PREMIUM FINANCING

Consider Premium Financing in Life Insurance Evaluations

Gift tax savings can result from having an irrevocable trust purchase life insurance with borrowed funds and making gifts to the trust that cover only the loan payments, rather than the full premiums on the insurance coverage.

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Clients are motivated by a wide variety of reasons to plan their estates. Some may wish to pass assets to family members in the most efficient way possible, while others seek to protect heirs by incorporating distribution limits and prudent distribution schedules. Still others may desire to pass on a legacy to future generations that will also benefit charities. One common element of these goals is the need for cash liquidity to accomplish the estate planning objectives.

Life insurance is a proven cost-efficient way of providing liquidity to an estate plan. When evaluating a client's insurance needs, estate planners should be familiar with the concepts of analyzing an existing policy and incorporating life insurance and premium financing into a newly designed estate plan.

At the death of the insured, life insurance provides cash to prevent a "fire sale" of family assets to pay estate taxes, or to make available cash to fund an endowment for charitable purposes. It is also used to provide an income stream to a surviving spouse or special-needs child. While owning life insurance can thus provide solutions, paying for the insurance coverage without incurring a gift tax could pose a problem.

The current estate tax laws place limits on gifts made by the grantor directly to heirs, or made to the grantor's irrevocable trust. These gifts can be used to purchase the necessary life insurance protection to assist in accomplishing the grantor's objectives. Any amount in excess of these limits may expose the grantor to a gift tax liability. [1] Annual premiums for life insurance can be quite large at older ages, and in many instances will exceed the annual gift tax exclusion amount and infringe on the lifetime exemption. Consequently, the life insurance protection is often reduced, or in some cases not acquired at all.

Reduce annual gift

To address this dilemma, some advisors suggest using a third-party bank to lend money directly to the irrevocable trust to purchase a life insurance policy. A premium financing strategy reduces the grantor's annual gift to the interest charge on the loan. This significantly reduces the annual gift needed to acquire life insurance. Further, because the loan is made directly to the irrevocable trust, the death benefit remains outside of the grantor's taxable estate. Although this strategy appears straightforward, it requires a full understanding of the many

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moving parts involved with a premium finance strategy. This understanding will guide the trustee through potential problems, such as the inability to manage debt, pay interest, and provide additional collateral.

A properly designed premium financing strategy needs to address these potential hurdles, and should be designed by a well-trained life insurance agent with experience in traditional premium financing. The framework of a typical premium financing strategy involves an irrevocable grantor trust, the grantor, and a life insurance policy. Once the amount of life insurance is established, the grantor creates an irrevocable trust to own the life insurance policy; this arrangement avoids the death benefit from being included in the grantor's taxable estate. [2] The trustee then completes the formal paperwork to underwrite the life insurance policy.

The life insurance agent works with the trustee to determine a qualified premium financing lending source that will provide a loan to pay the policy premium. The bank lends to the irrevocable trust an amount equal to the annual premium, and the cash surrender value of the financed policy is used as the primary source of collateral. The trustees pays the interest on the loan through gifts from the grantor. Depending on how the transaction is designed, the loan interest is either paid in advance, arrears, or accrued for a limited time. These loans are fully secured and non-amortized. In the event the loan is greater than the policy cash value, additional collateral is required from the trust or grantor. Collateral provided by the grantor is not considered a completed gift in the year it is posted. [3] If the loan defaults and the grantor's collateral is liquidated by the bank, however, such amount is considered a completed gift the year of liquidation and subject to the applicable tax. [4]

Enhance existing life insurance effectiveness

Premium financing can accomplish many objectives when the ownership of life insurance is important and can enhance the transfer of wealth to heirs when designed properly. As indicated earlier, one focus of this article involves an analysis of an existing life insurance policy. Let us determine the effectiveness of the original purchase, design, and strategy, and objectively uncover enhancements that may increase the life product's effectiveness and design that keeps within the grantor's objectives.

Hypothetical analysis of an existing strategy. On the advice of their advisor 15 years ago, Steven (age 50) and his wife, Sarah (age 49), established an irrevocable trust that gave the trustee a discretionary right to apply for and own a life insurance policy to address the couple's estate tax liquidity need. The objectives of this arrangement were two fold:

(1) To provide the necessary liquidity to address a future estate tax liability.
(2) To provide that liquidity without a current gift tax liability.

The irrevocable trust purchased a $10 million joint survivor universal life policy with a level death benefit. The annual premium was $59,000. At that time, the annual gift tax exclusion was $10,000. [5] With one child and two grandchildren, Steven and Sarah were able to make annual gifts of $60,000 to their irrevocable trust without being subject to a current gift tax liability, [6] and were comfortable continuing this annual gifting schedule. Thus, they contributed $60,000 to the trust each year, and the trust retained the $1,000 difference between the annual gift and the annual premium.

At the time of this analysis, the irrevocable trust had a cash balance of $15,450, resulting from the annual $1,000 investment over 15 years. Had the couple continued their current gift-giving schedule, the future account value within the irrevocable trust was projected to grow to $59,141 (net of income tax) at their current anticipated joint life expectancy of 22 years. [7] When added to the death benefit of $10 million at life expectancy, the future value of the trust would be $10,059,141, which should be sufficient to purchase assets from the taxable estate to accomplish their estate planning objectives. The reduced gift tax exclusion amount resulting from the first death was not originally considered. This reduction would subject the surviving spouse to a potential gift tax liability, which was an event they initially desired to avoid. (The gift tax exclusion for 2011 is $13,000, which would permit the surviving spouse to make an annual

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gift to the trust of $39,000—$13,000 × 3 beneficiaries—free of gift tax consequences.)

This contingent liability needs to be included in the current policy analysis. Furthermore, life insurance products have changed since the implementation of the original design. Additionally, trustees are becoming more aware of their responsibility and liability in managing assets for the future heirs. [8] A comprehensive life insurance review was in order. For the purpose of this analysis the annual gift of $60,000, the current policy cash surrender value of $1,012,951, and an assumed 3% after tax growth rate will be used to compare alternatives. Furthermore, all alternative policies for consideration are to be illustrated to remain in force until age 100.

Option #1— Section 1035 tax-free exchange. Various types of life insurance can used in connection with this option.

Joint survivor universal life. Over the 15 years since policy issue, the existing policy cash surrender value had grown to $1,012,951. Using their current ages, health class, and an available $1,012,951 of cash surrender value, the benefits of a Section 1035 tax-free exchange was explored. This would result in the purchase of a new joint survivor universal life policy of $10 million without realizing a taxable gain resulting from surrendering the existing policy. Furthermore, by directly transferring the cash surrender value from the existing policy into the new joint survivor universal life policy, the ongoing annual premium is reduced to $35,448. [9]

Steven and Sarah will continue to make annual gifts of $60,000 to their irrevocable trust, allowing for a greater annual cash investment of $24,552 within the irrevocable trust after the new life insurance premium is subtracted from the annual gift. At the couple's joint life expectancy age of 86 (or after 22 years), and assuming a 3% after-tax return, the future value of these additional investments after being added to the current trust value of $15,450 is projected to grow to $801,835, plus the death benefit of $10 million. The total projected asset value within the irrevocable trust is now $10,801,835, which represents an increase of $742,694 when compared to the results of the original design strategy.

Guaranteed joint survivor universal life. A second Section 1035 exchange consideration was to purchase a new guaranteed joint survivor universal life. After the cash surrender value from the existing policy is transferred to the new policy, the annual premium would be reduced to $41,244—netting an $18,756 remainder that is annually invested within the irrevocable trust. These additional investments, when added to the existing trust value of $15,450, would yield a future asset value of $619,534. With the addition of the death benefit, the total value within the irrevocable

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trust on the death of the survivor 22 years later will be $10,619,534.

In the event Steven and Sarah desired a policy that offered a guaranteed death benefit regardless of cash value performance, a guaranteed survivorship universal life policy is a consideration. However, in keeping true to the original gift tax objective, the reduced annual premium may still subject the surviving spouse to a gift tax liability when the first spouse dies, as a result of the reduced annual exclusion.

Joint survivor whole life. Should Steven and Sarah desire additional guarantees, a dividend-paying joint survivor whole life policy was also evaluated using the same Section 1035 strategy. Because the spouses were sensitive to not paying gift taxes and felt comfortable with continuing their annual gift to their irrevocable trust in the amount of $60,000, the joint survivor whole life policy did not fit within their objectives. Even though the cash surrender value of $1,012,951 was to be transferred to the new policy, the reduced annual premium of $136,850 exposed Steven and Sarah to a current gift tax liability and infringed on their lifetime exemption.

Option #2—premium financing. Now, let us revisit these options incorporating a traditional premium financing arrangement within the irrevocable trust. Although a Section 1035 exchange is often chosen by the trustee to avoid a possible income tax liability on gain in the event an existing policy is surrendered, is it really in the best interest of the trust beneficiaries? The tax on the policy surrender would be only a percentage of the whole, and the cash surrender value that is transferred into a new policy offsets the net at risk to the insurance carrier. This offset offers no additional death benefit to the trust, other than a reduced outlay.

An alternative consideration is to purchase a new $10 million joint survivor universal life policy and surrender the existing policy, investing the cash value net after income tax within the irrevocable trust. Then finance the premiums of the newly acquired policy. By surrendering the existing policy and collecting the $1,012,951 cash surrender value, the irrevocable trust will realize a taxable gain [10] of approximately $127,951, leaving a net after-tax value of $969,192 within the irrevocable trust. This money is retained by the irrevocable trust and invested at an assumed after-tax rate of 3%.

Because the premium schedule of a joint survivor universal life policy is flexible, and can be customized to work in concert with bank financing, the overall premium loan can be minimized. In this example, the annual debt interest is $34,523 [11] and is based on a customized premium schedule that finances an initial premium of $681,000 and required no additional annual premiums for 25 [12] years, which is three years past joint life expectancy. This initial funding maximizes the efficiency of the policy by using policy cash values to pay annual policy expenses and charges without requiring ongoing annual premiums.

Other than future interest rate movement, because of this initial funding, the loan balance remains level beyond the joint life expectancy. To enhance greater growth within the trust, the interest is paid by the trustee in arrears, allowing the full gift of $60,000 to be invested within the irrevocable trust in the first year of the transaction. Lastly, because the trust's assets have been increased by $969,192 from the net surrender value of the existing policy, when added to the existing $15,450 of trust asset value, future growth can be allocated to pay the annual loan interest including any anticipated increases in borrowing rates should they occur.

In the event the trustee believes future interest rate movement represents a liability that is greater than the gift tax exposure resulting from the death of either Steven or Sarah, a model that illustrates increasing borrowing rates should be performed. On the death of the surviving spouse, the outstanding premium finance loan balance is paid directly to the bank from the death benefit through a collateral assignment. To protect the integrity of the strategy, however, a special policy rider was initially purchased that returned all premiums paid or financed. This rider ensures that a net death benefit of $10 million is paid to the irrevocable trust for the benefit of the beneficiaries.

Summation. Over time, this second option may provide significantly more value to the heirs. Assuming a 3% after-tax growth rate within the irrevocable trust at the insured's anticipated joint mortality, the future value of the trust is projected to grow to $2,754,151, representing a significant increase in net value when compared to the first Section 1035 tax-free exchange option. When the death benefit is added, the total value of the irrevocable trust is now $12,754,151. (See Exhibit 1.)

Exhibit 1. Comparison of Alternative Insurance Arrangements

	Maintain Existing Strategy	Section 1035 Joint Survivor	Guaranteed Joint Survivor	Financed Joint Survivor
Annual gift	$60,000	$60,000	$60,000	$60,000
Death Benefit at LE*	10,000,000	10,000,000	10,000,000	10,000,000
Annual premium or debt interest	59,000	35,448	41,244	34,523
Initial trust value	15,450	15,450	15,450	15,450
Increase in trust value	0	0	0	969,192
Invested trust asset at LE*	59,141	801,835	619,534	2,754,151
Total	10,059,141	10,801,835	10,619,534	12,754,151

* Life expectancy--2001 CSO mortality table

Additionally, part of the analysis was to determine the gift tax ramification in the event either Sarah or Steven died at their individual life expectancy. Should this occur, the annual tax-free exclusion will be reduced by half, and gifts of premium or interest that exceed the current exclusion of

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$39,000 ($13,000 × 3 beneficiaries) may be subject to a current gift tax. Based on this hypothetical, but realistic occurrence, the annual premium of the Section 1035 joint survivorship universal life and the interest cost of the financed model do not subject the grantor to a gift tax liability should death occur and the tax-free exclusion is reduced. Although annual premium increases and interest rate upward movements are contingent on the economic environment, the additional capital within the irrevocable trust will serve as a safety net if cash flow increases do occur.

It is always a good practice to explore all alternatives, not just the obvious ones, when evaluating life insurance. Traditional premium financing, when designed correctly, may offer clients significant added value to their estate plan and should be included in any life insurance analysis. In this case, the projected value can grow to $10,059,141, or to a potential value of $12,754,151 without additional out-of-pocket outlay from Steven and Sarah. Understanding the variables and contingent liabilities related to each policy and funding method, incorporating a premium financing strategy, will allow the grantors to maximize their wealth transfer objectives while managing their gift tax exposure.

Integrating estate planning with premium financing

Creating a totally integrated estate plan using various tax strategies supports life insurance premium financing arrangements. When a life insurance policy is used as the vehicle to provide liquidity to an estate plan, a premium financing arrangement further discounts the hard costs associated with its purchase; it also allows greater leverage when using other estate planning strategies that transfer assets off the grantor's balance sheet. The use of grantor retained annuity trusts [13] and installment-sale arrangements are examples that create several benefits to enhance asset transfer, while at the same time provide the necessary funding of the arrangement itself. These strategies, when properly designed and executed, allow the high-net-worth clients to transfer assets off their balance sheet in a tax-efficient manner.

Because assets transferred into a grantor irrevocable trust [14] are no longer included in the grantor's taxable estate, they are no longer subject to estate tax. Furthermore, the transfer of assets that are marketable or provide some degree of cash flow to an irrevocable trust that owns a financed life insurance policy can provide funds to pay interest without requiring additional gifts from the grantor. Assets owned by the irrevocable grantor trust, in addition to the life insurance policy cash surrender value, represent a secure source of collateral for the lender's loan, thereby eliminating the need for the grantor to provide additional loan collateral. These assets may also serve as a loan exit strategy in the event the debt becomes unmanageable.

Asset transfer strategies that complement a life insurance premium financing arrangement include the following:

- GRATs.
- Installment sales.
- Part gift/part sale combination.
- Family limited partnership interests.

In fact, transfer or freezing technique can be designed to work in concert with a financed life insurance purchase to maximize the transfer of wealth both effectively and efficiently. The ultimate benefits of incorporating tax strategies into the premium financing arrangement are to provide funding necessary to satisfy the lender's interest payments, provide collateral for the loan, avoid gift tax issues in future years, provide loan exit strategies, and shift significant growth assets off the client's balance sheet. This requires insight and experience from both the estate planning professional and the life insurance professional.

Conclusion

Few financial instruments are more misunderstood by high-net-worth individuals and their advisors than life insurance and life insurance premium financing. As a result, a recommendation or analysis involving life insurance may not be as comprehensive as it should be. Besides selecting which specific life product is best suited for a particular client, how to purchase the policy should also be part of the analysis. A premium financing strategy offers benefits worth considering. It also provides additional design flexibility in the estate plan. In the event a premium financing strategy is not appropriate, the trustee always has the option to pay premiums in cash.

1

Sections 2505 and 2503(b)(1) .

2

Section 2042 .

3

Bradford, 34 TC 1059 (1960).

4

Sections 2505 and 2503(b)(1) .

5

Section 2503(b)(1) .

6

Crummey, *Crummey*, 22 AFTR2d 6023 , 397 F.2d 82 (CA-9, 1968).

7

The 2001 CSO Mortality Table.

8

Uniform Prudent Investor Act (IPIA)—expanded.

9

The premium is not guaranteed and is based on the policy's current cash value crediting rate and current mortality charges.

10

Section 72(c) .

11

Loan × (Base Index + loan spread) × 365/360.

12

Based on the NAIC carrier ledger assuming a 4.75% policy crediting rate.

13

Section 2702 .

14

Sections 671 through 679 .
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