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REVISITING PREMIUM FINANCED LIFE INSURANCE

MARKET TREND: Interest rates have been somewhat unpredictable and choppy over the past few years. While rate cuts were anticipated in the near future, these cuts have not materialized and some now doubt whether cuts will occur. As a result, families involved in premium financed life insurance structures have been re-evaluating those programs to ensure their success.

SYNOPSIS: Interest rates are a crucial component of a life insurance premium financed arrangement. In essence, the success of the arrangement hinges on whether the insured can obtain a positive economic arbitrage (i.e., achieve a rate of return -- within the policy itself or elsewhere in the insured's portfolio -- in excess of the interest rate charged on the premium financed loan). Due to interest rate uncertainty, these arrangements should be actively managed.

TAKE AWAYS: While a very important tool, premium financed arrangements should be carefully evaluated and actively managed post implementation. Since the success of the arrangement is based on a positive economic arbitrage, advisors should carefully evaluate and stress test (i) fluctuations in interest rates; (ii) fluctuations in the insured's portfolio; (iii) the parties assigned to monitor performance; (iv) exit strategies; and (v) tax implications.

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WHAT IS LIFE INSURANCE PREMIUM FINANCING?

Simply stated, life insurance premium financing is a process that involves the acquisition of a third-party commercial loan to purchase a life insurance policy. Similar to other commercial loans, the lender charges market interest, and the borrower (i.e., the insured), in some cases, makes installment payments on the loan until it is repaid or until the insured passes away. In the latter event, the balance of the loan may be repaid with the policy's death benefit proceeds. The loan is commonly secured against the policy cash value. Additionally, the insured may be asked to pledge additional collateral. Further, the lender may require a personal guarantee from the insured. The loan can be structured in various ways (e.g., amortized over five years or interest only with maturity in ten years). The loan interest is typically variable (adjusting year-to-year based on changes in market rates).

There are a variety of life insurance products that can be implemented in connection with a premium financed arrangement. However, variable products cannot be used as such products are considered registered products and non-marginable. Most often, whole life policies and indexed universal policies are used in connection with premium financed arrangements.

LIFE INSURANCE TRUST

For tax purposes, an irrevocable life insurance trust ("ILIT") is named as the owner and beneficiary of the insurance policy. A properly drafted ILIT and properly structured premium financed arrangement allows the policy to be held outside of the insured's taxable estate and avoid any transfer tax implications on the ILIT beneficiaries' receipt of the policy's face amount.

ARBITRAGE

There are two different economic arbitrages in play with a premium financed arrangement: (i) the policy's performance (e.g., the crediting rate applied by the insurer) and (ii) the insured's outside investment performance; either the policy or the insured's capital held outside the policy can outperform the borrowing cost.

1. **Policy Performance:** A life insurance illustration may, subject to floors and ceilings in some cases, project the cash value and the face amount based on an interest crediting rate or an investment outcome. The rate or investment outcome is typically assumed and illustrated prior to policy acquisition. Actual performance may be better or worse than illustrated. If the rate or performance credited to the policy is greater than the rate charged on the loan, then there is positive economic arbitrage.

2. **Portfolio Performance:** The insured is using the lender's capital to purchase the policy; thus, allowing the insured to deploy their capital as they wish (rather than using it to purchase the policy). Presumably, the insured can earn a higher rate of return than the financing cost, or in some instances, avoid triggering a capital gain by having to create cash. If the insured's assets outperform the cost to finance the policy, then, once again, there is positive economic arbitrage. Success!

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ECONOMIC CONSIDERATIONS

The interest charged on a premium financed loan is often variable, meaning as market rates fluctuate, the interest charged on the loan will likewise change. By way of a few examples: in 2020, the mid-term Applicable Federal Rate ("AFR") bottomed out at 0.35%; in 2020, average 30-year mortgage rates bottomed out at 2.6%. By April 2024 … just four years later, the mid-term AFR is 4.3% and the average 30-year mortgage rate is 7.6%. Managing toward a positive economic arbitrage these days can be a bit more challenging.

In today's economic environment, a premium financed arrangement should be actively managed. The arrangement should be evaluated and monitored on a regular basis. In short, the ILIT trustee who is responsible for the sanctity of the program, will play a pivotal role in this structure. Such trustees, who may serve under a fiduciary standard, should consider the items below.

1. **Changing Interest Rates:** Given the variable rate loan structure, insureds and advisors should be mindful of the following:

    a. Can the policy achieve a positive arbitrage?

    b. Can the insured's outside use of capital achieve a positive arbitrage?

    c. What impact will higher interest rates have on the economics of the arrangement?

    d. If negative arbitrage is present, how long can the insured tolerate it?

    e. Should the policy be "front-loaded" to ensure more cash value to buoy fluctuations?

2. **Stress Test:**

    a. What are some factors that could impact the anticipated performance of the insured's assets, and are they predictable?

    b. Consider using a Monte Carlo analysis for public asset portfolio performance predictions.

    c. Since premium financed arrangements often involve an ILIT, the trustee may already be under a fiduciary obligation to monitor performance.

3. **Evaluation:**

    a. Who is tasked to monitor the arrangement's performance?

    b. Would it be prudent to appoint an independent trustee and/or professional to monitor performance (in lieu of a family member or colleague serving in a fiduciary capacity)?

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4. **Understand the Details:** At times, insureds are unaware of the following situations that may arise in a premium financed arrangement. Insureds should understand and plan for the following.

   a. After implementation of an arrangement, insureds often forget that the rate charged on the loan varies from time to time. It is critical to plan for (and remember), and to monitor and manage, the rate variations.

   b. The insurance policy is pledged as collateral against the loan. Additionally, it Is frequently necessary for the insured to pledge collateral in addition to the policy. The insured should actively monitor and manage the collateral ratio to the loan amount as capital calls can occur.

4. Flexibility and Exit: In the event the premium financed arrangement doesn't perform as anticipated, it is critical to have built in the flexibility to exit out of the arrangement if needed.

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[1] *The Uniform Prudent Investor Act requires trustees to exercise reasonable care, skill, and caution in the management of trust investments; thus, the trustee of an ILIT is under a duty to carefully monitor and manage a premium financed arrangement. Under the Uniform Directed Trust Act, trustee duties can be bifurcated, allowing for a professional to serve as the trust's "investment advisor". Insured's may want to consider using an ILIT structured as a directed trust with a professional advisor serving as the ILIT's investment advisor to ensure proper management of the premium financed arrangement and to alleviate the trustee of the ILIT from potential exposure for improper oversight and management related to the arrangement.*

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FLEXIBILITY IS KING

Flexibility will be the key to navigating these programs. Accordingly, advisors should be positioned to pivot. Whether the arrangement is eventually paid at maturity or prior to maturity, there must be a strategy in place to satisfy the insured's obligations under the premium financed arrangement. This exit would allow the insured to curtail their borrowing costs should that become necessary. The following exit strategies should be considered ahead of time:

1. Cash Surrender Value: If the policy is a high cash value product (short pay, front loaded) and expected to accumulate large cash values, it may be possible to pay down the loan, in whole or in part, early using this cash.

2. Investment Fund: Exiting the arrangement early may be possible by allocating assets to an investment fund that can be easily liquidated early and made available to pay off the financing arrangement when needed. This fund will eventually need to be owned by the ILIT. Transfer(s) to the ILIT will result in the consumption of the insured's lifetime transfer tax exemption to the extent the value of the transferred assets exceeds the insured's annual gift tax exclusion. Be prepared as current lifetime transfer tax exemption amounts may be sunsetting pursuant to the Tax Cuts and Jobs Act of 2017.

3. Grantor Retained Annuity Trust ("GRAT"): In the event that the insured is lacking a sufficient amount of lifetime transfer tax exemption, or the insured simply wishes to prepare, it may be advisable to create a side-fund by implementing a GRAT. A GRAT is an example of an irrevocable trust that at the end of its "term", can be used to satisfy the loan.

4. Paid-Up Policy Additions: It may be sensible to target the policy funding to purchase paid up policy additions, creating an additional face amount to defray the borrowing costs.

Whether the financing arrangement is paid before maturity or upon maturity, an exit strategy should be considered. An exit strategy is especially critical when the economy and interest rates are volatile.

TAXING MATTERS

There are various tax implications associated with the implementation of a premium financed product. Advisors should carefully navigate the associated tax issues, especially in light of the IRS' increased scrutiny given to life insurance related transactions (e.g., policy valuations – M. Joseph Dematteo v. Commissioner, No. 3634-21 -- and split dollar -- Estate of Marion Levine v. Commissioner (158 T.C. No. 2)).

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1. **IRC SECTION 2042 – POLICY OWNERSHIP**

Advisors must carefully navigate Section 2042 of the Internal Revenue Code ("IRC"). In general, Section 2042 of the IRC provides that if the insured retains any incidents of ownership over the policy, the policy will be included in the insured's estate for estate tax purposes. Treasury Regulation Section 20.2042-1(c)(2) expounds on the definition of "incidents of ownership" and "generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy." Properly crafted ILITs and premium financed arrangements will avoid the pitfalls of Section 2042 of the IRC.

2. **ESTATE OF LEVINE – SPLIT DOLLAR**

Advisors should stay apprised to case law developments, such as the inter-generational split dollar case known as the Estate of Marion Levine v. Commissioner (158 T.C. No. 2). In Levine, the IRS asserted that the decedent retained an interest in the policy resulting in the policy's inclusion in the decedent's taxable estate under Sections 2036 and 2038 of the IRC (these sections generally result in estate inclusion when the decedent retains an interest in property transferred or the ability to modify the beneficial enjoyment of property transferred). A key fact of Levine, resulting in the taxpayer's ultimate victory (and the conclusion that the policy would not be included in the decedent's taxable estate under Sections 2036 or 2038 of the IRC), was that the decedent did not have the power, either alone or in conjunction with others, to terminate the split-dollar plan as such power rested with an independent party. This key fact distinguished Levine from the unfavorable holdings in Estate of Cahill v. Comm'r, T.C. Memo. 2018-84, and Estate of Morrissette v. Comm'r (Morrissette II), T.X. Memo. 2021-60). Premium financed arrangements should follow much of the caution exercised in Levine, including the potential use of an independent party, to avoid tax implications.

3. **MODIFIED ENDOWMENT CONTRACTS – INCOME TAX**

Avoid using a policy that is considered a Modified Endowment Contract ("MEC") under Section 7702A of the IRC. If the policy is considered a MEC, many of the income tax benefits afforded to life insurance products are nullified. Additionally, in a premium financed arrangement with a MEC product, when the policy is pledged as collateral, the policy owner loses the tax-deferred growth on the policy's cash values (resulting in taxable gain on the growing cash value in excess of premiums paid). Front loading the policy with cash will need to be balanced against the MEC rules.

4. **PERSONAL GUARANTEE**

The insured may be asked to personally guarantee the loan. There is some uncertainty on whether a personal guarantee constitutes an incident of ownership as contemplated under Section 2042 of the IRC resulting in the policy being included in the insured's taxable estate despite ownership by an ILIT. Further, the personal guarantee may constitute a gift from the insured to the ILIT (see Private Letter Rulings 9113009 and 9409018). If the personal guarantee is deemed a gift, the insured will have consumed an amount of the insured's lifetime transfer tax exemption in an amount equal to value of the personal guarantee. Further if the guarantee is deemed a gift and it goes unreported, there may be unintended generation-skipping transfer ("GST") tax consequences for the failure to make certain elections on a timely filed gift tax return. To avoid this outcome, advisors may implement a guarantee fee agreement, where the ILIT pays the insured a fee in exchange for their personal guarantee.

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5. **USE OF EXEMPTION**

Assets may eventually need to be transferred to the ILIT so the ILIT can satisfy its interest and principal obligations under the financing arrangement. The insured's transfer of assets to the ILIT may trigger the use of the insured's lifetime transfer tax exemption. There may be structures implemented, like a GRAT, that result in the transfer of assets to the ILIT with little to no use of the insured's lifetime transfer tax exemption. If the insured has an existing spousal lifetime access trust ("SLAT"), which is a very common estate planning structure, the ILIT may potentially be allowed to use the SLAT's existing funds. Furthermore, the funded SLAT may work as the ILIT vehicle.

Take Aways: While a very important tool, premium financed arrangements should be carefully evaluated and actively managed post implementation. Since the success of the arrangement is based on a positive economic arbitrage, advisors should carefully evaluate and stress test (i) fluctuations in interest rates; (ii) fluctuations in the insured's portfolio; (iii) the parties assigned to monitor performance; (iv) exit strategies; and (v) tax implications.

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