REGEV
FINANCIAL GROUP

PREMIUM FINANCING

A Guide to Legacy Preservation

Why finance the premiums?

Your current cash flow may already be committed to other expenses.

Financing reduces your liquidity needs, which is especially helpful if your assets are not readily convertible to cash.

You may not want to move assets that are working for you especially if the return on those assets in your current portfolio exceeds the cost of borrowing.

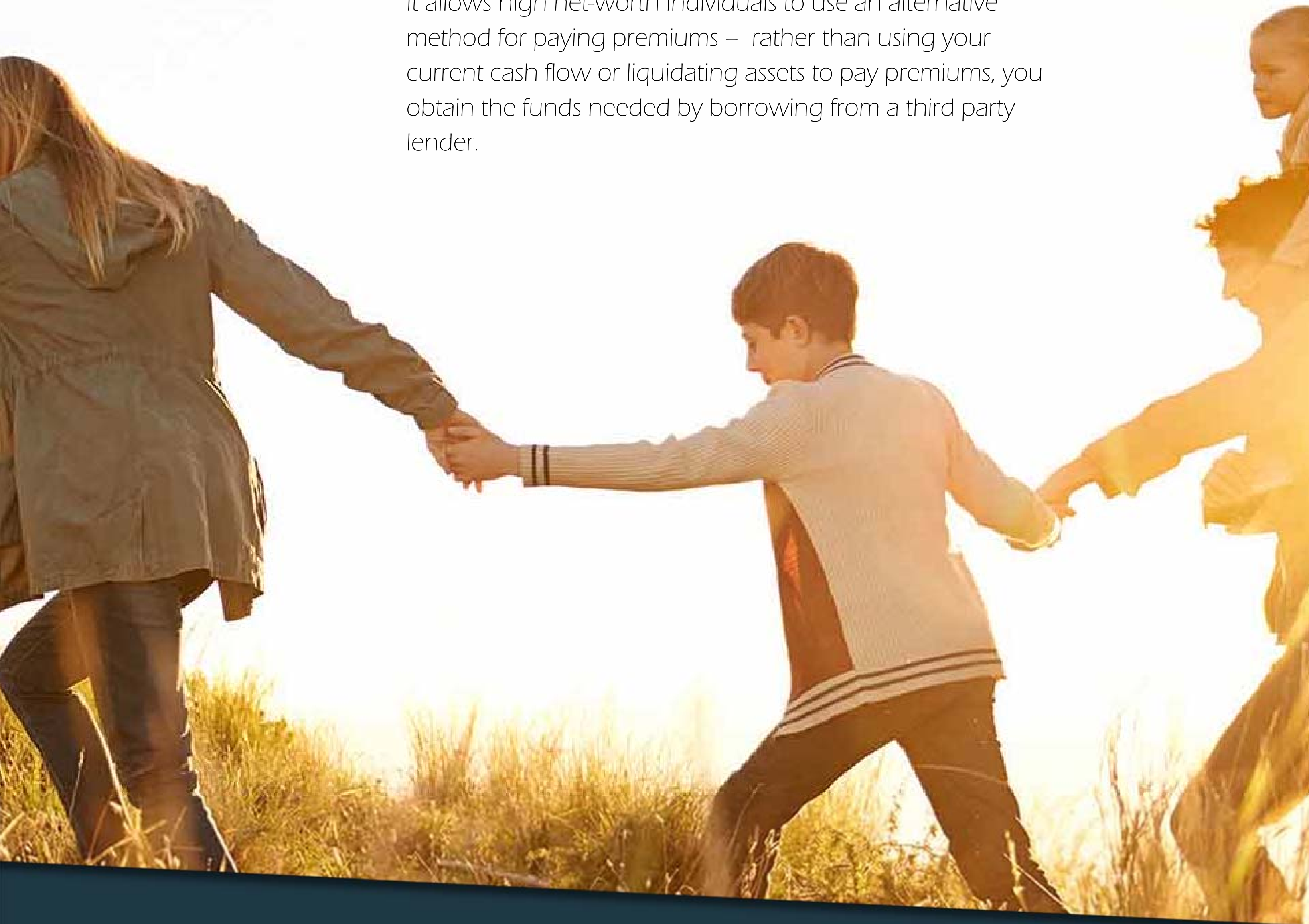
Financing can provide gift-tax leverage, as loans made to your Irrevocable Life Insurance Trust (ILIT) to pay premiums are not subject to gift tax. (within a certain threshold).

Capitalizing (or accruing) interest as part of the loan will increase the gifting leverage – in that case, there is no need to gift premium or loan interest.

What is Premium Financing?

Simply put, premium financing is a strategy for paying for life insurance.

It allows high net-worth individuals to use an alternative method for paying premiums – rather than using your current cash flow or liquidating assets to pay premiums, you obtain the funds needed by borrowing from a third party lender.



Uses for Premium Financing

Estate Planning

Life insurance is a key component of many Clients' estate plan with the policy owned by an irrevocable life insurance trust (ILIT or Trust) for the benefit of the Client's spouse, children, grandchildren and subsequent generations. The question that must be addressed is, "What is the best way to pay for the coverage?" Premium financing can be an attractive funding strategy that compliments other non-life insurance estate planning strategies. During the early years of the plan, the annual loan interest is substantially less than paying the full annual premium, resulting in smaller initial gifts to the ILIT to fund the coverage.

Business Planning

Businesses can use premium financing in a variety of different ways. A business might borrow the funds to obtain life insurance for key-person coverage, finance a non-qualified deferred compensation plan, set up a death benefit only plan for a key executive or obtain coverage for a buy/sell arrangement.

Client Profile

- High net worth ($10M for married couples, $5 million in the case of an individual)
- Need for substantial life insurance ($100k minimum initial loan available with some lenders)
- Insurable at favorable rates
- Sophisticated investor who understands complex financial transactions
  - Understands the risks outlined below
  - Understands the need for a rollout or exit strategy
- Has adequate assets acceptable to lender to post as collateral
  - Cash
  - CDs
  - Marketable Securities
  - Access to Letter of Credit
  - High Cash Value non-MEC Life Insurance Policies from a Highly Rated Carrier

Advantages of Premium Financing Plans

- The client can purchase life insurance with little initial impact on current cash flow or without having to liquidate existing investments (thus avoiding taxable gain upon liquidation).

- Premium financing can produce positive interest rate arbitrage if the after-tax growth in policy cash value and/or the growth in the Clients' investments exceed the interest on the underlying loan.

- The client can take advantage of gift tax leveraging. Life insurance, with an immediate death benefit, compliments non-life insurance estate planning strategies that all take time to transfer substantial wealth. Premium financing can minimize short to mid-term gifting.

- If the policy is owned outside the insured's estate, premium financing could eliminate the need to gift the entire premium. Only the loan interest may need to be gifted annually.

- If the lender allows the loan to be structured so that interest accrues and provide the policy performs very well, no gifting may be necessary.

Disadvantages of Premium Financing Plans

• Premium financing is a highly complex strategy that involves several risks (see more detailed discussion below):

- Policy performance risk
- Interest rate risk
- Policy lapse risk
- Collateral call risk
- Gift tax risk
- Income tax risk

• Over time, as each additional premium is borrowed, the interest cost increases and the net death benefit decreases by the amount of the outstanding loan.

• If the policy is owned outside the estate and interest is paid annually via gifts to the trust, gift tax issues could arise if the loan interest exceeds the client's annual gift tax exclusions and lifetime exemption.

• Fluctuations in future interest rates could have a major impact on the life insurance policy and underlying premium loan.

Types of Policies Suitable for Premium Financing

- Policies with strong cash values, whether survivorship or single life, are suitable for premium financing. Therefore, Whole Life (WL) is a great candidate.

- Variable UL is not suitable because, as a security, it is subject to the margin loan rules limiting the amount of the loan that can be secured with policy cash values.

- Guaranteed UL policies are generally not suitable due to the fact that cash values are very low or non-existent, requiring the Client to post substantially greater collateral.

- Term policies are generally not suitable for the same reason, i.e. cash values are non-existent, requiring the Client to post substantially greater collateral.

Case Study

Husband and Wife are each 60-years old and in excellent health. They have a substantial net worth acquired as real estate developers. Clients' attorney has recommended $10 million of survivorship coverage for estate planning purposes with a $200,000 annual premium payable for lifetime owned by and payable to an irrevocable life insurance trust (ILIT). Client is heavily invested in real estate, and likes the concept of using other people's money to fund the coverage. The Client expects to sell substantial properties in the next 3-5 years, freeing up funds to repay the loan and pay future premiums.

1. The Client or Clients create an ILIT.

2. The ILIT enters into a premium financing arrangement with a third part commercial lender

(possibly the Client's bank).

3. The ILIT will borrow each annual premium for up to seven years, pay the policy loan interest, posting the policy cash value and a portion of the death benefit as collateral.

4. To the extent that the policy cash value is insufficient to secure the loan, the Client posts collateral in the form of cash, marketable securities or a letter-of-credit acceptable to the lender.

5. Assuming the current loan rate is 4% (and will remain at that rate), loan interest on a $200,000 annual premium equals $8,000. The Client gifts $8,000 to the ILIT. *Note:* Borrowing rates typically vary at least annually. The level 4% rate is assumed for the sake of simplicity.

6. In the second year, an additional premium is borrowed for a total loan of $400,000, and the loan interest is 16,000. After 5-years, the total loan would equal $1,000,000 with an annual interest payments of $40,000.

7. At the same time that the ILIT purchases the policy, the Client gifts an interest in the discounted real estate that the clients expects to sell in the next 3-5 years. This acts as an exit strategy by providing a source of funds in the ILIT to repay the loan in the future and generate cash flow to pay future premiums.

8. Upon death, the policy proceeds are paid to the ILIT, net of the outstanding loan balance. Net proceeds or assets purchased from the estate with such proceeds are then managed and distributed according to the terms of the ILIT.

Premium Financing: Step by Step

An attorney drafts an Irrevocable Life Insurance Trust (ILIT) and the ILIT purchases a policy on your life. Because you don't own the policy, the proceeds will not be included in your estate for estate tax purposes.

A third party lender loans funds to the trust each year to pay the annual premiums on the policy. You may choose to finance a portion of the premium, all of the premium, or the premiums plus accrued interest and other costs.

Ideally, the loan will be fully repaid during your lifetime, at which time, your ILIT will own the policy outright. If not, any unpaid loan or loan interest is paid back to the lender from the policy proceeds at your death.

Any remaining death benefit is paid to your ILIT for the benefit of your beneficiaries.

Collateral

Premium finance loans are 100% collateralized at all times. The policy's cash surrender value serves as the primary source of collateral. however, additional collateral will most likely need to be pledged – especially in the early years of the contract, when the amount of the loan and accumulated interest exceed the cash surrender value. Acceptable forms of additional collateral include:

- Marketable securities
- Cash surrender value of other life insurance policies
- Letter of credit (from a bank with AA- or better rating)

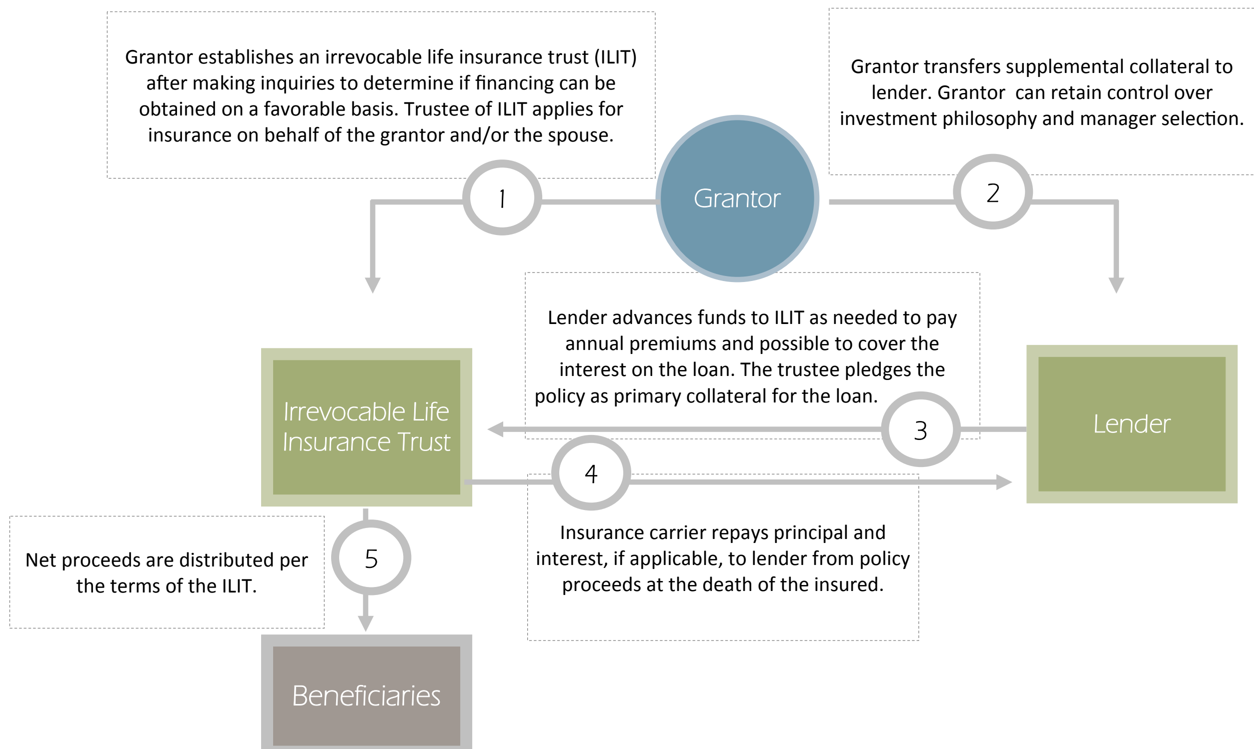
Assets that cannot be easily converted to cash, such as real estate, artwork or collectibles, may not be viewed as acceptable forms of collateral. However, these assets may be considered by the bank when obtaining a letter of credit.

Working with a Lender

Your agent will refer you to a financing company that will facilitate the loan and be responsible for the following details:

- Determine the loan rate. This will vary depending on the size and length of the anticipated loan, but usually is 2% over the current 1-year London Interbank Offering Rate (LIBOR) rate.
- Case design. The financing company will work with your life insurance agent to design a loan using conservative assumptions with a focus on meeting your objectives and controlling risk.
- Evaluation of collateral needs. In addition to original collateral requirements at the loan's inception, the financing company will assess any increases or decreases in collateral needs in future years of the loan.
- Manage loan renewals. You will be alerted when the end of the term of your loan is approaching and if action needs to be taken for renewal.
- Monitor loan exit strategies. Possible exit strategies will be examined on a year by year basis until the loan is retired.

Policy loans and withdrawals reduce the policy's cash value and death benefit and may result in a taxable event.



Exit Strategies

For all premium financing plans, it is highly recommended that an exit (or rollout) strategy be designed and implemented, ideally at the same time the premium financing is implemented, but certainly in the early years of the plan. Following are examples of some of the most common exit strategies that can be used when an ILIT is a party to the premium financing arrangement.

Policy Death Benefit

At death, the outstanding loan balance (including any accrued interest) is repaid to the lender and the net death benefit is paid to beneficiaries. This is generally not considered a viable rollout technique due to the risk of the insured(s) living too long with substantially increasing interest costs and a diminishing net death benefit (net of the loan).

Policy Values

This rollout technique assumes the policy cash values will be sufficient at some point in the future so that the policyowner can make withdrawals from the policy sufficient to pay all or a portion of the outstanding balance without causing the policy to lapse prior to the client's death. While it may be possible to create a policy illustration that shows a rollout via policy values, it should be kept in mind that the illustrated policy values are not guaranteed. There is a risk that the cash value may not be sufficient to rollout as projected. As a result, a client will have to look to other exit strategies in order to affect a rollout.

In some premium financing programs, interest is capitalized, i.e. accrued. Since loan interest is not paid, it accrues, increasing the outstanding loan balance and future interest due (as a result of compounding the loan interest). This puts a greater demand on policy cash values to terminate the plan. This is generally considered an aggressive strategy. This design should only be entered into by the most sophisticated clients with a full understanding of the risks of such a design. Stress testing of these designs is required.

Annual Exclusion and Lifetime Exemption Gifts (Side Fund)

Clients can use available annual exclusions or lifetime gift exemptions to make gifts to the ILIT. The ILIT then invests those gifted amounts a side fund. A husband and wife can each gift 1) $14,000 annually (2017) directly to or in Trust for each child and grandchild, and 2) $5.49 million (2017) during their lifetime.

Gift and/or Sale to a Dynasty Trust Defective Grantor Trust

Client creates an ILIT that is a Dynasty Trust, i.e. for the benefit of children, grandchildren, and/or future generations. The Trust is a defective grantor trust for income tax purposes. This means that all taxes generated by the Trust are paid by the Client (the Grantor), and if the grantor sells appreciated assets to the Trust, no gain is recognized on the sale. Assets appreciate in the Trust and can be used to 1) terminate the premium financing arrangement by repaying the lender the outstanding loan balance, and 2) paying future premiums from cash flow.

Risks & the Importance of Stress Testing

Policy Performance Risk

Policy values of policies utilized with premium financing plans are not guaranteed. Those values could be impacted by deteriorating mortality, expense or crediting rate experience. Since policy cash values are pledged as collateral for the loan and may be used as a source for repaying all or a portion of the loan, it is important to understand that the policy could perform worse than current assumptions illustrate and have a significant effect on the financing plan.

Note: Conversely, an improvement in policy performance could have a positive impact on the program.

Loan interest Rate Risk

In securing a loan to pay premiums, the lender may offer a variable monthly or annual loan rate, or one that is guaranteed for a limited period of time. As a result, over time there could be substantial fluctuations and increases in loan interest rates. Changing rates can dramatically affect the performance and costs of a program as follows:

1. Higher interest costs.
2. Posting of a greater amount of supplemental collateral.

Note: If policy performance and loan interest rates worsen together and/or if loan interest is capitalized (i.e. accrued), the effect of higher interest rates on the outstanding loan and additional collateral required is even more dramatic.

Collateral Call Risk

The lender's primary concern is security of the borrowed funds. In a typical premium financing arrangement, the ILIT pledges the life insurance policy as collateral to the loan. To the extent that cash surrender value is insufficient to secure the loan, the grantor pledges supplemental collateral. In the event of a loan default, the lender could call both forms of collateral. The surrender of the policy to repay the lender could trigger substantial income tax gain and the collateral call of the supplemental collateral posted by the grantor would create a taxable gift to the ILIT.

Loan Qualification Risk

Loans are typically for a specified term, e.g., one, five or 10 years. At the conclusion of the loan term, the borrower must re-qualify for a new loan term. If the borrower is unable to re-qualify for a new loan term, then the borrower will have to either repay the loan or find another lending institution. If new financing cannot be obtained, then the negative results outlined above could occur.

The Importance of Stress Testing

In order to educate advisors and clients on the risks inherent in a premium financing program, it is important to "Stress Test" the proposed plan. Stress testing involved the following:

1. Illustrating the program with reasonable and typically increasing future borrowing rates.
2. Illustrate the policy with lower crediting rates.
3. Illustrate the combined effect of 1 and 2.

Estate and Income Tax Considerations

Estate Tax

As with any life insurance, the insured must avoid holding any "incidents-of-ownership" in the policy to avoid inclusion of the death benefit in his or her estate (IRC Code §2042). Incidents of ownership include the right to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan and to obtain a policy loan [Treas. Reg. §20.2042-1(c)(2)]. If the Trust is the owner and beneficiary of the policy from the outset, then the insured should not have any incidents of ownership.

An issue that frequently arises is whether an insured's guarantee of a premium financing loan causes inclusion of the death benefit in his or her estate. Since a guarantee does not constitute an incident of ownership, it should not cause any estate inclusion. In PLR 9809032, the IRS indicated that the insured's loans to a trust to pay premiums did not create an incident-of-ownership. If the insured's own premium loans to the trust do not constitute an incident-of-ownership, then it would appear that the insured's guarantee of a loan taken by the trust from a third party would also not create one either.

Income tax

Generally, there are no income tax consequences with premium financing. Any monies the client gives with regard to annual loan interest payments by the trust on the loan are subject to gift taxation and applicable annual exclusions. Provided there has not been a transfer-for-value, the life insurance policy proceeds at death are received income tax-free pursuant to IRC §101(a).

However, if the bank requires supplemental collateral from the client as an additional guarantee on the loans associated with the premium financing transaction, a collateral call could subject the client to income tax consequences as a result of the gains triggered in the collateralized property.

Likewise, a collateral call by the lender requiring the Trust to surrender the policy could trigger taxable gain to the extent that the policy cash value plus any outstanding loans exceed the Trust's cost basis in the policy. Loan interest to finance life insurance is not deductible. IRC §264.

All guarantees subject to the claims paying ability of the issuing insurance company. The hypothetical case study results are for illustrative purposes only and should not be deemed a representation of past or future results. This example does not represent any specific product, nor does it reflect sales charges or other expenses that may be required for some investments. No representation is made as to the accurateness of the analysis. 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 tax treatment of trust proceeds. This material is for informational purposes only and is not meant as Tax or Legal advice. Please consult with your tax or legal advisor regarding your personal situation.

Content Sources: HCB Premium Financing, Wells Fargo, BNY Mellon

SagePoint Financial supports the use of legitimate premium financing and provides guidelines that clarify when Representatives may participate in a transaction in which premium financing is being used. Representatives of SagePoint Financial may not participate in cases in which any proposed financing does not meet the guidelines and policies listed below. SagePoint Financial requires premium financing arrangements for life insurance policies meet the following guidelines:

The customer(s) must have a demonstrated long-term need for insurance; • There is no pre-arrangement or intent at the time of the sale to transfer ownership or beneficial interest in the policy to an unrelated third party (i.e. life settlement company, viatical company or investment company); • If the loan is 100% collateralized by personal or business assets of the borrower, interest on the loan may be capitalized back into the loan balance - if policy is posted, only the cash surrender value may be used; • If the loan is not fully collateralized (minimum of 25% collateral required) then interest may not be capitalized back into the loan balance; • Collateral must consist of either personal or business assets and cannot be a personal guaranty; • When using the life insurance policy as collateral, the collateralized value is the policy's cash surrender value, not any other value such as the policy's secondary market value; • The lender fully underwrites the creditworthiness of the client; • The client's life expectancy is not a factor in the financing transaction; and • A valid exit strategy must exist; this strategy cannot include death of the insured or settlement of the policy. • In connection with its policy on Investor Owned Life Insurance ("IOLI"), SagePoint Financial will not support, nor knowingly act as a conduit for, financing arrangements or programs that have economic and other provisions that make it unlikely the customer will elect to maintain the coverage over the long-term, even in circumstances in which the customer may intend to do so at the outset. • It is also the policy of SagePoint Financial that its Representatives will not solicit or otherwise facilitate any such financing arrangement or program. SagePoint Financial will consider imposing discipline on any Representative violating this policy, and any transaction that may appear to comply with these policies and guidelines but is in fact an attempt to foster an IOLI transaction will be considered a violation of this policy. • Representatives are reminded that Section 11(d) of the Securities Exchange Act of 1934 prohibits a Representative or broker/dealer firm from arranging, or participating in the arrangement of, or even suggesting a customer seek financing in connection with the sale of any security, including variable life insurance policies. Moreover, many insurance carriers have implemented policies and procedures in connection with IOLI transactions and premium financing. • It is the policy of SagePoint Financial that its Representatives comply fully with all such carrier policies and procedures including, but not limited to, using carrier-approved financing vendors, working with customers to fully and truthfully answer all questions on carrier forms, and responding promptly and truthfully to carrier inquiries regarding a case.

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