Episode #245: Two “Different” Ways Premium Finance Can Amplify Your Wealth

Video Transcription

Welcome back. My name is Kyle, today's episode we're talking about how premium finance can help amplify your wealth, in one of two different ways.

Now as humans, we overcomplicate simple ideas such as premium finance, where we're just using a bank to pay part of or all of our premiums directly to an insurance company.

Let me show you the logic first. Let's say we have a home here that's worth $1 million. At the same time, we have a bank account with $1 million in it. The question becomes how do you pay for that home?

Well, exactly you put down a down payment and you mortgage the remaining balance, but why? We have enough cash to pay for it, why wouldn't we do that?

That's because there are benefits to a mortgage. We have a low cost to borrow, which allows us not to tie up assets for us to then leverage accordingly, and a lot of us have been doing that all of our lives. But let me throw in a little wrench here.

Let's swap out this home for an indexed universal life policy, and life insurance. At the same time you still have your $1 million in there, so how do you pay for this life insurance?

I'll be willing to assume that most advisors and clients have been encouraging and have been told to pay for the life insurance using that full $1 million inside your account. But why?

Similar to a mortgage, if we can find a lender that's going to give us low borrowing rates which allows us not to tie up our assets to be able to leverage those assets accordingly elsewhere, why wouldn't we do that all day long?

So, just because the asset class changed, our philosophy shouldn't. And so in today's episode, we're going to talk about two different types of people who use premium finance with life insurance as the funding vehicle, in two different types of ways.

The first one, to my right, is someone that's what's called a "maximum income." That's what he's trying to do using this policy. He's that executive, he's that high performer, he's making $200,000, $300,000 a year.

His goal is really just to maintain his current lifestyle in retirement, but the problem is that he lacks tax diversification. All this time he's been funding up his 401(k) deferring that tax until retirement, he carries good debt, he has maybe some real estate holdings, but he's in a way illiquid, but he understands leverage.

This person, he's trying to do one thing and one thing only, maximize his retirement tax-free income, and he's going to do that using indexed universal life and a bank.

Now, in this example we have a 45-year-old male, married, making $200,000 a year. Through his excess cash flow, he can carve off about $35,000 a year.

So, in this type of premium finance, we call it "hybrid," and what this hybrid is going to do is create three-to-one leverage. So, the bank is going to pay 66% of the premiums, and the client in this case is an individual going to make up 34% of those, in this sense, $35,000 a year.

So, all in he's paying $175,000 over a five-year period, while the bank is paying $525,000. The best part about it, there's no collateral, the bank uses the policy itself to secure the loan. Let's look at the benefits.

In this case, we know it's a five-year commitment only, he's buying $1 million of death benefit, and at his age, 65, he's going to be able to generate $61,000 of tax-free income.

At age 90 from a cumulative standpoint, that's $1.5 million all for his $175,000 out-of-pocket contribution, he's done funding by the age of 50. That's the first individual who wants to maximize income, is age 35 to 55, high performer, but not rich yet.

Well, flicking over to this other side of the board, we have someone that's more of a CEO, doesn't need income, he has about $5, $10, at a minimum of net worth, million that is, and what he's trying to do is preserve his wealth, use what he's built up over the years and be able to pass it on to his family in a tax-efficient manner.

The question, or his problem, is the IRS, Uncle Sam, is that future estate tax bill or the death tax that he's going to be able to face, and a lot of times these individuals don't have a plan in place, don't have an estate plan that can help shield and avoid that burden that will be on his family.

Now, characteristics of this individual are that he's illiquid, he has also maybe some business equity or real estate holdings, his cash flow is committed elsewhere, and he's just trying to find out how can I pay for this estate tax most efficient manner?

Also, look on over to this scenario, we have a 60-year-old divorced male, in good health, he's worth about $10 million today, and over the course of 25 years assuming a 5% growth rate, his estate is going to be close to $34 million.

His exemption based on this year is about $12 million, so you'll be able to reduce that dollar-for-dollar should he die at his age of 85. And what that's going to do, after you factor in a 50% tax rate both federal and state, his liability that his family is going to have to come out of pocket is about $11 million.

The question becomes, how do you want to pay for that? Do you want to use a seller-depreciated asset at your time that may have been in your family all these years and has some sentimental value, or do you want to foresee these burdens that could be on your family and finance a traditional policy?

Here where you're able to take on a little bit more leverage with a bank 5 to 1, and you're able to post, pay only $2.2 million that's not premium, that's interest on the loan plus principal.

At the same time, the bank will also fund $11 million, hence the 5 to 1 aspect and this $2.2 million has an $11 million death benefit at his life expectancy which will take care of that liability for his family.

Now, unlike this other program, this does have a form of collateral. Yes, the banks can use the policy, but they're also going to ask for outside assets, so we have to make up the difference between the loan balance and the surrender value inside the contract in this scenario.

But as you can see here, the common ground between these two different types of people, the two different ways they're using leverage is that they know they have a tax problem, and they're trying to mitigate that tax exposure at all costs by partnering up not only with an insurance company but with a bank.

To do what? To create arbitrage, to create a difference and create that spread or the difference between the borrowing rate and what we're able to earn inside these contracts.

These two types of people understand leverage and so should you. So, if this is something that you wanted to take a closer look at for your own unique situation, reach out to the financial advisor that shared this video, and see if it makes sense today.

That's all I have, signing out. Thanks.