



CONTINUING EDUCATION

October 2008



Life Insurance Planning with Financed Premiums





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Premium Financing

An important part of any high net–worth client’s financial picture



Premium Financing as a Tool

Standard Model

- Client-established trust borrows money from third-party lender unrelated to life insurance carrier



Premium Financing as a Tool

Loan Collateral

- Insured must take on a significant amount of risk
- Trust pledges collateral, and typically grantor personally guarantees loan
- Policy cash surrender value is collaterally assigned to lender



Premium Financing as a Tool

Other acceptable loan collateral includes:

- Cash
- Bonds
- Securities
- Letters of credit
- Cash surrender values of other life insurance contracts



Premium Financing as a Tool

Interest Component

- May be variable but with predetermined, fixed spread
- Spread may be fixed for life of loan
- Interest is payable on annual basis in advance, in arrears, or may be deferred



Premium Financing as a Tool

Prepayment and Repayment Options

- Prepayment—depending on the lender, there may be no prepayment penalty
- Repayment—loan can be repaid from:
 - Death benefit
 - Policy cash value
 - Grantor Retained Annuity Trust funds
 - Term policy used to hedge against premium finance loan
 - Cash/liquidity event



Premium Financing as a Tool

Modified Endowment Contract Issues

- Creating MEC not advisable in premium financing situation
- Collateral assignment on policy causes taxable gain to policy owner up to loan amount
- May be subject to penalty tax



Premium Financing as a Tool

Deductibility of Loan Interest

- Individual/trust: No income tax deduction
- Corporation/business: Deductibility depends on particular situation

Never suggest to an individual or corporate client that interest associated with a premium-financed life insurance policy is income tax deductible. Clients must consult with their own tax counsel to determine if loan interest is deductible in their particular situation.



Premium Financing as a Tool

Gift Tax Issues

- Is personal guarantee a gift from grantor to trust?
 - No tax until completion of gift
 - Private Letter Ruling 9113009
 - Private Letter Ruling 9409018



Premium Financing as a Tool

Estate Tax Issues

- Is personal guarantee an incident of ownership in policy that causes policy proceeds to be includible in gross estate of insured/guarantor?
 - PLR 9809032



Premium Financing as a Tool

Example: Client Ima Blueblood

- 70-year-old female
- 3 children and 5 grandchildren
- Estate value: \$10 million
 - \$5 million invested in real estate
 - \$5 million invested in securities

What recommendations do you have for Ima?



Example: Illustration for Ima Blueblood

Financed columns: 1-10

- Premium/Cumulative Loan (col. 1 & 2)
- Interest (col. 3)
- Retained Capital Accounts (col. 4 & 5)
- Net Outlay (col. 6)
- Retained Capital (col. 7)
- Net Death Benefit (col. 8)
- Death Benefit with Retained Capital (col. 9)
- IRR at Death (col. 10)

Nonfinanced columns: 11-13

- Policy purchased if no financing involved

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Unique Policy Situations

Loan Rescue: Section 1035 Exchange

- Existing life insurance policy has sizable outstanding loan
- IRC § 1035 exchange might extinguish existing loan
- Concept of “boot” and unfavorable tax consequences



Potential Solution

Loan Rescue: Section 1035 Exchange (Cont.)

- Trust borrows amount of outstanding loan from lender
- Lender pays policy loan, sending cash directly to original issuing insurance company
- Trust then executes IRC § 1035 exchange with no boot in transaction



Unique Policy Situations

Example: Client I.M. Loaded

- 70-year-old male
- \$1,250,000 old policy cash value
- After IRC § 1035 exchange, death benefit increases to \$3,004,000
- Annual premium reduced by \$7,500



Unique Policy Situations

Split-Dollar Arrangements: What is going on now?

- Final regulations



Potential Solution

The Premium Financing Strategy: Endorsement split-dollar rescue

- Allows parties to split-dollar plan to terminate plan before death
- Eliminates possible income tax on employee from economic benefit
- Returns assets committed to plan to entity funding premiums



Potential Solution

The Premium Financing Strategy: Endorsement split-dollar plans

- Entity or trust that receives policy obtains loan from lender
- Loan proceeds used to repay premium sponsor of split-dollar plan
- Repayment amount should equal policy's fair market value



Unique Policy Situations

Premium Financing Considerations

- Some financing programs will not finance in-force policies
- Potential solution: Add new coverage to in-force policy or exchange policy for new one
- Compare cost of interest payable to income tax due on split-dollar plan



Potential Solution

Premium Financing: Bonus for interest due on split-dollar plan termination

- Employee wants financing to terminate split-dollar plan
- Business could pay employee bonus equal to loan interest
- If policy owned by Irrevocable Life Insurance Trust (ILIT), employee can gift interest to ILIT



Unique Policy Situations

Premium Financing: Considerations for publicly traded companies

- Legal restrictions on publicly traded companies that make or arrange loans
- Use extra caution



Corporate Redemption with Multiple Policies

Example: Client Gee Whiz Games, Inc.

- 5 policies
- 1 borrower
- Premiums range from \$10,000 to \$60,000
- Cumulative loans qualify for premium financing based on minimum premium levels



Identifying Prospects for Premium Financing

Likely Prospects

- Estate value over \$5 million
- Traditional funding may have adverse gift tax results
- Client's investments illiquid but owns sufficient assets for collateral or can obtain letter of credit
- Satisfies minimum premium requirement on life insurance policy



Identifying Prospects for Premium Financing

Likely Prospects (Cont.)

- Business entity needs large amount of life insurance and owns sufficient assets to serve as collateral
- Client understands advantages of leveraging and is comfortable with financing concept



Proper Use of Premium Financing

- Does not reduce actual dollar cost of buying life insurance, since loan principal is eventually repaid to lender with interest
- Actual terms of each case will differ with lender and insurance carrier involved in premium financing program



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