Add Value Today

ESTATE PLANNING IN THE CURRENT ENVIRONMENT

In the current market environment, most people have focused their attention on immediate critical issues, including health and safety, employment and their financial situation. While estate planning may not seem like a pressing concern, volatile markets and low interest rates are creating compelling opportunities to plan for your family's future security. Individuals who updated their estate plans during the last market downturn were well rewarded. Now is another great time to review your estate plans. Are your plans up to date? How does the changing environment impact prior decisions? What strategies can you implement today to capitalize on the current low interest rate environment? In this paper, we will explore four estate planning strategies that benefit from the current market environment.

What Estate Planning Strategies Work Best in a Low Interest Rate Environment?

Planning in a low interest rate environment often involves strategies that take advantage of low interest rates to transfer wealth with minimal gift tax implications. Each of these strategies focus on moving any appreciation in excess of the appropriate interest rate or

"hurdle rate" to your intended beneficiaries from the transfer tax system.[1] The lower the interest rate, the easier it is to achieve a successful estate planning outcome.

The following estate planning techniques are particularly attractive in the current environment:

- Intra-family Loans
- Installment Sales to an Intentionally Defective Grantor Trust
- Grantor Retained Annuity Trusts
- Charitable Lead Annuity Trusts

ESTATE PLANNING INTEREST RATES

To understand why many estate planning strategies are so fruitful in a low interest rate environment, it is important to understand the Applicable Federal Rate ("AFR") and the Section 7520 Rate. Both rates influence how wealth transfers are valued for planning purposes. Published monthly by the IRS, the AFR and Section 7520 Rate are determined by a variety of economic factors.

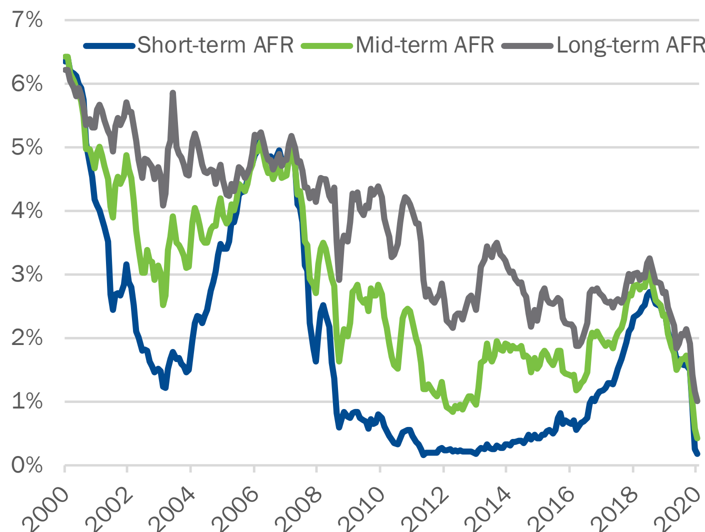
Applicable Federal Rate

The AFR is the minimum interest rate individuals can use for loans between related parties to avoid making a gift. There are three different types of AFRs: short-term for notes with maturities of three years or less; mid-term for notes with maturities between three and nine years; and long-term for notes with maturities greater than nine years. All three rates are near or at historic lows as presented in the chart below.

7520 Rate

The 7520 Rate, named after the IRS code that mandated its use, is the rate used to discount the value of annuities, life estates and remainder interests to their present value. It is equal to 120% of the midterm AFR. Because Section 7520 rates are tied to treasury rates, they have plummeted over the past two years as displayed in the chart below.

Applicable Federal Rates



Section 7520 Rates

Source: IRS, Hirtle Callaghan. As of September 1, 2020.

Intra-Family Loans

The simplest estate planning strategy in the current low interest rate environment is an intra-family loan – a direct cash loan to the person or trust that you wish to benefit. Individuals can loan money to family members at lower rates than those charged by commercial lenders. However, to ensure that the loan is not perceived as a gift by the IRS, the lender must charge the appropriate AFR as the minimum interest rate. If the loan recipient can earn a greater return on the amount borrowed than the interest rate being paid, he or she is able to keep the excess without any gift tax consequences.

[1] *The transfer tax system includes estate, gift and generation-skipping transfer taxes.*

The lower the interest rate, the greater the estate planning benefit.

For example, if a parent makes a 20-year $1 million loan to a child, the loan will be a successful estate planning tool if the child can earn over 1.00% (the long-term AFR for September 2020) with the money borrowed. If the child invests the proceeds and earns a 5% annual rate of return, he or she will grow the $1 million to $2,322,638 (while paying the interest on the loan annually) and will only have to repay his or her parents the original $1,000,000 at the end of the 20-year term. Therefore, the child is entitled to keep the difference of $1,322,638 without any gift tax consequences.

Families should consider refinancing existing intra-family loans with interest rates higher than the current AFR to take advantage of lower rates. This will reduce the amount the borrower must repay and may help to facilitate wealth transfer as the lender receives lower payments under the refinanced note and thus minimizes the assets being added back to the lender's taxable estate and subject to estate tax.

Installment Sale to an Intentionally Defective Grantor Trust ("IDGT")[2]

A sale of assets to an IDGT can be another attractive tool when interest rates are low. An installment sale to an IDGT is similar to an intra-family loan, but the borrower is a trust created by the lender as opposed to an individual. The lender (not the borrower) is responsible for any income tax, including capital gains tax, incurred by the trust. The lender sells an asset for its current fair market value to the IDGT. The IDGT gives the lender a promissory note in exchange for the assets with minimum interest set at the AFR.

IDGTs enable individuals to freeze the value of highly appreciating assets at current values and shift the future appreciation to the next generation. Because the lender is required to pay the trust's income tax liability, the loaned assets are able to grow inside the trust on an income-tax-free basis. For example, an IDGT holding $5 million in assets and earning 5% annually over a 15-year period would grow to almost $10.4 million unencumbered by taxes. Under the same conditions, a trust that needed to pay annual income taxes (assuming a 40% tax rate) would grow to only $7.8 million.

Similar to the intra-family loan, the goal of the sale to an IDGT is for the asset transferred into the IDGT to earn a greater rate of return than the interest charged on the promissory note. The lower the interest rate on the promissory note, the greater the opportunity for the asset to outperform. At the end of the loan term, any income and appreciation on the trust assets that exceeds the payments required under the note will pass to the trust beneficiaries free of estate and gift tax.

Grantor Retained Annuity Trust ("GRAT")[3]

A GRAT is an estate planning technique that allows for the transfer of the appreciation of assets at minimal or no gift tax cost. With a GRAT, the grantor transfers assets into a trust for a term of years while retaining the right to an annuity payment for a number of years. At the end of the trust term, the remaining assets are distributed to the trust beneficiaries. Individuals often create a series of short-term, rolling GRATs rather than a single, longer-term GRAT to increase the wealth transfer benefits and capitalize on market volatility.

The "hurdle rate" for a GRAT is the 7520 Rate. Therefore, any appreciation of the GRAT's assets in excess of the 7520 Rate (0.4% in September 2020) will pass to the GRAT's beneficiaries free of any gift or estate tax.

Now is also a good time to evaluate existing GRAT programs. For example, if you have an existing GRAT that is not going to be successful, consider substituting assets (cash and/or fixed income) and creating a new GRAT that has a better chance of success.

Charitable Lead Annuity Trust ("CLAT")

For those individuals who are charitably inclined, a CLAT works well when interest rates (in particular, the 7520 Rate) are low. A CLAT is similar to a GRAT, except instead of receiving the initial stream of annuity payments yourself, you designate a charity to receive them. When the trust ends, the remainder goes to your children or other designated beneficiaries.

As with a GRAT, the IRS values a CLAT using the Section 7520 rate. If the CLAT's investments outearn that rate, the excess passes to your beneficiary gift and estate tax-free. CLATs are appropriate for individuals who are philanthropic, are comfortable with losing control of, and income from, the estate planning assets, and wish to transfer asset appreciation to individual beneficiaries by using little or none of their gift tax exemption.

[2] For more information on IDGTs, read Hirtle Callaghan's article, "Estate Planning With Intentionally Defective Trusts."
[3] For more information on GRATs, read Hirtle Callaghan's article, "Heads I Win, Tails I Can't Lose – The Grantor Retained Annuity Trust."

What Assets Should You Consider Gifting in a Low Interest Rate Environment?

The best assets to gift in a low interest rate environment are those that have experienced a decline in value (or are currently undervalued) but are expected to appreciate in the future. This includes:

- Marketable securities
- Hedge funds
- Private equity investments
- Real estate
- Business interests

Closely-held business interests (partnerships, LLCs, S Corporations) are great candidates because they can often be discounted for valuation purposes due to lack of control and marketability provisions. For example, a $1 million minority ownership interest in a closely held business may be transferred to a beneficiary using only $700,000 of the lifetime gift tax exemption amount because it is illiquid and does not represent a controlling interest in the business (assuming the valuation is completed by a qualified appraiser).

Concluding Thoughts

The current economic conditions present a unique opportunity for families to pass a significant amount of wealth to the younger generations with minimal transfer tax exposure. However, it is important to consider which strategy meets your circumstance. Since 1988, we have been working hand in hand with families and their advisors to evaluate their estate plans. We welcome the opportunity to discuss how your estate and investment plan can capitalize on the current economic environment.

For more information, please reach out to your Investment Officer or Portfolio Manager.

Founded in 1988, Hirtle Callaghan is America's first Outsourced Chief Investment Officer, servicing institutions and families. In our role as Chief Investment Officer, we build global investment programs that are customized to each of our client's unique needs. The firm uses its collective purchasing power and aggregate expertise to access best-in-class specialist managers in diverse asset classes and strategies.

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