

PREMIUM FINANCED LIFE INSURANCE

A Comprehensive Overview

People who need substantial life insurance coverage for estate or business planning are often faced with a dilemma: Does it make sense to (or do they want to) use current cash flow or liquidate investments to pay the premiums? Financing offers high-net-worth individuals the ability to borrow the premiums to pay for an insurance policy, allowing them the use of funds they might have otherwise used to pay for the insurance.

Premium financing makes most sense when the individual has a definite need for insurance. Only when the need has been determined should premium financing be evaluated as an option that may allow the individual to retain his assets or income for use elsewhere. This should not be proposed as a “free” way to obtain life insurance.

Premium financing also makes sense when the interest rate on the loan is less than the insured could earn on assets liquidated to pay the premium. Additionally, it makes sense when the interest rate on the loan is less than the policy is expected to earn. An individual may want to enter into a premium financing arrangement to obtain a lower out-of-pocket cost for a policy, to minimize gift tax concerns, and to keep from using cash flow or liquidating assets to pay insurance premiums.

Minimums for most programs are \$2.5 million in net worth and \$200,000 a year income. The borrower must also be a bankrupt-remote entity (i.e., creditors cannot attach the individual’s assets for bankruptcy), such as an LLC or an irrevocable life insurance trust.

The goal of a well-structured premium financing program is to have the individual pay as little out-of-pocket as possible for life insurance, balanced against the risk that the interest rate of the loan will exceed the performance of the policy. In a typical premium financing arrangement, an individual applies for an insurance policy. At the same time, the individual applies for a loan from a lender. While the individual is being medically underwritten for the insurance policy, he is also being financially underwritten for the loan. Assuming the individual passes both tests, the policy is put in force and the financing is put in place.

Premium Financing Due Diligence

An individual should consider the following questions before entering into any premium financing arrangement:

- **How is the loan interest calculated?**
- **What is the loan commitment fee?**
- **How long is the loan renewable for?**
- **Is it a term loan for a short period of time? Or is it a loan that extends well past life expectancy?**
- **Is a personal guarantee required for the loan, or is it backed by the insurance policy?**
- **Is the program designed to be based on life expectancy, or is it conventional?**
Life-expectancy programs assume that the insured dies at his calculated life expectancy, whereas conventional lending is more consistent with insurance carrier objectives.

Premium Financing Arrangements

The following are the basic types of financing arrangements.

Borrowing premium only.

The individual borrows only premiums, and the individual pays the interest. If the policy is owned by an irrevocable life insurance trust, then the interest is considered a gift.

Borrowing premium and interest.

The individual borrows premiums and the interest on the loan and has no annual outlay. Policy design is key, because the policy must earn more than the interest rate; otherwise it will either lapse or require a substantial payment by the policyholder.

Borrowing some premium and interest.

The individual borrows some premiums or some interest, usually for a period of time.

Premium Financing Exit Strategies

Premium loans can be repaid in three main ways:

1. During life, from the borrower's available assets.
2. During life, from policy cash values (this generally requires the lender's approval if the lender is the assignee).
3. At death, from policy proceeds (this usually happens automatically).

Income Tax and Gift Tax Considerations

Important considerations include:

- Interest on a loan to acquire a life policy is generally considered personal interest and is not deductible under IRC sections 163 and 264.
- Loans to a trust for premium payments are not taxable gifts. It is unlikely that the IRS would consider a personal guarantee on a loan-completed gift until a payment is made.

Estate Tax Considerations

Important considerations include:

- Life insurance proceeds will be included in the insured's estate if the insured owns the policy or has any incidents of ownership. Under Private Letter Ruling (PLR) 9809032, the IRS ruled that even though an irrevocable trust had borrowed funds from the insured to purchase a policy and the loan remained outstanding at death, the proceeds were not includable in the insured's estate.
- Providing a personal guarantee on a loan should not cause incidents of ownership in the policy.