



Business Financial Planning

Substitute Creditor Arrangement

A substitute creditor arrangement can accomplish the goal of releasing a stockholder's/ guarantor's estate from liability on a corporate obligation and providing a source of income to the beneficiaries of the deceased guarantor's ILIT (Irrevocable Life Insurance Trust). In a substitute creditor arrangement, the bank lends a sum of money to the corporation, the repayment of which has been personally guaranteed by a stockholder / guarantor. In order to secure the debt obligation, a life insurance policy is purchased on the guarantor by the guarantor's ILIT. The guarantor makes annual gifts of cash to the ILIT to provide cash for premium payments to the life insurance company. If the guarantor's annual exclusion does not cover the total premium, part of the guarantor's unified credit may be used. The guarantor's ILIT also enters into a private agreement with the bank, stating that if the guarantor dies while the note is outstanding, the bank must sell the ILIT the note at its full value. If the guarantor dies before the loan has been repaid, the life insurance policy proceeds will be received by the guarantor's ILIT and will be used to purchase the note from the bank. Thereafter, the guarantor's ILIT will be the substitute creditor of the corporation.

Since the note remains intact and the ILIT becomes the substitute creditor, the insured's estate is not inflated through the increased business value, which would result if the note were paid off. Any proceeds over and above the reduced loan value are retained by the ILIT and are not reflected in the insured's or the insured's spouse's taxable estates. The ILIT will receive cash via the corporation's debt service on the note; the bulk of which will be tax-free return of capital with only the interest portion taxable as ordinary income. The corporation and the ILIT can negotiate the repayment of the debt to fit the cash flow needs of the ILIT's beneficiaries and the ability of the corporation to repay the note. This could be extremely important where the guarantor's death plunges the business into a temporary state of uncertainty, which may cause a less sympathetic creditor to become concerned and require immediate payment of the note. The substitute creditor arrangement permits the corporation to pass funds to the ILIT's beneficiaries through its installment payments on the debt.



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