Cannon Insights
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Planning Ideas—Premium Financing

Many affluent and high-worth (HNW) clients have been approached with life insurance premium financing proposals. These proposals appear attractive because they seem to offer free insurance. But whether you are the person making the proposal or the Advisor helping the client evaluate the proposal be aware of the risks and remember that if it looks too good to be true…well, you know the rest, right?

Premium Financing Basics

Premium financing works pretty much the way it sounds. A lender makes loans to the policy owner, usually an irrevocable life insurance trust (ILIT), for the purpose of paying premiums on a policy owned by the trust. Assuming the loans continue for the life of the policy at the projected interest rate and the policy performs as illustrated, the policy death benefit should exceed the loan principal, resulting in a net death benefit payable for the benefit of the grantor-insured's family.

First and foremost, it should go without saying that no matter how good the proposal looks, if the client doesn't need life insurance, Advisors shouldn't recommend life insurance. Second, the viability and attractiveness of premium financing hinges on a number of underlying assumptions including:

- **The amount and renewability of premium financing loans**
- **Interest rate charged on the loan**
- **Interest payments or accruals**
- **Collateral and loan repayment**
- **Policy performance**

It's essential that Advisors know what the assumptions are and what happens if things don't pan out as illustrated.

Amount of Loan

The typical proposal involves a "premium paying policy," one on which periodic premiums are required in order to keep the policy in force. A threshold issue is whether the lender is obligated to make loans year in and year out in order to allow the borrower to continue the policy. Said another way, under what circumstances is the lender not obligated to make loans, and what recommendations do you have for the client should loans not be available?

Keep in mind that lapse of an insurance policy due to non-payment of premiums can have adverse tax consequences. In connection with financed policies secured by the policy cash value, the taxpayer’s taxable gain is measured roughly by the difference by the total cash value and aggregate premium payments to date. In some cases, after repayment of the loan principal in the event of lapse, the net cash value remaining may be less than the taxpayer’s tax liability. This means the grantor-insured will be required to pay the taxes due with other funds.

Interest Rate

Bottom line—premium financing works if the interest rate charged by the lender is less than the cash value crediting rate applied by the insurer. Typically, the interest rate floats with the London InterBank Offer Rate (LIBOR) or Prime Rate. Currently rates are at or near historical lows and are almost sure to rise. If the insurer’s illustration projects current low interest rates far into the future, the viability and accuracy of the illustration should be called into question.

Interest Payments

The proposal may call for interest to be paid or accrued.

Interest accrued is added to loan principal, which if the loan is secured by the policy can significantly reduce the death benefit and cash value available to the ILIT. If interest rates rise, the accrued interest can so burden the policy that unanticipated out-of-pocket contributions by the grantor-insured will be required to prevent policy lapse. The contributions are considered gifts to the ILIT.

In most cases, the proposal will call for interest to be paid. If the policy is owned by an ILIT, the initial gift should be large enough to cover anticipated interest payments, or the donor will have to make annual contributions to assure payment of interest. In either case, care should be exercised to assure that gift taxes are minimized through proper allocation of the donor’s gift tax exemption and/or annual exclusion.

Payment of Principal

While many illustrations show the loans being repaid at death, the terms of the loan may allow the lender to accelerate loan repayment. For example, loan repayment may be accelerated if the borrower’s creditworthiness declines, based on personal financial statements the insured is required to periodically provide. Where an ILIT owns the policy, it is likely that the lender will require the grantor-insured to personally guarantee the loan.

Collateral

Premium financing loans are collateralized primarily by the cash surrender value of the life insurance policy. However, if the policy performs more poorly than illustrated there is the risk that the policy cash value will be insufficient to repay the loan. Typically, in this situation the loan agreement requires the ILIT to put up additional collateral. If the ILIT lacks sufficient assets to do so, the grantor-insured as the personal guarantor of the loan, will have to contribute additional assets to the trust. These contributions will be considered gifts for gift tax purposes. Whether or not they are taxable gifts will depend on the availability of annual exclusions and gift tax exemption to offset them.

Policy Performance

Typically, the life insurance illustration will project cash values and death benefits based on a fixed interest crediting rate. This is an **assumed** rate. In some years, performance may be better than illustrated. In some years, performance may be worse. Overall policy performance may be better or worse than projected. As noted above, unless the actual policy performs well enough to fully secure the loan, *and then some,* the proposed transaction won't be nearly as attractive as the client hoped and probably expected.

A final consideration is that clients are typically asked to sign disclaimers to the effect that they were aware of the risks of the transaction and obtained advice from their professional advisors, including you, before going forward. The consequence is to shift potential liability arising from poor policy performance, etc., away from the lender and insurer to the client and his or her other advisors.

Bottom Line

Clients often want life insurance to protect their families and preserve their wealth. At the same time, they tend to balk at paying premiums and are on the lookout for ways to get around doing so. But as with most things in life, there is no free lunch when it comes to life insurance, not even when the premiums are financed.

Planning Ideas and similar topics are covered in great detail in many of Cannon's professional development solutions. To find out more visit: www.cannonfinancial.com.

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