Premium Financing

Financed life insurance premiums offer attractive options for business owners looking to accumulate and distribute wealth. BY ALAN S. KUFELD AND FRANK W. SENECO

AS BUSINESS OWNERS BUILD PERSONAL wealth, they typically want to ensure that, in the event of their death, the value of their business equity will pass to a surviving spouse and heirs.

A variety of premium financing techniques—involving permanent life insurance comparable in value to the owner's business equity and borrowed premiums—offer a potentially attractive solution to this challenge.

Take, for example, a successful 40-year-old business owner who has built personal equity estimated to be worth $12 million in his business and now wishes to fund a buy-sell agreement with $15 million of individually-owned permanent insurance. The premium for this coverage could easily be $200,000 per year in after-tax dollars.

Borrowing the premiums could be a beneficial option for the following reasons:

- Permanent life insurance policies have a cash surrender value that, under current laws and regulations, can provide collateral for a secured loan.
- New types of permanent life insurance offer attractive options for the policy cash value that can diversify the business owner's portfolio and outperform the cost of financing premiums.
- Borrowing has federal estate/gift tax advantages when used with an Irrevocable Life Insurance Trust (ILIT).
- A thriving industry of specialty lending, called "premium financing," has evolved to facilitate this type of transaction by arranging personalized secured loans.

Fine-Tuned Leverage

Most business owners are familiar with the use of leverage to achieve financial objectives and they understand the benefits of borrowing vary with the type of asset financed. In a premium financing transaction, leverage can work on three levels:

- The contract provides the immediate benefit of leveraging a first-year premium payment into a far larger death benefit. In the example cited earlier, this leverage is 75 to 1—a $15 million death benefit acquired for a $200,000 first-year premium.
- The contract creates the potential

A Case Study

Scott is a 40-year-old successful hedge fund manager who, with his wife Nancy, has three young children. His current net worth is approaching $50 million—$30 million in the hedge fund and $20 million in real estate and other investments. The fund also has a large carried interest and there will be an IRD issue upon his death. He is confident in his ability to grow the fund in the future and, after meeting with his tax attorney, realized he needs $25 million in life insurance to accomplish all he is working for without suffering a substantial loss due to estate taxes.

Scott was advised of different estate freezing techniques but he feels he is too young to implement them. Also, he is not particularly interested in charitable giving at this time. He needs to keep sufficient liquidity for private schools, college and possibly graduate schools for his children. He is determined to not burden his children with high debt and student loans.

Because of these immediate goals, he needs to find the most cost effective way of paying for his long-term life insurance needs. Permanent insurance premiums quotes ranged from $80,000 to more than $200,000 per year. A premium finance arrangement would cost him, out of pocket, about $10,000 per year for 20 years.

Scott understands the benefit of leveraging as a financial strategy and is interested in seeing how it may be used to pay for his insurance. Because of his young age, Scott and his advisors concluded that an indexed universal life insurance policy with a death benefit guarantee would work best in a leveraged situation. The indexed universal life policy's cash value could over the long term exceed the borrowing rate for the premium finance loan because of the underlying indexes the policy is tied to. This strategy gives him time as his estate plan evolves and assets are moved to different vehicles which will not be exposed to estate taxes. Those assets or the earnings from them can be used in the future to pay down the premium finance loan.

The result is a flexible structure, not exposed to estate taxes, that lowers the chances that Scott will bear the cost of life insurance for his lifetime.

over time for the cash value to compound on a tax-deferred basis and eventually exceed the cumulative cost of premiums.

- The contract can have "tax leverage" because the death benefit is normally free of federal income tax. It also can be free of estate tax when properly structured and owned by an irrevocable trust.

The advantages of borrowing life insurance premiums are tangible and valuable. The strategy can potentially increase personal net worth modestly during the business owner's lifetime and increase the after-tax estate substantially after death. Premium financing also creates the flexibility to adjust the amount of leverage built into the life insurance contract at the time of purchase and periodically over time.

For example, a business owner could "dial up" the premium financing leverage at age 40, reduce it in increments starting at age 50 by repaying some loan principal and eliminate it by retiring the loan as retirement approaches. For younger owners who are just starting to build serious net worth, premium financing can be a bridge until personal assets grow or a sufficient income stream becomes available to fund life insurance.

The Structure Of A Typical Transaction

Although each premium financing transaction is customized, the basic terms and techniques are somewhat standard, as follows:

- The loan typically is non-recourse—secured by the policy's cash value and a letter of credit (LOC) equal to any shortfall between loan principal and cash value.
- The policy is permanent life insurance in which coverage is guaranteed for life or to a very high age (e.g., 110). In form, it may be whole life, fixed universal life or indexed universal life with a "secondary guarantee" of coverage. Variable life insurance is typically not used in premium financing because of regulatory restrictions on borrowing against securities.
- The loan interest is a floating rate typically tied to the 12-month LIBOR plus a spread. Spreads have recently ranged from LIBOR + 2.25% for loan commitments up to $2.5 million to LIBOR + 1.75% for commitments above $20 million. The loan interest is not tax deductible for an individual, trust or business entity.
- A loan arrangement fee of 1.0% to 1.25%, depending on loan size, is charged and can be capitalized into loan principal.
- The policy must be owned by a "bankruptcy-remote" entity so that the premium finance lender has clear priority claim against cash value collateral. An LLC or ILIT can qualify as bankruptcy-remote.
- A common arrangement is to fund the policy at the maximum level for the first seven to 10 years, which can guarantee the death benefit. This creates rapid cash value build-up and leverages policy benefits. Funding should avoid Modified Endowment Contract (MEC) status. In a "non-MEC" policy, loans and partial with-

drawals of cash value may be made on a tax-favored basis.

- The policy is typically purchased by an ILIT so that the death benefit can be paid free of federal estate tax (a three-year look-back period applies on policies transferred to an ILIT). The business owner normally is the insured person. Some "survivorship" or "second-to-die" policies allow two lives to be insured—a business owner and spouse—with the death benefit payable on the second death. The trust's beneficiaries may be a surviving spouse, children or, in the case of a business buyout arrangement, the LLC or other partners of the firm.

Estate And Gift Tax Advantages

The ILIT can help to avoid inclusion of the life insurance proceeds in the grantor's taxable estate. With a competent institutional trustee, it also can provide continuing management of assets and planned distributions to beneficiaries according to the grantor's wishes.

There is, however, complexity involved in setting up ILITs funded with large amounts of life insurance. The trust normally owns the insurance and pays premiums, and the grantor can gift to the trust an amount needed to pay premiums annually. Such gifts can qualify for the annual gift tax exclusion—currently $12,000 per beneficiary—if they are of a "present interest." Then, any premiums gifted to the trust in excess of the annual gift tax exclusion can be

sheltered under the grantor's lifetime gift tax exemption, which is currently $1 million. At the grantor's death, lifetime gift tax exemptions previously used will reduce the "applicable credit" for federal estate tax purposes, dollar-for-dollar.

For example, take a business owner who gifts premiums of $100,000 in one year to an ILIT established for four beneficiaries. Four annual gift tax exclusions, each worth $12,000, are used, covering $48,000 of premium. The remaining $52,000 will go against the business owner's lifetime gift tax exemption and offset the applicable estate tax credit by the same amount. If the client used up their lifetime gift tax exemption they would be liable for gift taxes of up to 45% on future gifts. Many advisors, it should be noted, believe this is not the best use of the lifetime gift tax exemption.

By reducing the out-of-pocket premium payment obligations, premium financing can soften the impact of gifted premiums on the grantor's estate planning. The annual gift to the trust could be limited to the amount necessary for the trust to pay financing charges, which normally is far less than premium cost. In the example above, it is possible that none of the lifetime gift tax exemption would be used.

Exiting The Loan

In evaluating a proposed transaction, business owners should understand the common strategies for exiting a premium financing arrangement. In addition to paying off the loan with liquid cash as it becomes available, the options include:

- Having the trust or estate pay off the loan after death, using insurance proceeds.
- Surrendering the contract and using its cash value to pay off the loan.
- Restructuring the loan.
- Using a combination of personal assets and policy withdrawals or policy loans to pay off the premium finance loan. This is not usually recommended because large withdrawals or loans may jeopardize the guaranteed coverage feature of the policy.

Premium financing arrangements normally do not include loan prepayment fees. Therefore the business owner can "dial down" leverage by paying off loan principal whenever liquid cash becomes available, such as during years when profits are strong and incentive allocations are high.

> **Premium financing** works best when the policy has the potential to grow cash value at higher rates than the cost of financing.

Policy Performance

Premium financing works best when the policy has the potential to grow cash value at higher rates than the cost of financing. An analysis of prevailing interest rates over the past 20 years by the British Bankers Association shows that one-year LIBOR rates have averaged 5.19%. A premium financing arrangement at LIBOR + 1.75% would have averaged 6.94% interest annually over this period.

Most whole life policies' cash value growth, including any dividends paid by mutual companies, is less than 7% annually. Also, regulations preclude premium financing arrangements from including variable life insurance. Fortunately, a type of permanent policy called Indexed Universal Life (IUL) has emerged to fill the gap. IUL credits to cash values an interest rate that is the higher of a percentage of returns produced by a market index such as the S&P 500 or a guaranteed minimum annual rate, such as 2.0%. Policy values are not subject to market fluctuations. Any cash value gains from year to year are locked into the contract.

We are seeing even more attractive "next generation" IUL products emerge. They credit cash value with interest based on an averaged "basket" of leading investment indexes, including those that invest in U.S. and international stocks. Other advantages of leading-edge IUL products include:

- *Lowest return dropped*–The index that produces the lowest performance for the basket over a given period of time is dropped from the average.
- *Variable basket weightings*–The highest performing index in the basket is given a greater weighting in the averaging process, on a look-back basis, than lower performers.
- *Five-year point-to-point measurement*–Index returns are measured on a five-year rolling point-to-point measurement, which helps to smooth out temporary dips and produce the most favorable cash value crediting rates for policyholders.

One death benefit option available in most IUL policies allows insurance protection to increase dollar-for-dollar with cash value. Choosing this option can help to protect estates that keep growing with company success and an owners' increasing equity values.

When Does Premium Financing Work Best?

Premium financing strategies can work best for business owners when

the benefits align with owners' personal needs, in the following ways:

- The owner has a need for permanent guaranteed life insurance coverage and has limited liquidity or cash flow to pay premiums.
- The owner expects liquidity or cash flow will improve at some point in the future and would like the flexibility to "dial down" life insurance leverage.
- The owner has significant personal net worth tied up in the company and is confident it will keep performing well.
- The owner believes the IUL basket of indexes has the potential to outperform the cost of financing premiums.
- The need for life insurance coverage is large enough to create gift/estate tax issues because gifted premiums would exceed the annual gift tax exclusion.

Because IUL cash value crediting rates can fall below financing cost over intervals, it is essential to implement premium financing programs with the help of professionals who can monitor results and maintain program advantages. If the program begins to deliver less benefit than planned, it is best to know this fact and take remedial action sooner rather than later.

In the right circumstances, and with experienced professional support, premium financing can be a valuable technique for helping business owners pursue wealth accumulation and distribution goals, including protecting and ultimately cashing out the value of their business equity. RW

Alan S. Kufeld CPA is a tax principal in the Rothstein Kass Family Office Group, specializing in the federal, state and local tax matters affecting high-net-worth individuals. Frank W. Seneco is the principal of Seneco & Co., a Connecticut-based advanced planning operation that specializes in high-end life insurance solutions for the ultra-affluent and their advisors.

Premium Financing: A Hybrid Solution

Younger hedge fund managers often find term life insurance coverage attractive. Level-premium term coverage can be very affordable for individuals under about age 45, over guaranteed coverage periods of up to 20 years. Premium cost, however, can increase sharply at the end of the guaranteed coverage period and become prohibitively expensive at older ages.

Premium financing arrangements may be considered a kind of "mid-ground" between term and permanent life insurance coverage, providing the advantages of both, as summarized in the included chart.

Feature	Term	Premium Financing	Permanent
Premium cost at younger ages	Low	Low	High
Premium cost at older ages	Very high	Low	High
Guaranteed coverage	For up to 20 years	For life (or age 110)	For life (or age 110)
Cash value growth potential	No	Yes	Yes
Premium financing cost	No	Yes	No