The Wait and See Advantage of Using Private Financing for funding Life Insurance Premiums

Well-advised affluent people are preparing for possible tax law changes that could have serious impacts on their ability to transfer businesses and other assets to their loved ones. Several significant federal tax proposals were introduced in early 2021 that could have a very significant effect on their estate plans. And, while no one can predict precisely which of the proposed may become law, the potential impacts are significant. To avoid the rush for access to talented professionals once the changes become effective, why not consider an approach that offers a “wait and see” option?

Typical Situation

The Tax Cuts and Jobs Act of 2017 temporarily increased the lifetime gift and estate exemption. The Act provides a window of opportunity to gift large amounts of money through the end of 2025 to children and grandchildren. But, as expected, many people are hesitant to give up control of their assets and gift them to future generations.

The following is a strategy that allows families to implement a strategy today that gives them the flexibility to “wait and see” when and if, they will “complete” the gift.

Family Profile

- Male, age 55, three daughters from a first marriage
- $25M total net worth - $8M in business interests, $4M in personal property, $13M in liquid assets.

Family Objectives

- Ensure that each daughter will receive $5M inheritance
- Pass remainder to current spouse or charity
- Preserve flexibility as the $11.7M federal estate tax exemption amount available in 2021 is only temporary (set to revert to $5M, indexed for inflation in 2026). Be in a position to capture this higher exemption but not be required to do so if the laws don’t change in unfavorable ways.

PLAN. INVEST. SUCCEED.®

Designing and Creating a Plan

Typically, individuals are reluctant to make large gifts today even if they have liquid assets that are generating income that are not needed for current living expenses. A creative solution is to create an Irrevocable Life Insurance Trust (ILIT) with daughters as the beneficiaries. In this example, the family could use private financing to fund $15M of life insurance owned by the ILIT. Nine annual premium payments of approximately $371k should provide enough premiums to carry the policy for his lifetime.

Mechanics

- Individual loans his ILIT approximately $5.7M under a 9-year note arrangement that is fixed at the current mid-term Applicable Federal Rate (1.0% in August 2021).
- His asset manager agrees that the loaned assets could be invested that targets a gross return of 8% annually.
- The ILIT's income from loaned assets would be used to make annual loan interest payments back to the individual ($57k) and pay the premium on the life insurance policy (approximately $371k)
- ILIT is structured as an intentionally defective grantor trust. The individual pays all the trust's income taxes. This allows the trust assets to grow more quickly because assets do not need to be extracted from the trust to pay taxes, and essentially the same taxes would have been paid by the individual if the ILIT had not been created in the first place.
- Before the increased exemptions sunset, the individual has the option to forgive the loan (i.e., make the gift) or be repaid according to the loan terms.

Why this makes sense

Flexibility and control are the key to this arrangement. The individual has a choice as to when to use his increased exemption – if he even decides to make a gift or not.

1. If individual decides to gift

   At any point between now and 2025 (expected sunset year), the individual can forgive the indebtedness of his ILIT, thus making a gift. At some point between now and 2025, the individual may realize he no longer needs the loaned assets or income generated by the assets and may be willing to take advantage of the opportunity to use the increased exemption amount to make a gift. This will increase the amount held in the trust for the benefit of his daughters and freeze the growth on the assets outside his taxable estate.

   As an example, in year 4 the individual decides to forgive the loan, the trust would retain the loaned assets ($5.7M) and hold the life insurance policy on his life ($15M), making the trust value over $20M at his passing.

2. If individual decides not to gift

   The 9-year loan design has a "built-in exit strategy" so that if the individual decides he does not want to make a gift at all, the ILIT will repay him the value of the note in year 10. The $15M life insurance policy will remain in the trust for his daughters (assuming the premiums paid carry it), and the assets used to repay the loan will be returned to his taxable estate.

Action steps

Current, temporary, tax laws offer a time-limited opportunity to execute significant wealth transfer planning. But qualified candidates contemplating this may be hesitant to start the process. Fear may exist of losing control over their assets should they need to access them in the future and or the tax environment changes. Designing a flexible plan with a "wait and see" component, like private finance in this situation, may be the key to initiate planning today.

BLBB Risk Services, led by Director Bob Flood, collaborates with our financial planning department by evaluating client liquidity needs and risks with possible insurance solutions. A properly designed and funded Insurance contract may act as a tool for creating liquidity to pay estate taxes and smooth the transfer of assets and businesses to the next generation. Contact Bob, or your BLBB financial advisor, at 215-643-9100 to discuss if an Irrevocable Life Insurance Trust (ILIT) is right for you.

Tax and legal counsel should be consulted for the drafting of these documents.

BLB&B Advisors, LLC, a registered investment adviser, does not sell insurance or annuity products and does not receive any commissions or other financial benefits from the sale of these products. Bob Flood, a Director of Risk Services of BLB&B Advisors, LLC is the principal and owner of LC Advisor, LLC. LC Advisor, LLC is an insurance brokerage firm that helps clients evaluate insurance needs including the various types of insurance available and amounts of coverage. A wide range of fee-based and commission-based product options are considered. The primary goal is delivering and servicing the best possible solution for the client. BLB&B Advisors, LLC and LC Advisor, LLC are not affiliated and BLB&B Advisors, LLC receives no financial benefits from the sale of any products sold through LC Advisor, LLC.