

# Planning Strategies



## Planning in a Low Interest Rate Environment

Low interest rates have been with us for the last 10 years. Interest rates not only impact investors, lenders and borrowers, but they also affect a number of planning strategies that are dependent on the time value of money. Whether it is intra-family loans, Grantor Retained Annuity Trusts, Charitable Lead and Remainder Trusts, or Qualified Personal Residence Trusts, in each case, low interest rates either improve or limit an individual's ability to transfer wealth in a tax-efficient manner or enjoy the benefits of charitable giving. Below are some of the basic concepts needed to understand estate planning in a low interest rate environment, and we are happy to discuss ways in which these strategies may be incorporated into your overall wealth strategy.

- 1. The Applicable Federal Rate (AFR)** is an interest rate that is set by the IRS that is used for a variety of purposes, such as assigning the minimum interest to be charged on loans between related parties.
- 2. Intra-Family Loans** are a great way for a parent to lend money to a child at a rate that is far below the rate charged by commercial lenders. In August 2019, the mid-term AFR (for loans between 3 and 9 years) is 1.87%. For example, a parent can lend a child money at 1.87% so the child can invest in real estate, a business or even stocks. As long as the transaction is structured as a *bona fide* loan, i.e., supported by a promissory note that bears adequate interest at the AFR or higher, and payments are made per the terms of the note, the IRS will respect the transaction as a true loan and not as a taxable gift. The child gets the advantage of borrowing at a low rate and the parent is able to freeze her estate since the note's value can never grow above face value. All future appreciation above the AFR inures to the child.
- 3. The Section 7520 rate** (also known as the "hurdle rate") is used for certain types of planning strategies that have been specifically sanctioned in the tax code. The rate is 120% of the mid-term AFR (compounded annually) and rounded to the nearest two-tenths of one percent. For example, 120% of the mid-term AFR for August 2019 is 2.24%, which is then rounded down to 2.2%.
- 4. Grantor Retained Annuity Trusts (GRATs)** are trusts that allow the grantor to transfer future appreciation over the Section 7520 rate to heirs. The grantor contributes assets to an irrevocable trust and retains an annuity (i.e., the right to receive a fixed dollar amount) every year for a period of years. Under tax regulations, the grantor may retain an annuity equal to the value of the property contributed to the trust, which offsets the amount of any taxable gift, thus "zeroing out" the gift. Appreciation of trust assets above the hurdle rate will benefit the remainder beneficiaries of the GRAT. Low interest rates improve the ability to successfully transfer wealth especially in a strong equity market where stocks can more easily outpace the low hurdle rate set by the IRS.
- 5. Grantor trusts** are trusts in which the grantor retains certain rights or powers that, under the tax code, cause the trust to be ignored for income tax purposes. As such, transactions between the grantor and a grantor trust (such as a GRAT) are not recognized for income tax purposes. Under these tax rules, the grantor of a grantor trust (such as a GRAT) may have the power to swap assets of equivalent value for those in the GRAT. By swapping out appreciated stock in a GRAT for cash, the grantor can lock in the post-contribution appreciation and pass it on tax-free. Since the swap is ignored for income tax purposes, no gain or loss is recognized on the exchange. During period of market volatility, this technique can be extremely powerful.

6. **Charitable Remainder Trusts (CRTs)** are tax-exempt trusts in which the grantor retains an income interest in the form of an annuity (fixed dollar amount) or a unitrust amount (fixed percentage) payable for a period of time. After the term ends, the balance goes to charity. Appreciated assets contributed to a CRT may be sold without an immediate capital gains tax bite. Instead, taxes on the gains are paid over time as installments are paid to the grantor. The grantor is allowed a charitable income tax deduction for the present value of the charitable remainder. This amount is measured by an actuarial calculation taking into account the number of years the trust is expected to run and the IRS Section 7520 rate. A longer term and/or lower interest rate reduces the present value of the remainder.
7. **Charitable Lead Trusts (CLTs)** pay an annuity or unitrust amount to charity for a fixed period of time and then dissolve by transferring any remaining balance to non-charitable beneficiaries, such as family members. There are two types of CLTs: One is a grantor trust and the other is not. If structured as a grantor trust, the grantor is allowed an upfront charitable income tax deduction for the present value of the lead payments to charity. If not, then the trust may claim a charitable deduction each year for amounts paid to charity. In both cases, income of the trust is taxable. CLTs work best in low interest rate environments because, like GRATs, the assets of the trust have a better chance of outperforming the IRS hurdle rate. If they do, there will be something left for the remainder beneficiaries.
8. **A Qualified Personal Residence Trust (QPRT)** is used to transfer a home to children at a discounted tax value. However in periods of low interest rates, the residual value of the home will be higher and so will the taxable gift. This means that QPRTs work best in higher rate environments. Assume that the grantor's home has greatly appreciated over time and has become a major asset of her estate. If she wants to remain living in the home and transfer its value to her children at a discount, she can do so by

transferring title to a QPRT. The tax code allows the homeowner to remain in the home during the QPRT's term after which the house is fully owned by her children or a trust for their benefit. If the grantor wishes to remain living in the home after the QPRT expires, she must pay rent to avoid having the home treated as part of her estate. Another important consideration is the potential loss of the stepped-up basis at death. Under federal tax rules, the basis of property transferred by gift carries over to the donee. So, the basis of a residence given to a QPRT will not be stepped up to fair market value as of the date of death unless the grantor dies before the QPRT term expires. However, in that case, there would be no benefit to doing the QPRT at all.

## GRATs and Charitable Lead Trusts work best in a low interest rate environment.

9. **The Federal estate and gift tax exemption is \$11.4 million per person.** The foregoing estate planning techniques are well established and may work well depending on your particular situation. However, it is important to understand your goals and options before undertaking any type of planning or trust structure. In some cases, it may be better simply to make a taxable gift. With the federal gift tax exemption being the highest it has ever been and since it is set to expire in 2026, making an outright gift of your home or other property may make more sense for you. No gift taxes will be due if your cumulative lifetime gifts fall below the exemption amount.
10. **Don't forget about state tax rules.** Most states have repealed their estate tax and only one (Connecticut) still has a gift tax. Most of these states have been steadily increasing their exemptions to match the federal exemption amount. However, each state has its own set of rules. We advise that you consult your attorney before undertaking any estate planning or major gifting program.



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Warwick M. Carter, Jr. is a Principal at 1919 Investment Counsel based in New York. As a Senior Wealth Advisor, his primary focus is generational wealth planning for high net worth individuals and families. He also advises on philanthropic planning. When giving advice, Warwick takes a comprehensive approach to assessing all aspects of a client's tax, financial and family situation. Warwick works closely with Portfolio Managers and Client Advisors in all of our offices to integrate wealth strategies with a client's investments. He regularly meets with outside advisors to devise appropriate solutions that will help grow wealth in a tax-aware way over the long term.

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## **About 1919 Investment Counsel**

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