

M INTELLIGENCE

PRIVATE LOAN TO TRUST

This private financing technique enables wealthy families to use arbitrage and pay for life insurance premiums on a tax-advantaged basis.

Private loans to trust can provide an effective way to shift wealth into trust while minimizing the need for large reportable gifts. Currently, low interest rates make this estate freezing strategy less costly to the client, and when combined with professional investment management, offers the opportunity for positive arbitrage.

OVERVIEW

Private financing is a useful option for high-net-worth (HNW) clients who wish to purchase a large amount of life insurance in trust and minimize reportable gifts. Private financing may also be an effective strategy for clients who recognize the need to shift assets into a trust but are concerned about losing long-term control over the gifted assets. By loaning funds to a trust, the client can anticipate receiving the funds back at a future date (assuming they survive the note term). While in the trust, the loan principal can be invested in income producing assets. The income generated can be used to service the loan interest, with any excess reinvested and/or used to pay life insurance premium(s).

Hypothetical example: Mr. Smith loans \$1 million to his irrevocable life insurance trust (ILIT) taxed as a grantor trust in exchange for a nine-year note at the mid-term applicable federal rate (AFR). The trustee reinvests the loaned proceeds in assets producing 5% income

annually. For simplicity's sake, assume the AFR in place at the time is 1%. The trustee would earn \$50,000/year from investments and use \$10,000/year to pay the loan interest to Mr. Smith. The remaining \$40,000 is retained in the trust and may be reinvested or used to pay premium on a life insurance policy insuring Mr. Smith's life. Typically, at the end of the nine-year loan term, the trustee repays the loan principal to the grantor. All other assets in excess of the loan principal (e.g., reinvested income, asset appreciation, and/or a life insurance policy) are retained in trust. There is no need to report a gift.

HOW CAN PRIVATE LOANS SUPPORT AN ESTATE PLAN?

The following guidelines can help determine whether a private loan to a trust is appropriate for a client.

- The grantor's estate is currently taxable or can be predicted to be taxable at life expectancy.
- The insured(s) must have a demonstrable life insurance need.
- The grantor is reluctant to make large gifts to trust due to concerns over loss of control.
- The grantor has exhausted or wants to preserve the lifetime estate and gift tax exemption.

- There is sufficient liquid net worth to support the grantor's lifestyle during the note term.
- If the trust is a grantor trust for income tax purposes, the grantor must be willing to support the ongoing tax payments.

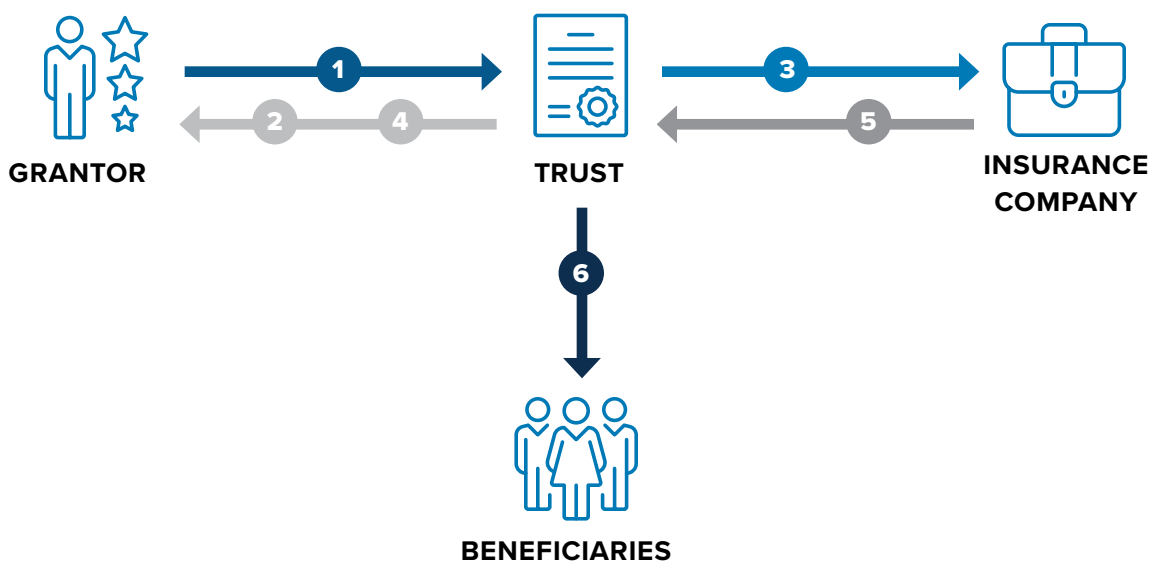
HOW DOES IT WORK?

The trustee finances the life insurance premium through positive arbitrage. The private-loan-to-trust technique differs from private loan-based, split-dollar based on how the life insurance is funded and the loan is collateralized. In private split-dollar, the loans to trust are used to pay premium and the policy is pledged as collateral for the premium loans. With private loan to trust, the loaned funds (typically, made as a lump sum

loan) are reinvested in income producing assets, and the loan is either unsecured, or secured by collateral other than the life insurance policy or cash values.¹ The income generated by the loan principal is used to pay loan interest back to the grantor/lender, with any excess reinvested and/or set aside to pay the life insurance premium(s). If the trust is a non-grantor trust for income tax purposes, the trustee will need to make interest payments to the grantor and pay taxes on investment income.

WHAT ARE THE BENEFITS OF PRIVATE LOANS TO TRUST?

Private loans made to a trust to help finance life insurance can provide advantages to certain clients.



1. The grantor establishes a trust and lends funds in exchange for a promissory note; the trustee invests funds in income producing assets.
2. The trustee pays interest to grantor/lender on an annual basis at the interest rate stated in the promissory note.
3. The difference between the income produced and the interest owed to the grantor/lender is used to pay the life insurance premium on a policy insuring the life of the grantor and/or spouse.
4. At the end of the note term, the trustee repays the loan principal; all other assets remain in trust.
5. When the insured(s) pass away, the policy matures and a death benefit is paid to the trust, income tax free.
6. The trustee manages trust assets per the trust's terms, for the benefit of the trust beneficiaries.

¹ Any loan that is secured by a life insurance policy cash value, death benefit, or both cash value and death benefit is considered a split-dollar loan whose terms must comply with IRC 7872.

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- **Gift tax efficiency:** The lump sum amount transferred to trust is a bona fide loan and therefore is not subject to gift tax reporting. If the income produced is sufficient to service the interest, no further gifts may be required.
- **Low AFR rates:** Fixed duration loans can be used to “lock-in” historically low AFR rates, reducing the cost of the transaction.
- **Investment control:** Borrowed funds can be invested in a variety of income-producing vehicles such as fixed income, real estate, or securities portfolios, allowing the wealth manager to retain assets under management.
- **Potential Estate freeze:** Private loans to trust can be an effective means of “freezing” the value of the loaned assets for estate, gift, and generation skipping transfer (GST) tax purposes. The value of the promissory note is retained by the lender. When the trust repays the loan with cash or other assets, all subsequent asset appreciation and income in excess of the loan interest remains in trust, free of transfer tax liability.
- **Tax-Free Death Benefits:** If the trustee purchases a life insurance policy, the proceeds from the life insurance policy will be received both income- and transfer tax-free.
- **Flexibility:** Loans may be renegotiated between the parties at a later date to take advantage of changing interest rates or evolving planning needs.

Lender flexibility: In addition to a grantor loan to trust, other lenders can include existing businesses, family LLPs/LLCs, other trusts, or family members. Depending on the parties’ relationship, the lender may face income tax consequences.

CONSIDERATIONS

As with any financed transaction, the client and their advisors should carefully consider what effect private loans will have on their broader financial and/or estate plan.

- The client/lender must be sufficiently liquid to make the loan, and financially secure enough to function without access to the principal for the term of the loan.
- While interest rates are currently low, the trust’s investments may still fail to produce sufficient income. If in any given year, the trust investments don’t generate enough income to service loan interest, subsequent gifts to trust may be needed, or the loan repaid.
- The trust should typically be structured as an intentionally defective grantor trust (IDGT) for maximum income tax efficiency within the trust.² Assuming the grantor is lending funds to their own IDGT, the loan is considered a tax neutral event and loan interest will not be taxable to the grantor. If the lender is another person, trust, or business, interest on the loan will generally be taxable to the lender.
- To avoid classification as a gift, any loan to trust must be a bona fide loan made at arm’s length, and not a transfer of equity. The client must take care to respect and observe the formalities of the loan.³ Ignoring the formalities of the loan may cause the IRS to disregard the transaction entirely and treat it as a disguised gift.
- Promissory notes are generally made for a fixed term, with the interest rate charged being equal to the AFR rate for the term.⁴ Demand notes may be used as well. While promissory notes may provide the grantor with additional flexibility (the right to demand repayment of principal at any time), if the trust owns life insurance on the grantor’s life, the promissory note should be drafted to avoid giving the insured any incidents of ownership in the life insurance policy under IRC sec 2042, or risk inclusion of the life insurance proceeds in the insured’s estate. **Alternatively, the trustee could purchase life insurance on the life of someone other than the grantor/lender (e.g., the spouse).**

² IDGTs are irrevocable trusts. While assets held in IDGTs generally remain outside of the estate of the grantor for transfer tax purposes, the grantor retains “ownership” of the trust for income tax purposes with all items of income being taxed to the grantor at his/her personal income tax rate, and not at the trust level. Grantor trusts are commonly created by including one or more of the powers described in IRC Sec. 671-679.

³ Some of the factors the IRS may consider in evaluating whether the transaction is a bona fide loan and not a gift include: a written promissory note including a repayment schedule and maturity date; an appropriate interest rate; interest paid on time and not forgiven; a realistic expectation of principal repayment (and the principal is actually repaid), and appropriate collateral or guarantees provided.

⁴ AFR rates for any given month may be found at <https://apps.irs.gov/app/picklist/list/federalRates.html>

The grantor of a grantor trust, or the trustee of a non-grantor trust, are responsible for recognizing income-tax liability on trust income. Note that a permanent life insurance policy accumulates cash value on a tax-deferred basis. Distributions from the

life insurance policy can be managed on a tax-free basis through withdrawals of basis and policy loans, assuming the policy is not a modified endowment contract (MEC) and remains in force at the death of the insured.

TAX IMPLICATIONS

LENDER	GRANTOR OR GRANTOR TRUST	NON-GRANTOR TRUST	FAMILY LLP/LLC
Income tax on interest payments:	For a grantor trust, there will be no income tax consequences to the grantor.	The trust will pay income tax on loan interest at the trust's tax rate, unless interest is distributed to beneficiaries (in which case, the beneficiaries will pay income tax on the distribution at their individual tax rate).	The owners will share the income tax liability on loan interest in proportion to their ownership interest in the LLP/LLC.
Estate tax:	If an individual is the lender, the note will be includable in their estate.	Loan principal will not be subject to estate tax, assuming the trust is not includable in the grantor's estate.	Loan principal is an asset of the business, and part of each owner's estate in proportion to their ownership of the LLP/LLC.

BEST PRACTICES

- The loan must be made with a clear expectation of repayment.
- Carefully consider the loan structure. Short-term notes may provide the client with additional flexibility, while long-term notes have the advantage of locking in current interest rates. As discussed, demand notes can be used to provide the client with the right to unilaterally call the loan but should be carefully managed to avoid implication of IRC Sec. 2042. Demand loans are variable in nature (they use the blended AFR rate) and expose the transaction to the risk of rising interest rates.
- While notes can be renegotiated at any time, the transaction should be performed "at arm's length." For example, if interest rates drop and the client wishes to refinance prior to the end of the note term, the client may be advised to furnish additional consideration as part of the transaction.
- If the trust's investments underperform, it could affect the ability of the trust to service loan interest and over time, make it more difficult to repay loan principal. The client may wish to "pre-fund" the trust through annual exclusion gifts. The amount that the grantor(s) can gift on an annual basis is equal to the number of donors multiplied by the number of trust beneficiaries (donees).⁵
 - Example: if the trust has seven trust beneficiaries and the annual exclusion limit is \$17,000, a single grantor may gift \$119,000 to the trust annually without requiring the filing of a gift tax return.
- The loan term will often match the number of premium payments on the policy (assuming a life insurance policy is involved). While it is not a requirement, some clients prefer the simplicity of having the entire transaction terminated at the same time.

⁵ In order to qualify for the annual exclusion, gifts must be "of a present interest." To qualify as a present interest, the trustee must issue "Crummey letters" to each beneficiary, notifying them of their right of access to the gifted funds. The mechanics of Crummey letter compliance are outside the scope of this piece.

- Although it is not required, it is often considered a best practice to “seed” the trust with a gift prior to executing the loan. This helps to provide additional economic substance to the transaction. It also provides the trustee with the funds needed to pay the first-year premium on a life insurance policy (before trust income has had time to accrue). A rule of thumb is the seed gift should represent 10% of the value of assets loaned to trust.

CASE STUDY

Consider the case of a young family with a growing estate, currently valued at \$50 million. The client understands the importance of funding an Irrevocable Life Insurance Trust (ILIT) but is concerned with potential changes in their personal/professional fortunes and changes in federal tax law. Fortunately, the family is highly liquid due to the sale of a business and does not need full access to the assets to support its lifestyle. Their advisors are proposing private loans to trust as a means of funding trust-owned life insurance on the husband’s life with the arbitrage. While a gift is involved (though not necessarily required), it is significantly smaller than would otherwise be needed to fund a trust-owned policy of this size.

Policy assumptions:

- Male, age 45, super-preferred
- Variable Universal Life policy; 7% gross rate of return
- Initial face amount: \$40,372,541
- 50% term blend
- Nine-pay; \$500,000/year
- Insured’s life expectancy: age 94

Loan and trust assumptions:

- Grantor/insured makes a seed gift to their trust of \$1 million in year 1, prior to issuance of the loan
- Nine-year note with balloon payment of principal at end of note term
 - Loan is repaid at the end of the note term
- Mid-term AFR; assumes 1% interest rate in effect at issuance of the loan
- Trustee invests in assets producing 6% annually
- Trust is a grantor trust for income tax purposes
- Grantor/insured is taxed at a combined state and federal blended rate of 34%

LOAN TO TRUST

YEAR	AGE	GIFT	LOAN	BoY INT. DUE (1%)	BoY INC. TAX (34%)	BoY TRUST BALANCE (NOT INCL. INSURANCE)	BoY TRUST WITHDRAWALS	GROWTH @ 6%	EOY TRUST BALANCE (NOT INCL. INSURANCE)
1	46	\$1,000,000	\$10,000,000	0	0	\$11,000,000	-\$500,000	\$630,000	\$11,130,000
10	55	—	Repaid	\$100,000	\$220,257	\$11,44,739	-\$100,000	\$80,684	\$1,425,424
20	65	—	0		\$46,347	\$2,408,224	0	\$144,493	\$2,552,717
30	75	—	0		\$83,000	\$4,312,762	0	\$258,766	\$4,571,527
40	85	—	0		\$148,641	\$7,723,499	0	\$463,410	\$8,186,909
49	94	—	0		\$251,126	\$13,048,690	0	\$782,921	\$13,831,611
55	100	—	0		\$356,227	\$18,509,816	0	\$1,110,589	\$19,620,405

LIFE INSURANCE POLICY

YEAR	AGE	PREMIUM	CASH SURRENDER VALUE	DEATH BENEFIT
1	46	\$500,000	\$0	\$40,372,541
10	55	0	\$3,798,041	\$40,372,541
20	65	0	\$7,006,467	\$40,372,541
30	75	0	\$11,863,238	\$40,372,541
40	85	0	\$19,722,779	\$40,372,541
49	94	0	\$28,573,865	\$40,372,541
55	100	0	\$33,108,171	\$40,372,541

Results at life expectancy (age 94):

- Trust assets: \$13,831,611
- Life insurance death benefit: \$40,372,541
- Total available to heirs: \$54,204,152

A VALUABLE PLANNING TOOL

Private loans to trust not only efficiently move wealth to a trust but can also fund life insurance policies and shift asset appreciation (over loan principal) out of the estate. For HNW clients with suitable liquidity, private loans to trust may prove an attractive option for life insurance funding.

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