PERSPECTIVE
FINANCIAL GROUP LLC

M INTELLIGENCE

M Intelligence pieces are designed to enhance understanding of sophisticated planning strategies and their applications.

M Financial Group continues to lead the industry in life insurance due care and client advocacy, providing valuable insight and analysis that delivers significant value to clients.

What is a Collateral Assignment?

Overview

A collateral assignment pledges a permanent life insurance policy's cash value and death benefits to another party and is most commonly used to secure a loan taken out by the policyowner. A collateral assignment primarily serves to protect the repayment interest of the lender.

Policy Ownership Rights

Policyowners have many rights in a life insurance contract:

Life Insurance Policy Ownership Rights
Surrendering the policy for its cash value
Taking policy distributions in the form of withdrawals and policy loans
Electing a non-forfeiture option
Designating primary and contingent beneficiaries
Electing dividend options (participating whole life)
Electing settlement options (how policy death benefits will be paid)
Exchanging the policy for another
Requesting reinstatement of a policy after lapse
Assigning the policy, in whole or in part, to another party

An assignment of all rights in a policy is considered an absolute assignment; this would essentially constitute a change of policy ownership. An assignment of specific rights, such as the right to cash values only, is referred to as a limited assignment.

An assignment provision within a life insurance policy specifies the conditions under which the policyowner may make an assignment. The purpose of this provision is to ensure the life insurance company is aware of the assignment in order to eliminate future disputes. A sample assignment clause might state:

> *You may assign this policy if we agree. We will not be bound by an assignment unless it has been received by us in writing at our home office. Your rights and the rights of any other person referred to in this policy will be subject to the assignment. We assume no responsibility for the validity of an assignment. An absolute assignment will be the same as a change of ownership to the assignee.*

Use of Collateral Assignments to Secure a Bank Loan

When a loan is made to an individual or a business, a lender typically requires the loan to be secured by collateral. Life insurance is an excellent form of collateral when the borrower is also the insured in the policy. If the insured dies unexpectedly, the lender will receive repayment from the insurance policy death benefit directly from the insurance company. Many commercial banks require the collateral assignment of a life insurance policy for personal or business loans during the loan term.

Use of Collateral Assignments in Life Insurance Planning

In many situations, life insurance policyowners use borrowed funds to pay premiums on the insurance policy. In addition to loans from a bank or commercial lender, policyowners often receive advances from an employer to facilitate the purchase of life insurance for wealth transfer, business succession, or executive benefit purposes. Intra-family loans are also commonly used when larger life insurance policies are owned by an Irrevocable Life Insurance Trust as a technique to fund the insurance policy while minimizing transfer taxes.

Establishing and Releasing a Collateral Assignment

In each of these situations, a collateral assignment of the life insurance policy is made to protect the lender's right to be repaid. A valid assignment will give the lender priority access to policy cash values and/or death benefits over the policy's beneficiaries.

In order to ensure the assignment is recognized by the insurer, the policyowner provides the insurer with a written document or uses the insurer's own collateral assignment form.

Collateral assignments are released by the lender when the debt is repaid, forgiven, or otherwise terminated. When this occurs, the insurance company is notified in writing by the asignee and will normally send written confirmation acknowledging the release to the policyowner.

A Special Consideration for Modified Endowment Contracts

Life insurance policies that fail to meet the definition of life insurance under Section 7702 of the Internal Revenue Code will be reclassified as Modified Endowment Contracts (MECs). Once a contract has been classified as a MEC, it will forever be deemed a MEC, and any contract it is exchanged for will be deemed a MEC.

Consequences of a MEC

- Generally, lifetime distributions from MECs are taxable as ordinary income until the distributions exceed the gain in the MEC (i.e., on a Last In, First Out basis).
- A 10% penalty is imposed on the includible amount of the MEC distribution, with limited exceptions (e.g., the MEC owner is disabled or older than 59½).

Collateral Assignments of a MEC

Pledges of MECs as collateral for loans could potentially trigger income tax consequences. Policyholders should consult their tax and legal advisors before assigning a MEC.

Summary

Collateral assignments used in connection with a life insurance policy can be extremely useful in securing loans. When an insurer has been notified of a collateral assignment, they have a legal duty to protect the lender's interest in the policy. Working with an experienced life insurance professional can ensure collateral assignments are used appropriately and insurers are properly notified.

For More Information

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A modified endowment contract ("MEC") is created when the amount by which the contract death benefit exceeds the policy cash value or "amount at risk" is less than the minimum allowed by the IRS. A MEC does not receive the same beneficial tax treatment as a life insurance contract. Also, if a life insurance contract becomes a MEC while inforce, the policy holder may be subject to additional taxes and penalties.

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