Premium Finance
Toolkit

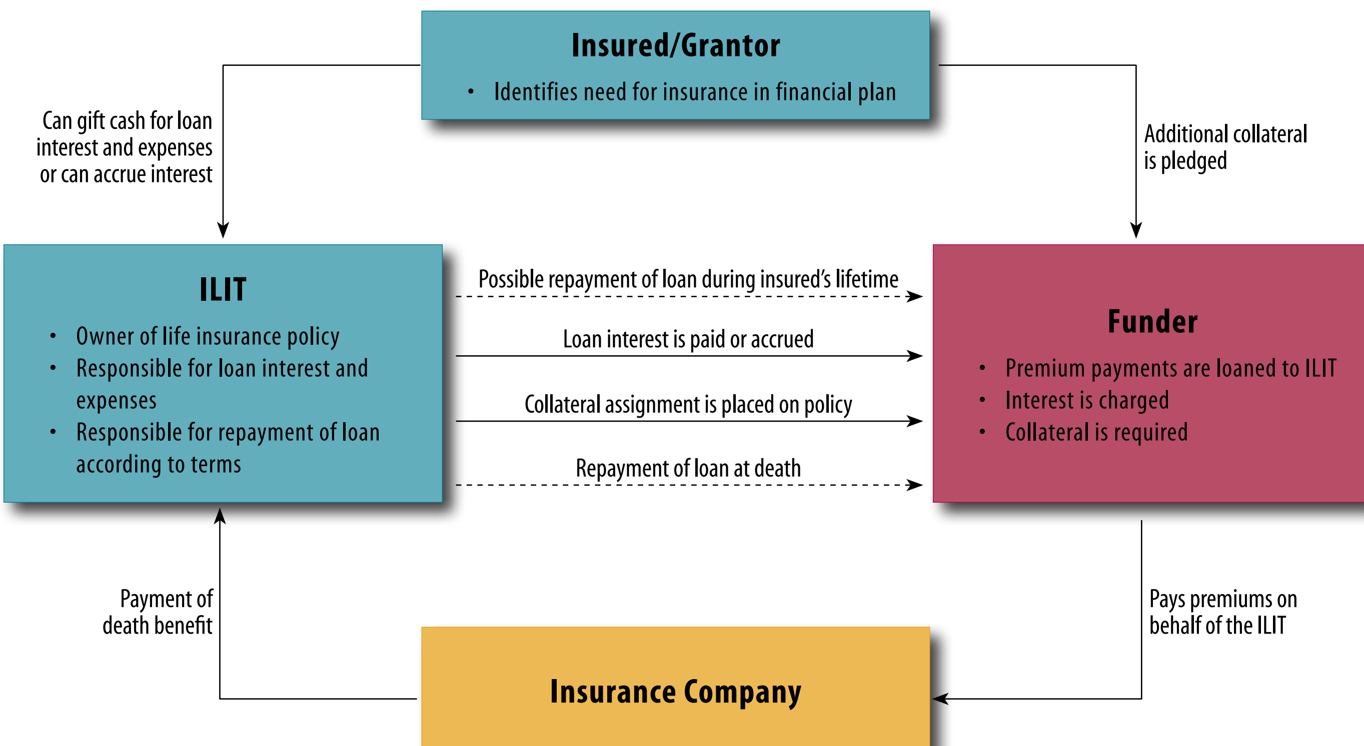
Concept Overview

Premium Financing – Acquiring needed life insurance coverage while preserving assets and minimizing gift taxes.

Premium Financing is a valuable tool available to clients who recognize the need for life insurance in their estate plan, yet have cash flow constraints or wish to minimize gift taxes. Premium Financing can put a needed life insurance policy in force today while the rest of the estate plan is being finalized. It can also provide leverage for clients who have high-performing assets and do not wish to liquidate those assets to pay life insurance premiums.

In a premium finance arrangement, the policy is typically owned by an Irrevocable Life Insurance Trust (ILIT)[1]. The ILIT borrows premiums from a premium finance funder. Interest and expenses on the loan are charged by the funder and may be paid annually by the ILIT or accrued if permitted by the funder. Collateral is required for the loan and in most instances includes the policy as well additional assets. Depending on the structure, the loan is repaid at the end of the loan term or at the death of the insured. After repayment of the loan principal, expenses, and accrued interest (if any), the ILIT retains the remaining death benefit proceeds which are then distributed in accordance with the trust document.

A Typical[2] Premium Finance Arrangement



[1] Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping tax). Failure to do so could result in adverse treatment of trust proceeds.
[2] Premium Financing arrangements vary according to the needs of the client's financial plan and the loan terms offered by the selected funder. A Premium Finance arrangement can be customized to accomplish different goals.

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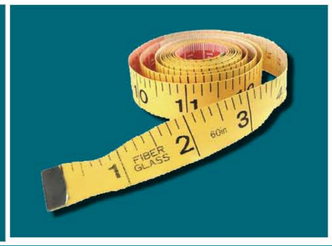

Concept Flow

Client Profile: High net worth clients who have a need for life insurance in their financial plans, but have cash flow constraints or would like to mitigate gift taxes. Also suitable for clients who have sufficient cash flow but have high performing assets they do not want to liquidate and who appreciate the concept of leverage. Clients typically must have a minimum net worth of $5,000,000 to qualify.

The client and his or her advisors identify the need for insurance in the financial plan. Using the Premium Finance Fact Finder, it is determined that premium financing will be utilized to fund the insurance solution.
(1)

The client is underwritten and obtains an underwriting offer from a life insurance carrier.
(2)

The client chooses a funder and applies for the loan providing any necessary financial information.
(3)

The loan is approved and a Term Sheet is prepared and presented by the funder(s). The client sets up the ILIT and provides any additional documentation to the funder. Collateral is determined and provided.
(4)

The loan, trust, and other documents are finalized. A formal application is submitted to the carrier with full disclosure of the financing structure and details.
(5)

The application is approved and the policy is issued. The funder pays the initial premium and the policy is placed in force in the ILIT. Interest is paid if due.
(6)

The structure is reviewed as necessary (annually) for additional premium loans and collateral levels. Interest payments are made by the ILIT when due (or accrued).
(7)

The loan is repaid from trust assets upon realization of the exit strategy.
(8a)

The loan is repaid from death benefit proceeds with death as the exit strategy.
(8b)

1.) The client working with his or her agent and other financial advisors identifies the need for insurance in the overall financial plan. The client wishes to use the tool of premium finance due to cash flow issues, gifting issues, and/or leveraging opportunities. A Premium Finance Fact Finder is completed as it provides information critical to the case design process.

2.) A client cannot apply for a premium finance loan without an underwriting offer from an insurance carrier. The economics of the financing strategy rely heavily on the underwriting class of the insured.

3.) After analysis of the case facts and underwriting offers, a desired funder or funders will be selected and loan applied for. Funders vary widely in the types of documentation required to approve a loan.

4.) If the loan is approved, the loan, trust, and any other related documents are executed. If the client is using an existing ILIT, the trust terms will likely be modified for approval by the funder and/or insurance carrier. If a new ILIT is created, the funder may provide a template trust. The amount of collateral needed will be set by the funder and provided by the ILIT and grantor.

5.) The trust and loan documents must be finalized before a formal application can be submitted to the insurance carrier. The insurer will review the transaction structure and details before approving the application.

6.) The insurance carrier approves the arrangement and issues the policy. The funder pays the premium directly to the carrier on behalf of the ILIT to put the policy in force. Interest is paid in advance if stipulated by the loan terms (not the case in all structures).

7.) The funder will tell the trustee and the grantor when new loans are made and interest payments are due (or accrued). Collateral requirements may fluctuate yearly with the amount of the loan balance and policy values.

8.) The loan will be repaid at some point in the future and the net death benefit will be paid according to the terms of the ILIT.
   a.) The loan may be repaid during the life of the insured according to the terms of the loan. GRATs, sale of appreciated assets, liquidation of a retained capital account (side fund), or other techniques are employed to provide a lifetime exit strategy.
   b.) For older clients (at least age 70, preferably age 75) their death may be used as the exit strategy. This does not work as an exit strategy for younger clients due to the unfavorable long-term economics and long-term risks of a financing strategy.

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Qualifying Prospective Clients

Premium Financing represents a source for funding a life insurance policy when (1) a client's assets are illiquid, (2) a client's assets are earning a higher rate of return than borrowing rates, or (3) a client has limited gifting ability. Please read the Q&A and Concept Overview and then use the questions below to help qualify a prospective client.

Question	Preferred Answer	Reasoning
What is the "ideal" client age?	Generally 70+	Older clients (with a life expectancy of approximately 15 years or less) allow for the life insurance policy, which is typically the only asset held in an ILIT, to be the primary source of loan repayment. Subject to minimum age requirements of the funder, younger ages can work if arbitrage between earnings on existing assets versus the loan rate is utilized for satisfying the loan. However, if this is to be the exit strategy from the loan, then those appreciated assets will have to be gifted to the ILIT (unless that has already been done) and gift taxes may apply.
Does the client have a large life insurance need?	Yes	Premium financing is not a reason to buy life insurance. It is a method of funding premiums. It should only be considered after proper fact finding has determined that a large life insurance policy needs to be acquired as part of the client's overall financial strategy and other premium payment methods are less attractive in conjunction with that strategy.
Does the client have significant net worth?	Yes	Not only do clients have to be able to financially justify the coverage amount being applied for, but they also need to have excess life insurance capacity. This means that their net worth is large to enough to allow for the new financed policy in addition to all life insurance already in force. Further, all funders and many life carriers have minimum net worth requirements to allow premium financing.
Is the client healthy?	Table 2 or better	Standard or better is optimum in a premium financing scenario; however, some funders can work with a case that is rated no worse than Table 2. Ratings have an adverse effect on the economics that financing the premiums is designed to achieve, by increasing the required loan with no policy cash value collateral offset.
Does the client understand leverage?	Yes	Ultimately, premium financing is like any other lending arrangement: it is a bridge that allows a client to obtain a critical asset (the life insurance policy) now and account for it later. It carries the interest rate and duration risks along with collateral requirements that are inherent to any loan. It is essential that the client has experience with and fully understands leverage.
Does the client have tax advisors?	Yes	It is critical that clients have tax advisors who can review all the loan, trust, and other documentation and economics associated with any premium financing transaction. Further, clients need to have a complete understanding of the income, estate, and gift tax implications associated with the life insurance policy in conjunction with their overall financial plan as well as with regard to interest and loan satisfaction.
Can the client post collateral?	Yes	Although some polices can be designed to provide the preponderance of the collateral requirements, Tellus does not participate in Nonrecourse Premium Financing. The client must be willing to post collateral as needed.
Did you read the Premium Financing Q&A and Concept Overview?	Yes	Premium financing transactions are complex with a number of moving parts. We strongly urge you, the agent, to read the Q&A and Concept Overview pieces provided in this Toolkit before calling with specific questions.

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Getting Started

Identifying Potential Candidates/Premium Financing Prospects

PART I — YOUR CLIENTS

Check your client list to make sure that you have spoken to all your clients who are likely to have an estate tax liability or other large life insurance need (estate equalization, business planning, etc.). If you have spoken to wealthy clients in the past who have not followed your advice, go back again with the questions and materials in this toolkit. Typically suitable clients are older age individuals and couples; however, younger people may also benefit from premium financing.

Ask yourself:

- ❍ Do you have older age clients who are likely to have an estate tax liability?
- ❍ Do you have clients who have a large insurance need other than estate tax liability?
- ❍ Do you have clients whose net worth is likely to have significantly increased since the last time you met with them?
- ❍ Do you have clients who are probably hesitant to liquidate high-performing assets in order to purchase life insurance you feel they need?
- ❍ Do you have clients whom you believe need more life insurance but who are already making full use of their annual exclusions and/or who have already used most or all of their lifetime gift tax exemptions?

List five (5) clients below:

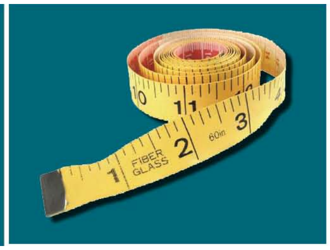
1. ______________________________
2. ______________________________
3. ______________________________
4. ______________________________
5. ______________________________

Once you have identified the clients, you can contact them and schedule a meeting. Use the Concept Overview, the Concept Flow and the Q&A, if needed, for a pre-meeting approach. Use the Fact Finder to collect pertinent information. Contact your Sales Manager to obtain more information and illustrations.

PART II — PROSPECTS

Any older age individual or couple with a large life insurance need could be a potential prospect for premium financing. While prospecting or meeting with prospects, look for those who:

- ❍ Recognize that they need significant additional life insurance.
- ❍ Are willing to place the insurance in force.
- ❍ May be hesitant to liquidate high-performing assets in order to pay premiums.
- ❍ Understand the concept of financial leverage.
- ❍ Are younger age individuals with significant long-term life insurance needs.



List five (5) prospects below:

1.__________
2.__________
3.__________
4.__________
5.__________

Part III — Advisors (CPAs and Attorneys)

Advisors such as CPAs and Attorneys are great referral sources. Work to educate them about the services you can provide. They are typically part of the estate and business planning that occurs and they can be advocates for the work that you do.

List five (5) Advisors who you have a relationship with that you can go see now:

1.__________
2.__________
3.__________
4.__________
5.__________

Use the Q&A and the Concept Flow as pre-approach materials before the meeting. Or simply use those items during a face-to-face meeting. Take a Fact Finder and ask to do a proposal for a client just to show the advisor the work that you do.

Other ideas:

- Use the Prospecting Letter template to create an inexpensive direct mail campaign to CPAs and advisors in your area. Send the materials and then follow up 3-4 days later. Do not wait too long.
- Contact local CPA and advisor associations. Often they are looking for a speaker or they may have study groups that you can speak to.

Part IV — Next Steps

Use the Fact Finder as a basis for gathering information about clients. Place special emphasis on their estate planning needs and/or their desire for a legacy. Ask specific questions about their assets and resources to pay for life insurance protection. Ask specific questions about the clients' goals. Send the information to your Sales Manager for processing.

Everyday Sales Toolbox — Premium Finance Toolkit

Sample Prospecting Letter

Clients

Once you've identified your current clients who may fit the Premium Finance profile, use this letter to introduce them to the concept. Place this letter on your letterhead.

(Date)

(Client Name)
(Address 1)
(Address 2)
(City, State, Zip)

Dear (Client Name),

You've spent a lifetime building your legacy. Shouldn't you be able to pass it on to your descendants the way you intended? Premium Financing may offer a solution to optimize the transfer of wealth and minimize estate and gift taxes without impacting current assets.

A properly structured premium financing strategy could provide additional opportunities to maintain or reposition your current assets while helping to complete your estate plan.

I will contact you to review the benefits of this opportunity and answer any questions that you may have.

Sincerely,

(Producer Name)

Everyday Sales Toolbox — Premium Finance Toolkit

Sample Prospecting Letter

Advisors

Once you've identified advisors who have clients that may fit the Premium Finance profile, use this letter to introduce them to the concept. Place this letter on your letterhead.

(Date)

(Advisor Name)
(Address 1)
(Address 2)
(City, State, Zip)

Dear (Advisor Name),

Often times in estate planning it's not the cost of insurance coverage that is the roadblock preventing execution of the life insurance component. Rather it's the unwillingness to liquidate highly appreciating assets or utilize personal funds to pay these expenses. Premium financing may offer an alternative funding source for maximizing a client's current financial position in conjunction with his or her overall estate plan.

In today's financial environment, a well designed premium financing strategy could allow you to maintain or re-position your clients' assets for other financial needs.

I will call on you shortly to discuss this opportunity in more detail.

Sincerely,

(Producer Name)

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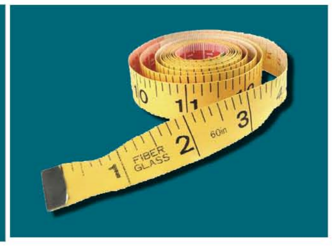

Implementation Steps

Steps to Setting-Up a Premium Finance Case

A prospect for this type of transaction is over the age of 70, with minimum assets of $5 million. There must be an insurance need.
(1)

Determine funder based on proposed insured's needs. To assist your Sales Manager, submit a Premium Finance Fact Finder.
(2)

Proposed insured tentatively applies for life insurance by submitting an Informal/ Authorization form.
(3)

Underwriting offer is obtained and a premium schedule will be determined.
(4)

The case is submitted to a funder for pricing.
(5)

Funder approves pricing and forwards a term sheet or funder's offer.
(6)

Once the proposed insured approves the terms, the funder will create the loan and trust documents. The client may need to have a trust drafted up or use an existing trust. The insurance application and illustration will be signed by all parties.
(7)

Underwriting will be completed and insurance carrier will issue an insurance policy. Funder will fund the policy. Delivery requirements will be signed by all parties.
(8)

The transaction will be completed once the collateral assignment is in force with the carrier.
(9)

1.) **Best Prospects** — The best prospects for this type of transaction are typically older age wealthy individuals.
  a. It is attractive for those who are age 70+ and need substantial life insurance coverage, but are unable to liquidate capital to fund an insurance policy.
  b. The minimum estate size is $5 million.
  c. There must be an insurance need.

2.) **Determine funder** — A Premium Finance Fact Finder should be filled out. It is important that the Fact Finder information be complete and accurate. This will help us determine which funder would most closely fit the client's needs. Contact your Sales Manager and submit the Fact Finder to have the information reviewed. Some determining factors:
  a. Length of the loan/terms
  b. Payment of interest along the way
  c. Interest rolled back into the loan
  d. Type of collateral
    i. Life insurance cash value
    ii. Cash
    iii. Marketable securities
    iv. Letter of Credit
  e. Can borrower repay at anytime? Penalty?

3.) **Proposed Insured applies for life insurance** — Before any case is submitted to a funder for review, you must work with your Sales Manager to see if the proposed insured is insurable. Once insurability is determined, your Sales Manager will advise you to complete an Informal/Authorization form. This will allow us to shop the proposed insured to several insurance carriers for the best tentative life offer. Be aware that an adverse underwriting offer may affect the economics of the case.

4.) **Underwriting offer is obtained and a premium schedule will be determined** — Once we have a tentative underwriting offer, we will request a carrier illustration from our Sales Support Department and we will package the case for submission to the funder.

5.) **The case is submitted to a funder for pricing purposes** — We will submit the following to the funder:
  a. Informal/Authorization
  b. Carrier offer
  c. Carrier illustration
  d. Funder credit application

6.) **If the pricing works, the funder will provide preliminary documents for the proposed insured to either accept or decline** — If the client accepts the term sheet/funder's offer, the client will sign the term sheet or offer letter and submit it back to the agent, who then forwards to us.

7.) **Transaction Management** — Once the signed term sheet is received by the funder, the funder will have the loan and trust documents created. The proposed insured will then complete and sign the loan and trust documents, insurance application, and insurance carrier illustration. The paperwork will then be returned to the agent, who will then forward to us. Once the funder reviews all the paperwork, they will create the trust or the client will create a new trust or use an existing trust. The funder will forward the signed insurance application and carrier illustration to us.

8.) **Underwriting will be completed and insurance carrier will issue an insurance policy** — Once the policy is issued (with delivery requirements), depending on funder, we will need to provide the policy and the delivery requirements (signed by the proposed insured and agent) to the funder. At this time, the funder will return the delivery requirements to us and wire the premium to the carrier.

9.) **Complete the Transaction** — The final process is to complete a collateral assignment for the carrier to process. Once the collateral assignment is in force at the carrier level, the transaction is complete.

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Questions and Answers

What is Premium Financing?

Premium Financing is a tool that offers high net worth clients an alternative method of funding large life insurance policies. The funds used to pay premiums are borrowed from a third-party funder. This minimizes the impact on the client's cash flow and eliminates disruptions to his/her investment portfolios. Premium financing can also mitigate the impact of gift taxes.

Premium Financing is a tool that offers high net worth clients an alternative method of funding large life insurance policies.

Who is the ideal or preferred prospect for premium financing?

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.

While a limited number of programs will accept individuals with a net worth as small as $2 million (exclusive of their primary residence), most programs 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 hard assets earning returns that are higher than the anticipated loan interest rate. Further, clients must be willing and able to pledge additional collateral, as may be required by the funder.

Clients with estates consisting of primarily non-liquid assets such as real estate may not be able to directly post these assets as collateral. These clients may be asked to provide a Letter of Credit (LOC) from a large highly rated US bank (pre-approved by the funder) as collateral for the loan. Depending on the type of LOC, it will need to be obtained annually at a cost to the client. The costs, requirements, and other details of the LOC will need to be arranged between the client and the bank.

How does it work?

- The need for life insurance is determined.
- The policy owner 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 owner.
- The borrower pledges additional collateral, as may be required, and pays loan interest to the funder according to the terms of the premium financing agreement. Loan interest may also be accrued in some circumstances, but is not recommended.
- 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. Otherwise, personal assets will be used to provide for the loan repayment. In some instances, repayment can come from the policy's death proceeds.

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 which are not associated with traditional life insurance policy purchases. Those additional risks include fluctuations in loan interest rate, fluctuations in the policy crediting rate, valuation of the life insurance policy, refinancing risk, duration risk, and the possible requirement for additional collateral held outside the policy.

In an environment of volatile interest rates, lending rates can tend to rise faster than product crediting rates. If lending rates are greater than the policy crediting rates for an extended period of time, negative arbitrage occurs and the values of the policy will not keep pace with the loan balance. When this happens, the borrower will be required to post additional collateral and may have to pay interest currently to reduce the amount of the outstanding loan.

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 Irrevocable Life Insurance Trust (ILIT) or his/her business (Corporation, Partnership, or LLC). In rare instances, the borrower can be an individual and typically requires prior approval from either the funder or the sponsor of the premium financing program.

Who is the funder?

The funders in established premium financing programs will be 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. Some premium financing programs have been created by independent marketing organizations that involve one or more funders and several life insurance carriers, while other programs involve one individual funder and one individual life insurance company. Independent marketing organizations and life insurance companies may help facilitate the premium financing process; however, neither will be a party to the loan agreement between the borrower and the funder.

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

What is the loan interest rate?

Loan interest rates are typically based on a recognized benchmark interest rate plus an additional spread. The most commonly used benchmark rate is the 12-month London Inter-Bank Offered Rate (LIBOR), although other rates (i.e. Prime) may also be used. The LIBOR is the interest rate at which banks offer to lend money to one another in the wholesale money markets in London. It is a common rate used in the global capital markets, and is published daily in the Wall Street Journal.

The spread above the base rate (LIBOR or Prime) typically ranges between 100 and 400 basis points, and varies by the amount of the loan, the creditworthiness of the borrower and the collateral that is posted. The base rate typically can be expected to fluctuate on an annual basis, however once negotiated, the spread can usually be expected to remain constant for the term of the loan. While the interest rate charged to the client will typically be fixed on an annual basis, 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 (i.e. LIBOR). However, borrowers may wish to negotiate a longer or a shorter lock-in period. Please note that lock-in rates are subject to market availability and do come at a premium.

When is the interest payable?

Unless there have been additional negotiations between the borrower and the funder, loan interest is typically due in cash at the beginning of the loan (in advance) and annually on subsequent policy anniversaries. In some instances, borrowers may negotiate to pay interest in arrears or to accrue some or all of the interest, adding it to the loan balance.

Are there minimum loan amounts?

Yes. The minimum loan amount will vary from one program to another. Some programs have a minimum annual amount. Others base their minimum on the total loan facility (the total specified loan amount).

How is interest calculated?
Some programs charge interest based on the total loan facility. Other programs charge interest on funds only as they are used.

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. In some programs, each annual premium will be treated as a separate loan. Therefore, a new loan process will need to be initiated each year that a premium is to be paid.

Other programs use a term-loan structure. The amount of the loan will include a multi-year premium payment pattern that can cover between 1 and 5 years. There may be programs that have longer term periods.

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 programs include them while others do not.

Depending on the individual program, these fees may have to be paid in cash, or they may be rolled up into the loan. Note: Without proper planning, rolling the fees up into the loan may cause the death benefit net-of-loan to decrease over time.

How are *Loan Acquisition Fees* calculated?
Some programs calculate the fee based on the total loan facility. Other programs will charge the fee based on the funds only as the loaned funds are received. Some programs 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, interest-sensitive whole life, universal life, and index universal life.

Variable policies are generally not acceptable for both collateral and regulatory reasons. Since variable policies are classified as securities, a premium financing transaction could also be required to comply with applicable SEC rules as well as regulations pertaining to purchasing securities on margin (Reg. U).

Several funders work with Index Universal Life policies for premium financing. The product combines the long term protection guarantees of a universal life insurance policy with the cash accumulation potential of equity index-linked interest options. The cash accumulation of these products may help mitigate a large portion of the collateral requirement. The carrier illustrations must be run with realistic assumptions; even a slight change to the underlying assumptions can change the results drastically.

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, depending on the type of assets being pledged. Acceptable collateral will typically consist of cash, cash equivalents, and liquid or readily marketable securities. Letters of credit are also acceptable, but will need to be pre-approved by the lender in advance. Each funder's requirements regarding collateral differ, so the program selected may be contingent on the client's needs with regards to collateral.

Cash and cash equivalents are likely to be valued either at or close to 100% of the asset's current Fair Market Value, while stock portfolios may only be valued at 50% of FMV.

For example, $1.00 of required collateral may be satisfied by $1.00 in a money market account, or perhaps as much as $2.00 of common stock.

Who actually provides the collateral?
Normally, collateral will be provided by the borrower.

How is the collateral handled?
Some funders will require that assets actually be transferred to a collateral account, to be managed by the funder. Other funders will accept an assignment of assets while allowing the clients to continue to manage their assets. In all cases, the assets pledged as collateral, as well as the life insurance policy, will be monitored regularly by the funder.

How often will the collateral assets be reviewed?
Funders will review the assets that comprise the collateral account a minimum of once a year.

Will the borrower ever have to pledge additional collateral?
In the event of adverse performance by either the life insurance policy or the pledged assets, the client may be asked to pledge additional collateral to secure the loan.

When does the loan have to be repaid?
Loans have to be repaid when the loan reaches *maturity* (unless renewed), upon the death of the insured, or in the event of default. Maturity may be defined as an event (i.e. death of the insured), or after a specific period of time (i.e. term of 1 to 5 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 will be at 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?

For older clients with life expectancies of 15 years or less, choosing to have the loan repaid at their death may be a valid consideration. However, repayment at death may not make economic sense for younger clients because of the potential long-term risks of fluctuating loan interest rates, policy performance, and collateral issues.

For trust-owned policies[1], the simplest exit strategy is for the clients to just gift the necessary funds into the ILIT so that the trustee is able to repay the loan. This strategy clearly has gift tax implications, and it probably won't be suitable for loan balances that significantly exceed the client's lifetime gift tax exemptions. Therefore, the client should consider other strategies of advancing funds into an ILIT in ways that minimize the gift tax implications.

The client may take the place of the third party funder 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. Typically, loan interest is based on the Applicable Federal Rate (AFR). It is generally less than the loan interest rate of most premium financing programs. If the ILIT has the necessary funds, it can pay the interest to the client in cash. Alternatively, the client can make annual gifts to the ILIT for the purposes of paying the interest. As a second alternative, the client can allow the ILIT to accrue the loan interest adding it to the loan balance. Clients should be aware that the accrued interest will be included in their taxable estate as will the loan balance.

Use of a Grantor-Retained Annuity Trust (GRAT) can also be an effective strategy for advancing funds into an ILIT with minimal gift tax consequences. The Walton case [Audrey J. Walton v. Commissioner; 115 T.C. No. 41; No. 3824-99 (December 22, 2000)] established that strongly performing assets can be transferred with virtually no gift tax consequences, if the GRAT is properly designed. The one caveat is that the Grantor must survive the term of the GRAT or the values will be brought back into the Grantor's taxable estate.

Selected assets are placed in a GRAT that has been designed to pay annuity income payments (at least annually) back to the Grantor for a stated period of time. At the end of the term, the remaining assets then pass to the GRAT beneficiaries. IRS formulas are used to calculate the values of the two GRAT components: the *Income Interest* that is paid to the Grantor, and the Remainder Interest that ultimately passes to the GRAT beneficiaries. Only the *Remainder Interest* is subject to gift tax. However, this can be mitigated by using a "Zeroed out GRAT."

The *Income Interest* is a *present value calculation* using the IRC Sec 7520 rate published monthly by the IRS. The *Remainder Interest* is determined by subtracting the *Income Interest* from the total value of assets placed in the GRAT. By selecting assets that earn a rate of return higher than the Sec 7520 rate, and also establishing the GRAT payout rate higher than the Sec 7520 rate, it is mathematically possible to reduce the *Remainder Interest* to (or very close to) zero.

When does it make sense to use "death" as the exit strategy?

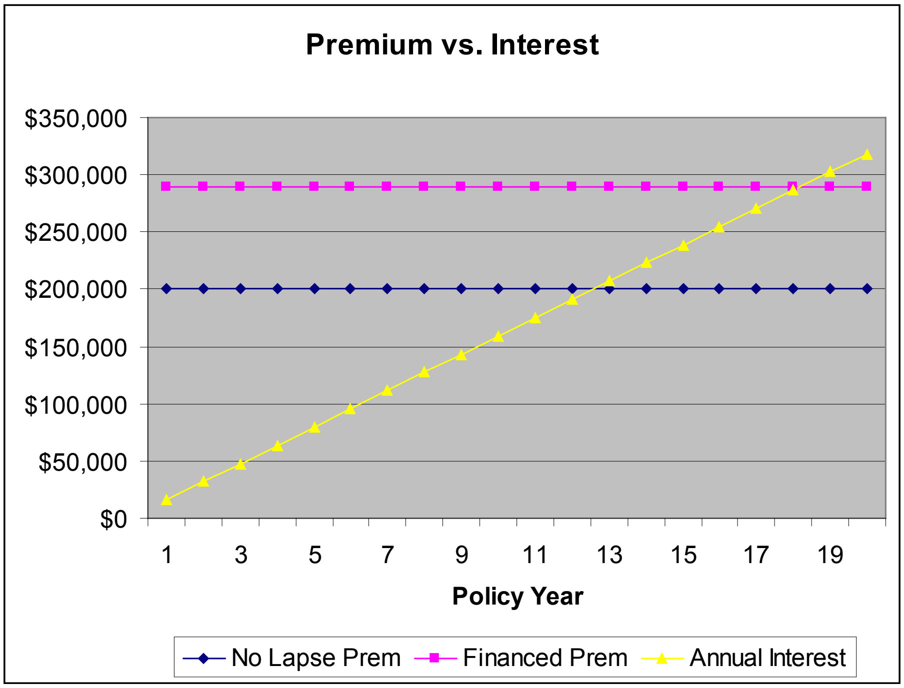
While each case needs to be evaluated on its own merits, assuming the death of the insured as the exit strategy has somewhat limited use.

Consider the following: A trust purchases a life contract on an individual and decides to finance the contract and repay the loan from the death proceeds. Premiums are borrowed annually as needed.

[1] Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping tax). Failure to do so could result in adverse treatment of trust proceeds.

Premium Finance
Toolkit

Client Info: Male, Preferred Non-Tobacco User
Assumed Loan Interest Rate: 5.5% interest for all years and the loan interest will be paid annually from out of pocket funds



Financing a life contract on a 65 year old male will require the trust to pay or account for interest for the insured's remaining years. A 65 year old male has a life expectancy of 22.3 years. Based on the stated interest rate of 5.5%, the loan's annual interest payment may begin to surpass the equivalent cost of a no-lapse guaranteed death benefit policy beginning in the financed contact's 13th year, well before reaching the insured's life expectancy. While leverage may still exist at that time, it begins to rapidly recede with each ensuing year.

Accruing the interest only shortens the "leverage" period.

Other ages are listed below:

Client's Age At Issue	**Projected Life Expectancy in Years**	**Loan Interest Exceeds Non-financed Outlay in Policy Year**
65	22.3	13
70	18.2	14
75	14.3	11
80	10.5	15
85	6.8	13

Based on the above, using death as an exit strategy may begin to make sense at age 80 and up.

How long does it normally take for loan approval?

Funders will normally not commence action on the loan application until the life insurance carrier makes an underwriting offer. Once an underwriting offer is made **and** the funder has received **all required documents**, the loan process typically takes at least 10 to 15 business days.

Is it appropriate to use policies that qualify as Modified Endowment Contracts in Premium Financing transactions?

Using a life insurance policy that qualifies as a Modified Endowment Contract (MEC) in a Premium Financing situation is usually not recommended and should be reviewed by the client's legal and tax advisors to determine whether such a structure would create problems.

Under Code Section 72, the IRS views the collateral assignment of benefits to the funder from a MEC policy 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 cash value of the contract immediately before the distribution exceeds the investment in the contract, regardless of surrender charges. Since Premium Financing cases often require an assignment of a portion of the life insurance policy to the funder as part of the security for the repayment of the loan, any cash value growth that is in excess of premiums paid will be treated as taxable income annually and taxed at ordinary rates. Additionally, if the insured is younger than age 59-1/2, a 10% penalty tax will 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 a producer in order to place a premium financing case?

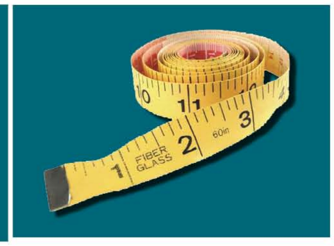
Participation in some programs will involve a commission split with the funder. In some cases, the funder will also require the producer to sign a confidentiality agreement. In addition, either the funder or the use of a particular life insurance product may alter the producer's normal compensation payout.

Should a cover letter/memo be sent in with a premium finance case?

Yes, the purpose of the cover letter/memo is to build a bridge between the application, client, and insurance carrier's underwriting unit. It should cover who is the client, the facts of the case, and the planning techniques considered for this client. This is the "WHO, WHY, HOW..."

The cover letter should also include details of the premium financing program being utilized, document the financial suitability of the arrangement for this specific client, and explain why premium financing meets the client's needs. It should also contain the client's plan to exit from the premium finance transaction.

Premium Finance
Toolkit



Fact Finder

Sales Manager: ________________________________

Sales Location: ________________________________

Client Information

Client Name ________________________________

DOB ________________________________

Sex/Underwriting Class ________________________________

Client 2 Name ________________________________

DOB ________________________________

Sex/Underwriting Class ________________________________

State ________________________________

Adjusted Gross Income (AGI) ________________________________

Federal Income Tax Bracket ________________________________

Producer Information

Name ________________________________

Company ________________________________

Address ________________________________

City ________________________________

State ________________ Zip Code ________________

Phone ________________ Fax ________________

Email ________________________________

Loan and Ownership Information

Is the client an officer or a director of a publicly traded company (Sarbanes/Oxley)?

☐ Yes ☐ No

How much insurance does the client currently have in place? ________________

How many potential beneficiaries are there (number of Crummey Beneficiaries)? ________

What is the client's estimated net worth? ________________

How much is real estate (%)? ________________

How much of the assets are liquid (%)? ________________

What will be used for collateral? ________________

How is the policy owner planning to pay the loan interest? ________________

Insurance Information

(Not for use with variable products.)

Type of Insurance ☐ UL ☐ SUL ☐ Other

Death Benefit ________________________________

What is the purpose of this insurance? ________________________________

____

Premium Financing Information

Interest Options:

☐ Interest in Advance ☐ Interest in Arrears

☐ Interest Accrued Number of Years ________________

Who will own this policy?

☐ Trust Owned ☐ Other ________________

Partial Payment ($) ________________________________

Exit Strategy

When does the policy owner plan to repay the loan? ________________

____

What assets will be used to repay the loan? ________________

____

Does the policy owner plan to make premium contributions after the loan repayment?

____

Will a side fund be used to help repay the loan?

☐ Yes ☐ No

If "Yes", what pre-tax interest rate should be assumed?

____

GRATS

GRAT Terms (years) ________________________________

Income Rate of Return ________________________________

Growth Rate of Return ________________________________

Discount rate of FMV of contributed assets ________________

FMV of assets to be contributed ________________

Comments

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____