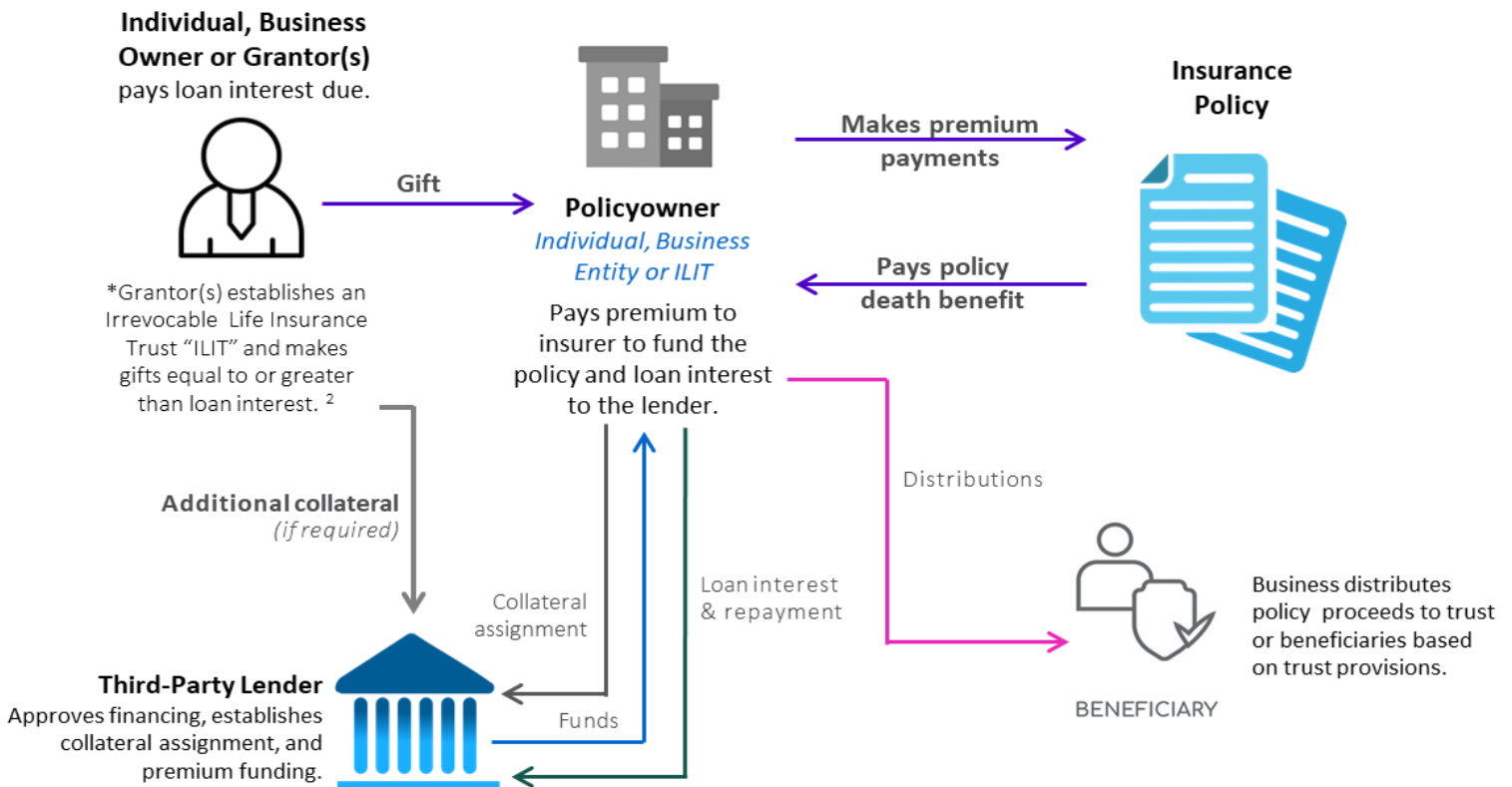


Premium financing is usually set up between a reputable third-party lender and an individual, a business owner, or an Irrevocable Life Insurance Trust (ILIT). Depending on who owns it, you, a business, or trustee will buy life insurance on your life – or on the lives of you and your spouse – and pay for the premiums with a loan from a third-party. The policyowner uses the life insurance policy as collateral for the loan, and other assets can be used as collateral if needed. Interest on the loan is paid to the lender by the policyowner throughout the loan period. The interest rate on the loan will vary each year and is typically based on the Secured Overnight Financing Rate (SOFR)<sup>1</sup> plus an additional amount for the duration of the loan.

When the insured person dies, the policy will pay out the death benefit. This money will be used to repay the lender the remaining loan amount. The remaining money will be given to the beneficiary(ies). Ideally, the loan should be repaid while the insured person is still alive using other assets or a combination of the policy's cash value and other assets. If approved, the policy and other assets used as collateral will be returned by the lender.

## How Premium Financing Works



## Potential Benefits of Premium Financing

- Fund or pay for significant life insurance coverage for estate planning or business succession purposes.
- Increase liquidity - death benefit proceeds can provide necessary liquidity to beneficiaries or businesses and, if properly structured, paid outside of the grantor's taxable estate.
- Retain assets – premium financing can help avoid liquidating assets to fund insurance premiums.
- Defer income and/or capital gains taxes - liquidated assets may be subject to income or capital gains taxes whereas borrowing funds via a finance structure to pay premiums can help defer recognition of gains on appreciated assets until such time as those assets can be properly liquidated in a tax-advantaged manner via death and provide a step-up in basis.

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## Understanding Loan Collateral

In all cases, third party loans must be 100% collateralized. The policy's cash value will be the primary source of collateral assigned to the lender. However, additional collateral may be required if the policy's cash value is not sufficient to cover the outstanding loan balance at any point in time. The collateral assignment provides a security interest for the lender in both the life insurance death benefit and the policy cash value. If the policy's cash value exceeds the third-party loan amount at any time in the future, you cannot access the policy values unless the lender allows.

### Types of collateral

When a lender requires collateral in addition to the life insurance policy, only liquid assets will be accepted. These assets can be liquidated by the lender at any time if the loan is in default. Acceptable forms of additional collateral vary by lender and may include:

- Marketable securities (valued at lender's discretion).
- Certificates of deposit (CDs) and money markets.
- Cash surrender value of other life insurance policies.
- Other cash equivalents such as treasury bills, commercial paper and short-term government bonds
- A letter of credit from a bank approved by the lender.

Lenders will monitor and evaluate the collateral requirements during the term of the loan. If there is a shortfall, you may be required to provide additional collateral.

## Loan Exit Strategies

An exit strategy or repayment plan is a key element to help reduce the possible risks of the premium finance arrangement. Several strategies are available:

### Policy cash values

If the policy has cash value that exceeds the outstanding third-party loan balance, and the lender agrees, you can withdraw and/or borrow policy cash values to repay the third-party loan value. Typically, the third-party lender will allow access to the policy's cash value to repay any outstanding loans. The distribution of policy cash values will reduce the death benefit and may cause the policy to lapse.<sup>4</sup>

### Retained business or other capital

Business or other assets that have been retained through the borrowing of funds, or cash flow generated from the sale of assets, can be used to repay the loan.

## For estate planning needs properly structured outside of your estate in an ILIT:

- **Minimize gift taxes** - Gift taxes on policy premiums may be minimized or eliminated when the policy is owned by an irrevocable trust, as third-party loans made to the ILIT to pay premiums may not be subject to gift taxes.<sup>5</sup>
- **Leverage gifts** - Third-party interest due is typically lower than the annual premium during the early years of the arrangement, which may provide opportunities to use annual exclusion and lifetime gift tax exemptions to make additional gifts or transfer other assets free of gift and estate tax.<sup>6</sup>
- **Other ILIT resources** - The ILIT may repay the outstanding third-party loan from other trust assets.
- **Additional gifts** - Over time, additional gifts can be made to the ILIT in the form of payments that fall within the annual gift tax exclusions and/or the lifetime gift tax exemptions in order to repay the third-party loan.<sup>7</sup>

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## Key Risks and Considerations

- **Loan interest rates** are established by the lender on an annual basis and can increase, which could result in higher loan interest payments than originally anticipated.
- **Policy performance** - lower than anticipated performance may require additional borrowing to fund the policy. Policy interest crediting rates can fluctuate, and thus require that you post additional collateral for the third-party loan.
- **Collateral** (additional) may be required based on the performance of the policy and other pledged assets. If the loan enters default, the assets pledged as collateral (in addition to the policy's cash value) may be called and possibly lost.
- **Tax treatment of loans** - for individuals, funds borrowed to pay premiums are generally classified as personal interest and not deductible for income tax purposes.<sup>8</sup> Businesses may have different circumstances.
- **Modified endowment contracts (MECs)** – pledging a policy that has been classified a MEC as collateral will be treated as a distribution from the policy, even if no actual distributions have been made. In this case, any policy cash value in excess of the basis (premium paid) is taxable as ordinary income. Additionally, an additional 10% tax may be imposed to the extent there is gain in the contract if the owner of the policy is under age 59 1/2.<sup>9</sup>
- **Personal guarantee** - the lender may require a personal guarantee from an individual who is also the trust grantor. The personal guarantee of the third-party loan may cause gift or estate tax consequences. You should consult with your personal tax professional for more information.<sup>10</sup>

## Is Premium Financing Right for You?

### **A premium financing strategy may be appropriate if:**

- You have a substantial need for life insurance.
- You do not want to liquidate assets to generate cash flow.
- You wish to minimize or eliminate potential gift taxes for estate planning needs.

Information herein is not intended for use as investment advice. It does not take into account specific investment objectives or the financial circumstances of any individual. Before considering any financial transaction you should consult your licensed financial professional.

<sup>1</sup> The Secured Overnight Financing Rate (SOFR) replaced LIBOR in June 2023 as a benchmark interest rate used by banks to price U.S. dollar denominated loans. SOFR rates are published daily by the New York Federal Reserve.

<sup>2/3</sup> Any gift to an ILIT that is intended to be a present interest and completed gift must be made to an ILIT, which contains Crummey power language. The applicable federal estate tax exclusion amount (indexed for inflation) is \$12.92 million per individual in 2023. In 2023, the lifetime gift tax exemption and generation-skipping transfer tax exemption is \$12.92 million (indexed for inflation) and the maximum tax rate for both of these taxes will be 40%. (Source: "Frequently Asked Questions on Gift Taxes," IRS, accessed Aug. 2023 <https://www.irs.gov/businesses/small-businesses-self-employed/frequently-asked-questions-on-gift-taxes>). For current information and an assessment of your particular situation, please consult with your tax professional.

<sup>4</sup> Policy loans and withdrawals are only available prior to the death of the insured(s) and will reduce the policy death benefit and cash value. This pay cause the policy to lapse and may be taxable. Withdrawals or loans on modified endowment contracts (MECs) may be subject to federal income tax and an additional 10% tax on amounts taken prior to age 59 ½.

<sup>5</sup> Refer to footnote 3 for source information. You should consult with your own tax or legal professional concerning your particular situation.

<sup>6</sup> See private letter ruling (PLR) 9809032. The IRS found that life insurance proceeds payable to a trust were not included in the insured's estate when an ILIT created by the insured had borrowed funds from the insured to pay the premiums. IRS private letter rulings do not constitute legal precedent and can be relied on only by the taxpayers who received them.

<sup>7</sup> Refer to footnote 3 for source information. You should consult with your own tax or legal professional concerning your particular situation.

<sup>8</sup> Interest on indebtedness to acquire or maintain a life insurance policy is generally considered personal interest and usually not deductible. Refer to IRC Section 1639h) and IRC Section 264(a).

<sup>9</sup> Refer to Internal Revenue Code (IRC) §72€(10) and IRC §72€(4)(A).

<sup>10</sup> Refer to Internal Revenue Code (IRC) §2033-2045 and Private Letter Ruling (PLR) 9113009.

**May not be approved in all Financial Institutions. Financial Professionals should check with their Broker Dealer for guidelines and approval prior to recommending a premium finance strategy to their client.**

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