Planning with Low Interest Rates – Strike While the Iron is Hot!

Summary

Low interest rates can provide a nice opportunity to pay for life insurance premiums by using loans, GRATs, CLATs, or installment sales. Given historically low interest rates, the time to use these techniques is now.

Related Information

Employer Loans to Employees to Buy Life Insurance *in brief*; A.P. Letter No. 180, Split Dollar Final Regulations: the Initial Analysis ; Grantor Retained Annuity Trust *in brief*; Split-Interest Charitable Giving Techniques *in brief*; Lifetime Charitable Giving *in depth*; Installment Sale to a Grantor Trust *in brief*.

For those who have been waiting for the right time to borrow or engage in other financing techniques to pay for life insurance premiums, wait no longer. The time for planning and for action is now. A window of opportunity exists because today's historically low interest rates have sharply reduced the cost for:

- using loans to finance new premiums on life insurance;
- refinancing prior loans;
- transferring funds to a grantor retained annuity trust (GRAT) or a charitable lead annuity trust (CLAT) as an exit strategy for premium financing techniques with an irrevocable life insurance trust (ILIT); and
- using an installment sale to purchase life insurance in an ILIT.[1]

Two different interest rates play a role here.

1. AFR. The first rate is the applicable federal rate (AFR), which is the minimum interest rate that can be used to satisfy the below-market interest rules under § 7872. How low is this rate currently? Pretty low – for example, the February 2013 annual mid-term AFR (used for loans with maturities of more than 3 years but not more than 9 years) is a mere 1.01%. And the February 2013 annual long-term AFR (used for loans with maturities of more than 9 years) is just 2.52%.

2. 7520 rate. The second rate is that which is found under § 7520, and is used to calculate gift tax values for gifts to GRATs, CLATs, and with other estate planning concepts. This rate is 120% of the applicable federal mid-term rate and thus is similarly low. This rate for February 2013 is 1.21%. The February rate is a slightly higher than the preceding seven

[1] See Advanced Planning publications, Grantor Retained Annuity Trust *in brief*, Split-Interest Charitable Giving Techniques *in brief*, and Installment Sale to a Grantor Trust *in brief*.

months, but is significantly lower than what it was in past years: it was 5.65% in February 2007, and 10.00% in February 1989.[2]

Loans

Premium financing can involve loans from employers or individuals.[3] Using a low interest rate translates into lower loan costs. The current low rates apply to new loans, but they also present a great opportunity to refinance existing loans. If AFRs begin to increase (as they most likely will at some point), the loan costs for new loans will rise. When this occurs, the parties might be able to structure the future loans with different loan maturity dates that can keep the average loan cost lower. This can be accomplished by selecting and locking in the best short-term, mid-term or long-term AFRs for each new or maturing loan to minimize the cost of future loans.

GRATs

How does a lower § 7520 rate maximize the benefits of a GRAT? Let's say Mom creates a GRAT and gives property worth $1 million to it and keeps the right to receive 5% annuity payments ($50,000 per year) for 10 years. At the end of the 10 years, any remaining GRAT assets pass to the beneficiary named in the GRAT – perhaps an ILIT which has borrowed money to pay premiums on a policy it owns. In this case, the ILIT can use the GRAT payout to help pay off the loan, or to pay future premiums. Mom's gift to the GRAT is the $1 million less the present value of the annuity payments, based on the § 7520 rate. The lower the § 7520 rate, the lower the value of the gift (and the more likely that the actual value of the property passing to the GRAT's remainder beneficiary, e.g., the ILIT, will be greater than what was subject to gift tax).

Numbers can tell the story better.[4]

	February 2013	**February 2007**	**February 1989**
§ 7520 rate	1.21%	5.65%	10.00%
Mom (age 60) gives to GRAT	$1 million	$1 million	$1 million
5% annuity payments	$50,000	$50,000	$50,000
GRAT term	10 years	10 years	10 years
Mom's taxable gift	$531,475	$624,920	$692,770

CLATs

Like a GRAT, a CLAT can have its remainder interest payable to an ILIT to help pay for any life insurance it holds. CLATs also work well with low interest rates, because a low § 7520 rate again reduces the value of the taxable gift (i.e., the remainder interest payable to the ILIT). A

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2 The March 2013 annual AFRs are: short-term, 0.22%; mid-term, 1.09%; long-term, 2.66%. The § 7520 rate for March 2013 is 1.40%. Rev. Rul. 2013-7.

3 Loans involving employers and employees generally fall within the treasury regulation definition of "split dollar," but not all loans fall within that definition. See, in particular, pages 21-30 of A.P. Letter No. 180, Split Dollar Final Regulations: the Initial Analysis; and Employer Loans to Employees to Buy Life Insurance *in brief*.

4 The values of the taxable gifts in the GRAT examples here are calculated by using the Estate Planning Tools software developed by Stephan R. Leimberg & Robert T. LeClair.

CLAT differs from a GRAT in that, with a CLAT, the lead annuity interest goes to a charity rather than back to the grantor, so charitable deductions are available.[5]

Installment sales

Another way to purchase insurance in an ILIT is with the help of an installment sale.[6] When a grantor sells an income-producing asset (e.g., S corporation stock) to an ILIT in exchange for a note, the grantor can lock in today's low rates for the term of the loan. Once the asset is in the ILIT, it will hopefully produce enough income to make payments on the note, *and* still have money left over to pay premiums on the ILIT-owned policy.[7] Of course, the lower the interest rate, the lower that the note payments back to the grantor will be, and the more likely it is that funds will remain in the ILIT to pay premiums (or to be used for other purposes). What's more, the relevant interest rate for an installment sale is merely the AFR for the term of the loan (short, mid, or long-term). This often is lower than the § 7520 rate – used for GRATs and CLATs – which is 120% of the mid-term rate.

Conclusion

Despite the different steps and considerations involved when using GRATs, CLATs, or installment sales, it's clear that low interest rates make it easier to finance life insurance premiums by lowering the financing cost or the gift tax cost. No one knows how long the current low rates will stick with us, so the time for planning is ... now!

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[5] See Advanced Planning publications, Lifetime Charitable Giving *in depth* and Split-Interest Charitable Giving Techniques *in brief*.

[6] See Advanced Planning publication, Installment Sale to a Grantor Trust *in brief*.

[7] The ILIT should generally be a grantor trust with respect to the seller of the asset. This results in there being no gain or loss recognized on the sale, and any income earned by the asset is taxed to the grantor (even though the income is paid to the ILIT).