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Premium Financing of Life Insurance





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Introduction

Typically, when an individual purchases life insurance, he or she pays premiums directly to the insurer with cash. But high-net-worth individuals often need large amounts of life insurance, requiring significant premium payments. Some individuals have sound financial reasons for not wanting to pay these higher premiums with cash--for example, they may not want to disrupt normal cash flow, liquidate high performing investments, or sell assets that would result in capital gains tax liabilities. For these individuals, premium financing may be an appropriate solution, allowing them to borrow the funds from a third party to pay the premiums for the coverage they need.

Premium financing is often used when a life insurance policy is owned by an entity--for example, an irrevocable life insurance trust (ILIT)--which may not have enough cash or assets to make large premium payments.

Although premium financing may seem like a simple concept, it actually involves complex transactions--and risk. Only individuals who are comfortable with leverage should consider this strategy. Be sure to consult with financial and tax professionals who have experience with premium financing before entering into any premium financing arrangement.

How premium financing works

Normally, there are two parties to a life insurance policy; the insured (who is often the policy owner) and the insurer, and one financial instrument; the life insurance policy. With premium financing, there can be up to four parties; the insured (who is often the borrower), the borrower (which can be an entity), the insurer, and a lender, and there are two financial instruments; the life insurance policy and a loan agreement.

The process is two steps: The borrower first applies for a life insurance policy, indicating that the premium will be financed. If the insurer indicates that they will offer the policy with financed premiums, the borrower then applies for the loan. The policy can be any suitable life insurance product, including a second-to-die policy.

Caution: *A variable life policy is not usually recommended because its volatility increases the risk that the policy's cash surrender value, which is typically assigned as collateral for the loan, may fall below the loan balance. This may result in the borrower having to furnish additional collateral, or the loan could be called, requiring the borrower to pay off the loan at an inopportune time.*

The borrower generally makes a down payment, and the lender makes the balance of the premium payments to the insurer. The borrower agrees to repay the lender for the loan principal, annual interest, and other costs (e.g., origination fees). The agreement to repay the loan is between the borrower and the lender--the insurer is not a party.

As with any other type of loan, premium financing loans generally have a fixed term. Under some arrangements, the loan is repaid in installments during the insured's life. More commonly, however, the loan is continually renewed during the insured's lifetime and repaid in full at the death of the insured out of the insurance proceeds. In the case of the latter strategy, the goal is to have enough death proceeds to both pay off the loan and provide sufficient funds to meet the insured's needs. Whether this goal is achieved depends upon the life insurance policy outperforming or at least keeping pace with the outstanding loan balance.

Interest rates on premium financing loans vary by lender and depend on the size of the loan and the loan type (see below). The rate is typically based on an index plus a spread (sometimes referred to as the credit margin). The rate is typically fixed for the term of the loan, which can be for periods of, say, 1, 3, 6, or 12 months, or 5 or more years.

Suitable borrowers

The borrower can be an individual, a trust, a corporation, a limited liability company, or other specialized vehicle (although some lenders may lend to an entity only), but this strategy is appropriate for high-net-worth individuals only (typically, \$5 million or more). Usually, the insured is age 65 or older, and the insured must:

- Need a large amount of insurance (e.g., 6 or 7 figure annual premium)
- Meet the policy underwriting requirements
- Meet the lender's requirements (e.g., minimum size loan, minimum collateral, and minimum net worth)



- Be able to pay annual interest and costs (in the case of a non-capitalized loan)
- Be aware of and comfortable with the risks

Types of premium finance loans

There are generally three types of premium finance loans: (1) non-capitalized, (2) capitalized, and (3) non-recourse or partial recourse.

Non-capitalized loan

With a non-capitalized loan, the borrower provides full collateral for the loan, which includes the cash surrender value of the life insurance policy, and additional collateral and/or a personal guarantee. The borrower pays the interest and other fees annually in cash, with the principal balance remaining relatively constant.

Tip: Distributions of dividends or loans against the policy cash value may cover a portion of the annual costs.

Capitalized loan

With a capitalized loan, as with a non-capitalized loan, the borrower provides full collateral for the loan, which includes the cash surrender value of the life insurance policy, and additional collateral and/or a personal guarantee. However, the borrower does not pay the annual interest and other fees in cash. Instead, the annual loan costs are added to the loan principal. Although with this type of plan, the borrower does not need cash, it carries more risk because the loan costs compound, thereby increasing the chance that there will not be enough proceeds at the insured's death to both pay off the loan and achieve the goals for which the insurance was purchased.

Non-recourse or partial recourse loan

With a non-recourse loan, the borrower pledges the cash surrender value of the policy and the death proceeds only. No other collateral is posted. The lender can only use policy cash values and the death benefit to satisfy the outstanding loan balance. Partial recourse loans have minimal collateral requirements--for example, 25 percent of the loan balance. Higher interest rates and fees are generally charged to compensate lenders for the increased risk. The lender also retains the right to take ownership of the policy if the loan goes into default.

Risks

Plan design risk

The insurance policy and the loan are separate and distinct transactions and operate independently. The lender may decline to renew the loan at the end of a term, perhaps because the borrower fails to re-qualify. This would put the insurance policy in jeopardy of cancellation for nonpayment of premiums if alternate funding can't be found.

Loan interest rate and qualification risk

Lenders usually require that the borrower re-qualify for the loan at each loan renewal, and that the collateral be re-evaluated. If the borrower's financial position has deteriorated, or the value of the collateral has declined, there is the risk that the loan will not be renewed or that it will be offered at a higher rate than the original agreement. If rising interest rates cause the loan balance to exceed the value of the collateral, the borrower may be required to post additional collateral. It is also possible that the loan could be called for default.

Tip: With larger premium finance arrangements, a cap, floor, or collar may be offered by the lender. A cap sets how high the interest rate can rise. A floor sets how low the interest rate can drop. A collar has both a cap and a floor.

Policy earnings risk

If the insurance policy does not perform as well as expected, the loan balance may exceed the value of the collateral. If this happens, the borrower may be required to post additional collateral to prevent the policy from terminating. Also, if the policy values fail to keep pace with the loan, more of the death benefit will be needed to repay the loan, reducing the ultimate death benefit that will be available to meet the insured's objectives.



Tip: To help the intended death benefit in excess of the loan keep pace with the loan balance, the insured may be able to add a special death benefit rider to the policy or an increasing death benefit option. This feature increases the death benefit by the amount of the cash value. However, this also adds to the cost of the policy.

Collateral risk

If the value of the posted collateral decreases, the borrower may be required to furnish additional collateral or pay down a portion of the loan.

Loan call risk

Some loans are callable on demand by the lender. Generally, the lender will only call the loan in the event of default. However, some lenders may call the loan if the value of the collateral decreases, or the financial condition of the borrower deteriorates. If the loan is called, the borrower may have to liquidate assets or cancel the policy to pay off the loan. In addition to actual dollar losses, this can also result in adverse tax consequences.

Tax considerations

Income tax

Interest on a premium financing loan is generally not deductible for income tax purposes by individuals, as it is classified as personal interest. However, for business-owned life insurance, an exception may apply--for example as when the insurance policy covers a "key person." This is a very technical area. You should consult an experienced tax professional.

Gift tax

Money transferred by the insured to an irrevocable life insurance trust (ILIT) for the payment of premiums is a taxable gift. Crummey rights of withdrawal held by the beneficiaries of the trust, however, allow the transfers to qualify for the annual gift tax exclusion. Transfers that do not qualify for the annual gift tax exclusion are exempt from federal gift and estate tax to the extent of the insured's available applicable exclusion amount.

Premium financing can help the insured leverage the annual gift tax exclusion and applicable exclusion amount because payments of annual interest and costs are less than the annual premium.

If the insured makes a personal guarantee, the guarantee may also be considered a taxable gift. The IRS is currently considering its position on this issue.

Estate tax

Life insurance may be includable in the insured's gross estate for federal gift and estate tax purposes if (1) the proceeds are payable to or for the benefit of his or her estate, or (2) the insured possesses "incidents of ownership" in the policy at the time of death or at any time during the three years prior to death, or (3) the insured transfers ownership of a policy within three years of death, and (4) estate taxes are imposed in the year of death.

Incidents of ownership is a legal term. It means any right to benefit economically or control the policy, such as: (1) retaining the right to change beneficiaries, (2) retaining the right to borrow on its cash value or pledge it for a loan, (3) retaining the right to surrender or cancel the policy, (4) retaining the right to assign the policy, and (5) retaining the right to elect or revoke a settlement option.

A personal guarantee for the payment of premiums has not as yet been recognized as an incident of ownership, or a retained right, power, or interest in the policy. However, there is very little law established to support this position.

IMPORTANT DISCLOSURES

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