

John Hancock

LIFE INSURANCE

Private Financing



Funding solutions that stand the test of time.



Private Financing is a useful option when premiums of a large life insurance policy could result in unwanted gift taxes, even when the funds to pay premiums are available.

What is Private Financing?

Private Financing refers to a loan arrangement between you and an Irrevocable Life Insurance Trust (ILIT)¹ in which you make loans of annual premiums on a life insurance policy to the trust. Alternatively, the loan arrangement can be established between an existing entity of yours, such as a business or family limited partnership (FLP), and the ILIT.



How does it work?

You, or your existing entity, will make a loan to your ILIT, the beneficiaries of which are your designated heirs. Your ILIT uses the loan to purchase a life insurance policy on your life, or the lives of you and your spouse. The ILIT pays you or your existing entity, as its lender, interest based on the Applicable Federal Rate (AFR).² The loan is usually repaid with the death proceeds, although serious consideration should be given to repaying the loan principal during lifetime.

Why Private Financing?

The benefits of privately financing large premiums on a needed life insurance policy include:

1. **Minimizing Gift Tax:** Gift taxes can be significantly lowered or avoided through use of a loan. If gifting to the trust is needed, it can be limited to the amount of interest paid by the ILIT.
2. **Taking Advantage of Low Interest Rates:** Privately financed loans are usually based on the 3-9 year mid-term AFR. It may also be possible to lock in a low rate on a lump-sum loan made to the ILIT. The ILIT can then use the loan to fund annual premiums.

The chart below shows a comparison of the Applicable Federal Rates (AFR) published by the government from February 2007 through February 2009 (rates are subject to change on a monthly basis).

DATE	SHORT-TERM	MID-TERM	LONG-TERM
February 2007	4.93%	4.69%	4.86%
February 2008	3.11%	3.51%	4.46%
February 2009	0.60%	1.65%	2.96%

3. **Keeping Loan Principal in the Family:** The principal will be repaid to you as the intra-family lender (and it will be subject to estate taxes to the extent that it forms part of your estate).³ Loan collateral requirements and other loan risks typical of commercial lending may not apply when the loan is privately financed.
4. **Providing Flexibility:** Loans may be made by an existing business, family limited partnership (FLP) or possibly a trust, and may be made annually or in a single lump sum.

Considerations

1. Cash flow must be available to make the loan.
2. The loan repayment may be subject to estate tax if you are the lender.
3. Loan interest payments will be subject to income taxes if the lender is a trust or partnership.

Tax Consequences

INCOME TAXES

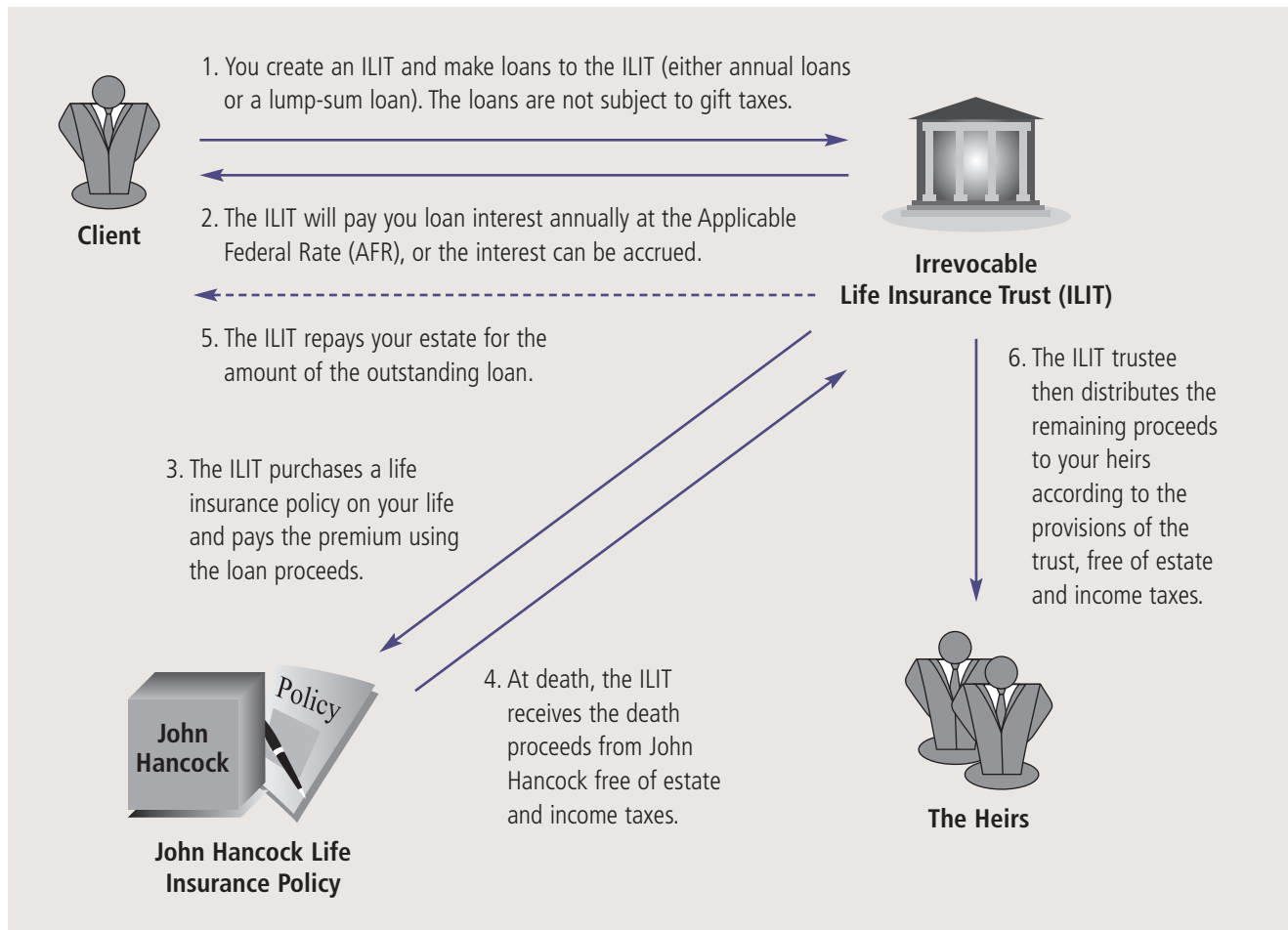
- If you are the lender, the ILIT should be set up as a “Defective Grantor Trust” so that there is no income taxation on the loan interest paid to you.
- If the lender is a trust, it will pay income tax at the trust tax rate on payments of loan interest unless it distributes that interest to its beneficiaries. In the case of such distributions, the trust beneficiaries will be taxed at their individual rates.
- Where the lender is a partnership, the limited partners will share responsibility for income tax on the loan interest as they would for any other partnership income.

ESTATE TAX

- If you are the lender, the loan principal will be paid to your estate and will be subject to estate tax.
- Where the lender is a trust, loan principal will not be subject to estate tax as long as the lending trust is not includible in your estate.
- If the loan is made by a partnership, loan principal becomes a part of each partner’s estate in proportion to their interest in the partnership.

Return of Premium Rider

The Return of Premium (ROP) rider on Universal Life policies results in the addition to the death benefit proceeds of a percentage (between 1% and 100%) of the total premiums paid. This feature helps to ensure that there is sufficient death benefit to repay the loan without depleting the amount of insurance protection required.⁴ In most Private Financing cases, it is not necessary to replace 100% of premiums since heirs will typically receive the loan repayment, net of estate tax. To lower the plan design cost, a 50% ROP, for example, may be sufficient.



Summary

Where liquidity presents no issues, Private Financing provides an effective means to maximize the amount ultimately available to heirs.

For more information about Private Financing or to see if this is the right type of arrangement for your situation, please consult your financial advisor.

1. Trusts should be drafted by an attorney familiar with such matters to take into account income, gift, and estate taxes, including generation-skipping transfer taxes. Failure to do so may result in adverse tax consequences.
2. The AFR is published monthly by the IRS. Its use helps to establish the arrangement as a fair market loan. If an interest rate less than fair market is used, income and/or gift tax may be due on the difference between interest paid at fair market rate and the actual rate used.
3. In a Private Financing situation, where the grantor is providing a loan to an irrevocable trust, it may be advisable for the trust to provide collateral for the loan. In order to establish that the Private Financing loan is a legitimate transaction, the following factors are often considered by the IRS: 1) if there is a promissory note or other evidence of indebtedness; 2) if interest was charged; 3) if there is any security or collateral for the loan; 4) if there is a fixed maturity date for the loan; 5) if a demand for repayment was made; 6) if actual repayment was made; 7) if the transferee had the ability to repay the loan; 8) if records reflected the transaction as a loan; and 9) if the transaction was reported for federal tax purposes as a loan.
4. The Return of Premium (ROP) rider allows clients to select a percentage of the premiums paid to be returned to the beneficiaries in addition to the death benefit. The rider increases the policy death benefit each year by the selected percentage until the insured reaches attained age 100. There are no further increases after age 100. There are costs associated with the ROP rider, as well as limitations on the cumulative amount that can be returned. Not available in conjunction with certain other riders.

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Insurance policies and/or associated riders and features may not be available in all states. Some riders may have additional fees and expenses associated with them.

Guaranteed product features are dependent upon minimum premium requirements and the claims-paying ability of the issuer.

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Not FDIC Insured	Not Bank Guaranteed	May Lose Value
Not a Deposit	Not Insured by Any Government Agency	