Concept Profile

The Risks of Non-Recourse Premium Financing

One of the latest sales concepts in the life insurance industry is Non-Recourse Premium Financing (NRPF). You may have already heard of such plans, or even been approached to purchase one. However, while NRPF may at first seem like a good way to secure inexpensive life insurance coverage for two years, in the long run it could be a poor choice for you and your family. Before you decide to apply for a NRPF insurance policy, you need to fully understand how it works and the risks you run should you chose to participate in such an arrangement.

WHAT IS NON-RECOURSE PREMIUM FINANCING?

Non-Recourse Premium Financing (NRPF) is a program that uses life insurance on your life as an investment for others rather than simply a wealth protection tool for your benefit. With this approach, an investor will lend your irrevocable life insurance trust (ILIT)[1] the premiums required to fund a large life insurance policy on your life. In return, your trust typically will be charged a high rate of interest, in the range of 9%–15%. In most arrangements, the interest payment is deferred and the investor will require that the cumulative loan, including the accrued interest, be repaid by your ILIT at your death or at the end of two years. So, if you die within the two year loan term, the death benefit will be used to repay the loan, interest, and any fees, and your ILIT will receive the remaining proceeds. If you do not die during this time period, your trust must pay off the loan, interest, and fees from other funds, or (since the note is non-recourse) your ILIT can decide to release the policy to the investor. In this case, the investor can then decide to maintain the policy on your life or sell it to another investor for profit. NRPF is sometimes referred to as "stranger owned life insurance," or SOLI, because the death benefit will ordinarily be payable to some person or entity unknown and unrelated to you and your family.

WHY DO INVESTORS MAKE THESE LOANS?

Given low interest and bond yields, third party investors, including domestic and foreign hedge funds, institutional investors, and viatical (life settlement) companies, are increasingly investing in life insurance policies because of the attractive returns they offer. In addition, even charities and foundations have taken an interest in investing in life insurance policies to increase returns and make up for a drop in charitable gifts. In the opinion of the investors making these loans (which are unsecured except for the life insurance policy itself) the benefit payable on death offers a better return than can be achieved with traditional investments with similar risk. In effect, these investors believe they can profit on the insured's death.

WHAT ARE THE RISKS IF I PARTICIPATE IN A NRPF PLAN?

While NRPF may at first sound like a good way to secure inexpensive insurance coverage for a few years, it comes with many risks.

Ownership Issues — If you decide not to repay the loan at the end of the term period, the NRPF company will own the policy on your life and collect the death benefit when you die. Before you enter into a NRPF plan, you need to consider if you are comfortable with strangers benefiting financially from your death while your own family may receive nothing. Neither you, nor the insurance company, can control to whom the NRPF company transfers the policy. There are few restrictions on the transferability of the insurance. In-force life insurance policies have even been known to sell on the Internet!

Keeping The Policy — At the end of the loan period, you may decide that you want to pay off the loan and keep the policy. However, you will owe more than just the premiums you borrowed. The loan interest rates charged by NRPF companies are often very high and there are sometimes contingent fees and charges to discourage repayment of the loan. Will you be able to afford to pay off the loan? Even if you can repay it, could you have obtained the coverage for less?

Insurability Issues — If the NRPF company keeps the policy on your life, you may be unable to secure the additional insurance coverage you need, or have to pay significantly more for it. Your insurability status may have changed, and you may now be uninsurable or highly rated. Even if you are still in excellent health, insurance companies may not have the ability to offer you more coverage. The insurance industry limits the amount of life insurance it will provide on each insured (called "capacity") so that they do not face too great an exposure if any one person dies. Since the NRPF policy on your life is still in effect, it is using up your capacity and the insurance company may not be able to offer you more coverage. As a result of mergers and consolidations, individual capacity has declined in the recent years. In five years, if your situation changes, will the NRPF deal stop you from buying coverage on your life for business or family needs?

Tax Issues — If you decide not to repay the loan and let the NRPF company keep the policy on your life, the IRS may determine that the difference between the value of the policy and the outstanding loan amount represents a "release of indebtedness," and hence is taxable to you.[2] The amount of this potential tax expense is complicated by the uncertainty over the value of the existing life insurance policy. While you may be obliged to pay the taxes, you won't have received any cash from the NRPF company to help offset this cost. Additionally, NRPF arrangements may face future IRS review, similar to the scrutiny charities are under for similar arrangements used in the charitable arena.[3] Are the benefits of NRPF worth enough to you to offset the possibility of scrutiny by the IRS?

Other Issues — The area of NRPF is so new and untested that other issues may emerge to reduce its benefits to you. For instance, it is possible that if the insurance company did not know about the NRPF agreement prior to issuing the policy, they could successfully contest the life insurance death benefit. Furthermore, the SEC may determine that such plans constitute a non-registered securities transaction. Do you really want to take these risks?

To truly protect your family from these risks, you may be better off buying the policy outright and ensuring your family will be covered.

CONCLUSION

While Non-Recourse Premium Financing may have some benefits, it is very new and untested from a tax perspective, and filled with risks. Before you participate in such a program, you should carefully weigh these risks and decide exactly whom you would like to protect if anything should happen to you: unknown "investors" or your family.

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. IRC §108(d)(3)
3. Although there is no legal guidance on the NRPF Plan, legislation (S.993) has been introduced in the Senate to penalize abuses involving life insurance contracts and tax-exempt organizations. This legislation follows up on a proposal addressing charities and investor owned life insurance included in the President's 2006 budget proposal. This legislation is being introduced in response to a growing concern that promoters are using life insurance contracts and the charitable insurable interest statutes in many states to obtain inappropriate benefits for private investors.

Individuals interested in this topic should consult with their own professional advisors to examine legal, tax, accounting or financial planning aspects of this topic.

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