

# Bearing Out the Benefits

By financing premiums for life insurance in trusts, clients can move large sums out of their estate and pay nothing out-of-pocket. But are the requirements outrageous?

*Gregory Taggart*

**A** LOT OF ATTENTION IS being given to the concept of financing premiums for life insurance held in an irrevocable trust to benefit the heirs of wealthy individuals.

Life insurance trusts are a fairly standard wealth-transfer tool: premiums are paid by the trust, and the beneficiaries are left with a potentially enormous death benefit free of estate and gift taxes. Problem is, insurance professionals and other consultants say, to adequately fund the trust to cover premiums,

grantors may have to liquidate high-performing assets and confront substantial transfer taxes—both of which your wealthy clients would like to avoid.

Some investors manage to fund the premiums with their lifetime gift tax exemption and their annual exclusions. In 2004, these amounts are \$1 million and \$11,000 respectively. But those exclusions aren't always adequate for the needs of the extremely wealthy, who are often looking to move millions of dollars outside their estate without incurring transfer taxes. In addition, they're often reluctant to buy insurance with money that could be better invested elsewhere, says John McSwaney, an insurance professional in Stuart, Fla. "Premium financing is simply a better way for those people to utilize their money," he says.

To understand the potential advantages of financing insurance premiums, consider a wealthy couple, both age



75 with a 14.8-year joint life expectancy, who through a life insurance trust purchase a \$10 million last-to-die universal life policy with an annual premium of \$226,021. Assume they've used up their unified exemptions and already commit their annual exclusions each year to Christmas presents. In short, any gifts they make to the trust to pay premiums will be subject to a 48 percent tax. To make the \$226,021 gift to the

trust, the couple has to pay \$108,490 in gift taxes, meaning they must commit \$334,511 to pay the first year's premium. Depending on what assets the couple uses, explains Bill Gray, chief executive officer of Tax Track Systems, an insurance consulting firm in Minneapolis, they may also have to account for state and federal income tax or capital-gains tax. And that's before factoring in any opportunity cost. Assume the couple has been earning 8 percent annually on their investments and that any money they use to fund the premiums and pay taxes misses out on that opportunity. In the 15th year, or just beyond life expectancy, they will have sacrificed \$9,809,295 in assets and potential earnings in exchange for a \$10 million death benefit.

Peter Katt, a fee-only life insurance adviser in Kalamazoo, Mich., argues, however, that including gift taxes as part of that bleak picture overstates the case. "Paying gift taxes has about a 33 percent leverage over keeping the



some use variable life. Typically, the trust borrows money from a bank or other financial institution to fund premiums. To secure the loan, grantors are required to put up some cash, cash equivalents, marketable securities, or other liquid assets as collateral. According to Brody, a loan guarantee by the grantor on behalf of a life insurance trust would not create an incident of ownership issue that would result in the proceeds of an insurance policy in the trust being taxed in the grantor's estate. Lenders also ask for a security interest in the cash value of the life insurance policy. As cash value grows so that the policy makes up a greater portion of the collateral securing the loan, the lender may release all or part of any other collateral the

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asset in your estate" and paying estate taxes later, argues Katt. That may be true, but gift tax not paid is money you can invest elsewhere—\$108,490 a year at 8 percent over 15 years turns into a very big number. And though paying gift taxes might be cheaper than the estate tax, says Larry Brody, an estate-planning attorney with Bryan Cave in St. Louis, "the point of premium financing is that you may not have to pay either."

Nevertheless, before you advise clients to finance their life insurance premiums, make sure you understand the various arrangements available and the risks associated with each. Most, if not all, programs involve a performance-based policy, either whole or universal life, though

grantor put up. Once the loan is collateralized, the bank extends credit to the trust, which in turn writes a premium check to the insurance company. When the insured dies, the trust pays back the loan from the insurance proceeds, and the remainder is distributed among the beneficiaries.

To mitigate the risk that a policy won't perform as illustrated, Dean De Marco, a managing partner with Premium Funding Group in New York, which arranges premium-financing transactions, cautions advisers to perform their due diligence, making sure to check the insurance company and the policy's rate history, as well as its expense ratios and mortality experience. In any event, arbitrage, the difference between the interest rate on the loan and the

policy's crediting rate, "is an absolute nonissue," De Marco says. "The real issue is, do you understand that the risk inherent in this program is that you may have to put up more collateral?"

Essentially there are two ways to structure these deals: pay the interest every year or at some other regular interval, or accrue the interest over the life of the loan so nothing is paid out-of-pocket, a strategy also known as the zero-net-outlay or roll-up approach. Gray primarily advocates accruing the interest for the life of the loan because it is the only way to take advantage of what he sees as the primary benefits of premium financing—avoiding transfer tax and putting your own money to better use elsewhere. What's more, says Gray, "pretty soon the annual interest payment will exceed the premium payment you are trying to avoid." Worse, compound the interest payments with potential gift tax exposure and significant opportunity cost, and the client could experience what Gray calls "economic inversion" before he or she reaches life expectancy. "In other words," he explains, "the insured will have put more money into the policy than he'll get from the death benefit."

Consider again the wealthy couple, both age 75, with a 14.8-year joint life expectancy who, through a life insurance trust, buy a \$10 million last-to-die universal life policy. According to data provided by Tax Track Systems, using the pay-interest method, a premium of \$226,021 is necessary to buy a level death benefit of \$10 million. Assuming a fixed 5 percent annual loan rate, interest payments will start at \$11,301 and increase each year by that amount until, beginning in the 20th year, they equal

or exceed the annual premium (see “A Matter of Great Interest,” below).

But accruing premiums and interest for life can have even more disastrous results, says Julian Movsesian, president of Capital Management Strategies, or CMS, an insurance marketing firm in Newport Beach, Calif. “It doesn’t work, because you can’t assume that the [interest] rate will stay the same forever,” says Movsesian, who counsels his clients to either pay interest as they go or accrue it for periods not exceeding five years. Depending on the collateral and the size of the loan, lenders typically charge the one-year London Interbank Offered Rate (LIBOR) plus 150 to 200 basis points. During the past year, interest rates have ranged at or about historical lows. As of July 30, 2004, the one-year LIBOR stood at 2.43 percent. But three years ago, it was 3.82 percent, and in April 1990, it got as high as 7.08 percent. Over the past 29 years, the average LIBOR plus 150 basis points has been 8.5 percent. Unless you pay the interest at regular intervals, Movsesian’s reasoning goes, rising interest rates can make a big loan even bigger—fast. In other words, under the lifetime-accrual method, lenders will take a much larger bite out of the insurance policy’s

death proceeds than under the pay-interest method, leaving much less to the trust’s beneficiaries.

That’s true, says Gray. To protect against such a possibility, he suggests adding a rider to the policy that essentially adds the outstanding loan and accrued interest to the initial death benefit, ensuring that the loan will be repaid from the rider, leaving the death benefit intact. Of course, Gray says, such riders can also be added to policies financed with the pay-interest method. But however you structure the loan, “those sort of riders get expensive,” says Randy Zipse, senior vice president of advanced marketing at John Hancock in Boston. Even Gray acknowledges that the rider he uses can double the premium.

Returning to the hypothetical couple, if they funded their policy using the lifetime-accrual method, the annual premium, including the cost of the rider, would be \$375,000, again according to data provided by Tax Track Systems. Because the borrower accrues the interest, the loan balance after 15 years, just beyond life expectancy, will be nearly \$8.5 million, some \$5.5 million more than the loan balance under the pay-interest approach. But the policy rider will provide enough additional death benefit to offset the out-

## A MATTER OF GREAT INTEREST

**T**HE TABLES BELOW COMPARE TWO WAYS OF FINANCING LIFE INSURANCE POLICY PREMIUMS: THE PAY-INTEREST METHOD, WHEREBY LOAN INTEREST IS paid annually as it comes due, and the lifetime-accrual method, whereby interest is rolled into the loan and paid off through the death benefit. Assume in both cases that the insured is a couple, both 75 with a 14.8-year life expectancy, with a last-to-die universal life policy. For both illustrations, the loan interest is fixed at 5 percent, and the policy’s crediting rate, the underlying rate of growth attributed to its investment component, is 5.15 percent. The lifetime-accrual design includes a rider that guarantees the death benefit will rise incrementally to cover the outstanding loan and interest, and if all goes according to plan, still leave a death benefit of \$10 million for heirs. A similar rider could be included in a policy financed using the pay-interest method. In that case, the annual outlay would be higher. Dollar amounts were generated using software provided by American International Group.

<i>Pay-Interest Method</i>		LIFE INSURANCE POLICY				PREMIUM-FINANCING PLAN				TOTAL
		Annual premium	Cash value	Surrender value	Death benefit	Annual outlay	Annual loan	Annual interest	Cumulative loan balance	Net death benefit
age 76	year 1	\$226,021	\$137,623	\$0	\$10,000,000	\$11,301	\$226,021	\$11,301	\$226,021	\$9,773,979
	80	226,021	751,871	523,290	10,000,000	56,505	226,021	56,505	1,117,931	8,882,069
	85	226,021	1,737,017	1,574,471	10,000,000	113,011	226,021	113,011	2,146,235	7,853,765
	90	226,021	2,228,933	2,168,317	10,000,000	169,516	226,021	169,516	2,950,056	7,049,944
	95	226,021	2,195,371	2,195,371	10,000,000	226,021	226,021	226,021	3,326,860	6,673,140
<i>Lifetime-Accrual Method</i>										
age 76	year 1	375,000	354,168	354,168	10,393,750	0	375,000	18,750	393,750	10,000,000
	80	375,000	1,919,365	1,919,365	12,175,717	0	375,000	103,606	2,175,717	10,000,000
	85	375,000	4,081,051	4,081,051	14,952,545	0	375,000	235,835	4,952,545	10,000,000
	90	375,000	5,864,565	5,864,565	18,496,559	0	375,000	404,598	8,496,559	10,000,000
	95	375,000	6,577,405	6,577,405	23,019,719	0	375,000	619,987	13,019,719	10,000,000

SOURCE: Tax Track Systems

Lenders usually ask for a security interest in the cash value of a life insurance policy. As that cash value grows, the lender may release all or part of any other collateral the grantor put up.

standing loan. (Keep in mind that if such a rider is added to a policy financed with the pay-interest method, leaving the death benefit intact at \$10 million, that would require a higher premium, and therefore greater interest payments.)

Those calculations are based on a fixed loan interest rate of 5 percent. What if rates rise substantially? For starters, says Gray, today a client can lock into a 10-year fixed rate of 5.5 percent on a premium loan, mitigating rate risk somewhat. What's more, "If we woke up one day and found the loan renewing at 15 percent, we could take a policy loan of 90 percent of the cash value and use it to pay down the bank loan at a negligible to zero cost."

Perhaps, but there are also other drawbacks with lifetime-accrual loans. Few, if any, lenders will guarantee that they will lend on a lifetime-accrual basis. For example, Imperial A.I. Credit in Jersey City, the lender for all CMS loans, reserves the right to requalify the borrower before extending each year's premium payment. Further, according to Zipse, "the rate on accrual loans is typically 25 basis points higher than if you pay interest every year."

Some lenders will provide accrual loans with rolling 10-year terms, which will renew as long as the borrower continues to meet the bank's credit and collateral requirements. Mellon Financial offers rollovers with flexible terms, explains Kerry Pulaski, first vice president of Mellon Private Wealth Management in Pittsburgh. In return, Mellon, like other lenders, asks for a security interest in the cash value of the life insurance policy. To cover any shortage, the bank also requires that the client place some assets under management at Mellon. "If that's not possible, we will look at some sort of custody arrangement," Pulaski continues. "Even so, we have clients who buy down their loan rate by giving us more collateral than we require."

The bank will lend for any term from two years to 10, with either a variable rate—based on the prime rate or LIBOR—or a fixed rate determined by the size of the deal and assets under management. The larger the deal, the greater the collateral, and the lower the rate. "If they start with a variable rate, they can roll into a fixed rate somewhere down the road," Pulaski explains. Mellon's program is also flexible in terms of the amount borrowed each year. For instance, the trust could borrow the full premium one

year, and the next year the grantor could decide to use his annual exclusion or some of his unified exemption amount and borrow only a portion of the premium. "What we do is set the max, and you take it from there," says Pulaski.

Mellon is not the only alternative for accrual financing, according to Gray. He often uses KeyBank in Cleveland, among other lenders, all of which are among the 10 largest banks in the world. Gray says the lenders he works with are aware of grantors' need to borrow until death. "And if the loan is adequately collateralized, they will keep it out until Gabriel's trumpet blows," he says.

Other lenders providing premium financing are Wells Fargo in San Francisco and First Hawaiian Bank in Honolulu, according to Zipse, who says that many of John Hancock's clients use their own banks.

One final caveat concerning the accrual method of financing: A client may have trouble qualifying for enough life insurance to pay off the accrued-interest loan, says Zipse. In addition to looking at whether they can justify the initial death benefit, life insurance carriers also look at the net amount at risk over the insured's life, because the longer an insured lives, the larger the death benefit becomes. Zipse recalls an illustration he once saw on a 70-year-old man for \$9 million of insurance. The policy was structured so that it grew each year just enough to cover the loan and interest accrual. At age 100, the policy had grown to over \$100 million. "Well, there was no way this guy was going to qualify" for that amount of insurance, Zipse continues.

What's more, says McSwaney, because the reinsurance market has tightened up since the terrorist attacks of September 11, 2001, an insured looking for a policy with jumbo limits—\$65 million, for example—must go to more than one carrier (see "Larger Than Life," July/August). Illustrating \$150 million net amount at risk may be easy enough, says McSwaney, but "the process for getting it is complicated and takes quite a while; it's not something that's going to be done by any agent on the street overnight."

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