Premium Financing

An Alternative Method of Funding Large Life Insurance Policies

Premium financing offers clients an alternative method of funding large life insurance policies. The funds used to pay premiums are borrowed from a third-party lender.[1] This is a valuable tool available to clients who recognize the need for life insurance in their estate plans, yet have cash flow constraints or wish to minimize gift taxes.

Ideal Candidates

Premium financing can provide leverage for clients who have high-performing assets that they do not wish to liquidate to pay life insurance premiums. It can also be useful as a temporary solution, allowing a needed life insurance policy to be placed in-force today while the rest of the estate plan is finalized. Appropriate clients:

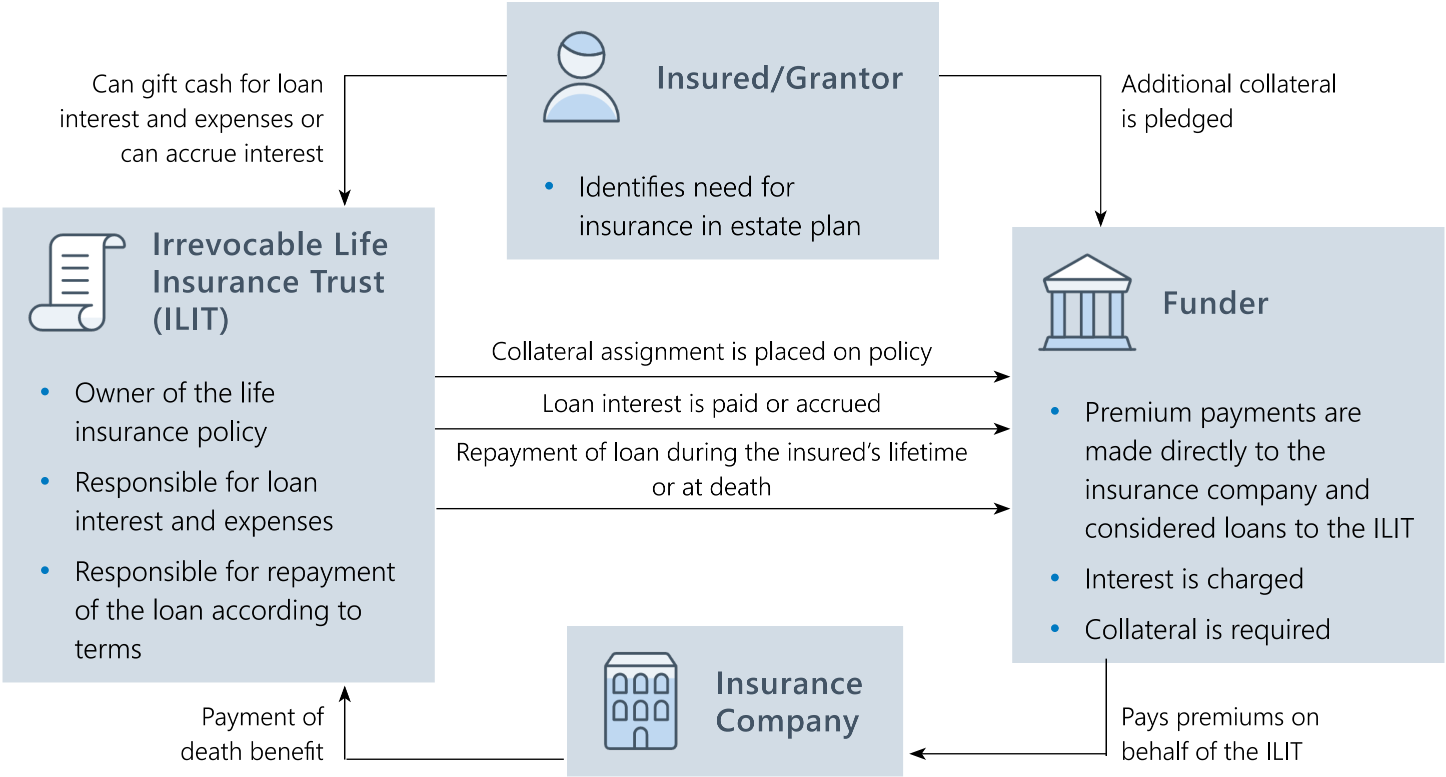
- Have a Life Insurance Need: First and foremost, suitable clients are those who recognize the need for additional life insurance protection on their lives, and are prepared to place that needed coverage in force. Their primary motivation should be to acquire needed life insurance without disturbing or liquidating a portion of their investment portfolio to pay premiums.
- Have a High Net Worth: Most lenders require applicants to have a minimum net worth of $10 million or more. Ideally, a significant portion of the net worth for these individuals (or couples) should consist of marketable investments or other income producing assets earning returns that are higher than the anticipated loan interest rate.
- Are Willing to Post Collateral: Clients must be willing and able to pledge collateral to guarantee the loan. Clients whose portfolios are primarily comprised of illiquid assets, such as real estate, may be asked to provide a letter of credit (LOC) as collateral for the loan, instead of their illiquid assets. The lender will need to approve the bank that provides the LOC.
- Have "Skin in the Game": Ideal clients will pay interest, a level outlay annually, and/or part of the premium.

[1] Crump does not work with all financing programs in the marketplace. Crump makes available programs that carriers have accepted. The financial professional and client(s) decide which financing program they will work with.

How Does It Work?

1. The need for life insurance is determined.
2. During planning conversations, premium financing is identified as an appropriate strategy. Crump's [premium financing fact finder] can help guide this evaluation.
3. The policy owner (typically, an irrevocable life insurance trust [ILIT]) applies for a life insurance policy on the life of the insured.
4. Once the policy has been approved for issue by the life insurance company, the policy owner (also the borrower) then applies to the lender for the funds to pay the premiums.
5. The lender processes the borrower's loan application, approves the loan, and ultimately advances the scheduled premium payments to the life insurance company on behalf of the policy owner.
6. The borrower pledges any additional required collateral and pays loan interest to the lender according to the terms of the premium financing agreement. Often the insured will be required to provide additional collateral when the borrower/owner is an entity, such as an ILIT, that does not hold significant assets outside of the policy.
7. Documentation is prepared and executed evidencing the loan.
8. Repayment of the loan is required. If sufficient, the borrower can use withdrawals or loans from the policy's cash value to repay all or a portion of the loan. Other exit strategies are discussed below. The borrower may need to repay the loan from personal assets. Such repayments by the insured might be deemed taxable gifts, depending upon the identity of the policy owner/borrower (for example, where the ILIT is the owner/borrower, payments by the insured will likely be treated as taxable gifts). In some instances, repayment can be made from the policy's death benefit proceeds.

Typical Premium Financing Transaction



Frequently Asked Questions

Are there risks associated with premium finance?

The borrower should understand that financed insurance is **not** free insurance and using this method to pay for life insurance may expose the borrower to additional risks that are not associated with traditional life insurance policy purchases. Those additional risks include fluctuations in the financed loan interest rate, fluctuations in the policy crediting rate, fluctutations in the policy's variable loan rate, valuation of the life insurance policy, the potential need for additional collateral held outside the policy, and the potential gift tax exposure if the insured is forced to repay the loan on behalf of an ILIT.

For clients who have a need for large life insurance policies as part of their estate plans, premium financing offers an alternative strategy for funding the premiums.

Premium financing is not a means for clients to afford life insurance. Financed insurance is **not** free insurance.

Who borrows the funds?

The policy owner borrows the funds. In the majority of cases, the borrower will be an entity — either the client's ILIT or the client's business. In rare instances, the borrower can be an individual, but this structure will require prior approval from the lender.

Who are the lenders?

Programs utilize capital from large, highly rated, and well-known financial institutions that have pre-authorized a significant level of funds to be used for financing life insurance premiums.

In some cases, clients may elect to rely on their own personal banking relationships for financing life insurance premiums. These clients and their banks will then be solely responsible for establishing the terms and conditions of their financing arrangements.

What is the loan interest rate?

Loan interest rates are typically based on a recognized benchmark interest rate plus an additional spread, depending on the size of the premiums being borrowed. The most common benchmark rate is the 12-month Secured Overnight Financing Rate (SOFR). SOFR is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities. It is a common rate used in global capital markets and is published daily in the *Wall Street Journal*.

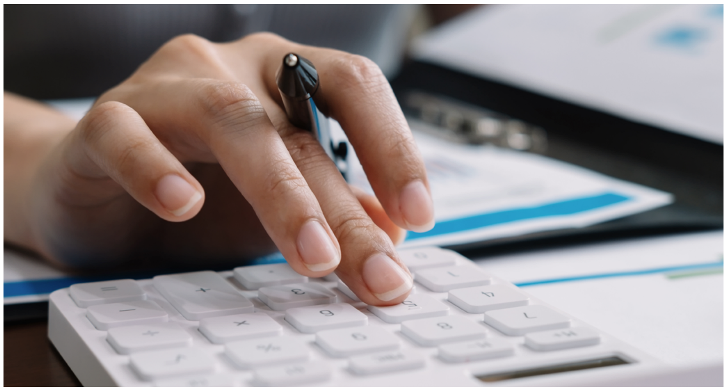
The spread above the benchmark rate typically ranges between 150-250 basis points, and varies by the amount of the loan, the credit-worthiness of the borrower and the collateral that is posted. While the benchmark rate used is expected to fluctuate on an annual basis, once negotiated, the spread typically remains constant for the life of the loan. Interest will typically be charged annually, though some lenders will negotiate other durations.

How often will the loan interest rate change?

For most loans, the interest rate will change annually, corresponding to changes in the benchmark interest rate. However, borrowers may wish to negotiate a long-term or short-term lock-in period where the interest rate will be fixed. Lock-in rates are subject to market availability and come at a premium.

When is the interest due?

In the typical arrangement, loan interest must be paid in cash at the beginning of the loan (in advance) and annually on subsequent policy anniversaries, though some borrowers may be able to negotiate different terms. In these instances, borrowers may be able to pay interest in arrears or to accrue some or all of the interest, adding it to the loan balance; such an accomodation will result in a higher lending rate. A consideration when negotiating the loan interest rate terms is that many life insurance carriers will not allow their products to be used when the client desires to accrue the loan interest.



Are there minimum loan amounts?

Yes, the minimum loan amount will vary from one lender to another.

How is interest calculated?

Some lenders charge interest based on the total loan facility (i.e., the total authorized loan amount for all planned premium payments). Other lenders charge interest on funds only as they are borrowed to make each premium payment.

Is the interest tax-deductible?

No, the loan interest in premium financing falls under the category of "personal interest," which is not deductible.

What premiums are borrowed and when?

This will vary by premium financing program. Lenders typically use a term-loan structure, where the loan amount includes a multi-year premium payment pattern that can cover between one to seven year terms.

Is there a loan acquisition or origination fee?

Loan acquisition fees (sometimes referred to as loan origination fees) are additional up-front fees paid by the borrower. Some lenders include them while others do not. The method of calculation varies by lender — some base the fee on the total loan facility, while other charge it only on the funds as they are disbursed. Additionally, some lenders may simply charge a flat fee.

What types of policies can be financed?

Both single-life and joint-survivor policies can be financed, although not all lenders will finance survivor policies. Acceptable types of policies are

- Whole life (WL)
- Universal life (UL)
- Indexed universal life (IUL)

Term and variable life policies are generally not acceptable.

What are the collateral requirements?

The lender will typically require that the life insurance policy be assigned as collateral. If the policy's cash surrender value is less than the amount of the loan, the borrower will be required to pledge additional assets. Each lender will establish its own individual collateral requirements, which may vary depending on the type of assets being pledged. Acceptable collateral normally includes cash, cash equivalents, and liquid or readily marketable securities. Letters of credit are also acceptable and are actually preferred by some lenders. Cash and cash equivalents are likely to be valued either at or close to 100% of the asset's current fair market value (FMV), while stock portfolios may only be valued at 50% of FMV.

Acceptable collateral normally includes:

- **Cash**
- **Liquid or readily marketable securities**
- **Cash equivalents**
- **Letters of credit**

Who actually provides the collateral?

Normally, collateral will be provided by the borrower. If the borrower is an ILIT with no assets other than the policy, the insured/grantor or some other source will need to provide the collateral.

How is the collateral handled?

Some lenders require that assets be transferred to a collateral account, managed by the lender. Other lenders will accept an assignment of assets and allow the client to continue to manage them. In all cases, the assets pledged as collateral, as well as the life insurance policy, will be monitored regularly by the lender.

Will the borrower ever have to pledge additional collateral?

In the event of adverse performance by either the life insurance policy or the initially pledged assets, the lender may require additional collateral to secure the loan.

When does the loan have to be repaid?

The loan must be repaid when it reaches maturity (unless renewed), upon the death of the insured, or in the event of a default. Maturity may be defined as an event (i.e., death of the insured), or after a specific period of time (i.e., a term of five, ten, or 15 years). In the case of most term loans, the balance is due and payable at the end of the term, unless the loan is renewed. Renewal of loans after the original term is not guaranteed and is subject to the lender's discretion.

Conditions of default will be described in the loan agreement. Most common examples of default are failure to pay interest when due or failure to provide collateral when required by the lender.

What planning strategies should clients consider regarding loan repayment?

There are a number of exit strategies that may be implemented:

- Use Policy Cash Value: The cash surrender value (CSV) of the life policy can be used in part or in total to repay the loan.
- Plan for a Liquidity Event: The borrower has a planned "liquidity event" in which cash is created to repay the loan. An example of this would be the sale of a business.

- Convert to Private Financing: The client may take the place of the third party lender by loaning funds to the ILIT so that the trustee can repay the lender. From that point forward, the ILIT will owe annual loan interest to the client.
- Implement a GRAT: Use of a Grantor-Retained Annuity Trust (GRAT) can also be an effective strategy for transferring funds to an ILIT with minimal gift tax consequences. One consideration is that the grantor must survive the term of the GRAT or the GRAT's value will be included in the grantor's taxable estate.

An exit strategy should be in place from the outset of a premium financing arrangment.

Is it appropriate to use policies that are considered Modified Endowment Contracts (MECs) in premium financing transactions?

No. While the client's legal and tax advisors must ultimately determine whether such a structure is advisable, a life insurance policy that is considered a MEC is typically not an appropriate asset for premium financing.

Placing a collateral assignment on a policy characterized as a MEC is treated as a distribution from the policy (even though no withdrawals are actually made), and that distribution is taxable as ordinary income to the extent that the policy's cash value is in a gain position immediately before the distribution (disregarding the effect of any surrender charges). Because lenders usually require that at least a portion of the life insurance policy be assigned to the lender as part of the loan collateral, any cash value growth that is in excess of premiums paid will be treated as taxable income and taxed at ordinary rates. Additionally, if the insured is younger than age 59 ½ or the policy is owned by a non-grantor trust or other entity, a 10% penalty tax may also be imposed. This tax liability exists whether or not an IRS Form 1099 is generated for the reportable income.

What will be expected of a financial professional in order to place a premium financing case?

Some lenders require a commission split. In some cases, the lender will also require the financial professional to sign a confidentiality agreement. In addition, either the lender or the use of a particular life insurance product may alter the normal compensation payout. Financial professionals should also verify that they have Errors & Ommissions (E&O) coverage which includes premium financing; most E&O does not include it by default.

Please keep in mind that the financial professional will need to service this transaction until the exit strategy is implemented. Some of these programs/lenders have these services built in, so that they will be able to help the financial professional service this transaction.

For further information on premium financing and other sales concepts, please contact your Crump representative.

Crump®

Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws. Failure to do so could result in adverse treatment of trust proceeds.