LIFE ADVANCED MARKETS

Flexible estate planning strategies

Private financing

Generally speaking, in the United States, we have the right to determine who is to receive the fruits of our labor after we pass away.

This right should not be taken for granted. However, taking advantage of it requires planning – especially when a family's estate includes substantial wealth, business interests, or other complex assets.

A well-designed estate plan strategy may help families minimize taxes that are triggered upon death; protect family wealth from creditors; avoid family strife; and protect beneficiaries from mismanaging their inheritance.

While there are a number of strategies for accomplishing such goals, many require irrevocable decisions be made with the limited ability to make modifications should circumstances change (e.g., changes in tax laws, changes in family dynamics, and changes in financial goals/needs).

Families and their tax advisor or attorney should take into consideration strategies for building a level of flexibility into their plans.

One such strategy is a private financing life insurance arrangement.

Life insurance may be a vital part of a client's overall estate plan strategy – providing funds to help pay estate taxes, funds for family members to acquire the family business, or simply providing a flexible asset (death benefit)[1] that is easily allocated among beneficiaries.

A common practice is to have the policy owned by an irrevocable life insurance trust (ILIT) in order to avoid estate taxes and control the distribution of death proceeds. Gifts are then made to the ILIT which uses the funds to pay premiums. One of the primary disadvantages of such a design is that the gifts are irrevocable. Should circumstances change for the client, they will not have access to policy cash values held within the ILIT.

A private financing arrangement is one way to address this issue. It functions like this:

Basic design:

- Life insurance policy is owned by a third party (typically a family member or ILIT).
- Instead of making gifts, the insured loans money to the owner of the policy to pay premiums.
- The loan is documented by a promissory note.
- Interest is charged at the appropriate applicable federal rate.

Advantages:

- Premium payments made are not gifts for gift tax purposes (as long as there is a legitimate intention to repay the loan).
- Promissory note terms are more flexible than commercial loans, and the lender may charge a lower interest rate than a commercial lender.
- The lender retains the flexibility to forgive the loan (turning the loan into a gift), or seek repayment should they need the cash flow at a later time.

[1] The death benefit is generally income-tax-free when passed on to beneficiaries.

Design considerations

- On cases involving higher premium payments, it may be advantageous to have a portion of the amount contributed treated as gifts to reduce the amount of the loan. Each individual may gift $15,000 (2020 annual gift tax exclusion) per beneficiary without being subject to the federal gift tax or using up their applicable exclusion amount.
- The appropriate applicable federal rate (interest charged) will depend on the term of the loan. If the loan is to be repaid in less than 3 years, the interest charged would be based on the short-term applicable federal rate. If the loan is to be repaid between 3 years and 9 years, the mid-term applicable federal rate would apply, and if the term of the loan is longer than 9 years, the long-term applicable federal rate would apply.
- If annual loans are made each year as premiums come due, the interest rate charged will fluctuate from year to year. An alternative would be to make one single loan and lock in the interest rate. The lump-sum loan may be contributed to a Premium Deposit Fund rider[1] available with Alllianz Life Pro+® Fixed Index Universal Life (FIUL) Insurance Policy to avoid creating a modified endowment contract.
- The client may allow the interest to accrue or they may require the policy owner to pay interest annually. Allowing interest to accrue will relieve the policy owner from the cash flow burden of paying annual interest, but it will result in a higher loan balance over time.
- It is very important that the loan be treated as a loan by the IRS and not a gift. When considering the characterization of the transfer of funds, the IRS will look at all the facts and circumstances involved.
- It is important to develop a repayment strategy. When and how will the loan be paid off? The loan may be paid off during the life of the insured, all in one lump sum, or in installments over a period of years. If policy cash values will be used to repay the loan, the policy should be properly funded and monitored.[2] The loan could also be repaid at the death of the insured. In this case the loan repayment would be paid to the insured's estate. There are also a number of ways the insured may contribute their own funds to the ILIT to repay themselves, all without incurring gift taxes or using up the insured's gift/estate tax exemption. Two of the more common strategies utilize the remainder values from a Grantor Retained Annuity Trust (GRAT) or a Charitable Lead Annuity Trust (CLAT) to provide sufficient funding to pay back the loan.

The following are a number of the factors the IRS may consider:

- ✓ Whether there was a promissory note or other evidence of indebtedness
- ✓ Whether interest was charged
- ✓ Whether there was any security or collateral
- ✓ Whether there was a fixed maturity date
- ✓ Whether a demand for repayment was made
- ✓ The ability of the transferee to repay
- ✓ Whether any records maintained by the transferor and/or the transferee reflected the transaction as a loan; and
- ✓ Whether the manner in which the transaction was reported for federal tax purposes is consistent with a loan.

TO LEARN MORE ABOUT private financing or FIUL solutions, call the Life Case Design Team at 800.950.7372.

[1] This feature is available at no additional cost, but is not available in all states. A Premium Discount Rate will be applied as premium is transferred into the life insurance policy.

[2] Policy loans and withdrawals will reduce the available cash value and death benefit and may cause the policy to lapse, or affect guarantees against lapse. Withdrawals in excess of premiums paid will be subject to ordinary income tax. Additional premium payments may be required to keep the policy in force. In the event of a lapse, outstanding policy loans in excess of unrecovered cost basis will be subject to ordinary income tax. If a policy is a modified endowment contract (MEC), policy loans and withdrawals will be taxable as ordinary income to the extent there are earnings in the policy. If any of these features are exercised prior to age 59½ on a MEC, a 10% federal additional tax may be imposed. Tax laws are subject to change and you should consult a tax professional.

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