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Help Your Physician Clients with Asset Protection by "Leveraging" Their Accounts Receivable

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In this era of litigation and abnormally high malpractice verdicts being handed down by out-of-control juries, protecting a medical practice's accounts receivable (A/R) is a white-hot topic.

There are various ways to protect a medical practice's A/R, and this article will discuss the number-one option being pitched by insurance advisers around the country. It will try to convey the real-world truth and actual financial benefit of the A/R Leveraging Plan to a physician in retirement.

Overview of the A/R Leveraging Plan

The A/R Leveraging Plan involves using a medical office's A/R balance as the *primary collateral* for a bank loan. The loan will be equal to the revolving A/R balance, generally ranging anywhere from 30 to 120 days. Depending on the lender used, the loan may be equal to the entire A/R balance (that has not otherwise been borrowed against). Since the bank will have a primary lien against the receivables' balance, this "asset protects" the balance from the claims of other creditors.

Once the bank loan is made, the loan proceeds can be invested for the purpose of providing the physician with death benefit protection and, potentially, a source of supplemental retirement income.

Cash value life insurance can be ideal for this purpose; since creditor protection may be a major concern, individually owned life insurance in many states is asset protected. In states where life insurance cash value is not protected, the client would instead use an LLC structure to asset protect the cash value.

Additionally, an individually owned life insurance policy may provide the physician with income tax advantages such as taking tax-free loans from the life insurance policy in retirement.

The bank making the loan will very likely require the life insurance policy be assigned as secondary collateral to the bank.

The loan will typically be outstanding as long as the physician is still working (i.e., until retirement). However, the loan will need to be extended from time to time, and the bank will likely do so, assuming the physician continues to be a good credit risk. Keep in mind that the receivables,

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once collected, will be income taxable.

Once the loan has been repaid, the bank's secondary collateral interest in the life insurance policy is released, and the physician now owns the policy unencumbered. At this point, the physician is free to begin taking potentially income-tax-free distributions from the policy cash value for purposes of supplementing his or her retirement income.

Figure 1:
A/R Leveraging Done Wrong

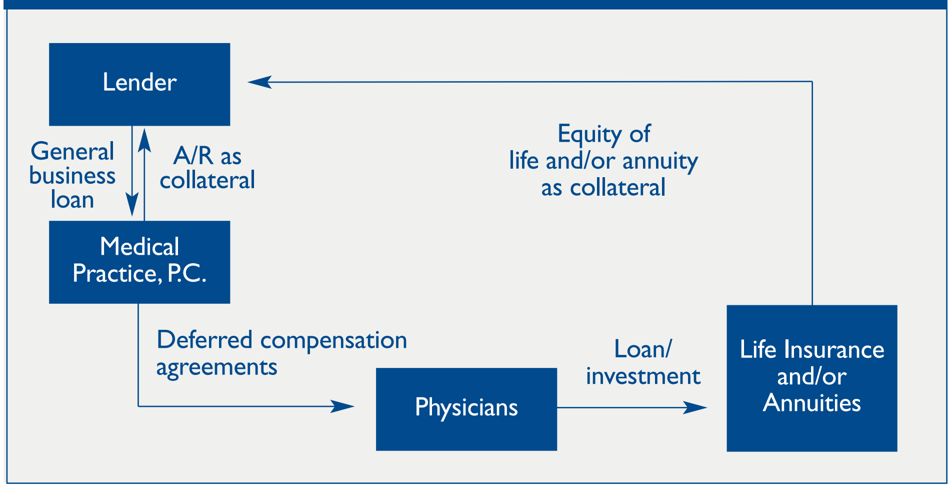
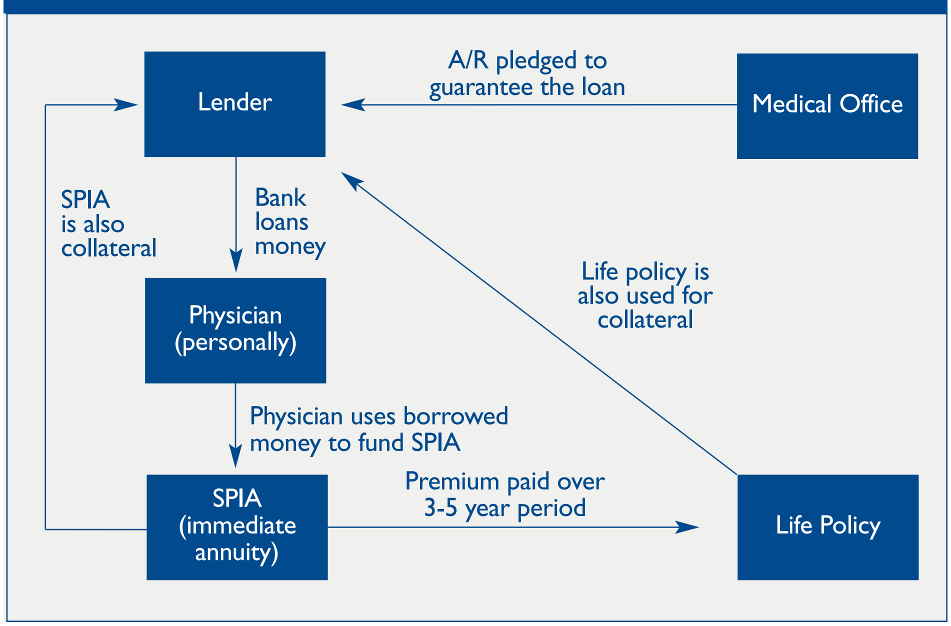


Figure 2:
A/R Leveraging Done Right



The Asset Protection Sales Pitch

The A/R Leveraging Plan can be a nice door opener when talking with physicians. While everyone seems to be an "asset protection" specialist these days, you can differentiate yourself by dealing with this topic in a manner that gives full disclosure (most agents only sell the upside of the plan). The following should be the typical sale process with the A/R Leveraging Plan:

Dr. Smith is visited by his local life insurance agent (or financial planner) who wants to discuss the important topic of "asset protection." Normally, Dr. Smith would not find time to meet with his insurance agent unless he had a real need, but since Dr. Smith is worried about losing his assets in a lawsuit he finds time to meet with the insurance agent.

The agent meets with Dr. Smith and tells him how physicians from all over the country have been losing their A/R in medical malpractice lawsuits. When the agent has Dr. Smith's attention, he asks: *"Do you have your A/R protected from lawsuits, Dr. Smith?"*

The answer 99% of the time is going to be no—and when Dr. Smith says no, the agent then explains how the A/R Leveraging Plan can help protect his medical office's A/R and potentially create a nice supplemental retirement plan.

As I point out below, in the real world, the A/R Leveraging Plan can work in the following three ways when considering the plan from a financial point of view:

- very well
- expense neutrally
- very poorly

When determining if the plan works financially for the client, you need to compare the investment returns with the nondeductible interest payment the client would be paying over the life of the plan versus how much money he or she could borrow from a life policy that was funded by using the plan.

A/R Leveraging—Asset Protection Nirvana?

Is the A/R Leveraging Plan an asset protection nirvana? The honest answer is, "sort of." The A/R Leveraging Plan *can* work well or poorly depending on the following factors:

- *Interest Rates.* The A/R Leveraging Plan requires a loan for upwards of 20 years. The lower the interest rates and the longer the loan rate is fixed, the better the plan will work.
- *Investment Returns.* If the investment where the borrowed money is placed does not perform well (7% or better), the likelihood of the A/R Leveraging Plan working better than post-tax investing is reduced (unless interest rates on the loan stay abnormally low).

If interest rates are moderate throughout the life of the plan and the return in the investment is similar to what the S&P 500 has done over the last 30 years, then the A/R Leveraging Plan, when done right, can be a nice and economically effective way to asset protect a medical office's A/R.

The problem in the past, and still in the marketplace with the A/R Leveraging Plan, is that it is not done right a majority of the time and is not sold with full disclosure.

A/R Leveraging Done Wrong

Before talking about the ways to implement a properly set up A/R Leveraging Plan, it is important to understand what is currently being pitched in the marketplace and what, in my opinion, is the "wrong" way to implement an A/R Leveraging Plan.

The method outlined in Figure 1 involves 1) making a bank loan to the business, which 2) distributes the loan proceeds to the participating physician(s) pursuant to the terms of a "deferred compensation" agreement. The distribution is treated as a property transfer under I.R.C. Section 83. 3) The physician then funds a life insurance policy with the distributed money, and 4) the life insurance policy is collaterally assigned to the bank as secondary collateral for the bank loan.

The client is told the following when being sold this Section 83 Plan:

- The medical practice can *write off the interest* on the loan. This is a much debated point, but I come down on the more conservative side and believe the interest on the loan to the medical practice is not deductible.
- The borrowed money that is poured into the life policy will *grow with no tax consequences* and can be borrowed from the life policy *income tax free* in retirement. What the promoters of the plan *do not* tell the client is when the cash in the life policy gets above the amount of premium poured into the policy, they will have to recapture as income each year the investment gains in the life policy. I call this "phantom income" because the client ends up paying tax on money not in his or her hands. For the specific reasons why a client in a Section 83 Plan would have to recapture the income, please feel free to give me a call and I would be happy to go over that with you.
- There is no immediate income recognition of the borrowed money. The promoters of the plan say because there is a "risk of forfeiture" of the life insurance policy back to the bank (because of the collateral assignment), the physician does not have to recognize income on

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The A/R Leveraging Plan involves using a medical office's A/R balance as the primary collateral for a bank loan.

the borrowed money. Without getting too technical with the reasons I do not believe that is true, I'll simply state that it is my position that Dr. Smith in the above example should recognize as income in the first year of the plan the $200,000 that was borrowed and poured into the life insurance policy.

- There will be enough A/R left in the medical practice to pay back the loan used to protect the A/R. This part of the sales pitch is very deceptive. What's the problem, and why won't the $200,000 of A/R on the books at termination pay back the $200,000 loan? Because the client will have to pay income tax on the A/R prior to paying off the loan.

Section 83 A/R Leveraging Summary

I would not recommend that anyone use a Section 83 Plan because:

- I do not believe the interest is deductible.
- I believe the client should recapture as income all the money borrowed in year one.
- I believe the client would have to recapture as phantom income all the growth in the life policy above its basis each year.

A/R Leveraging Done Right

A/R leveraging can be done "correctly" so as to asset protect a medical office's A/R (Figure 2). While reading over the following, keep in the back of your mind the most important question: While the A/R Leveraging Plan can be done correctly, is it a plan worth implementing given your particular circumstances and fears about the loss of your A/R in a lawsuit?

The Steps for A/R Leveraging Done Right

1. The bank loans money directly to the physician. The loaned money is equal to the amount of current "real" A/R on the books of the medical practice.
2. The physician purchases a single-premium immediate annuity (SPIA) with the borrowed money.
3. The SPIA pays income for 3 to 5 years, and that money is used to fund a life insurance policy that is supposed to act as a long-term investment for the physician.
4. The SPIA and life insurance policy are pledged as secondary collateral on the loan.
5. The medical practice's A/R is pledged as the primary collateral for the loan. That is as complicated as it gets when doing A/R leveraging the correct way. Because the A/R is pledged as the primary collateral for the loan, it is asset protected as long as the loan stays in place.

The Finances of the A/R Leveraging Plan

In the past, the A/R Leveraging Plan was sold more as a supplemental retirement plan than an asset-protection plan. This was in the old days when advisers really did not understand all the negative tax ramifications of the Section 83 version of the plan.

Instead of trying to explain in paragraph form how well or poorly the A/R Leveraging Plan works from a financial standpoint, I instead will use three examples outlined below. The important variables that *remain constant* with all three examples:

1. The client is a 45-year-old male in good health (Dr. Smith).
2. The client is looking to asset protect $200,000 of A/R and, therefore, the loan taken out in the example is that same $200,000.
3. The lending interest rate stays the same in the examples.

The important variables that *change* in the three examples:

1. The age when the client borrows money out of the life policy that was funded with the borrowed money to create "supplemental retirement income." In the first example, I use ages 71 to 85; in the second and third examples, I use ages 65 to 79. The longer you wait to borrow money income tax free from a life policy, the better the illustration will work.
2. The investment rate of return in the life policy. I assumed a 7.9% annual return in the life policy in the first two examples and a 6% rate of return in the third example.
3. The investment rate of return on the money Dr. Smith could have invested in the stock market if he did not implement the A/R Leveraging Plan.
4. I assumed the same investment rates of return with the post-tax brokerage account as I used in the life insurance policy (which is 7.9% in the first two examples and 6% in the third example).

Is A/R Leveraging a Good Deal Financially?

Assumptions/constants in the below examples:

- medical practice has $200,000 of "real" A/R on the books
- $200,000 of loan proceeds (used to encumber and asset protect the A/R)
- loan interest: 6% years 1–5; 7% years 6–10; 8% years 11–15; 9% years 16–20
- 45-year-old male physician, non-tobacco preferred (Dr. Smith)
- pre- and postretirement tax bracket: 40%

Example 1

Assuming a **7.9%** rate of return in the life policy and in the brokerage account; borrowing from the life policy from ages **71 to 85:**

Option One (invest interest payment)

- Loan interest invested @ 8% netting a 5.3% ROR would grow to $668,504 in 25 years.
- If Dr. Smith drew down the brokerage account he could take out $62,410 after tax a year from ages 71-85 (which should be in an FLP for asset protection).
- A/R taxable when Dr. Smith retires
- A/R vulnerable

Option Two (implement A/R Leveraging Plan)

- 25th year life insurance cash value: $950,000
- Initial death benefit: $758,000
- 15-year income-tax-free cash flow ages 71-85: $90,000
- Pledge of A/R to bank will take priority over other creditors and lawsuits to the extent of the loan balance and PA/PC guaranty.
- A/R taxable when physician retires

Financial Outcome: Dr. Smith would have an **extra $27,590 a year in post-tax retirement benefits** from ages **71 to 85.** This is **44% better** than taking the interest payment home and investing it post-tax in the stock market.

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Example 2

Assuming a **7.9%** rate of return in the life policy and in the brokerage account; borrowing from the life policy from ages **65 to79:**

Option One (invest interest payment)
- Loan interest invested @ 5.3%, net ROR would grow to $516,317 in 20 years.
- If Dr. Smith drew down the brokerage account, he could take out $48,200 after tax a year from ages 65-79 (which should be in an FLP for asset protection).
- A/R taxable when Dr. Smith retires
- A/R vulnerable

Option Two (implement A/R Leveraging Plan)
- 20th year life insurance cash value: $637,000
- Initial death benefit: $758,000
- 15-year income-tax-free cash flow ages 65-79: $50,000
- Pledge of A/R to bank will take priority over other creditors and lawsuits to the extent of the loan balance and PA/PC guaranty.
- A/R taxable when Dr. Smith retires

Financial Outcome: Dr. Smith would have an **extra $1,800 a year in post-tax retirement benefits** from ages **65 to 79.** This is **3.7% better** than post-tax investing.

Example 3

Assuming a **6%** rate of return in the life policy and in the brokerage account; borrowing from the life policy from ages **65 to 79:**

Option One (invest interest payment)
- Loan interest invested @ 4.2%, net ROR would grow to $459,109 in 20 years.
- If Dr. Smith drew down the brokerage account, he could take out $40,185 after tax a year from ages 65-79 (which should be in an FLP for asset protection).
- A/R taxable when Dr. Smith retires
- A/R vulnerable

Option Two (implement A/R Leveraging Plan)
- 20th year life insurance cash value: $442,000
- Initial death benefit: $758,000
- 15-year income-tax-free cash flow ages 65-79: $30,000
- Pledge of A/R to bank will take priority over other creditors and lawsuits to the extent of the loan balance and PA/PC guaranty.
- A/R taxable when Dr. Smith retires

Financial Outcome: Client would have **$10,000 a year less** in post-tax retirement benefits from **ages 65 to 79.** This is **25% worse** than post-tax investing.

What seems interesting about the above three examples and what can we learn from them?

What should quickly jump out at you is that, for the two illustrations that both worked better than post-tax investing, Dr. Smith had to wait at least until age 65 (and 71 worked much better) before accessing income-tax-free loans from his life policy.

You can look at this fact two ways: First, it is great that a physician can asset protect his or her A/R and at some point down the road have the plan work as a nice supplemental retirement plan (or at least a breakeven plan), or second, that you really don't want to get into a plan where you have to wait until age 65 to access money tax favorably from a life policy.

What should also seem interesting is even if Dr. Smith waited until age 65 in Example 3, he would have lost money with the plan. Because the internal rate of return of the policy was not high enough to counteract the rising interest payments, Dr. Smith would have been better off financially to invest the interest payments instead of implementing the A/R Leveraging Plan.

Estate Planning with the A/R Leveraging Plan

One issue I'd like to briefly discuss is the fact that, when implementing the A/R Leveraging Plan, the client purchases a life insurance policy with a death benefit that will pass to his or her heirs. The life insurance policy that is purchased is seen more as a supplemental retirement bucket, but it should also be seen as an estate planning tool.

It is possible to use the newly purchased policy in place of some or all of the term life insurance the client is currently paying for post tax.

For example, if Dr. Smith above was paying $1,500 for a $750,000 death benefit policy, he could choose to stop paying that premium because of the new life insurance policy that is purchased with the A/R Leveraging Plan. If I factored in the fact that Dr. Smith would not have to pay the $1,500 premium payment in Example 3 above, then Dr. Smith would have only been 16% worse off per year with the A/R Leveraging Plan versus the -25% listed in Example 3.

Side note: *If a medical practice can lower its malpractice insurance coverage and save money on insurance premiums, that savings can be factored into the financial viability of the A/R Leveraging Plan. A large savings on malpractice premiums can significantly improve the financial viability of the plan.*

When looking at the viability of the A/R Leveraging Plan, you need to make sure when and if you look at the plan that you look at it from all angles and do so with a consultant who knows the topic and will give "straight" advice.

Is the A/R Leveraging Plan Right for Your Clients?

If you are looking for a concept that is a nice door opener to physicians so you can discuss an "advanced" asset protection tool, you should consider learning about the A/R Leveraging Plan.

I would strongly recommend that you DO NOT sell the plan as strictly a "supplemental retirement plan." While the plan can work out well for the client financially, because the variables can change—and often in a negative direction for the client—I believe the more prudent way to sell the plan is as an asset protection tool that "might" work out as a supplemental retirement vehicle.

- *Income Tax Reduction*. If you are looking for an "income tax reduction" tool, there are others, like the ABC Plan, that allow clients to defer income without the inclusion of the staff.
- *Asset Protection*. If you live in a state that does not specifically asset protect life insurance or annuities, your clients would need to use a different structure than outlined above to make sure the life insurance or annuity investment is asset protected. This can be done through a simple LLC structure. If you would like help with this topic, please feel free to contact me. ■

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Want to Learn More about A/R Leveraging?

Check out Roccy DeFrancesco's upcoming Audio/Web Conference, *"What's Wrong with Accounts Receivable Financing; and The ABC Plan: A Way to Reduce Income Taxes,"* on **July 21, 2004.**

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