

Estate Planning in a Low Interest Rate Environment

May 2020

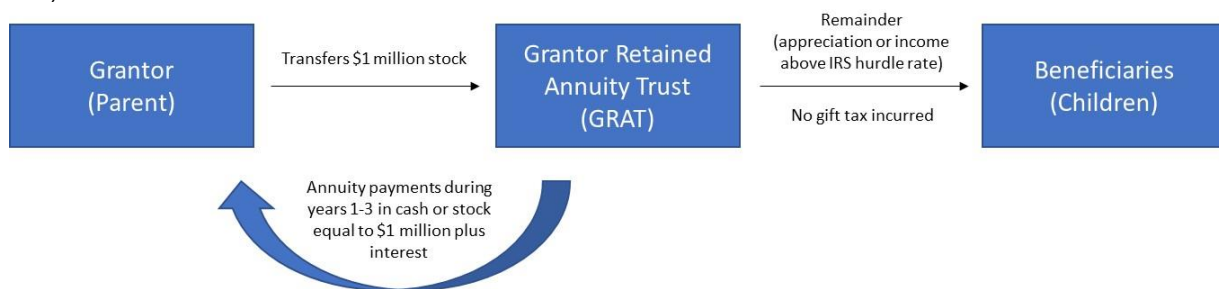
With interest rates at all-time lows, estate planning techniques in vogue after that Great Financial Crisis are returning to favor by wealthy Americans that have exhausted or nearly exhausted their lifetime gift tax exemption.

Four such techniques – Grantor Retained Annuity Trusts (GRATs), Charitable Lead Annuity Trusts (CLATs), Intra-Family Lending, and the Sale of Property to a Grantor Trust – are worth revisiting for opportunistic families contemplating inter-generational wealth transfer strategies.

MULTIPLE ZEROED-OUT GRANTOR RETAINED ANNUITY TRUSTS (GRATS)

A Grantor Retained Annuity Trust is an irrevocable trust, in which a grantor (such as a parent), transfers assets into a trust for the benefit of another (such as their children), in exchange for a fixed annuity payment back from the trust over a predetermined period (typically 2-3 years). At the end of the term of the trust, any assets remaining in the trust (due to appreciation or income) pass to the trust beneficiaries (children) free of gift and estate taxes.

In a Zeroed-Out GRAT, the grantor's annual annuity payments are set to be equal in value to the amount transferred into the trust plus interest, based on a minimum interest rate determined by the IRS (known as the Section 7520 rate).



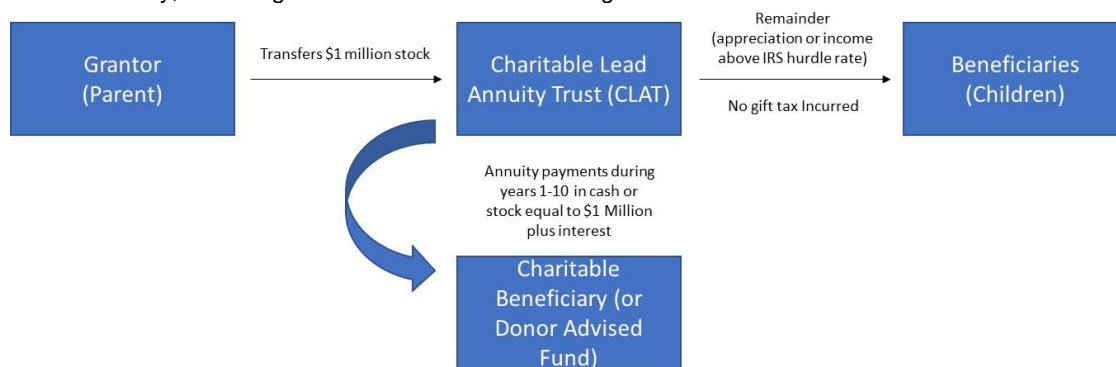
The goal is for the assets in the trust to outperform a hurdle rate set by the IRS, such that any outperformance can pass to the trust beneficiaries free and clear of estate taxes. The lower interest rates fall, the lower the hurdle rate, and thus the more appreciation that can be transferred estate tax-free to the next generation. As of May 2020, the Section 7520 interest rate (hurdle rate) fell below 1%.

If the investment performance of the GRAT doesn't exceed the hurdle rate, nothing is transferred to the beneficiaries, and the total value of the initial transfer is recaptured by the parent, who can try again by creating another GRAT if the interest rate environment is still favorable.

Savvy clients may consider forming 11 separate GRATs, investing each in one of the 11 different sectors of the S&P 500 through Exchange Traded Funds. By using multiple GRATs, investors increase the odds that they will lock in some appreciation during the term of the trust, due to the lack of correlation between sectors. Others may choose instead to diversify the term of their GRATs or the asset classes in which they invest (i.e. US vs International Developed vs Emerging Markets).

ZEROED-OUT CHARITABLE LEAD ANNUITY TRUSTS (CLATS)

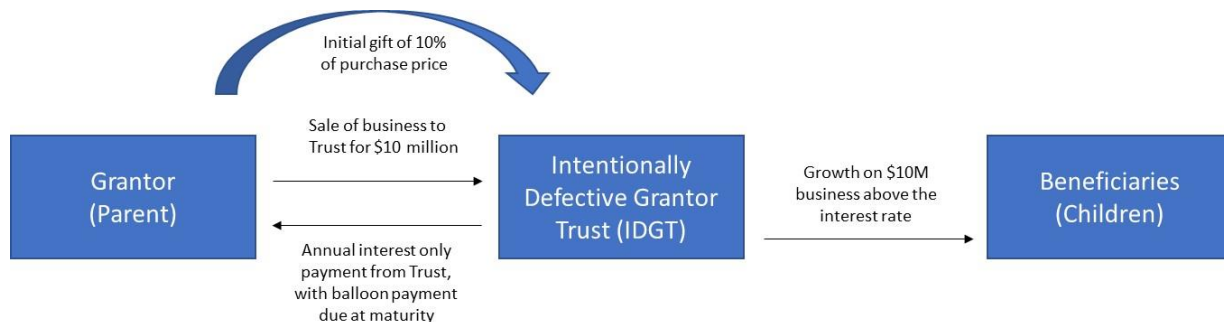
A Charitable Lead Annuity Trust is similar to a GRAT, except the annuity payments are made to a charity, rather than back to the grantor. Like the GRAT, whatever is left in the trust at the end of its term is distributed to the non-charitable beneficiaries, such as the children. The lower interest rates fall, the lower the annuity payment to the charitable beneficiary, and the greater the remainder that can go to the children.



For those that are charitably inclined, quickly appreciating assets, or high yielding investments (such as real estate), could be particularly attractive mechanisms of funding the CLAT and transferring the excess appreciation or income to the next generation free and clear of gift and estate taxes. This technique may be particularly interesting in the year in which a business is sold, as the grantor can receive a large tax deduction equal to their initial charitable contribution.

SELLING PROPERTY TO A GRANTOR TRUST

Selling highly appreciable property or a business can also be an effective strategy in a low rate environment. In this instance, the grantor sells property to a trust in exchange for a promissory note with an interest rate equal to the IRS's Section 7520 hurdle rate. The payments on the note would need to be funded from the income produced by the property that has been sold to the trust. It is possible to set up the note as an interest only note with a balloon payment, which could maximize the total amount transferred over the life of the trust. There is no capital gain due on the sale of the property to the GRAT, and the interest payments are not considered taxable income to the grantor. Like all grantor trusts, however, the grantor is responsible for paying income and capital gains taxes on the assets within the trust.



INTRA-FAMILY LOAN

In a low interest rate environment, a loan to a family member can be an attractive way of assisting family members without incurring a gift tax. This is particularly true for those that have exhausted their lifetime gift tax exemption. By making a loan at a rate equal to the section 7520 rate, parents can help children by undercutting mortgage rates charged by a bank, keep the proceeds from interest payments in the family (rather than paying interest to a bank), and avoid closing costs and fees typically associated with a mortgage. Additionally, each year parents could forgive a portion of the loan in an amount equal to the annual gift exclusion (\$15,000 per parent in 2020), even if their lifetime

gift tax exemption has been exhausted. Of course, the loan can be used for any purpose, such as a business purchase, grandchild's education, or even for investment purposes.

For those that have already engaged in intra-family lending, this may be an opportune time to consider refinancing an existing intra-family loan, reducing their interest expense, and increasing the wealth available for future generations of the family.

NEXT STEPS

There are many factors to be considered before committing to any estate planning decision. We would look forward to helping you determine which strategies may be most appropriate for your family's unique situation and goals, and assembling a meeting with your estate planning attorney and accountant to further explore what the implications would be for you.

As always, we look forward to answering any questions you may have for our team.

ABOUT THE AUTHOR

BRIAN LUSTER is a Principal and Chief Investment Officer of Collective Family Office located in York, Pennsylvania. With over 20 years of Wealth Management experience, Mr. Luster has previously served as Founder and CEO of a boutique Multi Family Office in New York City, as the Managing Member and Portfolio Manager of a long/short US event-driven value-oriented hedge fund in New York, and as a Senior Wealth Manager for BNY Mellon Wealth Management in Central Pennsylvania.

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ABOUT US

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