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Life Insurance's Role in Family Office Strategic Planning

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Family offices serve as an intergenerational hub for family legacy, comprehensive and effective wealth management, as well as estate and business transition. Life insurance can play an important role in the strategic planning for successful families, although feelings towards such insurance, in many cases, is best described as a love/hate relationship. Almost two thirds of high-net-worth individuals and families have expressed a distrust of the insurance industry, while, in direct contrast, three quarters of them acknowledge that life insurance plays a role in their strategic planning¹. This whitepaper will explore the value of life insurance as part of a robust estate and/or business plan and its role within the big picture perspective of family office legacy planning.

Despite the insistence of some overzealous agents, life insurance is not the panacea for all financial ills. It does, however, provide a solution for specific risks facing successful families; and when utilized and structured correctly, can help instill a sense of tranquility during turbulent times. Both simple and complex solutions can be tailored for the family office, but it is important to elevate the discussion beyond simply product towards risk exposures, risk management, and only then, optimal product solutions.

The purpose of this paper is to highlight some of the planning issues facing family offices where life insurance may be a viable solution; as well as sophisticated techniques utilized by family offices to structure coverage. As noted, the discussion of product selection is secondary to identifying the problem and developing strategies required to resolve specific issues.

Liquidity Needs

Liquidity at key moments for the family, the business, and the family office is essential, and if life policies are correctly owned and executed, they become immensely valuable in mitigating the dangers around illiquidity.

- **Survivorship-** Whether the family office is embedded in a business or operating as a stand-alone entity, the majority of assets are often invested in illiquid holdings. It would seem counter-intuitive that these wealthy families would need insurance coverage for survivorship, yet, in many cases, the patriarch's or matriarch's passing can cause a significant disruption as family members grieve and their family office begins the arduous probate process. Many families find that maintaining a policy on key family members can bring a sense of calm to an otherwise tumultuous period. The dollar amount of coverage can be nominal when compared to their overall wealth, but the liquidity provided can allow family members and the family office to take a deep breath and make optimal decisions. To avoid inclusion inside of one's estate, the policy should be trust-owned, and a spousal trust, children's trust, or other legacy trust are all viable options for ownership.
- **Estate Taxes-** The most prevalent usage of life insurance by high-net-worth families and their family offices is to provide liquidity for their heirs to pay projected estate taxes. It is only one of several legacy planning issues but the one with the most immediate financial implications. A 40% tax on assets inside of one's estate can cause a significant liquidity crisis, particularly since the tax is due within nine months of the date of death and due in cash. Illiquid assets can create a challenge when the need for liquidation is relatively immediate and trust-owned life insurance becomes a

¹ Swiss Life Global Solutions - "Risk and the Family Office: How Life Insurance Can Help" (May 18, 2022)

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valuable risk management tool in these instances. One of the many responsibilities of a family office is to coordinate a comprehensive effort to effectively shift as many assets as possible outside of the family's estate. This is done to minimize the effects of estate taxes as well as for asset protection purposes. The reality, however, is that it is difficult to eliminate all estate tax liability, but implementing an effective estate plan can reduce and better define the projected amount of tax due. Life insurance can then be utilized to provide the needed liquidity to avoid a forced sale of assets.

Estate Planning

Outside of the need for estate liquidity, there are other legacy planning issues where life insurance can be a viable solution. For example, family offices often find themselves struggling to find answers to succession and inheritance planning that allow heirs to live self-determined lives while maintaining family harmony. There are several other areas, in addition to estate tax liquidity, where well-structured life insurance can be utilized to solve planning issues facing successful families.

- **Estate equalization-** one of the more difficult decisions that successful families and family offices face is how to effectively deal with the “fair” distribution of their estate. The difficulty lies in the fact that, in some cases, there needs to be a differentiation between “fair and equal.” This determination, however, is easier said than done and life insurance can play an integral role in solving a number of these needs.
 - **Second marriages-** estate planning for blended families can be a delicate and complicated process, particularly if one spouse entered the marriage with significantly more wealth and sustained earnings. Whether both spouses had children prior to this marriage or not, determining an agreed upon estate plan can be a challenge. Life insurance is an answer to this dilemma, allowing potentially separate property assets to remain within one family line while insuring an inheritance for the other.
 - **Business holdings-** a challenge facing business owners is planning for children in or out of a family business. Children working in the business may not agree with a plan that includes sharing both revenue and value equally with their siblings. Once again, life insurance, structured to help equalize the estate, is an attractive solution. If all children already own stakes in the business, a buy-sell plan between family members is critical planning for a family office. In this case, regardless of terms of valuation metrics, insurance can provide the necessary liquidity to execute this plan.
 - **Farms/Ranches-** a challenge for family offices is planning for the family farm or ranch. In many cases, this asset represents a significant holding, but like the family business, not all heirs necessarily participate equally. As with the other estate equalization needs, insurance can be the solution to help maintain family harmony. In addition, if the family wants to maintain the farm/ranch as a legacy asset, the family office might consider funding a Family Trust with enough life insurance to both purchase and fund the future maintenance of the ranch. By implementing this strategy, they can create a multi-generational legacy asset, outside the reach of estate taxes, which has the ability to sustain itself for years of family use.

Charitable Planning

Family offices are charged with the effective use of charitable planning to meet the needs and goals of the families they serve. In most cases, the donation of existing assets is the most fulfilling method since it meets

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the family's altruistic goals while providing a current tax benefit for them. There are several uses for life insurance, however, that can be helpful within a family's estate plan.

- **Direct Gift-** many families and their family offices find that using life insurance to meet a testamentary pledge may be an efficient way to fund their desired gift. This is especially true for families with substantial illiquid investment holdings. The family office may find that the payment of premiums today is more cost-effective than the liquidation of assets upon death.
- **The Zero Tax Estate-** the charitably inclined family may decide that the most attractive means to reduce estate taxes is to leave their assets which remain inside their estate to charity. Many times, this involves a family foundation or donor advised fund. After all, there are only three potential beneficiaries for accumulated wealth; their family, charitable institutions, or Uncle Sam; and few choose to benefit the latter. Life insurance can play a significant role for the family office by replacing the donated wealth with tax-free benefits for the heirs. For some families, this allows the flexibility to give all their estate to charity and ensure that their heirs receive an equivalent benefit via insurance. It can be utilized by family offices to reduce the complexity of what can become quite complicated estate planning and enable families with the ability to make large charitable gifts during their lifetime.

Business Planning

Planning for the succession of business assets, whether that be an operating business or more passive investment entities such as LLCs and FLPs, can be more challenging than traditional estate planning. For non-related business partners, strategies are typically more straightforward, though still with a degree of complexity but absent the softer issues of family dynamics. When the succession plan includes children in and out of the family business, family offices are tasked with the more complicated responsibility of managing the goals and aspirations of all heirs. Once the original wealth creators have passed, it may become apparent that not all heirs have the same level of interest in the family business or necessarily care to be co-invested with their siblings. As Mark Twain said: "You never really know someone until you share an inheritance with them" and the succession of business assets can be a major catalyst for family disharmony. Life insurance, structured in conjunction with well-drafted legal agreements, is an effective solution to help fund a comprehensive succession plan and maintain family harmony.

- **Buy-Sell-** creating effective buy-sell plans is a requisite not only for an operating business but for the more passive entities formed to hold and protect investments for family members. Family offices not only have to ensure that continuity strategies are in place for these entities, but for the family office itself. Not only must comprehensive plans be developed, but they must be flexible enough to conform to the complex tax issues related to these asset sales. In addition, they must be reviewed periodically to ensure they meet the needs of all owners and contain default language acceptable to all parties, should the periodic document review be overlooked. Life insurance is the most viable option when it comes to funding these plans, but it still requires several decisions ranging from policy type, ownership structure, and tax -effective funding to ensure they comply with the overall tax strategy. Company ownership of the policy can cause an increase to the overall valuation of the business (based upon a recent IRS ruling² necessitating a degree of creativity in how these policies are owned.

² Thomas Connelly v. United States, U.S Court of Appeals (June 2023)

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- **Term vs. Perm-** many buy-sell plans are funded with term life insurance, yet that may not be the best option in most cases. Term insurance has a significant advantage when it comes to being cost effective, but the reality is that over 90% of term policies never pay their death benefit. Typically, if the owners live beyond 65-70 years old, the term policy has expired. They then find themselves without a funding mechanism when it is most needed.
- **Permanent Life-** though a more costly option than term, family offices should consider utilizing permanent life insurance in business succession planning when economically viable. In addition to having the funds available for the life of the insured parties, there are other uses that may advantage family members and business partners alike.
 - **Bonus out the policy-** One of the attractive features of permanent life insurance is the fact that it will be in-force when most needed. If a business partner, family member, or key person decides to retire for whatever reason, the policy is an attractive benefit that can be bonused to them for a variety of uses. This is a valuable instrument that can be utilized as a company benefit for retaining key personnel.
 - **Cash value-** depending on product chosen, funding structure, and guarantees, many permanent insurance policies build cash value in addition to offering a death benefit. Policies can be designed to offer maximum cash value at the optimal window (projected time of retirement or business transition), which allows for substantial flexibility in the use of the policy.
 - **Retirement income-** a popular strategy is to utilize the cash value of a life insurance policy for retirement income. This is achieved through tax-free loans from the policy and can help the retiring party with supplemental cash flow (tax-free).
 - **Disability/Long-term care-** depending upon riders associated with the policy, a permanent life insurance policy can help solve for needs regarding both disability and long-term-care.
 - **Estate planning-** whether individually or business owned, the policy can be gifted or sold to a trust to provide liquidity for surviving family members for both estate and/or potential income taxes.
 - **Business asset-** for businesses that have capital requirements to meet loan covenants, adding a high cash value rider to a permanent life insurance policy helps maintain the policy's cash value, making it a valuable asset for the business's balance sheet.
- **Pension Plans-** family offices looking to shelter income for high-earning family members may consider the more "modern" versions of pension plans, such as hybrid cash balance plans. Depending on a participant's age, pre-tax contributions can range to almost \$400k a year and there is no age limit for starting a plan. Coupling this substantial contribution with a portion dedicated to funding permanent life insurance within the plan, can truly supercharge the overall benefit. With proper structuring, the policy can be removed (via

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sale) once premiums are paid, providing substantial flexibility for its uses. Pension plans can be a tax advantaged method to fund life insurance with pre-tax dollars.

Tax-free Investment/Income

For many years, the consensus has been to defer income tax as long as possible through qualified plans and other specialized tax-advantaged investment strategies. The reality being faced by family offices and wealthy individuals today, is that tax rates may be higher in the years ahead, making deferral not quite as attractive. Despite how it may feel, today we are truly in the golden age of taxation with the lowest tax rates seen in the U.S. since the 1930's. This is across the full spectrum of tax including income tax, estate tax (along with the highest exemption in history), corporate tax, and capital gains tax. With deficits growing and government spending continuing to increase, it is hard to imagine that tax rates will remain indefinitely at such historically low levels. This is a valid reason for family offices to consider life insurance from an investment perspective as well as a source of income since both the death benefit and policy distributions (using loans) are generally tax-free.

- Internal rates of returns for an insurance policy's death benefit, based upon the insured's actuarial age, typically range from 5%-7%, depending upon policy construction and chosen product. Inventive methods of policy funding may increase these rates of return even higher. The taxable equivalent return for traditional investments may have to exceed 9%-10% to match the return generated by a permanent life insurance policy. In addition, some family offices are looking at interest rate sensitive products such as Whole Life or Universal Life, as a hedge to their equity exposure without directly investing in fixed income instruments. Life insurance, which can provide a secure, tax-free rate of return, is increasingly viewed as an investment class, as opposed to simply a risk management tool, by wealthy families and their family offices.
- Tax-free distributions from a life insurance policy can be an important part of a family's financial plan. This source of tax-free income, based upon policies with favorable loan provisions, will become even more valuable should we encounter a higher income tax rate environment. Structuring a policy for cash accumulation and eventual income distributions is an art form in itself and product selection is an important component. Historically, Whole Life policies have not been the best option for this strategy due to higher loan costs and lack of flexibility, while Universal Life policies tend to be better suited to meeting income/distribution goals. For family offices looking to generate tax-free income, a well-structured insurance policy may provide both a near-term death benefit and future income for the families they serve.

Policy Funding

For the typical family with a need for life insurance coverage, funding their policies is typically simpler, becoming more a function of desired benefit, product selection, underwriting status, and desired length of premium payments. For family offices, however, much larger policies are typically required to execute estate and business planning strategies and funding mechanisms become significantly more complicated. In addition to the costs of premiums and illustrated payment structure, there are tax consequences, both income and estate, as well as contribution limitations that must be carefully considered.

- **Premium structure-** once the desired amount of coverage is identified, the next "solve for" is to determine the most efficient method of funding the policy. As noted, for most conventional coverage, there are rarely significant tax consequences, even if the policy is to be trust-owned. By including children, and grandchildren as beneficiaries, along with a current annual exclusion of \$18,000 per person (\$36,000 per couple), most families can avoid gift tax and fund relatively substantial premium payments. However, this is not always

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the case for many and certainly a challenge for family offices looking to procure significant amounts of benefit for the families they serve.

- **Traditional premium structure-** for most policies, premiums are typically structured in what is termed a “shorter pay” manner (typically 10, 15, or 20 years) or payments for life. As a rule of thumb, the shorter the payment period, the higher the IRR at the insured’s actuarial age. Cash flow restrictions, in many cases, dictate the desired choice of years for policy funding.
- **Skip design-** some family offices may find that there are advantages to front loading a policy to take advantage of a current excess of cash available. In this case, future premiums can many times be “skipped” for a number of years, ranging from as few as 3-4 years up to 25+ years of no premium payments. Though an attractive strategy to many with improved IRRs through the insured’s actuarial age, the downside is substantial premium costs later in life. Living beyond that point in time greatly reduces the return profile of this strategy.
- **Income and pension design-** for families looking to generate maximum income from their insurance policy or fund life insurance within a pension plan, most utilize a shorter premium payment period of between 5-7 years. For incomes strategies, this allows for substantial premium contributions to the policy to quickly accumulate tax-deferred. For use of permanent insurance within a pension plan, the shorter premium period facilitates the repositioning (via sale or distribution) of the policy from the plan once all premiums are paid.
- **Private split dollar-** this planning technique is attractive to family offices and their clients by allowing payment of annual premiums on trust owned policies without incurring gift tax consequences by making large gifts that would exceed the client’s lifetime exemption. The loans made to trust have income tax implications and are usually treated as either a collateral assignment (economic benefit calculated upon the cost of term insurance) or a loan regime (typically an interest rate tied to the long-term AFR rate). In addition to traditional split dollar, there are private switch dollar plans (switching between the economic benefit and loan regime upon a triggering event) and intergenerational split dollar plans (grandparents funding policies on children’s lives for the benefit of grandchildren). Split dollar planning is an important tool for family offices looking to acquire life insurance but not utilizes additional estate tax exemption or generate gift taxes. They should be aware, however, that private split dollar plans require diligent administration and compliance to ensure their efficacy. This includes proper legal agreements that outline the responsibilities of all involved parties on issues including premium payment responsibilities, death benefit allocation, and the sharing of policy cash value.
- **Premium finance-** for the past decade plus, interest rates have been historically low making the financing of insurance policies through third party loans attractive to family offices and the families they represent. Provided that an arbitrage exists between loan rates and the policy’s rate of return, this is a strategy that has the potential to substantially increase IRRs based on the age-old strategy of utilizing leverage. Though there are plenty of well structured,

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financed policies with accompanying credit facilities, the use of premium finance, sold many times as “free life insurance,” has also had its share of pitfalls. The reality is that if a plan is well-structured, with realistic assumptions for both interest rates and market returns, as well as a viable exit strategy to retire the loan, premium finance of life insurance is a good strategy for family offices to consider. The current rate environment, with interest rates more “normalized” than over the past decade, presents an opportunity to illustrate realistic assumptions with the opportunity for upside should rates decrease in the future. As with all life insurance tied to either fixed income or market returns, the moving parts, both returns and costs, are based upon assumptions. The use of financing brings another variable to that equation. Current trends utilized by family offices include the restructuring (rescue) of previously issued policies as well as the blending of Whole Life into product selection to add return stability.

Private Placement Life Insurance (PPLI)

High net worth families are attracted to the potential benefits of private placement life insurance, and this strategy has grown rapidly over the past decade due to substantial interest from both family offices and investment advisors alike. PPLI is a niche life insurance product that offers high-net-worth investors an opportunity to combine the benefits of life insurance with tailored investment opportunities in a tax advantaged manner. Though it still functions as a life insurance policy, it allows the policyholder to allocate a portion of the premium payments to a wide range of investment options, including hedge funds, private equity, real estate, and other alternative investments. Being a life insurance policy, the cash value grows tax-deferred, allowing the accumulation of wealth without incurring annual income taxes on their investment gains. This is valuable for investments in tax inefficient strategies such as hedge funds and other alternatives which generate substantial short-term capital gains. Other benefits include the tax-free death benefit passing to beneficiaries, making it a valuable tool to help mitigate potential estate tax liabilities, as well as the asset protection provided for insurance related products. While this strategy can provide certain tax advantages, it is a complex financial tool and not without potential drawbacks. Some of the “cons” of PPLI are the costs associated with the strategy, which includes management fees, insurance charges and administrative expenses. In addition, family offices need to be aware of the liquidity constraints related to this strategy and potential legislative risks. Along these lines, it is important to note that the Senate released a report in February 2024 specifically targeting private placement life insurance. Though no regulatory changes were enacted, the strategy is on the government’s radar and proposals to curb the use of this strategy may be forthcoming. Family offices should rely on competent legal and tax advice (not necessarily from an insurance agent or investment advisor) before engaging in this strategy.

In conclusion, there are four core risk pillars for the family office - strategic risks, commercial risks, financial risks, and personal risks. Life insurance should be seen as a risk management solution for these families, which are often immensely complex in their business and investment holdings, as well as their family dynamics. Family offices are increasingly focused on helping families achieve overall financial wellness by analyzing clients’ lifestyle and financial goals – both personal and professional – and then using tools such as insurance to develop a holistic financial strategy that puts them on a path to achieving those objectives. As noted earlier, it is key for family offices to not simply talk product, but to understand the role of life insurance in the strategies utilized to meet their clients’ objectives. Life insurance is not a panacea for all financial ills but, as I hope we have illustrated, can be an integral component of a comprehensive plan, transferring wealth in a tax-efficient, protected manner and as a funding mechanism for estate and business planning strategies.

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