



M Financial Group™

January 2018

# M Intelligence

Enhancing understanding of sophisticated planning strategies and their applications.

## Inheritance Equalization

Conventional estate planning approaches to providing liquidity tend to consider only specific estate transfer costs—the federal estate tax, state death taxes, and various administration and legal expenses. However, clients often have legacy-related objectives in addition to these mandatory tax obligations. Chief among these is achieving their desired degree of inheritance-equalizing among all intended heirs. This goal can be especially challenging in the context of unique properties that may be earmarked for, or manageable only by, certain family members.

### Background

The **ownership** and **management** of family businesses or income-producing real estate need to be in alignment. This may be a straightforward matter to arrange during lifetime, but the death of the property owner can present severe problems in situations where these two factors are present:

- The unique assets are to be preserved, in kind, and managed effectively into the next generation; and
- Their value comprises the majority of the senior generation's estate.

Leaving the business or real estate, or farm or ranch, to the children actively involved in daily management is a smart **business** decision, but may not feel heart-right if the subject property equals 75% or more of the overall estate, as is often the case with an entrepreneur or closely-held business owner with a single focus.

### Estate Planning Consequences

The choice seems clear, though hard:

1. Split up the business and let all the children—active and inactive—own it equally, to the venture's distress, and even possible dissolution; or
2. Leave the business to only the active children who are capable of managing it, and the rest, the non-business estate, to the inactives, effectively disinheriting them.

### A Third Option: Life Insurance

The use of life insurance, judiciously positioned to avoid estate taxation, can instantly create at death a significant non-business estate, providing a meaningful inheritance for the children excluded from the business, farm, ranch, or real estate portfolio.

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## *Inheritance Equalization*

The above-described inheritance planning challenge is one confronted even by estates that are protected from **federal** estate taxation by falling within the combined husband-wife \$22.4 million exemption. Entrepreneurs and business owners are typically unable to build a separate liquid estate during lifetime, due to the constant need for ploughing capital back into the business. For them, life insurance fills the gap, for pennies on the dollar each year.

### Client Planning Situations

When addressing these inheritance-equalizing needs of large-percentage-of-estate business owners, and employing life insurance as the liquidity-creation tool, two broad arrangement patterns can be used:

- The business (or other unique asset) passes directly by bequest to the actives, with adequate life insurance set aside in trust to create a replenishment fund for the inactives; or
- The active children own the life insurance on the parent(s)' life, funding a purchase of the business from the estate at death, with those buyout proceeds creating an estate liquidity pool for distribution to the non-business inactives.

### Business Case Example

Brad Gordon is the owner of a large local independent lumber and hardware store valued at \$15 million, apart from the business real estate, and \$5 million of other assets. Due to husband-wife estate planning with their attorney, there will be no federal estate tax on the Gordons' combined \$20 million estate. Brad's daughter Sheryl, an MBA who has worked since her teenage years in their company, is currently CFO and ready to take over leadership at her father's retirement or death. Brad's two sons are schoolteachers who have no interest in the business.

### Brad's Objectives

To provide full business control for Sheryl, while generating adequate survivor-income for his wife, and meaningful non-business inheritances for his sons (not necessarily dollar-equal to Sheryl).

### Solution

Sheryl applies as the owner-beneficiary of a \$15 million life insurance policy on her father's life, enabling her to purchase the business outright at death.<sup>1</sup> The business real estate can pass to Brad's wife subject to a formal lease agreement back to the business, providing her rental income, and the business buyout proceeds can be shared equally among the sons, either immediately at death or deferred until their mother's death, in order to hold additional income-generating funds in trust for her.<sup>2</sup>

1. Premiums necessary for Sheryl to fund the life insurance on her father can be furnished either through a bonus, salary increase, or split dollar arrangement, depending on which program offers optimal tax & economic results.

2. An additional benefit of deferring the non-business children's inheritance in trust until mother's death is that liquidity is available to pay federal estate taxes in her estate, either due to asset growth or occurrence after 2025 when the exemption is substantially reduced.



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### Real Estate Case Example

Carl Sherman is a widowed real estate developer-manager with \$10 million of assets. He has a son and daughter active in the management of their properties and searching for additional opportunities. Carl's other son is a dentist in another state with no interest in the family venture.

#### Carl's Objectives

To pass the properties and real estate management company to the active children intact, giving them full control, while at the same time providing a meaningful but lesser value to his inactive son, considering the significant value his active children have already contributed to the business.

#### Solution

Carl establishes an irrevocable trust to hold \$6 million life insurance on his life. This amount will provide \$2.5 million for his dentist son's inheritance, \$1.5 million for state estate taxes and administration expenses, plus a \$2 million buffer to hedge against potential real estate growth that could push his estate into the federal estate tax range or—if death occurs after 2025—when the exemption drops and part of Carl's estate will inherently be exposed to federal taxation.

### Additional Life Insurance Planning Note

The inheritance-equalizing role of life insurance described in this brief is of course in addition to any estate tax cost estimates or other planning goals a client establishes. Collectively, these may include:

- Charitable bequests or other cash legacies outside the immediate family group.
- State estate or inheritance tax, which can reach as high as 16% in some jurisdictions.
- Federal estate tax to the extent the total estate exceeds \$11.2 million, or \$22.4 million in the case of a married couple. *[Note that for estates of decedents dying after 2025, the exemption threshold reverts to \$5 million per person + post-2011 inflation-indexing.]*
- A pool of additional income-producing capital for a surviving spouse to remain in his or her own world (in the case of a non-business spouse).

These should all be accounted for in addition to the appropriate inheritance-equalizing amount of coverage.



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### Summary

Most of these estate planning objectives are either severely compromised or even unachievable by an entrepreneur or business owner whose firm's growth and personal lifestyle needs consume most or all of the income generated. Adequate surplus is often unavailable to build a significant estate outside the family business. Through life insurance, purchased with discounted dollars during lifetime, a substantial non-business estate can be instantly created at death, funding and empowering an estate plan that provides meaningful inheritances to the family that are distinct from the business and its intended next generation manager-owners.

*This material is intended for informational purposes only and should not be construed as legal or tax advice and is not intended to replace the advice of a qualified attorney, tax advisor or plan provider.*

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