

# Who Should Own My Life Insurance? A Deceptively Complex Question

Do you know that you don't have to own your life insurance policy? In fact, your family may be better off financially if somebody else owns your life insurance policy.

If your net worth is substantial (see chart below), you might want to consider allowing your life insurance policy to be owned by either a third party or a trust to provide liquidity for estate taxes and costs.

APPLICABLE ESTATE EXCLUSION AMOUNTS			
Year	Gift Tax Amount	Estate Tax Amount	Highest Estate and Gift Tax Rates
2007	\$1,000,000	\$2,000,000	45%
2008	\$1,000,000	\$2,000,000	45%
2009	\$1,000,000	\$3,500,000	45%
2010	\$1,000,000	Repealed	Gift tax only, equal to top individual income tax rate
2011	\$1,000,000	\$1,000,000	55%

*The current federal laws tax people for the transfer of assets, either during their life or at death. The tax is imposed on estates with assets worth more than the applicable exclusion amount. As you can see, the estate tax applicable exclusion amount increases over the next several years. However, estate and gift taxes ranging from 39% to 55% for transfer of assets above the applicable exclusion amount, you may incur tax liability that could be partially avoided by proper ownership of your life insurance policies.*

When you die, the death benefit from your life insurance policy passes on to your beneficiary (ies) generally *income* tax free [IRC 101(a)]; however, it is not *estate* tax free. Although legislation has been passed to repeal estate taxes, the repeal is not effective until 2010, and then a sunset provision in the tax law *reinstates* the tax in 2011. If you own the policy at that time, the death benefit can be included in your estate. And, with estate tax rates as high as 55%, the results can be devastating.

## Look at These Examples

Imagine you and your spouse have a \$4,000,000 estate, including \$3,000,000 of property and investments and \$1,000,000 from the death benefit of a life insurance policy. Also assume that you both die after 2011 and your estate tax exceeds the applicable exclusion amounts. At a 53% marginal tax rate, your estate could owe \$530,000 (1,000,000 x 53%) in taxes on the life insurance, as detailed in the following chart.

	With Insurance Included in Estate
Marginal Estate Tax Rate	53%
Value of Life Insurance Policy Death Benefit	\$1,000,000
Total Estate Taxes Due on Life Insurance	\$530,000

Now imagine that all other assumptions remain the same; however, someone else owns the policy. The \$1,000,000 death benefit would still pass on to your beneficiary(ies), but it would no longer be included in your estate. Your estate would owe no estate tax on the life insurance, resulting in a savings of \$530,000.

With even larger estates, the results can be more dramatic. In the following chart, look at the difference in the estate tax owed when insurance is removed from the estate by the use of a different ownership arrangement.

	<i>With Insurance Included in Estate</i>	<i>Without Insurance Included in Estate</i>
Marginal Estate Tax Rate	55%	55%
Value of Life Insurance Policy Death Benefit	\$1,000,000	\$1,000,000
Amount of Insurance Subject to Estate Tax	\$1,000,000	\$0
Total Estate Taxes Due	\$550,000	\$0

### What Does Ownership of a Life Insurance Policy Mean?

If you are the owner of a policy, you have the right to:

- Borrow against the policy or withdraw cash value<sup>1</sup>
- Change the beneficiary
- Revoke, cancel, or assign the policy

If you have any of these rights, you may be considered to have ownership in the policy. And if you are also the insured, having ownership means that the death benefit will be included in your estate. To avoid this scenario, you basically have two options:

- Ownership of the policy by another individual
- Ownership of the policy by a trust

### Which Option Should You Choose?

Like any financial decision, choosing the proper ownership arrangement for your life insurance policy is a matter of choosing what best fits your situation after weighing the advantages and disadvantages. The following summary will help you decide which option is right for you.

### Implications of ownership by another individual

You can simply transfer ownership of your policies to a family member, or you can have that family member apply for and own a policy on your life. But, consider the implications if your family member

- *Encounters financial difficulties—He or she could borrow from the cash value of the policy without your consent and you wouldn't be able to do anything about it.*
- *Declares bankruptcy—The policy may be subject to creditors' claims.*
- *Divorces—The policy may be considered marital or community property and may be divided between the owner and his or her estranged spouse.*
- *Dies before you do—Who will own the policy then?*

Also consider that there may be other implications, such as:

- *Loss of control—He or she may exercise any right of ownership including borrowing against the policy if he or she wishes.<sup>1</sup>*
- *Limits on minor child—Make sure you examine laws in your state. Some states prohibit children under a certain age from owning life insurance policies.*
- *Conflicts with multiple children—If the policy is owned by two or more children, conflicts may arise when decisions must be made regarding the disbursement of benefits. Premium payments can also be problematic. Each owner should pay his or her portion of the premium or, alternatively, consider an agency agreement that clearly defines the duties and responsibilities of each child to ensure that no gifts are made in connection with premium payments. Further complications arise if one owner/child dies before the insured and his or her heirs are the other owners. Finally, if one child owns the policy for the benefit of multiple children, the owner/child will be deemed to have made a gift to the other children, thereby causing gift tax consequences.*

<sup>1</sup> Policy loans and withdrawals reduce cash values and death benefits, may affect any policy guarantees against lapse, and may have tax consequences.

- *Gift tax concerns—If the third party owner names someone else as the beneficiary, at the death of the insured, he or she may incur gift tax liability to the extent the death benefit proceeds exceed the gift tax annual exclusion. If the third party owner decides at a later date to transfer the policy to a trust, he or she may incur gift tax liability if the value of the policy exceeds the annual gift tax exclusion established by the federal government. In addition, transfers to a trust of which he or she is a beneficiary may cause all or part of the death proceeds to be included in his or her estate.*

There may be a better way to remove the value of your life insurance policy from your estate and still retain control over how the proceeds of the policy are distributed and perhaps even used. It's called an irrevocable life insurance trust (ILIT), and here's how it works:

### The ABCs of ILITs

Before we discuss ILITs specifically, it pays to review the concept of trusts in general.

Trusts are legal entities that people establish to hold assets for the benefit of others. As legal entities, trusts are separate and distinct from the people who create them, the people who benefit from them, and the people or corporations that hold legal title to the assets placed in the trusts. People set up trusts for a myriad of reasons: to ensure that assets are managed effectively and distributed according to the trust creator's wishes; to provide for family members who may lack the maturity, judgment or financial expertise to manage substantial assets on their own; and to help reduce estate taxes. People who create trusts are called *grantors*, and those who benefit from them are called *beneficiaries*. People or corporations that hold legal title to the assets in the trust and are responsible for managing and distributing them in accordance with the grantor's wishes are called *trustees*.

An ILIT is a type of trust created for the purpose of owning and serving as beneficiary of a life insurance policy. By placing the policy in the trust, you remove it from your taxable estate. When death benefit proceeds are paid, they are

paid to the trust. The result is a death benefit that is passed through the trust to your trust beneficiaries according to your instructions and is not reduced by estate and income taxes.

In today's environment of estate tax uncertainty, flexibility can be built into the trust to direct distribution of the life insurance funds in the event that estate taxes are, in fact, repealed long term.

### How do ILITs work?

Any trust is a complex document and requires the services of a knowledgeable attorney. In addition, you will have to select a trustee who may be a friend, family member, or even a corporation. In fact, for many people, a corporate trustee is an ideal solution to the challenge of finding someone who can fulfill the responsibilities of a trustee with complete professionalism and impartiality.

Once you've chosen a trustee, there is the question of whether to buy a new policy or simply transfer an existing one. If you transfer an existing policy on your life to your ILIT, you must survive the transfer by at least three years; otherwise, the death benefit will remain part of your taxable estate. If you decide to buy a new policy, it is important that the trustee apply for the policy on behalf of the trust and that the trustee be the owner and beneficiary of the policy.

### Premium payments from individual gifts

There are several tax issues of which you should be aware:

- *To provide your trust with the necessary funds to pay premiums, you may make gift tax-free transfers up to the annual exclusion amount (\$12,000 in 2007 and 2008, indexed in future years) to each trust beneficiary who has a limited withdrawal right called a Crummey right. Since each person has the right to make tax-free annual exclusion transfers, a married couple can currently transfer \$24,000 per beneficiary.*
- *For your gift to be gift tax free, you must make certain that your trust beneficiaries have a right to withdraw the gift, also known as a “Crummey Power.” This means that, when you give money to the trust, your trustee must provide your beneficiaries with written notice of their right to withdraw the gift made on their behalf. Your beneficiaries are given a number of days (generally 30–60 days) to exercise their right to withdraw the money for their own use. After the stated period of time, the trustee may use your gift to pay the premium on the life insurance policy.*

Of course, beneficiaries seldom exercise their Crummey powers because it would interfere with the estate plan that was established on their behalf. Be very careful here. There can be no documented or preconceived record of a discussion with the trust beneficiaries that potential annual gifts cannot or should not be taken. You should also realize that you do not need to give your beneficiaries Crummey withdrawal powers. As an alternative, you can make taxable transfers to the trust. The gift tax applicable exclusion will exempt the first \$1,000,000 of lifetime transfers from gift taxation.

### Required steps to establish an ILIT

1. The grantor establishes the trust and names the trustee and beneficiaries.
2. The trust applies for life insurance policy on the life of grantor.
3. The grantor makes gifts to the trust for payment of the life insurance premiums.

4. The trustee sends written notice to the beneficiaries, informing them of their right to withdraw funds during a specified period of time.
5. The beneficiaries choose to exercise or not exercise their right.
6. The trustee pays the insurance company the policy premiums using the available gifts after a specified period of time.

### Upon the insured’s death

1. The insurance company pays the policy death benefit to the trust.
2. The trust lends cash to, or buys assets from, the grantor’s estate to provide liquidity to the estate for paying estate tax, if necessary.
3. The trustee distributes (or continues to manage) the policy death benefit according to the grantor’s wishes.

### What happens after the death of the insured?

After the death of the insured, the insurance company pays the death benefit to the trust and the trustee distributes the money according to your wishes spelled out in the trust document. Because a trust is such a flexible instrument, you may wish to build in control over how distributions are made. If you have young children, for example, you might want the trustee to distribute only sufficient funds to support them until they reach the age of majority. At that age, you may want the trustee to distribute the remainder in a lump sum or over many years. Or, you may decide to have the trustee distribute the remainder to another individual. The possibilities are virtually limitless.

### So what are the limitations?

There are a few. The “I” in ILIT stands for irrevocable. An irrevocable trust is one that can’t be revoked or, for that matter, amended or terminated. In return, you receive the considerable benefit of being able to remove property from your estate to an entity that may provide you and your loved ones with current or future tax advantages. It should be noted that just because the trust is irrevocable, it does not mean it is inflexible. It is possible to include trust provisions that allow the trust to respond to changes in your situation. For example, it may be possible to add or eliminate trust beneficiaries.

If you transfer a life insurance policy to an ILIT, you are no longer the owner of it. Therefore, you have no control over the policy and can no longer enjoy such rights of ownership as:

- *Access to cash value in the policy through loans and withdrawals<sup>2</sup>*
- *The ability to change your beneficiary*
- *The opportunity to surrender the policy*

In addition, you should not serve as trustee of the ILIT. Rather, you should select a reliable trustee who will perform such critical functions as applying for the life insurance policy, paying the premiums, distributing the proceeds to beneficiaries according to the provisions of the trust, and perhaps lending cash to or purchasing assets from the estate to help pay estate taxes when they are due. Depending on the type of life insurance policy and the terms of the trust, it may be possible to have your spouse be the trustee.

The establishment of an ILIT will result in expenses associated with drafting the trust, annual record keeping and, in some cases, annual trust tax returns.

For most affluent people with sizable estates, the advantages of an ILIT far outweigh the drawbacks of irrevocability.

#### ILITS IN A NUTSHELL

##### Advantages

- *Preservation of your estate for your beneficiaries*
- *Control, as grantor, over when distributions will be made and who will receive them*
- *Liquidity to help pay estate taxes, if needed, after your death through loans to the estate or purchasing assets from the estate*
- *Management of life insurance proceeds for your beneficiaries*
- *Protection of the policy from creditors*
- *No trust tax return required if life insurance is the only asset held by the trust*

##### Disadvantages

- *Irrevocable*
- *Loss of control over the policy*
- *Expenses associated with drafting the trust*
- *Possible annual trust tax return*
- *Records must be kept*

## The Next Step

Irrevocable Life Insurance Trusts are only one—albeit a very important—component of an overall estate plan. To develop a plan that will not only preserve your estate from unnecessary taxation but embody your wishes for how assets will be distributed, you should seek professional guidance. Your licensed financial professional will be happy to work with your attorney and tax advisor to help you create a plan that's appropriate for you and can provide the appropriate life insurance and financial products.

## Who Will Own Your Life Insurance Policy?

For many people, the advantages of third party ownership clearly outweigh the disadvantages. But the issue of its appropriateness should be discussed in depth with your licensed financial professional, your tax advisor, and a qualified estate planning attorney.

Just as you've planned carefully to accumulate your current estate, you must plan to help assure that your assets go to the individuals you select without being eroded by costs that might have been avoided.

Who will own your life insurance policy?

Hopefully, this deceptively complex question and the information provided here will help you get started developing a plan that will help preserve the financial well being of your loved ones for years to come.

<sup>2</sup> Under appropriate circumstances, riskier and more complex strategies may be employed to give the insured limited access to cash value.

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*This material is designed to provide general information in regard to the subject matter covered. It contains references to concepts that have legal, accounting and tax implications. It is not intended as legal, accounting or tax advice. Consult your own attorney and/or tax advisor for advice regarding your particular situation.*

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