CBS | BROKERAGE

*Advanced Planning*

# Premium Finance Agent Guide

## AN ALTERNATIVE METHOD OF FUNDING LARGE LIFE INSURANCE POLICIES

Premium Financing offers clients an alternative method of funding large life insurance policies. The funds used to pay premiums are borrowed from a third-party funder. This is a valuable tool available to clients who recognize the need for life insurance in their estate plans, yet have cash flow constraints or wish to minimize gift taxes. Premium Financing can provide leverage for clients who have high-performing assets that they do not wish to liquidate to pay life insurance premiums. It can also be useful as a temporary solution, allowing a needed life insurance policy to be placed in force today while the rest of the estate plan is finalized.

First and foremost, suitable clients are those who recognize the need for additional life insurance protection on their lives, and are prepared to place that needed coverage in force. Their primary motivation should be to acquire needed life insurance without disturbing or liquidating a portion of their investment portfolio to pay premiums.

Most funders require applicants to have a minimum net worth in the $5 to $10 million range. Ideally, a significant portion of the net worth for these individuals (or couples) should consist of marketable investments or other income producing assets earning returns that are higher than the anticipated loan interest rate. Further, clients must be willing and able to pledge additional collateral, which is often required by funders.

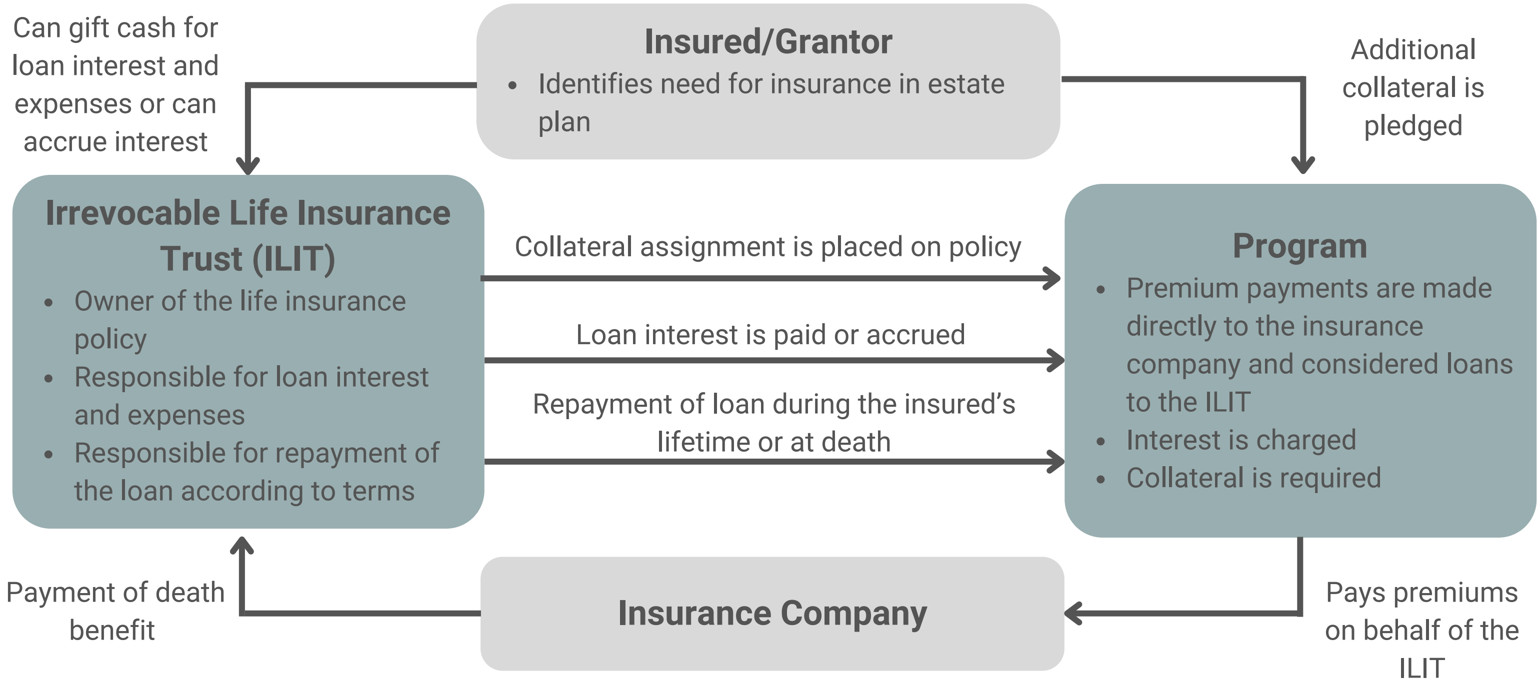
Clients whose portfolios are primarily comprised of illiquid assets such as real estate may be asked to provide a Letter of Credit (LOC) as collateral for the loan, instead of their illiquid assets. The funder will need to approve the bank that provides the LOC.

**Premium Financing can provide leverage for clients who have high-performing assets that they do not wish to liquidate to pay life insurance premiums.**

## HOW DOES IT WORK?

- The need for life insurance is determined.
- The policy owner (typically, an Irrevocable Life Insurance Trust [ILIT]) applies for a life insurance policy on the life of the insured.
- Once the policy has been approved for issue by the life insurance company, the policy owner (also the borrower) then applies to the funder for the funds to pay the premiums.
- The funder processes the borrower's loan application, approves the loan, and ultimately advances the scheduled premium payments to the life insurance company on behalf of the policy owner.
- The borrower pledges any additional required collateral and pays loan interest to the funder according to the terms of the premium financing agreement. Often the insured will be required to provide additional collateral when the borrower/owner is an entity, such as an ILIT, that does not hold significant assets outside of the policy.
- Documentation is prepared and executed evidencing the loan.
- Repayment of the loan is required. If sufficient, the borrower can use withdrawals or loans from the policy's cash value to repay all or a portion of the loan. Otherwise, the borrower's additional collateral will be used. Where the insured was required to provide additional collateral, the insured's personal assets might be used for repayment. Such repayments by the insured might be deemed taxable gifts, depending upon the identity of the policy owner/borrower (for example, where the ILIT is the owner/borrower, payments by the insured will likely be treated as taxable gifts). In some instances, repayment can be made from the policy's death benefit proceeds.

## TYPICAL PREMIUM FINANCE TRANSACTION




## FREQUENTLY ASKED QUESTIONS

### Are there risks associated with premium financing?

The borrower should understand that financed insurance is NOT free insurance and using this method to pay for life insurance may expose the borrower to additional risks that are not associated with traditional life insurance policy purchases. Those additional risks include fluctuations in the loan interest rate, fluctuations in the policy crediting rate, valuation of the life insurance policy, the potential need for additional collateral held outside the policy, and the potential gift tax exposure if the insured is forced to repay the loan on behalf of an ILIT (or some other individual or entity who is the policy owner).

### Who borrows the funds?

The policy owner borrows the funds. In the majority of cases the borrower will be an entity – either the client's ILIT or his/her business. In rare instances the borrower can be an individual, but this structure will require prior approval from the funder.

### Who are the funders?

Programs utilize capital from large, highly rated and well-known financial institutions that have pre-authorized a significant level of funds to be used for financing life insurance premiums.

In some cases, clients may elect to rely on their own personal banking relationships for financing life insurance premiums. These clients and their banks will then be solely responsible for establishing the terms and conditions of their financing arrangements.

### What is the loan interest rate?

Loan interest rates are typically based on a recognized benchmark interest rate plus an additional spread. Depending the size of the premiums being borrowed, the most common benchmark rates are Prime Rate or 12-month London Inter-Bank Offered Rate (LIBOR). LIBOR is the interest rate at which banks offer to lend money to each other in the London wholesale money markets. It is a common rate used in global capital markets, and is published daily in the Wall Street Journal.

The spread above the benchmark rate typically ranges between 100 and 300 basis points, and varies by the amount of the loan, the credit-worthiness of the borrower and the collateral that is posted. While the benchmark rate used is expected to fluctuate on an annual basis, once negotiated, the spread typically remains constant for the life of the loan. Interest will typically be charged annually, though some funders will negotiate other durations.

### How often will the loan interest rate change?

For most loans, the interest rate will change annually, corresponding to changes in the benchmark interest rate. However, borrowers may wish to negotiate a long-term or short-term lock-in period where the interest rate will be fixed. Lock-in rates are subject to market availability and come at a premium.

### When is the interest due?

In the typical arrangement, loan interest must be paid in cash at the beginning of the loan (in advance) and annually on subsequent policy anniversaries, though some borrowers may be able to negotiate different terms. In these instances, borrowers may be able to pay interest in arrears or to accrue some or all of the interest, adding it to the loan balance; such an accommodation will result in a higher lending rate. A consideration when negotiating the loan interest rate terms is that many life insurance carriers will not allow their products to be used when the client desires to accrue the loan interest.

### Are there minimum loan amounts?

Yes. The minimum loan amount will vary from one funder to another.

### How is interest calculated?

Some funders charge interest based on the total loan facility (i.e., the total authorized loan amount for all planned premium payments). Other funders charge interest on funds only as they are borrowed to make each premium payment.

### Is the interest tax-deductible?

No, the loan interest in premium financing falls under the category of "personal interest," and that deduction was eliminated by the Tax Reform Act of 1986.

### What premiums are borrowed and when?

This will vary by premium financing program. Funders typically use a term-loan structure, where the loan amount includes a multiyear premium payment pattern that can cover between one to seven year terms.

### Is there a Loan Acquisition or Origination Fee?

Loan Acquisition Fees (sometimes referred to as Loan Origination Fees) are additional up-front fees paid by the borrower. Some funders include them while others do not. Some funders calculate the fee based on the total loan facility. Other funders will charge the fee based on the funds only as the loaned funds are received. Some funders simply charge a flat fee.

### What types of policies can be financed?

Both single-life and joint-survivor policies can be financed, although not all funders will finance survivor policies. Acceptable types of policies are whole life, universal life, and IUL. Term and variable life policies are generally not acceptable.

### What are the collateral requirements?

The funder will typically require that the life insurance policy be assigned as collateral. If the policy's cash surrender value is less than the amount of the loan, then the borrower will be required to pledge additional assets. Each funder will establish its own individual collateral requirements, which may vary depending on the type of assets being pledged. Acceptable collateral normally includes cash, cash equivalents, and liquid or readily marketable securities. Letters of credit (LOCs) are also acceptable and are actually preferred by some funders. Cash and cash equivalents are likely to be valued either at or close to 100% of the asset's current fair market value (FMV), while stock portfolios may only be valued at 50% of FMV.

### Who actually provides the collateral?

Normally, collateral will be provided by the borrower. If the borrower is an ILIT with no assets other than the policy, the insured/ grantor or some other source will need to provide the collateral. How is the collateral handled? Some funders require that assets actually be transferred to a collateral account, to be managed by the funder. Other funders will accept an assignment of assets and allow the client to continue to manage them. In all cases, the assets pledged as collateral, as well as the life insurance policy, will be monitored regularly by the funder.

## Will the borrower ever have to pledge additional collateral?

In the event of adverse performance by either the life insurance policy or the initially pledged assets, the funder may require additional collateral to secure the loan.

## When does the loan have to be repaid?

The loan must be repaid when it reaches maturity (unless renewed), upon the death of the insured, or in the event of a default. Maturity may be defined as an event (i.e. death of the insured), or after a specific period of time (i.e., a term of five, ten, or 15 years). In the case of most term loans, the balance is due and payable at the end of the term, unless the loan is renewed. Renewal of loans after the original term is not guaranteed and is subject to the funder's discretion.

Conditions of default will be described in the loan agreement. Most common examples of default are failure to pay interest when due or failure to provide collateral when required by the funder.

## What planning strategies should clients consider regarding loan repayment?

There are a number of exit strategies that may be implemented:

- The cash surrender value (CSV) of the life policy can be used in part or in total to repay the loan.
- The borrower has a planned "liquidity event" in which cash is created to repay the loan. An example of this would be the sale of a business.
- The client may take the place of the third party lender by loaning funds to the ILIT so that the trustee can repay the funder. From that point forward, the ILIT will owe annual loan interest to the client.
- Use of a Grantor-Retained Annuity Trust (GRAT) can also be an effective strategy for transferring funds to an ILIT with minimal gift tax consequences. The Walton case established that strongly performing assets can be transferred with virtually no gift tax consequences, if the GRAT is properly designed. One consideration is that the grantor must survive the term of the GRAT or the GRAT's value will be included in the grantor's taxable estate.

## Is it appropriate to use policies that are considered Modified Endowment Contracts (MECs) in premium financing transactions?

No. While the client's legal and tax advisors must ultimately determine whether such structure is advisable, a life insurance policy that is considered a MEC is typically not an appropriate asset for premium financing.

Under Internal Revenue Code § 72, placing a collateral assignment on a policy characterized as a MEC is treated as a distribution from the policy (even though no withdrawals are actually made), and that distribution is taxable as ordinary income to the extent that the policy's cash value is in a gain position immediately before the distribution (disregarding the effect of any surrender charges). Because funders usually require that at least a portion of the life insurance policy be assigned to the funder as part of the loan collateral, any cash value growth that is in excess of premiums paid will be treated as taxable income and taxed at ordinary rates. Additionally, if the insured is younger that age 59 1/2 or the policy is owned by a non-grantor trust or other entity, a 10% penalty tax may also be imposed. This tax liability exists whether or not an IRS Form 1099 is generated for the reportable income.

## What will be expected of an agent in order to place a premium financing case?

Some funders require a commission split. In some cases, the funder will also require the producer to sign a confidentiality agreement. In addition, either the funder or the use of a particular life insurance product may alter the producer's normal compensation payout.

Please keep in mind that the producer will need to service this transaction until the exit strategy is implemented. Some of these programs/funders have these services built in, so that they will be able to help the agent service this transaction.

**For further information on premium financing and other sales concepts, please contact your CBS Marketing Director**