One Resource Group

AN INTEGRITY COMPANY

Premium Financing of Life Insurance

Premium financing is a strategy used primarily by high-net-worth individuals to acquire large amounts of life insurance without paying premiums directly from personal or trust cash flow. Instead, premiums are funded through a loan from a third-party lender. This approach may allow individuals to preserve liquidity, avoid selling appreciated assets, or maintain investment strategies while still securing necessary life insurance coverage.

Premium financing is most commonly used when policies are owned by entities such as **irrevocable life insurance trusts (ILITs)** that may not have sufficient cash flow to support substantial premiums.

Important: Premium financing involves leverage and complexity. It is appropriate only for individuals who understand and can tolerate financial risk. Professional legal, tax, and financial guidance is essential.

How Premium Financing Works

In a traditional life insurance arrangement, there are two parties—the insured (often also the policyowner) and the insurer—and one financial instrument, the insurance policy. Premium financing introduces additional parties and agreements:

- **The insured** (often the borrower)
- **The borrower** (which may be an individual, trust, or business entity)
- **The insurance company**
- **The lender**

Two financial instruments are involved:

- The life insurance policy
- A loan agreement

The Process

1. The borrower applies for a life insurance policy and discloses that premiums will be financed.
2. If the insurer approves the policy for premium financing, the borrower applies for a loan.
3. The borrower typically makes an initial contribution or down payment.
4. The lender pays most or all policy premiums directly to the insurer.
5. The borrower agrees to repay loan principal, interest, and fees under the loan agreement.

The loan agreement is solely between the borrower and the lender; the insurer is not a party to the loan

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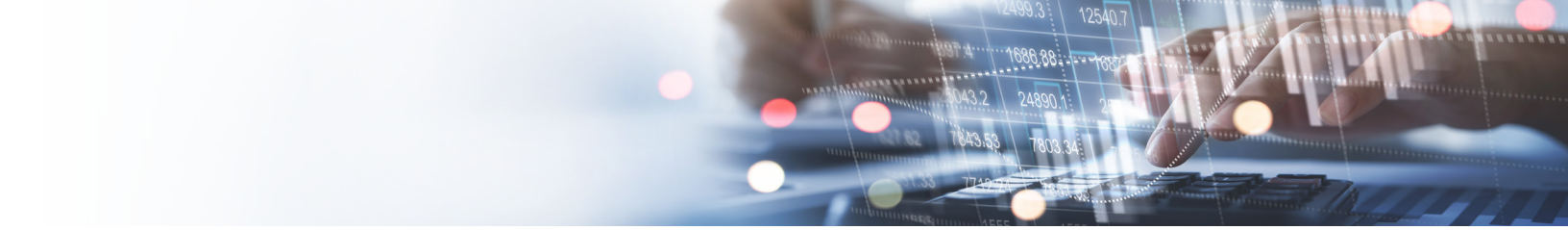

Loan Structure and Repayment

Premium finance loans generally have defined terms and are often renewed periodically. Repayment structures vary:

- **Interest-paid loans:** Borrower pays interest annually; principal remains relatively stable.
- **Capitalized loans:** Interest and costs are added to the loan balance.
- **Death-benefit repayment:** Loan is repaid at death from policy proceeds.

Interest rates are typically based on an index plus a lender spread and may reset at intervals (e.g., monthly, quarterly, annually, or multi-year periods). Larger arrangements may include interest rate caps, floors, or collars.

Suitable Borrowers

Premium financing is generally appropriate only for individuals or entities with substantial net worth and liquidity. Typical characteristics include:

- Net worth often exceeding **$5 million**
- Need for significant coverage with large annual premiums
- Ability to meet insurer underwriting requirements
- Ability to meet lender collateral and credit requirements
- Capacity to pay interest and costs if required
- Comfort with leverage and potential downside risk

Borrowers may include individuals, trusts, corporations, limited liability companies, or specialized planning entities, depending on lender policies.

Types of Premium Finance Loans

Non-Capitalized Loans
With a non-capitalized loan:

- Borrower pays interest and fees annually in cash
- Policy cash value is pledged as collateral
- Additional collateral and/or personal guarantees may be required
- Loan balance remains relatively stable

This structure typically involves less long-term risk than capitalized loans but requires ongoing cash flow.

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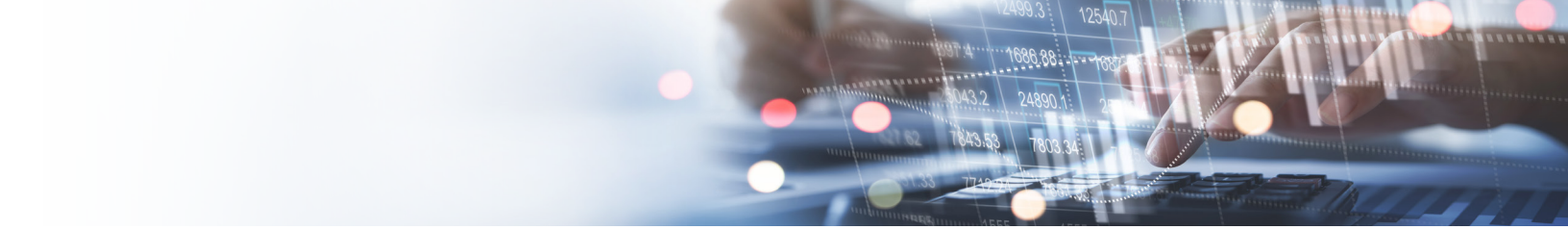

Capitalized Loans
With a capitalized loan:

- Interest and fees are added to the loan balance
- Cash flow requirements are reduced
- Loan balance grows over time

This structure increases leverage and risk, as compounding loan costs may erode policy value and reduce net death benefits.

Non-Recourse or Partial Recourse Loans

- Non-recourse loans: Lender's recovery is limited to policy cash value and death benefit
- Partial recourse loans: Borrower provides limited additional collateral (often a percentage of the loan balance)

These loans typically carry higher interest rates and stricter terms. In the event of default, lenders may assume ownership of the policy.

Risks and Considerations

Plan Design Risk
Life insurance policies and loans are separate contracts. If a lender declines to renew a loan, alternative funding may be required to prevent policy lapse.

Interest Rate and Qualification Risk

- Borrowers may need to requalify at each renewal
- Rising interest rates may increase loan costs
- Declining collateral values may trigger additional collateral calls

Policy Performance Risk
If policy values fail to keep pace with loan growth, more of the death benefit may be used to repay the loan, reducing the amount available to beneficiaries or planning objectives.

Collateral Risk
Declines in posted collateral value may require additional assets to be pledged or loan principal to be reduced.

Loan Call Risk
Some loans are callable. If a loan is called, borrowers may be forced to liquidate assets or surrender the policy, potentially triggering tax consequences.

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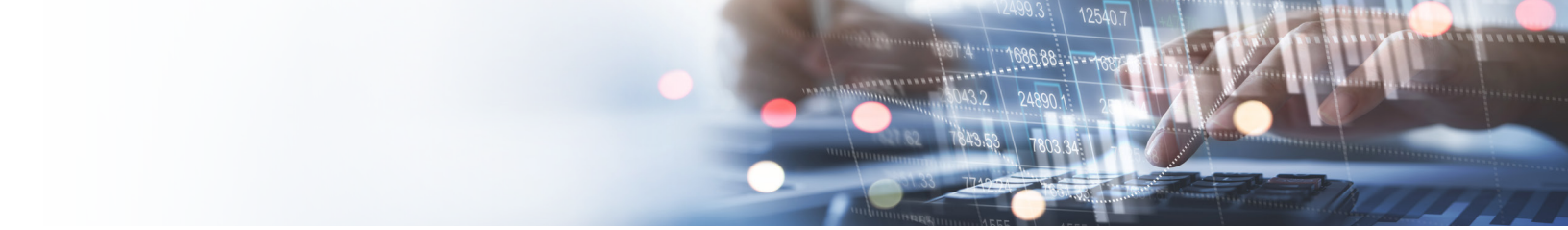

Tax Considerations

Income Tax

- Loan interest is generally **not deductible** for individuals
- Limited exceptions may apply in certain business-owned arrangements

Gift Tax

- Transfers to ILITs for interest or costs may be taxable gifts
- Crummey withdrawal rights may allow use of annual gift tax exclusions
- Personal guarantees may have gift tax implications, though guidance remains limited

Estate Tax

Life insurance proceeds may be included in the insured's estate if:

- Proceeds are payable to the estate
- The insured retains incidents of ownership
- Policy ownership is transferred within three years of death

Proper structuring is critical to managing estate inclusion risk.

Key Takeaways

- Premium financing can provide access to significant life insurance coverage while preserving liquidity
- The strategy is complex and involves leverage, interest rate exposure, and policy performance risk
- Appropriate only for financially sophisticated individuals with strong balance sheets
- Requires careful coordination among insurance, lending, tax, and legal professionals

IMPORTANT DISCLOSURES

One Resource Group does not provide investment, tax, or legal advice. The information presented here is not specific to any individual's personal circumstances.

To the extent that this material concerns tax matters, it is not intended or written to be used, and cannot be used, by a taxpayer for the purposes of avoiding penalties that may be imposed by law. Each taxpayer should seek independent advice from a tax professional based on his or her individual circumstances.

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