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Using Historically Low Interest Rates to Acquire Life Insurance: Sale to an IDGT

With the Applicable Federal Interest Rates (AFR) at historic lows and the amount an individual can gift sheltered by the gift tax exemption at a historic high, some of the most commonly used estate techniques are even more effective right now. One technique that is effective in a low interest rate environment is the asset sale to an intentionally defective grantor trust.

What is a sale to an Intentionally Defective Grantor Trust (IDGT) and how does it work?

A sale to an IDGT is an estate freeze technique where an individual sells property they own to a specially structured grantor trust in exchange for an arm's-length installment note. The following is a quick step-by-step summary.

1. **Legal counsel creates trust**
   Legal counsel creates a trust that is considered owned by the grantor for income tax purposes, but not considered owned by the grantor for estate tax purposes. The specially structured grantor trust gives the grantor enough control to cause all transactions with the trust and all earnings by the trust to be taxed, for income tax purposes, to the grantor. At the same time, the control given to the grantor is not sufficient to cause the assets to be included in his/her estate.

2. **Grantor gifts "seed funds" to the trust**
   Before the installment sale occurs, the trust must be funded with sufficient assets to support the position that the trust has economic substance independent from the sale. Typically, a gift is made of assets equal to at least 10% of the installment price.

3. **Sale of assets to trust in exchange for an installment note**
   The grantor sells income producing property to the trust in return for an installment note. Typically, the transaction is structured to achieve valuation discounts.

   The note can be structured in any number of ways, but is often designed to provide interest only payments with a balloon payment of the principal at the end of the note. The note is generally structured to bear interest at the appropriate AFR.

   No gain or loss is recognized when the asset is sold to the trust, or when interest payments are made by the trust to the grantor. This is because the trust and grantor are treated as the same for income tax purposes.

4. **Note repaid**
   At the end of the note term, the loan is repaid. Usually, the note term is made so that it will be repaid before the grantor's death to avoid the uncertainty concerning the income tax consequences. The appreciated value remains in the trust and passes to the heirs/beneficiaries.

The Tax and Insurance Opportunity

The tax savings mechanism is very simple... the value going to the heirs exceeds the value coming back into the estate from the loan's interest and principal repayment. The technique can also be an effective way to help fund the payment of a life insurance policy acquired by the grantor trust. The earnings generated from the assets in the trust can be used to pay interest due on the loan with the balance used to acquire a policy. When interest rates on the loan are low, there are more funds available to pay insurance premiums.

The following example assumes the sale of a $5 million asset, discounted by 25%, is made to a trust based on the terms of a 10-year installment note with a balloon payment with interest rates based on the AFR for June 2020 of 1.01%. The trust is seeded by a gift of $750,000. It assumes the assets do not grow in value, but produce $230,000 income annually. The earnings are assumed to pay the loan interest and premiums on a no-lapse SVUL from Prudential on a male and female age 60, both preferred non-smokers.

YR	Trust Side Fund (Gift)	Discounted Value of Assets to Trust	Cumulative Loan	Income Earned on Trust Assets @ 4%	Annual Interest Paid to Donor @ 1.01%	Remaining Funds Purchase of SUL	Death Benefit Amount
1	$750,000	$3,750,000	$3,750,000	$230,000	$37,875	$192,125	$9,612,922
5			$3,750,000	$230,000	$37,875	$192,125	$9,612,922
10			$3,750,000	$230,000	$37,875	$192,125	$9,612,922
11		($3,750,000)	$3,750,000	$30,000	$0	$0	$9,612,922

Use Loan Interest Arbitrage to Acquire Insurance

If your clients are hesitant about relinquishing control by an asset sale, they could simply loan property to the trust at AFR. As long as there is a positive spread between trust earnings and AFR, the excess can be used to acquire a life insurance policy as indicated in the table below.

	December Long-Term AFR	Interest payment would have been:	Remaining amount available to fund the premium:	Amount of death benefit that could be purchased:	Difference in death benefit compared to June 2020:
2016	2.26%	$84,750	$145,250	$7,264,336	($2,348,586)
2017	2.64%	$99,000	$131,000	$6,550,372	($3,062,550)
2018	3.31%	$124,125	$105,875	$5,291,531	($4,321,391)
2019	2.09%	$78,375	$151,625	$7,583,748	($2,029,174)
2020	June 1.01%	$37,875	$192,125		N/A

How DBS Can Help

To learn how an installment sale or inter-family loan to a trust can be used by your clients to acquire a life insurance policy, call DBS' in house resource, Terri Getman, J.D.*, CLU, CHFC, RICP, AEP (Distinguished).

*Not in the practice of law.

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