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Life Insurance: The Impact of Ownership

Robert H. Flashman, Kentucky Cooperative Extension Service state specialist for Family Resource Management
Celia Ray Hayhoe, CFP, Virginia Cooperative Extension specialist for Family Financial Management, Virginia Tech

The major reason most people buy life insurance is to provide financial support for beneficiaries in case the insured person dies prematurely. However, there are additional reasons for purchasing: to pay off a home mortgage or other debts, to pay for funeral expenses or a college education for children, or for investment or estate planning.

Knowing who owns a life insurance policy, who the policy covers, and who stands to benefit in the event of death are all important, but sometimes confusing factors. At the end of this fact sheet you will find a short glossary designed to help you understand terms related to life insurance and ownership.

Who Is Involved in a Life Insurance Policy?

Three important parties are involved in a life insurance policy:

1. The insured is the person whose life is covered by the policy. When the insured dies the death benefit is paid.
2. The beneficiary is the person who receives the insurance money.
3. The owner is the person who owns and controls the policy.

Who Is the Owner?

The owner could be the insured, the beneficiary, or some other party. Usually, the owner is the person whose life is insured. The owner could also be the insured's spouse or children. In other cases, none of these parties is the owner. One example is when a business buys insurance on its partners to cover the value of the insured's share of assets in the company.

The policy owner has certain important rights to the policy, including:

- paying the premium(s);
- naming the beneficiaries;
- determining the various options within the life insurance policy, such as settlement options;
- changing the owners of the policy in the future;
- borrowing from a cash buildup in the policy; and
- changing any other feature in the insurance policy.

Why Is Ownership Important?

Ownership has the greatest impact when major life events, such as divorce or death, occur. Upon the death of the insured, beneficiaries owe no income tax on insurance proceeds. However, the proceeds will be included in the owner's estate if the owner and the insured are the same person, regardless of who is the beneficiary. In this case, the owner's estate could be responsible for estate tax on insurance proceeds if, when added to the net worth of all other assets, the total exceeds $1.5 million in 2004 and 2005; $2 million in 2006 through 2008; $3.5 million in 2009; and in 2010, this tax is repealed. After 2010, the amount of the estate that is taxable returns to $1 million unless the estate tax codes are amended.

Estate Taxes Tip

The solution is to transfer ownership of a life insurance policy to the beneficiary to avoid having to pay

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federal estate taxes. However, be aware that if you die within three years of the transfer, the assets will be included in your estate. You can transfer ownership of a life insurance policy by completing an assignment form, which the insurance company will provide upon request. Before making any changes, it is best to get advice from your attorney and other financial advisers. You might want to discuss the pros and cons of an irrevocable life insurance trust.

Should You Transfer Ownership?

Think twice before you decide to make someone else the owner of your life insurance policy. While there may be tax benefits in transferring ownership, drawbacks do exist. You lose the right to change beneficiaries, and for policies with a cash value, you are no longer entitled to borrow the cash buildup or to use the dividends. You also forfeit the right to cancel the policy or any of the other features provided. If the owner is not the insured and the owner dies, the cash value (if any) will be included in the owner's estate when figuring estate taxes.

Glossary of Helpful Insurance Terms

A life insurance policy is a legally binding contract and, as with any other contract, you need to know what the contract actually says. Here are some commonly used insurance terms and their definitions.

Primary beneficiary(ies): the individual(s) or organization(s) who will receive money (called death benefit, face value, or "proceeds") from the insurance company when the insured person dies.

Contingent beneficiary(ies): the individual(s) or organization(s) who receives the proceeds if the primary beneficiary(ies) dies before the insured dies.

Insured: the person whose life is covered by the policy. When the insured dies, the death benefit is paid.

Owner (policyholder) of life insurance contract (policy): the person who exercises control over the policy. The owner can make any changes without the consent of anyone else, including beneficiaries, unless there are court-imposed constraints in place.

Reviewed by Raymond E. Forgue, Department of Family Studies, University of Kentucky, co-author of *Personal Financ*e, and Joe Botta and Lou Gorr, Virginia Cooperative Extension agents.