Traditional Premium Finance: The Premise and the Background

Produced By: The GB Financial Group

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Premise: Life Insurance is the only financial product in the world guaranteed to liquefy tax-free at death.

Who: Affluent individuals with a net-worth typically in excess of $15million and whose estates have liquidity needs at their death, most often to pay federal and state death taxes.

Why: The acquisition of life insurance requires current liquid assets to meet the significant cash flow needs, which can preclude an individual from obtaining the life insurance coverage needed. In addition, because of the tax-free nature of the life insurance benefit, the premiums used to fund the policy are considered a gift to the beneficiaries of the policy and thus exposed to gift tax. These tax implications can greatly reduce the long-term benefit of the policy and increase the required liquidity needed to fund the solution.

Background

A life insurance policy, when structured correctly, provides three valuable benefits: (1) a known death benefit; (2) tax-free treatment of that benefit; and (3) peace of mind for funding the estate plan to provide the liquidity needed following the death of an affluent insured. While the needs for liquidity at death vary, the most common purposes are (a) funding of an estate tax bill and (b) liquidity needed to assist in business succession (e.g. to fund a buy-sell type arrangement or to retire debt obligations).

The tax-free growth of the internal policy values and tax-free treatment of the death benefit proceeds of an insurance policy are some of the greatest benefits a policy provides. To protect the tax-free treatment, the insurance policy must be owned outside of the insured's estate. The most common form of ownership to meet this criterion is the Irrevocable Life Insurance Trust. The ILIT removes all ownership and direct control of the policy from the grantor, who in most cases is the insured. A further benefit of the Trust is the effective elimination of possible gift tax implications caused by any funded premiums potentially being considered a gift, because the trust will borrow the funds directly as the owner of the insurance policy.

This form of ownership of an insurance policy and removing it from the estate is one of the oldest components of a basic estate plan. Life insurance provides a social benefit. It provides for dependents and thus removes the risk of those dependents experiencing life-altering consequences after the passing of the family steward. The proceeds are tax free to the beneficiaries (no income, capital gain or other type of tax is levied); the proceeds are also not included in the estate of the insured. However the payment of the premiums by the insured on behalf of the trust is considered to be a present gift to the beneficiaries, thus those payments are exposed to the federal gift tax. That tax liability can be a significant burden and erode the long-term economic benefit the policy will provide. By having the trust finance the acquisition of the insurance policy, no present gift is made to the beneficiaries and thus the gift tax is effectively eliminated in a financed solution.

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Individuals with a net-worth below that of those qualifying for this type of solution will usually purchase term insurance or some form of permanent type of life insurance, with the intent to fund income replacement, college expenses or to pay-off a mortgage in the event of an untimely death. The permanent forms of life insurance can also be used as cash accumulation vehicles. The above two referenced types and uses of life insurance fall outside the scope of this structure.

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