Four Ways to Leverage Today's Ultra-Low Interest Rates in Your Wealth Planning

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As we navigate through this difficult time in the U.S. economy, a few bright spots emerge. One of those is the fact that interest rates, controlled by the Federal Reserve, are at all-time lows. This trend, of course, reflects a government policy intended to stimulate the economy and allow businesses and individuals easier access to capital. In fact, government officials have indicated that this policy will continue for the foreseeable future.

A near-0% interest loan policy certainly benefits Big Banks, which can borrow at close to 0% and lend profitably even at low rates. It also benefits Big Businesses, which can expand their operations with a near 0% cost of capital. Nonetheless, ultra-low rates can also significantly benefit the surgeon and his or her family. In this article, we will outline four ways they can do so, starting with the most obvious and popular, moving to a bit more complex.

1. Refinance Mortgages

As mortgage rates have now reached all-time lows, most homeowners have either refinanced their home mortgage already or have considered doing so. The calculations involved in evaluating the long-term benefit of a refinancing are not complex and can be clearly understood using a simple financial model. In fact, this is the type of evaluation that benefits physicians who are adept at financial modeling. For those of you who do not have a good handle on financial modeling, there are many websites that have mortgage comparison calculators, or a mortgage broker should be able to provide this analysis.

Regardless of where one finds the resource, the essence of the analysis is to compare an existing mortgage with a new mortgage offering a lower interest rate. A thorough knowledge of the existing loan terms (are there prepayment penalties?) and potential closing costs to secure the new mortgage are both essential. The goal is to calculate the "breakeven" point – the length of time at which paying the new lower-interest mortgage breaks even with the one-time additional costs of changing the mortgage. Bottom line: if the loan term is the same and you intend to remain in the home well past the breakeven point, then refinancing may be a good idea.

2. Refinance Other Debt

The same concept for one's home mortgage can be applied to loans as varied as practice real estate mortgages, rental property mortgages, practice lines of credit, practice equipment financing, and even student loans. As above, knowledge of existing terms and closing costs, as well as an accurate financial model, is required to make good financial decisions.

3. Use Premium-Financed Life Insurance

In our books and other articles, we have explored the relative strengths and weaknesses of term and permanent life insurance (whole life, universal life, equity-index life, etc). We also cover these topics in depth in our book (see below). The bottom line: there are significant tax, retirement, and estate benefits offered by permanent life insurance.

Nonetheless, in order to build up large permanent policies that generate six-figure annual tax-free retirement income, physicians generally need to make significant investments into such policies for at least a few years while they work. Many physicians would like the tax-free retirement income but are averse to paying large insurance premiums.

This is where premium financing comes in. One can finance these policies during the funding phase, only paying a few percentage points in interest, rather than the entire premium. Then, typically 10 to15 years into the plan, when cash values have grown, the cash value can then be used to pay off the loan principal. What remains is a large debt-free permanent policy that can be used to generate tax-free income through the physician's retirement.

While this description glosses over a complex and significant transaction with a number of risks and success factors, the essence of it remains arbitrage – growing the policy cash values at rates generally around 5 to7% annually, which is higher than typical premium financing interest rates.

Today, those rates have plummeted, with some banks offering rates below 3%, often with long-term lock options. As such, there has literally not been a better time to engage in this transaction since it became mainstream over 25 years ago.

4. Leverage Intra-Family Loans for Gift & Estate Planning

A core element of much sophisticated estate and gift tax planning is making loans between family members. Unlike loans between unrelated parties, intra-family loans must charge an IRS-specific minimum interest rate in order to make the loan legitimate. This is called the "Applicable Federal Rate" (AFR) and the IRS issues the AFR each month so taxpayers and their advisors know exactly how much interest must be charged in these scenarios. In fact, the IRS states three specific AFRs: the short-term rate (maturities of 3 years or less), medium-term rate (3 to 9 years) and long-term rate (maturities greater than 9 years). For example, these rates were .14%, .38% and 1.12% in October 2020.[i]

While the specifics go beyond the scope of this article, one can imagine all the ways physicians could transfer wealth tax efficiently among family members, trusts, partnerships and the like, when the interest rate allowed on long term loans today is a mere 1.12%.

Often such loans provide tremendous flexibility for clients who want wealth to transfer to younger family members (or trusts for their benefit) but want a "safety valve" back to them in case they need it. Using a loan to the individual/trust allows that flexibility. If the client, through the years, decides they do not need a portion of the loaned assets back, they can forgive the loan using their gift/estate tax exemptions. If the client does want the assets back, the loan is kept in force and they get the principal and interest, per the loan terms. Either way, by making a loan today, the family has built flexibility into their plans and done so for the cost of a tiny interest rate, dictated by the IRS itself.

Conclusion

All physicians should determine how they can best utilize today's ultra-low interest rates. For many, a few of the four tactics described here may be beneficial. As always, when implementing any of these options, be sure to work with a trusted experienced professional advisor.

References:

i. See https://www.irs.gov/pub/irs-drop/rr-20-20.pdf

SPECIAL OFFERS: The authors have recently completed ***Wealth Planning for the Modern Physician***, their first book for physicians in five years. To receive free print copies or ebook downloads of this book *or* ***Wealth Management Made Simple***, text **ICS** to 47177, or visit www.ojmbookstore.com and enter promotional code **ICS** at checkout.

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