The Wealth Design Center, LLC

Tax Reform Act Creates More Potential For Premium Financing

The gift tax provisions of the "Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010" (hereinafter "TRA 2010"or the "Act") could have a positive impact in life insurance premium financing in 2011 and 2012. Because the Act expires on December 31, 2012 and because the premium financing process can be time consuming, suitable clients should be alerted to the opportunities in the Act quickly. This article discusses several ways in which the Act's gift tax provisions make premium financing arrangements more attractive.

What Is Premium Financing?

Premium financing is a wealth transfer/estate liquidity strategy that has the potential to help wealthy people meet their estate liquidity objectives and transfer more wealth to their children and grandchildren. Few people are wealthy enough to be prospects for premium financing. See Table A for a profile of a suitable premium financing client. In a suitable premium financing arrangement, a wealthy person creates an irrevocable life insurance trust (ILIT) which purchases a large life insurance policy insuring his/her life. The ILIT trustee borrows money to pay the policy premiums from a commercial lender. The policy is collaterally assigned to the lender as security for repayment of the loan.

As part of the lending arrangement, the insured may be required to pledge additional collateral that is acceptable to the lender to fully secure the loan. If the loan is still outstanding at the insured's death, the death benefit proceeds repay the outstanding loan balance and the remaining death benefits are distributed to the trust's beneficiaries according to the terms of the trust.

Why Do Wealthy People Use Premium Financing?

Most suitable premium financing prospects have enough assets to pay their own premiums. Why do they choose to borrow the premium dollars from a commercial entity if they can afford to pay them themselves?

There are a number of good reasons why some wealthy people decide to use outside funds to pay their life insurance premiums, including:

1. They may be "asset-rich" but "cash-poor;" that is, their assets may be tied up in a variety of fixed or illiquid investments and cannot be easily converted into cash.
2. Converting assets into cash may trigger a variety of taxes, costs and fees such as: capital gains taxes, management fees and sales commissions. The extra costs, taxes and complexity of selling assets to create cash for premium dollars can make premium financing easier and more efficient than personally paying the premiums.
3. They may wish to save their cash and liquid assets for other purposes or to keep them available to deal with possible future crises and financial emergencies.

4. They may like the idea of using "other people's money" to pay their life insurance premiums which allows them to keep control of their assets rather than spend them and lose any of their growth or earning potential.
5. In today's low interest rate environment, borrowing premium dollars may be inexpensive relative to other available options.
6. Until TRA 2010, gifting limits may not have been high enough to allow direct gifting to be an effective alternative option for paying policy premiums.
7. Commercial loans generally do not create a gift by the client to their trust; consequently considerable gift tax savings may potentially be realized.

Favorable New Gift Tax Rules for 2011 and 2012

TRA 2010 significantly expands the tax-free gifting limits in 2011 and 2012. Effective January 1, 2011, the Act increases the lifetime gift tax exemption from $1,000,000 to $5,000,000 per donor for two calendar years. The generation skipping transfer (GST) tax exemption limit also increased from $1,000,000 to $5,000,000. Gifts and GST transfers exceeding these limits are potentially subject to gift and GST taxes at a maximum rate of only 35%. The increases in these limits have the potential to make premium financing arrangements much more flexible through 2012.

The expansion of the gift and GST limits offers wealthy individuals and married couples a wonderful opportunity to efficiently transfer more of their wealth to their children and grandchildren by making lifetime gifts before January 1, 2013. Individuals have an increase of $4,000,000 in gifting capacity over what they could give in previous years. Married couples have an increased gifting capacity of $8,000,000. Individuals who haven't yet used any of their lifetime gift tax exemption could give up to $5,000,000 while married couples could give away up to $10,000,000 if neither spouse has previously used any of his/her lifetime gifting exemption.

Life Insurance Sales Opportunities For Wealthy Clients

Parents and grandparents who are in good health and who can afford to make lifetime gifts have been given what may be a once-in-a-lifetime opportunity over the next two years. The increase in both the gift tax and GST exemptions to $5,000,000 creates unique potential to pass on large amounts of wealth to younger generations. Gifts to generation skipping transfer (GST) trusts have the potential to accumulate and distribute family wealth outside the federal transfer tax system for several generations (the exact length of time depends on a variety of factors, including state law). When life insurance is used as a trust asset, it may be possible to leverage those gifts into additional wealth for the trust beneficiaries.

New Premium Financing Arrangements

New premium financing arrangements could be quite attractive to wealthy individuals and families. The ability to combine their expanded gifting and GST exemptions with funds their ILIT trustees may borrow from commercial lenders could significantly increase the amount of wealth they could potential transfer outside the transfer tax system. At the same time, their premium financing arrangements could possibly be more flexible and efficient.

A hypothetical case may help make this clear. Let's assume James Smith (age 65) needs $15,000,000 of life insurance coverage to meet his estate liquidity needs. He has never used any of

his gift tax lifetime exemptions. He wants to establish a premium financing arrangement to cover the $900,000 annual premium cost. He creates an ILIT to own the life insurance policy.

These are some of the flexible design alternatives potentially available to him:

- Gift $1,000,000 in cash to the trust in 2011 so the trustee has funds to pay the annual interest due on the outstanding loan balance.
- Gift $3,000,000 in additional cash to the trust in 2011 to reduce the total amount of premiums that need to be borrowed and the amount of required outside collateral he will have to put up to finalize the loan.
- Gift an additional $2,000,000 to the trust in 2012 which the trustee may use to pay down the outstanding loan balance; this may also reduce or eliminate the need for outside collateral.
- Gift $1,000,000 in income-producing property to the trust in 2011; the trustee may use the income to pay interest and/or possibly pay off part of the outstanding loan balance.
- In either 2011 or 2012 create a 10 year Grantor Retained Annuity Trust (GRAT) funded with $10,000,000 in assets; the ILIT would be the remainder beneficiary of the GRAT; after 10 years the GRAT would end and the ILIT would receive the GRAT's remaining assets which the trustee could use to pay down or pay off the outstanding loan balance. If the Section 7520 rate is 2.4%, the gift tax value of a 10 year, $10,000,000 GRAT paying out 5% annually to the grantor is $4,483,000.

Existing Premium Financing Arrangements

TRA 2010's increased gifting limits give new flexibility to premium financing arrangements already in place. Wealthy clients have new potential opportunities to change or enhance premium financing arrangements they implemented years ago. To envision some of the possibilities, let's assume that James Smith's financing arrangement for his $15,000,000 policy was put in place five years ago and that the current loan balance is $4,500,000.

These are some of the new options he has for managing the arrangement:

- Gift $4,500,000 in cash to the trust in 2011 so the trustee can retire the outstanding loan balance.
- Gift $1,000,000 in cash to the trust in 2011 so the trustee has funds to pay the annual loan interest.
- Gift $2,000,000 in cash to the trust in either 2011 or 2012 so the trustee can pay back part of the loan balance (with a possible reduction in the amount of required outside collateral); the trustee may also retain part of the gift to pay annual interest costs on the reduced loan balance.
- Gift $1,000,000 in income-producing property in 2011 to the trust; the trustee may use the income to pay interest on the outstanding loan balance.
- In either 2011 or 2012 make a "discounted" gift using a 10 year GRAT funded with $10,000,000 in assets; the ILIT would be the remainder beneficiary of the GRAT; after

10 years the GRAT would end, the ILIT would receive the GRAT's remaining assets which the trustee could potentially use to pay down or pay off the outstanding loan balance. If the Section 7520 rate is 2.4%, the gift tax value of a 10 year, $10,000,000 GRAT paying out 5% annually to the grantor is $4,483,000.

Premium financing arrangements can be complex and involve a number of risks. The Act's expanded gifting limits appear to create life insurance funding alternatives outside of premium financing. Because gifts in 2011 and 2012 have a much higher exemption limit, it is possible some clients may decide to bypass the complexity and risks of premium financing altogether.

Three available premium financing alternatives include:

1. **Make Large Cash Gifts Directly to the ILIT**
   In James Smith's case, over the next two years he could give up to $5,000,000 directly to his ILIT (assuming no prior use of his lifetime gifting exemption). The trustee could use these funds to pay policy premiums. If James is married, his spouse could agree to "split gift" with him and allow the use of part or all of her $5,000,000 lifetime exemption to be applied to the gift. Thus, together they have the ability to supply the ILIT with up to $10,000,000 gift tax-free to pay premiums.

2. **Create A Private Loan Arrangement.**
   Instead of making large gifts to the ILIT, James could decide to lend the trustee the premium dollars himself. These transactions are known as Private Loan Arrangements. The trustee and grantor enter into an arm's length loan agreement using reasonable terms and setting a fair market interest rate. James lends the trustee the premiums under the loan arrangement's terms. In addition to lending the trust the premium dollars, James could make a lump sum cash gift to the trust so the trustee has funds to pay him interest on the outstanding loan.

3. **Use A Gift/Private Loan Combination.**
   James could also decide to use both gifting and Private Loans together in an integrated strategy. This combination approach could be useful if James' remaining gifting exemption is not large enough to cover the needed premium dollars or if he wants to have the option of getting back some of his premium dollars if his financial circumstances change, the tax law changes or he becomes dissatisfied with the life insurance policy. An example of this combination strategy would be for James to gift the trust $5,000,000 in 2011 and lend it $1,000,000 per year annually each of the next five years.

Conclusion

The two year expanded gifting window created by TRA 2010 continues the uncertainty surrounding wealth transfer planning. The Act's provisions are temporary and expire at the end of 2012. Clients who can benefit from life insurance policies with large death benefits often borrow the dollars needed to pay premiums from commercial lenders in premium financing arrangements. The Act's expanded lifetime gifting limits appear to create short term opportunities for premium financing clients to make their arrangements more flexible and potentially more efficient. The expanded

gifting limits may allow them to reduce the amount their trusts have to borrow to pay premiums and give their trusts cash to pay interest on outstanding loans. The expanded gifting limits may also give them the opportunity to avoid premium financing arrangements altogether. This appears to be a great time to talk to suitable clients and their tax and legal advisors about their new options in premium financing arrangements.

Profile of a Premium Financing Prospect

Premium Financing is not for everyone; it is a complex transaction which carries a variety of risks. A suitable premium financing prospect should meet these criteria:

- Has a need for life insurance death protection
- Has a net worth in excess of $5,000,000
- Has liquid assets to pledge as security for the premium loans
- Meets company underwriting guidelines
- Satisfies the lender's minimum requirements
- Has access to knowledgeable tax and legal advisors.