WRMarketplace

An AALU/GAMA Washington Report

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TOPIC: Free Fallin' – Plummeting Interest Rates Create Opportunities During Turbulent Times

MARKET TREND: As a result of economic uncertainty and unrelenting volatility in the market due to the COVID-19 pandemic, federal interest rates applicable to wealth transfer planning have plummeted to historic lows, providing motivated clients with a unique opportunity to freeze the value of a portion of their taxable estates and provide their desired heirs with access to appreciation as the economy recovers.

SYNOPSIS: Planning approaches tied to certain statutory "hurdle rates" established monthly and published by the IRS have become particularly attractive under today's market conditions, particularly as the benefits of the low rates are further amplified by severely depressed asset values. As a result, clients and their advisors may consider revisiting intra-family loans, grantor trust installment sales, GRATs, and CLATs, which can take advantage of these unique conditions to enhance wealth transfers to lower generations.

TAKE AWAY: As market conditions continue to drive statutory hurdle rates toward zero, now may be the ideal time for clients and their advisors to discuss various interest rate-based wealth transfer planning approaches. Time, however, may be of the essence, as even a 1% rise in these hurdle rates can dramatically impact the effectiveness of each approach.

SETTING THE STAGE – HOW LOW CAN RATES GO?

Each month, the IRS publishes the applicable federal rate ("**AFR**"), which sets the minimum interest rates that must apply to loans of varying lengths and terms to avoid treatment as a "below-market loan" by the IRS.**[1]** The May AFR rates for loans (applicable for all compounding periods) are as follows:

Term	**Applicable Rates[2]**
Not over 3 years	0.25%
Over 3 years but not over 9 years	0.58%
Over 9 years	1.15%

The IRS also publishes the "7520" rate, which serves as the hurdle rate for grantor retained annuity trusts ("**GRAT**s"), charitable lead annuity trusts ("**CLATs**"), and other split-interest trust techniques. The 7520 rate for the month of May is 0.8%.**[3]**

These low rates present unprecedented opportunities for higher net worth families to transfer assets to lower generations using only a nominal amount of lifetime gift exemption. The examples in this report will illustrate the potential effectiveness of these approaches under current conditions and, critically, how reactive that success might be to even modest hurdle rate increases of as little as 1%.

EXAMPLES

Intra-Family Loans. At today's low interest rates, intra-family loans present opportunities to transfer anticipated appreciation on temporarily depressed assets to lower generations.

***Example 1**.* David has a net worth in excess of $30 million. In consultation with his advisors, David loans $10 million in cash to his daughter, Carla. Carla issues a promissory note payable to David for $10 million, with interest payable annually at the AFR. Carla uses the $10 million to purchase a diversified basket of marketable securities and will be responsible for any taxes attributable to them. Consider the results for David and Carla with note terms of three, nine, and fifteen years and annual growth of the transferred securities at 4%:

Three-year note with interest payable at the short-term AFR of 0.25%

	Appreciation	Interest Payment	Principal Remaining
			$ 10,000,000
Year 1	$ 400,000	$ (25,000)	$ 10,375,000
Year 2	$ 415,000	$ (25,000)	$ 10,765,000
Year 3	$ 430,600	$ (25,000)	$ 11,170,600
			$ 1,170,600

Nine-year note with interest payable at the mid-term AFR of 0.58%

	Appreciation	Interest Payment	Principal Remaining
			$ 10,000,000
Year 1	$ 400,000	$ (58,000)	$ 10,342,000

Year 2	$ 413,680	$ (58,000)	$ 10,697,680
Year 3	$ 427,907	$ (58,000)	$ 11,067,587
-Intervening Years Omitted-			
Year 7	$ 490,739	$ (58,000)	$ 12,701,217
Year 8	$ 508,049	$ (58,000)	$ 13,151,265
Year 9	$ 526,051	$ (58,000)	$ 13,619,316
			$ 3,619,316

Fifteen-year note with interest payable at long-term AFR of 1.15%

	Appreciation	Interest Payment	Principal Remaining
			$ 10,000,000
Year 1	$ 400,000	$ (115,000)	$ 10,285,000

	Appreciation	Interest Payment	Principal Remaining
Year 2	$ 411,400	$ (115,000)	$ 10,581,400
Year 3	$ 423,256	$ (115,000)	$ 10,889,656
-Intervening Years Omitted-			
Year 13	$ 571,294	$ (115,000)	$ 14,738,649
Year 14	$ 589,546	$ (115,000)	$ 15,213,195
Year 15	$ 608,528	$ (115,000)	$ 15,706,722
			$ 5,706,722

The results are compelling, even at a three-year term. Note, however, that if interest rates were to rise by 1%, the effect is quite different. The appreciation transferred to Carla would drop by 27%, 29%, and 35% over the three-year, nine-year, and fifteen-year loan periods respectively.

The above example demonstrates the importance of locking in rates before even a modest rise. In addition, clients and their advisors should review any outstanding promissory notes and evaluate whether or not refinancing at today's lower rates might be feasible.

The loan approach also can be applied to maximize and enhance the tax attributes of different trusts set up by a grantor. Consider the next example:

Example 2. Carl has three adult children and eight grandchildren. Several years ago, Carl, as grantor, created two trusts for the benefit of his children and grandchildren. Carl's children are co-trustees of both trusts, one of which is exempt from generation-skipping transfer ("**GST**") tax ("**Trust One**") and another which is not exempt from GST ("**Trust Two**"). Carl's children are all wealthy in their own right and consult with their advisors for an approach that would permit greater asset growth in Trust One. The solution is a similar form of promissory note as in Example 1 with interest payable annually at the AFR. Trust Two transfers $10,000,000 in cash to Trust One in exchange for a promissory note at the appropriate AFR rate, depending on the desired term. If the cash is used to purchase assets which then appreciate, any such appreciation will be exempt from GST tax.

Using intra-family loans, however, requires careful coordination and review of numerous considerations with the client's full team of advisors. For instance, the loan parties must understand that borrowers must timely make all interest payments to the lender and must repay the principal in full upon the conclusion of the note term. The lender also must report the interest as income on any federal income tax returns (although if the loan is between two grantor trusts, or between a grantor and his or her grantor trust, no additional tax will be generated by the use of such a loan). Clients also should understand the economic risks. In the context of loans between individuals, if asset values decline, the value of the note (which would be included in the estate of the grantor/lender) remains fixed. As a result, if the assets do not recover, the grantor's estate tax liability could potentially be higher relative to those assets than would otherwise have been the case. Further, regardless of whether the transaction is between two individuals or two trusts, if the securities purchased with the borrowed cash are worth less than the loan balance when the loan term ends, other assets may need to be sold or transferred to satisfy the debt, potentially resulting in adverse income tax consequences.

Grantor Trust Installment Sales.[4] Another effective wealth transfer approach involves the sale of assets to a grantor trust. Often, the subjects of such sales are non-controlling business interests. The trust pays for the purchased business interest with a promissory note, typically tied to the then effective AFR rate for the desired term. As interest rates have fallen further since prior reports were published, it is incumbent for advisors and their clients to consider whether an installment sale to a grantor trust can produce even more favorable outcomes under current conditions. For example:

Example 3. Stephanie created a grantor trust several years ago for the benefit of her children and grandchildren (the "**SG Trust**"). The SG Trust currently has $1,000,000 of assets. Stephanie is the founder of Steph Co., currently worth $25,000,000. Stephanie anticipates that Steph Co. will be sold within the next five to seven years and wishes to transfer the appreciation of the company to the SG Trust. In consultation with her advisors, Stephanie decides to sell $10,000,000 worth of stock in Steph Co. to the SG Trust in exchange for a nine-year promissory note at the mid-term AFR of 0.58%. At this rate, annual interest payments on the note would equal only $58,000. An increase in the AFR by 1%, however, would increase the annual interest payments to $158,000, and a 2% AFR increase would raise those annual payments to $258,000. If the SG Trust is to fund annual note payments using distributions it receives as an owner of Steph Co., higher interest payments require more distributions and/or force the SG Trust to source other cash flow to make these payments. Accordingly, the low interest rate reduces the SG Trust's need for liquidity, whether from Steph Co. distributions or other assets, to make payments. Further, to the extent that distributions from Steph Co. are greater than the required annual interest payments, more assets will remain in the trust for Stephanie's descendants.

Installment sales, however, are not without risk. A purchasing trust must be sufficiently capitalized prior to the sale. The promissory note also must have a true economic effect, and interest payments must be made even if sufficient distributions are not made by the underlying company. Moreover, the note principal must be repaid even if the company is not eventually sold, and income tax consequences could arise if the grantor dies prior to the note's full repayment. Life insurance can assist in addressing these risks. A policy owned by and payable to an irrevocable life insurance trust can create the necessary liquidity for a family to address these issues while not increasing the size of the decedent's taxable estate.

GRATS. A GRAT is a split-interest trust that benefits from a low 7520 rate. The grantor transfers assets to the GRAT in exchange for a series of annuity payments over a specified term of years. Any assets remaining in the trust after the final annuity payment has been made can be transferred outright or held in trust for one or more desired beneficiaries. The value of the stream of annuity payments can be designed to approximate the value of the assets used to fund the GRAT, intentionally triggering a nominal gift for gift tax reporting purposes.[5] Most relevant for this report is the statutory assumption that GRAT assets will appreciate at the 7520 rate in effect during the month of the GRAT's funding. A GRAT funded in May 2020 will likely be "successful" if its assets appreciate at an annualized rate of return in excess of 0.8%, thereby clearing the hurdle rate and leaving assets in the trust for the designated remainder beneficiaries.

Example 4. Consider a two-year GRAT funded with $10,000,000 of marketable securities and annuity payments increasing by 20%, assuming annual asset growth of 4%, 6%, and 8%:

Two-year GRAT with 4% annual growth

	Appreciation	**Annuity Payment**	**Principal Remaining**
			$ 10,000,000
Year 1	$ 400,000 (4%)	($4,601,721)	$ 5,798,279
Year 2	$ 231,931 (4%)	($5,522,065)	**$ 508,145**

Two-year GRAT with 6% annual growth

	Appreciation	**Annuity Payment**	**Principal Remaining**
			$ 10,000,000
Year 1	$ 600,000 (6%)	($4,601,721)	$ 5,998,279
Year 2	$ 359,897 (6%)	($5,522,065)	$ **836,111**

Two-year GRAT with 8% annual growth

	Appreciation	Annuity Payment	Principal Remaining
			$ 10,000,000
Year 1	$ 800,000 (8%)	($4,601,721)	$ 6,198,279
Year 2	$ 495,862 (8%)	($5,522,065)	**$ 1,172,076**

As demonstrated, 4% growth results in a transfer of over $500,000 to the remainder beneficiaries at virtually no transfer tax costs after two years.**[6]** Growth of 8% produces a transfer in excess of $1,000,000.

Conversely, even small increases in the 7520 rate will adversely impact the potential transfer to the remainder beneficiaries. At 4% annual growth, an increase of even 1% in the 7520 rate will reduce the amount of assets available to the remainder beneficiaries by over 30%. The reduction increases to over 60% if the 7520 rate increases by 2%.

Given the above, advisors and their clients should be mindful that the success or failure of a GRAT is heavily influenced by the rates in effect on its funding date.**[7]**

CLATS

A CLAT is a split-interest irrevocable trust that provides for a "lead" charitable interest in the form of an annuity payable to one or more charitable organizations for a fixed term of years ("**annuity term**"). If a CLAT is treated as a grantor trust, the grantor will receive an immediate charitable income tax deduction in the year the CLAT is funded. Note, however, that if the grantor does not survive the annuity term, the charitable deduction received by the grantor in the year of funding may be subject to recapture.**[8]**

Similar to a GRAT, the value of the charitable annuity can be designed to approximate the value of the assets used to fund the CLAT. At the conclusion of the annuity term, the assets remaining in the CLAT can be distributed outright to any non-charitable beneficiaries or held in one or more continuing trusts for their benefit.**[9]** Accordingly, a CLAT will be successful if the CLAT assets appreciate at a rate exceeding the same 7520 rate used in connection with GRATs. The following example is illustrative of how powerful an approach a CLAT can be for certain clients.

Example 5. Jill has spent the last twenty years as the CEO of Acme Co. During her tenure, she has amassed a net worth in excess of $30,000,000. Having reached her contractually mandated retirement age in 2020, Jill is now retiring. As part of the compensation package agreed to when she joined Acme Co., Jill is now entitled to a one-time cash payout of $10,000,000, which she will have to recognize as ordinary income (subject to the highest marginal federal income tax rate of 37%). Jill wishes to be philanthropic but simultaneously would like to establish a nest egg for her favorite niece, Julia. Julia is currently age 20, and Jill would like funds to be accessible to her beginning at age 30. In consultation with her advisors, Jill creates a ten-year CLAT funded with $5,000,000, "zeroed out" to result in a minimal taxable gift of $826.60. This deduction will be particularly valuable in 2020 given the expectation of a sharp decline in Jill's taxable income (and, therefore, contribution base) in the years going forward. At the end of the tenth year of the CLAT, the remaining assets will be distributed to a lifetime trust for Julia's benefit. Consider the results, assuming annual asset growth of 5% and annuity payments increasing by 20% each year:**[10]**

Year	**Appreciation**	**Annuity Payment**	**Principal Remaining**
			$ 5,000,000
Year 1	$ 200,000	$ 203,450	$ 4,996,550
Year 2	$ 199,862	$ 244,150	$ 4,952,262
Year 3	$ 198,090	$ 293,000	$ 4,857,352
-Intervening Years Omitted-			
Year 8	$ 147,859	$ 729,050	$ 3,115,294
Year 9	$ 124,612	$ 874,850	$ 2,365,055
Year 10	$ 94,602	$ 1,049,800	$ **1,409,857**

This approach produces several striking results for Jill. For a taxable gift of $826.60, she has created a trust for Julia's benefit funded with over $1,400,000 while also donating roughly $5,000,000 to charitable causes. She also received a deduction against her income for funding the CLAT in the same year of her extraordinary separation payment.**[11]**

The impact of the historically low 7520 rate on this situation is immense. Applying similar assumptions using a 7520 rate of 1.8% reduces the remainder transferred to Julia's trust by over $400,000, or nearly 30%. Applying a 7520 rate of 2.8% reduces Julia's trust by more than $800,000, or over 60%.

Additional steps can be taken to better position an approach centered on CLATs to be successful. Most notably, a client may decide to create multiple CLATs at once, each with a different annuity term. Staggering the annuity terms can help manage both the mortality risk of the grantor (with respect to any potential recapture of the income tax deduction) as well as market volatility risks, allowing the amounts potentially held for the non-charitable beneficiaries to vest over several years. This approach also creates a ladder effect, making assets available to beneficiaries in stages as opposed to all at once. Note, however, that if asset appreciation does not outpace the 7520 rate, no assets would pass to the non-charitable beneficiary upon the conclusion of the annuity term.

TAKE AWAY

As market conditions continue to drive statutory hurdle rates toward zero, now may be the ideal time for clients and their advisors to discuss various interest rate-based wealth transfer planning approaches. Time, however, may be of the essence, as even a 1% rise in these hurdle rates can dramatically impact the effectiveness of each approach.

NOTES

[1] See Internal Revenue Code ("**Code**") §§1274 and 7872. Treatment of a loan as a below market loan may result in the imposition of gift tax.

[2] See Revenue Ruling 2020-11.

[3] See Revenue Ruling 2020-11.

[4] The concept of an installment sale is discussed in greater detail in *WRMarketplace No. 20-06*.

[5] GRATs are discussed in further detail in prior reports including *WRMarketplaces Nos*. *20-06, 15-34*, and *14-8*.

[6] The total value of the gift under these assumptions is $0.09.

[7] See *WRMarketplace No. 20-06*.

[8] See Code §170(f)(2)(B).

[9] Note that, for a variety of reasons beyond the scope of this report, CLATs are generally not a favored vehicle for GST planning.

[10] While CLAT annuity payments also can be designed as an equal amount each year, the 20% increase can help capture more of the expected asset growth for the remainder beneficiaries. This is an especially important feature to consider where a CLAT is funded with assets whose values are predicted to be only temporarily depressed.

[11] The value of the deduction that a grantor would receive relative to the funding of the CLAT depends on the amount and nature of an individual's income in a given year, the type of property donated, and the characteristics of the permissible recipient organizations pursuant to the terms of the CLAT Agreement. See Code §170 for further details regarding such limits.