Premium Financing

AN ASSET-LEVERAGING STRATEGY TO CAREFULLY CONSIDER

ADVANCED PLANNING

Life Insurance

Prudential

The Prudential Insurance Company of America

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Carefully Consider a Premium Financing Arrangement

Premium financing isn't a strategy for everyone. Because these are complex transactions, tax and legal counsel should be engaged to determine if your circumstances can benefit from employing this course of action. If you're considering this strategy, the complexities and risks involved require a fluent understanding of financial matters. In addition, you should:

- Understand that most financial options are associated with both risks and rewards.
- Be experienced with financial arrangements that have more risk and/or complexity by their very nature.
- Be comfortable utilizing debt to fund significant transactions.

Affluent individuals often use life insurance for planning purposes, including when implementing strategies that apply to their estates and businesses.

What if there was a way to **purchase the life insurance you need** without liquidating other investments or significantly impacting your cash flow?

And, what if, when properly structured, this strategy also helped you to **efficiently transfer assets to your children, grandchildren, and favorite charities**, with a potential reduction in gift and estate tax costs?

Premium Financing May Be the Right Strategy

Premium financing combines the use of life insurance to address an estate or business need by borrowing money from a lending institution in order to pay life insurance premiums. Candidates for this strategy have the ability to pay significant life insurance premiums out of pocket, but understand leverage, particularly in a low interest rate environment.

PREMIUM FINANCING: THE POTENTIAL BENEFITS

If premium financing is right for you, it may provide you with several benefits:

- Lower out-of-pocket expense potential, as compared with traditional premium-paying methods.
- Gift tax savings when the policy is owned by your irrevocable life insurance trust (ILIT).
- Lower impact on your existing personal assets because you are not required to liquidate them in order to pay life insurance premiums. Further, these assets may continue to be employed in your existing strategy.

PREMIUM FINANCING: WHAT IT IS NOT

When considering if premium financing is right for you, it is important to understand what premium financing is not:

- It is not a way for you to find funds to pay premiums on a life insurance policy when your ability to pay such premiums does not otherwise exist.
- It is not a simple strategy.
- It is not a strategy that reduces the cost of the life insurance policy.
- It is not free life insurance coverage.

How Premium Financing Works

There are two aspects to premium financing

1. THE LOAN APPLICATION

The lender sets the terms of the loan, interest rate, transaction fees, collateral requirements, etc. The loan can be structured for the amount of the premiums only, requiring annual payment of the loan interest, or the loan can be arranged so you do not pay the annual interest, instead adding it to the loan principal. (Ordinarily loan interest will be paid and not allowed to accrue.)

2. THE LIFE INSURANCE APPLICATION

The application is reviewed, taking into account your medical history and financial profile in order to determine if the amount of life insurance is justified and you are insurable. Generally, fixed and indexed universal single life and second-to-die life insurance policies may be used in a premium financing arrangement. Variable universal life insurance may not be purchased when financing premiums.

Premium financing can be structured in a variety of ways, depending on your specific insurance needs, the parties involved in the transaction, and the terms of the loan arrangement. One of the most common scenarios is where there is a need to create liquidity outside of a taxable estate for such needs as servicing outstanding debt or offsetting the impact of taxation on the estate.

Generally, premium financing may follow these steps in an estate liquidity scenario:

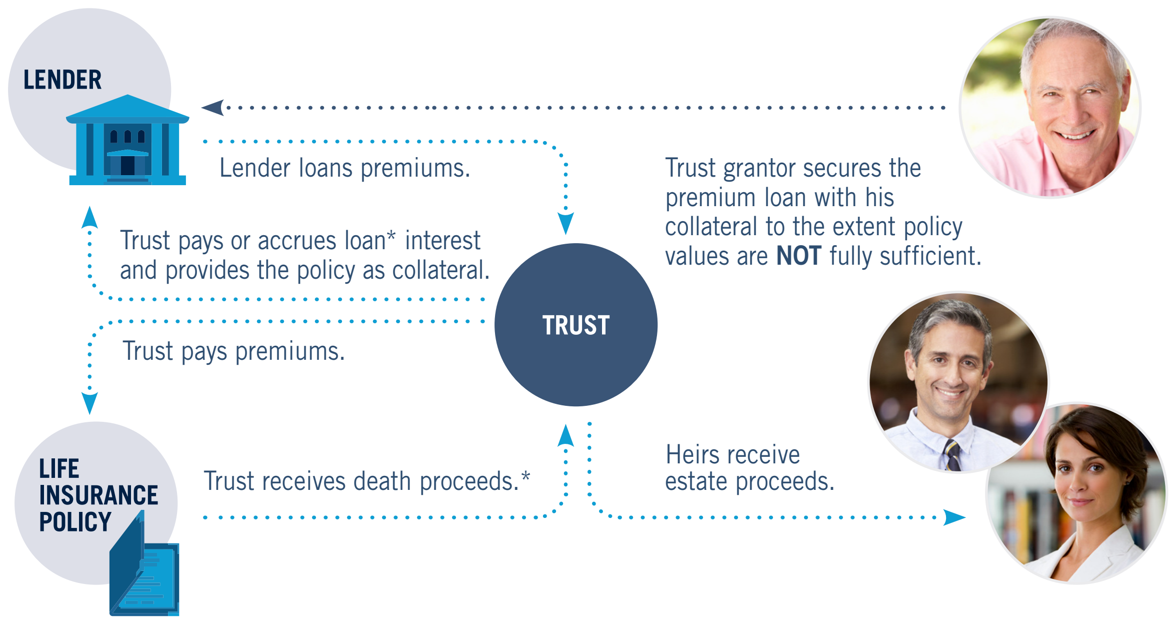
1. The insured/grantor works with tax and legal advisor to determine if the concept makes sense for the insured's/grantor's situation.
2. The insured/grantor establishes an ILIT to own the life insurance.
3. The insured/grantor and his or her tax and legal advisors implement the concept, which includes arranging for the financing to pay premiums.
4. The insured/grantor pledges the life insurance policy and additional assets at least equal to the outstanding principal and interest as collateral.
5. The ILIT borrows funds to pay the premiums due and collaterally assigns the policy to the lender in the event of premature death.
6. The ILIT pays premiums with the borrowed funds.
7. The insured/grantor will have demonstrated a plan or a strategy to exit the loan arrangement prior to death or at the time when the economics of the arrangement no longer make sense.
8. At the death of the insured, the trustee distributes proceeds to the heirs in accordance with the terms of the trust. Note that the grantor and insured cannot be the trustee of the ILIT.

ROLES

It takes a number of different individuals and organizations to implement a premium financing arrangement:

- **Legal and Tax Advisors**—Legal and tax counsel retained by the ILIT or insured/grantor. This role works to determine if premium financing makes sense for the insured's/grantor's situation.
- **Lender**—An institution that provides the financing for the transaction.
- **Insurance Professional**—An individual who helps to identify the insurance need and sells the life insurance policy.
- **Insurance Company**—The entity that provides the life insurance product being purchased.

Here's an illustration of how premium financing might work in a typical estate liquidity scenario.



**Death proceeds may be net of the loan balance, including any interest accrued, unless both are paid off prior to death. Prudential will require that an exit strategy be defined during the development of the case.*

There may be federal gift tax consequences associated with the funding of an Irrevocable Life Insurance Trust.

EXAMINING YOUR POSITION AS A PREMIUM FINANCING STRATEGY CANDIDATE

Candidates for premium financing are individuals with a high net worth who have estate or business planning needs. They can afford to pay substantial life insurance premiums, but desire to use their cash flow for other purposes. You will need to meet these standard requirements when considering a premium financing strategy:

- Individuals, businesses, or trusts with a substantial life insurance need.
- The life insurance requires an annual premium of $100,000 or more.*
- Paying premiums from investments would trigger capital gains and/or gift taxes.
- Have investments that can outperform the premium loan interest rate.
- In addition to qualifying financially, the insured will need to meet Prudential's medical underwriting standards.
- Exit strategy to unwind the loan arrangement.

**Lenders often set $100,000 as the minimum premium level for financing.*

Potential Risks

There are risks associated with premium financing that you should carefully consider with your tax and legal advisors. The major risks include:

1. INVESTMENT PERFORMANCE OF THE PLEDGED ASSETS

More assets than anticipated may need to be pledged to maintain the arrangement. This could happen when the value of the pledged assets is lower than expected or the costs of borrowing are higher than expected.

2. THE TERMS OF THE LOAN AND THE RELIABILITY OF THE LENDER

Lenders generally are not willing to make long-term commitments. This may mean that:

- You could face the prospect that the lender may decide to call the loan or choose not to advance additional funds to pay premiums, possibly forcing surrender of the policy or repayment of the loan from pledged assets and potentially triggering substantial taxes.
- You may be required to re-prove creditworthiness to keep the financing in place. If you do not qualify, the loan could be called, possibly forcing surrender of the policy or repayment of the loan from pledged assets and potentially triggering substantial taxes.
- The lender may renew the loan at an interest rate higher than anticipated, possibly causing the economics of the arrangement to no longer make sense. If the cost to borrow funds becomes greater than the earnings on assets held outside the trust, the economic viability of the concept is in jeopardy.

3. THE POLICY PERFORMANCE

In the event of premature death, it is important that the death benefit (net of loan principal and interest) be sufficient to meet your original life insurance objectives. Depending on the premium financing arrangement, the amount of the death benefit may be a crucial piece because it provides some, or all, of the funds to repay the loan, as well as minimize gift and estate transfers.

- If the interest credited on the insurance policy is less than expected, or the mortality and expense assumptions are unfavorably adjusted, then the policy may not support the original strategy objectives.
- Where the interest credited on the insurance policy is less than expected, there will often be a need for additional premiums and/or collateral. In the worst-case scenario, the policy could lapse and the loan would need to be repaid by liquidating the pledged collateral. This could trigger considerable taxable income. In addition, if the loan is a liability of a trust, repayment from pledged assets owned outside the trust may cause a significant taxable gift.
- If the insurance policy used as collateral is classified as a Modified Endowment Contract, all gain in the policy will be taxable each year as it accrues, including any applicable penalty tax.
- If the person insured lives too long, the loans may be much larger than anticipated, possibly exceeding the death benefit that can be paid under the policy.

4. "CROSS-OVER" POINT

The "Cross-Over" point occurs when the loan interest accumulates on the cumulative financed premiums to the point where it exceeds the actual annual premium payment.

It's important to understand that when the "Cross-Over" point is encountered, the economics of the financing arrangement may no longer make sense and you should consider terminating the loan arrangement.

So, what can be done to manage the risks associated with the "Cross-Over" point and other premium financing risks?

Premium Finance Exit Strategies

To manage the risks of a premium finance arrangement (including the "Cross-Over" point) will require that you have a plan to repay the loan—commonly referred to as an "exit strategy." These strategies are often formulated by your team of professionals, including your tax and legal advisors, who have an intimate understanding of your financial situation and can recommend a plan to pay back the financing in a way that's efficient for your unique circumstances. However, there are generally four ways to exit a premium financing arrangement. They are as follows:

1. Repay the loan using your own funds, not including the policy's cash values;
2. Use a combination of your own funds and the policy's cash values;
3. Use only policy cash values to repay the loan, but only to the extent the net cash value will be sufficient to maintain the policy to maturity;
4. Repay the loan using proceeds from the policy death benefit.*

** Prudential will require that an exit strategy be defined during the development of the case.*

Additional considerations to discuss with your tax and legal advisors:

- Assess a life insurance product's features to ensure it can respond to changes in loan interest rates.
- Determine whether it's possible for the loan to exceed the maximum death benefit payable.
- Consider a lender's financial soundness, commitment, and lending history using this strategy.
- Be prepared to pay premiums and pay off the loan at any time.

Determine If Premium Financing Is the Right Choice for You

There are many issues to weigh when considering premium financing. An arrangement like this is complex and may not be the right choice for your circumstances and overall financial goals. This is a strategy strictly reserved for the financially sophisticated who employ the advice and guidance of skilled tax and legal advisors. If you're comfortable with this type of borrowing strategy, premium financing may offer a way to achieve your financial objectives. For next steps, meet with your team of professionals to:

- Compare premium financing with other viable strategies.
- Develop an exit strategy to pay back the financing before entering the arrangement.
- Examine worst-case scenarios.