**Course Objective**

This course was created to teach and educate accountants, CPAs, EAs, attorneys, financial planners and insurance advisors about an important asset protection tool that can help many small to medium size businesses.

The biggest asset in many companies, especially professional companies, is the accounts receivable (A/R). Doctors, lawyers, CPAs/accountants, sometimes have millions of dollars in A/R on the books at any given time. With professional liability suits getting out of control, it is important for many clients to protect their company's biggest asset, the A/R.

This information will teach readers about the various ways a client can protect their company's A/R and will point out ways that many advisors around the country are doing it wrong. The wrong way to protect A/R is much more appealing, but has many pitfalls that can get the client in trouble from a tax standpoint. By using the "correct" way to protect a client's A/R advisors can show value added service to clients and solve a problem that most clients likely did not even know existed.

# Accounts Receivable Asset Protection

## Introduction

Accounts Receivable (A/R) Financing (also known as A/R leveraging) has been around for over 20 years. The concept has evolved quite a bit and some advisors around the country are using the concept for its **intended purposes, i.e. asset protection**.

For years the Section 83 Plan (discussed in this material) was the staple of the A/R Financing industry. As A/R Financing plans became more popular (mainly among insurance agents looking to sell life insurance), the plans started to become abused (shocking). Additionally, due to their popularity, more "vendors" got into the business, and some of those have decided to put the client's interest first, and provide "full disclosure." Through their intense research, they discovered that many widely accepted plans were not properly constructed, and could place those clients using them in a precarious tax situation.

Unfortunately, in today's A/R Financing marketplace there are still vendors doing the program wrong, and due to the ignorance of the client and their advisors, these plans are still being sold. One reason has to do with the fact that they appear more tax favorable for the client, and therefore more easily saleable.

This material will explain how to implement the A/R Financing plan the right way as well as the wrong way. While the wrong way is more easily saleable, implementing a correctly designed A/R Financing plan is still very beneficial for the right client. Obviously by doing it the "right" way, advisors will not subject their clients to liability and the advisors themselves.

## A/R Financing: The Basics

The concept of Accounts Receivable Financing has evolved from traditional factoring (selling A/R at a discount for immediate cash) and using the A/R to collateralize a Line of Credit, to more sophisticated approaches seeking to meet two primary objectives:

1. Shielding the A/R from creditors and lawsuits, and
2. Converting an otherwise stagnant asset into one that yields a return.

The primary users of A/R Financing plans are physicians, even though some approaches tout applicability to the non-physician marketplace. Physicians are particularly vulnerable to lawsuits, and the rapid escalation of litigation and resulting awards and settlements has created an acute awareness of the need for asset protection. Therefore, this material will address physicians as the primary client when helping with a client with the A/R Financing plan.

Most physicians operate their medical practices as separate entities. The separate practice entity may operate as a Professional Association (PA), a Professional Corporation (PC), a C Corp, an S Corp, a Limited Liability Company (LLC), or a Limited Liability Partnership (LLP). This separate entity is owned by the physician(s); however, the assets of the practice are owned by the practice entity and are subject to claims against that entity.

In asset protection planning the physician must address protecting not only personal assets, but also the assets owned by the practice. When a physician is sued for malpractice, his personal assets are at risk for any award or judgment in excess of his malpractice coverage. In virtually all circumstances, when a physician is sued the practice is also named as a co-defendant, and both the physician and the practice may be liable (depending on the nature of the claim).

Why is this important? For a physician who practices alone but has a separate entity, malpractice litigation has not only placed unprotected personal assets at risk, but also those assets owned by the practice. In most practices the largest single asset is the A/R.

For multiple physician practices the problem is magnified. If one physician in a practice is sued, unprotected personal assets are at risk. However, if the practice is named as a co-defendant, and the likelihood is high that it will be, all of the assets of the practice could be at risk. This, of course, includes the A/R of the physicians not being sued**. One physician gets sued, and the A/R of each physician is at risk.** Even if a client is being sued, **there is no reason to wait to implement an A/R protection plan**. While the protection plan will not protect the A/R from any current or known but not yet filed suits for malpractice, the medical practice should not wait, because to do so would continue to allow the A/R to be at risk of a lawsuit from any new patient/potential creditor.

For both single practitioners and multiple physician practices there is an additional risk. Practices can be sued for the actions of employees.

The physician(s) should be aware that no A/R Financing plan is going to shield the receivables if there is **current** litigation or if litigation is anticipated from a prior problem. To express this point another way, if there are clouds on the horizon or if it is raining on the physician, the plan will not work relative to shielding the A/R from the current problem. Practitioners should also check with local legal counsel to find out applicable State statutes relative to established time frames involving litigation of this type. Many States have established a time period in which "clouds may appear" that were not present at the time an asset was protected. For example, a State may establish a one year time period following the UCC1 filing, during which time a law suit may be filed and that asset would still be exposed.

## Common Elements

There are two common elements in the various approaches when attempting to asset protect the A/R:

1. A loan collateralized by the A/R,

2. A cash value life insurance policy funded by the loan proceeds

Unlike "Premium Financed" life insurance, which seeks to provide an economical way to purchase desired life insurance protection, A/R Financing plans are designed to use the tax advantages associated with life insurance to create cash values. Cash value policies are used as the primary wealth building tool in an A/R protection plan due to the fact that the **cash invested inside the life policy grows tax free and come out tax free via "policy loans**." Deferred annuities are not used as the primary investment in the A/R protection plan due to the fact that income, when received will be income taxed. Additionally, if a client takes "distributions" from a life policy, that will not necessarily come out of the policy income tax free.

A significant additional consideration is that many States allow life insurance cash values to be protected from creditors. This protection may also be applicable to annuity values. This protection varies widely from State to State, and the physician should be aware of statutes that apply to his/her domicile. If a client lives in a state where life insurance is not asset protected, the client can make it asset protected by using a simple LLC structure (which is discussed in the educational module on advanced estate planning).

## The First Generation of A/R Financing Plans

Generally considered to have been developed in Florida, the first A/R plan used a Deferred Compensation approach. A number of insurance firms marketed the concept of borrowing funds to purchase life insurance policies owned by the physician/shareholder, pledging the accounts receivable of the Professional Corporation as collateral for the loan. The Professional Corporation would enter into an agreement with each of its physician/shareholders stating the following terms:

-The Professional Corporation would borrow from a third-party lender an amount equal to the accounts receivable attributable to each physician/shareholder.

-The borrowed funds would be used to purchase a life insurance policy and a single premium immediate annuity to be issued to the physician as the owner and the insured.

The reason for the use of two policies is to avoid the life insurance policy being treated as a "modified endowment contract" (thereby being taxed as an annuity and losing the tax advantages of life insurance), which would result if the life insurance policy were funded too rapidly. The single premium immediate annuity is structured so that the payout corresponds to the maximum rate at which the life insurance contract can be funded and not treated as a modified endowment contract. As annuity payments are made, they are paid directly (or indirectly, through the Professional Corporation, as agent for the physician/shareholder) to the issuer of the life insurance policy as premium payments.

-As a condition to the Professional Company entering into the arrangement, the physician/shareholder would agree that rights to the Insurance Contracts would be subject to forfeiture upon violation of certain provisions of his employment agreement.

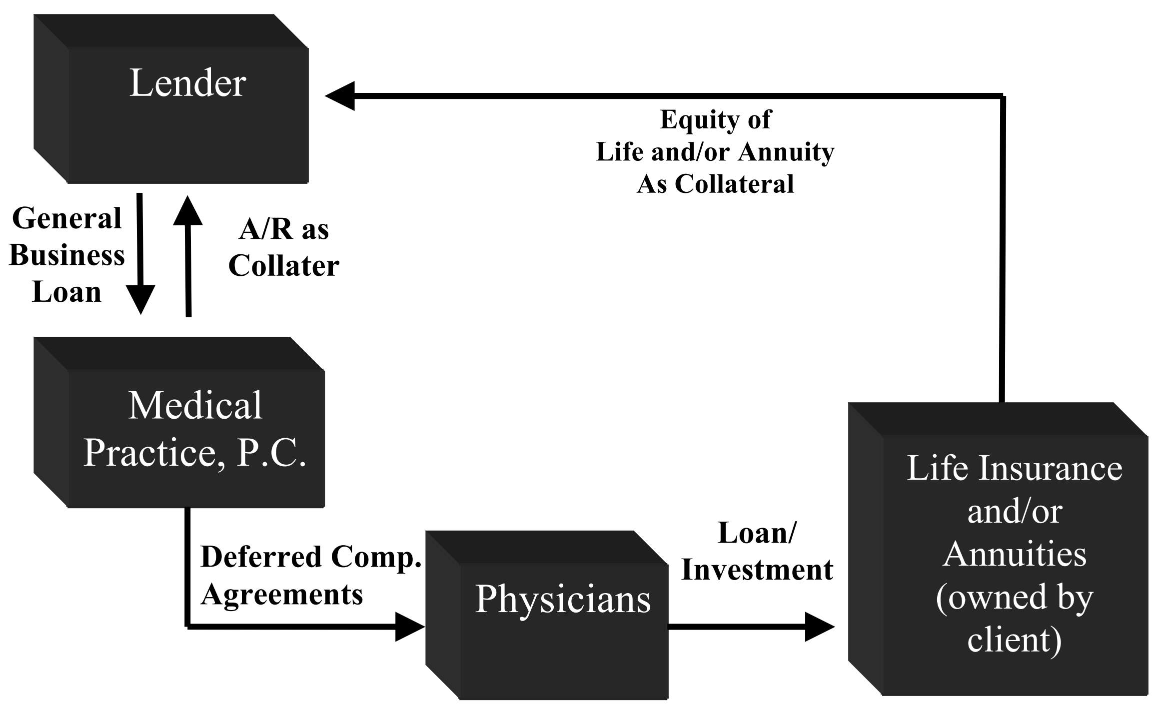
-If the Physician forfeiture provisions are invoked, the Professional Corporation would be entitled to recover the amount it deposited into the Insurance Contracts.

-The physician/shareholder would pledge the Insurance Contracts as **secondary collateral** for the third-party loan in the event that, at maturity of the Loan (typically upon the Physician/shareholder's termination of employment), the accounts receivable attributable were insufficient to repay the portion of the third-party loan funded into the Insurance Contract. To secure this pledge, the Insurance Contracts are collaterally assigned to the third party lender and the Professional Corporation.

-At loan maturity (plan termination), the accounts receivable of the Professional Corporation attributable to the physician/shareholder are used to repay the debt. In the event of a shortfall, the third-party lender will look to the Insurance Contracts for the additional collateral. Under the loan agreement, the third-party lender may not exercise its rights under the collateral assignment of the Insurance Contracts for a period of time (e.g., six (6) months) to reasonably assure that efforts to collect the receivables have been exhausted.

There will always be a shortfall when repaying the loan if the A/R pledged stays the same until termination of the program. The sales pitch from unknowledgeable or intentionally deceptive advisors is that the A/R on the books will be enough when a client retires to pay back the loan. The problem with this is that before the A/R can be used to pay back the loan, income taxes must be paid at the client's personal tax bracket before it can be used to pay off the loan. Therefore, if a client is in the 40% tax bracket at the time of retirement, there will be a shortfall of 40% from the A/R to pay off the original loan.



Since the Insurance Contracts, for individual debtors, are exempt from attachment (absent a "fraudulent transfer") in some states, the Insurance Contracts will be protected against personal liability. In states where life insurance is not asset protected, a simple LLC would be used to protect the life insurance cash value from creditors, and allow the client tax free loans from the insurance policy. This LLC structure is discussed in the advanced estate planning educational module.

To the extent that the accounts receivable are pledged to the third-party lender **as first collateral**, to repay the loan used to acquire the Insurance Contracts, they would not be available to satisfy any other debt of the Professional Corporation, including a tort judgment until such time as the loan is repaid and the collateral released. Any receivables in excess of the amount needed to satisfy the secured loan would be subject to the claims of creditors.

The plan usually called for taxation of cash values to occur at the point in time when the annual cash value increases exceeded the basis; i.e., loan amount, in the policy.

For example, if a practice had borrowed $100,000 and placed this amount into a SPIA, which in turn made five equal premium payments into the life insurance policy, the cash values in the life policy would typically equal $100,000 sometimes around the 6$^{th}$ or 7$^{th}$ year. As the cash values grew over and above the $100,000 basis, the increases would be recognized as taxable income to the physician until such time they equaled the original loan amount. All subsequent growth was deemed to be tax-deferred because this growth was inside the life insurance policy.

In summary, the first $100,000 of cash values are deemed to be non-taxable because it was subject to a Substantial Risk of Forfeiture. The second $100,000 of cash values would be recognized as income because they were deemed to be the value of the A/R "owed" to the physician. All subsequent growth in cash value (inside the life insurance policy) is tax-deferred because it was occurring inside the life insurance contract.

Finally, and one of the biggest selling points to the program, was that the interest on the loan was stated to be **deductible** to the practice as an ordinary business expense. The **number one reason** advisors stopped selling the A/R leveraging plan is the fact that they learned that the interest is **not** deductible to the client. If the interest cost of the plan is not deductible, it is much more difficult to sell the plan as a "deferred compensation" plan.

## The Problems

The previously discussed Deferred Compensation approach was very popular until early 2003 when a tax memo was issued by a premier law firm in

Texas; Locke, Liddell & Sapp. This memo addressed the mechanics of this approach, and after it was made public it caused most practitioners using this type of plan to stop. The Wealth Preservation Institute has been given permission to publish this tax memo in this educational material.

The Locke, Liddell & Sapp memo, presented here, details the following issues associated with this approach:

1. Deductibility of Loan Interest
2. Timing of Inclusion of Income
3. Substantial Risk of Forfeiture
4. Prohibited ERISA Transaction

## Summary of Discrepancies in Promotional Materials from Actual Tax Results

As structured, the faulty programs generally marketed cannot achieve the desired income deferral of the amount funded into the Insurance Contracts because the restrictions imposed are insufficient to create a "substantial risk of forfeiture." This defect can likely be corrected by revisions to the documents.

If the defects in the documents were corrected, with respect to creating a "substantial risk of forfeiture", for transactions entered into before the "Split-Dollar" regulations became final; when the cash value of the life insurance policy exceeds the amount subject to forfeiture risk, the Physician/shareholder would not have been taxed on the incremental build up. However, at the time the forfeiture risk lapses, the entire value of the life insurance policy will be included in the income of the Physician/ shareholder, not just an amount equal to the original funding.

If the defects in the documentation are corrected, with respect to creating a "substantial risk of forfeiture", for transactions entered into after the "Split-Dollar" regulations became final; when the cash value of the life insurance policy exceeds the amount subject to forfeiture risk, the Physician/shareholder will be taxed on the incremental build up attributable to the originally funded amount. Additionally, at the time the forfeiture risk lapses, the originally funded amount will be included in the income of the Physician/shareholder.

The interest on the indebtedness to fund the insurance purchase will not be deductible.

These defective programs may be construed as a form of deferred compensation, absent modifications to the documentation, in which case, pledging the policies for the loan would be a prohibited transaction under ERISA.

# Tax Consequences to Physician/Shareholder

An essential objective of this concept is to obtain income deferral for the amounts funded into the Insurance Contracts.

Application of Split-Dollar Rules to Life Insurance Policy

During 2002, the IRS issued several pronouncements regarding the taxation of "split-dollar" insurance arrangements. These included IRS Notice 2002-8 and proposed regulations issued under several provisions of the Internal Revenue Code. Included within the proposed regulations is the definition of a "split-dollar arrangement", which is defined as:

> "…any arrangement between an owner and a non-owner of a life insurance contract that satisfies the following criteria—
>
> (i) ***Either party to the arrangement pays, directly or indirectly, all or any portion of the premiums on the life insurance contract***, including a payment by means of a loan to the other party that is secured by the life insurance contract;
>
> (ii) ***At least one of the parties to the arrangement paying premiums*** under paragraph (b)(1)(i) of this section ***is entitled to recover (either conditionally or unconditionally) all or any portion of those premiums and such recovery is to be made from, or is secured by, the proceeds of the life insurance contract***; and
>
> (iii) The arrangement is not part of a group-term life insurance plan described in section 79." Prop. Treas. Reg. § 1.61-22(b)(1)(i). [Emphasis added]

Furthermore, under the proposed regulations, any arrangement between the owner and non-owner of a life insurance contract is treated as a split-dollar insurance arrangement if:

> (A) The arrangement is entered into in connection with the performance of services and is not part of a group term life insurance plan described in Section 79;
>
> (B) The employer or service recipient pays, directly or indirectly, all or any portion of the premiums; and
>
> (C) The beneficiary of all or any portion of the death benefit is designated by the employee or service provider or is any person whom the employer or service provider would

> reasonably be expected to designate as the beneficiary." Prop. Treas. Reg. § 1.61-22(b)(2)(ii).

The type of transaction discussed in this (as to the life insurance) clearly falls within the definition of a "split-dollar arrangement" under the proposed regulations.

The split-dollar regulations outline two "mutually exclusive" regimes for taxing split-dollar arrangements:

(1) the loan regime; or

(2) the economic benefit regime.

## Loan Regime Inapplicable

Under the proposed regulations (which helped bring an end to the use of the first generation A/R Leveraging plans), in instances in which the employee is the owner of the insurance, the general rule under the regulations would require that the transaction be treated as a "split-dollar loan", in which case the employee would be deemed, under the loan regime, to have received a below-market interest loan, resulting in the inclusion of imputed income (imputed interest) based upon the value of the "loan". However, to constitute a split-dollar loan, the regulations require that the following criteria must be met:

> (A) The payment is made either directly or indirectly by the non- owner to the owner (including a premium payment made by the non-owner directly to the insurance company with respect to the policy held by the owner);
>
> (B) ***The payment is a loan under general principles of Federal tax law or***, if it is not a loan under general principles of Federal tax law, ***a reasonable person would expect the payment to be repaid in full to the non-owner*** (whether with or without interest); and
>
> (C) The repayment is to be made from, or is secured by, either the policy's death benefit proceeds or its cash surrender value.

Based upon the manner in which the transactions discussed in this material are structured, it does not appear that the funding of the Insurance Contracts meets the criteria for a "split-dollar loan" because the amount advanced is not a loan within the meaning of Federal tax law, nor is it likely that the amount funded will be repaid by the physician/shareholder. Under the transaction discussed in this material, it is contemplated that unless the receivables are insufficient to repay the loan to the third-party lender, the amount funded into the Insurance Contracts will eventually vest in the physician/shareholder, and there would be no obligation to repay the Professional Corporation the amount advanced. Consequently, the transactions as structured do not meet the criteria for a "split dollar loan" within the meaning of the proposed regulations.

## Determining "Owner" of Life Insurance Policy

The regulations define how to determine the "owner" of the policy for purposes of applying the tax rules. With the exception of non-equity split-dollar insurance (where the only benefit conferred upon the employee is current death benefit coverage), the owner is the person named as the policy owner of the contract. If two or more persons are named as policy owners, and no one person holds all incidents of ownership with respect to the policy, then the person who is the "first-named policy owner" is treated as the owner of the entire contract. Under the typical transaction described in this material, all "incidents of ownership" are not conferred upon the physician/shareholder. The term "incidents of ownership" includes, *in part*, the right to <u>assign</u> the policy, to <u>pledge</u> the policy or to <u>obtain a loan against</u> the surrender value of the policy. A reversionary interest in the policy is also an incident of ownership.

In the type of transaction discussed here, several incidents of ownership are conferred upon the Professional Corporation until the lapse of the forfeiture provisions and repayment of the third-party loan, with the remaining incidents of ownership conferred upon the physician/shareholder as the policy owner. However, while neither the employee nor the employer have all incidents of ownership, the employee, who is the "named policy owner" is treated as the owner of the entire contract.

## <u>Economic Regime Inapplicable</u>

The split dollar regulations provide that, as a general rule for split-dollar life insurance arrangements that are taxed under the economic benefit regime, the owner of the life insurance contract is treated as providing economic benefits to the non-owner of the contract, and those economic benefits must be accounted for fully and consistently by both the owner and the non-owner. The value of the economic benefits, reduced by any consideration paid by the non-owner to the owner, is treated as having been transferred from the owner to the non-owner.

The employee must include as income the value of any interest in the cash surrender value of the contract provided to the employee during a tax year. The employer's right to a return of its premiums affects the valuation of the employee's interest under the arrangement, and, therefore, the amount of the employee's current income.

In addition, the employer is treated as providing current life insurance protection. For tax purposes, the cost of this protection for a year is the amount of the death benefit coverage multiplied by the life insurance premium factor from IRS guidance, reduced by any premiums paid by the employee.

It would also appear that as structured, the type of transaction discussed in this material would not meet the criteria for treatment under the economic regime. The economic regime applies if:

> "(A) the arrangement is entered into in connection with the performance of services, and the employee or service provider is not the owner of the life insurance contract . . ."

## General Tax Law Principles Apply

Consequently, since the amounts advanced are not "split-dollar loans" and the Professional Corporation is not the owner of the life insurance contract, neither the "loan regime" nor the "economic benefit regime" apply to the funding of the life insurance. Therefore, the general principles under Section 61 and 83 of the Internal Revenue Code would apply to the transaction. This is consistent with the preamble to the proposed split-dollar regulations which states:

> "Unless the non-owner's payments are certain payments made in consideration for economic benefits, general Federal income, employment . . . tax principles apply to the arrangement. For example, if an employer pays premiums on a contract owned by an employee and the payments are not split-dollar loans under § 1.7872-15, the employee **must include the full amount of the payments in gross income** at the time they are paid by the employer **to the extent that the employee's rights in the life insurance policy are substantially vested**." [Emphasis added]

**NOTE**: It is important to note that the split-dollar rules only apply to life insurance. However, the same general principles of the tax law under Section 61 and 83 of the Internal Revenue Code also apply to the funding of the annuity contract.

## Taxation of Cash Value Build-up

Under the transactions discussed in this material the cash value of the life insurance policy will eventually exceed the amount borrowed from the third-party lender. It is contemplated that the physician/shareholder will not be subject to a risk of forfeiture on the cash value of the policy in excess of the loan amount.

The IRS, in TAM 9604001, dealt with the application of Section 83 of the Internal Revenue Code to split-dollar arrangements in which the cash value of the policy exceeded the amount due back to the employer. The facts involved two single-premium collateral assignment split dollar policies. The IRS ruled that in addition to the employee being taxed on the value of the current life insurance coverage, since the cash surrender value of the policies exceeded the amount owed to the employer the employee was annually taxed under Section 83 of the Internal Revenue Code on the increase in the cash surrender value belonging to the employee.

Given the interaction with Section 72(e)(6) of the Internal Revenue Code, taxing the incremental increases in the cash value of a life insurance policy would be extremely complicated to apply because subsequent increases in cash surrender value would necessarily be attributable in part to the employee's part of the contract (the amount the employee was previously taxed upon under § 83) and therefore that part would have to be identified and taxed under § 72 (e)(6), i.e., upon withdrawal.

Nevertheless, it does appear the IRS's position regarding this material, is that the incremental increase in cash value above the amount subject to forfeiture is currently taxable. The IRS indicated in IRS Notice 2002-8 that for arrangements entered into before the publication date of the final regulations, it will not assert its position in TAM 9604001 that a § 83 transfer has been made of a portion of a policy's cash surrender value merely because the cash surrender value exceeds the amount due to the employer. By implication, the IRS will likely assert its position in TAM 9604001 in instances in which the economic regime and loan regime do not apply to a split-dollar arrangement entered into on or after the publication date of the final regulations.

**NOTE:** It has been asserted (at least by some vendors marketing the A/R Financing program) that once the cumulative amount reported as income by the Physician/shareholder is equal to the amount funded into the Insurance Contracts, the Physician/shareholder will be treated as being fully vested in the life insurance policy and that no further amounts (including the originally funded amount) will be income to the Physician/shareholder. This position is inconsistent with then proposed spilt dollar regulations and the general principles under Section 83 of the Internal Revenue Code. Only the portion of the cash value which has either been previously included in income, or which is attributable to appreciation on the portion of the cash value previously included in income, will escape subsequent taxation as the forfeiture risk lapses.

## Guidance from the split dollar regulations

The regulations state that for arrangements entered into before the split-dollar regulations became final, cases in which the value of the life insurance protection is treated as a economic benefit provided by an employer (i.e., the economic regime is applied) as sponsor under a split-dollar arrangement, the IRS will allow such treatment for so long as the parties to the arrangement continue to treat and report the value of the insurance protection as an economic benefit provided to the employee. This treatment will be accepted by the IRS **without regard to the level of the remaining economic interest that the sponsor (i.e., employer) has in the life insurance contract**.

Therefore, transactions of the type discussed in this material that were entered into prior to the date the split-dollar regulations became final could have elected to be treated subject to the economic regime, even if the employer did not satisfy the requirements as the owner of the policy under the regulations. Consequently, until the arrangement is terminated, or until the employer ceases to report as income the value of the life insurance coverage, there will be no income event to the employee (except for the annual inclusion of the value of the current life insurance coverage). However, since transactions discussed in this material do not satisfy the requirements to come under the economic regime, transactions entered into on or after the publication of the final regulations will be subject to the general principles of Sections 61 and 83 of the Internal Revenue Code.

As we discussed, for split-dollar life insurance arrangements entered into before the date of publication of final regulations, the Service will not treat an employer as having made a transfer of a portion of the cash surrender value of a life insurance contract to an employee for purposes of section 83 solely because the interest or other earnings credited to the cash surrender value of the contract cause the cash surrender value to exceed the portion thereof payable to the service recipient.

The effect of this rule is that even though a physician vests in the cash value of the policy in excess of the initial funded amount, for transactions entered into prior to the date of publication of the final regulations, the incremental increase in value above the amount subject to forfeiture risk will not be considered as a transfer under Section 83 (and therefore not currently taxable). However, for transactions entered into on or after the date of publication of the final regulations, incremental increases in the cash value which vest would be includable in income.

The Physician/Shareholder does not receive any investment in the contract under Section 72(e)(6) of the Internal Revenue Code with respect to a life insurance contract that is part of a split-dollar life insurance arrangement subject to Section 83 of the Internal Revenue Code until the value of the insurance contract (or undivided interest in such contract) is taxable under section 83. Therefore, until the Physician/Shareholder vests in the entire life insurance contract, there will continue to be a recognition of income as the value of the policy continues to increase and with respect to the current cost of insurance under the portion of the policy in which the Physician/shareholder is not substantially vested.

## General Rules of Section 83

Under the general principles of Section 83 of the Internal Revenue Code, a transfer of property is taxable to the employee unless the rights to the property (in this case the life insurance contract) are subject to a “substantial risk of forfeiture”. The forfeiture provisions contained in the documents in the typically marketed program, without modification, are not sufficient to create a substantial risk of forfeiture. The promotional material from some marketers asserts that the a substantial risk of forfeiture exists because of the obligation to apply the cash value of the Insurance Contract(s) to repay the Loan in the event the receivables attributable to the Physician/shareholder are insufficient to repay the Loan. However, while there is a risk of forfeiture, this risk is not substantial given the value of the receivables, which serve as **primary collateral for the loan**. Furthermore, the additional service requirements contained in the typical documentation (e.g., serving on committees, maintaining a minimum work week schedule, etc.) do not impose a requirement of the future performance of “substantial services” within the meaning of Treas. Reg. 1.83-3(c).

Consequently, to avoid current taxation, the documents would have to be revised to provide for additional forfeiture risk to the Physician/shareholder. The documents could be revised to contain a covenant not to compete. The restriction period under the covenant not to compete would need to extend to a period beyond the Physician/shareholder’s period of employment (e.g., 12 months). This should generally be sufficient to create a substantial risk of forfeiture. Alternatively, the agreements could provide for forfeiture if the physician/shareholder fails to complete a minimum period of service (e.g. 10 years) except in the case of death or disability. In either instance, **the Physician/shareholder will be required to include the value of the policy as income at the time the forfeiture risk lapses.**

Under Treas. Reg. Sec. 1.83-3(c), an enforceable covenant not to compete **will not** ordinarily be considered to result in a substantial risk of forfeiture unless the particular facts and circumstances indicate to the contrary. Factors which may be taken into account in determining whether a covenant not to compete constitutes a substantial risk of forfeiture are the age of the employee, the availability of alternative employment opportunities, the likelihood of the employee's obtaining such other employment, the degree of skill possessed by the employee, the employee's health, and the practice (if any) of the employer to enforce such covenants. In this instance, with the possible exception of a physician who is close to retirement, it should be possible to establish that a substantial risk of forfeiture exists. See, Example 5 of Treas. Reg. Sec. 1.83-3(c), in which a substantial risk of forfeiture was found to exist with respect to a covenant not to compete.

It is also critical, to avoid current taxation, that the Physician/shareholder not have the right to receive the annuity payments, but rather that they be paid directly to the life insurance company. The documentation of the typically marketed program does not restrict the ability of the Physician/shareholder to receive the annuity distributions, which would likely result in current income if such a payment were received by the Physician/Shareholder.

## Single Shareholder Practices

In determining whether the possibility of forfeiture is substantial in the case of a Physician/employee who owns a significant amount of the stock of the Professional Corporation, the IRS will consider: (i) the Physician/employee's relationship to other stockholders and the extent of their control of the Professional Corporation, (ii) the position of the physician/employee in the Professional Corporation and the extent to which he is subordinate to other employees, (iii) the Physician/employee's relationship to the officers and directors of the Professional Corporation, (iv) the person or persons who must approve the physician/employee's discharge, and (v) past actions of the Professional Corporation in enforcing the forfeiture provisions.

In the case of a Professional Corporation owned by a single Physician/shareholder, it will be **virtually impossible** to create a substantial risk of forfeiture because of the degree of control the Physician/shareholder exercises over the Professional Corporation.

## Deductibility of Interest

## Single Premium Policies

The number one selling point to the incorrectly constructed A/R Financing plans is that the interest on the loan an employer takes out to fund the plan is deductible.

Section 264(a)(2) of the Internal Revenue Code provides that amounts paid or accrued 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. This prohibition applies even though the insurance is not on the life of the taxpayer and regardless of whether or not the taxpayer is the annuitant or payee of such annuity contract. A contract is considered a single premium life insurance, endowment, or annuity contract, for the purposes of Section 264(a)(2) of the Internal Revenue Code, if substantially all the premiums on the contract are paid within **four years** from the date on which the contract was purchased.

## Systematic Borrowing

Section 264(a)(3) of the Internal Revenue Code provides that that 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 the cash value of such contract are not deductible under section 163 or any other provision of the Internal Revenue Code. This rule applies whether or not the taxpayer is the insured, payee, or annuitant under the contract.

The amount disallowed as a deduction under Section 264(a)(3) of the Internal Revenue Code is determined with reference to the entire amount of borrowing to purchase or carry the contract, and is not limited with reference to the amount of borrowing of increases in the cash value. If the stated annual premiums due on a contract vary in amount, borrowing in excess of the amount of the premium vary in amount, borrowing in connection with any premium, the amount of which exceeds the amount of any other premium, on such contract may be considered borrowing to pay premiums for more than one year.

In the typically marketed A/R Financing program, all premiums are paid with borrowed funds. Consequently Section 264(a)(3) applies and the interest is **not deductible**. Since the marketers of these plans typically sell them as a tax strategy by indicating the interest on the loan is deductible to the company, revealing to a client and his/her advisor that the interest is not deductible will limit the sales of the plan to those who are truly concerned with asset protecting their A/R.

While some exceptions apply to the deduction disallowance provisions of Section 264 of the Internal Revenue Code, none appear to be applicable to the type of transaction discussed in this material. The trade or business exception under Section 264(d)(4) of the Internal Revenue Code only applies to deduction disallowances under Section 264(a)(3) of the Internal Revenue Code (and not 264(a)(2) or (4)). Furthermore, to be within this exception, the indebtedness must be incurred to finance business obligations rather than to finance cash value life insurance. Borrowing by an employer to finance business life insurance, such as key-man or split dollar life insurance arrangements, is not considered to be incurred in connection with the employer's trade or business within the meaning of the trade or business exception. See, Treas. Reg. § 1.264-4(d)(4).

No exception under Section 264(a)(2) exists for indebtedness incurred to purchase a single premium immediate annuity, despite any lack of tax deferral.

## Application of ERISA

With the poorly designed but highly marketed program there is also the potential for the program to be construed as a deferred compensation plan. A funded deferred compensation plan, even if non-qualified, is subject to the trust and vesting requirements of ERISA. Consequently, if the program constitutes a deferred compensation plan, it would be a prohibited transaction for the life insurance policies to be pledged as collateral, and the rights to the benefits would be required to fully vested within five (5) to seven (7) years. Clearly the intent is to substitute the insurance funding for the Physician/shareholder's right to receive salary continuation, based upon subsequent collection of accounts receivable from services rendered prior to termination, rather than a deferral of income currently due to the Physician./shareholder. Therefore, this issue can likely be remedied by revising the documents to properly reflect that the program is intended not as a deferred compensation program, but as a split-dollar arrangement in substitution for salary continuation.

In ERISA Advisory Opinion 92-22A the Dept. of Labor stated that ERISA's general standards of fiduciary conduct would apply to the selection and retention of a life insurance policy under a split-dollar arrangement. Section 404(a)(1)(A) of ERISA provides, in part, that the fiduciary of a plan shall discharge his or her duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries. Section 404(a)(1)(B) requires a fiduciary to discharge his or her duties with the care, skill, prudence and diligence, under the circumstances then prevailing, that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

The Advisory opinion further states that, a plan fiduciary may provide benefits under a death benefit plan, through a life insurance policy whose cash value element belongs exclusively to the sponsoring employer, without violating the requirements that the selection (and retention) of the policy be prudent and be made solely in the interest, and for the exclusive purpose, of providing benefits for plan participants and beneficiaries. Consequently, so long as the right to pledge the policy is limited to the portion of the cash value to which the Professional Corporation has a retained interest, and the program is characterized as a split dollar arrangement, the pledge of the policy for the loan used to fund the insurance premiums should not constitute a prohibited transaction.

## Other Considerations

1. Choice of Product: Variable Universal Life contracts were those most consistently used in Deferred Compensation Plans involving A/R financing. Equity minded clients liked the idea of being able to enjoy tax-deferred growth on mutual fund sub-accounts while having deductible loan interest on the source of the life insurance policy premiums. The additional benefit of tax-free distributions made this type of policy very popular. Of course this was in a time when mutual funds and mutual fund sub-accounts inside VUL policies were enjoying the unprecedented growth of the 90's. Banks typically overlooked the market risk associated with VUL policies, and when the market dropped dramatically, many plans turned "upside down."

   Another potential problem associated with VUL contracts was the Securities Act of 1934. Financial Advisors selling this plan and using VUL contracts simply overlooked specific provisions of this law which state that neither a broker dealer, nor its registered representative, may participate directly or indirectly in a loan process the intent of which is to use the loan proceeds to purchase a securities product. Additionally, advisors with only life insurance licenses could not sell VUL policies and therefore this significantly limited the number of advisors who could sell the plan.

2. The Amount of Initial Death Benefit: Most of these plans used initial face amounts far in excess of the minimum, **non-MEC** amount resulting from the premium flow from the SPIA. Usually the life insurance illustration would show a reduction in the death benefits after the initial seven year period; however, the costs associated with the high death benefits had a dramatic effect on cash values, and commissions.

## Basic Mechanics

All A/R Financing Plans use a loan from a bank. The loan is collateralized by the A/R, **and once the bank files a UCC1 this lien takes priority over any other creditor**. It is paramount that the A/R be truly at risk and truly serving as primary collateral for the loan.

All A/R Financing Plans also use life insurance as the funding vehicle for the plan. Some plans will fund the premiums over a two or three year period. Some will fund the premiums over a longer period of time; i.e., five years. Some plans will escrow unpaid premiums while other plans will use a SPIA as the depository for the loan proceeds and the source of the premium deposits. It should be kept in mind that while avoiding a MEC under the 7 Pay Guidelines the shorter the premium paying period the higher the required initial death benefit.

Even if the death benefit is reduced later in the contract there are significant costs associated with the additional death benefits.

# Types of Plans

A/R Financing Plans are structured in one of two ways:

1. A Practice Loan Approach, or

2. A Personal Loan Approach

## Practice Loan Approaches

In these types of plans, the practice applies for a loan, generally in an amount equal to its collectible A/R. It will collateralize the loan with the A/R, and the bank's UCC1 filing will shield the A/R from other potential creditors. Once the non-taxable loan proceeds have been received by the practice, it then seeks to do something with those proceeds for the benefit of the physician(s). The methodology of transferring the loan proceeds from the practice to the benefit of the physician is what differentiates the plans.

1. Loan the Proceeds to the Physician.

Under this approach the practice receives the loan proceeds from the bank and then loans those proceeds to the physician(s), who then takes the borrowed money and purchases life insurance via one of the funding methods previously described. There are numerous issues associated with this approach.

This type of arrangement creates a Split Dollar arrangement under the Loan Regime of the Split Dollar regulations that went into effect January 1, 2004. Whether the practice and the Physician(s) actually have a Split Dollar Agreement is immaterial because an arrangement has been established whereby one party, the practice, lends money to another party, the physician(s) to buy life insurance. Creating a Split Dollar arrangement under the Loan regime necessitates addressing several issues.

First, under the Loan Regime regulations there is a taxable value on the loan received by the physician(s). This value is the Applicable Federal Rate (AFR) times the amount of the loan. For example, if the AFR is 2% and the loan to the physician is $250,000 then the physician must report 1099 income of $5,000. If the AFR increases, so too does the taxable income.

An additional concern with this first issue is, who is going to provide these calculations to the physician(s), and at what cost.

Second, IRS regulations are quite specific that money borrowed to fund a Split Dollar arrangement are not tax-deductible.

Third, not only must the bank loan to the practice be repaid, the loan from the practice to the physician(s) must be repaid. Typically the bank loan to the practice is repaid by A/R received by the practice after plan termination; i.e., retirement. That money comes in to the practice and goes to the bank. It is not a deductible expense to repay a loan so the A/R used to repay the loan may become taxable income to the physician(s). The physician still owes money to the practice and either must pay the amount owed or if that amount is forgiven, it becomes taxable income to the physician.

Fourth, and the largest issue, is that this type of arrangement creates a new asset on the practice's Balance Sheet that is of equal value to the A/R and is not protected. As soon as the practice lends the loan proceeds from the bank to the physician(s) it has created a new asset called A/R from the physician(s). It is not only unshielded but is actually a more desirable asset that the actual A/R.

One plan being marketed that uses this methodology suggests there can be a provision in the loan agreement between the practice and the physician(s) which will allow for forgiveness of the loan to the physician(s) in the event of malpractice litigation. This not only creates immediate taxable income to the physician but also may be deemed a fraudulent transfer of assets.

2. The Pass-through Entity

Most physicians' practices are structured as some type of pass-through entity, such as a sub-S corporation. In this type of entity "profits" and "losses" pass through to the owner(s) at the end of the taxable year.

Under this type of plan the practice makes a loan and collateralizes the loan with the collectible A/R. It then bonuses the loan proceeds to the physician(s) as taxable income. This bonus is a deductible expense to the practice and, theoretically, will create a loss in the practice that passes through to the physician(s) and offsets the taxable income. It becomes a "wash", and the physician realizes the borrowed money tax-free.

Again, there are several issues that should be addressed.

The first is the deductibility of the interest. Only the IRS can say whether the interest on a loan, when used as the source of a bonus to a shareholder, is a reasonable, customary and bona fide business expense. The IRS will consider these three questions:

a. Is this reasonable?
b. Is this customary?
c. Is this a bona fide business expense?

The second is reasonable compensation. Again, only the IRS can determine what is reasonable compensation. Is it reasonable for a physician to receive a bonus which will probably be hundreds of thousands of dollars over and above a well above average income?

Third is the Red Flag. Even if all else meets muster, losses of this magnitude are definitely audit triggers. The physician(s) waving this flag better be certain that everything involving their personal and practice IRS dealings is up to very close scrutiny.

**Fourth, and most important, are basic accounting rules. In a pass-through entity a loss may only be passed through if there is an equivalent basis in the entity. In other words the physician(s) must have contributed basis to the practice before they can realize such a loss. Not many have**.

3. Other Approaches

There are a variety of practice loan approaches that vary from the above. They all seek to accomplish the same end result; a plan in which the interest is deductible and there is minimal taxation to the physician(s). The sheer complexity of these plans and required internal practice structure alterations often cause them to be rejected. In addition there are numerous “gray” areas that cause more conservative practitioners to seek other avenues.

One plan suggests that the practice create a new and separate entity, an LLC. The A/R owned by the existing practice entity assigns the value of the A/R to the physician(s), who then contribute that value to the LLC. The LLC applies for a loan, using the A/R as collateral. It then buys the life insurance and, under one scenario, and owns the policy(ies). Totally or partially deductible interest is touted. A similar approach suggests an arrangement in which the cash values of the policy are owned by the physician(s), and the death benefit is owned by the LLC.

There are several questions to be asked about these plans. How does the physician(s) receive assignment of the A/R’s value without taxation? If the new LLC owns the life insurance policy(ies) how does it distribute the cash values to the physician(s) after the plan is terminated? Who absorbs the taxation on the realized A/R used to repay the loan at retirement? How does one determine the amount of loan interest, if any, that is deductible? And, how do you structure and administer a Loan Regime Split Dollar arrangement if you attempt to separate the elements of the life insurance policy(ies)?

Another approach suggests that the A/R loan proceeds inside the practice entity can be distributed at Capital Gains rates, and 85% of the loan proceeds can then be placed in the life insurance contract and grow tax-deferred while deducting the interest on the loan to the practice. Assume for a moment that the loan proceeds can, indeed, be distributed at Capital Gains rates; currently 15%. If these loan proceeds are distributed as excess accumulations in the practice entity and it becomes insolvent, the physician(s) will be personally liable for the insolvency.

Also consider the double taxation of the A/R. Assuming it can be distributed at a 15% Capital Gains rate, it will be taxed again at ordinary rates when it is used to repay the loan. And, who gets hit with it at that time? Probably the physician(s) still practicing when the first one retires.

Another approach suggests that physicians "go bare", and drop all malpractice coverage. The practice entity then applies for a loan, collateralized by the A/R. It uses the loan proceeds to fund a Deferred Compensation plan using a Variable Annuity as the funding vehicle. The problems with Deferred Compensation plans have already been reviewed. In this strategy the physician(s) is definitely using loan proceeds to purchase a single premium annuity, which is the "kiss of death" for deductible interest on the loan. In addition, all A/R plans require the underlying funding vehicle be used as secondary collateral. As soon as the Variable Annuity is collaterally assigned to the bank it loses its deferred nature. Some tax authorities also suggest that not only is any gain taxable in the year it is realized, but it may also be subject to the 10% pre-age 59 ½ penalty.

In summary, the various practice loan approaches all have one thing in common: they attempt to structure a plan that will allow the interest on the loan to be deductible. Careful consideration should be given to any attempted tax deduction, and one should seek the advice of a competent tax professional before taking a large tax deduction. The first thing that must always be addressed in any practice loan plan is what the practice entity does with the loan proceeds. The second thing is: Who takes the hit on taxable income when the loan is repaid?

# The Personal Loan Approach; The "Right" Approach

In this approach there is no attempt to create an arbitrage situation through deducting interest on the loan and receiving tax-deferred growth on the loan proceeds. A personal loan to the physician is used, and personal loan interest is not deductible. This **conservative** approach takes no deductions and avoids no taxes. The mechanics are simple and easily understood with no "gray" areas.

With the IRS hammering away at abusive 412(i) Defined Benefit Plans and 419A(f)6 Welfare Benefit Plans, it is only a matter of time before they focus on the abusive A/R Financing plans discussed in the prior material. We believe that the prudent approach for clients truly concerned with asset protecting their company's A/R is the personal loan approach.

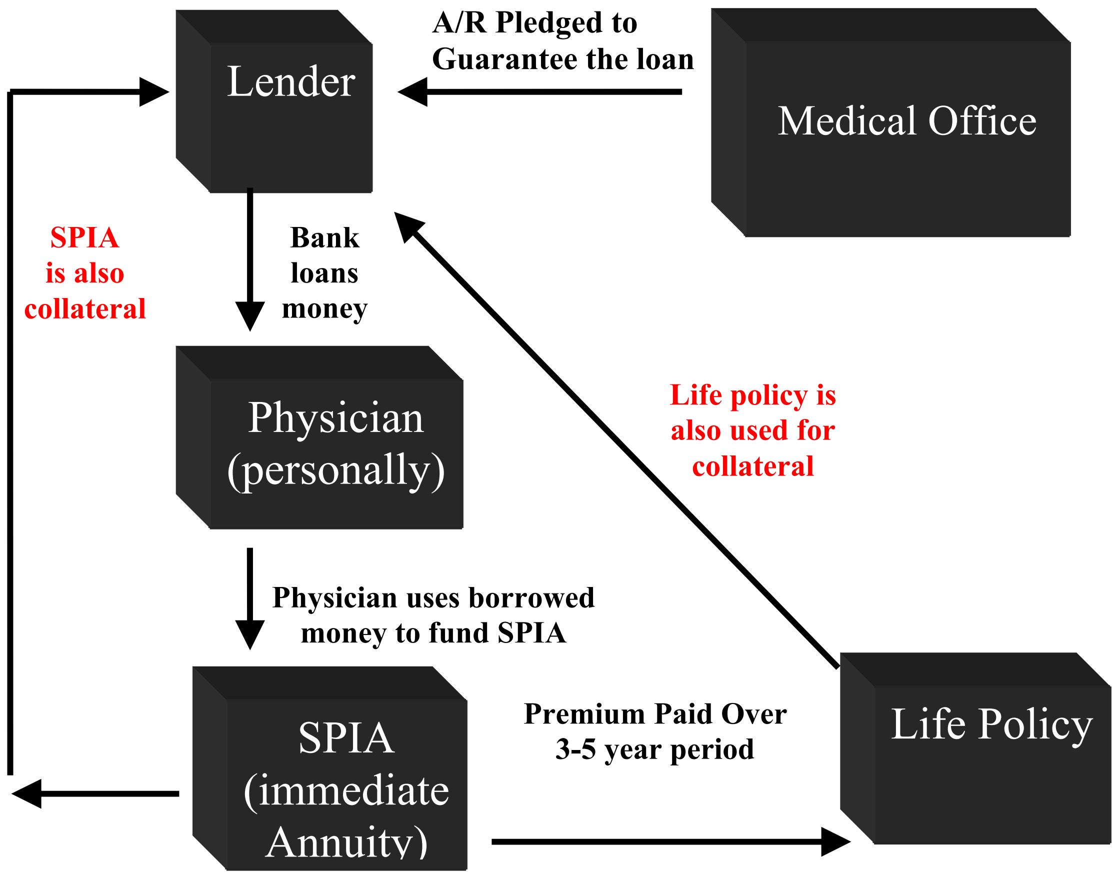
## The Mechanics

A physician applies for a personal loan in an amount equal to his/her collectible A/R. This will be an interest only loan. Two forms of collateral are given to the bank. The primary collateral for the loan is a Guaranty by the physician's practice using the collectible A/R as collateral for the Guaranty. The bank accepts this practice Guaranty, files a UCC1, and the A/R are shielded.

The loan proceeds are then typically used to purchase a Single Premium Immediate Annuity (SPIA) that funds a life insurance policy with 5-6 payments. The SPIA is a "period certain" immediate annuity with no life contingency. A SPIA is used to guarantee the premium payments to the life insurance policy, and payments from the SPIA are spread over a 5-6 year period to make certain the life policy has low insurance costs (as dictated by the 7-pay MEC rules).

Both the SPIA and the life insurance policy are owned personally by the physician. The physician offers the lender the values in both policies as secondary collateral. If the plan is structured to the advantage of the physician and the protection of the bank through the utilization of minimum, non-MEC face amounts and other policy enhancements, these values can be 90-95% of the loan amount in the first year.




Since the loan is an interest-only loan, repayment occurs when the plan is terminated, usually at retirement. When the physician leaves the practice, his/her A/R not yet collected is realized by the practice. At the direction of the physician this A/R is paid to the lender to repay all or part of the personal loan. If there is insufficient A/R to repay the loan the physician has personal responsibility for any balance due. Cash values accumulated in the life insurance policy could be accessed for this purpose. Likewise, if more A/R is realized than is needed to repay the loan, any surplus would typically be paid to the physician. In either event, the entire cash flow from the A/R is taxable income.

This type of plan clearly meets one of the primary objectives in A/R financing—shielding the A/R from creditors and lawsuits. In States with creditor protection of life insurance cash values there is the additional advantage of having the "value of the A/R", the loan proceeds, paid into the personally-owned life insurance policy, thus creating cash values that are also protected. The A/R is shielded by the practice Guaranty and UCC1 filing, and in States with cash value creditor protection the value of the A/R is also protected. In States where life insurance is not asset protected a simple LLC structure can be utilized to make it asset protected (see the advanced educational module on estate planning).

In the personal loan approach there is no interest deduction for the loan interest. Does this lack of a deduction negate the other objective of A/R financing—receiving a yield on an otherwise stagnant asset? In most cases, no.

The best way to analyze the effectiveness of this approach is to make relatively simple Lost Opportunity Costs calculations. If the physician implements this plan he/she will have to pay non-deductible, after-tax interest payments to the bank, and thus will have lost the opportunity to invest this money. Conversely, if the physician implements the plan he/she will have the cash value accumulations inside the life insurance policy and also the income tax-free death benefits of the policy.

A simple way to determine whether the plan is “a good deal” is to compound the invested interest payments at the same gross rate of return of the life insurance policy less an assumed pre-retirement tax bracket. For example, if the loan amount is $100,000 and the loan interest is 5% then the physician could invest $5,000 per year by not implementing the plan. Assuming the life insurance policy yield is 6% and the $5,000 per year would receive the same yield in a pre-retirement tax bracket of 20%, the $5,000 would be compounded at a 4.8% net rate of return. The resulting values at the assumed termination age, usually age 65, can be compared with the cash value accumulations at the same age.

These calculations address only comparing the yield. Many physicians will find the plan desirable even if the invested interest payments (Lost Opportunity Costs) and the insurance cash values equal each other; i.e., wash. This is because they have accomplished the other objective, shielding their A/R, and are no worse off for having done so.

Is there an arbitrage in the personal loan approach? Yes, but not because of the differential between tax-deductible interest and tax-deferred growth. The arbitrage, although small, comes from having the full value of the loan proceeds placed into a life insurance policy through five premium payments and then growing tax-deferred. This tax-deferred growth on a large sum of money will, in most cases, exceed the taxable growth on the otherwise invested interest while at the same time shielding currently unprotected assets.

As an example, if a plan participant borrows $100,000 and uses the loan proceeds to make five $20,000 premium payments, all $100,000 is inside the tax-deferred life insurance policy in slightly over four years. If the loan interest is 5% then the plan participant only has $5,000 per year to invest in a taxable investment. Even with the ancillary costs associated with the life insurance policy, $100,000 inside a life insurance policy is, in most cases, going to grow faster than $5,000 per year in a **taxable** investment.

This over-simplified example illustrates the absolute necessity of using a minimum, non-MEC death benefit in order to minimize the costs of insurance. It should also be pointed out that the arbitrage decreases with the length of time. More $5,000 "payments" being invested will eventually catch up with the five $20,000 premium payments paid into the life insurance policy. It is for this reason that not only should Lost Opportunity Costs be calculated and considered, but also the value of shielding a vulnerable asset in light of these costs. In summary, this strategy does not yield a super-leveraged arbitrage, nor is it intended to do so. In most cases a physician can capitalize his/her A/R, simultaneously shield the A/R from creditors and lawsuits, and be either ahead, or no worse off, for having done so.

## A/R Financing and Non-Physician Entities

The catalyst in considering an A/R financing plan may be one or a combination of two things:

-Doing something to receive a yield on an otherwise stagnant asset, and/or

-Shielding this vulnerable asset from creditors and lawsuits.

There are a number of professions to whom A/R financing plans would be attractive. In addition to medical doctors and doctors of osteopathic medicine, these plans may be appropriate for chiropractors, physical therapists, speech and language therapists and a variety of other professions that have the commonality of

1. Stable A/R
2. The desire to receive a yield on stagnant A/R
3. A feeling of vulnerability

In addition to the above, independently-owned nursing homes and pharmacies may find such a plan attractive as well as attorneys, who have malpractice problems similar to physicians.

Regular business entities will find A/R financing less applicable. Most businesses with A/R usually already have a Line of Credit encumbering the A/R and/or they will factor (sell) their A/R. Businesses also tend to have less stable A/R and may not feel the vulnerability inherent in medical practices. The general lack of loan interest deductibility eliminates the arbitrage leveraging aspect of the plan, and most business owners who would otherwise have stable, unencumbered A/R do not usually find sufficient financial motivation to implement such a strategy, knowing their A/R would be "tied up" and thus eliminating any future use of this asset.

# Conclusion

A/R financing plans can be very advantageous in those specific situations where a professional, most often a physician, has a feeling of vulnerability relating to his/her practice's A/R. The plan should be implemented with the full knowledge that in most any scenario, the interest on the underlying loan is not deductible. Careful consideration should be given to every legal and tax aspect, and professional counsel should be sought relative to these issues. The plan should accentuate the accumulation of cash values and not excessive death benefits, and should have a distinct flexibility feature that allows the plan to be terminated after the premium funding period with adequate cash surrender values available to pay off the loan. If the plan design is correct, the participant can have the peace of mind of knowing he/she has created a sound personal savings program while simultaneously shielding a valuable and vulnerable asset.