PARTNERING FOR EXCELLENCE

Informational ideas important to large and complex cases

Advanced Sales DIGEST

Vol II, Issue 2 ◆ May 2006

Accounts Receivable Financing

by Glenn H. Plotkin, J.D., M.S., CFP, CLU, ChFC, CTFA
Advanced Markets Consultant
AIG Life Brokerage

The Prospect and the Problem.

Many professionals are well aware of methods to generate significant and stable cash flows from their businesses. Understanding opportunities to capitalize on the potential economic value of these flows and protecting their vulnerability to creditors may be another story. The essence of accounts receivable financing is the potential for achieving long term economic benefits for individuals and asset protection with respect to business-generated cash flows. Perhaps the best way to illustrate the opportunities available from accounts receivable financing is through a hypothetical case.[1]

The theoretical client is John Doe, M.D., a specialist in obstetrics and gynecology (an "OBGYN"). John is 50 years old and has been in practice for over 20 years. His practice, which includes several other specialists, is structured as a limited liability company ("LLC") and taxed as a partnership. John has annual wage income in excess of $600,000 and his practice generates historically stable accounts receivable of about $5 million annually. John's share of the receivables is about $1 million.

John maintains a small office used primarily for consultations, but he has privileges and access to medical facilities and equipment at a local hospital. Other than accounts receivables, the practice owns few other assets. Although John currently owns a level term life insurance policy and makes contributions to his practice's qualified pension plan, he has concerns about the adequacy of the policy and whether he will have sufficient liquidity in order to retire comfortably at age 65.

John knows that his practice, by its very nature, involves significant potential exposure to malpractice liability. Some of his patients are subject to very severe health problems and, despite John's best efforts to provide the highest level of care, many experience less than desired medical results. While attending a recent medical convention, John learns that OBGYNs experience an average of 2.6 malpractice claims filed against them during their careers.[2] He also learns that as of 2002, 52 percent of all awards from such claims exceeded $1 million and 25 percent of all awards exceeded $3,500,000.[3] Fortunately, John carries individual malpractice insurance in the amount of $1 million per claim, but he is subject to a variety of troublesome events beyond his control: (i) his malpractice insurance premiums are rising substantially every year; (ii) there is no assurance that his coverage amount will not decrease in the future; and (iii) he could experience a claim well in excess of his coverage amount.

In the event John is sued for malpractice, the largest and most readily available asset subject to seizure by a plaintiff, after partial satisfaction from malpractice insurance proceeds, may be the practice's accounts receivable; or at least his share of the receivables. The results could be

continued on next page

For agent use only. Not for public dissemination.

economically disastrous. John could lose substantial income even in the short term: the primary value of his practice and a principal source of his expected retirement income. At age 50 it could take John years to recover financially from a judgment or even a settlement in excess of his malpractice coverage. As John's insurance advisor, how can you help him?

It starts with a thorough analysis of John's personal and business financial plans, a clear focus and explanation of the problem, and the recommendation of an appropriate solution. In this case, John's exposure to malpractice liability and the size of his accounts receivable generate the problem. How can his largest asset be protected? Could the protection strategy also reposition a dormant asset into one providing the potential for growth? A potential solution is financing the accounts receivable and placing the loan proceeds in a financial product that provides safety, stability, a substantial income tax-free death benefit and the potential for significant long term cash value accumulation: life insurance.

The Mechanics of Accounts Receivable Financing.

1. A third party lender makes a loan to the practice roughly equivalent to John's share of the practice's accounts receivable. That share of receivables is pledged by the practice as collateral. Since the loan transaction is at arm's length, the practice should realize no tax from the receipt of the loan proceeds.

2. From the loan proceeds, the practice will make a cash distribution to John. Subsequently, John or his appointee will purchase a life insurance policy on John's life and possess all incidents of ownership. Since John's practice is taxed as a partnership, the distribution of the loan proceeds may not be deemed taxable income to John; rather, he could experience a step-up in basis in his ownership interest in the practice entity equal to the amount of debt for which he became liable under the LLC's operating agreement. In this case, John, in his capacity as an LLC member, is assuming 100 percent of the debt incurred by the loan.

3. The policy should be funded at the maximum level allowable under the "7-Pay Premium" test but must not be classified as a Modified Endowment Contract ("MEC"). In the event the policy collateralizing the loan was deemed a MEC, increases in cash value could be subject to income tax. Loans are generally structured in two methods: (i) consecutive loans equal to the maximum permitted annual life premium; or (ii) one loan that is held in either a single premium immediate annuity or a deposit account making installment payments of the maximum permitted annual life premium.

4. The practice will pay interest only on the outstanding loan balance. Interest paid by the practice may, or may not, be a deductible business interest expense pursuant to IRC Secs. 264, 162, and 163.[4] The type of business entity conducting the practice may determine the extent of annual taxable income realized by John.[5]

5. Upon issuance of the insurance policy on John's life, the policy owner (John and/or his appointee) executes a collateral assignment of the policy to the lender. At this point, the lender has a secured first lien on both John's share of the practice's accounts receivable and the life insurance policy. Since the lender is counting on the life policy to partially secure its loan, the generation of large policy cash values are very attractive to the lender.

6. The practice maintains the loan arrangement for as long as John desires or until his retirement. While the loan is in place, the life insurance cash values are being credited with interest at prevailing rates.

7. John anticipates terminating the loan upon his retirement. In order to repay the loan balance, John will collect his share of the practice's accounts receivable, pay income tax upon their receipt and repay the loan with the difference. If the receivables do not fully satisfy repayment of the outstanding loan balance, John could access other assets to satisfy the difference. Policy cash values, if selected, could be distributed to John potentially income tax-free to satisfy the difference. At this point, the lender

continued on next page

releases its perfected lien on the receivables and terminates the collateral assignment of the policy.

Visualizing the Process.

See Attached Chart

Immediate and Midterm Benefits.

What have you helped John accomplish?

1. The third party lender's secured lien on both John's share of the practice's receivables and the new life insurance policy may be superior to the claims of general creditors, including plaintiffs in malpractice suits. While virtually no strategy is "bulletproof," John's general creditors may be deterred from action by the existence of the lender's superior lien.[6]

2. The practice's accounts receivable, although the lifeblood of the practice, is essentially a dormant asset. By repositioning the value of the dormant receivables, John is able to purchase a life insurance policy on a leveraged basis providing stability, security, an income tax-free death benefit and substantial cash surrender value that he may access at retirement on a tax-favorable basis through policy withdrawals and loans.

Long Term Benefits - Looking to the Future and Retirement.

Not all of John's planning problems are necessarily solved at retirement. For example, once the lender releases its lien on the policy, John no longer enjoys the potential asset protection layer created by the lender's prior security interest. If John is the policyowner, the first area to research is the extent of state law exemptions and protection afforded to individuals with respect to ownership of life insurance products. States have widely varying levels of asset protection that should be explained by a competent attorney representing John. In the event John's state of residency fails to provide adequate asset protection regarding insurance products, John may want to explore the use of entity ownership of the policy. Ideally, this should be considered and/or implemented at the inception of the financed arrangement. In addition to potential asset protection, proper entity ownership in concert with accounts receivable financing may accomplish both estate and business planning goals. For example, entity ownership could remove policy cash values and death benefit proceeds from John's estate for estate tax purposes. Policy death benefits could also be structured to finance buy-sell arrangements with respect to his practice.

Hypothetical Insurance Analysis.[8]

American General Life Insurance Company has developed a life insurance product exclusively for use with accounts receivable financing named AG Elite Value Index Universal Life. Product details are contained in the Company-approved policy brochure (AGLC101720).

Assume the following:

1. John is rated SNT and pays three annual premiums of $333,333 into a universal life policy. Using the guideline premium test, the minimum initial death benefit is about $5 million. In order to maximize future cash surrender values, the policy death benefit is reduced to about $1,500,000 at age 58.

2. At John's projected retirement age of 65, the policy cash surrender value is about $1,660,000. If John chose to take level annual non-taxable policy distributions from age 65 through 80, each such distribution would approximate $160,000.[7]

3. Assuming the foregoing policy distributions, at age 85 (arbitrary life expectancy) John's policy would still have a death benefit of about $615,000 and cash surrender value of nearly $388,000.

Final Considerations.

Accounts receivable financing is not a new concept. What has changed over time are the products life insurance carriers provide to collateralize loans. Several carriers offer policies with high early cash values relative to premiums paid in order to immediately maximize the value of the collateral pledged for financing.

Advisors must also consider the selection of a lender that is both experienced and qualified to financially underwrite a loan secured by accounts receivable and a life policy. This requires an understanding of valuation of receivables and how life insurance policies work. The loan should anticipate a potentially long term length (perhaps 20 years

continued on next page

or longer) and carry a competitive borrowing rate. All parties to the transaction should understand how the loan operates in order to keep the strategy from failing. Given the fact that two transactions are essentially occurring simultaneously (loan underwriting and insurance underwriting), it may be advisable to work with a firm that specializes in accounts receivable financing in order to coordinate and administer the transaction. Several reputable firms exist to fulfill this function. At this time, AIG Life Brokerage has entered into marketing arrangements with two such firms: ARLIS and Entaire Global. For more information about these firms, please call the Advanced Markets group at 800-659-5920. Additional information about accounts receivable financing can be found in the Company-approved marketing brochure: "Asset Protection Programs for Professionals" (AGLC101722).

Many estate and business planning attorneys suggest that asset protection issues pose a greater threat to their clients' financial security than taxation. While many asset protection strategies should be considered, and some employed, accounts receivable financing may be especially attractive and appropriate for business professionals generating significant and predictable cash flows.

This material is for agent/advisor use only. Please be advised that any information provided in preceding material shall not be construed by any person as legal, tax or accounting advice. AIG Life Brokerage strongly suggests that any life insurance owner, proposed owner, insured or proposed insured retain the services of qualified tax, accounting and legal counsel for advice on such matters. To ensure compliance with requirements imposed by U.S. Treasury Regulations, we inform you that any tax advice contained in the preceding material (including any attachments) was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

[1] The following discussion regarding accounts receivable financing is generic and is not an illustration of any particular plan or structure promoted in the marketplace.

[2] American College of Obstetricians and Gynecologists (ACOG) 2004 National Survey of Members, (2004).

[3] Jury Verdict Research, Current Awards and Trends in Personal Injury: 43rd ed. P. 18 (2004).

[4] Participants in accounts receivable financing programs should retain an independent tax professional for advice about the availability of such deductions and other matters related to the tax consequences of these transactions.

[5] Many of the income tax aspects of policy ownership and premium funding are beyond the scope of this material. Generally speaking, however, when the business entity borrowing funds from a third party lender is of the pass-through variety (e.g., partnership or LLC taxed as a partnership), the funds advanced by the sponsoring business to the individual participant for the purchase of life insurance may be deemed adjustments to the individual participant's basis and avoid recognition as compensation or a taxable distribution to the individual participant. [See IRC Sec. 752.] If the business entity advancing funds to the individual participant is not a pass-through entity, such as a C-corporation, the business entity may have to enter into a subsequent loan arrangement with the individual participant in order to finance the premiums advanced. Such arrangements are often referred to as "back-to-back" loan arrangements and may be governed by IRC Sec. 7872. Notwithstanding particular circumstances, back-to-back loans generally result in an income tax "wash" at the business entity level; however, all interest owed to the sponsoring business but unpaid by the individual participant may be realized by him/her as ordinary taxable income. Businesses and individual participants considering accounts receivable financing strategies should retain appropriate professional counsel to provide advice with respect to specific tax treatment.

[6] Prospective clients should retain a competent attorney for advice with respect to asset protection measures.

[7] Such distributions are generally accomplished first from policy cash value withdrawals to cost basis, then from policy loans.

[8] The hypothetical analysis provides theoretical policy death benefits and cash surrender values. Benefits from actual insurance illustrations may differ substantially from those described above.

FLOW CHART