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To own or not to own your life insurance policy?

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ABSTRACT

Life insurance proceeds are generally subject to the estate tax. An exception is when the policy is owned by the beneficiaries and the insured gives up ownership and control, including the ability to change beneficiaries. Should the insured strategically own the policy contract and potentially subject proceeds to estate and inheritance taxes, or relinquish control, with the beneficiaries owning the policy, and escape such transfer taxes? This paper addresses how the estate tax influences the choice of life insurance ownership. Using samples of estate tax returns, the empirical evidence suggests that those facing high estate tax rates are more likely to forgo ownership and have proceeds excluded from their estates, and provides further evidence on the incentive effect of taxes and in support of the strategic bequest motive.

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1. Introduction

The adequacy of life insurance and the factors that shape the demand for it over the life cycle are often the key questions of interest in the literature (e.g., Auerbach and Kotlikoff, 1991; Bernheim et al., 2003). This demand may be motivated by the desire to leave bequests (Yaari, 1965; Campbell, 1980). It may as well be shaped by income tax considerations in the case of whole life contracts, as the inside build up is not taxable, or by liquidity constraints faced in disposing of one's estate at death and succession planning (Holtz-Eakin et al., 2001; Hau, 2000; Verdon, 2008).

Life insurance coverage is also employed in gauging the strength of bequest motives (Bernheim, 1991). Little attention, however, is paid to the nature of these motives (e.g., altruistic vs. strategic), and how this may shape the form of ownership of life insurance contracts. A parent, or the insured in general, may give up ownership of a policy contract to designated beneficiaries and with it the ability to change such beneficiaries in the future. Alternatively, the insured may retain the ability to change beneficiaries at any point in time. In the latter, and because the insured maintains ownership, proceeds pass through the estate and are potentially subject to the US estate tax. In the former, and because the policy is owned by the beneficiaries, proceeds bypass the estate and go directly to the heirs free of tax.

To be more specific, an individual may acquire an insurance policy, pay the premiums every year (or lump sum in a single premium), and then have the proceeds included in their estate and potentially subject to estate taxation. Alternatively, the individual may transfer ownership to the recipients (preferably in the form of a life insurance trust), and thereby have the proceeds bypass the estate tax. For a given contract, if bequests are altruistic and the objective is to maximize the net of tax bequests, then the beneficiaries (trusts) should own the contracts. On the other hand, if bequests are strategic as in Bernheim et al. (1985), then the insured (e.g. parent) may wish to maintain control, and with it the ability to change beneficiaries. But this ownership subjects the proceeds to estate taxation. With the top estate tax rate well over 50% during much of the past seven decades, the implications of the form of ownership are not trivial.

In many ways the ownership question is reminiscent of the findings in the literature on the timing of transfers and their allocation between lifetime or inter vivos gifts and bequests (Bernheim et al., 2004; Joulfaian, 2005; McGarry, 1999; Page, 2003). The key distinction here is in the timing of the designation of the recipients of life insurance proceeds. The various bequest motives have different implications for the form of ownership as the estate tax can be avoided if the insured is willing to part away with ownership and control in designating the ultimate beneficiaries. Which form is pursued is ultimately an empirical question. In this paper, I explore the determinants of the form of life

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insurance ownership with particular attention to the role of the estate tax. To my knowledge, I believe this paper is the first to examine this subject.[1]

Section 2 of this paper provides a brief description of the estate tax treatment of life insurance policies. Section 3 addresses issues related to modeling the ownership decision, as well as data sources. Administrative records consisting of estate tax returns of decedents in 1989 through 2003 are employed, which provide information on life insurance proceeds included as well as amounts excluded from the estate, in addition to the size and composition of wealth and demographics. Empirical findings are reported in Section 4. The results suggest that taxes are an important consideration in shaping the form of ownership. Section 5 concludes.

2. A brief review of the estate tax treatment of life insurance proceeds

The estate tax was enacted in 1916, and life insurance proceeds first became taxable under the Act of 1918. Under the Act, proceeds from policies owned by the decedent, plus proceeds in excess of $40,000 from life insurance policies owned by others (on the life of the insured), were included in the gross estate and potentially subject to the estate tax. This remained the law until the Act of 1942, when all proceeds from policies where the decedent paid the premiums or had an incidence of ownership ("premium paid" test) were also made taxable.[2] With the introduction of the Internal Revenue Code in 1954 and the consolidation of the various acts, the "premium paid test" was dropped and only proceeds from policies directly owned by the insured, or where the insured had any control, remained taxable and includable in the estate.

Current law continues the tax treatment of life insurance introduced in 1954. More specifically, insurance proceeds are subject to the estate tax only when the insured owns or in any way maintains any control over the life insurance policy contract. The latter may include the right to change the listed beneficiaries; the right to borrow against the policy or pledge it as a collateral for a loan; the right to assign policy ownership; and the right to cancel the policy or, in the case of whole life insurance, surrender it for its cash value.

In order to avoid the tax, and at its most basic level, the policy should not name the estate of the insured as the beneficiary and avoid any incidence of ownership. An insured may transfer ownership of an existing insurance policy to the beneficiaries. Alternatively, the insured may form an irrevocable life insurance trust to benefit the heirs and transfer ownership to it. The same process can be extended to transfers at the time a new policy is acquired. Insurance trusts typically cost about $1000–2000 to draft and implement. And so it is not too difficult or very costly for the well off to exclude life insurance proceeds from an estate and avoid taxation provided that the insured is willing to give up control.[3]

The insured need not assign ownership to beneficiaries at the time of the signing of the life insurance contracts, as they are able to transfer ownership at any point in time in the future. In the case of whole life insurance policy, the cost of transferring an existing policy may increase if the owner (insured) decides to change ownership a few years into the contract as gift taxes may apply on the cash value of the policy (inside build-up). Gift taxes may apply if this value exceeds the annual exclusion ($10,000 or $20,000 per couple, indexed) and the size of exempted estate ($600,000 for most of the period studied in the paper).[4]

Gift taxes may also apply to the transfers made to trusts to pay for the premiums. Again, these premiums have to exceed the annual exclusion and the size of the exempted estate before triggering the gift tax. Insurance premiums vary by the age and health of the insured, as well as the type of insurance (term vs permanent). Consider a 70 year old male entrepreneur in excellent health. The premium on a $5 million 10-year term policy contract is about $45,000 per year. If the insured transfers $45,000 per year to the insurance trust, the annual gift tax exclusion will shelter part of the transfer from the gift tax. In time, the cumulative transfers in excess of the annual exclusion will eat into the estate tax exemption. Nevertheless, there are elaborate schemes that can be devised to avoid potential gift taxes on transfers made to a life insurance trust to pay the insurance premiums (Johnston, 2002). More importantly, and at a tax rate of 55% for a taxable estate of $3 million, the $5 million insurance proceeds will trigger an additional estate tax of $2.75 million when the insured has direct ownership.

3. Modeling the form of life insurance ownership

3.1. The role of preferences

Consider a bequest motivated individual who wishes to leave behind life insurance policy proceeds L to benefit his daughters. If the insured holds or owns a fraction α of the policies directly, then his estate will pay an estate tax of $\tau\alpha L$, where τ is the estate tax rate. The daughters receive $(1-\tau)\alpha L$ from policies held by the insured owner, and receive the remaining $(1-\alpha)L$ from policies they own, or which are held by an irrevocable trust set up on their behalf and out of the control of the insured, free of tax.

The choices are clear: hold the insurance contract directly and have the estate pay a tax on proceeds, or forgo ownership and control and have the proceeds flow free of tax to the daughters. The insured chooses from these two forms of ownership so as to maximize his utility:

$$max \;\; U[O, B] \tag{1}$$

where $O = (1-\tau)\alpha L$ represents ownership by the insured, and $B = (1-\alpha)L$ represents ownership by the beneficiaries. When differentiated with respect to α this yields:

$$(1-\tau)U_O - U_B = 0 \tag{2}$$

or,

$$\frac{U_B}{U_O} = 1-\tau. \tag{3}$$

The insured allocates contracts between the two forms of ownership at the point where the marginal rate of substitution is equal to the net of tax rate. The heirs receive only $(1-\tau)$ of every dollar in life insurance proceeds from contacts controlled by the insured, but this loss in bequests is offset by the greater utility derived from controlling the policy when bequests are, say, strategic ($U_O > U_B$).

The above framework can be modified to focus on the allocation of premiums rather than proceeds. But because the underlying contracts and terms are identical except for the nature of the owner, their allocation should be identical. Another possible extension is to introduce financial education where those acquiring large insurance contracts L may receive better and most likely free advice related to ownership forms, thereby rendering α endogenous to L.[5] This is not dissimilar from the effect of financial education on retirement savings (Bayer et al., 2009; Bernheim and Garrett, 2003; Choi et al., 2002).

[1] Also, it is not clear from the literature whether previous studies of the demand for life insurance address insurance contracts not owned by the insured.

[2] The Act repealed the $40,000 life insurance exemption from policies owned by beneficiaries. At the same time it expanded the general exemption of $40,000 that applied to all estates to $60,000; this was mostly a revenue neutral change.

[3] Dynastic trusts and other complex arrangements can be costlier to set up.

[4] The annual exclusion in 2013 is $14,000 or $28,000 per couple, and the size of the exempted estate is $5,120,000.

[5] The size of contracts (L) may also mitigate the effects of the fixed cost of setting up a trust for those who wish to forgo ownership but prefer not to hand over the policy to beneficiaries directly.