Insurance Premium Financing

Executive summary
There are times when life insurance can play an important role in helping to manage the legacy plans of an individual or family. A common use of life insurance is to provide liquidity at the time of estate settlement. It helps protect the interests of family members and business owners when dealing with an estate that surpasses the lifetime exemption. That exemption equals $5,340,000 for an individual in 2014, or potentially double that for a married couple. The exemption amount is indexed annually for inflation. If you determine that insurance can serve a critical purpose in preserving your legacy or business planning objectives, it is important to make sure you have the appropriate coverage.

Once the type, amount and structure of coverage are determined, the next question is how to pay for it. Cash may be available to pay for premiums, but you may want to avoid reducing available cash reserves. Selling existing portfolio positions to fund the policy is another option, but this approach is not always desirable. Certain assets aren’t easily liquidated and even when they are, doing so may have tax implications. Reducing holdings to free up cash may also eliminate the opportunity to potentially generate additional returns from the assets that were sold, or in the case of a business, may have an impact on its balance sheet.

An alternative approach is to consider the potential advantages of financing life insurance premiums. This involves leveraging your existing assets rather than liquidating them. It may make the purchase of life insurance coverage more accessible for you if your assets are not readily liquid or if you prefer to retain those assets. The ability to purchase life insurance may allow you to take the steps that are necessary to potentially protect your estate, your family and other beneficiaries.

Financing for premiums
Once you’ve identified the appropriate insurance coverage and plan structure, you may determine that it is not efficient to liquidate assets to pay the premiums. By leveraging your assets through a financing strategy, you may continue to invest assets that did not have to be sold to pay premiums. There may also be tax advantages to utilizing a financing strategy, which should be discussed with your tax advisor.
If you’ve already established a financing arrangement to pay premiums on an existing policy, it may be worth considering the potential of re-financing. A comparison of terms between your existing premium financing plan and an updated arrangement can help determine if re-financing is a cost-efficient option.

Be sure to consult with your financial, legal and tax advisors to assess the benefits of a financing approach to premium payments.

**Tax issues when funding insurance through a trust**

There are important estate tax considerations when life insurance policies are owned inside an Irrevocable Life Insurance Trust (ILIT). When an ILIT is established, the grantor of the trust provides funding so the trust can purchase the insurance policy. The Trustee of the ILIT names the trust as the beneficiary of the insurance proceeds. Upon death, the trust beneficiaries are paid in accordance with the terms of the trust. Gift taxes are an important consideration in determining the source of funding to pay premiums. If existing assets are directed to the trust, either as an outright gift or as a loan, to pay for life insurance premiums, the sum may be sufficient to trigger gift tax consequences and count against the unified gift and federal estate tax lifetime exemption. (In 2014, gift taxes apply on gifts of greater than $14,000 per beneficiary. That number is inflation-adjusted periodically. The lifetime exemption for gift and estate taxes is $5,340,000 in 2014, adjusted annually for inflation.) Consideration should also be given to the potential impact of estate taxes at the state level.

Financing premiums may allow you to amplify the power of these exemptions. The ILIT could borrow the funds to make premium payments, with gifts or exemptions covering the annual interest costs on the borrowed amount.

**The fundamentals of financing insurance premiums for a trust**

Obtaining insurance premium financing is a customized process designed to address needs that are unique to each individual. Here are the primary steps in the process:

**#1 – Assessing needs and options**

- **Determine the insurance need** – the process begins by working with a Wealth Management Advisor and/or financial advisor and other key partners, such as an attorney, tax advisor or licensed insurance agent to assist with determining your insurance need. Once the appropriate coverage is identified, the plan to fund the premiums will be determined. Most insurance companies will request to review any premium financing structure as part of an enhanced underwriting process before issuing the policy.

- **Review funding options** – a decision can be made if individual assets will be used to pay the premiums or if leveraging existing assets through insurance premium financing is a better alternative. In either event, the purchaser of the policy may need to demonstrate the ability to pay the cost of the premiums directly.

**#2 – Obtaining financing**

- **Apply for financing** – if financing is the preferred option, U.S. Bank reviews the product selection and policy design to assure the structure and costs of the policy are appropriate for the financing strategy. We then carefully evaluate the potential borrower’s own financial circumstances, determine if and how a loan can be structured and if it is sufficient to meet the terms of the policy. In subsequent years, the loan terms and the borrower’s qualifications are reviewed annually by U.S. Bank before additional financing is approved.

- **Identify collateral to back the loan** – specifying assets to U.S. Bank that serve as collateral for the loan is a critical aspect of premium financing. The cash surrender value of the insurance policy can be used as security for the loan, but in the early years of the policy, additional collateral may be required as the cash value is often insufficient to secure the full value of the loan.
Typically, either cash or liquid assets are also pledged to back this type of financing. Over time, as cash values increase, personal assets that were used as collateral can be released from that obligation.

- **Determine an “exit strategy”** – during the term of the loan, it may not be necessary to pay down the principal value of the loan. However, a strategic, logical source of repayment must be identified at the time the loan is received. It’s important that the borrower not rely on the policy’s death benefits as a source of loan repayment. In many cases, the loan can be repaid from cash values accrued in the life insurance policy. If that amount is not sufficient, other assets can be liquidated in order to repay the balance of the principal. Before choosing a financing strategy or in the early years of your financing plan, you should work with professionals (financial, tax and legal advisors) to determine the most effective method of repaying the loan with minimal tax impact.

#3 – After financing is approved

- **Apply loan to pay premiums** – for each period that financing is approved (usually covering several years), a loan is put in place and insurance policy premiums will be paid from it.
- **Make interest payments** – periodic interest payments are required throughout the term of the loan, even though principal is not typically repaid at that time. In some cases, interest may represent a significant sum. If a trust owns the policy and the grantor of a trust must provide the funds to cover the interest costs, careful consideration should be given to potential gift tax implications or how the gift will count against the lifetime unified gift and estate tax exemptions for the grantor.

At some point, premiums on the policy are fully paid and ultimately, the loan is repaid, generally in accordance with the “exit strategy” developed earlier in the process.

**The role of life insurance in estate planning**

When the time comes for assets held in an estate to be passed on to beneficiaries, the need for sufficient liquidity is vital. The concern for those who have assets that exceed the estate tax exemption thresholds ($5,340,000 for an individual, potentially $10,680,000 for a married couple in 2014, both amounts indexed annually for inflation) is that a large portion of assets in the estate meant for beneficiaries may have to be liquidated to pay estate taxes.

Life insurance can play an important role in providing necessary liquidity. If an insurance policy is purchased inside an Irrevocable Life Insurance Trust (ILIT), the policy proceeds (at the time of the death of the insured) may be passed on to beneficiaries of the trust income tax-free. Insurance proceeds can be passed along to beneficiaries of the estate and may replace the value lost to taxes when the estate settles. Alternatively, if the estate is passing on assets that aren’t liquid (a business, property) or investments that may potentially have to be sold at an inopportune time to meet the tax liability, insurance proceeds can instead be used to cover taxes that are due.

If a large portion of an estate is directed to qualified charitable organizations, there are specific strategies that can be considered to limit tax liabilities that may not necessarily involve life insurance as part of the solution.

**The role of life insurance in smaller, but complex estates**

The need for substantial insurance death benefits isn’t limited to estates that may be subject to federal estate taxes. There are other circumstances where life insurance can play an important role, particularly for individuals who may have significant assets that are relatively illiquid but have limited cash reserves. Some examples include:

- Business owners who want to maintain existing assets on the company’s balance sheet. Insurance can be used to help keep the business operational, allowing the beneficiaries who stand to inherit the business to avoid having to liquidate the company.
• Farm or ranch owners who have much of their wealth tied up in land, equipment and livestock that may not be readily liquidated. Insurance can provide liquidity to help keep the farm or ranch operating.

• Individuals with a concentrated stock position (representing a significant portion of their portfolio) where there may be a need to provide liquidity to protect a stock position, particularly if it has a low cost basis.

The life insurance need should be defined and a specific policy solution determined before premium financing is considered.

Key considerations

• It is important to understand all estate and gift tax implications of your estate liquidity strategies, so be sure to consult with experienced professionals on these issues.

• Interest rates on the loan will vary, so borrowing costs could become more expensive if rates move higher. The applicable interest rate is based on an underlying index, such as the LIBOR (London Interbank Offered Rate) index.2

• Ownership of an existing life insurance policy can be transferred to a trust, but it will be deemed to be part of the insured’s estate if he or she dies within three years of the transfer. New life insurance policies purchased for estate liquidity needs should be purchased directly by the trust to avoid incident of ownership.

• Changes in the market could affect the cash value of your policy and may require additional collateral be pledged to secure the loan.

Conclusion

There may be no financial matter as personal as planning your legacy. We understand the importance of focusing on your specific needs as you determine how you may want assets distributed to future generations of your family and other potential beneficiaries. Our team can partner with your other advisors, such as insurance, legal and tax professionals to ensure that any strategy recommended is consistent with your best interests and overall financial objectives.
Contributed by:

- **Rick Bottoni** – Senior Vice President & Regional Trust Manager, U.S. Bank Wealth Management – Fiduciary Services
- **Steve Engel** – Senior Wealth Strategist, The Private Client Reserve
- **Rachel Ferguson** – Senior Vice President, Managing Director, The Private Client Reserve
- **Matt Healy** – Managing Director, Client Risk Management, Ascent Private Capital Management
- **Paul Loux** – Regional Credit Manager, The Private Client Reserve
- **Taylor Miller** – Private Banking Managing Director, The Private Client Reserve
- **Barbara Scharf** – National Insurance Trust Manager, U.S. Bank Wealth Management – Fiduciary Services
- **Carol Goetsch** – Head of Insurance, U.S. Bancorp Investments

---

1. Life insurance death benefit proceeds are generally excludable from the beneficiary’s gross income for income tax purposes. There are exceptions, such as when a life insurance policy has been transferred for valuable consideration. Please consult a tax advisor for more information.

2. This is the average interest rate estimated by leading banks in London in order to borrow money from other banks. It is regularly used as a benchmark to establish a lending rate to individuals, institutions or business entities.

---

**reserve.usbank.com**

---

Investment and Insurance Products are:

<table>
<thead>
<tr>
<th>NOT A DEPOSIT</th>
<th>NOT FDIC INSURED</th>
<th>MAY LOSE VALUE</th>
<th>NOT BANK GUARANTEED</th>
<th>NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY</th>
</tr>
</thead>
</table>

This information is not intended to be used as the primary basis of investment/insurance decisions. Because of individual client requirements, it should not be construed as advice designed to meet the particular investment/insurance needs of any client.

U.S. Bank, U.S. Bancorp Investments and their representatives do not provide tax or legal advice. Each individual’s tax and financial situation is unique. You should consult your tax or legal advisor for advice and information concerning your particular situation.

**For U.S. Bank:**

Deposit offered by U.S. Bank National Association, Member FDIC. Credit products offered by U.S. Bank National Association are subject to normal credit approval.

U.S. Bank is not responsible for and does not guarantee the products, services or performance of U.S. Bancorp Investments.

**For U.S. Bancorp Investments:**

Investment products and services are available through U.S. Bancorp Investments, the marketing name for U.S. Bancorp Investments, Inc., member FINRA and SIPC, an investment adviser and a brokerage subsidiary of U.S. Bancorp and affiliate of U.S. Bank.

Insurance products are available through various affiliated non-bank insurance agencies, which are U.S. Bancorp subsidiaries. Products may not be available in all states. CA Insurance License# 0E24641.

This information represents the views of the authors, but not necessarily those of U.S. Bancorp Investments. Such opinions are subject to change without notice.

© 2014 U.S. Bank N.A. (4/14)