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Premium Financing: The Last Choice—Not the First Choice

For decades, one of the most common expressions among life insurance professionals has been, "Clients do not object to owning life insurance; they simply object to paying for it." In a never-ending quest to satisfy clients' wishes, a growing number of life insurance agents have been working overtime to devise new strategies to propose to clients and their advisors in the sophisticated, high-income, high net worth marketplace—with or without the blessing of life insurance companies' sales, marketing, and compliance departments.

The following discussion explains what these advisors are attempting to accomplish and how they are doing it. We'll also comment on the positive and negative aspects of one version of a premium financing technique. Because new variations of the basic technique are constantly surfacing, our emphasis will be on showing you the "big picture" and pointing out some of the pitfalls and opportunities.

These techniques for financing premiums focus on minimizing gift taxes and allowing clients to use their cash flow and assets for purposes other than to support life insurance. All the premium financing variations presume that the grantor's guarantee of loans to an irrevocable life insurance trust (ILIT) does not cause inclusion of the policy proceeds in the grantor's estate for estate tax purposes. Professionals have drafted opinion letters addressing this important point.

Commentators have cited both Ltr. Rul. 9745019 and Ltr. Rul. 9809032 as standing for the proposition that the mere lending of money to an irrevocable life insurance trust for the purpose of paying premiums does not constitute an incident of ownership for federal estate tax purposes. We agree. A carefully drafted trust should protect against incidents of ownership and, therefore, prevent inclusion of the death proceeds in the estate.

Another question is whether the grantor's act of guaranteeing a loan to a trust is, in and of itself, a gift. In other words, should the contingent liability that the guarantee represents be counted as a gift? While there is little guidance on this point, some commentators take the position that the guarantee is not a gift. If other estate planners are uncomfortable with this approach or have conservative clients, then methods exist to measure the economic value of the guarantee for gift purposes (such as commercial surety bonds); however, that process is beyond the scope of our current analysis.

Assuming the commentators and opinion letters are correct, and that their conclusion can be expanded beyond the facts of the few private rulings, we are not as concerned about the mechanics as we are about the actual performance of the policies and the viability of the overall strategies.

Traditionally, the most common ways to reduce the amount of gifts when purchasing life insurance are (1) split-dollar techniques using U.S. 38 or P.S. 58 rates and (2) contingent or *Cristofani* beneficiaries. How much more leverage could clients obtain, though, if their ILITs borrowed money from a third-party lender to pay

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the U.S. 38 or P.S. 58 rates—or even the entire premium, for that matter—and then the clients calculated their gift to the trust as the amount of the interest payment due on the loan?

A variety of borrowing strategies

Some strategies involve the trustee borrowing an amount equal to the U.S. 38 or P.S. 58 costs from third-party lenders, while other strategies are based on taking loans from policy cash values. Obviously, there is some significant additional leverage—especially at older ages—when borrowing. But there is no "free lunch." Loans, whether from a third-party lender or from policy cash values, must eventually be repaid either from death proceeds or out of pocket. In any case, borrowing to pay these relatively minimal U.S. 38 or P.S. 58 costs is by far the least important issue that we will address.

The notion of a trust borrowing to pay premiums, or premiums plus interest, is the larger and perhaps more dangerous issue. In our opinion and that of the advisors we consulted, borrowing substantial sums of money can be an extreme solution, appropriate only in extreme situations. For example, a client may indicate that he can't or won't sell assets to pay premiums, won't pay capital gains, and *won't pay gift taxes.*

We believe borrowing strategies should be considered in exceptional cases, such as where annual premiums exceed $250,000 and the client's net worth surpasses $10 million. Nevertheless, we are concerned that smaller premiums will be financed in the future if advisors propose strategies (almost) too good to be true. In the case of smaller premiums, the usual gift minimization strategies—such as split-dollar and the use of *Cristofani* beneficiaries—accomplish the client's objectives with much less effort and risk.

With that in mind, we'll focus on borrowing techniques involving large amounts of money and the appropriateness of these strategies. We will also address the performance issues.

Example. Assume the clients are Husband and Wife, both age 60. Their net worth equals $80 million in illiquid assets (i.e., a large block of stock that the clients cannot or do not want to sell, real estate, and a closely held business). These clients need $40 million of life insurance, which will require an approximate annual premium of $600,000. They have two children and three grandchildren, and an

annual income of $750,000. This couple cannot afford to pay the annual premium from cash flow, and they don't have enough beneficiaries to avoid gift taxes through annual exclusions. In this example, purchasing life insurance and paying for it in the traditional way may be an untenable solution. These facts represent an extreme situation calling for potentially extreme solutions.

There are several ways to borrow money to pay premiums and, by doing so, minimize the size of the gift and eliminate the usual gift taxes. By implementing one of these strategies, we could help our clients preserve cash flow and protect their current investment opportunities. In other words, borrowing could enable the clients to purchase desperately needed estate liquidity without disturbing their other financial endeavors. In this sense, clients can have their cake and eat it too—acquiring life insurance without liquidating assets to pay for it.

One financing technique is simply to have the ILIT borrow the cost of the U.S. 38 or P.S. 58 rates from a third-party lender. The grantors of the trust can make a gift to the trust in an amount equal to the annual interest due on the loan. This is obviously a significantly smaller sum of money than the amount of the loan itself. This strategy assumes the grantors have enough personal cash flow to enter into a private split-dollar arrangement with the trust for the balance of the premium.

If the grantors do not have sufficient cash flow to fund the balance of the premium, a second technique is to have the trust borrow the entire premium from a third-party lender. The grantors can then make a gift of the amount of interest due on the loan and personally guarantee the loan with collateral. Finally, if the clients can't or don't want to pay the interest, the trust can borrow principal and interest from a third-party lender. In this last scenario, there are no gift taxes, no disruption of current cash flow, and no liquidation of current assets to pay premiums. Again, the loan must be personally guaranteed by the grantors, and their assets must be pledged as collateral.

Premium financing techniques are all about leverage and arbitrage. It is possible to buy more life insurance for the same net cash outlay when making a gift of the interest due on U.S. 38 or P.S. 58 costs, rather than giving the entire U.S. 38 or P.S. 58 costs. Furthermore, if one borrows at a nondeductible 8% and can invest at higher rates (at least 200 basis points (bps) more than the lending rate), one can come out ahead. Regarding the concept of arbitrage, clients and their advisors might legitimately question—especially in the current volatile marketplace—what would happen if borrowing rates were higher than investment rates of return. (For example, at this writing, the major stock market indices are in negative territory for the year 2000.) In the answer to that question lies a critical *caveat*.

Risks of borrowing

The more money borrowed, the greater the risks and the higher the costs. Obviously, the ultimate loan balance will have to be paid—either out of pocket during the insured's lifetime or from death proceeds. If the intent is to pay off the loan at death, more death benefit will have to be purchased to obtain the needed face amount after the loan is paid. A larger death benefit requires a higher premium, resulting in greater borrowing needs and higher charges.

For instance, a couple can purchase a non-financed, second-to-die policy with a $10 million death benefit for a $212,000 annual premium for ten years. If financing is used, a larger death benefit must be purchased in order to pay off the loan at death and still yield the same net $10 million death benefit. In this situation, assuming advanced cash payments of the annual interest on the loan, the required premium would be $261,000—hardly a free lunch.

There are at least two major risks. The first involves the terms of the loan and the credibility and ongoing profitability of the lender. Each year, the guarantors of the

loan have to prove creditworthiness. Additionally, each year the lender must be willing to lend money for another year—a questionable proposition if the loans are unfavorable or inadequately secured. At an assumed interest rate of LIBOR plus 150 to 250 basis points, lenders need to specialize in these kinds of loans or need huge volume to assure profitability. ("LIBOR" refers to the London Inter-Bank Offered Rate which can be found in daily newspapers such as *The Wall Street Journal*. It is the base interest rate used by lenders to lend between one another. LIBOR-linked loans allow you—for better or worse—to pay an interest rate closer to the real cost of money; and the LIBOR rate is set every three months. These rates tend to be cheaper during periods of low interest rates, but higher when rates go up.) If a lender failed to lend money for another year, as loan balances were increasing significantly, the results could be disastrous.

The second major risk relates to policy performance. If the declared investment rates of return or the interest crediting rates of the company are less than expected, the policy might not support the original plan. If mortality and expense assumptions are adjusted unfavorably to the client, the plan will not perform as expected. The borrowing needs would increase to pay the higher-than-anticipated expenses, more collateral would be required at possibly higher interest rates, and the entire plan could be jeopardized—becoming a collapsing house of cards. This is a worst-case scenario.

Two additional issues cause concern. First, variable universal life is often the product of choice, and advisors are assuming 10% to 12% "average" gross compounded returns. If advisors showed varied rates of return (reflecting up and down markets) or a "Monte Carlo" model, the results would not look as promising. Second, we are seeing too many homemade spreadsheets that appear to violate state laws governing illustrations and advertising. In some cases, insurance advisors are presenting strategies and policy values without the prior approval of insurers.

Checklist for practitioners

Here is a checklist for advisors:

- Borrow as little as possible.
- Keep the duration as short as possible.
- Always determine if policy illustrations are complete and in compliance with state laws.
- Prepare illustrations at different rates of return for both up markets and down markets.
- Look for detailed spreadsheets and verify the numbers.
- Consider worst-case scenarios and develop an exit strategy.
- Compare the proposed strategy with all viable alternatives.
- Make sure that the clients and all their advisors understand the strategy, the increased risks, and the potential cost increase.
- Consider a "disclosure" document that requires clients to approve all assumptions being used and to acknowledge an understanding of the risks.
- Constantly monitor policy performance.
- If there is a strong need for borrowing plus a thorough understanding of risk, proceed but with caution.

As the above discussion shows, the traditional approach for paying premiums is generally the best course of action if clients can afford to pay premiums and annual exclusions are available to avoid gift taxes. If clients think they can achieve a significantly higher return by investing their money rather than by paying insurance premiums, or if clients are unable to pay premiums due to limited cash flow or the nature of their assets, consider a premium financing technique. Remember that an exit strategy is essential and clients who borrow should be prepared—before they enter into a premium financing arrangement—to pay premiums if necessary or advisable later.

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