M Financial Group™

November 2016

M Intelligence

Enhancing understanding of sophisticated planning strategies and their applications.

Private Premium Financing

What Is Private Premium Financing?

Private premium financing is the funding of life insurance premiums through a personal loan to an Irrevocable Life Insurance Trust (ILIT).

In a typical ILIT, the trust's "Grantor" establishes the trust and then makes cash gifts to fund the purchase of an insurance policy. The gifts of large premium amounts may exceed the amount of tax free gifts that can be made using annual exclusions, causing the excess to be subject to gift tax. By lending the funds to the trust, rather than gifting them, gift taxes can be reduced or eliminated.

How Does Private Financing Work?

In the typical private premium financing arrangement, the Grantor makes a loan to an ILIT that is structured as a Grantor Trust.[1] The trustee uses the borrowed funds to purchase life insurance on the Grantor's life. Any excess funds are invested by the trustee.

Each year, loan interest is due from the ILIT to the Grantor.[2] These interest payments may be made using assets in the Trust that are not needed for insurance premiums. If the Trust funds are insufficient to meet the interest payments, the Grantor can make cash gifts to the ILIT. These gifts can be structured so as to take full advantage of annual gift tax exclusions.

Loan Repayment

The loan may be repaid during the Grantor's lifetime from the assets of the Trust (including any cash value of the life insurance policy).

If the Grantor dies with the loan outstanding, the death benefit of the policy provides the funds necessary to repay the loan. If the loan is repaid to the Grantor's estate at death, the proceeds are includible in the Grantor's estate for tax purposes.

Split Dollar Regulations Apply

Under the scenario described above, the loan is effectively secured by the death benefit of the life insurance policy. As such, the Grantor and the Trust have entered into a split dollar arrangement, which is subject to the loan split-dollar regulations of REG. 1.7872-15.

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1. Although private premium financing loans are usually made by the Grantor, they can also be made by a family member, a Credit Shelter Trust, another existing trust, a Family Limited Partnership (FLP), or a Limited Liability Company (LLC).

2. Loan interest may also be accrued, though the lender would have "phantom" annual interest income.

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Interest Rate

Most private financing arrangements are structured as a term loan, which requires the loan to be repaid within a specified number of years. Term loans use a fixed rate at least equal to the appropriate Applicable Federal Rate (AFR):

- Short term AFR for a loan term less than 3 years
- Mid term AFR for a loan term of 3 to 9 years
- Long term AFR for a loan term of 9 years+

Private financing arrangements may also be structured as a demand loan (i.e., the lender can demand repayment at any time). These loans use an interest rate at least equal to the blended 7872 AFR. Demand loans are less popular, as the interest rate on the loan must be re-determined each year at the current 7872 rate.[3]

Benefits of Private Financing

- Minimizes gift taxes
- Takes advantage of low AFRs
- Avoids paying interest to a third party lender
- Avoids collateral issues
- If the lender is the Grantor, and the Trust is structured as a Grantor Trust, no taxes are due on the interest payments[4]

Considerations

- If interest rates increase, annual interest due on a demand loan would rise accordingly
- "Circular" transactions such as gifting cash to the ILIT and then immediately paying loan interest from the cash gift should be avoided

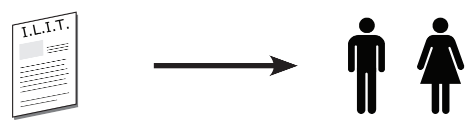
Exit Strategy

When entering into a premium financing arrangement, it is wise to have a definitive plan on when and how the loan will be repaid. If the intent is to use the cash value or death benefit from the policy to repay all or a portion of the loan at a future date, the policy should be carefully monitored to ensure that it is performing as expected. A contingency strategy should also be developed which may involve the possible planned liquidation of other assets to repay the loan.

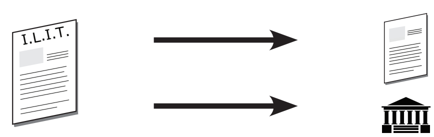
Private Premium Financing

1. Grantor makes a Loan to the Irrevocable Life Insurance Trust (ILIT).

2. Trust makes annual interest payments to the Grantor.

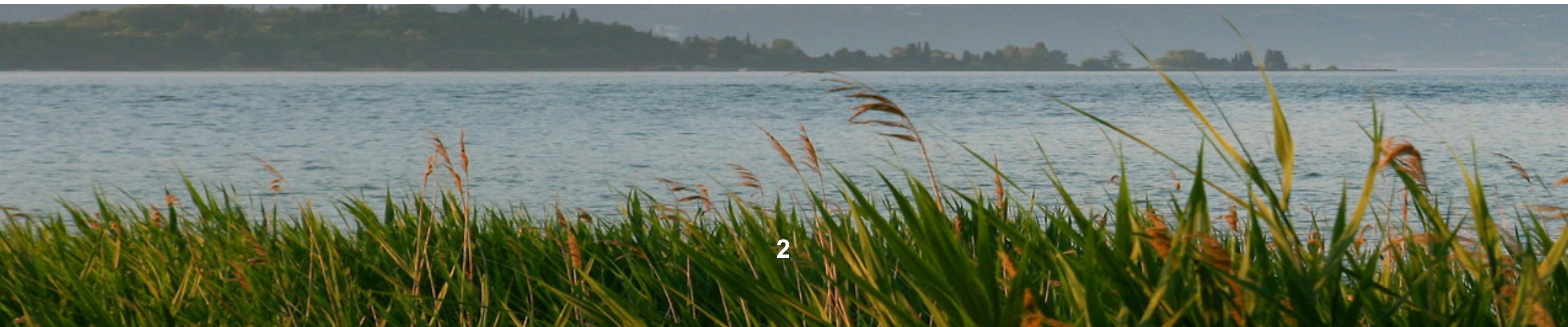


3. The ILIT pays premiums on a life insurance policy and invests any excess borrowed funds.



3. Use of a demand loan in a transaction between a Grantor and an ILIT may cause inclusion of the life insurance policy in the Grantor's taxable estate under IRC Section 2042. Clients should consult their professional advisors before entering into any sophisticated financial arrangement.

4. Revenue Ruling 85-13 provides that no income tax is due on interest payments when a Grantor makes a loan to himself/herself.



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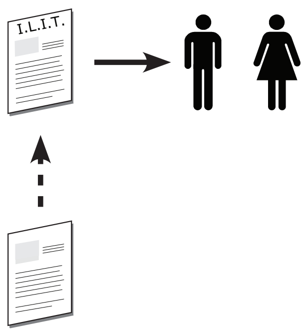
Private Premium Financing

During Life OR At Death

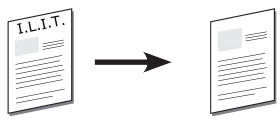
During Life

Trust uses assets (possibly life insurance policy cash value) to repay loan.

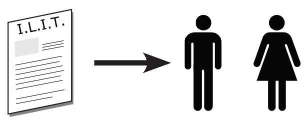


At Death

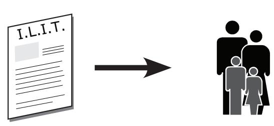
4. Death Benefit proceeds are paid to the Trust.



5. Trust uses proceeds to repay loan.



6. Remaining trust assets are passed to the heirs.



Contact Information

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