Life Insurance Uses in Farm Estate Planning
Michigan State University Extension Service
Ralph E. Hepp, Myron Kelsey, Department of Agricultural Economics
Issued September 1980
6 pages

discontinued

MSU Ag Facts — *Extension Bulletin E-1346, September, 1980, FILE: 17.152*

Life Insurance Uses In Farm Estate Planning

By Ralph Hepp and Myron Kelsey
Department of Agricultural Economics

WHEN A FARMER DIES, there is an immediate need for cash to take care of things like medical and nursing bills, funeral expenses, settling of debts, and payment of taxes and probate fees. If the necessary cash is not available, the farm business the family worked most of their life to build may have to be mortgaged or liquidated, at least in part, to meet these obligations.

By the nature of farming, cash is a scarce commodity. In earlier or middle farming years — the period of growth — a farmer puts all spare cash back into the operation. Certainly the family isn't poor, but their limited liquidity can put the business in jeopardy if the owners should die suddenly.

The word "liquidity" represents a very important concept to sound estate planning. It refers to the amount of readily available cash in an estate or possessions that can easily and quickly be converted to cash.

How can a farmer protect the business and family against this lack of liquidity? One of the major tools used in estate planning to accomplish this goal is life insurance.

By its very nature, life insurance is designed to (1) provide protection for the named beneficiaries, or (2) set up a rigid savings program, or (3) create a combination of both.

Uses of this tool in a farm business are many and varied. Before we go into these, however, let's take a look at different basic kinds of life insurance.

Types of Insurance

TERM INSURANCE is the simplest kind of life insurance contract available providing financial protection. Basically it is temporary insurance.

It insures a person's life for a stated number of years — or term — that the policy is in effect, such as 5, 10, or 15 years. It has no cash or loan value and is payable only if the insured dies within the specified period.

Protection ends when the stated term expires. If the policy is renewable, it can be extended to a new term without the insured individual providing further proof of health through a medical examination. If it is not renewable, the insured, in effect, starts all over with the necessity of proving his insurability.

Term insurance may also be convertible. If this provision is in the policy, a person may exchange the term insurance for permanent insurance within a specified period of time without taking a medical examination.

Term insurance has the lowest premiums of any life insurance policy and is relatively inexpensive, especially when the insured person is young and the term is short. Because of the increased risk to the insurance company, the longer the period of term insurance contracted, the higher the rates will be. Also, with each new term contracted, the rates for a given amount of insurance will go up with the age of the applicant.

There is also a type of term insurance called reducing or declining term. With this, the premium remains the same each year, but the amount of protection reduces. This type is frequently used to protect a debt being paid off in installments.

WHOLE LIFE INSURANCE is a permanent policy that guarantees protection for your entire life. It combines financial protection and investment. Whole life is available in two basic types of policies, depending on how long premiums are paid. These are ordinary life and limited pay life.

With an ordinary life policy, premiums are paid until the insured individual's death. Then the face value of the policy is paid to the stated beneficiaries. Cash surrender and loan values increase during the life of the policy.

Limited pay life is very similar in that the policy is in force during the person's whole life, but premiums are paid for only a limited number of years. Since fewer premiums are paid than on an ordinary life policy, the premiums are larger. By the same token, cash and loan values accumulate at a faster rate.

Policies are generally written for a specific number of years, such as a 20 pay life policy, or to a specific age, such as to age 65.

If only protection is the goal, with some cash value at maturity, whole life insurance may be the answer. This is especially valuable to farmers in their late 40s and 50s seeking insurance protection for their families.

ENDOWMENT POLICIES place more emphasis on savings than do other types of insurance. They are designed to accumulate a certain amount of money over time, meanwhile providing life insurance protection. The policy is written for a specific period and for a certain face value. Twenty-year endowments are common, but 10-year, 30-year, and endowments at a specific age are also written.

If the insured dies before the policy matures, the face value is paid the beneficiary. If the insured is still living when the maturity date arrives, the full face value can be collected or other options taken to receive the policy proceeds. However, the life insurance coverage of the policy ceases as of the date of maturity.

Comparisons

In choosing an insurance policy, both the needs to be filled in the estate plan and your ability to pay must be considered. Usually a compromise is needed between the two. Term insurance policies written for a limited period provide maximum protection at the least cost, but only for the period of coverage. They have no surrender value and offer no protection after the term.

Endowment policies written for a limited time are one of the most expensive types of life insurance. They provide the least protection and the most investment.

However, it must be recognized that labels or names given to types of policies are not the deciding factors in cost. A term policy written to age 100 or an endowment policy written to age 95 will have about the same yearly cost as an ordinary life insurance policy. For a given age level, the yearly premium rate will depend on the term or length of the policy, the number of payments, life expectancy of the insured, and disposition of the face value.

Life insurance should be considered as another tool for accomplishing estate planning goals. Know the problem areas in which life insurance can be of service and then pick the kind and amount of insurance that will best fulfill your aims at a price you, your family, and your business can afford.

But what are some of the problem areas where the cash provided by life insurance would be helpful?

Final Expenses

Few farm families have sufficient savings to pay medical and death expenses if a member of the family should die. Since most farm assets are not easily or quickly converted into cash, some sources of funds should be specifically provided for this purpose. A nominal amount of ordinary life insurance on each member of the family can readily provide available cash for such emergencies.

There are also probate expenses and tax outlays to consider. When an estate becomes large, federal estate taxes can become a major expense at death. A $600,000 net estate transferred to a spouse may require paying about $40,000 in federal estate taxes. Some families purchase ordinary life insurance on the estate owner (s) to cover these taxes. Other estate planning tools could be used to reduce these taxes. Both alternatives or a combination should be considered.

Family Living Costs

The death of the breadwinner can be a serious financial loss to a young family. The annual income needed to provide the basic necessities of life for a family are quite high. The bigger the family, the heavier the burden. This becomes even greater as the children move through their teens.

Young farmers generally don't have the amount of owner equity in the farm business that can be used to support the family in case of death. Income may also be restricted because the young family has put its earnings back into the budding farm business.

Life insurance can be purchased to provide at least some of the lost income if the breadwinner passes away. A 10- or 20-year convertible term insurance policy is an excellent program for a farmer in this situation. The limited dollars available will purchase the maximum amount of protection for the family. Protection, not savings, is the critical need in this situation.

When the children start to become financially independent and owner equity in the business increases, some of this term insurance that was purchased for protection can be dropped or converted into ordinary life insurance.

For people of modest income and little property, the purchase of life insurance may be one of the only ways possible to build an estate for family protection.

Farm Transfer

A farmer works hard to build up the farm business and to make it profitable. If the family desires to pass the business on to the heirs, certain steps will have to be taken to make sure this is possible. As was mentioned earlier, taxes, settlement costs, and death expenses can put a large strain on farm businesses that have little or no cash reserve. There may also be a need for cash to hire help to run the farm until the children get old enough to take over. Or there may be a need for enough cash for the spouse to have some breathing time free from pressures to look over the alternatives available.

It is important that a surviving spouse and children try to remain 'normal' in their usual surroundings for a time after death. Life insurance can provide the funds that will make this time possible. It can also help preserve the assets of the estate by eliminating the necessity to sell under pressure.

Take for example a young or middle-aged farmer who is at that stage of the farming career where all of his money is invested back each year into the farm. The debt load is heavy and the equity is still low. If a $70,000 or $100,000 term life insurance policy is owned, it can help protect the business and transfer it intact to the family if an accident or illness claimed the life.

At another time in the business development, there might be a partner — a father, another relative, someone outside the family, or later, a daughter or son. Without proper estate planning, the death of a partner can put a strain on the operation. This can be avoided by use of insurance as part of a buy and sell agreement between the partners.

Assume there is a $100,000 farm partnership between two partners. The partners make no provisions and one dies. The surviving partner may have to sell the business and give half the proceeds to the heirs. By one's death the survivor may be out of the farm business. On the other hand, the partners can create a buy and sell agreement that calls for each partner to pay the heirs of the deceased partner $50,000 for their half of the business. Then each would take out a $50,000 life insurance policy on the life of the other partner. If one partner dies, the other partner collects $50,000, which in turn is presented to the heirs for their half of the business. They usually are required to sell it as part of the buy and sell agreement. Buy and sell agreements assure that the surviving partner (s) can more easily retain control of the farm business.

A special kind of life insurance arrangement, designed originally for business situations, is called joint life. A joint life plan insures two individuals under one policy. The policy pays off on whichever of the two dies first. The survivor then has the option of continuing the policy without evidence of insurability if he or she is under 65 years old.

The joint life plan is adaptable for partnerships, husband and wife, father and son, mother and daughter, or about any other combination you might consider. The main advantage is the reduction in premiums over what the two individuals would have to pay separately.

Credit Insurance

Major, outstanding loans are often one of the expenses difficult to pay after the death of the farm operator. Loan payments can be covered by a declining term insurance policy or credit life insurance.

It is common practice for many credit agencies to write credit life insurance on the borrower, assuring automatic loan payment in case of death. In some cases it is a required part of the loan. The same protection can be obtained in a term life insurance policy purchased by the borrower. For young farmers, the latter method may be the cheaper alternative.

Retirement

An investment program through an endowment life insurance policy or retirement income policy to mature at age 60 or 65 can provide retirement income. The savings feature of a life insurance policy provides a relatively fixed dollar investment. It does not fluctuate in value like common stocks do during periods of inflation. Most of the farmer's assets — machinery and livestock — are usually considered in the same category as common stock in that they can vary widely in value over time.

Many farmers during their lifetime accumulate a large amount of owner equity in their business and are able to use the returns from this investment for retirement income. In some cases, this income plus social security benefits are adequate for retirement income without purchasing an investment program through life insurance. For others, this is not possible. Only you can make this determination for your family situation.

Savings

Endowment life insurance can be purchased to provide savings for many purposes. Education for the children is a common use. Regular payments required on these policies force the insured into a systematic savings plan.

The major disadvantage is that the returns may be lower than those from other investments, including those in the farm business. This is particularly true for a young farmer who is almost always short on capital for business investments.

Insurance on Wife

Most of the attention on insurance falls on the husband because usually he is the main operator of the farm business. There are several reasons, however, to seriously consider some amount of insurance on the wife.

The wife plays an important part in the farm business and has special tax deductions as an estate beneficiary. If the wife dies first, there may be a marked increase in total taxes paid by her estate and later that of her husband. Insurance on her life may be advisable to compensate for the additional estate taxes that will be incurred on her husband's estate as well as the additional income taxes the husband would have to pay.

Also, if the husband isn't insurable, insurance on the wife's life can help build up a reserve for payment of taxes in the combined estates.

Perhaps as important or more important is the establishment of a fund to help the husband take care of the home and family if his wife should die at a young age, leaving a house and children to be cared for in addition to the family farm. Although the contributions of the wife, which run from tractor driver to nurse to cook and bottlewasher, are often taken for granted, they would be expensive to replace if it was necessary to hire them done.

The Beneficiary

If a life insurance policy is purchased mainly to offset death costs and estate settlement expenses, perhaps a trust should be the beneficiary if you are seeking to avoid probate expenses. Above and beyond the amount needed for these purposes, generally an individual beneficiary should be named.

Because a life insurance policy is a legal contract, the face value of the policy must be paid to the listed beneficiary (ies). This is an advantage because designation of the individual who is to receive the benefits generally is not open to negotiation or court efforts to upset the contract. But it is also a heavy responsibility on the insured to make sure the beneficiary listings on his policies are kept up to date. Otherwise the money will not go to the correct individuals to complete the estate plan.

Cash within the estate is a "must". When this need is met, the farmer can transfer money outside of the estate to someone else by giving control of the policy. Basically, the rule is that to escape federal estate taxes, the deceased insured individual must not have retained any incidents of ownership in the policy. This means mainly that the insured no longer has the power to borrow on the policy or to change beneficiaries. Someone else must own and have complete control over the policy and pay the premiums.

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, it can do this through what are called settlement options. When any settlement option is chosen, the company keeps the stipulated sum and pays it out to the beneficiary of the policy in the manner selected.

The insured can specify exactly how the life insurance proceeds are paid to the family in case of death, or the choice can be left for the family to make later on. When it uses one of these options, a family knows exactly what its income from the policy will be and exactly 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. Older people can take advantage of this provision in their policies by converting their cash values into retirement income.

There are four basic settlement options:

INTEREST OPTION — The company holds the money and pays interest on it. The company pays at a current interest rate which is usually considerably higher than the rate guaranteed in the policy. Arrangements can generally be made to withdraw part of the money if desired. The remaining money can be withdrawn later or left to someone 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 used up.

TIME OPTION — A regular monthly income is paid for the desired period of time. The amount of monthly income is determined by the money and interest available.

LIFETIME INCOME OPTION — This plan is very different from the other options. The amount received depends on (1) how much money you have coming to you, (2) the rate of interest guaranteed by your policy, (3) how old you are, and (4) whether you are a man or a woman.

Managing Your Life Insurance

ONCE AN insurance contract has been purchased and the policy received, it is seldom thought of again. Life insurance is a sizeable investment and a key factor in your overall estate plan, and there are certain steps that should be taken to make sure it fulfills the purpose for which you purchased it.

THE POLICY itself is your copy of the contract with the insurance company. It is not possible to collect on the contract without a policy.

When the policy arrives, read it over to make sure it lives up to the understanding you had with the insurance agent. If you have any questions, contact the agent or company at that time. Chances are you will be having the policy for a long time so you might as well make sure you have what you want at the beginning. Most agents and companies will respond quickly to your request for information.

Keep the policy with your important papers. Make sure the beneficiaries know where it is kept. One disadvantage about keeping it in a safety deposit box is that the box is sealed at your death and there may be a delay before it is opened as part of the probate proceedings.

If the policy is lost or destroyed, contact your insurance company. They will require that you fill out a lost policy affidavit. They keep careful records to make sure that the beneficiaries don't try to collect twice at your death. Replacing a policy is usually a fairly simple matter.

BENEFICIARIES — The main purpose of having an insurance policy is to transfer a settlement to the person or persons of your choice. You make the choice by designating the beneficiary or beneficiaries of the policy. However, times, situations, and family conditions change. It is important that you in turn periodically review your beneficiary listings and change them when necessary. This is a fairly simple task. Contact your insurance company. Usually they will send you a change of beneficiary form to fill out. When it is received by the company, it is attached to your policy and the change is completed.

In addition to naming the beneficiary of the policy, you also have the right to select the manner in which the proceeds of the policy will be paid to the beneficiary.

You can select any of the four options, or you can leave the selection of payment option up to your beneficiaries. In many cases this is the wiser move because the beneficiary will be in a better position to evaluate his or her financial condition and needs at the time of settlement.

Presenting a Claim

When a death occurs, the beneficiary can start settlement proceedings. The company will send a claimant's statement which must be returned with proof of death, usually a copy of the death certificate. The claimant's statement includes, among other things, an outline of how the proceeds are to be handled — which of the settlement options should be used and how. With most claims, it is just a question of normal processing. This will generally only take two to three weeks. However, if problems develop, it can take longer.

An insurance contract is an important investment and a key factor in your total estate plan. As such, it should be properly cared for and "managed" to produce the desired benefits.

Part of Plan

The type of insurance, beneficiaries, payment options, settlement options, ownership of the policy — all of these factors and related decisions turn on the goals and needs of your specific estate plan.

Many companies have agents with experience to discuss your needs as they relate to your estate plan. Some of these companies, in fact, have individuals who specialize in relating insurance to estate plans and who will counsel with you free of charge about the various options available to you. It will be well worth your while to arrange a meeting with one of these knowledgeable individuals as you are in the process of developing your estate plan.

Only by examining your position with the help of experts will you be able to obtain the protection your family needs or reach your savings goals to the best degree that your financial position will allow.

Some of the factors that should be included in your evaluation are: annual income needs of your family, number of years income is needed, amount of owned equity, availability of family assistance, earning ability of the spouse, income available to make premium payments, and social security benefits.

Many insurance agents recommend that the amount of insurance should be five times annual earnings. This may be excessive insurance for some families and not enough for others.

It is a general rule that the earlier in their lives a young farm couple creates an estate plan, the more effective it will be in helping them to reach their goals. This is especially true with insurance. The younger the person taking out the policy, the greater the financial advantage in terms of lower premium payments. As farm couples grow older, the insurance alternatives they can afford become more and more limited.

This publication has been updated from information originally prepared by the authors for use in **Michigan Farmer** magazine.

MICHIGAN STATE UNIVERSITY
CES
COOPERATIVE
EXTENSION
SERVICE

Cooperative Extension Service Programs are open to all without regard to race, color, or national origin. Issued in furtherance of cooperative extension work in agriculture and home economics, acts of May 8, and June 30, 1914, in cooperation with the U.S. Department of Agriculture. Gordon E. Guyer, Director, Cooperative Extension Service, Michigan State University, East Lansing, Michigan 48824. Price 20 cents. Single copy free to Michigan residents. 2P—5M—9:80—MP