HOW LOW INTEREST RATES CAN IMPACT YOUR GIFT AND ESTATE PLAN

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The purpose of this paper is to review common wealth transfer strategies and examine the impact of interest rates (at the time of execution) of each strategy. The examples and conclusions following are not meant to encourage or discourage the use of these strategies, but are merely to provide a basic understanding of the potential benefits. In practice, the advisory team must understand the client's overarching goals and objectives, their level of risk tolerance, and all the resources available to them before making a recommendation.

For purposes of illustrating the wealth transfer strategies we will use the following hypothetical scenario: *George and Jane, both 65, have a net worth of $30M and are concerned about paying estate taxes. A thorough review of their available resources and their expected cash flow needs illustrates that they have a very low probability of running out of assets during their lifetime and that they will likely leave a large estate to their heirs. George and Jane have 2 children, Tom and Janet, who are both happily married with children. Tom and Janet are each successful in their own careers and George and Jane are not concerned about the impact of leaving an inheritance to them.*

- **Intra-Family Loans**

  The first wealth transfer strategy we will discuss is intra-family loans. Intra-family loans are exactly as they sound: **a loan from one family member to another, typically a loan from parents to their children or grandchildren.** Intra-family loans are a simple but effective way to transfer wealth from one generation to another. For illustrative purposes, let's assume that Tom is interested in expanding his successful dental practice. He has calculated a total cost of the expansion to be $1M. He has discussed the expansion with his business banker who quoted a business loan at a rate of 6% due to the level of risk involved. Assume the current AFR (applicable federal rate) for a mid-term rate as prescribed by the IRS is 1%, George is comfortable with the risks involved, and proposes an intra-family loan to Tom for the $1M at 2%. The loan is structured as interest only with a balloon payment at the end of the 9 year term. The benefit of the intra-family loan to Tom in this case can be calculated simply as the arbitrage between the market rate of 6% and the AFR rate of 1%.

  For simplicity, let's assume the loan is issued and maintained for 9 years and then paid off in full. The arbitrage in this example is $450,000 (Tom pays $450,000 less interest than he would have if he had financed the project through the bank). The benefit to George and Jane is that the appreciation of the $1M loan, which is still part of their taxable estate, is "capped" at 1% during the 9-year term. If the dental practice is successful, any excess return above the 1% rate is captured outside of George's taxable estate and directly benefits Tom and his beneficiaries. A key variable to the success of this strategy is the arbitrage between the AFR rate and market interest rates.

  Now, let's assume that in this scenario the AFR rate was 4% instead of 1%. The interest savings for Tom is reduced from $450,000 to $180,000. Even under this scenario the intra-family loan may be a successful wealth transfer technique, but the benefit to Tom and his beneficiaries is reduced and George's taxable estate will grow at a higher rate.

- **Grantor Retained Annuity Trust**

  The next wealth transfer strategy we will review is a zeroed out Grantor Retained Annuity Trust ("GRAT"). **A GRAT is a trust set up and funded by a grantor for the benefit of someone else (typically children or grandchildren).** "Zeroed out" simply means that the trust is structured such that there is no taxable gift generated as a result of the transfer. The terms of the trust require that the grantor be repaid the original principal of the trust plus interest based on the current IRS prescribed 7520 Rate (equal to 120% of the mid-term AFR Rate). A GRAT can be a successful wealth transfer strategy, assuming the grantor has assets that they feel will appreciate at a rate greater than the IRS rate.

  Jane recently purchased $1,000,000 in shares of XYZ Corp, a high growth company in the medical technology field. Jane believes that XYZ Corp. is poised to take off and does not need or want the appreciation to be captured in her taxable estate. Jane sets up a GRAT with a 4-year term; the current 7520 rate is 2.2%. Jane's hunch was correct and XYZ Corp stock appreciates by 10% each year during the term of the GRAT. Under this scenario, after the 4 year term, Jane will have received back $1,035,250 in annuity payments (the original principal plus interest at the IRS prescribed rate), leaving a balance of $262,951 which would be distributed to Tom and Jane free from gift of estate taxes. The GRAT effectively shifted the growth from George and Jane's taxable estate to Tom and Jane's. Under the same scenario, assuming that the 7520 rate is 6%, the amount of wealth passed tax free to Tom and Janet is reduced to $124,745.

- **Defective Grantor Trust**

  The third and final wealth transfer strategy we will review is an installment sale to a defective grantor trust.

  For simplicity, assume George and Jane have already set up and funded a defective grantor trust ("defective" meaning that the income within the trust passes through to George and Jane's tax return.) George and Jane own a commercial real estate property valued at $2,000,000, which currently generates net rental income of $140,000. In order to "freeze" the value of the property in their estate, George and Jane sell the property to the trust in exchange for an interest-only, 9-year note at the mid-term applicable federal rate of 1%. The terms of the note are interest only with a balloon payment at the end of the term. Assuming the value of the property is not discounted (which would add further leverage to the strategy), and the value does not appreciate during the 9 year term, each year George and Jane will effectively pass $120,000 (the rental stream less the annual interest on the note) to the trust free from estate and gift tax. At the end of the term the note could be refinanced for a new term, George could buy the property back at fair market value, or if the property is sold the note could be repaid. Assuming the value of the property does appreciate at 4% per year, George and Jane effectively transferred an additional $80,000/year to the trust. Combined under this scenario, they would pass $1,800,000 of wealth from their taxable estate to their heirs free from gift or estate tax. If the current mid-term AFR rate was 5.05%, the amount of wealth transferred is reduced from $1,800,000 to $1,071,000.

The above examples illustrate the potential benefits of wealth transfer strategies, particularly in a low interest rate environment. Given the right set of facts and circumstances, these techniques can be a powerful way to transfer wealth from one generation to another and reduce future estate taxes. Higher interest rates reduce the leverage and probability for success under these techniques, but even in a higher interest rate environment they can still be effective depending on the situation and the goals and objectives of the family involved.