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Estate Planning and Life Insurance

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Estate Planning for Everyone

Life insurance – both term and permanent – can play a critical role in fulfilling one's estate planning objectives. It is all too often thought that life insurance serves the objectives of only affluent individuals who face potential estate tax liability. Although this is important, there are many uses for life insurance that should be considered as part of everyone's estate plan regardless of net worth.

Providing Peace of Mind

In the absence of proper planning, outstanding financial obligations and expenses associated with the death of a loved one can create significant financial hardship for surviving family members. These financial obligations may include any outstanding debt (such as a home mortgage or auto loans), medical and/or long-term care expenses, and any income tax owed by the decedent's estate. Expenses associated with death include funeral and burial costs, estate administration fees, and costs of probate. These costs vary from State to State and can range anywhere between 5 and 10% of the value of the decedent's estate. To provide peace of mind, life insurance should be considered an integral component of every estate plan. Not only is the life insurance death benefit available at the time it is needed most, it is also received generally income tax-free.

Making Asset Division Easier

Life insurance is a great vehicle to achieve estate equalization. Estate equalization comes up when the estate has some illiquid assets and when the individual has more than one beneficiary. Dividing cash among multiple beneficiaries is easy math and easy to execute. But in most cases, an estate has assets that are difficult if not impossible to divide. For example, a business or a piece of real estate takes time to liquidate. When the market is not seller-friendly, the beneficiaries may be forced to accept a purchase price much less than the fair market value upon the individual's death. With life insurance as part of this equation, if one beneficiary is happy to keep the illiquid asset, the rest of the beneficiaries can be fairly treated with the death benefit payouts. In short, life insurance provides a flexible option to the individual and the next generation regarding how to pass on the wealth in a way that meets the family's goals and objectives.

Leaving a Legacy

The phrase "leaving a legacy" means different things to different people.

For some, leaving a legacy involves ensuring financial security for surviving family members and other loved ones after their death. The death benefit of life insurance can contribute to this financial security in a number of ways, including 1) replacing the income the decedent earned before death; 2) preserving cherished family assets which may otherwise need to be sold to generate liquidity to meet financial obligations; and 3) providing the family a liquid source of funds for whatever needs and desires may arise, such as supplemental income for the surviving spouse and higher educational expenses for children and grandchildren.

For others, leaving a legacy involves charitable giving. Life insurance is well-suited for charitable giving as it offers flexibility based on the individual's objectives. For instance, the individual may own the life insurance policy and name a charity as beneficiary. This allows the individual the ability to change the beneficiary should life circumstances change. Alternatively, the individual may consider gifting a life insurance policy (as well as annual gifts of cash for premium payments) to the charity. In addition to the gratification and fulfillment that accompanies giving to one's favorite charity, the individual may qualify for income and/or estate tax charitable deductions.

To help achieve the goal of leaving a legacy, those who own an individual retirement account ("IRA") may consider leveraging the IRA as the source of funds to acquire life insurance. Informally referred to as a Legacy IRA, this strategy creates an opportunity for one who may not have access to other liquid resources to provide valuable life insurance benefits to families and charities.

Satisfying Unique Needs of Small Business Owners

Small business owners are faced with numerous priorities and constant decisions on their journey from establishing – to growing – to maturing – to leaving their businesses. Life insurance can play a key role in many of these phases. Related to estate planning, however, is the business succession phase. Small business owners often depend upon the proceeds from the future sale of their business as their retirement income. This makes a properly drafted buy-sell agreement of utmost importance. While there are several ways to fund a future buy-out obligation under a buy-sell agreement, life insurance is an ideal funding source because it provides access to funds when the buy-out event occurs. Whether the buy-out occurs during the business owner's lifetime or upon death, permanent and/or term life insurance provides access to funds for the buy-out potentially in an income tax-efficient manner.

Many small businesses are family owned and operated. However, not all of the family members may be involved in the business. In these situations, business owners are faced with the challenge of how to plan for those not involved in the business upon their retirement or death. As mentioned above, in a strategy called estate equalization, business owners can use life insurance as the means by which to equalize the inheritances among those children involved in the business and those not involved. While those involved in the business will receive the business interests, life insurance can provide an equal benefit to those not involved in the business. Moreover, this strategy may allow the business owner to avoid any potential discord among family. When discussing estate planning with business owners, determining whether estate equalization is an important objective should not be overlooked.

Addressing Special Situations

In addition to the numerous aforementioned focused uses of life insurance in estate planning, there are many broader situations where life insurance can play an equally important role. Examples of these special situations include planning for 1) a minor child; 2) a beneficiary with special needs; 3) a foreign national; or 4) general spendthrift concerns. Life insurance can provide an effective means by which to provide for the financial security of the individuals in these situations without jeopardizing or thwarting any overall financial strategies, goals, and objectives.

Estate Planning for High-Net-Worth Individuals

In addition to the aforementioned uses of life insurance in estate planning for everyone, life insurance plays an important role in estate tax planning for high-net-worth individuals. Depending on the value of one's estate upon death, the estate may be subject to both Federal and State estate taxes. Life insurance can be an ideal source of liquidity for the estate to cover these taxes. However, to satisfy this objective the affluent individual is typically not the owner of a life insurance policy insuring their own life. This would result in the death benefit being part of the estate for estate tax purposes thereby increasing the overall estate tax liability.

There are numerous life insurance ownership strategies that avoid this outcome. One of the most commonly used strategies involves the affluent individual establishing an irrevocable life insurance trust ("ILIT") to be the owner and beneficiary of the policy. Upon the insured's death, the life insurance death benefit paid to the ILIT may be used to provide the estate with liquidity through the trustee either 1) lending money to the insured's estate; or 2) purchasing assets from the insured's estate. With proper drafting and execution, such transactions between the ILIT and the insured's estate should not cause the death benefit to be added to the insured's estate for the purposes of calculating the estate tax.

Of Significance

The 2017 Tax Cuts and Jobs Act doubled the gift and estate tax exemption amount starting in 2018, which has been adjusted for inflation in the subsequent years. This higher exemption amount is set to sunset on December 31, 2025. On January 1, 2026, the exemption amount will revert to the pre-2018 amount of $5 million base per person ($10 million base for married filing jointly), as adjusted for inflation.

In light of this upcoming significant reduction, the time for planning is now. It is time to use the higher exemption amount before you lose it through making larger outright gifts or via more advanced estate planning strategies, many of which involve the use of life insurance in an irrevocable trust. As with the ILIT, the goal of these strategies is for the life insurance death benefit to serve as a source of liquidity for the insured's estate taxes without the death benefit itself being included in the insured's estate. This may be accomplished with proper planning and proper trust drafting.

Conclusion

During the development and implementation of an estate plan, it is important to consider the role life insurance can play in its effective execution. Life insurance is a flexible solution that may allow one's estate plan to be more comprehensive and complete, thereby ensuring the right assets, go to the right people, at the right time, and in the right way.