Leveraging Succession Capital

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Having been in the Wealth Management business for over 25 years I have come to appreciate how vital life insurance can be in developing an estate plan for high and ultra-high net worth individuals. A common use, of course, is to fund estate tax liquidity requirements. However, life insurance has other practical applications. Many business owners use it to fund buy/sell agreements and/or for key man purposes.

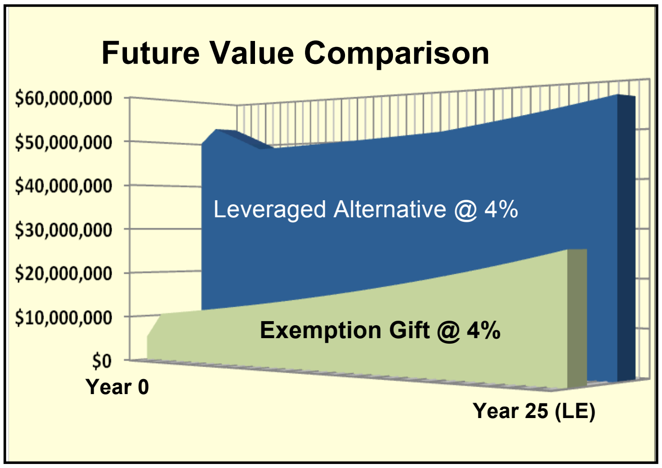
While there is frequently a necessity and economic justification for life insurance, it is not surprising that many individuals do not purchase it. The writing of annual premium checks for several hundred thousand dollars is unappealing to many. Even those who have the required cash flow or readily marketable investments often want to hold on to these assets for other purposes. Other families of wealth might have most of their assets in relatively illiquid investments, such as their business or real estate, and are not in a position to write large premium checks on an annual basis.

Life insurance should be considered when there is a need for it. And, like most things, should only be purchased by those who can afford it. Once these criteria have been met, there are several options to pursue. The one that is the focus of this article is **life insurance premium finance**. With this innovative technique the individual, trust or limited liability company that becomes the owner of a policy borrows money from banks or other financial organizations to fund annual premiums. Thus, the unpleasant requirement of writing large checks each year to an insurer is eliminated.

2010 Tax Relief Act – It's time to take action

Let us take a look at a couple for which we recently arranged a **$37** million policy. I will refer to them as Mr. and Mrs. Smith. The Smiths were advised by their tax counsel to establish a $10 million trust to reduce their taxable estate. Their four grandchildren were named beneficiaries of the trust. Under present law, Mr. Smith and Mrs. Smith could each gift $5 million to a trust without incurring gift tax. This rule is likely to change at the end of this year and could revert to the former $1 million gift exemption when the current tax law expires.

As a practical matter, Mr. and Mrs. Smith had three choices for the $10 million they decided to place in an irrevocable life insurance trust for the benefit of their grandchildren. First, they could have invested the funds in a conservative stock and bond portfolio with an anticipated annual return of 4%. A second option would have been to use the $10 million to, over time, purchase a life insurance policy for the benefit of their grandchildren. A third alternative was to elect, in effect, both the first and second options. That would allow the Smiths to build a $10 million investment portfolio of stocks and bonds **and** purchase a large amount of life insurance.



The Smiths, who were in their early 60s and in good health, had a joint life expectancy of 25 years. Assuming that they died at that time, the projected results of the three options would vary significantly. If they had selected the first option, where the $10 million was placed in a balanced portfolio yielding 4%, the $10 million would have grown to **$26.1** million. The results of the second option i.e. the purchase of only life insurance is more difficult to calculate, since it would depend upon the timing of the funding of the policy and other factors.[2] The third option, which was ultimately chosen, was to establish the $10 million stock and bond portfolio yielding 4% **and** borrow $10 million to purchase life insurance. This combined arrangement was projected to result in **$56.3** million going to the grandchildren. By selecting this option, the Smiths truly leveraged their succession capital.

Premium Financing and the use of Leverage

There are several reasons why a bank would lend $10 million to purchase life insurance. First, the Smiths are wealthy with a strong balance sheet. Second, the policy and its cash value would be pledged to the bank in consideration for the loan. Third, to the extent the cash value of the policy was less than the loan, the Smiths would be asked to pledge to the lender a securities account they might have at their investment management firm.

In many cases, including the one cited here, the cash value of the policy is high even in its early years. This is accomplished while avoiding possible Modified Endowment Contract issues. Commissions and other expenses are taken from the transaction over time and not up-front as is typical with most life insurance policies. Collateral to secure the loan beyond the assignment of the policy to the lender is often minimal and temporary.

Upon the deaths of the Smiths, which are actuarially projected to be in 25 years, the policy will pay a **net** benefit of **$37** million to the grandchildren. The beneficiaries will also receive the net proceeds of the $10 million stock and bond portfolio that was projected to grow at 4%. As previously stated, that amount is $26.1 million. Since the lender needs to be repaid its principal before paying the beneficiaries of the policy, the total gross amount of the policy is actually larger than $37 million. In this case, and by design, the death benefit initially was **$45** million and reduced to $37 million to ensure favorable tax treatment of the policy. Annual loan interest was paid each year by the Trust and/or the Smiths. Additionally, based on the premium financing design, the outstanding premium loan was paid off using cash values from the policy.

Conclusion

It is important to recognize that life insurance premium finance is not an off-the-shelf commodity and does not represent a "one-design fits all" strategy. Transactions are custom-made to address one's particular circumstances and objectives. A policy needs to be constructed by specialists who are not only experts in life insurance, but who also have the experience and reputation with financial institutions to achieve favorable financing terms and conditions for clients.

As a result of recent events, the use of leverage can have a negative connotation to some. And premium finance is often misunderstood or confused with the questionable business of life settlements. For these and other reasons the concept of premium finance must be fully understood and explained by individuals knowledgeable in this field.

Leverage and life insurance premium finance are not used without the assumption of risk. The risks, however, are manageable. If they were not, major banks would not be lending into this market. Their interest rate spreads over LIBOR or under prime are generally very reasonable and suggest minimal credit risk.

My experience, and that of my colleagues, is that life insurance premium finance is most appropriate for those with a liquid net worth in excess of $5 million and/or in situations where the annual premium is at least $100,000. Over the last 15 years our partners have arranged over $30 billion in face amount of these policies for individuals as young as 46 and as old as 86. Only top-rated insurers are used to write the policies.

In summary, it is important to identify the need for coverage, be certain that it is affordable, and that only financially strong and reputable institutions are engaged as lenders and insurers. To make certain that these and other aspects of a transaction are properly organized, it is imperative that people who are experienced in this specialized area craft and fully explain the policy and that knowledgeable tax counsel is retained. With likely changes in tax law starting in 2013, visiting with one's advisors should be done sooner rather than later. Such a meeting is advised irrespective of whether one is inclined to take advantage of this creative financing technique.

[1] *Kevin M. Kilcullen, Partner of Stern & Kilcullen, LLC and Dean De Marco, COO of Succession Capital Alliance contributed to this article.*
[2] *It would be reasonable to assume, however, that the results would fall somewhere between the first and third option.*