Avoiding Insurance Landmines

Premium financing is an excellent way to insert life insurance into an estate plan, but faulty structuring can prove disastrous. BY KEITH M. BLOOMFIELD AND FRANK W. SENECO

LIFE INSURANCE OFTEN IS THE BEST WAY to pay estate taxes, providing a more predictable solution than asset sales from the standpoint of issues such as timing and leverage. And one of the best to obtain life insurance for wealthy clients is through premium financing.

Premium financing refers to a group of strategies that use borrowed money to pay life insurance premiums, either in total or in part. The structure of premium financing can be very complex and intricate. When done correctly, it can prove very advantageous for the ultra-high-net-worth client. When done poorly, it can be a complete disaster.

The first step typically involves the creation of a life insurance trust, which buys the client's life insurance and borrows money to pay the premiums.

The loan interest is usually slightly higher than a published rate, such as LIBOR. Periodically, the loan renews and sometimes the interest rate is reset. The loan interest is paid yearly or sometimes more frequently. In some scenarios, the interest can be accrued.

Loans beyond a certain number of years, commonly five years, are not guaranteed. When that time limit is reached, an assessment is made of the life insurance policy's performance, the credit worthiness of the client and the potential forms of collateral.

Collateral for the loan comes in a number of forms. It includes the cash value as well as the death benefit of the life insurance. Other assets such as securities and real property can also be used as collateral. But no matter what, the client is responsible for the loan.

The types of life insurance policies that are usually used include whole life, universal life and equity-indexed universal life. Both whole life and universal life are predicated on long-term interest rates. In contrast, premium financing uses short-term interest rates.

Why is premium financing suitable for high-net-worth clients? One reason is that the use of borrowed money allows clients to capitalize on leverage in a way that doesn't put pressure on cash flow. Furthermore, it reduces the need for gifting.

Common Missteps

Some events can sabotage a client and his or her life insurance policy. The following scenarios are the ones we see most often:

1. Need for more collateral. Whether it's because the policy's internal buildup of cash value is not sufficient or other collateral has decreased in value, sometimes there's a need to post more collateral to keep the transaction viable.

2. Interest rate mismatch. This is when the interest rate on the loan becomes too big to keep the life insurance policy in force. This usually leads to a need for more collateral.

3. Poor life insurance policy design. Very often, when premium-financing transactions go bad, it's because the policy was poorly designed. Sometimes this is because the policy was minimally funded; other times it is because the projected returns were unrealistic. This then leads to the need for more collateral.

4. Inability to renew the loan. It's not always possible for the client to continue to borrow money to pay the premiums. This could be due to a number of reasons, ranging from the ones we mentioned above to the lender getting out of the business. If maintaining the policy is dependent on renewing the loan and that proves impossible, then the transaction collapses.

Case Study

A hedge fund principal with a net worth of $470 million dollars has $215 million in real estate and business interests. The client discounted and froze the value of the various real estate and business interests with a part-gift/part-sale of the assets to multiple Intentionally Defective Grantor trusts. The client also took advantage of a charitable lead trust strategy to bring offshore hedge fund carried interest assets back onshore. This offset income taxes due while benefiting charities and eventually heirs. What's important to note is that before life insurance for estate tax purposes is considered, all viable legal strategies should be employed.

The client, with his accountant and attorney, decided to obtain $150 million in life insurance to pay estate taxes. The premiums for this much life insurance were large and well beyond the annual gift exclusion that was available. Meanwhile, the $5 million applicable exclusion was used with the Intentionally Defective Grantor trusts. The primary reason premium financing was used was that the client determined he could invest the money and get a better return than the interest on the loan used to buy the life insurance.

The client chose a 30-day LIBOR loan with rates averaging under 2%, including the lender's fees. Using high-cash-value life insurance policies, he was able to secure the $150 million of coverage from multiple insurance companies, with business interests used as collateral for the loan.

The risks in this strategy are that the loan interest rate could increase over time and that the investments could underperform, particularly with multiple policies. Either of these situations could result in a need to post more collateral. To mitigate this risk, annual loan interest will be paid out of trust assets. Additionally, the policies' guaranteed cash value increases make it extremely unlikely that additional collateral will be required. This design provides a positive arbitrage over the borrowing costs, and any excess earnings and or dividends enhance the arbitrage further.

In this situation, the client was well schooled on the risks involved. He recognized that additional funds would probably be needed for premiums because of the likelihood borrowing rates will increase. At the same time, the trust structures give him the ability to move money among the different life insurance policies. With this arrangement, cash flows are available to pay the premium finance arrangement to keep it in balance, regardless of annual gifting limitations. Finally, the ability to move the loan among various lenders gives the opportunity to lock in longer-term rates if rates start to increase.

When it comes to premium financing, it's essential to continually watch and evaluate all the moving pieces. Additionally, when implementing such a transaction there needs to be a predefined way to exit if circumstances change dramatically. There always needs to be a way to unwind the transaction for the client.

Implications

Premium financing can be a very effective and worthwhile way to purchase large life insurance policies. However, when not done expertly, the approach can be disastrous for all involved. It's essential that the ultra-high-net-wroth client and his or her advisors clearly understand the nature of the transaction and all the potential complications.

These transactions, like all life insurance transactions, need to be monitored carefully and continuously. Changes in the client's life, his or her economic situation, and the performance of the life insurance policies will all impact the effectiveness of the transaction. By staying on top of the situation, potential missteps are regularly readily avoided. PW

Keith M. Bloomfield is president of the Forbes Family Trust multifamily office.

Frank W. Seneco is president of Seneco & Associates, an advanced planning and life insurance boutique.