

## AICPA Wealth Management Insider



### Life Insurance Premium Financing

Who should consider the strategy and what to look for?

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It is one of the most controversial topics in the life insurance industry. Yet, in the last 12 years to 15 years, premium financing has grown into one of the most valuable tools for high-net-worth (HNW) individuals to purchase genuinely needed life insurance — the amount they need — allowing them to then execute strategies to transfer wealth in the most cost and tax-effective manner.

Premium financing is typically appropriate in the following situations:

- Estate is typically greater than \$5 million;
- Traditional funding of a policy inside an ILIT (Irrevocable Life Insurance Trust) will create gift taxes;
- Individual or family wealth is illiquid, but assets are available for collateral or a letter of credit can be obtained;
- Trust grantor and trustee understand financial leverage and are comfortable with the financing concept;
- Clients with significant insurance needs who desire to finance the payments with little or no out-of-pocket costs;
- Clients reluctant to liquidate high-yielding assets to make policy payments;
- Clients uncertain of the current status of the Federal Estate Tax and wish to hedge their insurability;
- Clients who are reluctant to recognize losses in significantly depressed portfolios;
- Clients who want to replace lost wealth with life insurance without losing personal assets; and
- Clients with significant Gift Tax exposure on gifts to pay large premiums

But they should consider it carefully!

Leverage creates the potential for significant upside *and* downside.

*It's all about the economics of the loan and the performance of the policy!*

In a typical transaction, the ILIT borrows from a third-party lender, the lender lends the full premium to the ILIT, the grantor gives the ILIT the annual amount necessary to cover the interest, the ILIT collaterally assigns the policy to the lender and the grantor may have to personally guarantee the loan.

Sounds simple enough? Here are some of the issues you and your client need to consider before entering

into any premium financing arrangement:

- What spread over the loan interest rate must the policy earn? Generally, the policy will have to produce returns of 150 to 300 basis points over the loan interest rate. The loan will usually be based on London Interbank Offered Rate (LIBOR). Lower performance runs the risk that there will not be enough cash in the policy to collateralize the loan.
- Any other fees?
- 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? Other forms of collateral? (Some examples: cash, CDs, government-issued bonds, nonfinanced life insurance policy cash values, letter of credit — banks charge 0.5 percent — one percent of credit amount, securities.)
- Which life insurance product works best in the particular financing arrangement? Universal Life, Index Universal Life, Variable Life?
- Is the premium financing arrangement approved by the insurance carrier?
- Is the program designed to be based on life expectancy or is it conventional? Life-expectancy programs assume that the insured dies at his IRS-calculated life expectancy. If your client lives beyond that, the loan amount will start to exceed the cash value and the program will unwind. In short, is there a viable exit strategy for the loan?

### **Premium Financing Arrangements**

The following are the basic types of financing arrangements:

- *Borrowing premium only:* Your client borrows only the amount of the premiums and they pay the interest. If the policy is owned by an Irrevocable Life Insurance Trust, then the interest is considered a gift.
- *Borrowing premium and interest:* Your client borrows the premiums and the interest on the loan and has no annual outlay. Policy design is key in this situation.
- *Borrowing some premium and interest:* Your client 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:

- During life, from the borrower's available assets
- During life, from policy cash values
- At death, from policy proceeds

### **Estate Tax Notes**

- *Personal Guaranty.* Not recognized as incident of ownership in the life insurance contract that could create estate inclusion under IRC Sections 2033-2045.

The IRS ruled in PLR 9809032 that life insurance proceeds payable to a trust are not included in the

insured's/trust creator's estate despite the fact that the trust had borrowed funds from the insured to pay the premiums and the loans remained outstanding at the time of death. The IRS stated that the trustee possessed all incidents of ownership in the policy.

- *Gift tax Notes.* If a person guarantees another's debt, there is a gift if payment is required pursuant to the guarantee.

It is less clear whether merely providing the guarantee is itself a gift. The Tax Court in *Bradford v. Commissioner* held that no gift was made since there was no certainty that a guaranty payment would be required.

Some final thoughts to ponder on:

- The simpler the Premium Financing design and the less assumptions for its success,
  - The cheaper and more efficient the insurance product can be;
  - The less client has to depend on product performance;
  - The less number of things can go wrong; and
  - The less expensive it will be to fix any problems.
- The more complicated the plan design and the more assumptions made,
  - The more expensive the policy will be;
  - The more dependent the client will be on policy performance;
  - The more number of "other" things will have to go right; and
  - The more expensive it will be to fix any problems.

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