FINANCING LIFE INSURANCE THROUGH BORROWED PREMIUMS

BY

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The confluence of low interest rates and the confusion surrounding split dollar financing since 2001 has caused the insurance industry to advance financed life insurance as an alternative to split dollar arrangements. The concept is quite simple, as well as appealing: borrow from a third party lender (other than the insurer) all of the premiums and, if possible, defer both the principal and interest until the death of the insured and the payment of the policy proceeds. The policy, if it performs properly, will add paid up additions of coverage that will pay the debt created by premium borrowing and allow the net proceeds to be used for their intended purpose.

A. Structure

To work effectively, the policy must generate an internal return exceeding the interest rate that the owner is paying on the borrowed premium amounts. The economic efficacy is completely dependent on an arbitrage between the investment component return on the policy and the interest paid to a lender.

The policy, in order to provide a level death benefit, must generate paid-up additions of coverage that match the amount of principal and accrued interest that will be repaid upon the death of the insured. The mathematics of financed life dictate that the age of the insured is critical. In fact, age 70 seems to be the youngest age of an insured that will sustain premium financing. If the insured is younger, the life expectancy is concomitantly longer, and more borrowed funds are necessary to finance the policy until death. Because a lender unquestionably will have a variable interest rate, the longer that the loan is outstanding, the greater the risk for increased interest costs, as well as the risk of a decreasing return on the policy.

The insured will finance the policy directly with a third party lender (typically a bank) who is familiar with life insurance and willing to loan on an "evergreen" or interest-only basis. If the loan is amortized over a stated period, cash demands for repayment can be prohibitive. A lender may be willing to accrue the interest and have the principal of the debt and the interest paid out of the proceeds of the policy upon the death of the insured. However, application of the original issue discount ("OID") rules of Internal Revenue Code sections 1272-1275 may dissuade lenders from accruing interest over the life of the loan. The OID rules would cause the lender to recognize the interest income on an annual basis, despite the fact that it receives no cash until the loan is fully repaid at the death of the insured. The lender would not recognize additional income at the time that the accrued interest is finally paid.

The insured may, and one would expect that he or she would, transfer the insurance contract to another owner, typically a life insurance trust. The loan, in that instance, might run directly to the trust, with a guaranty by the insured. The loan also could be directed to the insured who would transfer the borrowed proceeds to the trust for the payment of premium. Relative advantages from a tax perspective will be discussed below.

Most lenders will require a guaranty if a life insurance trust owns the policy. Regardless of the borrower, the policy typically will be required as security for the loan. Additionally, if a trust owns the policy, the insured grantor will be asked to guaranty the loan or fund the trust with sufficient assets as security for the loan. Financed life insurance may supplant split dollar on an older policy. The loan would pay off the employer and future premiums could be borrowed to continue the policy.

B. <u>The taxation of financed life insurance</u>

If the loan runs to the insured grantor who, in turn, transfers the proceeds to the trust on an annual basis, the grantor will be deemed to have given that amount subject to a gift tax. If the borrowing is done by the insured, however, the debt will be a claim against the estate and, thus, deductible against the gross estate. But how could the loan be made to the insured and yet avoid the gift tax when the insured transfers the borrowed funds to the trust?

To avoid the gift tax, the grantor may consider imposing an overlay of a private split dollar arrangement on the borrowed funds from the bank, which are then advanced to the trust. In this combined arrangement, the grantor would transfer funds to the trust under a private split dollar agreement. This would avoid the gift tax, but it would create an asset ostensibly of equivalent value to the bank loan, thus nullifying the impact on the estate of the deduction of the bank loan. Although the obligation from the trust under the private split dollar agreement to the insured is of purported equal value, the fair market value of that obligation should be substantially less than its stated dollar amount. No such discount would apply to the bank loan. In the case of a second-to-die policy that is structured in the manner suggested above, the surviving grantor after the death of the first spouse should consider transferring the obligation to another trust, thus establishing the discounted value of the split dollar obligation.

If the trustee of the life insurance trust borrows directly, the grantor would not make a gift by transferring the borrowed funds to the trust. Correspondingly, the bank debt, which is an obligation of the trust, would not be a claim against the estate and deductible against the estate tax. If the bank requires the grantor to guaranty the payment, will the guaranty be an annual gift measured by the amount of the loan advanced for that year? If the IRS adopts the rationale it articulated in PLR 9113009, the guaranty should not constitute a gift in that year. Harris v US, 902 F. 2d 439 (5th Cir. 1990) (holding that a shareholder guaranty did not create basis to the shareholder in an S-corporation).

The interest, regardless of who owns the policy, will not be deductible against the income tax. First, the borrowing would constitute personal interest and thus not be deductible under Section 163(h). In any event, Section 264(a)(2) would disallow the interest deduction for amounts paid on a loan used for acquiring the insurance policy. Properly structured, however, the interest might be deductible against the estate tax. If the loan allows the accrual of the interest with the entire amount of the principal and interest payable at the death of the insured, the entire amount, including the interest, should be deductible as a claim against the estate. IRC § 2053. If the trust borrows the funds and the insured grantor guaranties the loan with the bank, does the guaranty constitute an incidents of ownership resulting in the inclusion of the policy in the insured's estate? Properly structured, the guaranty, by itself, should not result in the inclusion of the proceeds. On the other hand, if the guaranty allows access to the policy during the life of the grantor, the insured risks inclusion.

C. **Comparison with split dollar**

As indicated above, private split dollar may be used in connection with premium financing. There are distinct differences between split dollar and premium financing viewed as separate financing vehicles. The chart below illustrates these differences.

SPLIT DOLLAR	FINANCED LIFE
1. Premium	
Employer pays all or employer/employee split the cost of the premium with economic benefit or imputed interest attributed to the employee.	Third party lender furnishes all of the premium and interest.
2. Gift & income tax	
Foregone interest at AFR or economic benefit is treated as income or a gift.	Gift of the amount paid by insured/grantor, which can be interest, if interest is required on an annual basis and the trust is not separately funded, which itself would constitute a gift in most cases, unless the assets were transferred by sale. The guarantee by itself is not a gift.

3. Estate tax

The insured/grantor should not have proceeds included in estate, if a life insurance trust is holding the policy.	Same.

4. Incidents of ownership and majority owner of a closely held corporation

No inclusion if debt only and policy is merely security for the payment of debt. No expanded powers over the policy or its cash value.	Same.

5. Interest deduction

None. IRC § 264.	No income tax deduction because interest constitutes personal interest. IRC § 163.