Optimize Your Estate Plan by Incorporating Life Insurance

Upon the death of an individual, estate taxes are generally due within nine months of death. Purchasing life insurance in an irrevocable life insurance trust ("ILIT") is one of the most common and least complicated estate planning strategies to create liquidity to pay estate taxes, or to replace wealth lost to estate taxes. This also helps to avoid a "fire sale" of illiquid assets to raise the necessary cash to pay the taxes. Implemented and managed correctly, the life insurance proceeds are collected by the ILIT, which can then buy illiquid assets from the estate (thereby converting illiquidity to cash) or lend money to the estate, to pay the taxes. The decedent's heirs are typically also the beneficiaries of the ILIT, so the decedent's wishes to distribute their assets and wealth to their heirs are met.

While an ILIT is the most common use of life insurance in estate planning, there are many other uses which can help to enhance the estate plan and ensure that your intentions and objectives are met for you, your family, and other heirs. We'll briefly summarize a few.

When there are assets that are hard to split among multiple beneficiaries, life insurance can act as an estate equalizer. For example, if one child is active in the family business, but the others are not involved, it makes little sense to leave the business to all children equally. The business, however, is often the most valuable asset, so leaving the business to the one active child may seem unfair because remaining assets may not have the same monetary value. Naming the other children as the beneficiaries of life insurance proceeds can be used to equalize their inheritance.

The effectiveness and success of certain estate planning strategies, such as a grantor retained annuity trust ("GRAT"), or qualified personal residence trust ("QPRT"), depends upon the individual outliving the term of the trust. For example, in a GRAT, the individual gifts assets into the GRAT in return for an income stream from the GRAT for a certain period. At the end of the term, the asset is no longer included in the estate, reducing the size of the taxable estate. Of course, there may be gift tax consequences. The success of the strategy, however, requires the individual to outlive the term of the trust. Similarly, in a QPRT, an individual gifts a primary or secondary home into a trust in return for the right to continue living in the home for a certain period. At the end of the term, the home is no longer included in the estate, reducing the size of the taxable estate. There may also be gift tax consequences for the gift, but the premature death of the individual, prior to the end of the term, negates the benefits of the strategy. In those situations, life insurance, particularly if held in an ILIT, is the perfect hedge to protect against a premature death because the insurance proceeds can help satisfy whatever estate taxes are due from the unsuccessful strategy.

Another common estate planning strategy is the sale of assets to a trust, commonly known as an Intentionally Defective Grantor Trust ("IDGT"). No, there is nothing wrong with the trust, it is just the name given to the trust to take advantage of certain quirks in the tax law. Properly implemented, the strategy allows an asset to be sold to the trust with no income tax consequences. This has the effect of removing the asset, as well as all future growth of the asset, out of the taxable estate and replacing it with a promissory note that presumably is worth less than the future value of that asset. Obviously, a high growth asset is desirable, such as a successful business. This asset may also generate income that can be used to purchase life insurance to enhance the strategy and create additional wealth for the beneficiaries of the IDGT, typically the grantor's family and heirs. The IDGT, in effect, also acts as an ILIT and is a force multiplier.

There are also several charitable strategies used at death to help minimize estate and income taxes. Gifts to charities would typically include estate and/or income tax deductions. But charitable gifts result in assets that would have gone to heirs being redirected to charity. Those assets can no longer be counted as part of an heir's inheritance. Life insurance can be used to replace the wealth given away to charity to make the heir's inheritance whole.

Life insurance can also be used to create a family legacy for future generations. For example, life insurance can be used to fund a trust that is designed to benefit children, grandchildren, and generations beyond. This trust is commonly known as a "Dynasty Trust," and life insurance can be an effective way to leverage gift tax and generation skipping transfer tax exemptions. This result assumes that the ultimate life insurance death benefit is significantly higher than the aggregate premiums gifted into the Dynasty Trust. Designed correctly, the Dynasty Trust can last for hundreds of years, if not in perpetuity, for the benefit of future generations.

Lastly, life insurance is often used to fund a Special Needs Trust ("SNT"). Children or other dependents that have various injuries, disabilities or illnesses may need special care, particularly after parents or other caregivers are gone. Government programs may provide assistance for the basic necessities of life, but an SNT is designed to supplement that to provide for additional care, comfort, educational opportunities, specialized treatments, and more, not covered by those government programs. Life insurance proceeds can provide a source of funds when caregivers are gone, to provide those benefits, while still qualifying for government assistance.

As you can tell, life insurance is an ideal tool to optimize an estate plan. It can provide money at the right time to pay taxes, replace wealth, and to enhance and perpetuate a family legacy. It can also make various estate planning strategies more efficient.

For More Information Contact:

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