Life Insurance and Estate Planning

It should go without saying that every client should have an estate plan. For the smaller estates, major considerations can be addressed by simply drafting a will to help with the disbursement of assets. Larger estates have additional considerations due to the potential asset depletion that arises from estate taxes. In 2009, an individual had an estate tax exemption of $3.5 million, and a married couple, with proper planning, could have a combined exemption of $7 million. Any individual or married couple with larger estates would be subject to estate taxes that could be as high as 55%. Large and small estates will often include life insurance in their estate planning as a way to not only provide liquidity to their estate and equalize inheritances — but also to diversify their portfolio.

Life Insurance as a Protection Asset

Life insurance has the unique characteristic that it grows tax deferred, and upon the death of the insured is tax free.[1] While many factors affect the internal rate of return of a life policy (such as gender, age, risk class, etc.), it is reasonable to expect that many life insurance policies at life expectancy will provide returns between 6–8%.[2] This rate is both the gross and net rate, as there would be no capital gains or ordinary income tax due. Depending on the client's tax bracket, the rate of return on other assets would have to be between 10–12% to equal the rate of return on the life insurance. Thus life insurance provides an attractive yield and a good means of diversification among other assets.

One could argue that the rate of return of a life insurance policy is unpredictable; after all, it is determined at the death of the insured. But risks are inherent with all asset classes, whether they are stock, real estate, gold, etc. With life insurance, if one lives too long the internal rate of return decreases, but on the contrary if one dies prematurely the internal rate of return (IRR) is higher. There is no way to predict actual return, but the return on life insurance is likely to be equivalent to, if not higher than, the return on other assets.

Life Insurance and Liquidity

In smaller estates, life insurance can provide the means for income replacement, to help beneficiaries fund retirement and college loans, and provide the liquidity to pay down debt. For the most part, large estates use life insurance to either provide liquidity for estate taxes or to make the estate whole for the depletion due to the estate taxes (remember depletion can be as high as 55%).

In large estates, life insurance is typically purchased in an Irrevocable Life Insurance Trust (ILIT). This is done to avoid increasing an already taxable estate and compounding the estate tax problem. As long as the trust is drafted properly, the life insurance proceeds and other trust assets will be excluded from the client's estate.[3] At the death of the insured, the proceeds will flow income tax free, in addition to estate tax free to the ILIT. At the death of the client, all the assets in his or her estate are valued, and the executor with the help of counsel will figure the estate tax liability. It is a misconception that the estate tax liability is then directly paid from the ILIT. Doing this would bring the entire value of the ILIT into the estate. Instead the ILIT would purchase assets from the estate, infusing cash into the estate and placing these assets into the ILIT. (Note that if the estate has cash to pay the taxes, no sale is needed; the trust has money that makes up for the depletion of estate taxes.)

An important fact to note is that the estate must be settled and thus estate taxes are due nine months after the client has passed away. If the client did not have the ILIT, the estate would be forced to use assets to satisfy the bill. Bearing in mind recent market conditions, selling assets during a downward spiral is not always favorable. Other times the executor may have a hard time selling assets in that time period, as is the case with commercial property or partnership interest or other non liquid assets. Life insurance provides that liquidity to prevent such undesirable events.

Estate Equalization

Another benefit of purchasing life insurance is that one can equalize the estate among the beneficiaries. Frequently, when a client's estate is made up primarily of a business, there may be only one beneficiary who wants to take over the business. Thus insurance can be purchased to offset the entire business going to the one beneficiary and the remainder beneficiary can then inherit the life insurance as a means to equalize the estate. This becomes valuable as the business is typically not liquid and thus separating the business for equalization purposes may not be feasible. It is a win-win situation for all: one beneficiary inherits the business and the other inherits his or her share through life insurance proceeds. Not only does this apply to business cases but also for those cases in which one child inherits a home and personal property.

It's important to remember that life insurance is a valuable tool for both large and small estates. The value life insurance provides is immeasurable with its attractive yield, liquidity in a time of need, and its role in helping make estates whole and fair as it pertains to the beneficiaries.

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1. Life insurance death benefit proceeds are generally excludable from the beneficiary's gross income for income tax purposes. There are few exceptions such as when a life insurance policy has been transferred for valuable consideration.
2. The IRR on death benefit is equivalent to an interest rate at which an amount equal to the illustrated premiums could have been invested outside the policy to arrive at the net death benefit of the policy.
3. Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping transfer tax). Failure to do so could result in adverse tax treatment of trust proceeds.

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