



PREMIUM FINANCING

INTRODUCTION

For clients who are financially successful, wealth transfer planning that includes life insurance is a critical step in preserving wealth. Though a life insurance policy is typically owned by an Irrevocable Life Insurance Trust (ILIT) or other entity so that the proceeds are not subject to estate tax, the gifts of potentially large life insurance premiums your client makes to the trust may be taxed as gifts. Moreover, your clients may not prefer to liquidate high-performing assets, and incur additional taxes in doing so, in order to pay large premiums. In some cases, your clients may not have the funds available currently to pay the premiums required to do proper planning. Premium financing can be helpful in overcoming these types of planning obstacles.

WHAT IS PREMIUM FINANCING?

Premium financing is a method of borrowing the cash to fund a large life insurance need. Since the premiums are borrowed, they are not taxed as gifts. That is, your client's trust or other entity may borrow the premiums from a third-party lender annually. Your client can then make gifts of only the loan interest to the trust or business, which in many cases will be covered by the available annual gift tax exclusions.¹ And, by financing life insurance premiums, your clients do not need to liquidate assets and are more likely to accomplish their transfer planning goals.

HOW DOES PREMIUM FINANCING WORK?

The client, as borrower, applies for a John Hancock universal life insurance product. Once an underwriting offer has been made, the client then submits a premium financing application with the lender. The lender will establish the terms of the note, including the loan interest rate and payment schedule. Although the life insurance policy will be used as collateral for the loan, the lender may also require additional collateral to cover the time period before the policy's cash values are sufficient to cover the loan liability. It is important to note that John Hancock is not a party to the loan arrangement.

CANDIDATES FOR PREMIUM FINANCING

The candidates for premium financing are typically your older clients with a net worth of at least \$5 million, but usually higher. Your clients who are business owners, or who have the majority of their assets invested, and need life insurance with a premium requirement of more than \$100,000 are the best prospects for financing. Moreover, your clients earning an investment return above that of the loan interest rate may benefit the most from a premium financing plan.

COMPONENTS OF PREMIUM FINANCING

Premium financing works very much like a personal loan. Although your client's ILIT or business borrows the premiums from the lender, your client may be required to personally guarantee the loan.² The borrower will then pay loan interest to the lender using annual gifts from your client. Ultimately the heirs will receive the life insurance proceeds from the trust net of the loan repayment. However, it is important to consider alternative ways of repaying the loan before death should loan repayment become necessary during lifetime.

Types of Premium Loans – Typically, a new life insurance policy is purchased or an existing policy is exchanged for a newer, more cost-effective one. The amount of the annual loan will be equal to the annual premiums required for the new policy.

If a policy exchange is being considered, any outstanding loan balance on the existing policy is usually repaid by the lender in full and carried forward in the new premium loan balance. Although in many cases, a policy loan can be carried over into the new policy in the exchange, the policy loan cost must be compared to the premium loan cost. Care must be taken, however, to assure that the exchange that carries over a policy loan does not cause adverse income tax results.³

Also, it may make sense to finance the collateral assignment repayment, often referred to as a roll-out, of an existing split dollar policy through a new financed policy. That is, if the economic benefit costs associated with a policy under a split dollar plan are becoming costly, or if the arrangement may cause taxation on equity under the new split dollar rules, considering the exchange of an existing policy for a new one may make sense.⁴ In this case, the lender would pay the roll-out and include the roll-out amount in the cumulative loan balance going forward.

Loan Interest Rate – Typically, the lender will establish a loan rate formula at the inception of the loan, based on LIBOR (London Interbank Offered Rate) plus a spread that averages in the range of 175 to 300 basis points. Although the spread is usually fixed for the duration of the loan, the LIBOR will change annually. The loan interest can be paid at the beginning or at the end of the year. Alternatively, the loan interest can be deferred in some cases for a short period of time, though this is not recommended.

Historically, the monthly LIBOR from February 1997 to February 2007 ranged from a low of 1.09% (March 2004) to a high of 6.83% (November 2000). Over this ten-year period, with the current interest rate spreads, the interest rate on a loan would have ranged from a low of 2.84% (with a 175 basis point charge) to a high of 9.83% (with a 300 basis point spread). A final illustration is required to ensure that the client understands the financing terms. (Source: www.mortgage-x.com)

Loan Collateral – Typically, premium loans are collateralized by the insurance policy. However, the lender may require additional collateral for the period of time that the policy's cash surrender values are not sufficient to cover cumulative premiums loaned by the lender. It is important to note that for as long as there is a collateral assignment of the policy's cash values, the owner of the policy is usually restricted from using the cash values for personal needs.

Since the lender has a security in the life insurance policy's cash values, a cash value rider may be added to the policy. This rider spreads the policy's costs over a longer period of time leaving more of the cash value intact for collateral purposes. This may result in a lower collateral requirement.

Typically your client will provide the additional collateral since the ILIT or business may not have the funds. Assets that are typically used as collateral are cash, cash equivalents, a letter of credit, and marketable securities. Marketable securities are usually discounted for fluctuations in the market value of the assets. Although real estate and privately held stock are generally not used as collateral, some lenders do allow these assets to secure a letter of credit. Also, some lenders require that they manage or hold the collateral during the term of the loan.

A policy that is classified as a Modified Endowment Contract (MEC) under IRC §7702 will trigger income taxation on the gain when the policy is pledged as collateral for the loan. Therefore, MEC policies are rarely used in a premium financing arrangement. If a MEC policy is used, John Hancock will require a hold-harmless agreement to be signed by the borrower.

Personal Guarantee – It is common for the lender to request that your client agrees to personally guarantee the loan. Although there is some thought that this personal guarantee may be considered a taxable gift, there is supporting authority to the contrary. The authority is based on the fact that there is no economic outlay and no transfer of property ownership.⁵

Loan Repayment – A Return of Premium rider (ROP) is often used if the lender is assumed to be repaid its cumulative premiums at death. This rider allows the initial death benefit required for the family to remain intact, net of the loan repayment, by increasing the death benefit annually by the amount of the annual premium loan. There is a cost to the rider and a cost/benefit analysis should be done to determine the benefits of using it.

A loan exit strategy is also critical to the success of the financed plan. Although many financed plans contemplate loan repayment at death from policy proceeds, it is possible to design the plan so that the loan is repaid before death using funds projected to be available in the future from the trust side fund, a credit shelter trust, a family limited partnership or another family trust, or even from the policy's cash values. A side fund in an Irrevocable Life Insurance Trust (ILIT) made up of annual gifts your client makes may be used in the future to make loan interest payments as well.⁶

EXAMPLE

Facts: Inez Friedman, age 75 and a non-smoker preferred health risk, has a total estate of \$20 million. She is the owner of a national chain of restaurants which are now operated by her four children. The business has been incorporated and is now called The Friedman Corporation.

Inez determined that it is now time to review her financial plans. She does not want to liquidate assets and incur gift tax to pay the annual premiums on a life insurance policy needed to accomplish her wealth transfer goals. Looking for answers to this problem, she turned to her financial advisor, Charles Wertz.

Recommendation: Charles recommended that Inez establish an Irrevocable Life Insurance Trust (ILIT). The ILIT can then borrow the premiums for a \$10 million policy from A.I. Credit.

Results: The trustee of the ILIT will take a loan to finance a John Hancock Protection UL-G policy. Once John Hancock makes an underwriting offer on the policy, Charles will submit the required financial documents to the lender for review. Although the regular premium for a \$10 million Protection UL-G is \$292,512, Charles recommended that they finance the premiums and add a 100% Return of Premium (ROP) rider to the face amount.⁷ Since the ILIT will depend on the life insurance policy to repay the loan, the ROP will ensure that there will be sufficient death benefit remaining for the family net of the loan repayment. The ROP rider will increase the premium to \$414,329 annually. The chart below compares the costs and benefits of a financed approach with a non-financed approach. The result is that the financed approach can reduce the annual gifts as well as the annual out-of-pocket costs while increasing the death benefit and consequently the Internal Rate of Return (IRR) on the life insurance policy. The estimated average loan interest rate is 6%, but this rate will be adjusted annually.

YEAR	ANNUAL OUTLAY FINANCED POLICY	ANNUAL OUTLAY NON-FINANCED POLICY	NET DEATH BENEFIT FINANCED POLICY	NET DEATH BENEFIT NON-FINANCED POLICY	IRR FOR FINANCED POLICY ⁸	IRR NON-FINANCED POLICY ⁸
1	\$24,860	\$292,512	\$10,000,000	\$10,000,000	40,125.68%	3,318.67%
5	\$124,299	\$292,512	\$10,000,000	\$10,000,000	179.31%	72.79%
10	\$248,597	\$292,512	\$10,000,000	\$10,000,000	46.04%	21.61%
15	\$372,896	\$292,512	\$10,000,000	\$10,000,000	19.08%	9.75%

The data shown is taken from a hypothetical calculation. It assumes a hypothetical rate of return and may not be used to project or predict investment results.

Inez was able to leverage the assets and have the ILIT take out a loan to finance a much-needed life insurance policy. Implementing a premium financing program was an easy and effective way to resolve her wealth transfer issues.

THE PRIVATE FINANCING APPROACH

Using an alternative financing approach, your client can finance the life insurance premiums directly. That is, the trust or other entity can borrow the funds from your client directly. This approach is ideal for clients who have the cash available to make premium payments but want to avoid excessive gift tax costs. In this scenario, the gift amount is only the annual interest on the loan. Since the note would be an intra-family loan, the interest rate should be set at or above the current applicable federal rate (AFR).⁹ More typically, the loan interest is deferred in a family loan situation and paid either from death proceeds or from other sources during your client's lifetime. Private financing is a nice alternative to premium financing. Since no third-party lender is involved, there are no collateral requirements to address and the risk associated with third-party loan arrangements are eliminated.

However, your client will need to plan for the estate tax consequences of private financing. Upon death, the repayment of the loan from the borrower to your client's estate will now be part of the taxable estate. As a result, potentially a good portion of the loan repayment will be subject to estate tax. Your client can use the enhanced ROP rider to cover these taxes.

BENEFITS OF PREMIUM FINANCING

Financing large life insurance premiums may allow your client to:

- minimize gift tax;
- fund a large life insurance need at a low interest cost without affecting current cash flow or requiring taxable liquidation of assets;
- transfer wealth without giving up control of invested assets;
- provide heirs with the gift of your client's ability to borrow; and
- utilize a potentially tax-efficient alternative to split dollar.

LIMITATIONS

Although premium financing may be a cost-effective method of minimizing gift tax costs, when considering such an arrangement it is important to understand the following:

- Premium financing should generally not be used as a financing tool to fund the purchase of life insurance on a zero to minimal outlay basis;
- The loan interest paid by the borrower is not deductible in any circumstances;
- Interest rates can fluctuate dramatically. Therefore, it is important to illustrate a higher-than-average loan interest rate based on the projected loan term;
- If your client's credit worthiness is in question, it is possible that additional collateral will be required by the lender. If the collateral is not available, the lender may not extend further credit and the policy may become in danger of lapsing.

PREMIUM FINANCING VERSUS SPLIT DOLLAR ARRANGEMENTS

For many clients, premium financing may present a viable alternative to a split dollar arrangement. Both premium financing and split dollar arrangements can help clients reduce their gift tax costs on large premiums, but at older ages, premium financing will typically have a lower cost than split dollar. In addition, following the publication of IRS Notice 2002-8 and the final split dollar regulations, collateral assignment equity split dollar arrangements can no longer be established after September 17, 2003.

SUMMARY

Premium financing is a good alternative for your high-net-worth clients who need estate liquidity but do not want to liquidate their invested assets and want to avoid gift taxes associated with paying for a large life insurance need.



1. The gift tax annual exclusion allows each individual to give up to \$11,000 per year (indexed annually for inflation and subject to specific rules) to an unlimited number of people without paying federal gift taxes. See IRC §2503 (b). In order for gifts to qualify for the exclusion, the trust beneficiaries must be given rights of withdrawal known as “crummey powers.”
2. Generally, the IRS has not indicated that a personal guarantee by an individual would constitute a gift to a trust or would be an “incident of ownership” in a life insurance policy for estate tax purposes. However, clients must consult their tax advisors for further guidance on this issue.
3. The transfer for value rule and/or taxable boot may apply in a 1035 exchange in which there is a loan and/or a change in ownership of the policy. It is important to consider the tax consequences of the transaction with your personal tax advisors.
4. On September 11, 2003, the treasury and IRS issued final split dollar regulations which provide strict rules on the design of split dollar plans, when taxation of the policy equity applies and the measurement of economic benefit costs. Consideration of a lifetime exit from a split dollar plan must take into account these new rules to avoid adverse tax consequences. The IRR on death benefit is equivalent to an interest rate at which an amount equal to the illustrated premiums could have been invested outside the policy to arrive at the net death benefit of the policy.
5. A private letter ruling affirming the service's position that the guarantee is taxable was subsequently withdrawn. Ltr.Rul.9113009, withdrawn by Ltr.Rul.9409018. Also, a shareholder's basis in an S corporation does not increase when the shareholder provides a guarantee on behalf of the S corporation. Further guidance is provided by an internal field service advisory (1994 FSA Lexis 217) that makes mention that a guarantee is not a gift because no property has been transferred and the guarantor's position has not changed.
6. If a trust is being considered as a loan repayment vehicle, the language of an existing family or credit shelter trust should be reviewed by your client's tax advisors to make sure that the trustee has the power to make discretionary distributions to repay the loan. Trusts should be drafted by an attorney familiar with such matters, to take into account income and estate tax laws (including generation skipping transfer tax). Failure to do so could result in adverse tax treatment of trust assets.
7. The Enhanced Return of Premium rider (ROP) allows clients to select the percentage of the return of premium desired. The rider will increase the death benefit each year by that percentage of the premium loan so that in any given year, the death benefit will increase by that percentage, a percentage of keeping as much of the original face amount intact for heirs. There are costs associated with the rider, as well as limitations on the cumulative amount that can be returned.
8. The IRR on death benefit is equivalent to an interest rate at which an amount equal to the illustrated premiums could have been invested outside the policy to arrive at the net death benefit of the policy.
9. The IRS publishes the applicable federal rate on a monthly basis.

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