Private Premium Financing

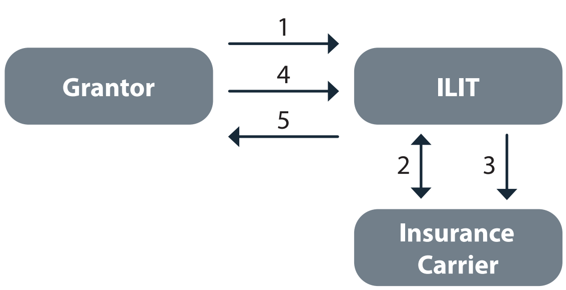
WHAT IS PRIVATE PREMIUM FINANCING?

Affluent individuals sometimes find that the premium costs for their desired amount of life insurance exceed their annual gift tax exclusion and remaining lifetime gift tax exemption amounts.* Premium financing has been a popular strategy for funding irrevocable life insurance trusts (ILITs), where a third-party lender loans the premiums to the ILIT, thereby avoiding taxable gifts. The grantor makes annual exclusion gifts to the ILIT that may be used to pay interest on the loan balance. At some point in the future, policy cash values are accessed to repay the cumulative loan and the ILIT owns a life insurance death benefit outside of the grantor's taxable estate.

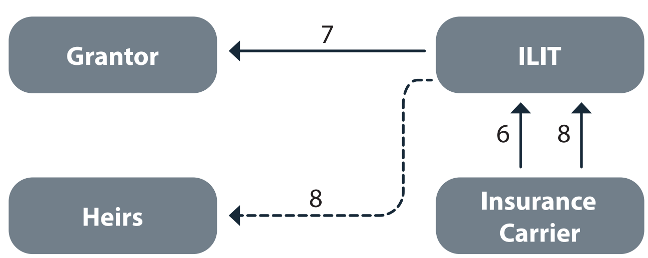
Disadvantages of commercial premium financing include interest rate risk, non-recovery of interest gifts and additional collateral requirements required by the lender. For the individual with liquid assets, it may make sense to be their own lender via a private premium financing arrangement. In a private premium financing arrangement with a grantor ILIT, interest rates are based on the appropriate applicable federal rate (AFR) and can be fixed to eliminate interest rate risk. Plus, interest gifts are recovered income tax-free via interest payments, and no additional collateral is required.

HOW DOES IT WORK?

Now:



In the Future:



1. Grantor loans annual premiums to ILIT.
2. ILIT applies for life insurance on the life of the grantor.
3. ILIT pays annual premiums to insurance carrier.
4. Grantor makes annual exclusion gifts to ILIT.
5. ILIT pays grantor annual interest accrued.
6. ILIT withdraws cumulative loan from life insurance policy.
7. ILIT repays grantor cumulative loan.
8. At death of the grantor, ILIT receives life insurance death benefit estate and income tax-free for the benefit of heirs.

ADVANTAGES

- **Reduce/Eliminate Taxable Gifts –** Where the individual's lifetime exemption is not available to cover large annual premiums, the private premium financing arrangement may avoid having to make taxable gifts.
- **Large Lump Sum Loan Not Required –** Allows grantor to monetize non-liquid assets, incurring taxable gains over the premium payment period.
- **No Additional Collateral –** Unlike commercial premium financing, a private premium financing arrangement between a grantor and their ILIT does not require additional collateral beyond the life insurance policy.
- **Low Interest Rates –** Grantor may take advantage of the lower short-term Applicable Federal Rate (AFR) under the private premium financing arrangement and switch to the mid or long-term AFR rate to lock in those rates should interest rates rise.
- **Tax-Free Interest Income –** Loan interest income paid to grantor is not subject to income tax if the ILIT is a grantor trust.
- **Interest May be Accrued –** Interest between a grantor and a grantor trust may be deferred.
- **Recovery of Costs –** Grantor recovers cumulative premiums advanced plus annual exclusion gifts via interest payments.

DISADVANTAGES

- **Policy Performance –** The ability to repay the cumulative premiums loaned is dependent upon the efficiency of the life insurance policy, including the performance of underlying indices.
- **Additional Loans/Gifts –** Additional loans or gifts to the ILIT may be required should the policy not perform to expectations.
- **Illiquid Assets –** Where the grantor's personal investments are illiquid, they will need to monetize those assets to provide the premium loans and any gifts, recognizing any ordinary or capital gains income.
- **Taxable Interest –** Loan interest payments are subject to income taxation if a trust or partnership is the lender.

THE BOTTOM LINE

The private premium financing arrangement may be an efficient premium funding strategy for an affluent individual who has the financial wherewithal to fund the life insurance premiums, but not the gifting capacity.

* The gift tax annual exclusion allows each individual to give up to $15,000 (in 2018) per year to an unlimited number of people without paying federal gift taxes. An individual may transfer the full exemption amount of $5.6 million (in 2018), either during life or at death, as long as the total amount transferred does not exceed the current exemption.