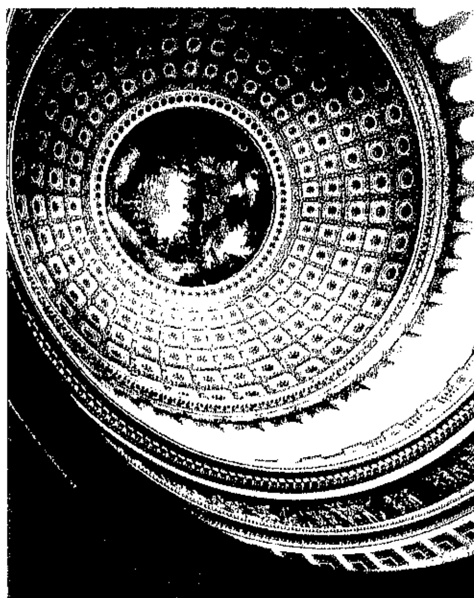
Protecting an Estate With Leveraged Life Insurance

Funding life insurance with borrowed capital may enhance the wealth transfer strategies of affluent individuals and their families.

Life insurance can be an essential estate planning tool for wealthy individuals and their families. In fact, for wealth holders who lack liquidity—for example those whose wealth is tied up in real estate, tax-deferred retirement plans or closely held companies—the life insurance death benefit is a proven way to generate the cash flow necessary to cover future estate tax obligations upon the death of the insured. Unfortunately, large life insurance policies typically require large premiums, especially if the insured individual is elderly or has pre-existing medical conditions.



To complicate matters, most estate planners advise individuals not to hold life insurance policies in their name directly, regardless of who is named as the beneficiary under the policy. For example, a policy owned by an individual (who is also the insured) will be included in the individual's estate for estate tax calculations, even if his or her children are named as beneficiaries under the policy. To ensure that the death benefit escapes estate taxes, policies are instead usually held in an irrevocable life insurance trust (ILIT). Therein lies the core estate planning challenge: If the trust owns the policy, technically it is the trustee of the trust that must pay the substantial policy premiums on an ongoing basis. The insured can make gifts to the trust to cover the premiums. However, the insured should be cautious about the annual and lifetime gift exemptions under current federal law, which may

not permit donors to transfer enough assets tax-free to cover the steep premiums.

One increasingly popular solution to this planning dilemma is the use of premium financing to fund the life insurance policy. With this strategy, the trustee of the ILIT borrows money to help pay the premiums. One large initial loan may provide the funds to support the policy, or a series of loans can cover the annual premiums. Either way, the loan is not a gift to the trust, so it will not create a gift tax obligation. The loans are typically collateralized with the life insurance policy, and, in many cases, other assets owned by the insured.[1] Another option is to make annual gifts to the ILIT to take advantage of the annual gift tax exclusion while using borrowed funds to cover the remainder of the premium payments. "The problems associated with gifting assets to an ILIT are a primary reason to consider leveraged life insurance," says Howard Ehrlich, Director of Life Insurance at UBS Financial Services Inc.

As with any strategy involving leverage, there are risks. Before deciding whether a life insurance policy should be financed with a loan, it is essential to evaluate how a policy may fit within the context of a holistic estate plan, as well as to weigh the benefits and risk considerations.

Generating Liquidity With Life Insurance

Wealthy individuals and families use life insurance for a variety of reasons. One particular benefit of life insurance is the enhanced liquidity (via the payment of the death benefit) it provides—an important consideration when assets pass from one generation to the next and an estate tax bill is due. If an individual's assets are illiquid, it may be necessary to sell them at inconvenient times, under unfavorable terms or even to prematurely distribute assets from tax-deferred retirement accounts to raise cash. Life insurance proceeds may prevent premature, unfavorable or otherwise untimely sales or withdrawals of assets by heirs and offer an efficient estate-tax solution.

Estate liquidity is especially important given current uncertainties regarding the estate tax. In 2005, federal estate law dictates estate assets over $1.5 million be taxed at a top rate of 47 percent.[2] Even if the federal estate tax is repealed, state death taxes are on the rise. Moreover, any legislation that repeals or alleviates the burden of federal estate tax may increase capital gains taxes on inherited assets that are sold. That is the case under current law: When the federal estate tax briefly disappears in 2010, a tax on the sale of inherited appreciated assets appears.[3]

There may be other needs for liquidity as well. For example, a father who wants to leave a family business to his daughter might need cash to bequeath to his sons to equalize the value of each child's inheritance.

Illustrating the Value of Life Insurance

A fictional case study helps illustrate the role that life insurance can play in a comprehensive wealth transfer strategy—and the crucial role that leverage plays when premium outlays are steep. Consider the case of a widow who dies in 2005. Her estate consists largely of two residences (together valued at $3 million), an IRA ($2 million) and interests in a family business ($5 million). Federal and state taxes of more than $4 million are due within nine months of her death.[4] How will her children, who inherit the assets and are the beneficiaries under the IRA, raise money to cover the tax? Even if the children were willing to sell their mother's homes, there still would not be enough liquidity. Meanwhile,

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1 Collateralizing a loan contains risk. Upon request, your Financial Advisor can provide you with a brochure entitled "Risk Associated With Securities Based Lending," which explains some of those risks.

2 "New Estate Tax Changes Will Confuse Business Owners" by Paul N. Gada, CCH Tax and Accounting (http://www.toolkit.cch.com/columns/taxes/01-213taxcutestate.asp)

3 Ibid.

4 "Estate Tax Questions," Internal Revenue Service (http://www.irs.gov/businesses/small/article/0,,id=108143,00.html)

tapping the IRA would trigger income tax that could have been deferred for decades. Selling shares in the family business is neither desirable for the heirs nor practical.

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There are, unfortunately, few appealing choices. If this dilemma had been anticipated, however, the widow in our example could have purchased a $4 million life insurance policy. Upon her death, the widow's beneficiaries would have received $4 million in cash to pay the estate tax bill, and the entire estate—the homes, the IRA, and the family business—all could have remained intact.

In this example, the decision about where to hold the policy is just as crucial as the decision to buy it in the first place. If the widow had died with a $4 million insurance policy in her estate, the death benefit would have been subject to estate tax. That means her $10 million estate would instead have been worth $14 million, and the tax bill would have increased to about $6 million. In other words, the $4 million life insurance proceeds would have helped the heirs, but there would still have been a cash shortfall: The widow would have paid for a $4 million life insurance policy but still has a $2 million shortfall to cover the increased estate tax bill due to improper planning.

There is a strategy to address this difficulty: The insurance policy could have been held outside of the widow's estate. Specifically, many estate planners would recommend that an irrevocable life insurance trust (ILIT) be created to own the policy[5] (if one of the widow's children had owned the policy instead, there could have been serious complications if that child had predeceased her mother). With an ILIT, the trust would collect the $4 million upon the widow's death without owing any estate tax, provided proper procedures have been followed. Then, the trust could either buy assets from, or lend money to, the estate, ensuring necessary liquidity. Typically children are the beneficiaries of an ILIT, an arrangement that satisfies tax obligations while allowing heirs to maintain control of assets that are left to them.

Leveraged Life Insurance in Action

Let's recast slightly the example of our widow to explore the utility of leveraged life insurance. Assume that the widow is in her 70s and reasonably healthy. The premiums on a $4 million insurance policy might total $120,000 or more per year. Any money provided to the trust to pay premiums would be considered a gift to the beneficiaries of the trust. If the widow has named her two children as beneficiaries of her ILIT, sophisticated planning would allow her to give $22,000 gift tax-free ($11,000 to each of the two beneficiaries) to the ILIT in 2005, using the annual gift tax exclusion. In future years, that allowance will gradually increase to $24,000, $26,000, and so on.

Still, the annual gift tax exclusion doesn't permit a large enough sum to be transferred gift tax-free to the ILIT to cover $120,000 or more in annual premiums on the insurance policy. Not only must the widow find the cash to pay these premiums; she would also use up her $1 million gift tax

[5] "Irrevocable Trusts and Life Insurance: They Stand the Tests of Time" by Richard W. Duff, *Journal of Financial Planning* (http://www.fpanet.org/journal/articles/1999_Issues/jfp0499-art6.cfm)

exemption, if it's still available, and subsequently pay gift tax for doing so. Furthermore, if she has to liquidate appreciated assets to help pay the premiums, capital gains taxes may also be due. Larger estates requiring more life insurance coverage may have to pay much greater premiums, triggering even steeper gift and capital gains tax obligations.

Entering leveraged life insurance strategies provides a variety of options for meeting annual premium obligations in situations such as this. "Two potential strategies for leveraging life insurance have emerged," notes Ehrlich. "They are known as premium financing and private financing." With premium financing, Ehrlich explains, funds for premiums are borrowed from a third-party lender; for private financing, funds are borrowed from an insured individual or related party.

It's important to understand the nature of these strategies. "The purpose of such transactions is not to receive 'free life insurance,'" says Ehrlich. Specifically, real debt will be incurred and the repayment of that debt—typically upon the death of the insured—will reduce the life insurance proceeds payable to the beneficiary. In addition, the interest payment on the debt can be significant in a rising interest environment, and must be satisfied upon due. As a result, leveraged life insurance should be viewed as a potential financial arrangement, similar to using borrowed funds for the purchase of real estate or the expansion of a business. The expenses can be significant, but the projected benefits may justify the costs.

Two Ways to Leverage Life Insurance

Each of the two methods for leveraging life insurance offers specific advantages as well as potential drawbacks.

Premium financing: With premium financing, the loan is most likely secured by the insurance policy itself, and, in many situations, by the insured individual's other assets as required by a third-party commercial lender. Premium financing typically involves life insurance that contains a cash value. "In these arrangements, premiums are usually large enough so that the policies are overfunded," says Ehrlich. "This will help the cash value grow to the point that it is large enough to help pay off the loan, and other collateral may no longer be necessary." Before that time, lenders' requirements regarding other collateral may vary. Ideally, trustees should choose a lender that permits financial assets being held as collateral to be bought or sold, if necessary, to comply with the insured's overall investment planning.

As for the third party commercial lender's loan terms, premium financing arrangements often call for variable interest rates that use a spread on top of the LIBOR (London InterBank Offered Rate). Interest (which is not tax deductible) on the loan should be paid regularly to prevent accruals from swelling the loan balance. If the insured dies, the death benefit, which would include a rider to pay the stated death benefit plus the amount of premiums paid, would be used to pay off the loan.

Private financing: A variation on premium financing is known as private financing, which allows the insured or a relative to make a loan directly to a defective grantor trust, assuming sufficient cash is available. A defective grantor trust is different from a typical irrevocable trust in that income generated from the trust would be taxed to the grantor. However, at death, the assets in the trust would not be included in the grantor's estate for estate tax purposes. Otherwise, the loan may be made by a corporation, partnership, limited liability

company (LLC) or another entity controlled by the insured individual.

With private financing, loan interest is paid to the person or entity making the loan. For intra-family loans, potential tax problems may be avoided by setting the interest at the applicable federal rate (AFR), published monthly by the Treasury Department. Ultimately, the process is similar to that of premium financing—at the death of the insured individual(s), the loan will be repaid from the insured's liquid assets or from the life insurance proceeds, and the remaining death benefits can be used to help ensure estate liquidity.

One particular benefit of life insurance is the enhanced liquidity (via the payment of the death benefit) it provides—an important consideration when assets pass from one generation to the next and an estate tax bill is due.

Weighing the Risks

If you are considering using leverage to purchase life insurance, how can you evaluate which technique is most appropriate for your circumstances? There are some general rules that can help guide the decision.

Premium financing is the only option if there is no person or controlled entity capable of making the necessary loans. This is frequently the case: Wealthy individuals who are most interested in leveraged life insurance are usually those with illiquid assets, so there may not be a source of readily accessible cash. "If there is cash available, private financing may be preferred," affirms Ehrlich. With this method, there is no loan approval process and no required collateral deposits to secure the loan.

If private financing is possible, some of the risks associated with premium financing can be reduced, including the following:

- **Lender risk.** With private financing, there may be less risk that a loan will be called prematurely, and may have less risk that the lender will decide against loan renewal. On the other hand, "with premium financing, you need an exit strategy in case, midway through the arrangement, the lender decides it no longer wants to hold the loan," says Ehrlich. Furthermore, with private financing all interest is paid to a related party, so these sums—which can be substantial—are kept within the family or related parties.

- **Interest-rate risk.** Because a related party is the lender and interest rates are usually set at the AFR for the term of the loan, private financing minimizes the risk of adverse interest-rate movements. With premium financing, however, rising interest rates pose a very real risk since they might reduce the ultimate payoff or jeopardize the entire strategy. If the adjustable rate spikes sharply, the insured individual may also need to provide additional collateral.

There are certain risks that cannot be avoided whether premium or private financing is used. These include:

- **Tax risks.** If the transaction is structured improperly, there may be adverse estate, gift, and income tax consequences. Because intra-family interest payments may be subject to estate and income tax, private financing might present even more challenging tax issues than premium financing. Loans must be formalized, and the formalities must be observed so that the transaction can't be recast as a taxable gift, for example.

- **Insurance company risk.** As with any other insurance transaction, it is vital to purchase the policy from a highly rated insurance company likely to be solvent at the death of the insured individual.

Big Picture Considerations

For either type of leveraged life insurance, affluent individuals should ensure that this strategy is appropriate for their particular financial needs. [UBS Financial Services Inc. recommends that only individuals over age 60, with at least $5 million in liquid assets (or $10 million in total assets) should consider premium financing, and similar standards may be applied to private financing.]

Generally, variable life insurance policies are not considered suitable for leveraged purchases because of the uncertainty of cash value accumulation.[6] Thus, premium and private financing arrangements usually involve whole life or universal life insurance. When purchasing either whole life or universal life policies, individuals may want to consider a "return of premium" rider for extra premiums. That is, extra insurance premiums are paid in order to increase the death benefit by an amount sufficient to help repay the loan.

Regardless of whether a return-of-premium rider is purchased, these strategies generally are structured to have premiums to be paid for a fixed amount of time (although in many cases this cannot be guaranteed), perhaps nine or ten years. Going forward, the cash value in the policy is expected to be sufficient for keeping the coverage in force. Of course, circumstances change and financial plans may require recalibrating. Nevertheless, for estate plans that call for ample amounts of liquidity, life insurance may be the answer—and borrowing to obtain the appropriate amount of coverage may be the crucial factor that makes the broader wealth transfer strategy viable.

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[6] "Insurance: An Analysis of Premium Financing" by Peter C. Katty, *Journal of Financial Planning* (http://www.fpanet.org/journal/articles/2004_Issues/jfp0704-art4.cfm)

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