

## **Course Objective**

This course was created to educate estate planners, CPAs/accountants, financial planners and attorneys about Premium Finance Life Insurance. This course was developed create a foundation that will give advisors a detailed overview of how Premium Financed Life Insurance works and when to introduce it as a cost effective alternative to help clients purchase life insurance in a cost-effective manner.

This course will teach the pros and cons of traditional Premium Finance Life Insurance that are being used for estate tax purposes, business needs, i.e., key-man insurance, buy-sell agreements and charitable purposes. In addition, we'll discuss the typical client profile, the basic plan designs, and the economic variables involved such as LIBOR plus loans, collateral requirements, and the exit strategy that one should be aware of before introducing the concept to a client.

This course will also briefly introduce the concept of nontraditional premium financing where the borrower signs a non-recourse loan in which there is no liability, no personal guarantee, and no additional collateral requirement to the borrower. Understanding the difference between recourse and non-recourse loans may give the reader the knowledge to implement more plans.

Overall, this course covers basic, intermediate, and advanced material that every advisor who has high net-worth clients should know.

# **Premium Finance Life Insurance**

## **Introduction**

Premium Finance Life Insurance is a concept that, in its purest form, is quite simple. The actual transaction, however, can be quite complex; and the details require expertise on both the insurance side and the finance side. Fundamentally, premium financing means borrowing money, typically from a third party lender, to pay life insurance premiums. Many advisors pitch premium financed life as a way to purchase a “free” death benefit. This would only be the case IF the assumptions on the illustration (for loan rates and crediting in the life insurance policy) stay true.

## Theory Behind Premium Financing

The theory behind premium financing is that it allows high net-worth individuals who have a need for life insurance, whether it is for estate liquidity, wealth accumulation/transfer, business succession planning, or charitable planning, to defer using their liquid assets to fund a life insurance policy. Individuals with significant wealth are familiar with the benefits of leveraging and using credit at the right time to enhance their financial situation. In a low-interest environment, financially astute individuals will consider financing rather than being forced into untimely liquidation of personally owned assets. The combination of these aspects can make premium financing an attractive solution for high net-worth individuals.

## Client Profile

As stated earlier, premium financing is a complex transaction. Only high net-worth individuals who are sophisticated enough to understand the transaction, or have their own tax and legal advisors who recommend it, should consider this type of transaction. Premium financing is not for everyone (even though it might seem so due to massive marketing by undereducated insurance advisors looking to make a big life insurance sale).

The basic client profile is:

- Need for life insurance (not a want)
- Net worth of at least \$10 million dollars
- Liquid net assets available to pledge as collateral for the loan
- Health condition that will meet all the underwriting guidelines of the insurance company

Other mutually exclusive factors that make some clients better candidates for premium financing may include:

- Second to die vs. single life policy
- Ability to pay interest costs annually rather than accruing them
- No current liquidity to pay life insurance premiums
- Lifetime exclusion exhausted
- Understanding of foreign currency

When you understand why these factors would make one client a better candidate than another, you will recognize who is a real candidate for premium financing.

## Benefits of Premium Financing Using an ILIT

**-No up-front out-of-pocket cost for the life insurance premium is required to place the life insurance coverage.**

-Borrowed premiums are not subject to gift or income taxes—the amount of the gift is determined on the interest payable, if any, and not the premium payment.

-Policy owner receives all the tax advantages of life insurance:

- Death benefits are generally income tax and estate tax free.
- Cash value accumulation grows tax deferred.
- Cash value can be withdrawn up to cumulative premiums income tax free (as long as the settler of the trust is not the beneficiary).
- Cash value can be borrowed income tax free.

-Other benefits of premium financing include the following:

- Defer using liquid assets to fund life insurance policy.
- Ability to preserve existing investment strategies.
- Avoidance of taxes from liquidating assets to pay premiums.

## Types of Premium Financing Plans

There are generally two traditional types of premium financing loans available; however, not all lenders participate in both types of arrangements. In one arrangement, **only the premium payments are financed**. The borrower is required to pay the lender interest in cash on a quarterly or annual basis.

In another common arrangement, **both the premiums and the loan interest that accrues are financed**. The lender in this type of loan arrangement will normally not receive any monies until the death of the insured. These two lending arrangements are not the only two possibilities, however most common financing loans usually take one of the two forms or a hybrid of the two concepts.

It is important to point out a fee that typically gets thrown in at the last minute that many advisors pays little attention to. This fee is a loan origination fee and is usually 1% of the total amount to be financed. Keep in the back of your mind that usually there is a loan origination fee, typically 1% of the total amount to be financed, that is due upfront or, in some cases, it can be rolled into the loan balance.

## **Type I – Only the Annual Premium Payments are Financed (Interest Due in Cash)**

In this particular loan arrangement, the lender only loans the annual premium payments each year. The borrower pays either quarterly or annual interest payments on the cumulative loan balance. If the borrower is an ILIT (Irrevocable Life Insurance Trust), then the insured usually gifts an amount annually to the trust to cover the annual interest cost. This structure may create a gift tax issue as the cumulative loan balance increases; however, comparatively, the cash gift necessary to pay the interest is significantly less than paying the total annual premiums out of pocket. Also, we hope the life insurance policy cash value will eventually grow to the extent that the borrower may be able to take distributions in the form of loans and withdrawals to pay the interest going forward and, in some cases, ultimately pay off the loan altogether.

## **Type II – Both Premiums and Loan Interest are Financed (Interest Accumulated on the Loan)**

In this particular loan arrangement, both the premium and loan interest is financed. The borrower does not pay the annual interest cost to the lender, but rather the annual interest cost is added to the loan balance. The borrower has no cash-flow needs and no out-of-pocket costs. This sounds great and preferable to most clients and advisors; however, there are additional risks associated with this type of financing arrangement because the increasing amount of the loan balance (accumulated premium payments plus accumulated interest) creates an increasing annual interest cost.

In this type of financing arrangement, the borrower's intent should be to not repay the loan during the insured's life but rather at maturity (death of the insured). Consequently, this type of loan arrangement **requires having an increasing death benefit**. The death benefit must not only cover the accumulated premium payments, but also the interest that is accruing on the borrowed money to cover premiums and interest, as well as the amount of death benefit that the insured intends to pass to his/her beneficiaries at death.

In short, this loan arrangement also carries a higher risk if the cash value in the policy underperforms or the loan-interest projections do not meet future expectations. If interest rates on the borrowed money increase and the crediting amount (investment return) in the life policy has poor returns, an inversion occurs. If this happens in the first few years of the loan, it will put extra stress on the policy and would probably require additional collateral, or, in a worse case scenario, additional cash to be contributed into the policy. A discussion of interest rates vs. crediting rates and collateral requirements are discussed later

## **Various Other Financing Arrangements**

Although the two plan types discussed above are the most commonly seen in the market today, there are numerous creative variations, a few of which are important to mention.

Some loan arrangements use offshore banks where the loan is based on foreign currency. One might consider this option when interest rates offshore are substantially lower than the U.S. rates. This type of loan strategy should only be presented to those individuals with a full understanding of currency risk (very few clients qualify).

Other loan arrangements simply customize and combine the elements of a Plan Type I and a Plan Type II to fit the client's overall objective. For instance, some loan arrangements may let the borrower pay some of the interest and roll the rest into the loan. Some arrangements may take advantage of using the monies from a 1035 exchange to lower the loan principal, or maybe support future interest payments. In short, these types of arrangements can help reduce the overall amount to be borrowed while simultaneously limiting or eliminating the amount of gift tax that would be required to fund the trust.

The financing arrangement finally chosen will be dependent on numerous factors from both the insurance, as well as the financing side of the equation. However, in the final analysis, the financing arrangement chosen will depend on the client's overall financial situation and need to have life insurance.

## **Objectives of a Premium Finance Plan**

The policy owner's mid-to-long-term objective in a premium financing plan is dependent on which type of plan is implemented. However, consistent with all plans is the desire to increase the cash value account in the life insurance policy to the point where the collateral requirements are substantially reduced or totally eliminated. Again, depending on which type of plan and what type of policy is purchased, this event could come sooner rather than later. Let's examine the objectives of a Type I vs. a Type II plan to gain a better understanding.

### **Objectives of Type I Plan (Interest Due in Cash)**

The short-to-mid-term objective in paying the annual interest cost of the loan is to build up enough cash within the policy to eliminate the requirement for any additional collateral (and at some point the need to continue to pay the interest).

The long-term objective of this type of plan is to, at some point in the future, have built up enough cash value to have the capability to satisfy three different issues simultaneously.

- 1) Retire the debt, which would
- 2) Eliminate annual interest costs
- 3) Create a large enough cash account to support the policy until maturity (death of insured).

## **Objectives of Type II Plan (Interest Accumulated on the Loan)**

The short-term objective in a plan that accrues the annual interest cost is to create a plan where the insured has no out-of-pocket costs while simultaneously setting a collateral requirement that the client can comfortably live with throughout the term of the loan.

The long-term objective to this type of plan is, at some time in the future, to have built up enough cash value in the life insurance policy so that no additional collateral requirements will be necessary going forward. At maturity (death of insured), the loan plus the accrued interest will be repaid with death benefit proceeds from the life insurance policy that was originally financed.

## **Two Separate Financial Transactions**

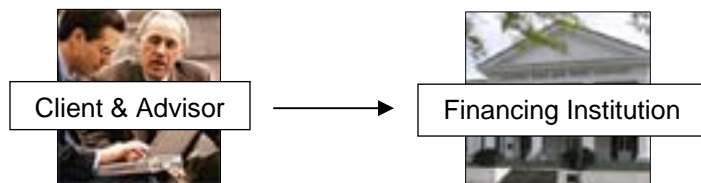
A client who is interested in premium financing will complete applications on two independent financial instruments. The first will be a life insurance policy and the second a loan to borrow the funds necessary to pay the future premiums of the life insurance policy.

### **Step 1 – Choosing the Correct Life Insurance Policy**



The first step in premium financing is to determine that the client is insurable. While the client (insured) is waiting for an underwriting offer from the appropriate insurance company, the process of determining what type of premium financing plan will meet the client's overall objective should be completed.

## Step 2 – Negotiating the Financing



Once the insured has been approved, or a formal underwriting offer is made, then the client will have real numbers to review and should determine the type of premium financing plan to implement. It is also at this point that the lender will begin its financial review and require the borrower to provide certain basic information, which may include the following:

### **Borrower's Information**

- Name
- Address
- Contact information
- Tax ID
- Trust Agreement
- Trustee Information
- Previous Tax Returns
- Balance Sheet
- Income Statement

### **Insured's Information**

- Name
- Address
- Contact information
- Social Security Number
- Personal Income Statement – Annual Income and Expenses
- Personal Balance Sheet - Net Worth Statement

### **Plan Information**

- Interest Payment Options:
  - Plan Type I – Pay Interest or
  - Plan Type II – Accrue Interest
  - Other Type
- Name of Carrier
- Details of Life Insurance Policy

### **Loan Information**

-Amount of Loan

-Term of Loan

- Length of loan is dependent on the lender
- Many times dependent on whether interest is paid or accrued

-Interest Rate Reset Frequency

- Three month LIBOR
- Twelve Month LIBOR
- Five Year LIBOR

-Interest Payment Due

- Plan Type I – Pay Interest - usually paid at annual interest rate reset date
- Plan Type II – Accrue Interest – interest amount for prior period will be added to the principal amount of the loan at the first day of the following period.

-Loan Pricing - Dependent on a number of factors

- Loan amount
- Interest paid or accrued
- Loan origination paid or accrued
- Type of collateral

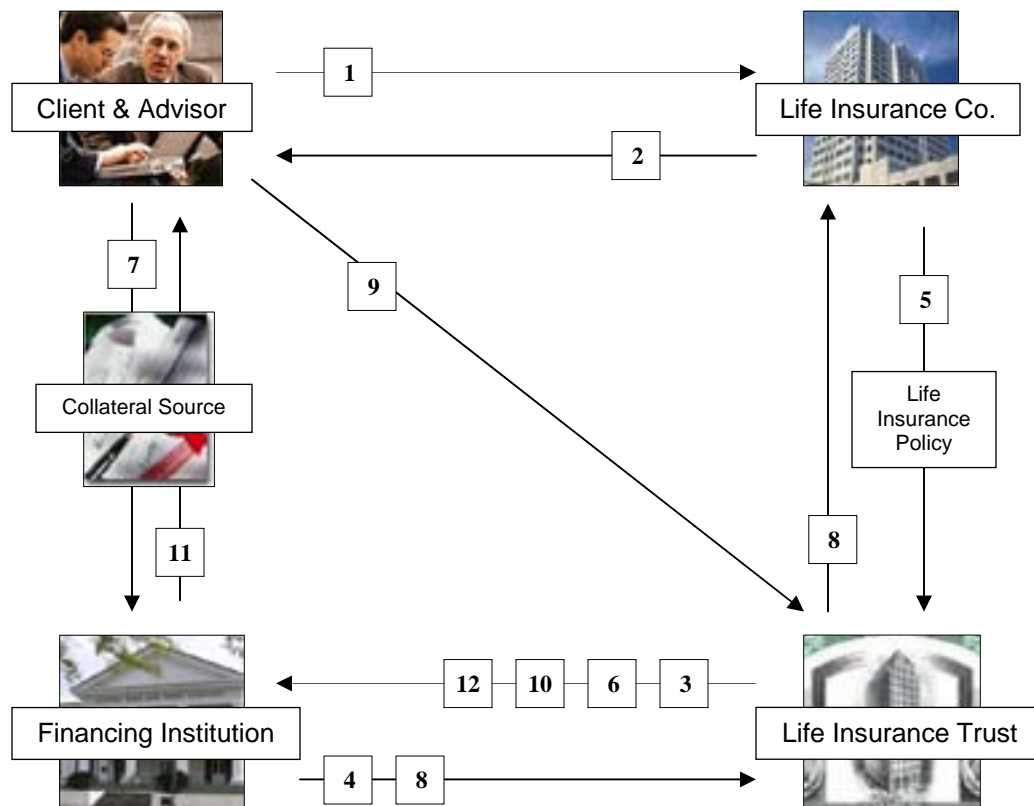
-Loan Origination Fee – A fee will be charged on the full amount of the loan that will be borrowed to pay the future premiums and interest if the interest is being accrued.

-Refinancing Fees – If the lender agrees to refinance the loan balance at the end of the term, there will be a fee charged for the new loan. This charge is similar to a loan origination fee.

Understanding that there are two separate financial transactions that rely on each other is a very important concept to convey to the insured and to his/her other advisors. One transaction cannot be completed without the other. Managing the process becomes an integral part of the transaction. Understanding the process will shorten the timeframe and help the entire transaction from being dragged out unnecessarily.

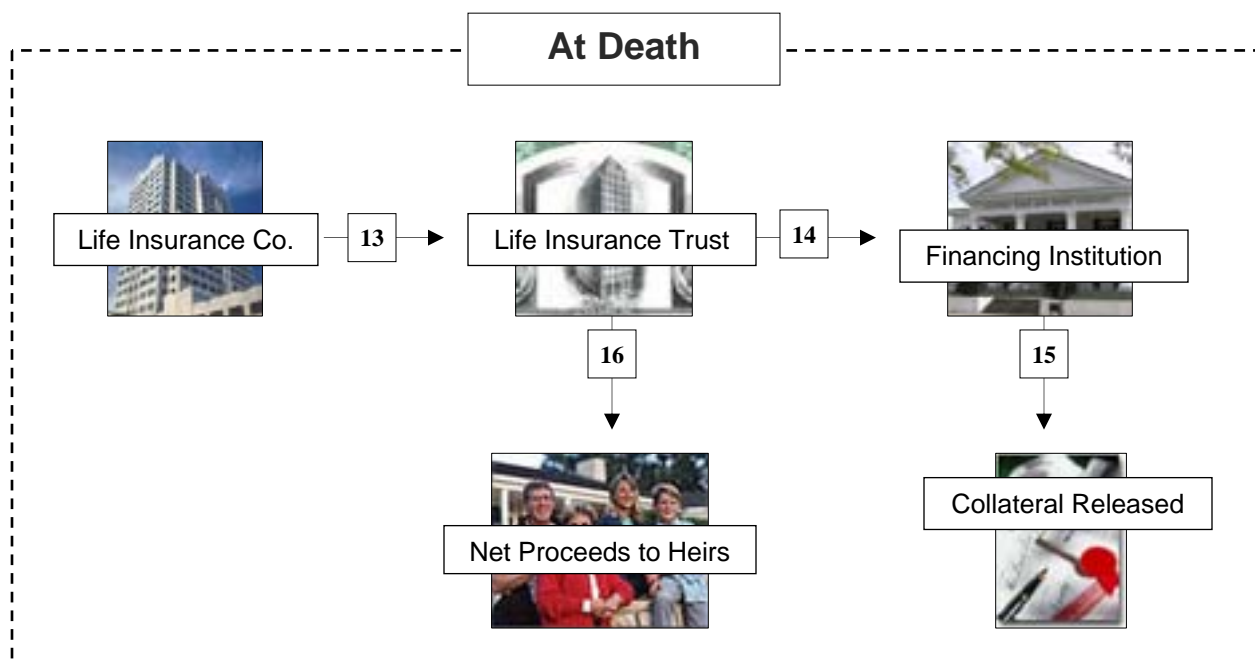


## Basic Premium Financing Flowchart (During Life)



### Process During Life

1. **Application for Life Insurance** – Proposed insured submits a life insurance application.
2. **Policy approval** – The life insurance company issues a formal underwriting offer.
3. **Application for Loan** – The Irrevocable Life Insurance Trust submits loan application.
4. **Loan approval** – The financing institution approves the loan
5. **Policy issued** – The life insurance company issues the life insurance policy to the ILIT as owner.
6. **Pledge of life insurance policy** – The ILIT (policy owner) collaterally assigns the policy to the financing institution as part of the collateral needed to secure the loan.
7. **Pledge of additional collateral** – If required, the insured delivers a personal guarantee to the financing institution for any additional collateral needed to secure the loan.
8. **Funding** – The financing institution provides funding to the insurance company as premium payment on behalf of the ILIT.
9. **Interest payments gifted** – If loan arrangement requires, the insured gifts interest payments to the ILIT.
10. **Interest payments** – The ILIT pays the annual interest cost to the financing institution.
11. **Collateral released** – The point at which the cash value of the life insurance policy has grown to a level that the cash value alone meets the financing institutions collateral requirements.
12. **Policy proceeds** – The ILIT may use the policy cash values through policy loans or withdrawals to repay the loan.



## Process at Death

13. **Death benefits distributed**– Upon death of insured, insurance company pays the death benefits to the ILIT.
14. **Loan repaid** – ILIT pays the financing company the loan balance if not repaid previously in number 12. Loan balance may include loan origination fee, premium payments advanced, and accrued interest charges, if any.
15. **Collateral released** – Once the loan balance is repaid, the financing institution releases collateral, if any.
16. **Net death benefits distributed** – The balance of the death proceeds less repayment of any loan balance is distributed to the insured's heirs income and estate tax free.

## What are the Economics of Premium Financing?

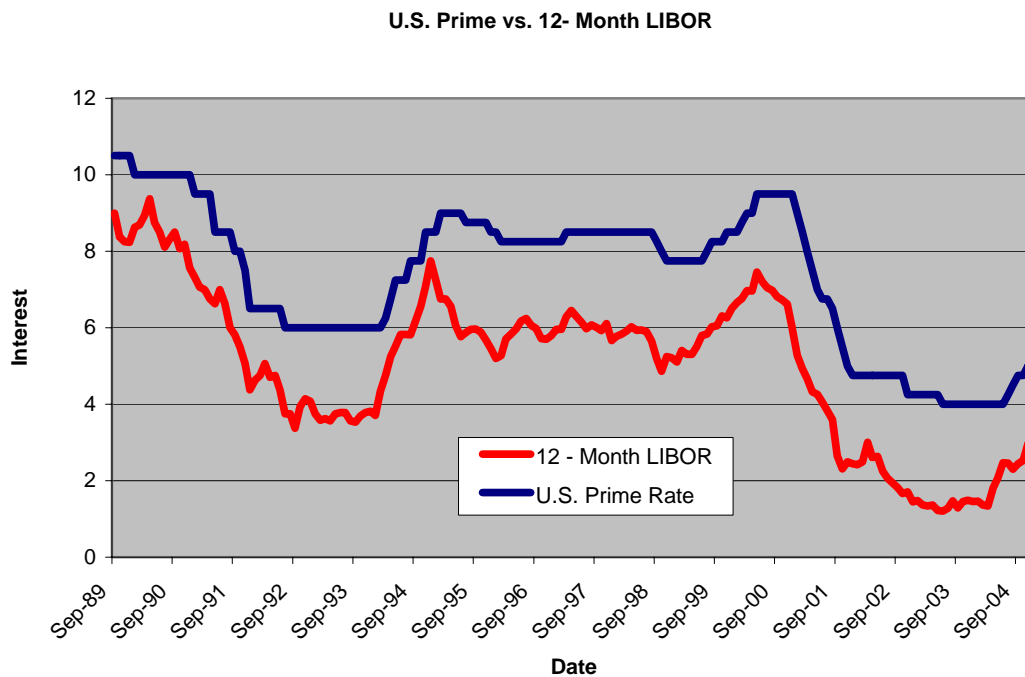
### Interest Rates

One of the most important economic components in a Premium Finance loan arrangement is the Interest Rate relationship. The success of many plans depends on the movement that the interest rate has over time. While there is no way to predict the future of interest rates, looking at the history will help demonstrate earlier rate relationships. Understanding LIBOR vs. the Policy's crediting rate is a critical factor in the analysis of a Premium Finance loan arrangement.

## LIBOR

Most premium finance loan arrangements are tied to a specified spread over LIBOR plus an additional 100 to 250 basis points. LIBOR is an acronym for London Interbank Offered Rate. LIBOR is the rate of interest that banks offer to lend money to one another in the wholesale money markets in London. LIBOR is a standard financial index that is used in the U.S. capital markets. The BBA (British Bankers' Association) compiles LIBOR as a free service and releases it to the market every day. BBA LIBOR is provided in seven international currencies. Furthermore, LIBOR rates are quoted as a fixed rate for different periods. Some lenders refer to this time as the funding period or the interest period, which usually carries a 12-month reset. However, some lenders may wish to reset the rate as few as every 3 months while others are willing to go as long as 5 years.

To get a better understanding of where LIBOR rates have been historically and also compare it to a benchmark rate that most people understand, let's compare twelve-month LIBOR to PRIME over the last 14 years.



Two common indices used in bank loans are the Bank Prime rate and the LIBOR rate.

## Policy Crediting Rate

Usually the type of policy that is used in a premium financing arrangement is a Universal Life policy. This type of policy has two fundamental components:

- 1) Annually increasing term component
- 2) Tax-deferred cash component

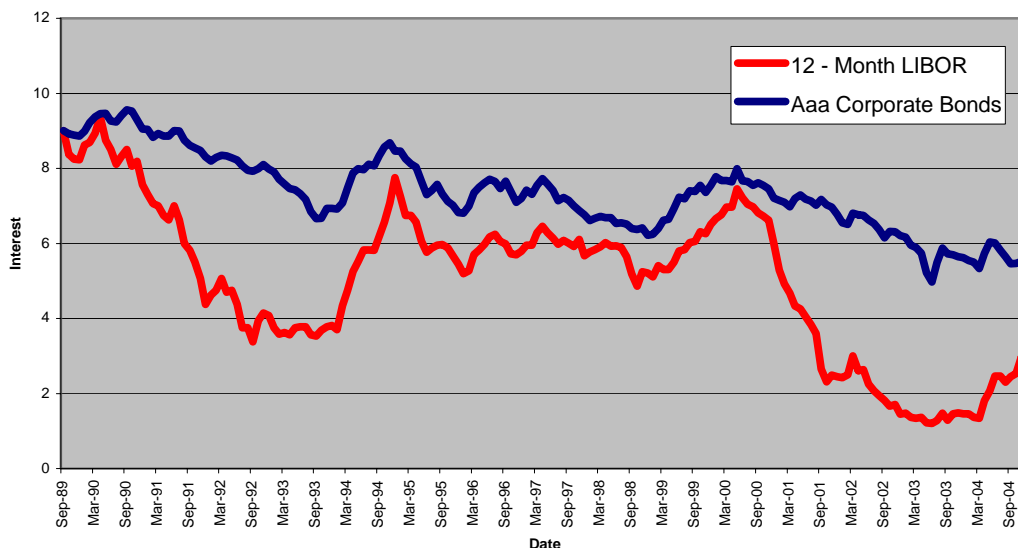
When premiums are paid, the mortality and the policy's expenses (term component) are subtracted from the premium being paid and the balance is placed into the cash value account (tax-deferred cash component). Typically, the borrower is going to pay the maximum premium (over funding) allowable while keeping the policy classified as a non-MEC (Non-Modified Endowment Contract) under the Internal Revenue Code. If too much cash gets funded into a life insurance policy, it would then qualify as a MEC and would be taxed differently which could cause difficulty in a premium finance transaction. (See the education module on life insurance for a thorough explanation of the MEC rules).

Assume for discussion purposes that the client is going to use a policy that has extra cash. Let's now look at the interest rate (policy crediting rate) the carrier is going to pay on the cash value account. The success of a premium financing plan is directly related to how much cash is in the cash value account and what rate it is earning vs. the loan balance and its corresponding interest rate being charged. **This difference is what must be managed because it is this spread that will ultimately make or break the program.**

The crediting rate can change at different intervals within the policy contract. The crediting rate adds a time value benefit to the cash value account (tax-deferred cash component) that can be higher than the guaranteed crediting rate (for most quality UL policies, the actual crediting rate is higher than the guaranteed contractual minimum). One of the policy owner's major objective is to have the policy's crediting rate exceed the interest rate on the loan (LIBOR plus) by at least 100 basis points on a consistent basis (especially in the first few years).

Life insurance carriers frequently allocate their general account in the bond market. They purchase high-quality and limited maturity bonds and other medium-term maturity fixed-income instruments. Keep in mind - the net investment rate will vary from carrier to carrier. The chart below compares the movement in seasoned Aaa Corporate Bonds to the movement of 12-month LIBOR.

Aaa Corporate Bonds vs. 12- Month LIBOR



What this chart shows is that historically , the bond rate has been higher than the LIBOR rate. **The success of a premium financing plan is dependent on the arbitrage between the LIBOR plus rate** (loan interest rate) and the rate the cash value is earning within the life insurance policy (Policy Crediting Rate). Although the policy crediting rate of the life insurance policy is determined by the carrier, there is a correlation between the declared rate and the net investment rate the carrier does receive on its own assets.

## Collateral Requirements

A second economic component of premium financing is understanding what the collateral requirements are under the terms of the loan agreement, and how they can be “called” to pay off part or all of the loan. Traditional premium financing plans rely on the cash value inside the life policy for the majority of the collateral. Most lenders will apply a 90% to 100% valuation on the **cash surrender value** (not cash account value) in the calculation to determine any additional collateral requirements. This means, in most cases, especially in the early years of a policy, there will be additional collateral required by the borrower until the cash account value can build to a point where the percentage valuation of the cash surrender value required by the lender exceeds the loan balance (which may include accrued interest charges). This is a key concept to grasp for the client. For example, if a client borrowed \$1.2 million to fund a life policy, the cash “surrender” value might be \$800,000. The cash account value might be as high as \$1.1 million. With most premium finance plans, the lender would require that the client come up with \$400,000 in additional collateral the first year. If the collateral was based on the cash account value, the client would only have to come up with \$100,000 in additional collateral. See the example below.

## Type II Plan - (Interest Accumulated on the Loan)

The table below is being used for illustrative purposes only, and is intended to demonstrate one possible funding method for life insurance. Assumptions: Financing a \$10 million second-to-die policy for a male nonsmoker age 70 and a female nonsmoker age 67. Interest costs are being accrued and added to the balance annually. The interest rate on the loan is fixed at 4.875%, and the crediting rate within the policy is fixed at 6%. A loan origination fee of 1% was rolled into the loan at inception, and an additional origination fee is added every 5 years.

a	b	c	D	e	f	g	H	i	J
Age	Annual Life Insurance Premium	Loan Balance BOY	Interest Due On Loan	Interest Paid In Cash	Interest Accrued (Financed)	Required Collateral @100% (C+D)	Cash Surrender Value "CSV"	Collateral Value of Insurance Policy (H*94% thru 100%)	Additional Collateral Required (G-I)
67	1,203,268	1,263,431	61,592	0	61,592	1,325,023	808,919	798,368	526,655
68	1,203,268	2,528,291	123,254	0	184,846	2,651,545	2,007,808	2,007,808	643,737
69	1,203,268	3,854,813	187,922	0	372,769	4,042,736	3,291,220	3,211,076	831,660
70	1,203,268	5,246,004	255,743	0	628,511	5,501,746	4,647,405	4,494,488	1,007,258
71	1,203,268	6,705,014	326,869	0	955,381	7,031,884	6,080,634	5,850,673	1,181,211
72	1,203,268	8,299,217	404,587	0	1,359,968	8,703,804	7,620,312	7,283,902	1,419,902
73	1,203,268	9,907,072	482,970	0	1,842,937	10,390,041	9,258,268	8,823,580	1,566,461
74	0	10,390,041	506,515	0	2,349,452	10,896,556	9,846,058	9,258,268	1,638,288
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87	0	19,446,052	947,995	0	11,726,943	20,394,047	21,379,656	20,186,965	207,082
88	0	20,394,047	994,210	0	12,721,153	21,388,257	22,635,838	21,379,656	8,601
89	0	21,388,257	1,042,678	0	13,763,830	22,430,934	23,959,471	22,635,838	0
90	0	22,430,934	1,093,508	0	14,857,338	23,524,442	25,387,892	23,959,471	0

At age 89 in this example, the percentage valuation of cash surrender value, column (h), finally exceeds the loan balance, column (g). It is at this point that the collateral requirement equals 0. Typically, when the interest is accumulated on the loan, the borrower almost always has to provide additional collateral for the life of the loan. The above is an exception to the rule due to the fact that the policy being financed was a second-to-die policy. However, if the policy above was financed on a single life rather than two lives, the numbers would be significantly different involving even more collateral than above and would require the collateral to be held for a longer time period.

On the other hand, when only the premiums are financed (Type I Plan), and the borrower pays the interest annually, the cash value of the life insurance will usually increase to an amount that eventually any additional collateral will no longer be needed. In a Type I Plan, collateral requirements not only are smaller than a Type II Plan but also are required for a shorter period of time. As explained earlier, paying the interest costs annually rather than accruing them creates less financial risk and also less overall stress on the transaction.

## Additional Collateral

In a traditional premium finance plan, the borrower will usually need to provide additional collateral in the early years of a life insurance policy's life. As discussed earlier, this additional collateral will usually be pledged by the insured themselves thus making the clients liable for the loan. The amount of collateral and the time period it must be held will depend upon a number of circumstances. As discussed above, paying the interest vs. accruing the interest is one of the major factors affecting the need for additional collateral. Other factors that could affect the collateral requirements include but are not limited to the following:

- Interest rate (LIBOR) movement over the term or the loan
- Type of policy (1<sup>st</sup> or 2<sup>nd</sup> to die)
- Age of insured
- Policy crediting rate
- The term of the loan
- The loan amount borrowed
- Currency of the loan

Additional collateral will usually be in the form of an irrevocable Letter of Credit issued or confirmed to the lender. The typical cost for a letter of credit is 1% of the amount of the credit which is paid each year. Depending on the lender, the collateral accepted may take on many forms, such as High-grade marketable securities, US government obligations, and corporate bonds (treated A or better by S & P). Note that the advanced rate on these different types of collateral will also depend on the lender involved. The advanced rate is the percentage of the current market value of the asset that the lender is willing to accept as collateral. Failure to maintain a sufficient acceptable collateral requirement may cause the loan to default, which would require the loan, and any interest charges, to be paid to the lender.

## Recourse Loan

Typically, most traditional premium finance loan arrangements as described above are transacted on a **recourse basis**. This usually means the lender needs a guarantee that the loan will be paid back by the borrower. This guarantee is usually held against the cash surrender value of the life policy as well as the death benefit of the policy being financed. If it stopped here, the loan, from a practical point of view, would be considered a non-recourse liability with only the insurance policy acting as collateral for the loan.

However, generally as a rule, in the early years of the policy's life, the cash value of the policy will be less than the loan balance and, thus, additional collateral will be required. Since the borrower (which is typically ILIT) usually does not have a lot of cash or assets other than the policy itself, this obligation usually takes the form of the insured pledging additional collateral or giving a

personal guarantee. Therefore, this additional collateral or guarantee makes the insured liable for the loan.

The borrowing entity will generally be required to be bankruptcy remote. A borrower is considered bankruptcy remote if the borrower's assets are not affected by the bankruptcy proceedings of the insured that the life insurance is being purchased on. Fortunately, for a variety of estate and tax planning reasons, the borrower typically will be an Irrevocable Life Insurance Trust whose assets are not affected by bankruptcy proceedings for an individual client who personally guarantees the loan.

In short, there are numerous variations of loan arrangements being developed today. Understanding your client's goals and needs and the programs available will help you determine which financial arrangement will be a good fit for a client and, most of all, make the client comfortable with the transaction. Under certain circumstances, traditional premium financing may be an excellent strategy to purchase life insurance. However, it is important that both the client and their trusted advisor understand the economics of the transaction and the risks associated with them.

## Exit Strategy

Understanding the exit strategy of a premium financing plan is probably one of the most important components of the plan itself. The exit strategy, no matter what plan is selected, always begs two questions be asked. "When will the collateral be released and when will the loan be repaid to the lender?" The answers to these questions in many scenarios will help the insured make the decision on which plan to implement or not.

### **Scenario 1 – Loan repaid at death of insured.**

The net death benefit repays the cumulative loan balance, and the remaining death benefit is distributed to the insured's beneficiaries. All collateral assignments, if still held, are released upon repayment of loan.

### **Scenario 2 – Loan repaid from cash value within the policy**

The cash value accumulates to a point where there is enough in the policy to repay before death. Once the loan is repaid during a client's lifetime, there should still be enough cash left in the policy to accumulate and pay future premiums to keep the policy in force to maturity (death of insured). In this scenario, any additional collateral requirements above the cash value needed would have been reduced many years prior to the loan being repaid.



### **Scenario 3 – The cost of borrowing (LIBOR plus) increases faster than the crediting rate within the policy**

This scenario represents the major financial risk in a premium financing transaction. If LIBOR plus rate (borrowing rate) increases to the point where the spread between the borrowing rate and crediting rate within the life insurance policy (on the cash value) is close enough that the cost of borrowing exceeds what the policy is making, a decision needs to be made.

If this scenario continues, either additional collateral or maybe even additional cash may be required to keep the policy in place and viable. Unfortunately, if this scenario occurs at the wrong time, or is extended for an unusual amount of time, continuing to keep the life insurance policy in force would be ill advised. In a worse case scenario, the collateral that was held by the lender could be called to satisfy the debt at the end of the loan term and the life insurance would be surrendered.

In some cases, it may be advised to pay the loan off and eat the collateral requirements but continue the policy and pay the annual premiums going forward. This, of course, will depend on the certain variables including the insured's current health, age, and the current need for insurance.

### **Scenario 4 – Selling the life insurance policy in the secondary market**

In the last few years, a new market for the sale of life insurance policies has evolved; it's called the Life Settlement market (see the education module on life settlements for detailed information on this topic). A Life Settlement is the sale of a life insurance policy by a senior for an amount greater than the Cash Surrender Value of that policy into the secondary market. The secondary market includes institutional buyers, such as large banks; or non-institutional buyers, such as large pension funds or other investment groups that purchase life insurance policies as a part of their investment portfolio.

Depending on the age of the insured (usually 70 years of age or older) or life expectancy (usually 8 years or less), a viable option may be to sell the life insurance policy in the secondary market and pay off the loan balance from the sales proceeds. Depending on the situation, the sale of the policy could create a positive outcome.

In short, understanding all the exit strategies of a premium finance plan will not only help the client and/or advisors decide what type of plan to implement, but also will help everyone better understand the risks and rewards of the overall premium finance plan.

## Overcome Obstacles

A high net-worth individual has various options, as well as obstacles, when determining how to pay for the cost of life insurance. The biggest obstacle a client faces when deciding to purchase life insurance is making the commitment to fund sometimes sizable premiums out of current assets. Clients usually know the financial consequences of not purchasing life insurance for estate tax purposes; however, no one likes to address this necessary evil. Presenting the right option (potentially premium financed life) to the individual at the right time may help them overcome this obstacle that has kept many frugal/cheap clients from purchasing life insurance for their estate plans.

Traditionally, an individual who needs life insurance for estate tax liquidity or wealth transfer will purchase life insurance through an Irrevocable Life Insurance Trust (ILIT). Life insurance policies properly implemented in an ILIT are considered by the Internal Revenue to be held outside one's estate and, therefore, the death proceeds are not subject to estate taxes. However, in order to take advantage of this tax benefit, an individual must either already have the necessary funds within the ILIT or gift the necessary funds to the ILIT each year for the ILIT to make the premium payments. On larger life insurance policies, the premium payments are typically so large that eventually the individual may have to pay gift tax on the monies contributed to the ILIT, which could become very expensive (see gift tax issues). Not considering any advanced estate tax planning strategies on ways to get more money into the trust, an individual could be facing a hurdle that they may not want to deal with. It's easy for an advisor to tell a client to gift \$50,000+ to an ILIT every year when the money is not coming out of the advisor's pocket.

Let's examine a worst case scenario. Mr. Rich, age 48, earns approximately \$500,000 annually. Out of that \$500,000, he pays about 40% in income taxes, which leaves him with \$300,000 net after tax. Mr. Rich wishes to purchase a \$10 million life insurance policy for estate tax purposes at a cost of \$98,000 a year. For whatever reason, Mr. Rich has exhausted his annual and lifetime exclusion to the point that any money contributed to the ILIT requires him to pay gift tax. Therefore, for Mr. Rich to contribute \$98,000 a year into his ILIT it will cost him approximately \$144,060 a year because of the gift tax of \$46,060. After subtracting the \$144,060 from the \$300,000, Mr. Rich now has \$155,940 of disposable income. Knowing Mr. Rich, after he looks at the numbers and realizes what it will cost him annually, he will usually say no thanks and walk away.

This is not an uncommon scenario, even if there were no gift tax issue involved. Typically, the sticker shock of the cost of life insurance paralyzes many people; and they rationalize not making the commitment to purchase life insurance even though they need it.

## A Simpler Way

One of the benefits of Premium Financing is the ability to significantly reduce and perhaps **eliminate gift taxes** on monies needed to fund the ILIT. Since the an ILIT is borrowing the money to pay the life insurance, the individual client does not have to contribute monies to the trust in order to pay the life insurance premiums. In the case of Mr. Rich above, he not only saves \$98,000 a year for the annual insurance premiums but also \$46,060 a year in gift taxes. In short, the typical obstacles of using disposable income to pay premium payments and gift tax on the premium payments are eliminated; unfortunately, we simultaneously create other obstacles that are attributed to premium financing.

One of the new obstacles, in some cases, as you will learn later, is that an amount that equals the interest on the loan may be required to be contributed to the ILIT by the client to satisfy the finance requirements. This is usually not a problem until the interest costs paid by the ILIT grow to a point that it creates a gift tax issue for the client. However, all things considered, using premium financing is a tremendous advantage in certain situations and even more so for people who appreciate the principal of leveraging.

## Side-Account Theory

A concept that many advisors overlook is the side-account theory. A side account is an investment account that accumulates separately while the client watches how well the cash value of the premium-financed life insurance policy grows. If the premium-financed life policy has interest rates on the borrowed money that stay low, and the life policy is crediting good growth on the cash value, the side fund will not be needed as a hedge to pay interest on the loan (and, therefore, the side fund can pass to the heirs or be used as the client sees fit while living). If, however, interest rates on the loan in the policy rise to an unexpected level, or if the life policy does not do well internally with its investment returns, the side fund can be used to pay for interest expenses on the loan.

Mentally the client is putting money into the side fund that would normally have been paid out of pocket for to buy a life insurance policy by gifting premiums to an ILIT. If the side-fund money is not needed due to the premium-financed life policy performing as planned, then the side fund need not be accessed and, therefore, will remain an asset of the client and the estate. Once advisors and clients fully understand this technique, it puts in perspective how to manage and minimize the risk in this type of transaction.

Let's use Mr. Rich again to illustrate how this side account works. What is Mr. Rich going to do with his excess disposable income? Let's assume in our first scenario that Mr. Rich invests \$144,060 (premium savings of \$98,000 plus \$46,060 gift tax saved) in a tax-deferred investment returning 6% every year for

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the next 12 years. Let's also assume in scenario two that Mr. Rich does not have a gifting issue, and the realized savings is only the premium of \$98,000 a year. In this scenario, Mr. Rich will need to invest \$98,000 and have the ability to earn 12% tax deferred every year for the next 12 years to receive the same results as our first scenario.

The table below will demonstrate how to minimize the real risk if one includes a side account in one's analysis of a premium financing transaction. Assumptions: financing on \$52 million single life policy for a male nonsmoker age 48. In year 32, the death benefit will increase to net a death benefit of approximately \$10 million to the ILIT. Interest costs are being accrued and added to the balance annually. The interest rate on the loan is fixed at 4.0%, and the crediting rate within the policy is fixed at 5.1%. There is a loan origination fee of \$135,000 (1% of total amount being borrowed), which was paid at loan inception. Notice in the side accounts that since the \$135,000 loan origination fee was due at inception, a person would not realize a savings until the second year. This is the reason why the side account for both scenario 1 and 2 is zero in the first year, then starts accumulating in year 2.

a	B	C	D	e	F	g	h	j	Side Account	
									Scenario 1 \$144,060 at 6% tax- deferred	Scenario 2 \$98,000 at 12% tax- deferred
48	2,700,000	108,000	2,808,000	0	108,000	2,808,000	2,585,135	222,865	0	0
49	2,700,000	220,320	5,728,320	0	328,320	5,728,320	5,286,203	442,117	90,757	68,320
50	2,700,000	337,133	8,765,453	0	665,453	8,765,453	8,023,329	742,124	248,906	186,278
51	2,700,000	458,618	11,924,071	0	1,124,071	11,924,071	10,858,857	1,065,214	416,544	318,392
52	2,700,000	584,963	15,209,034	0	1,709,034	15,209,034	13,828,681	1,380,353	594,240	466,359
53	0	608,361	15,817,395	0	2,317,395	15,817,395	14,353,649	1,463,746	782,598	632,082
54	0	632,696	16,450,091	0	2,950,091	16,450,091	14,893,870	1,556,221	982,258	817,692
55	0	658,004	17,108,095	0	3,608,095	17,108,095	15,449,178	1,658,917	1,193,897	1,025,575
56	0	684,324	17,792,418	0	4,292,418	17,792,418	16,019,553	1,772,865	1,418,234	1,258,404
57	0	711,697	18,504,115	0	5,004,115	18,504,115	16,605,812	1,898,303	1,656,032	1,519,172
58	0	740,165	19,244,280	0	5,744,280	19,244,280	17,206,052	2,038,228	1,908,098	1,811,233
59	0	769,771	20,014,051	0	6,514,051	20,014,051	17,907,060	2,106,991	2,175,287	2,138,341
60	0	800,562	20,814,613	0	7,314,613	20,814,613	18,632,282	2,182,331	2,458,508	2,504,702
61	0	832,585	21,647,197	0	8,147,197	21,647,197	19,384,693	2,262,504	2,758,722	2,915,026
62	0	865,888	22,513,085	0	9,013,085	22,513,085	20,181,763	2,331,322	3,076,949	3,374,589
63	0	900,523	23,413,609	0	9,913,609	23,413,609	21,030,844	2,382,765	3,414,270	3,889,300

Looking at the above table, in the twelfth year at age 59, the side accounts in both scenarios have grown to an amount greater than the additional collateral requirements. This is a critical crossover point because it is at this intersection that the money that was saved could act as the collateral going forward and in effect minimize or eliminate the recourse part of the loan.

Let's examine this point a little closer. What is the recourse part of the loan that a person is liable for? It's the additional collateral that one puts up to guarantee or secure the loan. Therefore, in a worse case scenario, a lending institution's only recourse would be to call the collateral to support the debt repayment. Therefore, if the client created a side account from the money saved, and that account grows to a level that it can act as the future collateral for the loan, didn't the client then, in effect, protect against the biggest risk? Yes, and at the same time this retained capital should continue to accumulate and compound providing an additional, but separate, capital side account. Also notice in years 13 that the side accounts are growing proportionately faster than the collateral requirements thus creating not only an excess cushion but also a substantial positive arbitrage.

In short, the power of premium financing lies within the same simple concepts related to leveraging a non-financed life insurance policy for estate tax liquidity. The opportunity is not to evaluate premium financing as a transaction by itself but rather as an alternative to the traditional non-financed funding of life insurance.

## **Tax Issues**

### **Gift Tax Considerations**

It is readily apparent for advisors and clients who look at premium financed life that one of the benefits is the potential of reducing the amount of money to be gifted to an ILIT to purchase life insurance in the traditional manner. Since the ILIT is borrowing the funds in the premium-finance scenario, there is no need for the insured (grantor of the trust) to gift the amount of money needed to pay the premium payments of the life insurance policy.

The out-of-pocket savings with premium-financed life is more evident on larger life insurance policies, where the premium payments are typically so large that the annual estate tax exclusions will be used up in a very short period of time. Once the amount of money contributed to the trust exceeds the annual exclusions available, additional amounts will be treated as a taxable gift for Federal gift tax purposes, [Section 2501 of the Internal Revenue Code].

In the case of gifts, the first \$11,000 of gifts made to anyone (\$22,000 for married couples electing to "split" gifts) can be free of any gift tax consequences for the donor, [Section 2503(b)]. In addition, every taxpayer has a lifetime exclusion (unified credit) that allows gifting a sum of money over their lifetime before incurring any gift tax liability. The Unified Credit is available for gifts made during a person's lifetime, or assets owned by a person at the time of death. The

Economic Growth and Tax Relief Reconciliation Act of 2001 made the following changes to estate and gift taxes:

Under prior law, the same unified credit amount applied to both the gift tax and the estate tax. Under current law, however, the unified credit against taxable gifts will remain at \$345,800 (exempting \$1 million from tax) through 2009, while the unified credit against estate tax increases during the same period. The following table shows the unified credit and applicable exclusion amount for the calendar years in which a gift is made or a decedent dies after 2004.

Year	Gift Tax Purposes:		Estate Tax Purposes:		Both Purposes:
	Unified Credit	Applicable Exclusion Amount	Unified Credit	Applicable Exclusion Amount	Top Tax Rate
2005	345,800	1,000,000	555,800	1,500,000	47%
2006	345,800	1,000,000	780,800	2,000,000	46%
2007	345,800	1,000,000	780,800	2,000,000	45%
2008	345,800	1,000,000	780,800	2,000,000	45%
2007, 2008 and 2009	345,800	1,000,000	1,455,800	3,500,000	45%

When the annual cash gift exceeds the annual gift tax exclusion amount and the lifetime exclusion is depleted, there will be a gift tax due. To address this issue, many advisors have typically incorporated Crummey Powers, which will allow an individual to increase the number of beneficiaries of the Trust, thus allowing a larger gift to be made without paying gift tax.

However, for those premium-financing arrangements that require an annual interest payment (Type I Plans), the interest payment may grow to a point where it would require the grantor of the trust to make additional gifts (which would exceed any amount of \$11,000 per spouse gifts) unless the trust had assets that it could use. Unfortunately, if the amount of interest on the loan exceeds the combined annual exclusions and the available lifetime exclusion (unified credit), the grantor of the trust may have to make future contributions that would be deemed a taxable gift to the trust.

## **Does a Personal Guarantee for the Loan Made to the ILIT Constitute a Gift?**

Another gift tax consideration for the client surrounds the lender's requirement of a personal guarantee or additional collateral needed to secure the

loan. Remember, it is usually the grantor (insured) securing the loan for the borrower. Typically, the borrower has no other liquid assets other than the life insurance policy being financed. Whether that personal guarantee or additional collateral given by the grantor should be considered a gift may become an issue. In a PLR 9113009, the IRS found a guarantee to be considered a completed gift as soon as it became legally enforceable. Commentators to PLR 9113009 argued that IRS should not be able to impose a gift tax on a contingent liability that didn't reduce the grantor's assets, and wouldn't unless or until the guarantee payment was made. Furthermore, in PLR 9409018, the IRS withdrew that portion of PLR 9113009 that dealt with the treatment of the guarantee as a taxable gift. To date, there has been no further guidance on the IRS's position on this gift tax issue. So, we recommend that the client consult with tax adviser(s) on the gift and estate tax issues related to this transaction and err on the conservative side.

## **Estate Tax Considerations – Incident of Ownership**

Another issue regarding the personal guarantees made by grantor surrounds the question of personal guarantee and whether giving one creates incident of ownership of the life policy. The wrong answer to this question makes the death benefits included in the insured's taxable estate. To answer this question, we need to turn to Internal Revenue Code Section 2042, where incidents of ownership are described. In its description, the meaning of incidents of ownership is not limited to ownership of the policy but also includes a reversionary interest. If a premium-financed life situation is created where the client has a reversionary right to the proceeds of the life policy, there is a possibility that the proceeds of the policy may return to the decedent, which could subject the death benefit to estate taxes.

If the insured merely provides a loan guarantee for the ILIT, he/she obtains no rights to the policy and also cannot exercise any rights of control over the policy. Consequently, all the rights and benefits of the policy remain with the ILIT. Therefore, under this scenario, the death benefit of the life insurance policy is not included in the taxable estate of the insured.

Further clarification was given in PLR 98009032, where the IRS found that incident of ownership was not found even though an ILIT created by the insured had borrowed funds from the insured to pay the life insurance premiums. In this case, the IRS found the life insurance proceeds were not includable in the insured's estate. Think about this case - the facts went further than just a loan guarantee. In this case, the insured had five loan balances still outstanding at the time of death. The IRS still ruled that the decedent did not retain any interest in the trust or incident ownership of the policy.

This is one of the many reasons why the individual client's tax and/or legal advisors should be involved early in the planning process. Determining all the tax

consequences and how to benefit best from this type of transaction should always be determined by the client's trusted advisor.

## **Non-recourse Loan Arrangements**

Up to this point, all loan arrangements dealing with premium financing were **recourse** loans. As we have learned, in a traditional premium finance arrangement, the financing institution requires the borrower to guarantee the loan and or put up additional collateral that would secure the loan. Now let's examine the opposite of a recourse loan, which is a non-recourse loan. The definition of a non-recourse loan is a loan for which no partner or related person bears the economic risk of loss. In its purest sense, a non-recourse loan means no liability to the borrower. The lender has no recourse to the borrower, and the borrower has no legal responsibility to pay the loan or the interest on the loan.

### **How Would you Like to Offer a Client the Ability to Purchase a Life Insurance Policy on a Non-recourse Basis?**

What if you were told that this type of loan existed to purchase life insurance? What if you were told that the borrower could purchase life insurance with zero net out-of-pocket costs, no personal guarantees, and no additional collateral requirements?

What if you were told that the loan is fully collateralized by the future value of the life insurance policy and that the policy's projected future value provides the basis that lenders are comfortable using as full collateral for the loan. How would you like to offer such a loan to your clients? You are probably saying to yourself that this sounds too good to be true and also at the same time wondering what's the catch. Well, there is no catch; rather it's a great opportunity for affluent individuals older than 70 to capitalize on excess life insurance capacity.

Although there is no catch, there is the good news and there is the bad news to these types of loan arrangements. The good news is that everything that was just described above is true and also, in certain situations, the insured can even receive additional upfront benefits. The bad news is that these types of loan arrangements are sometimes only good for 24–30 months. The loan provides short-term financing to families who need additional time to arrange long-term funding of their policies. It provides families with the ability to bind coverage, locking in their insurability while permanent arrangements or transfers of premium dollars can be put in place. An ILIT is the owner of the policy. If death occurs, the net death benefit (death benefit less loan balance) is received by the trust and distributed to the beneficiaries, insured's heirs, or maybe their favorite



charity. Speaking of charities, these types of programs can also be utilized to create substantial short, mid, and long-term dollars for nonprofit organizations with zero out of pocket, no liability, and no additional collateral requirements from the client.

These loan arrangements are a unique premium-finance program that allows the client to finance premiums using a non-recourse loan. The policy's projected secondary market value in two years provides the collateral for the loan that covers the cost of the premiums. As you are well aware by now, Traditional premium financing requires the insured to:

- Finance the premiums on a recourse basis
- Personally guarantee the loan
- Collateralize with personal assets

## **Why No Additional Collateral?**

The market has changed such that institutional buyers now recognize the future value of a life insurance policy. After the two-year contestability period, a life insurance policy is viewed as an asset, which can have a substantial value in the huge secondary market (Life Settlement Market) that is growing dramatically. The value this policy has in the secondary market, coupled with the fact the policy is on an older individual, brings a value that the lenders are very comfortable with.

## **Client Profile**

- Insured age 70 years of age or older in insurable health
- Borrower is generally an Irrevocable Trust
- \$5MM Minimum Net Worth

## **Advantages include:**

- Non-recourse loan
- Zero net out-of-pocket costs
- No additional collateral
- No liability/ no personal guarantees
- Maximum death benefit, \$5, \$15 and \$50 Million
- Top-rated insurance carriers
- Protects current insurability thereby allowing future estate plan to be put in place
- Charity applications

There are a handful of these types of programs available today, and they vary in size and design. These programs are much easier to complete on the financing end than a traditional premium-financing program. The financial

documentation and requirements necessary from the lender are minimal compared to traditional premium financing. This is all good news; however, the age of the client is key to this type of program. Starting a “traditional” premium-finance program after a certain age, typically 70, is usually not a cost-effective proposition. Typically, there would not be enough time to build the necessary cash needed within the policy to support the increasing mortality cost within the policy being financed.

On the flip side, a person needs to be at least 70 years of age or older in order to even qualify for a non-recourse loan. In short, a non-recourse-loan arrangement should not be looked at as an alternative to traditional premium financing using a recourse loan, but rather as an alternative or an option for an older individual to capitalize on their excess life insurance capacity.

## Conclusion

At this point, it should be quite obvious that traditional premium-financing transactions are complex. From choosing the type of plan, to the insurance carrier, to the financing institution and its financing requirements, there are many decisions to be made now and in the future. Premium financing may be a viable solution for a client’s insurance funding, but the program is not without risk. The interest rate on the loan balance and projected crediting rate within the policy are just two variables that may deviate in the future. An unforeseen interest rate spike or a sudden downturn in the market may affect even the best plans.

It is imperative that one understands the most important component of a premium-financing plan is not only having a specific exit strategy, but also understanding alternative exit strategies if circumstances change. Could a transaction be designed with no out-of-pocket costs now and in the future? Could the collateral requirements be eliminated in the future? Could we pay the loan off with the accumulated cash value? Could this be a way to purchase life insurance for free? Could we accumulate enough cash from the premium savings in a side account that would minimize or eliminate a collateral requirement? Could a permanent positive arbitrage be created? The answer to anyone of these questions from on the onset of a properly implemented plan could be a resounding yes. However, it should never be presented this way. Circumstances change, and those who borrow should be prepared to make premium payments or pay the interest costs if the economics of the transaction change. No one can predict the future; however, we can plan and be aware of the unexpected. Furthermore, understanding all the exit strategies of a premium-finance plan will not only help the client and/or advisors decide what type of plan is appropriate, but also will help everyone involved in the transaction better understand the risks and rewards of the plan proposed.

It is without question that anyone considering premium financing include their legal and/or tax advisors from the onset of the transaction. Their input from

the beginning will help guide the process as well as help answer financial and tax considerations that even a sophisticated client may not know himself. Creating a premium finance plan should be a creative process where many different alternatives should be examined and illustrated to properly explore all possible solutions for the client.