

Exit Strategies

Careful consideration should be made to determine whether the concept of Premium Financing is suitable. The client, and his or her advisor, should determine the client's risk tolerance and decide whether the concept is an acceptable risk.

If the client has a fairly low risk tolerance, then the potential long-term risk of using premium financing can be greatly diminished by utilizing a rollout technique. Following are examples of some of the most common exit strategies that can be used when an ILIT is a party to the Premium Financing arrangement.

Rollout via Death Benefit

This is not a rollout technique. At death, the net death benefit paid to beneficiaries is the balance after any outstanding loan balance is satisfied. It typically works best for older clients (generally older than 80) who are unlikely to be in the arrangement for more than 10-15 years.

Rollout via Policy Values

This rollout technique assumes the policy cash values will be sufficient at some point in the future so that the client can make a withdrawal from the policy large enough to pay off the outstanding balance without causing the policy to lapse prior to the client's death.

While it may be possible to create a policy illustration that shows a rollout via policy values, it should be kept in mind that the illustrated policy values are not guaranteed. There is a risk that the cash value may not be sufficient to rollout as projected. Capitalization of the interest on the loan greatly exacerbates this risk. This exit strategy is usually not a viable solution to mitigate long-term risk. Even if it may be possible to rollout using policy values, this is not likely to occur for at least 20-30 years, as it takes quite a while for there to be sufficient gain to sustain the policy after rollout.

Rollout via Outside funds

Grantor Retained Annuity Trust (GRAT)

A GRAT is a type of trust that pays a fixed amount each year to the grantor during the term of the trust and distributes assets to the designated beneficiaries (remaindermen) upon termination. When the GRAT is created, the value of the taxable gift to the remaindermen is determined by deducting the value of the grantor's retained interest from the fair market value of the property transferred to the trust. The grantor's retained interest is valued using the IRC Section 7520 rate. In general, the lower the rate, the lower the value of the taxable gift. Additional gifting leverage can be obtained by transferring assets to the GRAT, such as family limited partnership interests or non-voting stock, that qualify for valuation discounts. Depending on the assets gifted and the term and payout of the GRAT, it may be possible to create a zeroed-out GRAT (also known as a Walton GRAT) for gift tax purposes.

A GRAT can be used as a rollout technique for Premium Financing simply by making the ILIT that owns the policy the remainder beneficiary. When the GRAT terminates, the ILIT receives any assets remaining in the trust. Then the ILIT uses these funds to repay part of or the entire loan associated with the Premium Financing arrangement.

Charitable Lead Unitrust or Annuity Trust (CLUT or CLAT)

A CLAT or CLUT is structured similarly to the GRAT with a couple of differences. First, a fixed percentage (CLUT) or amount (CLAT) is paid annually to a charity, rather than to the grantor. Secondly, if the trust is structured properly, the grantor can also take a charitable income tax deduction.

Similar to a GRAT, a CLUT or CLAT can be used as a rollout strategy for Premium Financing by naming the ILIT as the remainder beneficiary. A CLUT (but not a CLAT) has a distinct advantage over a GRAT in that the grantor's generation skipping tax (GST) exemption can be allocated up front to the relatively small taxable gift (since GRATs are subject to the Estate Tax Inclusion Period [ETIP] rule, the GST exemption cannot be allocated upfront). This means that any interest passing to the ILIT is GST exempt. Thus, a CLUT can be used effectively as a rollout strategy for a Premium Financing arrangement involving a dynasty trust.

Outright Gifts

The client could make taxable transfers to the trust or make annual gifts maximizing his or her gift tax exclusions and lifetime exemption. These gifts could include assets that qualify for valuation discounts, like non-voting stock or interests in a limited partnership. The trust then has the assets necessary to pay off the loan should the client wish to terminate it early.

Existing Assets Already Held by ILIT

If the client already has assets in the trust prior to the Premium Financing arrangement, those assets may be used to pay off the loan early if necessary.