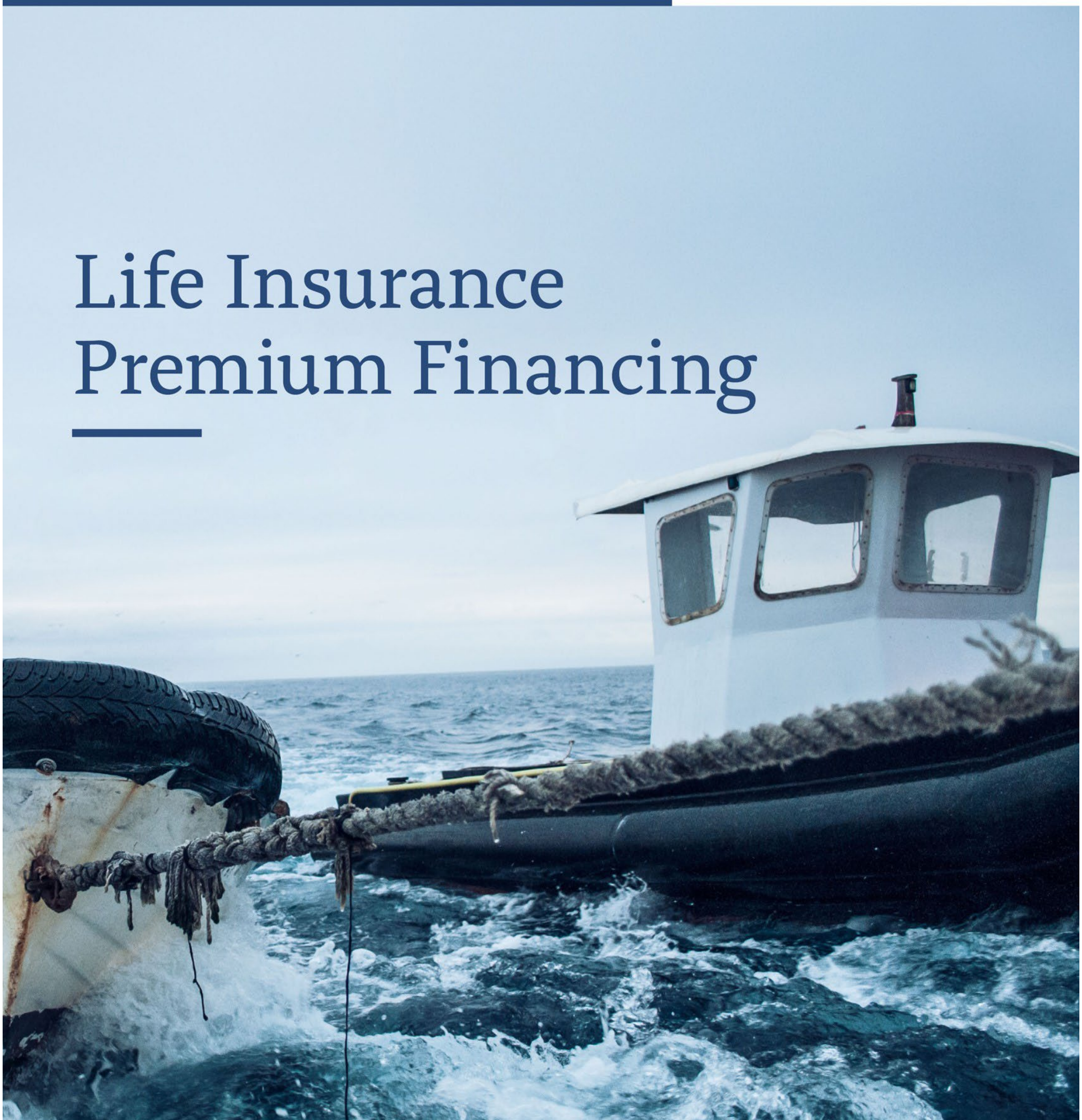
THE NAUTILUS GROUP®

Life Insurance Premium Financing



Life Insurance Premium Financing

Premium financing is a strategy combining a life insurance need, such as business succession or estate and wealth preservation, with financing utilized to satisfy recurring insurance premium obligations. Premium financing enables high net worth clients to obtain the life insurance coverage required without altering existing cash flow or liquidating other assets. High net worth individuals with access to credit facilities may therefore be able to take advantage of a favorable interest rate environment to preserve returns on capital that would otherwise be devoted to premiums.

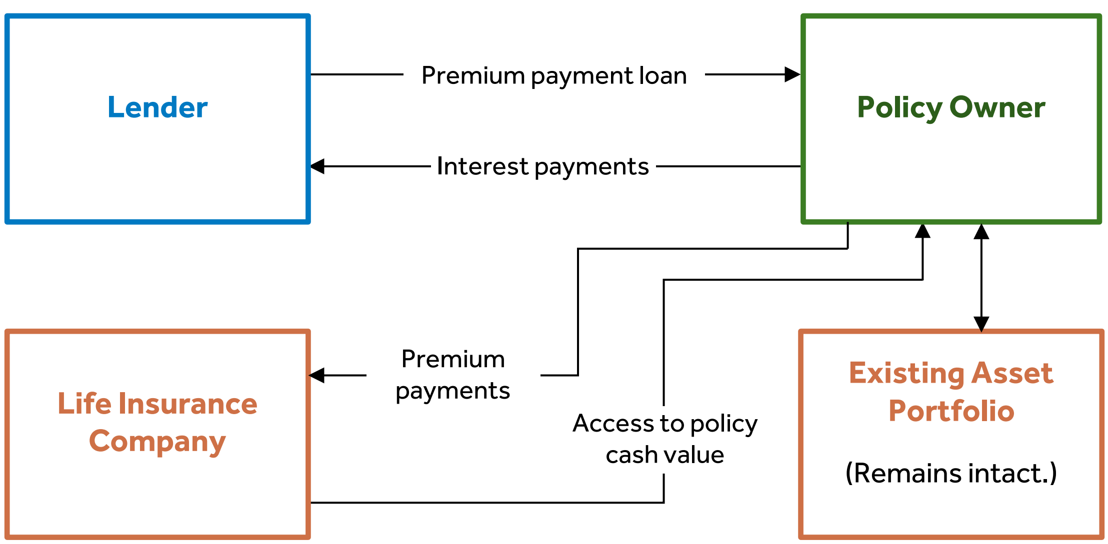
Ideal situation to utilize premium financing

Premium-financed contracts are generally ideal for closely held companies and high net worth individuals, typically aged 40 or older. Generally, the investment performance of the personal assets not liquidated to pay premiums (or in other words, the retained capital) is expected to be greater than the interest rates imposed on the loan to pay premiums on life insurance.

At the arrangement's core, the client engages in arbitrage where he/she expects to earn a higher interest rate of return from his/her investments than the interest expense to be incurred on the premium financing loan. For this to occur, a lender must be willing to lend large amounts for long periods, at favorable interest rates, with the repayment of the loan principal at some later date, such as a future liquidity event (anticipated inheritance, sale of business asset, etc.) or possibly even the death of the insured.

Premium financing loans

Summary of premium financing arrangement



Structure

The interest rate imposed on a loan to finance insurance premiums will vary among lenders and loan amount but are often stated as a margin above a stated loan rate, such as the Prime Rate, the London Interbank Offered Rate (or LIBOR for short), or the Secured Overnight Financing Rate (or SOFR for short). As with any loan, the greater the loan amount, the lower the margin rate. These margin rates will fluctuate over time and affect performance of the premium financing arrangement as compared to the original illustration. The ability to obtain the premium financing loan and the amount of any loan for which the client would be eligible likely will determine what type of lending arrangement, if any, is available to the client.

Collateral

Loan collateral is often necessary in a premium financing arrangement. Satisfying a lender's collateral requirements can be quite challenging. Generally, the total amount of collateral required by the lender, and how that collateral is valued, are the primary considerations determining whether the borrower has adequate collateral. Some lenders may not value every asset at its face value or even its fair market value, adding anticipated liquidation costs to the collateral value.

The total amount of collateral required likely will vary based upon the asset classification being pledged as security for the premium financing loan. The primary asset pledged, of course, will be the life insurance policy's cash surrender value, and cash surrender value collateral may be based often on 95% or more of the guaranteed or non-guaranteed amounts. For the additional collateral required, the Federal Reserve Board's banking regulations will influence the value placed on an asset for purposes of pledging that asset as collateral.

A popular choice for additional collateral is a portfolio of marketable securities. Notably, Regulation U of the Federal Reserve Board governs loans by entities involving securities as collateral and the purchase of securities on margin. This Regulation U limits the amount of leverage that can be extended for loans secured by securities for the purpose of buying additional marketable securities, including stocks, mutual funds, exchange-traded funds, and other market-traded securities. Another popular choice for additional collateral is a letter of credit, although such collateral will increase the overall costs of the transaction.

Premium financing preferred life insurance products

The individual's needs determine the appropriate life insurance product. Utilizing a modified endowment contract (MEC) in a premium financing arrangement should be avoided. The Internal Revenue Service likely will characterize assignment of the MEC's benefits to the lender as collateral to secure the loan, which, in turn, will be treated as a distribution from the policy, causing any annual growth (greater than basis) in a policy's cash value to be taxed as ordinary income. When use of a MEC is contemplated, the tax consequences must be reviewed by legal and tax advisors to determine whether such an arrangement is appropriate given the circumstances.

Also, certain life insurance products, notably indexed universal life (IUL) insurance, perform much differently than whole life insurance. Whole life insurance provides a guaranteed future cash value each year, so at a minimum, the insured knows how much cash is available. The difference is that while IUL insurance is a fixed rate policy and has a minimum guaranteed rate, such a policy cannot guarantee a minimum cash value amount. Additionally, whole life guarantees a minimum net return, whereas IUL may have only a guaranteed minimum rate. However, with IULs, if the internal costs of IUL insurance exceeds the guaranteed minimum rate, then there is no guaranteed cash value.[1]

---

1 Certain tax advantages are no longer applicable to a life insurance policy if too much money is put into the policy during its first seven years, or during the 7-year period after a "material change" to the policy. If the cumulative premiums paid during the applicable 7-year period at any time exceed the limits imposed under the Internal Revenue Code, the policy becomes a "Modified Endowment Contract" or MEC. A MEC is still a life insurance policy, and death benefits continue to be tax free, but any time you take a withdrawal from a MEC (including a policy loan), the withdrawal is treated as taxable income to the extent there is gain in the policy. In addition, if you are under age 59½, a penalty tax of 10% could be assessed on those amounts and upon surrender of the policy.

Risks associated with premium financing arrangements

Although a premium financing arrangement is appropriate for high-net-worth individuals, certain risks should be considered before entering into such a financing arrangement. These risks include, but are not limited to, interest rate risk, qualification risk, and policy earnings risk. During times of low interest rates, premium financing arrangements can be very attractive, but if interest rates rise, then misfortune may abound. Most often, a premium financing loan will be pegged to a variable interest rate, such as the previously mentioned SOFR. If a fixed interest rate can be negotiated for the premium financing loan, even for only a portion of the loan period, the client may benefit.

Lenders typically require borrowers to re-qualify each time the loan is renewed, at which time the loan's collateral is revalued. If the value of the collateral has fallen below a certain threshold, the insured may have to provide additional collateral against the loan, or worse perhaps even requalify for the loan. Otherwise, the loan could become due or offered for renewal at a higher rate. Since the loan is renewed at the end of each term until the loan is repaid, qualification risk is present always, whether related to the value of collateral or some other factors pursuant to the lender's underwriting standards.

If the life insurance policy's cash surrender value underperforms, the loan balance could exceed the value of the collateral, in which case the insured would be forced to provide more collateral to avoid default. Likewise, if the policy death benefit fails to increase, then the life insurance policy could provide less coverage than originally anticipated when the loan is ultimately satisfied. Taken to the extreme, if a life insurance policy's death benefit is inadequate to repay the loan and any interest, then other estate assets would have to be used to repay the loan.

Exit strategies from premium financing arrangements

How to roll out of a premium financing arrangement is a critical discussion to have with any borrower. Prior to the insured's death, if the arrangement no longer makes economic sense, perhaps due to the premiums financed becoming more expensive than outright payment of such premiums, the borrower may choose to retire the premium financing loan.

Typically, with any premium financing arrangement, an irrevocable life insurance trust (ILIT) is the owner, beneficiary, and borrower of the life insurance policy. Any prepayment of loan principal will come from ILIT funds, and any policy loans and/or withdrawals likely will reduce the policy face value and perhaps increase the possibility of a policy lapse. Therefore, exploring options as to how to best fund the ILIT makes economic sense.

Exit strategy options

Lifetime gifts to the ILIT - Gifts are made during lifetime to fund the borrower ILIT to pay loan interest. Additionally, further lifetime gifts can create a sinking fund for future repayment of the loan principal. Reliance upon a future liquidity event, such as an anticipated inheritance or sale of closely held business interests, is typically the source of funds to repay the premium financing loan.

Loan to the ILIT - The ILIT grantor loans a lump sum of money to the ILIT. The interest rate on such loan can be set at the effective applicable federal rate (AFR) when the loan is made. The ILIT will either pay interest annually to the grantor or the interest is accrued. Assets loaned to the ILIT are used to repay the lender. As with the lifetime gifts situation, some future liquidity event is typically the source of funds to repay the premium financing loan.

Life insurance policy cash value - Policy cash value may be used to repay all or a portion of the premium financing loan, while leaving the policy in force following loan repayment. Although the policy owner may make withdrawals and/or borrow from the policy's cash surrender value to repay the premium financing loan, the cash surrender value may be insufficient to repay the lender fully. Where policy loans are used to repay the premium financing loan, interest at the prevailing rate is added to the amount of the policy loan, if not repaid. If the policy is surrendered, indebtedness greater than cost basis will be taxable. Neither the loan nor the interest needs to be repaid during the insured's life; however, the death benefit proceeds would be reduced by the total policy indebtedness, including accumulated interest.

Sale to an intentionally defective irrevocable trust (IDIT) - An IDIT sale is an arrangement in which a transferor sells an appreciating or income-producing asset to an irrevocable trust in exchange for a promissory note. This arrangement, if done correctly, will defer recognition of taxable income on the note. The borrower ILIT is named the beneficiary of the IDIT. When the IDIT makes its final installment or balloon payment to the transferor, any remaining assets in the IDIT can then be transferred to the ILIT to repay the loan.

Grantor retained annuity trust (GRAT) - An asset is transferred to a GRAT and the grantor retains a fixed annuity for a specific number of years (referred to as a term certain). The transfer to the GRAT is a taxable gift, calculated at the fair market value of the asset less the retained annuity interest by the grantor. Synching the terms of the GRAT and the premium financing loan will result in availability of the remainder of the assets transferred initially to the GRAT at the same time as principal on the loan is due, and the assets then can repay the loan.

Charitable lead annuity trust (CLAT*)* - A CLAT may be utilized much in the same way that an IDIT sale or a GRAT may be used. The donor transfers an asset to the CLAT, and the trust distributions are made to a charitable organization annually over the CLAT term. The ILIT can be named as the remainder beneficiary of the CLAT, and at the end of the CLAT term, the remaining assets in the CLAT will pass to the ILIT.

Death - If the insured dies during the term of the loan, then repayment of the loan balance can be made using the death benefit proceeds. While this exit strategy is obvious, caution is necessary as long-term loans carry risks, making it important to consider any of the above alternative strategies.

Tax considerations

Estate tax

If the policy is owned by the insured outright, upon the death of the insured, proceeds would be included in the owner's taxable estate. To avoid inclusion of proceeds in the taxable estate, the owner might consider having an ILIT own the policy. Ownership of life insurance through an ILIT enables the trust grantor to remove policy values from his/her taxable estate. Upon the insured's death, the trustee receives life insurance proceeds estate tax free. (If the policy is owned by an ILIT, cash value may be accessed through spousal access provisions, loans from the trust, or funding policy premiums through a split dollar arrangement.)

Pursuant to Section 2035(a) of the Internal Revenue Code (IRC), life insurance policy proceeds are included in the gross estate of the insured if, at any time during the three years immediately preceding death, the insured possessed any incidents of ownership in the policy. Premium financing is often utilized when life insurance will be purchased by an ILIT to provide a source of liquidity with which to pay estate taxes and other transfer costs. If the insured has made a personal guarantee to repay a premium financing loan, then questions arise as to whether the insured has made either an additional gift to the ILIT (a gift that would be difficult to value) and whether the personal guarantee can be considered as incident of ownership in the policy that could cause estate tax inclusion under the IRC.

Use of premium financing assumes that the insured's guarantee of loans made to the ILIT do not result in inclusion of the policy proceeds in the insured's estate for estate tax purposes. When a personal guarantee is required by the lender, the estate tax consequences must be reviewed by the insured's own legal and tax advisors to determine whether such an arrangement will cause inclusion in the insured's estate.

Gift tax

If the policy is owned by an irrevocable trust, then, in addition to premium finance loan proceeds, the grantor (or any donor for that matter) can make gifts to the trust to fund any shortfall to ongoing life insurance premium obligations. Additionally, if interest and other premium financing loan servicing costs are contributed to the ILIT, those costs likely would be considered gifts too. The annual gift tax exclusion amount allows a donor to give up to $19,000 (in 2026) to an unlimited number of recipients per year without being deemed a taxable gift; however, pursuant to IRC §2503(b)(1), only gifts of a "present interest" qualify for the annual gift tax exclusion. To ensure gifts to an irrevocable trust qualify as present interest gifts, the trust should include "Crummey" withdrawal provisions, giving each beneficiary a limited right to withdraw gifts to the trust. In addition to relying on the annual gift tax exclusion to make tax-free gifts to an irrevocable trust, an individual donor may utilize the basic exclusion amount ($13.99 million in 2025) to make tax-free gifts to the trust to fund any ongoing premiums in addition to the financed premiums.

Income tax

IRC §163(h)(2) states, as a general rule, that no deduction shall be allowed for personal interest paid or accrued during the taxable year. Interest on a premium financing loan is classified as personal interest, and therefore generally is not deductible for income tax purposes by individuals. Personal interest does not include interest paid or accrued on indebtedness properly allocable to a trade or business. IRC §163(j)(5) states, as a general rule, that a deduction shall be allowed for business interest paid or accrued during the year. Therefore, for business-owned life insurance, an exception may apply (e.g., as when the insurance policy covers a key person). The income tax deductibility of business interest is a highly technical area. If tax deductibility of the loan interest is desired, it is imperative that the tax consequences be reviewed by the client's own legal and tax advisors to determine whether such an arrangement is appropriate given the client's unique circumstances. The decision to enter into a premium financing loan should not be based upon whether the loan interest will be deductible for income tax purposes.

As a result of H.R.1 of the 119th Congress (commonly known as the One Big Beautiful Bill Act), the estate, gift, and generation skipping tax exemptions amounts enacted under the Tax Cuts and Jobs Act of 2017 were made permanent. Effective January 1, 2026, the exemption amount will be $15 million per person ($30 million for a married couple), with annual adjustments for inflation. For asset transfers in excess of the applicable exemption amount and otherwise subject to such taxes, the highest applicable federal tax rate remains at 40%. In addition, under different rates, rules, and exemption amounts (if any), there may be state and local estate, inheritance, or gift taxes that apply in your circumstances. These materials are prepared by The Nautilus Group®, a service of New York Life Insurance Company, and are made available to all Nautilus Group member agents and, as a courtesy, to select agents of New York Life Insurance Company. New York Life, its agents, employees, and affiliates do not provide tax, legal or accounting advice. Please consult your own tax or legal advisor for advice pertaining to your specific situation. SMRU 5018410 Exp. 12/31/2028