

M INTELLIGENCE

COMMERCIAL PREMIUM FINANCE

Commercial premium finance is a source of liquidity that may help complete the life insurance element of an estate or business plan for those who qualify.

High-net-worth (HNW) individuals and families can use substantial amounts of life insurance to meet estate planning, liquidity, asset accumulation, and business planning needs. Once the amount of insurance and ownership structure is determined, the discussion usually turns to how the premiums will be paid. A starting point for this conversation is whether to pay premiums out of pocket. However, this approach may not be the best option for HNW clientele, particularly for individuals whose assets are largely illiquid, who wish to avoid making large reportable gifts to a trust, or whose return on assets outpace lender interest rates.

A creditworthy party, usually the policy owner (an individual, trust, or business) or the insured, borrows money from a commercial lender to pay premium on a life insurance contract (see “How Commercial Premium Finance Works”). The loans are fully collateralized by policy cash values, with the insured posting additional collateral as necessary to make up any shortfall. If the loan is held until death (assuming the borrower can requalify), interest costs may become undesirable or less advantageous. Therefore, it is a best practice to plan a strategy to repay and exit the loan in a way that ensures the policy will stay in force.

WHAT IS COMMERCIAL PREMIUM FINANCE?

Commercial premium finance is a temporary way to pay insurance premiums. The concept itself is quite simple.

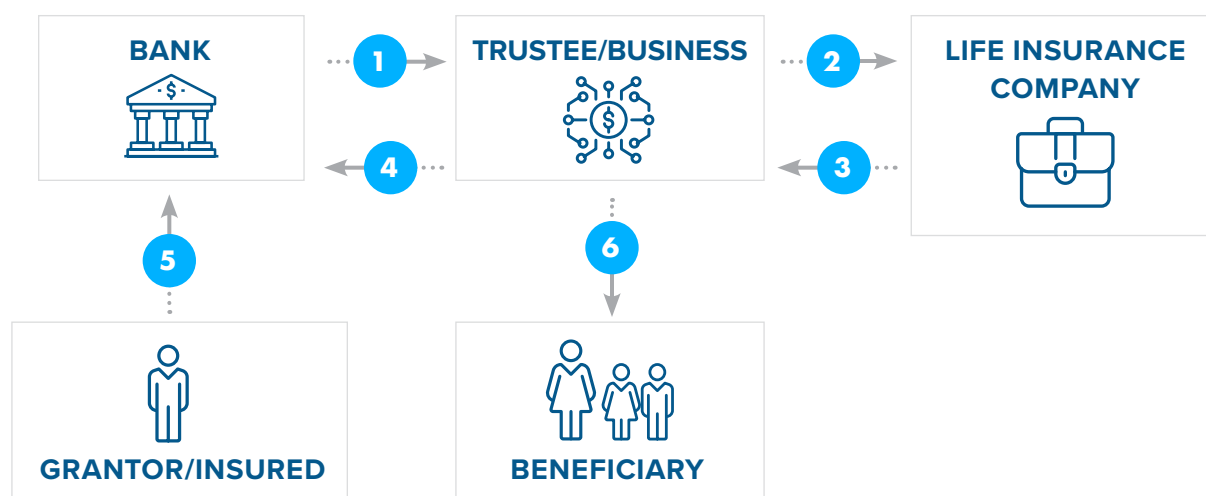
Who is eligible?

Eligibility for premium financing requires the insured/borrower to meet the following criteria:

- A demonstrable life insurance need
- Able to meet life underwriting guidelines
- Able to meet bank underwriting guidelines
- Net worth over \$5 million (lender and insurance carrier financial guidelines may vary)
- Generally, age 70 or younger (insurance carriers may accept older ages)
- Cash, cash equivalents, and marketable securities of at least \$2 million to \$3 million

HOW COMMERCIAL PREMIUM FINANCE WORKS

- 1 Bank loans' funds to trustee/business to finance life insurance premium
- 2 Trustee/business uses loans to pay premium on life insurance policy
- 3 Life insurance policy is delivered to owner (trustee/business)
- 4 Owner makes collateral assignment of policy to bank and makes loan/interest payments where applicable
- 5 Grantor/Insured posts additional collateral where applicable
- 6 At death of insured, the death benefit is paid to the beneficiary of the policy, minus any outstanding loan principal (plus capitalized interest where applicable) paid to the bank. If the owner is a nonnatural entity such as a trust or business, the owner must also be the beneficiary of the life policy.



WHAT ARE THE BENEFITS TO FINANCING POLICY PREMIUMS?

A commercial financing arrangement has many benefits, although financing premiums are subject to certain manageable risks. Potential benefits include:

- Avoidance of the sale (or need to sell) of illiquid or highly appreciated assets and associated taxes to pay cash premiums. The sale of real estate and closely held business interests are common assets that individuals may not wish to liquidate.
- Investable assets may remain invested, reducing the opportunity cost of the transaction when such assets experience a return greater than the loan interest rate.
- Positive arbitrage to the extent life insurance policy cash values earn more than the loan interest rate.
- A more gift tax-efficient way to fund life insurance owned by an irrevocable life insurance trust (ILIT).

WHAT ARE SOME OF THE RISKS ASSOCIATED WITH COMMERCIAL PREMIUM FINANCE?

There are some manageable risks associated with a commercial premium finance arrangement. Key risks to consider include:

- **Interest rate risk:** Commercial premium finance loans are often variable, and if interest rates increase, so may the borrower's out-of-pocket expense. If the borrower capitalizes interest, it will place more financial stress on the transaction.
- **Policy performance risk:** Most life insurance policies have some sort of risk of underperformance; reduced crediting rates, dividends cuts, or indexed segments may not perform as illustrated. Underperformance may result in the lender requiring additional collateral, delay in exiting the loan, and/or reduced net benefit available for the beneficiary(ies).

- **The lender may choose not to renew the loan:** In the case of non-renewal, the borrower would be required to repay the loan and seek refinancing through another lender or forced to pay the premiums out of pocket.
- **Variable collateral values:** If the pledged collateral value falls, posting additional collateral may be required.

TYPICAL LOAN TERMS

While loan terms will vary by lender, they may share similar characteristics:

- Fully collateralized, full recourse financing. The loans are fully collateralized by the life insurance cash surrender value (typically at 95%–100% loan-to-value). Additional collateral will be required if at any point the loan principal is greater than the policy's cash value. The loan-to-value ratio of additional collateral will be determined on a per asset class basis.
- Interest rates are linked to a given benchmark such as LIBOR (London Interbank Offer Rate), SOFR (Secured Overnight Financing Rate), or Prime plus a spread determined by the size of the overall loan. Generally, the larger the loan commitment, the lower the interest rate spread and overall interest rate of the loan.
- Loan rates may be “locked in” for a term of years or vary annually.
- Loan interest is generally paid annually in arrears; although, in some instances, interest may be paid in advance or capitalized.
- Loans are generally interest only with a balloon payment of principal (plus capitalized interest, if any) at the end of the loan term with option to renew.
- Lenders will have minimum borrowing commitment levels both in amounts borrowed and term of years.
- Loan duration are generally between one and 10 years with the bank providing for requalification at the end of each loan term.

EXITING A COMMERCIAL PREMIUM FINANCE ARRANGEMENT

While commercial premium finance is a powerful means of funding a life insurance policy, it is a temporary

means. The loans must be repaid. Borrowers, as a best practice, should anticipate exiting the loan as quickly as possible to avoid long-term exposure to interest rate risk and the risk of policy underperformance. Below is a non-exhaustive list of some techniques that are used individually, or in combination, to pay back the loan and exit the commercial premium finance arrangement:

- **Death benefit.** Should the insured die before the loan is repaid, the death benefit proceeds will be applied to repay loan principal. The long-term nature of this strategy may further expose the participant to interest rate and policy performance risk. It is often more responsible to elect some combination of exit strategies not related to death benefits.
- **Maximize annual gifts to the trust to pay loan interest.** Where a trust is a direct or indirect party to the arrangement, the grantor(s) could maximize the use of the annual gift tax exclusion. The amount that the grantor(s) can gift on an annual basis is equal to the number of donors multiplied by the number of trust beneficiaries (donees).¹ For example, if the trust has seven trust beneficiaries and the annual exclusion limit is \$17,000, a single grantor may gift \$119,000 to the trust annually without requiring the filing of a gift tax return. If married, and both spouses make gifts to the trust (or they elect to “gift split” with one spouse using both spouses’ annual exclusions), they would be able to gift \$238,000 a year without a reduction in their lifetime gift and estate exemptions. The funds gifted to a trust can be used to pay interest on the loan with any overage invested in a side fund to assist in the repayment of the loan at a later date. Gifts that do not qualify for the annual exclusion will be reportable on IRS Form 709 and will reduce the donor’s lifetime gift and estate tax exemption.
- **Policy cash values.** Life insurance policy cash values can be accessed via policy loans (not reported as taxable income as long as the policy remains in force at death). These cash values can be used to pay back the outstanding loan principal. Care should be given to ensure that the policy has sufficient cash values after loan repayment to keep the policy in force.
- **Personal assets.** In some instances, commercial premium finance can be used to provide liquidity for HNW individuals and families whose wealth is largely

¹ In order to qualify for the annual exclusion, gifts must be “of a present interest.” In order to qualify as a present interest, the trustee must issue “Crummey letters” to each beneficiary, notifying them of their right of access to the gifted funds. The mechanics of Crummey letter compliance are outside the scope of this piece.

composed of illiquid assets such as a closely held business interest and/or real estate. A commercial premium finance loan can provide them with the liquidity to purchase the needed life insurance without altering their timelines for the future sale of illiquid assets.

Once those assets are sold, the proceeds can be used to pay off the loan. Please note that this may involve a reportable gift if the policy is held in an irrevocable trust and the amount exceeds annual gifting limits previously discussed.

- **Grantor Retained Annuity Trust (GRAT).** A GRAT is a trust instrument that can provide the potential for gift tax-efficient wealth transfer. It is an irrevocable trust that provides the grantor with a retained annuity interest for a term of years. When that term of years expires, the remaining balance of trust assets passes to the named remainder beneficiary. If a trust holds the financed life insurance, the trust will be the remainder beneficiary. All gift tax consequences are determined at the outset when the trust is funded. The amount of the gifts is the value of trust contributions less the present value of the retained annuity interest. Properly structured, a GRAT may be “zeroed out,” which means that the value of the initial gift will be minimal. This strategy is favorably affected by a low interest rate environment, and — should trust assets appreciate significantly — will provide a gift tax-efficient means of shifting personal assets to the trust. These funds can then be held in trust, reinvested, and ultimately used to help pay back the commercial premium finance loan.

BEST PRACTICES

Commercial premium finance can work well if care is taken to properly design and manage this funding strategy:

- It makes sense to stress test the transaction when evaluating whether commercial premium finance is right for a given individual or family. Interest rate risk can be shown by illustrating increasing interest rates on the commercial premium finance loan. Policy performance risk can be shown by illustrating sub-optimal policy performance and/or by illustrating at guaranteed minimum crediting rate, particularly in the early years of the transaction. Such guidance will

highlight how changes in the baseline assumptions could affect long-term viability and, in the short term, what additional collateral may be required.

- Consider designing financed life insurance policies to provide maximum cash value accumulation potential. This will help reduce the need for outside collateral and, if the policy performs, provide additional policy cash values to assist in loan repayment. Life insurance policies with little-to-no cash value will require significant additional collateral, assuming a bank is willing to accept such an arrangement.
- Variable Universal Life (VUL) policies use registered investments to help build cash value, which if pledged as collateral for a loan, are deemed to fall under the purview of “Reg U,”² resulting in certain loan limits, margin rules, collateral requirements, and banking regulations. As a result, neither lenders nor carriers are currently expressly permitting VUL policies to be used in commercial premium finance transactions.
- Pay interest every year to avoid capitalization of interest. There are no further additions to loan principal when interest is paid in full every year. Capitalizing interest will be compounded in the loan principal, making it more difficult to exit the arrangement in a timely fashion, and may also reduce the net death benefit available to the policy’s beneficiary.
- Life insurance policies that fail the testing requirements of IRC Sec. 7702 and become Modified Endowment Contracts (MECs) may not be a good fit for commercial premium finance unless you plan to use other collateral and to exit the loan with other non-policy funds. MECs are taxed differently than traditional life insurance policies in critical ways.
- Subject to IRC Sec. 72, a collateral assignment of a MEC is considered a distribution and may be taxable to the policy owner. Distributions from MECs are deemed taxable to the extent that the cash value in the policy prior to the distribution exceeds the investment in the contract. In future years, if there is additional gain over the adjusted investment in the contract, it will be taxable in the year accrued.³ In short, a fully collateralized MEC may result in an annual income tax liability and may not be a suitable option for commercial premium finance.

² Regulation U generally restricts lenders on how much credit they may extend when margin stock is collateral for the loan. Margin stock includes, among other assets, over-the-counter securities and securities listed on national exchanges. 12 C.F.R. § 221.2.

³ IRC Sec. 72(e)(4)(A)

CASE STUDY

There are a myriad of ways to structure a premium finance transaction. A simplified example of how one such premium finance transaction may look follows below. Here we have a hypothetical wealthy business owner who recognizes the need to purchase a significant amount of life insurance but would prefer to allocate cash flow back into the business instead of into life insurance premium.

Premium financing provides the flexibility to do both. In addition to a simplified premium finance ledger, we will also provide an example of the client's retained capital, and how this can grow over time. Bear in mind that the actual performance will differ from nonguaranteed illustrated values.

EXAMPLE — PREMIUM FINANCE LEDGER

YEAR	AGE	PREMIUM PAID	OUTSTANDING LOAN	INT. RATE	INTEREST DUE	OUTSIDE COLLATERAL	CSV NET OF LOAN	DB NET OF LOAN
1	51	\$497,644	\$497,644	3.25%	\$16,173	\$169,530	(\$169,530)	\$10,000,000
5	55	\$497,644	\$2,488,220	4.25%	\$105,749	\$62,775	(\$62,775)	\$10,000,000
10	60	—	\$3,483,508	5%	\$174,175	—	\$789,347	\$10,000,000
15	65	—	\$3,483,508	5%	\$174,175	—	\$2,073,555	\$10,000,000
17	67	—	(\$3,483,508)	n/a	0	—	\$2,509,006	\$10,000,000
20	70	—	0	n/a	0	—	\$3,065,308	\$5,517,555
25	75	—	0	n/a	0	—	\$4,293,422	\$6,783,607
30	80	—	0	n/a	0	—	\$5,901,362	\$8,320,920
35	85	—	0	n/a	0	—	\$7,668,796	\$9,739,371
40	90	—	0	n/a	0	—	\$9,370,463	\$11,057,147
45	95	—	0	n/a	0	—	\$11,346,397	\$12,707,965

Policy assumptions

- Male, age 50, super-preferred
- Indexed Universal Life policy; 5.18% non-guaranteed crediting rate
- Non-MEC policy with initial face amount: \$10 million; return of premium death benefit (opt. C), CVAT testing
- 7 pay — \$497,644/year (\$3,483,508 total premiums paid)

Premium finance assumptions

- Client borrows all premium
- Client pays interest out of pocket every year until the loan is fully repaid
- Increasing interest rate: Initial loan interest rate of 3.25%; increasing by 25 basis points every year until reaching 5%, which will be maintained for the remainder of the loan term
- Policy cash values pledged for loan collateral are given 100% collateral value (actual collateral value given to the policy will differ by lender); excess

collateral required from outside assets in first five policy years

- Premium finance loan repaid out of policy cash values in year 17 via policy cash values

Retained capital assumptions

- Retained capital increases on an annual basis by the amount of free cash flow the client has to reinvest in their business, real estate, or other investments. This is determined by the premium that the client borrowed (would have otherwise paid out of pocket) less out-of-pocket expenses (loan interest).
- Illustrating an 8% rate of return on retained capital

EXAMPLE — RETAINED CAPITAL

YEAR	AGE	RETAINED CAPITAL (BOY)	PLUS NON-FINANCED PREMIUM LESS INTEREST DUE	GROWTH AT 8%	RETAINED CAPITAL (EOY)
1	51	0	\$481,471	\$38,518	\$519,988
5	55	\$2,204,655	\$391,895	\$207,724	\$2,804,274
10	60	\$4,336,602	(\$174,175)	\$332,994	\$4,495,421
15	65	\$5,268,328	(\$174,175)	\$407,532	\$5,501,685
17	67	\$5,753,711	\$0	\$460,297	\$6,214,008
20	70	\$7,248,018	\$0	\$579,841	\$7,827,860
25	75	\$10,649,717	\$0	\$851,977	\$11,501,694
30	80	\$15,647,928	\$0	\$1,251,834	\$16,899,762
35	85	\$22,991,940	\$0	\$1,839,355	\$24,831,295
40	90	\$33,782,703	\$0	\$2,702,616	\$36,485,319
45	95	\$49,637,874	\$0	\$3,971,030	\$53,608,904

EXAMPLE SUMMARY

	CONTRIBUTION PHASE YEARS 1–7	ACCUMULATION PHASE YEARS 7–16	LOAN REPAYMENT YEAR 17	DEATH BENEFIT YEAR 40
END OF YEAR TOTALS	END OF YEAR 7	END OF YEAR 16	END OF YEAR 17	END OF YEAR 40
Annual Premium	\$497,644	\$0	\$0	\$0
Loan Balance	\$3,483,508	\$3,483,508	\$0	\$0
Cash Surrender Value	\$3,674,448	\$5,850,895	\$2,509,006	\$9,370,463
Interest Cost	\$592,196	\$2,159,775	\$2,159,775	\$2,159,775
Net Death Benefit	\$10,000,000	\$10,000,000	\$10,000,000	\$11,057,147

Hypothetical example for illustrative purposes only.

A VALUABLE LIQUIDITY OPTION

HNW families and business owners have diverse needs that the key attributes of a permanent life insurance policy may help meet. For the right client, commercial premium finance may provide a valuable liquidity option. As with any financed transaction, both the upside and

downside exposures are increased. It is critical to work with an experienced life insurance planning professional who can walk you through the planning and design of the life insurance policy, as well as the commercial premium finance and repayment strategy.

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