Estate Planning Opportunities in the Low Interest Rate Environment

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COVID-19 has created havoc for financial markets around the globe. As the United States Unemployment Rate is approaching Great Depression levels and the Gross Domestic Product (GDP) continues to be revised downward, it's difficult to find any economic positives in the current environment. However, perhaps a silver lining that can be gleaned from the current economic situation is low interest rates. While mortgage rates are at historic lows and the rate of refinances of existing mortgages appears to be strong, there are additional planning opportunities that may not be quite as apparent.

Each month, the government sets minimum interest rates that the Internal Revenue Service (IRS) allows for private transactions. Generally, if a loan includes a rate lower than these published rates, the transaction would lead to tax consequences. This set of rates is known as the Applicable Federal Rate, or AFR. Three rates comprise the AFR, including short-term (3 years or less), mid-term (more than 3 years up to 9 years) and long-term (more than 9 years). The AFRs released for June, 2020, are at historic lows. The specific rates are shown in the chart below.

Applicable Federal Rates (AFR) for June 2020	
Short-Term	.18%
Mid-Term	.43%
Long-Term	1.01%

For a high-net-worth client with significant estate tax and liquidity concerns, it is common to implement a gifting strategy in conjunction with an irrevocable life insurance trust (ILIT). The client gifts the annual exclusion amount to the ILIT, and the trustee leverages the gifts into the much larger, liquid sum provided by a life insurance death benefit. However, if the client's available annual exclusions are insufficient to cover the entire life insurance premium, the trust would need additional funds to meet the premium obligation. Rather than using part of the client's lifetime gift & estate tax exemption, today's low interest rate environment makes private financing a worthy alternative.

Private financing is one of the simplest strategies relying upon low interest rates. While there are many variations of this strategy, it generally involves a loan arrangement between a grantor and his or her ILIT, where the grantor loans funds to the ILIT in exchange for a promissory note with interest charged at the relevant AFR. The ILIT trustee has the necessary funds to pay the life insurance premium each year as well as the necessary interest to pay to the grantor. If the trust invests the borrowed principal, the return may be used to provide additional funds for these obligations during the grantor's lifetime. Given the low rates illustrated in the chart above, the trustee shouldn't have too much difficulty in securing investments that will outperform the current interest rates. The loan is generally extinguished upon the grantor's death through use of the life insurance death benefit, though the grantor could also decide to make use of his or her lifetime gifting exemption to pay off the loan.

This strategy is commonly implemented with a series of annual loans to the trust. The grantor would generally loan the exact premium amount to the trust in exchange for a new promissory note each and every year. This would also mean that interest rates on each annual loan will vary. To lock in today's historically low interest rates, for clients able to do so, may make a single lump sum loan to the trust. If the loan exceeds 9 years in duration, it currently allows for a 1.01% long-term interest rate. Consider the following case study illustrating this variation of the strategy:

<u>Case Study</u>

Andy and Beverly, a high-net-worth couple, have a liquidity need of approximately $3 million to address potential estate tax liability upon the death of the survivor of them. A $4.5 million survivorship life insurance policy requires 20 annual premiums of $53,000, and Andy and Beverly's only adult child, Charlie, is the sole beneficiary of their ILIT. Even if Andy and Beverly use their $15,000 annual exclusions ($30,000 combined) for Charlie to transfer funds to the trust, they would still have a $23,000 deficiency in gifting capacity without using their lifetime gifting exemptions. However, Andy and Beverly already utilize their annual exclusion gifts to transfer cash to Charlie, as they prefer to see him enjoy the gifts during his lifetime. To avoid disruption of this gifting program, other methods of transferring sufficient cash to the ILIT must be considered. Andy and Beverly don't want to use any of their lifetime gift & estate tax exemption, so they instead decide to loan $1.5 million to the ILIT in exchange for a 25-year promissory note and a 1.01% interest rate. The ILIT trustee uses the borrowed funds to pay the annual life insurance premium and the loan interest of approximately $15,000 owed back to Andy and Beverly. After Andy and Beverly pass away, the trustee uses a portion of the death benefit to pay off the $1.5 million promissory note and the remaining $3 million is used to address the estate's liquidity need. Andy and Beverly were able to secure the needed life insurance death benefit for their estate without using any of their lifetime gifting exemption.

Private financing allows significant flexibility in structuring the loan type and term. A more sizable annual premium will generally lead to a longer loan term. Additionally, it is quite common for the loan term to equal the number of premium payments required to fund the policy. In today's historically low interest rate environment, it would not be unusual to see clients lock in loans rates for the longest term possible.

While these are challenging financial times for many, the current interest rate environment provides opportunities for those looking to further fortify their estate plans. It is an unprecedented time for strategies such as private financing, sales to intentionally defective trusts, and grantor retained annuity trusts. Any of these strategies may be just the silver lining clients were seeking during these difficult and unusual times.