ADVANCED MARKETS
Quick Concept

Global Atlantic FINANCIAL GROUP

Low Rates & Intra-Family Loans

Planning for High Net Worth Families

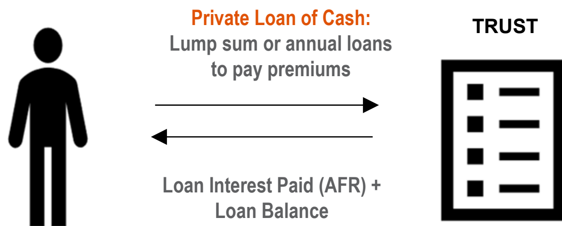
Interest rates have dropped yet again and high net worth (HNW) families have another opportunity to use the low rates to complete their wealth transfer planning and secure the right amount of life insurance. Since there is no telling when rates will rise, carpe diem is in order.

In a nutshell, HNW families can make loans of cash or assets to their heirs, or to a family trust for the benefit of heirs. Because the loans must be repaid, they are not taxable gifts. By making loans, parents have tremendous flexibility because the loan can be *repaid, refinanced or forgiven* later, depending on circumstances and tax law at the time. An intra-family loan approach offers families the luxury of time to decide *when and if* to make permanent gifts, without having to delay planning.

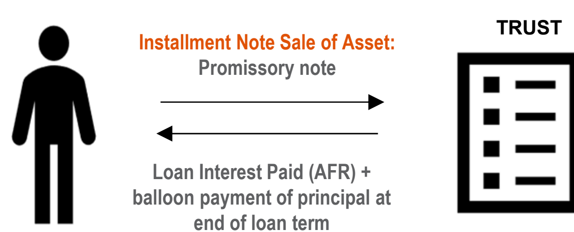
Where does life insurance fit in? Low rates mean **there can be more available from the trust's rate of return, net of the loan interest payments, to fund the life insurance.**

HOW AN INTRA-FAMILY LOAN WORKS:

Scenario A



Scenario B



The Applicable Federal rate (AFR) published by the government monthly is used to determine loan interest in private loan arrangements between family members and family trusts [1]. The charts below illustrate a combination of *assumed gross rates of return on trust assets* and the *mid-term AFR rates* (used for loans that are 3-9 years in duration). The difference between the return (often referred to as "arbitrage") and the AFR is what could be available to fund life insurance premiums.[2]

6% Hypothetical Rate of Return - August 2020: .41% loan interest = 5.59% left to fund insurance

Assuming 4% Growth Rate

Monthly AFR	Mid-Term AFR Rate	Potential Arbitrage
Jan '20	1.69%	2.31%
Apr '20	.99%	3.01%
May '20	.58%	3.42%
Jun '20	.43%	3.57%
Jul '20	.45%	3.55%
Aug '20	.41%	3.59%

Assuming 6% Growth Rate

Monthly AFR	Mid-Term AFR Rate	Potential Arbitrage
Jan '20	1.69%	4.31%
Apr '20	.99%	5.01%
May '20	.58%	5.42%
Jun '20	.43%	5.57%
Jul '20	.45%	5.55%
Aug '20	.41%	5.59%

Assuming 8% Growth Rate

Monthly AFR	Mid-Term AFR Rate	Potential Arbitrage
Jan '20	1.69%	6.69%
Apr '20	.99%	7.01%
May '20	.58%	7.42%
Jun '20	.43%	7.57%
Jul '20	.45%	7.55%
Aug '20	.41%	7.59%

[1] Assumes Grantor Trust so that tax on annual trust earnings are paid by grantor and not the trust, leaving more in the trust to do planning. Trusts should be assessed and drafted by an attorney familiar with matters.

[2] For a loan to be considered an arm's length transaction, **the IRS requires a fair market rate of interest be charged**. The government AFR rates published monthly are considered fair rates of interest. The AFR rate can be locked in for the term of the loan at the time the loan is executed. The short-term AFR rate is used for loans less than 3 years; the mid-term AFR rate is used for loans with a term of 3-9 years; and the long-term AFR rate is used for loans of more than 9 years. Interest can be paid annually, monthly or quarterly, or it can be accrued.

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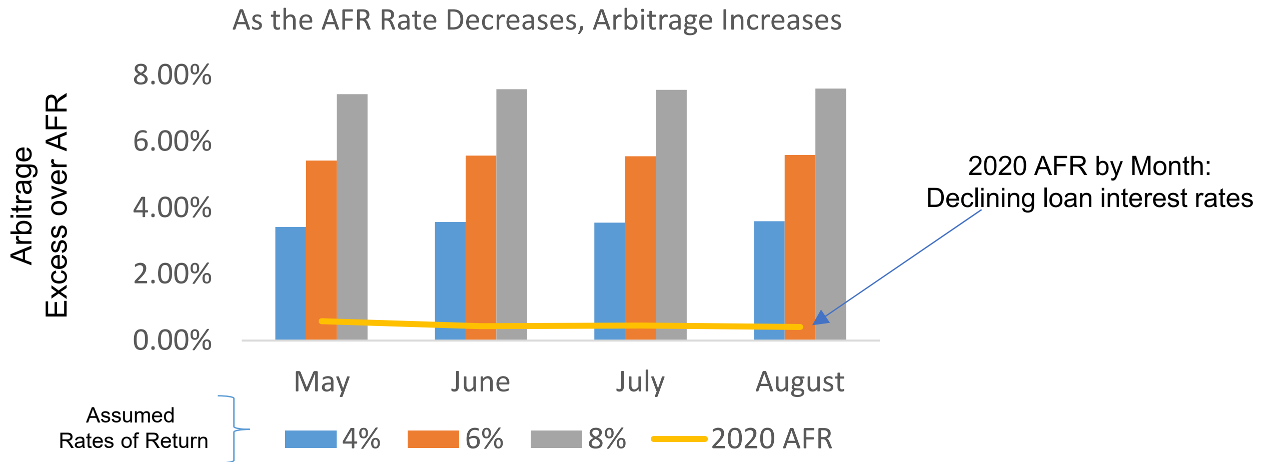

IT'S ALL A MATTER OF PLANNING AT THE RIGHT TIME

Assume a hypothetical client needs life insurance and the annual premium is $100,000 for 9 years. Sometimes clients don't want to part with large sums of cash to pay premium. In the right circumstances, making a loan to a family trust to pay the premiums may make sense. The loans can be made annually in the amount of the premium. Alternatively, the loan can be made in a lump-sum. The solve for the lump sum loan amount is based on the projected trust growth over the note term. The more growth that can go toward premiums and principal repayment, the lower the upfront loan amount that is required. The lower the AFR rate, the more there is left over from the trust's return to fund premium.

In the chart below, consider the lump sum loan required back in 2000 and 2007 when AFR rates were higher, compared to the loan required today to support 9 years of $100,000 premium payments along with the principal repayment, assuming a 6% trust rate of return. In December 2000 there is negative arbitrage, meaning 0.21% more in principal is required than the 6% return supports to fund all premiums. Compare this to the excess 5.59% available in August 2020 which decreases the principal amount of the loan by over $500,000 compared to 2000.

Assuming 6% Growth Rate

Monthly AFR	Mid-Term AFR Rate	Potential Arbitrage	Lump Sum Required
December 2000	6.21	-0.21%	$1,248,201
December 2007	4.58%	1.42%	$1,047,201
August 2020	.41%	5.59%	**$741,662**

The lump sum loan required is based on solving for the amount needed to fund 9 years of $100,000 of annual premiums and repayment of principal based on a 6% rate of return. Assumes the loan interest will be paid annually based on the mid-term AFR rate used for 9-year notes. Also assumes that the trust is drafted as a *Grantor Trust* which allows the trust income taxes to be paid by the grantors-- in this case assumed to be mom and dad.

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