The Basics of Third-Party Premium Financing

High net worth (HNW) individuals with significant estate or business planning needs and a temporary liquidity issue may find that premium financing can be an economical way to pay for needed life insurance coverage.

While recognizing the importance of the insurance as part of legacy planning, some prospective insurance owners are unwilling to divert cash flow away from other purposes or to liquidate assets to pay the policy premiums.

Third-party premium financing (or, simply, premium financing) offers a potential solution. It is a method of paying for life insurance using annual loans from a third-party lender such as a bank.

In a typical transaction, a financial institution lends money to an irrevocable life insurance trust (ILIT) each year for the premium. The insured gives money to the trust each year so that it can pay interest it owes to the bank.

Although the loan interest increases the cost of acquiring the policy, premium financing can be a benefit in the right situation, as it can enable the purchase of needed life insurance, but with an initial out-of-pocket cost significantly lower than the full premium amount.

Premium financing is not a means of obtaining free life insurance. Although many arrangements provide a lower initial out-of-pocket cost when compared to the full annual premium, the interest owed to the bank can exceed the premium in later years. At a minimum, the interest cost is added to the premium cost. Offers that appear to be no or low cost insurance usually involve costs and risks that may not be clear at first glance.

Premium financing arrangements involve a number of risks, as discussed on the following pages.

How does paying premiums using premium financing work?

Sophisticated estate plans often serve to both minimize estate taxes and provide liquidity at death — replacing assets lost to estate taxation. Life insurance owned by an ILIT often plays a significant role in such plans. Since the life insurance proceeds are in the ILIT, they will usually not be included in the insured's estate and can be used to purchase assets or make loans to the insured's estate or revocable trust to pay estate taxes and any debts and expenses.

Premium financing can provide an alternative means to pay the premiums due on a permanent life insurance policy owned by an ILIT.

The ILIT borrows funds from a third-party lender to pay the premiums. The Trust is the owner of the policy and is also identified as the borrower on the premium financing documentation. The loan interest for the borrowed funds is paid out-of-pocket by the ILIT each year to the third-party lender.

Let's analyze the transaction:

A HNW grantor, anticipating a significant estate tax liability, sets up an ILIT to own a life insurance policy. The ILIT applies for the policy. The insurance company begins the life insurance underwriting process, reviewing the application medically and financially. Prior to issue, the trustee negotiates with a lending institution for a series of loans, the principal of which will pay each year's premium as it comes due.

Ownership

In a typical structure, an ILIT would own the policy from the inception to avoid the three-year lookback if a policy is gifted to an ILIT. The trust's terms would allow for the purchase of life insurance and for borrowing from a lending institution.

The Loan

The criteria to determine eligibility for loans are at the sole discretion of the third-party lender and are separate and distinct from the criteria to determine eligibility for life insurance coverage. Some lenders make premium loans for the life of the policy. Loan conditions can differ significantly between lenders and even between different borrowers at the same lending institution. However, lenders usually require that the loan be fully collateralized at all times. Most lenders condition future premium loans on verification of the client's ongoing financial stability. Many only allow the borrowed amount to cover payment of the premium dollars of the insurance policy. While some lenders allow some interest to accrue, more commonly, interest will be due annually.

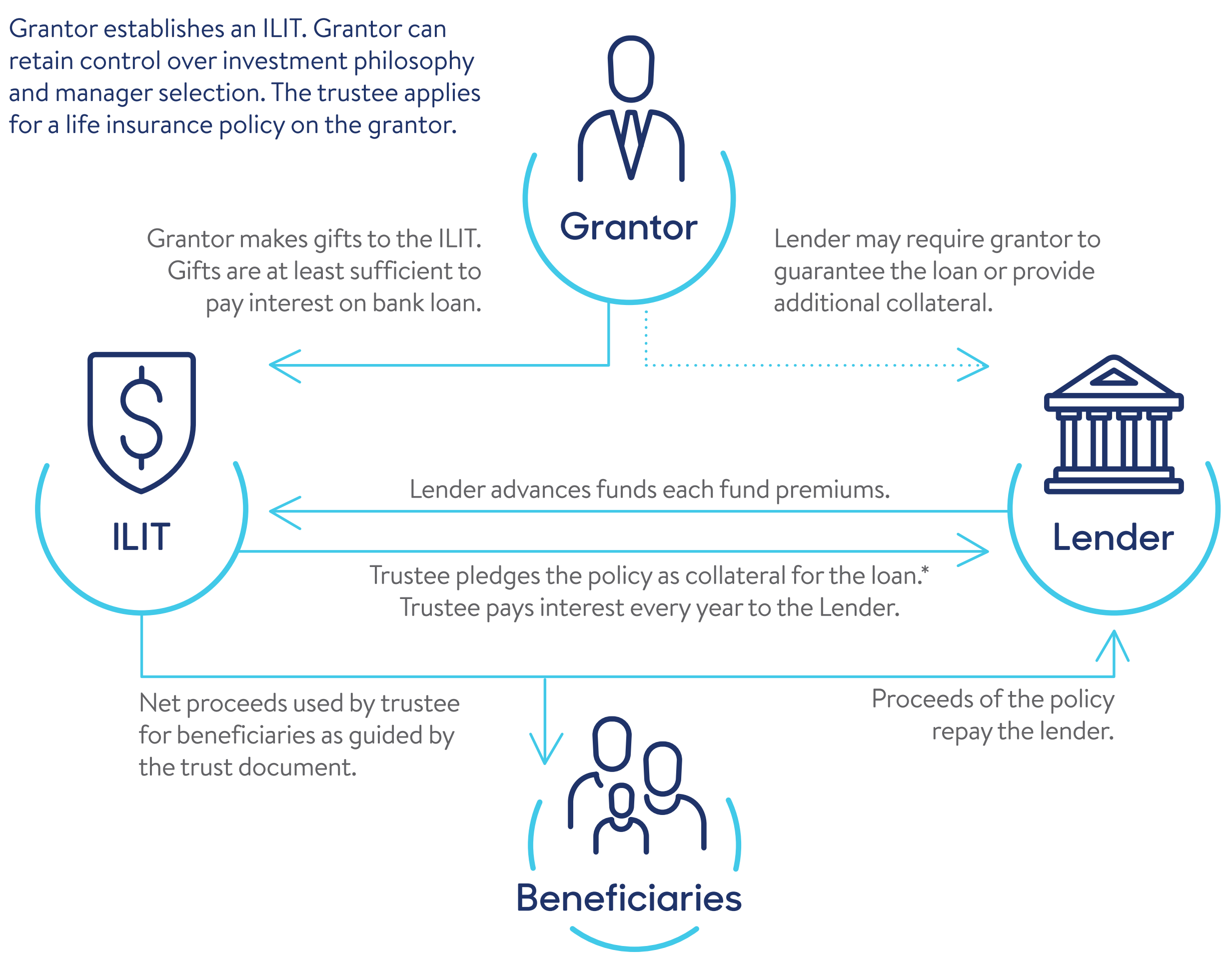
Gifts to Pay Annual Interest and Gift Tax

In some arrangements, the ILIT will have sufficient assets to pay interest owed to the financial institution each year. In other arrangements, the grantor gives yearly to the trust, enabling the trust to pay interest due. This can affect the grantor's gift-giving capacity in that they can exhaust the grantor's annual exclusion gifts **($16,000 per recipient in 2022)** and use up a portion of the lifetime gift exemption **($12,060,000 in 2022)**.

This situation may be preferable to some clients, however, when compared to the exclusion and exemption cost of gifting the full premium amount each year. Where the total premiums necessary to purchase coverage could exceed the lifetime gift tax exemption that the insured is willing to use towards insurance, a premium financing plan can reduce the gifting capacity used. Loans are not gifts. As a result, clients can often design financing arrangements that use significantly less gift tax exemption and fewer exclusions.

Premium Financing a Life Insurance Policy

For Estate Planning



*A collateral assignment makes the lender the primary assignee for cash value and death benefit until the loan is repaid.

The Loan Interest Rate

Interest on premium loans is usually based on a publicly available standard rate, such as the Secured Overnight Funds Rate (SOFR) or the Prime Rate, plus a spread determined by the lender. Barring any future renegotiation, the spread will not change for the life of the loan.

In this example, loan interest is paid from the trust to the bank. If the trust does not have sufficient assets to pay loan interest, the grantor would first give to the trust any interest owed by the trust to the lender. Gifts in excess of applicable annual exclusions **($16,000 per recipient for 2022)** would use the grantor's lifetime gift exemption **($12,060,000 for 2022)**. However, the gifts of loan interest are generally less than the cost of the premiums which are borrowed.

Lending institutions are very specific as to whom they will lend money. They have their own financial underwriting criteria. Generally, in order to qualify for third-party premium financing, you must have assets and income sufficient to pay the premiums without the financing. You must also have sufficient assets and an estate tax need.

Collateral

Third-party lenders typically require premium finance transactions to be 100% collateralized at all times. Life insurance policy cash values in the policy serve as one source of collateral for the loan, but additional assets may be required (particularly in the early years of a policy). Where a policy does not yet have substantial cash surrender value, collateral shortfalls are covered by additional collateral pledged by the trust or the grantor personally. It should be noted that under most lending arrangements, policy death benefits exceeding the premium loans do not count towards meeting collateral requirements.

Where the policy cash value is insufficient to fully collateralize a loan, other trust assets and assets of the insured may have to be posted in order to secure the loan. In most premium financing lending agreements, the lender will include the following amongst its requirements:

- Policy cash value and death benefit assigned to the bank as primary collateral.
- Additional collateral such as cash, marketable securities , or letters of credit, will be required (as applicable) if the policy cash value is insufficient. The lender may require cash and securities to be held in accounts at the lender.

Loan Repayment

There are three basic ways to repay the loan principal:

1. **At death:** Most policies are structured to have the death proceeds pay off the third-party loan balance if the insured dies while the loan is outstanding; the remainder death proceeds going to the beneficiary. Increasing premium costs for older insureds makes it more difficult to achieve this goal while still providing the necessary death benefit for the original purpose (e.g., estate tax liquidity). However, the need to pay or accrue interest every year increases the overall cost of financing and may make this strategy unattractive.
2. **Set up an exit strategy:** HNW individuals age 60 and younger may wish to design the policy so that the third-party premium loan can be repaid from the policy cash values at a pre-determined date. Policies should be designed and funded so that policy loans and distributions are not taxable.
3. **The HNW individual repays the loan out-of-pocket:** This is a common method, especially if a large inheritance, a contractual payment, or other liquidity event is expected. The ILIT does not use policy values to repay the bank, but instead uses other assets available to the trustee.

What are the potential benefits of premium financing?

- Borrowing may offer lower opportunity costs than liquidating assets to pay for needed coverage. The opportunity cost is the cost (sacrifice) incurred by choosing one option over an alternative.
- Minimum impact on current investment portfolio, business, or real estate assets.
- Avoids incurring tax theat may apply if assets are liquidated to pay premiums.
- Reduces initial net out-of-pocket outlays for life insurance.
- Potential for competitive interest rates on borrowed funds at rates lower than earnings on client's assets.
- Maximizes cost efficiency as measured by the internal rate of return (IRR) on death.

What are the downsides of premium financing to fund needed life insurance?

- Borrowing for insurance financing may reduce borrowing capacity for other opportunities.
- Drops in asset values may require the posting of additional collateral.
- If collateral is unavailable, further credit may not be extended and the loan may be called.
- In the long run, the overall costs of premium financing will be higher than paying premiums out-of-pocket. Lenders requirements plus the premium loan and the loan interest due may make this program uneconomical.
- In an increasing interest rate environment, the cost of borrowing will be larger than originally projected.
- Accrual of loan interest can increase the loan liability dramatically. The interest accrual option should be entered into with caution. MassMutual® requires interest to be paid annually on premium financing arrangements for its policies.
- Since dividends and other policy crediting amounts are not guaranteed, premium financing arrangements using dividend paying policies pose concerns. It is recommended that insureds and their financial professionals review a sensitivity analysis with a dividend of a ½ or 1 point below the current dividend scale.
- Any leveraged strategy is based on current financial condition and needs. Those interested in premium financed insurance should work with a financial professional to continually re-evaluate the premium financing strategy to account for changes in circumstance.

We can help you determine if third-party premium financing is a viable strategy for obtaining needed life insurance coverage. In order to obtain a loan the lending institution will require financial underwriting. In order to obtain a life insurance policy you must go through medical and financial underwriting.

Contact your financial professional to learn more about this strategy and if it is right for you.

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