John Hancock
LIFE INSURANCE

Sales Strategy

Private Financing

Many wealthy clients need large amounts of insurance to protect their families and help pay estate taxes due at death. These clients often have no trouble paying for the insurance premium, and may even have an asset or entity set aside as the funding source for the premium payments. Rather, these clients are concerned about avoiding gift taxes and finding a way to fund the large insurance policy without having to make large taxable gifts. For these clients, Private Financing may be the solution.

WHAT IS PRIVATE FINANCING?

Private Financing, also known as self-financing, is the funding of life insurance premiums through a personal loan between an insured or a family member and an Irrevocable Life Insurance Trust (ILIT).[1] The loan may also be between a closely related entity, such as a Credit Shelter Trust (CST) or a Family Limited Partnership (FLP), and an ILIT. Unlike Premium Financing through a third party lender, by having a closely related entity or individual act as the lender, there is no need for collateral deposits or significant increases in premiums to account for the required loan repayment. The loan repayment itself ultimately remains within the insured's family.

HOW DOES IT WORK?

The insured, family member, trust or partnership loans the premiums for a life insurance policy on the insured's life to an ILIT, the beneficiaries of whom are typically the insured's children. The ILIT pays the loan interest based on the Applicable Federal Rate (AFR), as published monthly by the government. Usually at the death of the insured, the loan is repaid using death proceeds paid to the ILIT, although the loan may be repaid earlier. Once the estate is settled, or the trust or partnership makes distributions, the beneficiaries of the estate receive the loan repayment.

If the insured or family member is the lender in a privately financed plan, the loan repayment will be made to the estate and consequently, will be subject to estate tax. However, if an existing trust is the lender, no estate tax will apply since the loan repayment at death is not included in the insured's estate. The amount of the loan repayment made to a partnership that is included in the taxable estate is the insured's proportional interest in the partnership at death.

Furthermore, income taxation may apply to the loan interest payments made to a trust or partnership. If a trust is the lender the trust must pay income taxes at the trust tax rate on the loan interest payments made to it by the ILIT unless the payments are distributed to the beneficiaries, in which case, the beneficiaries receiving the payments will pay tax at their individual tax rates. If a partnership is the lender, the limited partners will share in the income taxation associated with the loan interest payments based on their proportional interest in the partnership. If the insured is the lender, the ILIT should be set up as a "defective grantor trust," so that there is no income taxation on the loan interest.

BENEFITS

- The heirs, in many cases, receive the loan repayment, net of estate tax.
- The cost of a Return of Premium (ROP) rider, if needed, is minimized through the use of a partial return of premium.[2]
- The gift tax costs of the plan may be avoided or significantly lowered since the gift is only the loan interest and not the full premium.
- No collateral deposits are required to secure the loan.
- There is no risk of the loan being called by a third party lender.
- The loan can be made annually or in an up-front lump sum to create a sinking fund or to provide the trust funds to purchase an income-producing asset.
- No loan approval process by a third party is necessary.

CONSIDERATIONS

- The insured must have the cash flow to pay the full premium and/or must be able to make a lump sum cash loan, or offer an unneeded income-producing asset to be used as the loan source.
- The loan repayment may be subject to estate tax if the insured is the lender.
- Income taxes must be paid on the loan interest if an existing trust or partnership is the lender.

DESIGN CONSIDERATIONS

Private financing allows for a great deal of flexibility in plan design. The key factors to consider when designing a personally financed life insurance case include:

1. Source of Premium Loan: The lender may be the insured, a family member, or an existing trust, partnership, or another closely related entity that has the funds to lend premium payments.

- **Insured as Lender:** If the insured acts as lender, he or she must have cash flow sufficient to make annual premium loans to the ILIT. Alternatively, the insured can make a single contribution, characterized as a combination loan/gift to the ILIT, to be used for future annual premium and loan interest payments, or to provide the ILIT with the funds necessary to purchase an income-producing asset.
- **Existing Trust as Lender:** If the source of the premium loan is an existing trust, such as a credit shelter trust (CST), the trust can lend the ILIT the funds for the premiums. Or, the trust can be used in the future to repay the loan principal if repayment occurs before death. Note: in order for an existing trust to be used as the lending or loan repayment source, the trust language must allow for the trust to make such loans or payments.
- **Other Entity/Partnership as Lender:** If the source of the premium loan is another entity, such as a family limited partnership, the partnership lends the ILIT the premiums. The ILIT makes interest payments to the partnership and the interest payments are income taxable to the partnership. The partnership can also be used as the loan repayment source if the loan is to be repaid prior to death.

2. Use of Return of Premium Rider: The Return of Premium (ROP) rider can be used to repay the premium loan and to keep the original death benefit intact. The ROP increases the original face amount of the insurance by the amount of annual premiums paid to date. In private financing, it is not necessary to replace 100% of the premiums paid since a portion of the loan repayment will be returned to the insured's estate net of estate taxes. In most instances, a 50% ROP can be used, although the ROP amount can be between 1–100% (the cost of a 50% ROP is less than a 100% ROP). For cases in which an existing trust is the lender, no ROP may be necessary since the loan repayment will not be subject to estate tax. Although repayment to a partnership for a loan will not be subject to estate tax directly, a partial ROP may be needed since the part of the loan repayment belonging to the insured as a partner will be subject to estate tax at his or her death.

3. Loan Interest: Consideration must be given to whether loan interest should be paid annually or whether it should be deferred and for how long. In most cases, notes will have loan interest paid by the ILIT annually. Although deferring interest means no out-of-pocket costs in the short run, the compounded cost of the interest deferral could become prohibitively expensive, potentially diminishing the value of the death benefit.

4. Loan Repayment: The loan principal is typically repaid at death using the death benefit from the life insurance policy. However, the loan may be repaid earlier to minimize the long-term cost of the arrangement. Repayment may come from the ILIT side-fund, an existing trust or partnership, or from life insurance cash values.[3]

5. Type of Note: Typically, in private financing, the applicable federal rate (AFR) published monthly by the IRS is used in the loan arrangement in order to insure that the note is considered a fair market loan.[4] AFR rates are variable rates and can be used in term or demand notes.

- **Term Loan:** The AFR can be fixed for the life of the loan and the rate is based on the month the loan is established. Depending on the term of the loan, the AFR for short-term (0–3 years), mid-term (3–9 years), or long-term (9 years or more) rates may be used.

- **Demand Note:** A demand note has an annually changing interest rate that can be appealing in a low interest rate environment. If a demand loan is outstanding for an entire calendar year, the government's blended rate must be used. In July of each year, the government publishes the blended rate for the current year. The average of the IRS blended rates for January 1997 through January 2007 was 4.17%.[5]
- **Client's Annual Gifting Strategy:** Annual exclusion gifts of only the loan interest or gifts made within the gift tax exemption amount can be made to the trust side-fund, an investment account inside the ILIT. This side-fund can be used to pay the loan interest and/or principal in future years. Combination lump sum gifts and loans can also be made to the trust side-fund, creating a sinking fund to pay annual premiums and loan interest. The ILIT side-fund balance is added to the death proceeds at death and provides additional funds to heirs.[6]

CASE STUDY: DIANE MUNSON

The Facts: Diane Munson, age 62, is a non-smoker with preferred underwriting status. She has a total estate value of $20,000,000, made up of a diversified investment portfolio.

The Problem: Diane currently has $5,000,000 of life insurance and knows she needs an additional $5,000,000 of coverage. However, since she only has $22,000 of annual tax-free gifts available, Diane does not want to make gifts of additional premiums to pay for a new policy since that would cause gift tax problems. However, Diane has plenty of liquidity and is open to creative solutions as long as she does not have to pay gift taxes.

The Solution: Private Financing with a Lump-Sum Loan.

Diane has plenty of liquidity, and could afford to pay the premium outright if she chose. However, she is strongly opposed to paying gift taxes in any form. Therefore, her planner Charles Tapper has advised her to consider private financing. In addition to using her $22,000 of annual exclusion gifts, Diane can make a lump-sum loan to an ILIT and avoid paying gift taxes as long as the trust pays or accrues interest at the appropriate applicable federal rate (AFR). Charles recommends that Diane make a lump-sum loan to the trust of around $3.6M for 9 years, and use the income earnings from the lump-sum to pay the loan interest and the annual insurance premium. While this may seem like a high amount, Diane is happy with this plan because she knows she will get the loan amount back with interest in year 10, and best of all, she does not have to pay any gift taxes. Assuming that the lump-sum loan earns a total return of 9%, the current mid-term AFR is 4.86%*, and Diane contributes her $22,000 annual exclusion gifts, the trust will have enough earnings to pay the interest and an annual premium of $188,207. This premium will purchase a $5,000,000 Protection UL-G policy on a 9-pay basis, based on Diane's age of 62 and her non-smoker preferred status. At the end of the 9th year, the trust will pay the loan with interest back to Diane and own the policy outright.

YEAR	INITIAL LOAN	CUMULATIVE LOAN @ 4.86%	LOAN REPAYMENT	TRUSTSIDE FUND @ 9%	DEATH BENEFIT	NET TO HEIRS
1	$3,691,176	$3,870,567	$0	$3,842,216	$5,000,000	$4,971,649
2		$4,058,677	$0	$4,006,850	$5,000,000	$4,948,173
3		$4,255,928	$0	$4,186,301	$5,000,000	$4,930,372
4		$4,462,767	$0	$4,381,902	$5,000,000	$4,919,136
5		$4,679,657	$0	$4,595,108	$5,000,000	$4,915,451
10		$5,657,876	$5,657,876	$0	$5,000,000	$5,000,000
20		$0	$0	$0	$5,000,000	$5,000,000

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.

* February 2007

Summary: Through a Private Financing arrangement, Diane Munson was able to secure an additional $5,000,000 of death benefit in trust for her heirs, without having to pay any gift taxes.

JOHN HANCOCK SOLUTIONS AND PRIVATE FINANCING

John Hancock's Solutions concept illustration system can illustrate the power of this simple concept. The Private Financing module, like all John Hancock Solutions concepts has crisp, clean ledgers, easy-to-understand charts and graphs, and comes with a complete package of marketing materials.

For more information on Private Financing, please contact your local John Hancock Representative or call the Advanced Markets Group at 888-266-7498, option 3.

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 tax treatment of trust proceeds.
2. The enhanced Return of Premium rider (ROP) allows clients to select the percentage of the return of premiums desired. The rider will increase the death benefit each year by that percentage of the premium loan selected so that in any given year, the lender will get back from the death benefit what it paid to date in premiums, keeping a larger portion of the balance of the original death benefit intact for the family. There are costs and fees associated with this rider. Please review the policy contract for more information.
3. The value of the life insurance death benefit may be significantly reduced when cash values are used to repay all or a portion of the loan. A side fund is an accumulation of assets growing at a specified rate.
4. If an interest rate less than fair market is used, income tax and/or gift tax may be due on the difference between the fair market rate and the actual rate of interest paid.
5. The illustrated rate is assumed to be constant for all plan years, whether the loan is a demand or term loan. However, actual rates may vary and may be higher or lower than illustrated. Thus, the actual accrued interest cost for any plan year and the actual aggregate total accrued interest cost of the plan may be more or less than illustrated.
6. The side fund is an accumulation of assets inside the trust, growing at the rate of investment vehicles.

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