THE INS AND OUTS OF POLICY OWNERSHIP

Although it is difficult, planning your estate requires you to consider what the financial situation of your family would be like if you were gone. It is during this kind of projection that most people realize the importance of owning life insurance.

Once you decide that you need to be insured, the next step is deciding who should insure you. You can own an insurance policy on yourself—but so can your spouse, business, or trust. We believe that understanding the rights of ownership—as well as the pros and cons of each type of ownership—can help clarify your ownership questions.

Ownership rights

A life insurance policyowner has the right to control the economic benefits of the policy. There are two categories of ownership: outright ownership and incidents of ownership. *Outright ownership* is afforded to the individual whose name is on the policy as the owner. *Incidents of ownership* refer to the specific rights of ownership; some of these include:

- The right to transfer ownership rights
- The right to change certain policy provisions
- The right to surrender or cancel the policy
- The right to pledge the policy for a loan or to borrow against its cash value
- The right to name and to change a beneficiary
- The right to determine how beneficiaries will receive the death proceeds

The outright owner can retain all incidents of ownership, or he or she can defer some incidents of ownership to other individuals.

Ownership options

There are several different ways that policies can be owned. Owning a policy on your life is the most common; however, any person or legal entity can own life insurance on another person—as long as the policyowner has an insurable interest in the insured. An insurable interest exists when one person has a financial interest in another person's life. Spouses are assumed to have an insurable interest in each other. The same holds true for parents and children. Certain business relationships may also create an insurable interest, such as when a business insures its key employees or when a bank guarantees repayment of a loan with a life insurance policy on the borrower.

When considering different ownership options, it is important to weigh the advantages and disadvantages of each before you decide who should own your life insurance policy.

1. You own your own policy. With this type of ownership, you pay the premiums, you are named as the insured on the policy, and you control all of the ownership rights.

Advantages and disadvantages

Life insurance proceeds from a policy on your life can be included in your taxable estate if (1) you own the policy outright; (2) you have any incidents of ownership in the policy at the time of your death; or (3) you transfer ownership of the policy within three years of your death. Inclusion of life insurance proceeds in your taxable estate isn't a problem if your taxable estate (including any includable life insurance proceeds) is less than or equal to the applicable exclusion amount. If your taxable estate (excluding any includable life insurance proceeds) exceeds the applicable exclusion amount, you should consider alternate ownership of policies on your life.

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2. Your spouse as owner. With this type of policy ownership, your spouse is responsible for the premiums and has control of the ownership rights, and you are named as the insured.

Advantages and disadvantages
In most states, if you name your spouse as the owner of your life insurance policy, the proceeds won't be included in your taxable estate. Generally, when your spouse is the beneficiary, the death proceeds escape estate taxation because of the unlimited marital deduction. But a problem arises when a policy insures one spouse and the owner is the other spouse while he or she names a third party as beneficiary. For example, if the beneficiary of a policy on the husband is someone other than his wife, a transfer subject to gift tax occurs when the husband dies and the proceeds are payable to the third person. The policyowner has just made a gift to the beneficiary.

3. Another individual as owner. For this type of ownership, the individual is responsible for the premiums and controls the ownership rights, and you are named as the insured on the policy.

Advantages and disadvantages
Sometimes, it may be advantageous to name another individual as the owner of your life insurance policy. Proceeds of such a policy will not be includable in your taxable estate. Keep in mind, however, that if the policyowner dies before you, the cash value of the policy (not the face amount) is includable in that person's taxable estate.

4. An irrevocable life insurance trust (ILIT) as owner. The trust owns the policy and is required to pay the premiums. The insured can either place payment in the trust or place income-producing assets into the trust to cover the cost of the policy. When the insured dies, the proceeds are distributed to the trust, and distribution to the beneficiaries of the trust is made according to the trust agreement.

Advantages and disadvantages
An ILIT may be used to keep life insurance proceeds out of your taxable estate. But it's important to note that an ILIT is a complex estate planning tool and must be properly created to be effective. Before taking advantage of such a device, seek the assistance of an estate planning professional.

Transferring policy ownership

If you own a policy on your life, you may want to transfer ownership to another individual (e.g., to the beneficiary) to avoid inclusion of the proceeds in your estate. Transferring ownership of a policy is easy: Simply complete a change-of-ownership form provided by your insurance company. Remember, though, that even if you transfer ownership of an existing policy to another individual, it may be included in your estate if you die within three years of the transfer.

Summing it all up

Life insurance is an important part of your estate plan. There is no question that you should be insured, but choosing the insurer can be a complex and challenging decision. By reviewing your entire financial plan, we can help you determine which form of ownership will most benefit you and your loved ones.

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