

Issues AND INSIGHTS

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Wealth Transfer Strategies for Rising Interest Rates

IN THIS ARTICLE

- Interest rates are a key component of wealth transfer strategies, and any changes in the rates will affect these strategies
- Some strategies are particularly beneficial in a low interest rate environment, while others become more suitable as rates continue to rise
- Until rates rise significantly, the tipping point for changing to high-rate wealth transfer strategies is in the distant horizon

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In December 2016, the Federal Reserve raised the interest rate and has indicated it expects to continue to raise interest rates in small increments in 2017. Interest rates are a key component of wealth transfer strategies, and any changes in the rates will affect these strategies. In a low interest rate environment, there are certain strategies that are particularly attractive; however, different methods will become more suitable as the rates continue to rise, and financial strategies always require consideration of individual circumstances.

UNDERSTANDING THE RATES

There are two interest rates that are particularly important in estate planning. The first is the Applicable Federal Rate (AFR), which is the minimum rate that intrafamily loans must bear to avoid a gift tax. Loans to a related party that don't bear the AFR are deemed disguised gifts to the extent the stated rate is below the AFR.

The other is the rate mandated in Section 7520 of the Internal Revenue Code (Section 7520 rate) that is used to determine the value of gifts split between the two parties. These rates are currently at or near historic lows. See Figure 1 for

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FIGURE I
Comparison of Applicable Federal Rates & Section 7520 Rates: January 2001–2017

Date	Short-term AFR (0-3 Years)	Mid-term AFR (3-9 Years)	Long-term AFR (Over 9 years)	Section 7520 Rate
Jan. 2017	0.96	1.97	2.75	2.4
Jan. 2016	0.75	1.81	2.65	2.2
Jan. 2015	0.41	1.75	2.67	2.2
Jan. 2013	0.21	0.87	2.31	1.0
Jan. 2012	0.19	1.17	2.63	1.4
Jan. 2009	0.81	2.06	3.57	2.4
Jan. 2004	1.71	3.52	5.01	4.2
Jan. 2001	5.90	5.61	5.78	6.8

select AFR and Section 7520 rates from January 2001-2017.

PLANNING IN A LOW INTEREST RATE ENVIRONMENT

There is still sufficient time to utilize the current strategies that are effective in low interest rate environments because, as mentioned earlier, current interest rates still remain near record lows. These strategies are particularly attractive for transferring assets that have the greatest potential for appreciation, and include the following:

Grantor Retained Annuity Trusts (GRATs)

A GRAT is a vehicle to transfer the growth on assets to future generations at reduced gift and estate tax costs. The grantor (or donor) transfers assets expected to appreciate in value to an irrevocable trust for a term of years. The grantor usually receives an annuity payment that is equal to some or all the value of the assets transferred to the trust plus interest as prescribed by the tax law. At the end of that period, the assets remaining in the trust after the payment of the annuity pass to family members or to a trust for their benefit. A GRAT is a split interest gift, and the Section 7250 rate is used to determine the actuarial value of the annuity retained by the grantor and the value of the future interest passing at the end of the term of the trust. To the extent that the assets in the GRAT appreciate at a rate higher

than the Section 7520 rate, the appreciation will pass to the family free of wealth transfer taxes.

Setting the length of the GRAT term is critical because the grantor must survive the term of the annuity in order for the tax benefits to be realized. If the grantor dies before the end of the term of the trust, the assets remaining in the trust will be includible in the grantor's taxable estate.

Charitable Lead Annuity Trusts (CLATs)

The CLAT works similar to a GRAT except that a charity receives the annuity instead of the grantor. Family members still receive what is left in the CLAT at the end of the term of the trust. Like a GRAT, the value of the CLAT remainder interest and the annuity interest are valued using the Section 7520 rate. To the extent that the assets in the CLAT appreciate at a rate higher than the Section 7520 rate, the appreciation will pass to the family free of wealth transfer taxes.

An added benefit to the CLAT is that it can be structured to take advantage of an income tax deduction in the first year of the CLAT for the value of the annuity. If the CLAT is structured that way, income received by the CLAT is taxed to the grantor even though the income is not received by the grantor. This is especially beneficial in years where the grantor will have significant income in the year the CLAT is created.

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The CLAT is also an effective alternative to a GRAT for grantors who do not need a current stream of income and are charitably inclined.

Intrafamily Loans

When properly structured, an intrafamily loan can provide attractive lending rates to family members without gift tax consequences. The borrower can use the proceeds for any type of purchase, including the purchase of a car or a home, or to add to a trust or fund an investment. So long as the interest rate is equal to or above the AFR, there is no gift. The AFR is usually more attractive than what's available commercially.

It is important to structure an intrafamily loan so that it is not treated as a gift. In addition to bearing interest at the AFR, it must be repaid. While repayment terms may be very liberal to the borrower, it is important to note that the interest is taxable to the lender. In the case of a loan used to purchase a home, the loan must be secured by a properly recorded mortgage to be deductible by the borrower. All intrafamily loans should be evidenced by a written promissory note.

Installment Sales to Grantor Trusts

A grantor trust is a trust that is recognized for federal gift and estate tax purposes, but ignored for income tax purposes. The grantor pays all income taxes incurred by the trust, but the trust is excluded from the estate of the grantor. In effect the payment of the income taxes is an additional "gift" to the trust each year. The trust itself is essentially tax free and can grow faster than a non-grantor trust. The grantor can sell assets to the trust in exchange for a note. This will freeze the value of the asset sold to the amount of the note. As with an intrafamily loan, the AFR is the minimum interest on the note to avoid any gift tax. This sale provides for the transfer of the appreciation of the asset above the AFR free of estate and gift taxes and without the recognition of any capital gains tax because the sale is disregarded for income tax purposes.

Since these sales are not specifically permitted by statute and entail more risk, it is important to carefully

structure the transaction with appropriate terms for the installment note. In addition, the asset being sold must be valued by professionals to determine the sales price. The installment may be structured as a balloon note or amortized over the term of the note. The trust is typically funded with a seed gift from the grantor equal to 10% of the purchase price of the property being sold to the trust.

STRATEGIES TO CONSIDER WHEN RATES BEGIN TO RISE

While interest rates need to rise significantly before the above strategies fall out of favor or at least become less beneficial, there are other strategies that become more attractive as interest rates begin to rise. Those strategies include:

Charitable Remainder Annuity Trusts (CRATs)

A CRAT can be established during the lifetime of the grantor or upon the grantor's death. The CRAT is similar to a CLAT in that it is a split interest trust. The difference is that the initial interest in the trust, the annuity, is payable to a non-charitable beneficiary instead of a charitable beneficiary. The assets remaining in the CRAT after the payment of the annuity—the remainder interest—is payable to a charitable beneficiary. The annuity payment to the charity must be equal to 5% to 50% of the initial value of the assets placed in the trust. The non-charitable beneficiary can be the grantor or the grantor's spouse or another individual. The present value of the remainder interest that eventually passes to the charity is deductible for income taxes as a charitable contribution by the grantor upon creation of the CRAT.

The assets of the CRAT are excluded from the estate of the non-charitable beneficiary, but if the non-charitable beneficiary is other than the grantor or the grantor's spouse, the present value of the annuity is considered a taxable gift upon the creation of the trust. The CRAT can sell the assets in the trust and avoid immediate income taxes upon the sale, although a portion of

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FIGURE 2
Comparing interest rate-sensitive strategies

Low Interest Rates	
Strategy	How it works
Grantor Retained Annuity Trust (GRAT)	Grantor transfers assets expected to appreciate in value to an irrevocable trust and receives an annuity payment for the trust's term; assets remaining at end of term pass to family members or to a trust for their benefit
Charitable Lead Annuity Trust (CLAT)	Similar to GRAT except a specified charity receives the annuity payments during the trust's term, not the grantor; assets remaining at end of term pass to family members or a trust for their benefit
Intrafamily Loan	Loans made to family members at the minimum AFR provide attractive lending rates without gift tax consequences; the loan must be repaid to avoid qualifying as a gift
Installment Sale to Grantor Trust	Grantor sells assets to the trust in exchange for a note, freezing the value of the asset sold to the amount of the note; grantor pays all income taxes incurred by the trust, but the trust is excluded from his/her estate
High Interest Rates	
Charitable Remainder Annuity Trust (CRAT)	Reverse of a CLAT, grantor receives annuity payments during trust's term and a specified charity receives the remaining assets at end of term
Qualified Personal Residence Trust (QPRT)	Grantor establishes a trust to hold his/her personal residence and retains right to live in it for trust's term; grantor gifts the remainder interest to beneficiaries at end of term

the capital gain might be subject to income tax upon the payment of the annuity to the non-charitable beneficiary. The value of the charitable remainder interest is determined by using the applicable Section 7520 rate. The remainder interest must be at least 10% of the value of the assets transferred to the trust. As a result, higher Section 7520 rates result in a higher annuity payout to the non-charitable beneficiary.

Qualified Personal Residence Trusts (QPRTs)

A QPRT is a trust established by the grantor to hold the grantor's personal residence. The grantor retains the right to live in the residence for a term of years and usually gifts the remainder interest to family members. The present value of the remainder interest is a taxable gift to the family members. The Section 7520 rate is used to calculate the present value of the remainder interest. The higher the Section 7520 rate, the less the present value of the remainder interest. As a result, the lower the present value of the remainder interest the lower the taxable gift.

The grantor must survive the term of the trust in order

for the value of the residence to be excluded from the grantor's estate. After the end of the term of years for the grantor to remain in the residence ends, the grantor must vacate the residence or pay the remainder beneficiaries rent equal to the fair market value of the rental value of the residence.

WHAT'S ON THE INTEREST RATE HORIZON?

Interest rates need to rise significantly before GRATs, CLATs, and intrafamily loans fall out of favor. The current thought is that there will only be small, gradual increases in the AFR and the Section 7520 rate over the next year. As a result, the economics of these strategies are only slightly less beneficial than in the past few years.

Some strategies such as the CRAT and QPRT discussed above will become more attractive as interest rates rise. Until the rates rise significantly, the tipping point for changing to high-rate wealth transfer strategies is in the distant horizon. Slowly rising interest rates means the decision should be when to implement the low interest rates strategies rather than discarding them altogether.

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Bruce is responsible for developing and implementing comprehensive financial, estate planning, and wealth transfer plans for high-net-worth families and entrepreneurs as part of the National Business Owners Advisory Services Group. Bruce works closely with clients and their advisors to define each client's specific goals and objectives before developing an appropriate plan. Bruce has more than two decades of experience in estate and financial planning for families and closely held business owners. He holds a Juris Doctorate from the Washington University School of Law and a bachelor's degree in Accountancy from the University of Illinois.

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