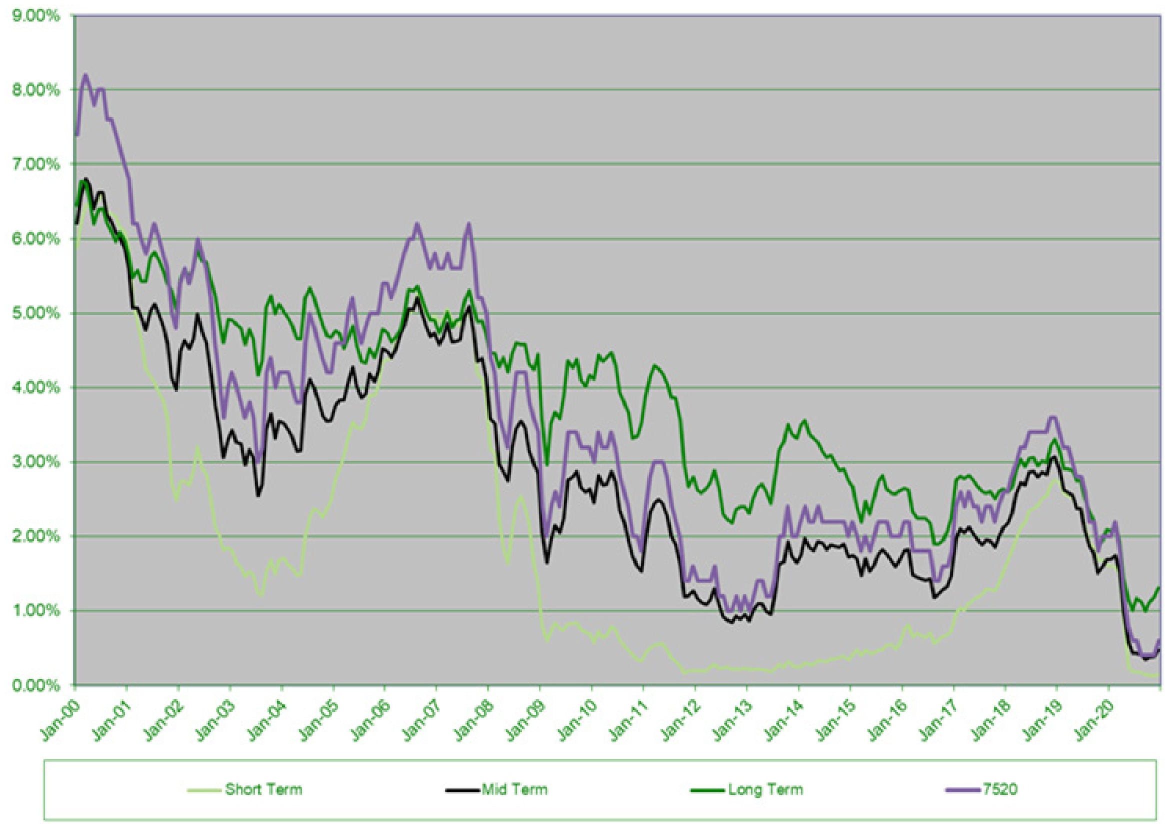
When the Interest Rate Bottoms Out, Opportunity Knocks

Historical AFR & 7520 Rates



Each month the IRS publishes the Applicable Federal Rate (AFR) that serves as the benchmark of market rate for private interest-bearing transactions. And since the start of the millennium that AFR has been in a steady decline, dropping from almost 7% in 2000 to just over 1% in 2020. Watching the AFR drop is more than an amusing pastime for individuals with a substantial net worth, it's also a signal that it's time to start examining those private interest-bearing transactions.

The most obvious and frequently utilized transaction is the private loan, generally between an individual and a trust that the individual created. Under this private loan model, the individual lends assets to the trust, then the trustee invests the assets and utilizes those assets, or the income off of those assets, to meet the trust's goals, which are often the purchase of life insurance. As a general rule of thumb, if the trustee is just utilizing the income from the assets there needs to be at least a 3% spread between the income generated by the asset and the AFR in effect for the loan.

When the AFR is 6.5% those lent assets have to work really hard to overcome that 3% spread, but would barely notice the spread on a 1.5% AFR. Of course, if the asset generates more than 3% over the AFR, the excess income becomes the trust's asset, effectively removing that excess income from the lender's taxable estate. The private loan transaction has become particularly popular in 2020 because historically low AFRs are combined with historically high, yet temporary, gift and estate tax exemptions. In 2020, an individual can transfer up to $11.58M without paying a gift or an estate tax. However, under current tax law, this exemption will be cut in half by the end of 2025.

Given the size of the exemptions and their temporary nature, wealthy individuals are looking for transactions that put them in the position of being able to use the exemption in the future, right before it's reduced. Which is where the private loan comes in. These individuals can enter into a loan today, utilizing the low AFRs, and then just wait to see what happens with the gift and estate tax exemption. Because the AFR is so low, it is possible to allow the loan transaction to continue as originally designed with the trustee repaying the loan balance at the end of the loan's term. Or the lender can forgive the entire loan should they decide to utilize their gift tax exemption.

By capitalizing on today's low AFRs, individuals are able to give themselves the luxury of time in order to decide which technique will fit best into their overall estate plan with any changes to the current tax laws. The private loan transaction also allows them to transfer appreciation and excess income out of their taxable estates and to purchase the life insurance they need for liquidity or their overall financial plan.