# Uses of the "BILIT™" – Business Irrevocable Life Insurance Trust and Solving Inequities in Business Continuation Agreements

Business Continuation Agreements are often partially funded or totally funded with life insurance. Most, if not all, of the life insurance proceeds are includable in the estates of the business owners. The basics of estate planning often dictate the removal of life insurance policies from the ownership of the insured either to outright ownership by younger generations or preferably to an Irrevocable Life Insurance Trust. *Query – Why don't practitioners do the same for business owners?* The premise of this article will be to introduce you to the BILIT™ and to encourage usage for the benefit of your clients. The BILIT™ solution encompasses much of the knowledgebase you currently possess, together with a few twists and drafting details, which will be discussed later in this article.

A sample case will be used to economically illustrate the BILIT™ in contrast with a traditional cross purchase business continuity agreement. As many practitioners prefer to use cross purchase due to the advantage of the step-up in basis to the surviving owners, the example will focus on that method. The step-up in basis becomes increasingly important in the unlikely event of estate tax repeal.

Additionally, this article will address the seldom-discussed economic inequities inherent in most Business Continuation Agreements and potential solutions to these economic inequities. These inequities as well as the potential solutions also apply to the BILIT™.

**What is a BILIT™?**

A BILIT™ is simply a basic Irrevocable Life Insurance Trust used for business continuity purposes. The name BILIT™ (pronounced "bill it") is used to contrast it with an ILIT (Irrevocable Life Insurance Trust), which is used for personal, rather than business continuity purposes. The life insurance product can be funded by the business through either a Split-Dollar premium financing concept or a Section 162 bonus to the employee. Each business owner's BILIT™ will own the life insurance policies on the <u>other</u> business owners' lives.

Every dollar of net life insurance proceeds and the business interests they purchase will avoid inclusion in the estates of the current business owners. The potential additional cost would be the gift of economic benefit to the BILIT™. With appropriate use of generation skipping provisions, some or all of the proceeds and the business interests they purchase can avoid estate inclusion for generations. The BILIT™ also makes it easier to keep the ownership and control of a business with a family for generations. The BILIT™ combined with creativity and flexibility makes it one of the best tools available for sophisticated practitioners.

**A Traditional Example –Chart 1**

Wewillsurvive, Inc. is a corporation worth $15 million with three equal owners named Peter, Paul, and Susan. For simplicity of discussion, we will assume the profits of Wewillsurvive, Inc. are drained annually and the company's value remains constant at $15 million. We will also assume that Peter, Paul, and Susan have substantial other assets so their business interest (or the cash purchasing it) will be taxed at 55% for estate purposes. (It is recognized that the estate tax might be deferred due to the use of the marital deduction.) Their corporate attorney, Ida Smith, Esq., has explained the step-up in basis advantage of a Cross-Purchase Buy-Sell Agreement versus an Entity Buy-Sell Agreement. The owners have decided to fully fund their Buy-Sell Agreement after discussions with their insurance agent, Lowell Trustworth, CLU. The current Buy-Sell Business Continuation Agreement provides for the purchase of the remaining life insurance policies on the survivors' lives from their respective estates.

As per *Chart 1*, Peter purchases a $2.5 million life insurance policy on Paul and a $2.5 million policy on Susan. Paul purchases a $2.5 million life insurance policy on Peter and a $2.5 million policy on Susan. Susan purchases a $2.5 million life insurance policy on Peter and a $2.5 million policy on Paul. The policies can be financed through either a Split-Dollar or a Section 162 Bonus arrangement. Lowell Trustworth recommended with Ida Smith's concurrence the Split-Dollar financing method. We will also assume the net proceeds are always equal to the initial amount insured after repayment to Wewillsurvive, Inc.

In our example it is assumed that Peter dies first, followed by Paul and then Susan. When Peter dies Paul and Susan receive $2.5 million each and each purchases half of Peter's $5 million business interest in Wewillsurvive, Inc. The estate for Peter now has $5 million in cash but the next generation will only inherit $2.25 million after estate taxes. Paul buys from the estate per the Buy-Sell Agreement the life insurance policy on Susan's life for $2.5 million and Susan buys the insurance policy on Paul's life.

Lowell Trustworth, recognizing the increase in the value of Paul's and Susan's ownership from $5 million to $7.5 million each now sells a new life insurance policy of $2.5million each to Paul on Susan's life and vice versa. At this point in time, Paul and Susan each own $7.5 million on each other's life. This $7.5 million is comprised of the original policy, the one purchased from Peter's estate, and the new one sold by Lowell Trustworth.

Paul now dies and his estate receives $7.5 million from Susan for the 50% interest in Wewillsurvive, Inc. The estate for Paul now has $7.5 million in cash but the next generation will only inherit $3.375 million after estate taxes. Susan purchases the three $2.5 million insurance policies on her life from Paul's estate.

Susan now owns 100% of the company worth $15 million and $7.5 million of life insurance on her life. If she died the next day, the next generation will inherit $10.125

million after estate taxes. (It is understood that the $7.5 million of life insurance could be transferred to an Irrevocable Life Insurance Trust and Susan may well survive the three-year “contemplation of death” period.)

**The Net Economic Result**

As we look at the economic results of this very traditional arrangement, we find them to be most unsatisfactory. We have been able to pass only $15.75 million through the three shareholders’ estates to the next generation. We had the original business, worth $15 million, plus $20 million of life insurance (the original $15 million insurance purchase plus the additional $5 million insurance purchase after Peter’s death.) $35 million of assets all subject to estate taxes. Every dollar of life insurance purchased was taxable in one of the owner’s estates! Is this efficient? Of course not!

Most advisers, for clients with sufficient assets, will recommend the transfer of life insurance from the estate of the owner to the next generation or to an Irrevocable Life Insurance Trust. This is a popular and well-accepted technique. Yet, when a business continuation agreement is involved many advisers’ heads seem to be buried in the sand.

**The BILIT™ Solves the Insurance Inefficiency - Chart 2**

The BILIT™ will allow every dollar of life insurance purchased in our example to be left outside the estates of Peter, Paul, and Susan. All three owners will have their own BILIT™. As a BILIT™ is simply an Irrevocable Life Insurance Trust with some minor adjustments, this article will not go into depth regarding the construction and provisions of an Irrevocable Life Insurance Trust.

The Grantor of the BILIT™ will generally be the owner of the business interest. In our example, Peter, Paul, and Susan will each be the Grantor of their own BILIT™. The BILIT™ will generally be defective for income tax purposes. The trustee(s) of the BILIT™ are generally the other business owners or the spouse or children of the business owner. Sometimes a corporate trustee is used for a period of time. There are exceptions where the client’s advisers may prefer to have other grantors and or trustees. The creativity and legal interpretations of the client’s advisers will determine the appropriate selections. It is beyond the scope of this article to cover every possible combination but the information, which follows in this article, will create an appropriate recommendation for the client’s advisers. Split-Dollar premium financing is preferable to a Section 162 Bonus as the gift to the BILIT™ is smaller.

Using the same assumptions as in the Traditional Example, Peter’s BILIT™ will initially own a $2.5 million life insurance policy on Paul and a $2.5 million policy on Susan. Paul’s BILIT™ will initially own a $2.5 million life insurance policy on Peter and a $2.5 million policy on Susan. Susan’s BILIT™ will initially own a $2.5 million life insurance policy on Peter and a $2.5 million policy on Paul.

When Peter dies Paul's BILIT™ and Susan's BILIT™ receive $2.5 million each and each BILIT™ purchases half of Peter's $5 million interest in Wewillsurvive, Inc. The BILIT™s now own the part of Wewillsurvive, Inc. previously owned by Peter. Thus, neither Paul's or Susan's estates have increased in value through the business redemption. The estate for Peter now has $5 million in cash but the next generation will only inherit $2.25 million after estate taxes. Paul's BILIT™ buys from Peter's BILIT™ per the Buy-Sell Agreement the $2.5 million life insurance policy on Susan's life and Susan's BILIT™ does the same with the policy on Paul's life.

Lowell Trustworth, recognizing the increase in the business value of Paul and Susan's respective BILIT™s sells a new life insurance policy of $2.5million each to Paul's BILIT™ on Susan's life and Susan's BILIT™ on Paul's life. At this point in time, Paul and Susan's BILIT™s each own $7.5 million on each other's life. This $7.5 million is comprised of the $2.5 original policy, the $2.5 million policy purchased from Peter's estate, and the new $2.5 million policy sold by Lowell Trustworth. Thus, each BILIT™ owns $7.5 million of life insurance plus the $2.5 business interest purchased from Peter's estate.

Paul now dies and his estate receives $5 million from Susan's BILIT™ for its original interest in Wewillsurvive, Inc and Paul's BILIT™ receives $2.5 million from Susan's BILIT™. The estate for Paul now has $5 million in cash and the extra $2.5 million in cash resides in Paul's BILIT™. The next generation will inherit $4.75 million after estate taxes. Susan's BILIT™ purchases the three $2.5 million insurance policies on her life from Paul's BILIT™.

Susan and her BILIT™ now own 100% of the company worth $15 million and $7.5 million of life insurance on her life. She owns her original business interest and her BILIT™ owns a $10 million business interest plus $7.5 million of life insurance on Susan's life. If she died the next day, the next generation will inherit $19.75 million after estate taxes

**The Huge BILIT™ Advantage**

If you review *Chart 3*, you will see the differences in the Traditional Example versus a BILIT™ business continuation agreement. Every dollar of life insurance purchased escapes inclusion in the estates of the three business owners! The only asset included in the business owners' estates is the original ownership interest in Wewillsurvive, Inc.

The $15 million of life insurance originally purchased and the $5 million of life insurance subsequently purchased at the first death totals $20 million. If a 55% estate tax is applied to the $20 million, there is an estate tax of $11 million. $11 million is the exact dollar advantage of using the BILIT™. The BILIT™, in the unlikely event of estate tax repeal, is still a valuable tool. The step-up in basis is an advantage. Assets placed in a BILIT™, potentially for generations, provide asset protection as well as estate tax avoidance if the proposed law reverses direction in the future.

**The Devil Is In The Details**

In the BILIT™ Example, the life insurance policies were transferred freely from one BILIT™ to another BILIT™. Advisers should be concerned about the "transfer for value" issue. You want the life insurance proceeds to be income tax-free at death. One method of avoiding the "transfer for value issue" is to make a transfer between partners.

Creative planning allows this exception to take place. Many businesses set up partnerships to lease equipment. Some owners of businesses create investment partnerships with their fellow owners. If the partnership included Peter, Paul, Susan, and each of their BILIT™s, policies could be freely transferred among the partners. If you were conservative you could also include Wewillsurvive, Inc., as a partner. Thus, all of the entities involved would be partners.

If the arrangement for the insurance funding utilized the split dollar concept, you would use a traditional split dollar arrangement. This should not be equity split dollar, which might be welcome relief to the advisers with the current uncertainty created by Notice 2001-10. At a death, when policies are transferred from one BILIT™ to another BILIT™, the purchase price would be the unused portion of the economic benefit for that particular year. The life insurance policy design should have a death benefit in excess of the cash value and be equivalent to the value of the specific business interest. A traditional arrangement for split dollar need not be used. I leave the funding flexibility design to your individual creativity.

The funding arrangement might use a Section 162 Bonus arrangement unless the gift to the BILIT™ is too large. At death, the purchase price of the insurance policies would be their interpolated terminal reserve.

Control is very important to business owners. The owners may have a concern when a business interest is transferred to a BILIT™. The Buy Sell Agreement could make the stock or partnership interest when transferred into the BILIT™ non-voting or limited. The other owners could be trustees of the BILIT™ until death of the individual's BILIT™ triggers successor trustee(s). Independent trustees could be used. The business might be split with voting and non-voting stock if a corporation or split with general and limited interests in a partnership. The non-voting or limited interests could be purchased by the BILIT™s with the voting or general interests purchased by the owners.

As you have seen the BILIT™ can improve traditional business continuity planning. Your own thoughtful process can create many combinations and permutations of the BILIT™ concept as presented in this article.

**Solving Economic Inequities in Business Continuation Agreements**

Though the BILIT™ vastly improves the efficiency of using life insurance as the funding vehicle for Business Continuation Agreements, it does not solve the basic economic inequities inherent to most such agreements.

In both *Chart 1* and *Chart 2* those who survive always do better economically than those who die. In our example, we assumed the business did not grow or decline in value. If there is business growth, both *Chart 1* and *Chart 2* underplay the already huge inequity. A decline of the business will not be addressed.

In the Traditional Example of *Chart 1*, Peter's heirs receive $2.25 million while Susan's heirs receive $10.125 million. In the BILIT™ displayed in *Chart 2* Peter's heirs receive $2.25 million and Susan's heirs receive $19.75 million. Would you rather be heirs of Peter or Susan? The monetary differences between what Peter, Paul, or Susan's families ultimately receive are enormous.

If Peter, Paul, and Susan were all relatively close in life expectancy at the inception of the business continuation agreement, do any of them have assurance as to the order of their deaths? While they are currently healthy and insurable, might they vote for a more equitable solution? Do you as their adviser have an obligation to inform them of their options during the planning or review process? Risk is not the best element when planning for one's family, so why not devise more equitable solutions? The balance of this article will address a number of economic inequities with potential solutions. Again, creativity and the needs of your client will help solve these inequities.

**The Common Disaster Provision**

Does your Business Continuation Agreement contain a Common Disaster Provision? In talks given to Estate Planning Councils and other professional groups over the last fifteen years, I have only had two attorneys state they have included a Common Disaster Provision in such an agreement. Life insurance professionals are most familiar with the term, common disaster provision, as it is often used in the beneficiary designation forms used by life insurance carriers. The beneficiary concept is simple. If the primary beneficiary dies within a stated period, usually 30 to 180 days after the insured, the death proceeds will pass to the contingent beneficiary instead. This concept, though applied differently, may be applied to solve an economic inequity within a Business Continuation Agreement.

Let's assume BILIT™s are in place. Peter and Paul go out to a restaurant for lunch one day and Susan stays and supervises the business. They promise to bring her back a salad. On the way to lunch they are involved in a terrible automobile accident. Peter dies immediately, almost at the stroke of noon, but Paul is rushed to the hospital and after receiving the best medical care possible dies at 1 A.M.

Peter's heirs receive $5 million before taxes and Paul's heirs receive $7.5 million. Peter died on day one but Paul died on day two. Does a thirteen-hour difference in time of death justify a 50% increase? Of course not! If Peter and Paul had married sisters, how well would their family relationship endure if Paul's wife received 50% more than Peter's wife? Even a competent insurance adviser like Lowell Trustworth could not have a carrier issue $2.5 million of additional coverage while Paul was in intensive care. Most Business Continuation Agreements provide a redemption over a specific time frame at a defined interest rate for the balance of the business value not fully insured.

A Common Disaster Provision might have provided for the appropriate buy out amount on each life to be divided equally if another death occurred within the stated time frame. Thus, Peter and Paul's heirs would have each received $6.25 million. The $6.25 million would have consisted of $5 million of cash and a $1.25 million note. Certainly, a common disaster provision provides a more equitable solution.

**Non-Transferred Life Insurance Policies**

Most Business Continuation Agreements provide, as in our examples for the transfer of policies for the interpolated terminal reserve value after the death of a business owner. The agreement does not need to provide for such transfer. Paul's estate or Paul's BILIT™ could have kept the policies on the lives of Peter and Susan if the agreement were properly drafted. Eventually $10 million would have been received before estate tax for the benefit of Paul's heirs. If the policies were funded on a split dollar basis, the split dollar agreement could have provided for continuing premium payments after Peter's death by Wewillsurvive, Inc. If Section 162 Bonus was used for funding, Peter's death might have occurred after all the policies had become self-supporting. Under the Traditional Example these policies could be passed to the credit shelter trust and might even be generation skipping. Under the BILIT™ Example, they would already be out of the surviving spouse's estate.

**The Insurance Industry's Product and Rider Solutions**

New products and riders provide flexibility for creative alternatives and solutions. Second to die policies, first to die policies, guaranteed purchase options, and beneficiary purchase options are some of the tools that may be used. The combinations and permutations of all of these products and riders along with single life insurance provide all the flexibility needed to achieve the majority of goals of the business owners. It is beyond the scope of this article to cover all the possibilities or to fully educate you about these flexible tools. Rather, a few examples should suffice to encourage greater education and knowledge about these underutilized tools, which can create closer economic equality. The professional advisers working as a team can offer solutions within the economic framework of the client while maintaining fairness, equity and harmony to the greatest possible extent for the survivors.

Peter, Paul, and Susan might have purchased a first to die life insurance policy for $2.5 million. This policy would pay at the first death of the three of them. Peter's family might have received $7.5 million instead of $5 million as a more equitable solution, which comes closer to the benefit Paul's family would receive.

Second to die policies could also be combined with non-transferred policies to assure adequate funding for Paul and Susan without additional insurance being purchased after Peter's death.

The surviving business owners may not always enjoy the best of health in the years following their original insurance purchase. They may be rated or even uninsurable for life insurance purposes. Beneficiary purchase options allow significant additional life insurance to be acquired on the lives of the beneficiaries of the life insurance policy where the primary insured has died without providing any evidence of insurability. Some of these riders allow acquisition of the new life insurance policy on a current age basis while others allow purchase on an original age basis. If all those insured had been age 40 originally and Peter died 10 years later at age 50, policies could be issued at Paul and Susan's ages 50 or even 40!

**Conclusion**

Ideas can be powerful. Creative uses of existing life insurance policies and riders can be powerful. When you allow open and honest communication with other advisors, your clients are advantaged, you gain expertise, and you might even have fun.