called a "yearly renewable" term policy.

Whole Life policies provide a death benefit for the entire life of the insured. They also provide for a tax-deferred build-up of cash values. The cost of whole life insurance is usually greater than term insurance during the early years. Premiums are paid over the life of the policyholder or for a specific period. When premiums are paid over the lifetime of the insured, the contract is called a "straight whole life" policy. For example, suppose a 30-year-old man buys $30,000 worth of coverage. He could pay an annual premium of $239 for a whole life policy with no policy dividends. Contracts with premiums paid over a shorter period, such as 20 years, are "limited-pay whole life" policies.

With a whole life insurance policy, a person can borrow an amount from the insurance company up to the current cash value of the policy. You can repay the amount borrowed when you want, or not at all. However, the interest on the loan is due each year on the policy anniversary. Also, if you die before the loan is repaid, the amount previously borrowed is deducted from the death benefit provided to the beneficiaries.

Universal Life Insurance and **Adjustable Life Insurance** offer flexible premium payments, an adjustable death benefit, and cash values that are often tied to current interest rates. Most contracts pay a current interest rate that competes well with other options available in the money market. However, these rates are not guaranteed over the life of the contract. Premiums are deposited in a special fund. From this fund, the company deducts its fee and the monthly costs for the protection that covers the life of the policyholder. After making these deductions, the company credits interest to the fund at the market rate.

Much of the appeal of universal life insurance stems from its tax treatment, which is the same as for other life insurance products that meet specific standards. Examples of this tax treatment include tax-deferred build-up of income and cash value, and no income taxation of proceeds to the beneficiary.

Compare the administrative costs of universal life insurance. Ask if the charges are ***front-loaded*** (deducted before the premium is credited to cash value) or ***back-loaded*** (paid by you if the policy is surrendered).

Variable Life Insurance builds cash value that can be invested in a wide variety of separate accounts, and the choice of the accounts is left up to the contract owner. Thus, policyholders may obtain higher cash values and death benefits than with policies calculating benefits based on a fixed rate of return. Conversely, policyholders also assume the risk of negative investment performance.

Life insurance agents selling variable life insurance must be registered representatives of a broker-dealer licensed by the Financial Industry Regulatory Authority (FINRA) and registered with the Securities and Exchange Commission. If you are interested in this type of policy, be sure the agent gives a prospectus containing an extensive disclosure about the variable life policy. Review the prospectus carefully to understand the potential risks associated with the investment.

A **survivorship life insurance policy**, or second-to-die policy, insures two lives, usually a husband and wife. The policy provides benefits to the heirs only after the last surviving spouse dies. For example, John and Mary bought a survivorship policy. John died first, and under the terms of the policy, Mary did not receive any benefits. After Mary dies, their children receive the benefits. Survivorship life insurance is usually less expensive than traditional single-insured life insurance. The premium is based on the joint life expectancy of the insured. Survivorship policies are available as variable universal life and whole life insurance policies.

Comparing costs

The actual premium for a life insurance policy depends upon a particular company's rates and other factors. Whether or not dividends are paid on the policy will affect net premium cost. The occupational classification and health status of the insured may also influence premium rates. Most companies also give rate discounts for policies of generous size. The annual cost of insurance also depends, in part, upon whether premiums are paid on a monthly, quarterly, or annual basis.

One way to compare the costs of various term life insurance policies is to ask the agent for the interest-adjusted ***net cost index***. That index represents the cost per thousand dollars of coverage during the term of the policy. The lower the index, the less expensive the policy is over time. A term policy with an index of 1.47 is a better buy than one with an index of 2.28.

If a person wants their insurance policy to also be a savings vehicle, expect to pay higher premiums than paid for term insurance. Use the interest-adjusted net cost index to compare the costs of two cash value insurance policies. For cash value insurance, the index is frequently called a ***surrender index***.

A second index, the ***net payment cost index***, is helpful for comparing cash value insurance policies if the primary concern is the death benefit, not the cash value. With either index, the lower number indicates a lower cost policy.

Remember that cost comparisons should only be made between similar plans of life insurance. The index for a cash value policy cannot be compared with that of a term policy. Compare index numbers for the actual policy (for the age of the insured) and the amount of insurance to buy. Slight differences in index numbers may be less important than other policy features or agent services. In addition to the cost index, consider whether the policy meets your needs and if the premiums are affordable.

Rating insurance companies

The financial health of insurance companies is evaluated by major rating companies such as A. M. Best, Duff & Phelps, Moody's Investment Services, Standard & Poor's, and Weiss Research. Ratings are available online, from insurance agents, or directly from the rating company. However, a person should be aware that each company has different definitions and formulas for determining financial stability. To illustrate: an A++ is the top grade from A.M. Best, while AAA is the top grade of Standard & Poor's.

For this reason, the ***Comdex Ranking*** has been established. Comdex is not a rating itself, but a composite of all the ratings that a company has received. The Comdex ranks companies on a scale of 1-100, in relation to other companies that have been rated. A high rating does not guarantee safety, but it is one of the best means available to consumers to gauge an insurance company's financial health.

Settlement options

Life insurance usually provides for payment of benefits in a lump sum. However, if a family wants to put some or all of its life insurance money away for future spending, a variety of settlement options are available. When a settlement option is chosen, the company keeps the stipulated sum and pays amounts to the beneficiary of the policy in the method selected.

The policy owner can specify how the life insurance proceeds are to be paid to the beneficiaries, or the choice can be left for the beneficiary to make after the insured dies. When one of these settlement options is used, a beneficiary knows exactly what the policy's income will be and how long this income will last.

Settlement options can be used by living policyholders, too. For a living policyholder, the cash value of a policy forms the basis of the settlement arrangement chosen. At retirement age, the policyholder can convert the policy's cash value into retirement income. There are four basic settlement options:

Interest option – The company holds the life insurance proceeds and pays interest at a rate that is higher than the rate guaranteed in the policy. Arrangements can be made to withdraw part of the money if desired. The remaining money can be withdrawn later or left to someone or a nonprofit named by the beneficiary of the policy.

Amount option – A regular monthly income of a desired amount is paid until the money and the interest it earns are depleted.

Time option – A regular monthly income is paid for a desired period. The amount of monthly income is determined by the money and interest available.

Lifetime income option – This plan is vastly different from the other options as it provides a monthly income for life. The amount received depends on:

1. the amount invested,
2. how much money the person wants to receive,
3. the rate of interest guaranteed by the policy, and
4. how old the beneficiary is at the death of the policyholder.

Presenting a claim

When a death occurs, a beneficiary can start settlement proceedings by notifying the life insurance agent who will help file the claim. The company will send the beneficiaries a claimant's statement that must be returned with proof of death, usually a copy of the death certificate. The claimant's statement includes an outline of how the proceeds are to be handled – that is, which of the settlement options should be used and how. With most claims, processing takes two to three weeks. However, the timeframe may be longer if there are complications such as questionable death circumstances.

Is life insurance for me?

There are many insurance companies, agents, and variations among life insurance policies. Shop around for the best policy at the least cost to satisfy your financial goals. Before purchasing insurance or changing policies, ask these questions:

- Is life insurance needed? If so, for what purposes?
- If life insurance is needed for debts, mortgages, taxes, or family income, how much do I need?
- How much can I afford to pay for annual premiums?
- What kind of life insurance should be purchased: term, whole life, universal life, variable, or adjustable?
- Which company provides the best policy for me at the lowest cost? Is it a financially sound company?
- Once life insurance is purchased, regularly review insurance needs and make changes if needed.

Many of these questions can be answered by a qualified and experienced insurance agent.

Acknowledgement

This publication has been reviewed by representatives of the following organizations who recommend its reading by those using insurance as an estate planning tool:

- National Association of Insurance and Financial Advisors — Montana Chapter

Disclaimer

The information appearing in this MontGuide is presented for informational purposes only and should not be considered legal or tax advice or be used as such. For specific legal and tax advice, a reader should confer with his or her own attorney, certified public accountant, or other qualified professional.

MT199211HR, REVISED 03/25

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