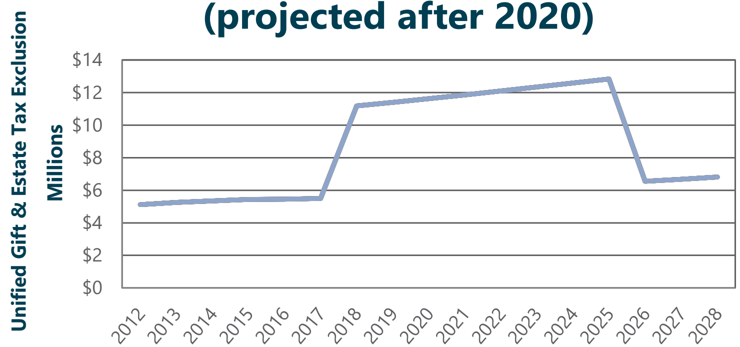
Private Finance: The Time is Now!

Interest Rate and Estate Tax Volatility: Are Your High Net Worth Clients Locking in Their Opportunities?

Private financing is a common estate planning technique that allows high net worth individuals to use the arbitrage between the minimum Applicable Federal Rate (AFR) for interest charged between related parties, and the rate of return on their investments, to pay the premiums on trust-owned life insurance with minimal use of their lifetime gift exclusion (absent a small seed gift). With interest rates now at record lows, the technique is well-positioned to allow clients to lock in today's rates while insuring against projected increases in the estate tax.

The left chart below illustrates the mid-term AFR, which is the interest rate applicable to private financing transactions where the loan term is greater than three but no more than nine years. As you can see, the rate is now considerably lower than its historic averages. Meanwhile, the exclusion from gift and estate taxes is currently at an all-time high, but projected to return to pre-2018 levels (albeit inflation-adjusted) in 2026. Changes in Washington, DC could cause the exclusion to be lowered sooner or further, however, with little notice.

Source: http://apps.irs.gov/app/picklist/list/federalRates.html



Source: https://www.irs.gov/businesses/small-businesses-self-employed/frequently-asked-questions-on-estate-taxes

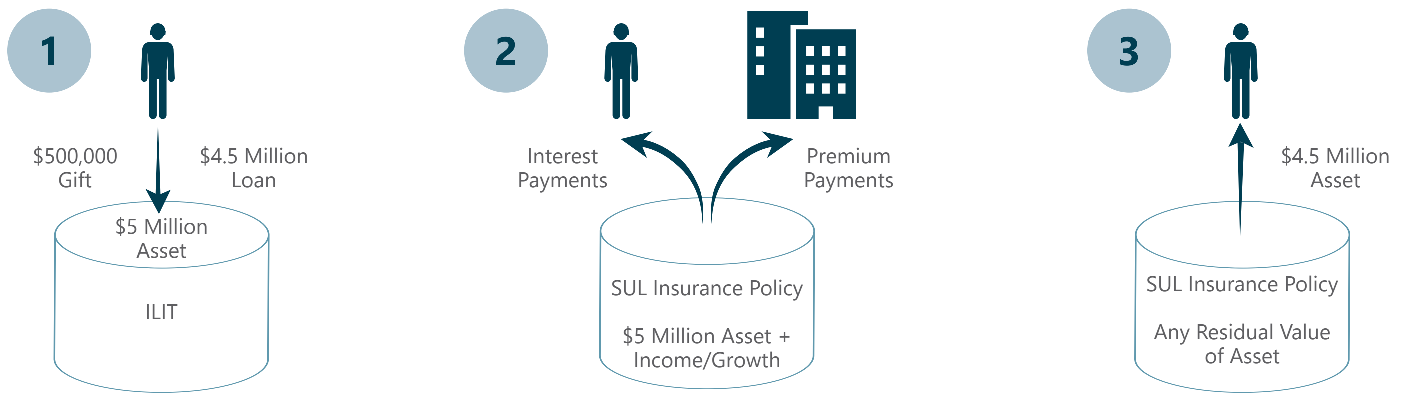
Who might take advantage of this opportunity? Many individuals have established gifting programs to use their annual exclusions to buy life insurance. Often, these policies are owned inside of Irrevocable Life Insurance Trusts (ILITs).[1] However, clients with large estates may have a need for larger amounts of life insurance than what can be purchased with their annual exclusion gifts and they may object to the significant gift taxes associated with gifting the additional dollars to the ILIT. Private financing may be able to provide an alternative method for funding these annual premiums. Generally, once the trust is established, the client can lend a sum of money to the trust. Because the loan is usually coming directly from the insured and going to his or her ILIT, collateral may not be required as it would be with a commercial loan. Once the loan is made, the trust will invest the assets. All income received over and above the required annual interest payment due back to the client could be used to purchase life insurance inside the trust.

Private financing also allows for flexibility and quick reaction to legislated changes to transfer taxes. If the exclusion amount were to be reduced on short notice, the client may forgive the loan to the trust and count it as a gift before the higher gift exclusion vanishes. On the other hand, if the estate tax were repealed, the trust could pay back the loan in part by transferring ownership of the policy to the client.

Case Study

Let's consider the example of a married couple, who are both age 65, in good health and expect to owe some estate taxes. How can they use private financing to purchase a life insurance policy to cover those taxes?

[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 treatment of trust proceeds.



1. One spouse—in our example, the husband—can set up an ILIT and fund it with a $5 million income-producing asset. But instead of immediately gifting $5 million, he treats $500,000 as a gift, and makes the other $4.5 million a loan. The ILIT, for purposes of this example, borrows $4.5 million of cash from the client and takes back a nine year, interest bearing recourse promissory note. The note is locked in at 0.41% interest for nine years,[2] with a balloon payment due at the end of the term.
2. The ILIT trustee manages the assets in the trust for income and earns a 5% rate of return.[3] The ILIT trustee also will purchase a Survivorship Universal Life policy on the clients' lives with a $10,795,125 face amount and $263,700 premium due annually for nine years.[4] The ILIT uses income and principal to pay interest back to the clients for the promissory note, and premiums to the insurance company.
3. When the balloon payment comes due—or sooner if desired—the trust may pay back the note by transferring $4.5 million worth of its current assets back to the clients. Any excess appreciation of the assets that isn't needed to pay interest or insurance premium stays in the ILIT, along with the paid-up SUL policy.

Assumptions

AFR Loan Interest Rate	0.41%
Trust Owned Asset Return	5.00%
Seed Gift	$500,000

The following table calculates the cash flow and value of this hypothetical plan.

Year	Loan Amount	Beginning of Year Asset Balance	Loan Interest Paid to Grantor	End of Year Loan Balance	Beginning of Year Annual Premium	Trust-Owned Asset Growth	E.O.Y. Trust-Owned Asset Balance	Life Insurance Death Benefit
1	$4,500,000	$5,000,000	$18,450	$4,500,000	$263,700	$236,815	$4,954,665	$10,795,125
2		$4,954,665	$18,450	$4,500,000	$263,700	$234,548	$4,907,063	$10,795,125
3		$4,907,063	$18,450	$4,500,000	$263,700	$232,168	$4,857,081	$10,795,125
4		$4,857,081	$18,450	$4,500,000	$263,700	$229,669	$4,804,600	$10,795,125
5		$4,804,600	$18,450	$4,500,000	$263,700	$227,045	$4,749,496	$10,795,125
6		$4,749,496	$18,450	$4,500,000	$263,700	$224,290	$4,691,635	$10,795,125
7		$4,691,635	$18,450	$4,500,000	$263,700	$221,397	$4,630,882	$10,795,125
8		$4,630,882	$18,450	$4,500,000	$263,700	$218,359	$4,567,091	$10,795,125
9		$4,567,091	$18,450	$4,500,000	$263,700	$215,170	$4,500,111	$10,795,125
10	($4,500,000)	$111	$0	$0	$0	$6	$116	$10,795,125

This strategy may be considered for those who have exhausted their lifetime credit or those who want to use that lifetime credit to gift other assets. Alternatively, if the clients later decide it is beneficial to treat the outstanding loan as a gift instead, they may forgive the note and report it as a taxable gift at the time of loan forgiveness.

For appropriate clients, private financing may present an excellent opportunity to put needed insurance in place. **For further information on this topic and other advanced concepts, please contact your Tellus Account Manager or Advanced Sales Director.**

[2] Based on the Applicable Federal Rate for mid-term loans in August 2020.
[3] Assuming the trust is considered a grantor trust for income tax purposes, the grantor may pay the taxes due on the ILIT's income at their usual marginal rates, and this does not constitute an additional gift. In addition, the ILIT's annual interest payments are received income tax free from the trust to the grantor.
[4] John Hancock Protection SUL, based on a 65 year old male at preferred non-tobacco and 65 year old female at preferred non-tobacco in the state of Michigan. Illustration run August 4, 2020.

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