A Closer Look

Interest Rates Will Impact Your Estate Plan

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In Brief

- **Some estate planning strategies work well when interest rates are lower; some work well when rates are higher.**
- **When interest-rate trends change in one direction or another, it can have meaningful estate planning implications. Depending on where you are in the process — in the contemplation stage, in the midst of planning, or having already implemented a plan — the optimal approach might be to reengineer an existing strategy, implement a new strategy as soon as possible, or wait to implement a strategy.**
- **It's important to speak with your advisors periodically about any existing estate plans you may have or might be contemplating.**

After a decade of trending lower, interest rates turned up at the end of 2015, beginning a slow but steady rise — at least until recently, when the Federal Reserve hit the pause button on its rate-hike plans.

Interest rates affect many things, including borrowing costs, stocks, bonds, and even currencies. They also have an impact on estate planning strategies.

Some strategies work well when interest rates are lower; some are more effective when interest rates are higher. And where you are in the estate planning process — in the contemplation stage, in the midst of planning, or having already implemented a plan and transferred wealth — will need to be considered as well. It could make sense, for instance, to wait to implement a strategy. Maybe locking in today's low rates now is advisable. Or perhaps reengineering an existing strategy could be the best approach.

In this *A Closer Look*, we discuss interest rates and why they're important in estate planning, highlighting several of the most popular wealth-transfer strategies and when they are most (and least) effective.

Wherever you are in the planning process, now is a good time to speak with your advisors, who can review your situation and help you craft an approach that considers interest-rate trends and makes the most sense for you.

Interest Rates and How They Affect Planning

How is the taxation of estate and gift planning strategies tied to interest rates?

We've already noted above that interest rates, after an extended period of low levels, have been trending upward, fueled in part by a pattern of quarter-point increases in the federal funds rate by the Federal Reserve (Fed).

The federal funds rate (fed funds rate) is the interest rate that banks charge each other for short-term loans. (It is one of the principal tools the Federal Reserve uses to influence the economy and achieve its goals of full employment, stable prices, and moderate long-term interest rates.)

But what does the fed funds rate have to do with other interest rates — and with estate planning specifically?

Quite a lot, though not directly. Typically, an increase in the federal funds rate has a chain-reaction effect on long-term rates. Basically, when the Fed changes the fed funds rate, banks adjust their prime rate — the lowest rate banks can offer for mortgages and loans — up or down accordingly. Among other things, a change in the prime rate will affect costs for mortgages, car loans, business loans, and other consumer loans. It also impacts the two primary interest-rate metrics used in the taxation of gifts and bequests:

- **The Section 7520 rate.** Named after a section of the tax code, the 7520 rate is the legally required rate for several estate planning strategies. It is often referred to as the "hurdle rate" because certain strategies depend on investments returning more than the 7520 rate to be successful — so they tend to be most effective when the 7520 rate is low.

  The 7520 rate is recalculated by the Internal Revenue Service every month. It is equal to 120% of the then-current midterm applicable federal rate, or AFR (see below for a discussion of the AFR) rounded to the nearest two-tenths of one percent. For March 2019, the Section 7520 rate stands at 3.2%.

  The 7520 rate in its current form was established on May 1, 1989. Since then, the average rate has been 6.0%. Exhibit 1 reflects the monthly rates, with a trend line. Recently, the rate has been trending higher, but we have not seen the average rate since January of 2001 (the year a stamp cost $0.34 and a gallon of gas cost less than $1.50).

The Mathematics of Gifts and Taxes

Gift tax value often is based on the "subtraction method," by which the taxable gift is determined by subtracting the computed value of the retained interest from the fair market value (FMV) of the transferred asset:

FMV – retained interest = taxable value or charitable deduction value

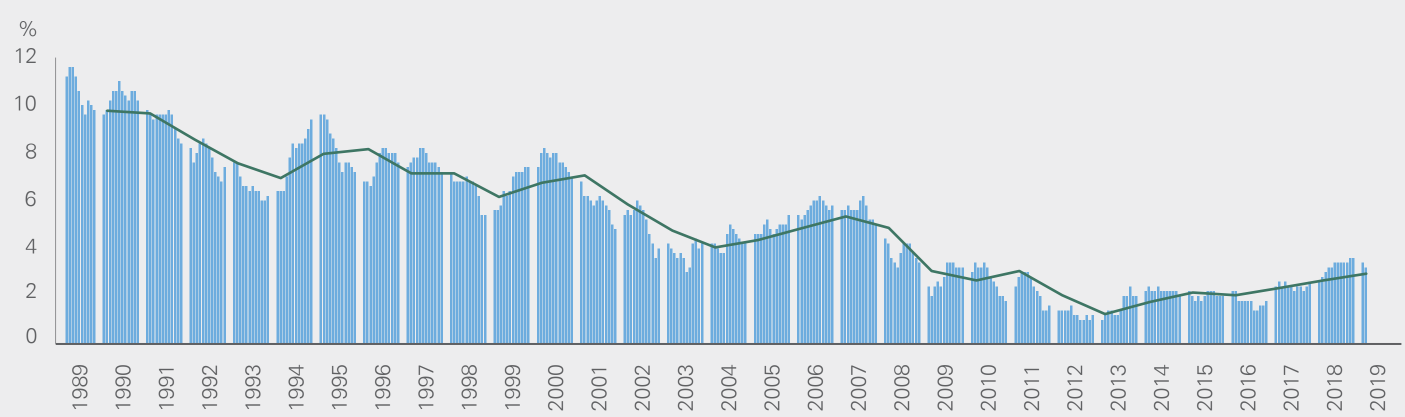
The retained interest is determined using an interest-rate factor (the AFR or 7520 rate).

For example, in a Qualified Personal Residence Trust (QPRT), a donor places her home into a trust but retains the right to live in it for a designated period. The higher the interest rate, the higher the value of the retained right to live in the home, which results mathematically in a smaller (more taxpayer-friendly) gift:

FMV of the house – computed value of retained right to live in it = taxable gift

- **The applicable federal rate (AFR).** The AFR represents the minimum interest to be charged on loans to avoid triggering imputed income or gift taxes. Certain wealth-transfer strategies that use the AFR to determine the present value of future payments are more effective when rates are higher. Essentially, a higher AFR will mean a lower present value — and, consequently, lower tax obligations.

Exhibit 1: History of 7520 Rate



Source: Internal Revenue Service

The AFR is trifurcated into short, mid, and long term, and it is based on the average interest rate for relevant yields on similar-duration Treasury obligations.[1] For March 2019, the short-, mid-, and long-term annual AFR rates are 2.55%, 2.59%, and 2.91%, respectively.

With very limited exceptions, the interest rate applicable when the strategy is put in place remains effective for the duration of the structure. For example, the 7520 "hurdle" rate for a grantor retained annuity trust, or GRAT, is captured when the trust is funded, and that rate remains in effect for that GRAT regardless of its duration.

Interestingly, the IRS announces the rates for a succeeding month around the twentieth day of the preceding month. Thus, the rate announced, say, on March 20 will be effective for April transfers. This can make the last week of each month a window of opportunity to implement certain strategies.

What Does This Mean for You?

No matter where you are in the estate planning process — thinking about planning, in the midst of planning, or have all planning complete — rates can have a significant impact:

- **If you're thinking about estate tax planning.** Crafting an effective estate plan can be a complex process depending on your financial situation, the nature of your assets, and a host of other family-specific factors. Interest rates are an additional — and critical — factor that should be considered, and preferably sooner rather than later. If you're contemplating estate planning, it's important to speak with your advisors about the ideal structures for your intended beneficiaries, including charities. Once these discussions are complete, you'll be able

Which Wealth Transfer Strategy for Which Rate Environment?

More Efficient Strategies in a Higher-Rate Environment

- **Charitable remainder annuity trust (CRAT).** The donor places an asset in a charitable trust; an annuity is paid to one or more persons (including the donor) for a term of years or lifetime; the remainder is given to a designated charity.
- **Qualified personal residence trust (QPRT).** A homeowner places a residence in trust but retains the right to live in it rent free for a designated period; the remainder (the residence) passes to heirs.*
- **Split-interest purchase (SPLIT).** The senior generation purchases a lifetime income interest in an asset; the younger generation purchases the remainder interest and receives the asset when the senior generation passes away.

More Efficient Strategies in a Lower-Rate Environment

- **Charitable lead annuity trust (CLAT).** A donor places an asset in a charitable trust. An annuity is paid to charity for a period of years; the remainder passes to heirs.*
- **Grantor-retained annuity trust (GRAT).** A grantor places assets into an irrevocable trust but receives the original value of the assets plus any appreciation up to the hurdle rate (7520 rate) over the term of the GRAT; any remaining assets pass to heirs.*
- **Private annuity.** An asset is sold to younger-generation family members (or trust); the asset is paid for via an annuity to the seller for a period of years or lifetime.
- **Intra-family loan.** Loan to a friend or family member (or trust) at the minimum interest rate needed to avoid imputed income or gift taxes. Payments are often interest only with a balloon at the end, enabling an arbitrage.

* Outright or in trust.

[1] There are three AFR rates. The short-term rates are determined from the one-month average of the market yields from marketable obligations, such as U.S. government Treasury bills ("T-Bills") with maturities of three years or less. Mid-term AFR rates are from obligations of maturities of more than three and up to nine years. Long-term AFR rates are from bonds with maturities of more than nine years.

to make an informed decision about whether to implement them now, or risk economic performance while waiting for interest rates to rise.

For example, if you wish to put a charitable remainder annuity trust in place with a financially stable asset, perhaps it would be sensible to wait until rates are higher.

If, instead, you are considering using an asset (such as pre-IPO stock) that may experience a substantial increase in value in the short term, it may be sensible to fund the CRT at the lower rate so as not to miss the pop in performance.

- **If you're in the midst of planning.** You should revisit the structures with your advisors. This is particularly true for strategies such as intra-family loans and sales to grantor trusts.

  The reason is that these typically include interest-only promissory notes. It may be possible to refinance the notes now, regardless of their due date. The result would be to "lock in" the current interest rate for a new (and perhaps even a longer) term, protecting the note from being restated if rates move higher.

  For example, perhaps the loan was made in 2012 with a nine-year term (this was done to capture the mid-term AFR). It thus comes due in 2021, when interest rates could be meaningfully higher than they are today. You could refinance the balance (or most of it) for a new nine-year term beginning in 2019 and not coming due until 2028.

  Further, we are in a less-than-common economic period with a "flattening yield curve," which in oversimplified terms occurs when the yields of longer- and shorter-duration bonds are disproportionately close to each other. One consequence is that the AFR rates are less disparate than typical. Thus, it might be possible to refinance a shorter-term note for a longer-term one with less than the typical leap in the minimum interest rate.

  Also, if you are currently employing a GRAT strategy, you might consider establishing a series of what we refer to as "shelf GRATs." These are GRATs established under current law and rates, and then placed in reserve, or "on a shelf," to be used if and when favorable.

  An example may help illustrate this concept:

  A rolling two-year GRAT program subjects each renewal to the then-present 7520 rate. If the rate is up at that time, it creates a higher "hurdle" for this strategy. However, when using a shelf GRAT strategy, along with establishing a two-year GRAT funded with an asset you expect to appreciate significantly (pre-IPO stock for this example), you also create a mid-term GRAT with, for example, a four-year term, and fund it with low-volatility assets, such as fixed income securities. (Many strategies employ a series of mid-term GRATs with varying terms.)

  As we mentioned above, this mid-term GRAT will retain the (presumably) lower hurdle rate. In later years, if the 7520 rate is up substantially (or if the law has changed to disallow short-term GRATs), you could take the mid-term GRAT "off the shelf" and swap in the volatile asset in exchange for the bonds. This would place the (hopefully) appreciating assets in a GRAT subject to the more favorable earlier rate and law. (See Exhibit 2 on page 5.)

- **If your wealth transfers are complete.** If you've transferred all the wealth you wish to, at least for now, you should review your strategies to see if the new tax law or possibly higher interest rates may have an adverse impact on ultimate transfers.

  Because of numerous changes in the relevant tax law, this review should cover the impact of the temporarily increased exemptions and higher rates on any formula bases requests, as well as analysis of capital gains basis management:

  – The higher exemptions may cause an imbalance in your intended bequests. For more information, see our *A Closer Look,* "Why You Need to Review Your Estate Plan Today."

  – If you have formulaic split-interest transfers or increases in bequests that are interest-rate sensitive, rerun the numbers to ensure they pass a higher-interest-rate stress test. For example, you may have included in your estate plan a charitable lead trust to be funded with an amount that equals your GST exemption. With higher exemptions and higher AFRs, would the amounts that go to charity and then to your grandchildren be what you intended?

  – With the reduction in the estate tax rate and the changes to the income tax laws, it is now more important than ever to include income tax planning, especially capital gains, within the estate plan.

Exhibit 2: Single Shelf GRAT Example

Key Takeaway: A Shelf GRAT strategy can help to keep hurdle rates low in a rising rate environment.

2019 Four-Year GRAT
Funded with Bonds

- For two years, grantor maintains bonds and pays annuity, as required.
- In 2021, grantor swaps bonds for equivalent value in stock (tax-free).

Result: For final two years of original term, serves like a two-year GRAT, but under presumed more favorable original 7520 rate, creating a greater likelihood of a successful wealth transfer.

2019 Two-Year GRAT
Funded with pre-IPO Stock

Assume in 2021 that the stock has not grown in value, but the 7520 rate has risen significantly.

This means a new 2021 two-year GRAT would have a much higher "hurdle," thus diminishing the wealth transfer.

Grantor

- In 2021, the grantor receives the balance of stock from the 2019 two-year GRAT.
- Instead of creating a new 2021 two-year GRAT at the presumed then-higher hurdle rate, client swaps stock into the 2019 four-year GRAT for equivalent value in bonds (tax-free).

Stock
Bonds

Source: Bessemer Trust

Consider that you may have established an irrevocable grantor trust into which assets were gifted or sold. These trusts are designed to hold assets that no longer will be included in your taxable estate. The benefits include protecting the appreciation on these assets from your estate tax — and their entire future value from your heirs' estates potentially for many generations (e.g., in Florida, for 360 years).

However, one trade-off is that there will not be a "step up" in basis for assets in the trust. In contrast, assets in your estate will receive a step up (or step down) in basis equal to their fair market value upon your death. In many cases, we find that the assets in the trust have grown in value and thus have significant unrealized capital gains, and assets remaining in your estate have high bases, often because they include cash and fixed income.

It may be possible to utilize a swap or substitution power to exchange the high-basis assets in your name with the low-basis assets in your trust, positioning your heirs to benefit from a step up. If the exchange is for an equivalent value (e.g., $2,000,000 of cash in your name for $2,000,000 of highly appreciated securities in your trust), there will be no income tax. So, there would be no income tax on the exchange, and a free basis step up at your death.

Other forms of basis management, including the exercise of powers of appointment or even decanting, also can be used to achieve greater tax efficiency for completed planning.

Next Step: Speak With Your Advisor

Interest rates impact many aspects of our lives, including our estate plans. We've described the basic characteristics of some of the most popular wealth transfer strategies, and when they tend to be most efficient. However, the optimal wealth-transfer strategy for you entails many more considerations. The decision to implement a new strategy today or wait, to reengineer one already in place, or to leverage the benefit of one already completed needs to be assessed in the full context of your circumstances and objectives — and, crucially, with the assistance of experienced planning professionals. Your advisors can help you weigh the potential benefits of different strategies and determine concrete actions to ensure that the maximum amount of your wealth will transfer tax efficiently to those persons and causes you wish to support.

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