The Role of Life Insurance in Estate Equalization

One of the many daunting issues confronting individuals in the estate planning process is determining how and to whom assets will be distributed upon their death.

Many have the desire for their estate to be divided equally amongst their immediate family members. However, often overlooked are the challenges one may encounter with this objective particularly when a significant portion of the estate is comprised of illiquid assets such as a family residence, real estate, or a closely-held family business. Leaving these assets to a single heir may not only result in an inequitable division of the estate, but also strife and feelings of resentment among family members. Leaving these types of assets to multiple heirs can create administrative problems and practical challenges with which the heirs will be forced to deal at a very vulnerable time.

Estates comprised of illiquid assets are better equipped to handle these dilemmas when a relatively equal portion of the estate is comprised of liquid or easy to liquidate assets. These liquid assets serve as the method by which the estate can provide equally for the family members who will not inherit the illiquid assets.

However, it may be uncommon for estates to be comprised equally of both liquid and illiquid assets. In these situations, equalizing the distribution of the estate among family requires additional planning. An ideal way to implement an estate equalization strategy is to incorporate permanent life insurance.

Here's How

The illustrations on the following page demonstrate how the addition of life insurance increases the liquidity of one's estate, thereby fulfilling the objective of estate equalization.

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The client, with input and guidance from their legal and tax advisors, determines which heirs will inherit illiquid assets – such as real estate or closely-held business interests – and calculates the fair market value of those assets.

Real Estate
Valued at $3 million

Business Interests
Valued at $3 million

The client purchases life insurance on their own life and names the heirs who do not inherit the illiquid assets (real estate or closely-held business interests) as beneficiaries. If estate taxes are a concern, an irrevocable life insurance trust may be used to own the life insurance policy to avoid estate inclusion of the death benefit. The individuals who do not inherit the illiquid assets would be named as beneficiaries of this trust.

Life Insurance Policy
$3 million Death Benefit

Upon the client's death, the illiquid assets transfer in the manner prescribed by the client in their estate planning documents and the life insurance death benefit is used to provide for the heirs that do not receive any of the illiquid assets. If structured correctly, the death benefit will be large enough to provide an equitable division of the estate among all of the heirs.

Heir 1 receives Real Estate ($3 million)

Heir 2 receives Business Interests ($3 million)

Heir 3 (beneficiary) receives Life Insurance Death Proceeds ($3 million)

Other Advantages

- The death benefit is generally received income tax free[1] and may provide better overall returns than traditional savings vehicles.
- Permanent life insurance provides a cash value that accrues on an income tax-deferred basis and may provide tax free loans and withdrawals[2] to cover expenses associated with the administration of the estate and other assets owned by the client such as real estate or a family business.
- Income derived from other assets such as real estate or a family business can be used as a funding source for the life insurance premiums.

1 The death benefit proceeds from a life insurance policy are generally excludable from the beneficiaries gross income for tax purposes with a few exceptions. Please consult with your own tax, legal and accounting advisors before engaging in any transaction.

2 Loans and withdrawals will reduce the death benefit, cash surrender value and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Policies classified as a modified endowment contract may be subject to tax when a loan or withdrawal is made. A loan or withdrawal from a policy that is a modified endowment contract may also be subject to a 10% penalty if taken prior to the owner attaining age 59.5 unless another exception applies.