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Supplemental Retirement Plans
Premium Financing vs. Executive Bonus

There are quite a few agents and agency's out there marketing what is often referred to as account receivable financing. This is basically just another variation of premium financed life insurance. The most common design is where a business owner has his or her company borrow money which can then be transferred to a life insurance policy or an annuity product which is personal owned by the business owner.

Life Insurance Design

The life insurance is typically designed for accumulation purposes with four or a five planned premiums using the minimum non MEC level death benefit. The premiums are either borrowed as needed (over four or five years) or borrowed as a lump sum. If borrowed as a lump sum, a Single Premium Immediate Annuity (SPIA) is often used to funnel the money into the policy over the four to five years to avoid creating a MEC (modified endowment contract).

Premium Finance Design

The premium finance design typically has the company paying loan interest each year with the intent of paying off the loan balance at retirement age 65. The loan can be paid off either with company assets or using the cash values in the life insurance or annuity product. To qualify for this type of loan, the life insurance policy or annuity is used as collateral as well as the company's account receivables and or other corporate assets.

S Corp Tax Advantages

In my opinion the only reason to potentially use this strategy is with a pass through entity (S Corp, LLC, and Partnership). With a pass through entity, profits and losses pass through to the owner(s) at the end of the taxable year. Under this type of design the business takes out a loan and collateralizes the loan with the companies collectible account receivables or other business assets. It then bonuses the loan proceeds to the business owner(s) as taxable income. This bonus is a deductible expense to the business and, theoretically, will create a loss in the business that passes through to the business owners and offsets the taxable income. It becomes a "wash", and the business owner realizes the borrowed money tax-free.

Tax Consequences at Retirement

When the business owner retires, the company could use its current account receivables to pay off the outstanding loan balance. If this is done, the outstanding account receivables are collected resulting in taxable income to the business. Because of the pass-through status, the income is paid to the business owner(s), resulting in individual taxable income. The bottom line is if the business forgives the loan (i.e. pays off the loan) it creates a taxable event to the business owner. If the business owner used an annuity product with this strategy and used the annuity cash values to pay off the loan, this would also result in a large taxable event due to the normal taxation of annuity products. If a personally owned life insurance product was used, the business owner could pull money out tax free and then pay off the outstanding loan without incurring any taxable event (this assumes we implemented the strategy with a pass through entity and used the "wash" accounting mentioned above).

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The Sizzle

At first glance the strategy sounds pretty attractive. The business owner is able to get a large lump sum of money out of his company without paying any current income taxes. The money is personally owned by the business owner growing at a compound interest rate in a tax efficient product while his company only has to pay simple interest on the loan balance. To add even more sizzle to the concept, agents marketing the program typically tell business owners they can write off (deduct) the loan interest. They may suggest the business owner consult with their CPA to confirm the deductibility of the loan interest but even if the CPA doesn't agree on the deductibility of the loan interest, the program is still being touted as a great supplemental retirement plan.

Deducting the Loan Interest

The problem with deducting the loan interest is sections 264(a)(2) and 264(a)(3) of the Internal Revenue Code. Section 264(a)(3) states amounts paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment, or annuity contract (other than a single premium contract or a contract treated as a single premium contract) pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in cash value of such contract are **not deductible** under section 163 or any other provision of the Internal Revenue Code. Section 264(a)(2) states amounts paid on indebtedness incurred or continued, directly or indirectly, to purchase or to continue in effect a single premium life insurance or single premium annuity contract are **not deductible** under section 163 or any other provision of the Internal Revenue Code. Bottom line, it appears you can't deduct the loan interest when using the loan proceeds to purchase any kind of life insurance or annuity product.

So if we implemented the most attractive viable design with this concept (business owner with a pass through entity, using life insurance and not deducting the interest) how does it compare to alternative supplemental retirement plans using the same dollars?

The following example is an actual case where the competition presented the account receivable premium finance concept to a business owner (female age 39, preferred n/s). A 35% tax bracket was used in the comparisons as well as the exact same Index UL product (a projected crediting rate of 8% and an early cash value rider was used on the Index UL product).

Option 1 Account Receivable / Premium Finance Program

$1,000,000 Total loan, 6% Loan interest rate
$60,000 Annual loan interest cost (not deductable by company)
$1,560,000 Total loan interest cost to company (60k x 26 years = 1,546,000)
Life Insurance Design:
$250,000 Premium years 1-4
$7,620,000 Level death benefit reducing to 5.8mm in year 12 (minimum non MEC death benefit)
$1,000,000 Loan is paid off using cash values from the policy at age 65.
$3,410,998 Death benefit at normal life expectancy (age 86)
$383,847 Tax free retirement income ages 66-100

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Option 2 Executive Bonus Plan

$60,000 Annual premium (deductable by company and taxable income to the employee/business owner)
$1,014,000 Total cost to company after tax deduction (60k x 26 years = 1,560,000 x 65% = 1,014,000)
$546,000 Total tax cost to employee/business owner (60k x 26 years = 1,560,000 x 35% = $546,000)

Life Insurance Design:

$60,000 Premium for 26 years (ages 39 to 64)
$2,309,834 increasing death benefit (minimum non MEC death benefit)
$546,000 Cash from the policy at age 65 to offset taxes paid by employee/owner (vs., no taxes in option 1).
$3,384,808 Death benefit at normal life expectancy (age 86)
$392,589 Tax free retirement income ages 66-100

Summary

If supplemental retirement is your primary concern, these two comparisons clearly illustrate it does not make a lot of financial since to implement the account receivable / premium finance design described above. I even gave the premium finance option some advantages with this comparison. I assumed a very attractive loan interest rate of only 6%. Lenders in this space typically offer loans based on LIBOR or Prime. LIBOR has been around since 1988 and has a historical average of 5.39%. If you add a typical bank margin on top of that (typically 1.25% to 2.50%), your long term lending rate would be somewhere between 6.64% and 7.89% (Prime loans would be even higher). In addition, I really didn't need to pull the additional $546,000 out of the executive bonus plan at age 65 to offset the personal income taxes the employee / business owner had to pay over the 26 year time frame. Due to the fact the loan interest is not deductable to the company, the premium finance option ended up costing the company and additional $546,000.

The bottom line is the executive bonus plan provides more retirement income and has a lower net cost to the company compared to the poorly designed premium finance strategy above. Why would you want to deal with all the additional issues and risks associated with premium financing (loan approval, collateral requirements, loan interest rate risk, lender risk (lender could bail out of the program) for an inferior plan?

Does this mean premium financing does not work and should not be used for supplemental retirement plan? Absolutely not, it just means the premium finance design mentioned above is a bad one. There are actually different designs that make a lot of financial since and could be tremendous supplemental retirement plan for the right client. If you would like to know more about the correct way to design a premium finance case, or need an executive bonus illustration, please give me a call.

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