



By Rebecca R. Ryan & Richard L. Harris

Using Loans to Finance Life Insurance Premiums

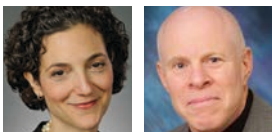
When and how to use this strategy

Those purchasing significant death benefit life insurance often contemplate how to most efficiently pay policy premiums. Their aim is to maximize insurance benefits, pay as little as possible and minimize taxes. One option is to borrow from a commercial lender, finance company or private bank. This complex strategy, called “premium financing,” can be powerful but isn’t appropriate for all investors. Let’s take a closer look at this tool.

Premium Financing Basics

Premium financing is a strategy that involves taking a loan and using the proceeds to pay policy premiums (and, in some cases, the interest on the loan itself) during an insured’s lifetime. Marketable security assets and the net cash surrender value (CSV) of the underlying insurance policy secure the loan. Premium financing is potentially beneficial for a number of reasons. It offers possible tax benefits, as borrowed premium payments and pledged marketable securities may not be subject to gift taxes. Additionally, the use of leverage allows investors to maintain long-term investment strategies and avoid taxes on liquidated assets used to pay premiums. However, as with any financing vehicle, there are issues to consider, including interest rate fluctuations, collateral maintenance, loan duration and the covenants, terms and conditions of the loan.

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When to Consider

Generally, practitioners should employ premium financing transactions as part of a comprehensive estate plan. An individual works with her advisors to determine how much insurance is needed. Once she considers other estate-planning techniques, she establishes an irrevocable life insurance trust (ILIT) to own the policy and ensure the policy death benefits remain outside of her taxable estate. After she determines the death benefit need, the insured must select the type of life insurance policy. The array of life insurance products is vast (see below), and selecting the best product can be a daunting task for an estate-planning attorney to handle alone. Thus, it’s imperative to work with a team of advisors who have a deep understanding of this topic and proven experience with high-net-worth individuals and their complex estate-planning needs.

Only after ascertaining the insurance amount needed and desired product(s) can one truly explore third-party financing. To determine if premium financing makes sense, consider the following questions:

What’s the cost of not taking action? What options are available to purchase the policy and pay the premiums? What’s the total cost for the policy and lifetime premiums? How much would it cost to use a short-pay scenario (only certain insurance products can be short paid)?

Compare the alternatives to how much it would cost to borrow funds by leveraging existing assets. The primary costs and requirements associated with third-party financing are: (1) interest expense, and (2) pledging assets as collateral (that is, the opportunity cost or any management or custody fees).

How it Works

The ILIT trustee negotiates with a financial institution



to procure a loan to pay the premiums as due. The life insurance policy is the primary source of collateral; however, additional collateral must be pledged for any gap between the CSV of the policy at the lender's approved advance rate and the outstanding loan balance. This additional collateral is typically satisfied with a pledge of personal assets and, often, a personal guaranty. Interest is due quarterly, semi-annually or annually. The interest rate is most often London InterBank Offer Rate (LIBOR) or prime, plus a spread. The spread over the base index depends on the strength of the borrower or sponsor, but it typically starts at 1.50 percent. As with most commercial loans, the loan is subject to a borrowing base and, when properly administered, is reviewed regularly.

Example: An ILIT is set up to purchase a \$20 mil-

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lion policy on the grantor. Because the premium is high (\$500,000 per year), the grantor is looking at ways to fund the policy while minimizing the taxable gifts. The grantor has 10 *Crummey* beneficiaries. If the premium is gifted each year and the annual exclusion is \$14,000, 10 beneficiaries result in a \$360,000 shortfall per year. This shortfall means that over time, the grantor would exhaust any available lifetime exemptions, and gift taxes would be required. Further, this situation can be exacerbated with a generation-skipping trust. So, even though the grantor can afford the premiums, it may make sense to look at alternative methods to deal with the gift taxes. The grantor decides that financing the initial premiums makes the most sense. The interest costs (and the gifts to the ILIT to pay those costs) ideally fall within the *Crummey* amounts.

There are other reasons someone might want to use premium financing to pay for the insurance. The individual may be illiquid at the time she takes out the policy and needs a loan for only a short time. Or, the individual believes that her investments (public or pri-

vate) will outperform the interest rate on the loan and wants to take advantage of arbitrage. Regardless of the reason, there must always be an exit strategy to repay the financing during the insured's lifetime. Each year, the loan may reduce the life insurance benefit to the trust. Superannuation risk (that is, the insured lives too long) is considerable.

Assume the trustee is able to get a commitment from a lender to fund the first five premiums (subject to the continuing creditworthiness of the borrower and pledgor). The loan is at 12-month LIBOR plus 2.25 percent. That would put the initial interest rate at approximately 3 percent. If the loan is for an amount greater than the CSV, the individual will have to pledge acceptable collateral for the difference and often provide a personal guaranty.

On each anniversary, the lender will:

- Calculate the interest rate for the upcoming period.
- Confirm there's adequate collateral for the loan—If the insurance policy cash values aren't sufficient, the lender will require a pledge of collateral or an increase in pledged collateral to make up the difference.
- Review the borrower, sponsor and pledgor financial positions to confirm creditworthiness.

Variables. Premium financing features a number of variables, including loan amount, interest rate, whether interest is capitalized, type of insurance policy acquired, corresponding CSV, availability of collateral, term of the loan, continued creditworthiness of the borrower and how the loan will be retired.

Strategy. The exit strategy, including source of repayment, is determined at the outset. If the reason for premium financing is arbitrage, the expectation is that the return on retained assets or policy CSV growth consistently outpaces the borrowing rate and, at some point in the future (typically between Year 15 and Year 20), the loan can be repaid from the CSV, outside assets or a policy loan. If the strategy is to use an exogenous asset to repay the loan, estate-planning techniques like grantor retained annuity trusts (GRATs) and installment sales are typically used in connection with the financing to properly position assets to repay the loan at a defined date in the future.



Type of Insurance Policy

There are four basic policy types that are used in premium financing: whole life (WL), general account flexible premium (universal life (UL) or GAUL), equity index universal life (EIUL) and universal life with secondary guarantees (GUL). The structure of each policy varies and affects the outcome of the strategy. The fundamental difference among policies is what's guaranteed and how the savings component of the policy works.

In WL, the basic cash value is guaranteed. It's not guaranteed in UL. For WL and GAUL, the investments that affect the cash value or dividends are the general

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investments of the insurance company. There's a fundamental disconnect between the interest rate on the premium financing loan and the growth of cash value due to the fact that most insurance companies use a portfolio rate to determine the dividend paid to each policy. A portfolio rate is the weighted average rate of return for all of the insurance company investments (most of which are high quality bonds). Because investments have different maturity dates, as each individual investment matures, the money received is reinvested at the prevailing rate. For example, if an insurance company has a portfolio with investments maturing in one to eight years, the weighted average rate of return will change each year. Because there are old and new investments, the average rates of return will lag behind the current rate of return of the new investments. In a period of declining interest rates, the portfolio rate will be higher than the current rate because there are investments in the portfolio that were made at higher rates. When interest rates are rising, the opposite takes place. The important distinction is that the investment rate of return used to determine cash values or dividends lags

behind the current market interest rate. Because the loan interest rate is based on a current rate, the two rates don't match up. If an investor expects a direct correlation between the policy investment rates and the loan interest rates, such that the policy investment return and the interest rate go up or down at the same time and to a similar degree, she's mistaken.

EIUL has a different crediting or savings mechanism. The rate of return of the accumulated policy value is affected by the rate of return of the selected stock index(ices). Stock index performance doesn't correlate with interest rates. Often, premium financing is presented using those products because of the arbitrage possibilities (illustrated as a linear lifetime positive spread between the borrowing rate on the loan and the crediting rate in the policy). However, an illustration is just an illustration. What actually takes place will be different from what was modeled. In fact, borrowers can be sure it won't work as illustrated. By making certain assumptions regarding the future average index rate, illustrations tend to show outlooks rosier than what the future may provide. While there's downside protection in the EIUL policy, the costs of insurance and expenses will still have to be paid, potentially resulting in a lower value.

Lastly, GUL has a different design from any of the above. The policy is designed primarily for death benefit, with CSV being a relatively unimportant component. Because the cash values are very low or non-existent, the amount of collateral the guarantor will have to pledge is much greater than with any of the previously discussed policies. The benefit of the GUL is twofold: a relatively lower premium and a cost-efficient death benefit policy. However, the non-insurance collateral requirements will be higher, often for the full amount of the loan.

Who Should Consider?

Premium financing is best suited for sophisticated investors with an understanding of finance, insurance and estate planning. Because it's unlikely that individuals will possess expertise in all of these areas, a team of advisors should be assembled. At the very least, the team should include an estate planner, premium financing lender and insurance agent. Often, due to the significant size of the transaction and inherent risks, the team should also include a fee-only insurance consultant

knowledgeable in all the relevant areas. The more that individual knows about estate planning, finance and life insurance, the better the advice. Modeling should be performed to show different scenarios: interest rates, outside investment results and growth of cash value. The scenarios should clearly demonstrate the elements of risk—what can go wrong and the consequences.

If an investor is using premium financing as an arbitrage strategy, he absolutely needs to know how the finance, insurance and his own investments work. Further, individuals with a short-term liquidity need may use premium financing to obtain the right coverage at their current age, thereby eliminating concern about future health changes. It can't be emphasized enough that borrowers should have an exit strategy. For example, assuming the strategy is successful, two ways to effect a clean exit are having the ILIT be the: (1) remainderman of a GRAT, or (2) purchaser of assets from the individual for an installment note. In the case of the sale of an asset for an installment note, the holder of the note needs to be aware that the premium financing lender will expect its loan to be fully subordinated to the bank loan. A third exit strategy is for the grantor of the trust to personally loan money to the trust, which the trust will use to repay the premium financing loans.

Alternatives

If an investor has liquidity and cash flow issues when she wants to purchase the insurance, she may consider convertible term insurance. The key benefit is that when converted—while the insured will be older—she's guaranteed that the rating class will be the same as at issuance, regardless of her actual health status. The issue of how to pay the premiums can be addressed at that point.

There are two other ways to pay for the policy dealing with gift tax issues using split-dollar arrangements. An in-depth analysis of these arrangements is beyond the scope of the article, but here's a brief summary. One can provide for split-dollar arrangements by:

- (1) Making annual premium advances with the repayment being for the greater of the sum of the advances or the cash value. The gift-measuring method is the cost of 1-year term insurance (based on government

regulations) on the net amount at risk.

- (2) Making loans each year. Because these are loans between related parties, Internal Revenue Code Section 7872 and Treasury Regulations Section 1.7872-15 govern the interest rates to be used. Using the example above of the loans to fund \$500,000 annual premiums, in third-party premium financing, the interest rate will change with the foundational index. Apart from the fact that the rates to be

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used under the above rules will be lower than those from an outside lender, the rate for a particular loan can be locked in for as long as desired, including for the life of the insured. (For example, the long-term applicable federal rate for March 2015 is 2.19 percent. A loan made for life will lock in that rate until the death of the insured.)

If the individual doesn't have the liquidity to loan the premiums, it may make sense to personally borrow the money from an outside lender, and in turn, loan the money to the ILIT. The interest rate on the loan to the ILIT will be lower than the interest rate on the outside loan. The interest in the ILIT can be accrued, eliminating any taxable gifts. The individual's interest payments to the lender won't be gifts. The individual's loan receivable from the ILIT will be subrogated to the extent of the outside loan due.

Too often, the ability to finance has been used as a reason to purchase insurance. Financing merely modifies the outcome of the life insurance policy. While financing provides an alternative to paying out of pocket, it's neither free insurance nor risk free. 