

PREMIUM FINANCING

INTRODUCTION

The net worth of individuals over the age of 55 has increased substantially over the last decade. For these individuals, there is an immediate need for estate planning and life insurance. However, finding the liquid assets to purchase the life insurance policy is not always a simple matter. Individuals with a high net worth are often reluctant to tap into other assets to purchase a life insurance policy. Doing so might result in income or capital gains taxes, or their other assets might simply be performing exceedingly well.

WHAT IS PREMIUM FINANCING?

Premium financing allows individuals who have a life insurance need to defer using their liquid assets to fund a life insurance policy. In a premium financing arrangement, the individual takes out a loan from a third party lender to pay the premiums on a life insurance policy.

HOW DOES PREMIUM FINANCING WORK?

The borrower applies for a life insurance policy. Once an underwriting offer has been made, the borrower applies for a premium financing loan. The borrower and third party lender negotiate the terms of the loan including the interest rate and payment schedule. Typically, the life insurance policy (and other liquid assets) is used for collateral against the loan. The loan may be repaid in a lump sum, over time, or at the death of the insured. The life insurance policy is typically issued with a "Return of Premium" rider whereby the total amount of death benefit equals the initial death benefit plus the amount of the loan (total premiums paid). At death, the loan is paid off with proceeds from the insurance policy, and the beneficiary is left with the original policy face amount.

PROSPECTS FOR PREMIUM FINANCING

The ideal prospects for premium financing are usually individuals over the age 60 whose net worth is at least \$5 million. In addition, they should have a need for a life insurance policy with a minimum annual premium of \$100,000 or more. Typically, these individuals will be business owners or have the majority of their assets tied up in other investments including real estate.

HOW IS A PREMIUM FINANCING LOAN TYPICALLY STRUCTURED?

The following are typical terms to a premium financing loan:

1. The insurance policy requires annual premium payments or a single, lump sum payment. The amount of the premium is borrowed from the third party lender.
2. The borrower will pay interest annually at the beginning of the year. In some cases, the interest may be paid at the end of the year (in arrears) or borrowed as part of the loan.
3. The loan interest rate is based on LIBOR plus a spread (typically 150 to 200 basis points) and is reset every year. Fixed rate loans are available.
4. The lender agrees to make cumulative loans up to a specified amount. If the client needs to borrow funds in excess of that amount, the lender may require the borrower to requalify.
5. The loan is collateralized by the insurance policy in addition to other collateral.
6. The lender takes a collateral assignment in the cash surrender value and death benefit of the financed policy.
7. The client signs a personal guaranty.



HOW IS THE INTEREST RATE DETERMINED ON A PREMIUM FINANCING LOAN

The lender usually calculates interest based upon the one-year London Interbank Offered Rates (LIBOR) to which it adds a fixed spread. The one-year LIBOR rate is not fixed, and may vary from the rate used in illustrations. The loan interest rate will be fixed on an annual basis and may vary from year to year. It is possible to obtain a fixed interest rate for a term of 5 to 10 years. The fixed rate is typically higher than the current variable rates.

SELF-FINANCING APPROACH

Some clients prefer the “self-financing” approach where the insured or a trust or partnership established by the insured loans the annual premium to his/her irrevocable life insurance trust (ILIT) and the ILIT only has to pay the annual interest cost. The ILIT should be set up as a grantor trust to avoid income tax to the grantor on the interest payments. This approach can be ideal for clients who have the cash to pay the premiums but want to avoid excessive gift tax costs. Clients only have to gift the annual interest to the ILIT each year, since the premium loan is not considered a gift to the trust. Since this is an “intra-family loan”, the interest rate should be set at or above the current Applicable Federal Rate (AFR). Whether the insured finances all or part of the premium, self-financing is a popular technique that is an attractive alternative to traditional premium financing, since it does not require financial underwriting or collateral for the loan.

Estate Tax Issue. Although self-financing can be a better alternative for some people than premium financing, clients need to plan for the estate tax consequences of doing self-financing. Upon death, the loan from the insured to the ILIT will become an asset of the taxable estate, and the principal balance at death will be subject to estate tax. As a result, 50% of the death benefit may be lost to estate tax. The top estate tax rate in 2004 is 48%, and it will drop to 45% by 2009. However, depending on what happens after 2010 when the current estate tax provisions expire, the top estate tax rate may return to 55%. Clients can use the Return of Premium rider to cover the estate tax on the loan balance.

THE PROVADA ADVANTAGE

Provada’s Advanced Marketing team works with agents and advisors to deliver customized premium financing solutions to their high net worth clients. We are here to support financial professionals in all aspects of business development – from client seminars and meetings, to preparing detailed illustrations and presentations, to facilitating the insurance and financial underwriting process.

SUMMARY

Premium financing is an excellent alternative for high net worth individuals who have a need for life insurance coverage, but who do not want to liquidate assets to pay the annual premium. Assets may continue to be deployed in other investment vehicles, real estate, or business ventures. In addition, gift taxes might be reduced or even eliminated.

CASE STUDY

Facts: John Martin, an independent life insurance agent, approached Provada about a potential business opportunity. His client, Janet Bernstein, age 75, non-smoker preferred, has a total estate of \$20 million. She is the owner of a chain of high-end shoe stores, which are now operated by her son. Including her son, Janet has a total of seven beneficiaries who she would like to address within her estate plan.

Janet is concerned about the impact of estate taxes. She understands the benefits of using life insurance to fund estate taxes. However, she does not want to liquidate assets to pay an annual premium on a large policy. Her business and other investments are continuing to appreciate. In addition, Janet would like to minimize the amount of gift taxes she has to pay.

Recommendation: John recommended that Janet establish an irrevocable life insurance trust (ILIT) to take out a loan for a \$10 million life insurance policy.

Structure: The trustee of Janet's ILIT will take out a loan to finance a \$10 million life insurance policy. Once an underwriting offer is made by the selected carrier, John will submit the required financial documents to the lender for review. Janet has the option of working with any lending institution she desires, including her own bank. However, she decides to take advantage of Provada's Premium Finance Solution that provides multiple lending sources specifically for situations just like this. The loan terms are negotiated and the first year interest rate is established at 3.50%. For the purpose of this example, it is assumed that the interest rate will increase by 50 basis points annually, and that the interest rate will be capped at 6.50%.

The premium for a \$10 million policy is \$285,454 presuming that the premium is paid in all years. John recommended that Janet select the Return of Premium (ROP) rider on the policy. Since Janet's ILIT will be relying on the life insurance death benefit to repay the loan, having the ROP rider will ensure that there will be sufficient death benefit for the trust after repaying the loan. The ROP rider will increase the premium for the financed insurance to \$434,445 annually assuming that premiums are paid in all years. The death benefit will increase by the amount of premium paid. The chart below compares the financed approach with the non-financed approach and shows how Janet can reduce her annual outlay and gifts to the trust while at the same time increase the internal rate of return (IRR) on the life insurance policy. In addition, there will be no gift taxes due for several years since the amount gifted to the trust is only the interest on the loan, which is less than the annual gift tax exclusion for the seven beneficiaries.

Year	Annual Outlay for Financed Insurance	Annual Outlay for Non-Financed Insurance	Death Benefit for Financed Insurance	Death Benefit for Non-Financed Insurance	IRR for Financed Insurance	IRR for Non-Financed Insurance
1	\$15,206	\$285,454	\$10,434,445	\$10,000,000	66665.37%	3403.20%
5	\$119,472	\$285,454	\$12,172,224	\$10,000,000	206.10%	73.85%
10	\$282,389	\$285,454	\$14,344,448	\$10,000,000	48.80%	22.03%
13*	\$367,106	\$285,454	\$15,647,783	\$10,000,000	26.96%	13.44%
20	\$564,778	\$285,454	\$18,688,896	\$10,000,000	7.12%	5.08%

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* Life expectancy



Provada Insurance Services, Inc.
 201 Mission St., Suite 1940, San Francisco, California 94105
 877-PROVADA (776-8232)
 www.provada.com info@provada.com
 CDI #0E20490

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