Premium financing

The concept

Premium financing is a way of acquiring needed life insurance with borrowed funds. The strategy typically involves a fair market loan arrangement between a commercial lender and an irrevocable life insurance trust, or ILIT, established by the prospective insured.

Benefits

This technique enables the grantor to acquire life insurance without having to make a gift of premium dollars to the trust. This means that the strategy is particularly useful when the amount of life insurance needed is so large that the premiums would exceed the grantor's annual gift tax exclusions and lifetime applicable gift tax exclusion and expose the grantor to taxable gifts. The approach is also helpful when the grantor needs life insurance but is temporarily illiquid and unable to contribute premium dollars to the trust. It may also be advantageous when the grantor has an investment portfolio that is liquid but the grantor wants to maintain use of and control over the assets that would otherwise have to be liquidated to pay premiums.

Tax considerations

- The only gift to the trust by the grantor would be if the grantor chose or was required to pay all or a portion of the interest charges to the trust on the premium loans
- The death proceeds would be paid to the trust both income and estate tax free

Steps

- The grantor/insured creates an ILIT
- The ILIT borrows funds to pay the policy premiums and collaterally assigns the policy to the lender; the loan interest may be paid annually or deferred depending on the terms of the loan and/or the restrictions of the life insurance carrier
- The grantor pledges additional assets to secure the loan
- At the grantor's death, the loan (if not previously repaid) is repaid from the death proceeds, and the remaining funds are distributed to the ILIT beneficiaries

Note that there are financial risks to the grantor that interest rates will rise; the lender may not renew the loan; or the policy may not perform as planned, requiring additional collateral to be pledged. Consequently, premium financing arrangements should be accompanied by an exit strategy and only undertaken only by individuals or couples with substantial wealth.

How it works