An Overview of Premium Financing

Currently, there are a number of premium financing plans that are available and marketed to insurance buyers. Until recently, equity split dollar arrangements have been a more common method of leveraging the funding of large permanent life insurance policies. Split dollar plans have been especially popular due to the effectiveness of this technique for purchasing large amount of life insurance outside a taxable estate with little or no gift tax. However, with the release of IRS Notice 2002-8 and the final regulations governing split dollar effective for split dollar plans implemented after September 17, 2003, the interest in alternative premium funding alternatives has increased.

OVERVIEW

The most common premium financing plans are sold to affluent U.S. and international citizens with a defined life insurance need and a minimum annual premium commitment of $50,000. However, some of the more exotic premium financing plans currently being marketed may be targeted to much larger purchases of insurance along with much larger annual premiums. Individuals that have an insurance need sometimes turn to a premium financing alternative because financed premiums may allow an individual to:

- Purchase life insurance without traditional liquidity requirements, allowing cash and other assets to be used for other purposes or invested in alternatives providing a higher return.
- Reduce, and perhaps eliminate gift taxes on third-party or trust owned life insurance.

Financed insurance is utilized in most of the same applications as non-financed insurance, including family and income protection, estate liquidity, wealth transfer, and charitable planning. A premium financing plan has the attraction of potentially lowering the cost of purchasing life insurance, with some premium financing plans resulting in zero out-of-pocket outlay for the borrower.

PLAN DESIGN AND VARIATIONS

The lender in a premium financing arrangement is almost always a bank or other financial institution that has the regulatory approval to make consumer loans. Sometimes the bank is located offshore. The more common premium financing arrangements seem to usually take one of two forms.

Only the Annual Premium Payments are Financed
Under this arrangement, the lender loans the annual premium each year. The borrower is required to pay either quarterly or annual interest payments on the cumulative loan balance. Usually, loan interest is paid in advance by the borrower who is also the owner of the life insurance policy. In

essence, the arrangement is treated as a series of one-year loans, with the amount borrowed increasing each year by the amount of the required annual premium payment. Sometimes, the interest is initially paid out-of-pocket, but eventually, when the life insurance policy has sufficient cash value, the owner/borrower may be able to take distributions from the insurance policy to pay the interest until the loan is ultimately repaid.

Both Premiums and Loan Interest are Financed
Under this arrangement, the lender not only finances the premium payments, but the interest associated with the loan as well. With this type of plan, the lender will not receive any payments from the borrower until the death of the insured. At that time, the lender is repaid both the principal loan amount (equal to the cumulative total of all the premiums borrowed), and all of the accumulated interest from the insurance proceeds of the life insurance when the insured dies. The insurance proceeds in excess of the loan and interest repayment is paid to the insurance policy's beneficiary. This type of premium financing plan requires a substantially increasing death benefit in order to provide the needed insurance protection for the policy owner, in addition to repaying the lender the cumulative premiums borrowed and the cumulative interest accrued on the loan.

Other Hybrid Arrangements
There are other creative variations of premium financing arrangements. Some use offshore banks and base the loan on foreign currencies where interest rates are significantly lower than in the U.S., such as the Japanese Yen. Other arrangements simply utilize a middle ground between the two basic forms of premium financing discussed above by paying some of the interest, and rolling the rest into the loan balance. The number of variations that are being developed are endless.

FINANCING AND BORROWING RISKS

Under certain specific circumstances, premium financing may be an excellent leveraging technique for the purchase of life insurance. However, while many plans are considered, relatively few are actually implemented. There are a number of reasons why a premium financing plan is eventually not implemented after closer scrutiny.

Interest Rates and Loan Structure. The interest rates for premium financing arrangements is usually tied to a market index (i.e. a specified spread over LIBOR). Most lenders in the U.S. are offering rates from 150 to 250 basis points over LIBOR. Generally, the loan is arranged as a series of one-year loans, or as a demand loan so that the lender can adjust the loan interest rate periodically based on changes in market interest rates. This also allows the lender to review the borrower's financial status periodically so that the lender can verify the credit worthiness of the borrower. The success of a premium financing plan is often dependent on the spread between the loan interest rate and what the cash value of the life insurance is earning. If the cash value of the life insurance does not grow sufficiently faster than the interest rate on the loan, the premium financing arrangement may fall apart. A general rule of thumb is that the cash value should be earning 200 to 300 basis points more than the loan interest rate, but this rule may vary significantly by the type of financing plan being offered and the type of life insurance policy purchased.

Collateral. Premium financing plans rely on the cash value of the life insurance policy to provide a significant amount (if not all) of the collateral for the loan. However, lenders typically discount the cash value of life insurance for collateral purposes by 50 to 80 percent, depending on the type of life insurance policy utilized. This means that the borrower almost always has to provide additional collateral to the lender. When only the premiums are financed and the interest is paid by the borrower, the cash value of the life insurance will usually increase so that eventually additional collateral will no longer be required. For those premium financing arrangements where both the premiums and interest are borrowed, a significant amount of additional collateral is almost always going to be required by the lender.

Exit Strategy. Another major factor in the success of a premium financing arrangement is the "exit strategy". Is there a plan to repay the loan during a specific time-frame? The exit strategy for some premium financing arrangements is that the loan will be repaid upon the death of the insured. The economics of a premium financing plan that is going to repay the loan from the insurance proceeds may differ greatly depending upon the timing of the insured's death, and therefore present an unacceptable risk to the borrower.

In general, the success of almost any premium financing plan is going to be dependent on how well the life insurance policy performs in relation to the loan interest rate. If the interest rate on the loan increases sharply, and the policy performance does not keep pace, the bank may require additional collateral. As one of its options, the bank may be able to call the loan and force the use of the life insurance policy's cash value (and other collateral) to repay the loan.

TAX AND CASH FLOW ISSUES

Other issues that should be considered before implementing a premium financing plan include the following factors:

- For those premium financing arrangements that require the interest to be paid, the interest paid will grow substantially each year as a new premium payment is borrowed. The ability to service the interest payments often becomes a substantial financial outlay. If the insurance is owned by a third-party or trust, this amount may also become a significant taxable gift.
- Some plans may try to structure the premium financing arrangements so that the interest is a deductible expense. Generally, interest on loans used to pay life insurance premiums **is not** deductible. However, general business interest may be deductible. Whether the interest in a particular case may be deductible will depend on the specific facts of the arrangement and is a matter for the borrower's tax advisor.
- Under some premium financing arrangements, when a trust borrows to purchase life insurance, interest will have to be paid. This generally requires the grantor of the trust to make gifts unless the trust has other assets it can use. If the amount of the interest payment exceeds the combined annual exclusions and available unified credit, the grantor may have to make taxable gifts to the trust.

- When a trust borrows to pay life insurance premiums, the lender may require a personal guarantee or secondary collateral from the grantor of the trust. There is the question of whether that personal guarantee or collateral on behalf of the trust is a gift, and if so, what is its value? Another issue regarding this situation is whether providing a loan guarantee or collateral results in the inclusion of the policy in the grantor's estate for estate tax purposes. Again, these issues will depend on the specific facts of the arrangement and is a matter for the individual's tax or legal advisor.

CONCLUSION

Although equity split dollar arrangements are not as attractive as they once were as a premium funding arrangement, other effective techniques for moving wealth outside of an individual's estate are still available. These techniques can be further leveraged by incorporating the use of life insurance and are very efficient from both an estate and a gift tax perspective. In fact, funding the purchase of life insurance using more traditional estate planning techniques will probably carry much less risk than the typical premium financing techniques.

However, if individuals needing insurance coverage believe that investing their assets rather than paying insurance premiums can achieve significantly higher returns, or if these individuals are unable to pay the premiums for the necessary insurance coverage due to limited cash flow or the nature of their assets, premium financing may be a viable alternative. While there are certain risks inherent in a premium financing plan, it can be an effective method of funding life insurance premiums as long as the risks are identified and managed. When considering a premium financing plan, it should be analyzed under a variety of economic conditions, including a worst-case scenario, so that the impact on the plan is determined.

The most important point when considering a premium financing arrangement is that having an exit strategy is essential. Those who borrow should be prepared to pay premiums if necessary, or if advisable later should circumstances change. Additionally, it is critical to understand how the lender will be repaid, either form the insurance proceeds when the insured dies, or from other assets that will remain invested until needed.

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