Episode #241: How the Wealthy Use Leverage to Pay for Estate Taxes

Video Transcription

Hello. My name is Kevin Nuber. Thank you so much for watching today's "Money Script Monday" video where I'm going to be talking about how to use leverage in order to pay for your estate taxes.

You see, when we're very young all the way through adulthood, we get taught the same thing as most America, which is that you should pay cash for every major transaction or major capital purchase that you engage in.

So, for example, if you're going to buy a car, you're supposed to pay in cash. If you pay for a house, if you buy a house, you should pay cash. But if you can't, no big deal, just finance it. But make sure to do the shortest-term loan possible, 15 years, so that you pay the least amount of interest out-of-pocket. Leverage and debt are your enemies, and paying interest is a sin.

Now, for wealthy people, the paradigm is completely different. Wealthy people understand that debt can be their friend, paying interest is not a bad thing as long as you're earning interest somewhere else. And when it comes to these major capital purchases, many times they're going to choose to use financing or leverage to pay for that transaction.

Let's say you go buy a really big piece of property or you go buy a business. You're not going to use your hard-earned assets for that transaction. You're going to use a bank and you're going to finance it.

If you're a billionaire and you're going to buy a billion-dollar company, you're not going to go use your cash in order to buy that company.

You're going to finance that transaction and just pay the interest out of pocket in order to make that purchase.

So today, what I'm going to be talking about is how to pay for your estate taxes. What if you don't do anything? And then what if you do it the normal way, which is just the safest, and pay the premium? Or what if you'd finance your transaction and borrow the money that you're going to use to pay for your estate taxes?

So, let's start with what if you don't do anything at all. So imagine this, you've been working your entire life. You might not have had anything as a young man or woman. But as you've grown older, you've accumulated wealth.

You started a business, you started buying properties, you've worked really, really hard to accumulate all this wealth. And now you're finding out that because of how estate taxes work in the United States, on the day that you die, you're going to have a really big estate tax liability.

You have two choices. One is you can pay the money to the IRS, or you can have that money go to your kids. Now, I know that some people might not have the best idea of how they feel about their kids getting a whole bunch of money, but I'm pretty sure nobody loves the IRS so much that they would just love to just give them $10 million of their hard-earned money just because they love the IRS and the government so much. I'm pretty sure most people would rather have it go to your kids, that $10 million.

So in this example, what I'm going to show you is what if you don't do anything at all? And for this particular client, if they did nothing and they lived to age 85, age 86, this client's estate tax liability would be $11 million.

$11 million of their wealth is going to the government because they just love the government so much. That's if you do absolutely nothing at all.

Once you realize this issue, you say, "Okay, well, I want to start doing some stuff now while I'm still alive and plan for this estate tax liability so I can make sure that that money goes to my kids and not the IRS."

What you do is you go, and you do some estate reduction strategies, but one inevitable component is going to be using life insurance in order to cover that liability.

Now, if you listen to the common wisdom and you go search on the internet, everyone's going to tell you that the cheapest way to buy life insurance is term insurance. You should only do term insurance, it's the only way that you should do it. And in fact, that's going to be the cheapest.

Over your life expectancy, you would pay $1.1 million in total premium. But the problem is if they're only going to cover this person until the age 85 and if they live to age 86, they're going to have no death benefit and they're still going to have $11.1 million of estate taxes.

So, term insurance might be the cheapest, but it's the cheapest for the reason that it's not going to be there potentially on the day that you die. So, you say, okay, I'm not going to do that. That doesn't make any sense because I'd basically lose the 1.1 million of money.

I'm going to go buy a policy that's guaranteed for the rest of my life. This is the least risky strategy, with no risk whatsoever, completely guaranteed; however, the total out-of-pocket cost would be $4.1 million.

Now, it's still a good deal because you're paying 4.1 million out of pocket. In exchange, you're getting $10 million of death benefit that's going to pay for your estate taxes.

So, it still could work. But because you're wealthy and, in your accumulation of wealth, you've used leverage, you've financed purchases that you buy, you understand that if you can borrow at a favorable rate, then why use cash? And you can actually finance the premiums that you pay for life insurance.

So instead of paying $4 million out of pocket, what if you just borrow that money and just pay the interest out of pocket? Could you use leverage in order to pay for those estate taxes? And the answer is yes, absolutely.

In this example, if we run a premium finance type policy using leverage, your out-of-pocket cost would be $900,000 of the total out-of-pocket cost. And the result is, is that life expectancy, your death benefit is going to be just under $16 million of death benefit, which is more than enough to cover your estate tax liability.

You can see the power of leverage here. You're using other people's money because you're financing it. Your out-of-pocket cost in the form of interest payments is only 900,000, and you have more than enough to cover your estate taxes.

Now, this sounds too good to be true. But the truth is, anytime you use leverage or anytime you finance a transaction, you're bringing in an element of risk into the scenario.

For example, what if your loan rate goes up? What if interest rates go up? And second, what if the life insurance policy itself doesn't perform at a sufficient rate in order to cover the liability on the loan?

So what we do is we do something called a stress test. What if these two stressors happen at the same time? Our policy doesn't perform as well as we thought, and the interest rate on the loan goes up.

Well, the result is, is that your out-of-pocket cost stays the same, $900,000; however, the amount of death benefit that you have just goes down to $9.2 million. In either scenario, the stress test, or the full scenario, you're going to have somewhere between $9 million and $15 million of tax-free death benefits with only 900,000 out-of-pocket to cover your estate taxes.

So here you are. You realize that you have a potential estate tax liability, and you don't love the IRS. You want to make sure that that money that you have earned goes to your children. And you realize that if you do nothing, you're going to have this huge estate tax liability.

You go and search for your different options, and you see that term insurance isn't going to work because it's not going to be there on the day that you die.

You also don't like the idea of tying up $4 million of future cash flow in order to cover this estate tax liability. So you do what other wealthy people do and use leverage to pay those premiums.

By doing that and by using other people's money, you can substantially reduce your out-of-pocket cost to prepay your estate taxes now while you're still alive.

So, if you want more details about exactly how this transaction works, you can see below in the show notes, you can find this entire detailed report, which shows a projection of this particular client's estate tax exposure, how we come about doing that calculation and the math.

It runs the different scenarios, the different types of policies, runs the finance policies, and the different stress tests, and you can then see exactly how using leverage to pay for your estate taxes might work in your scenario.

Thank you so much for watching.