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Wealth Planning Update

3 Wealth transfer strategies in a low interest rate environment

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Key takeaways:

- With federal interest rates relatively low for the time being, the current environment may make it attractive for those considering IRS rate-linked strategies as a part of a wealth transfer plan.
- The techniques discussed here are particularly effective if implemented when interest rates are relatively low. If rates increase, they may not be as attractive. Proposed legislation may also remove some opportunities that are available today.

What this may mean for you:

- If you are considering transferring your assets, carefully evaluate the use of rate-linked strategies to help enhance the transition of your family's wealth before rules surrounding these potential wealth transfer strategies may be changed.

We continue to experience unprecedented times related to the economy and historically low interest rates despite slight increases in rates from 2020 levels. Changes in interest rates can have an impact on certain wealth transfer strategies due to divergence between the interest rates prescribed by the IRS for these strategies and the overall economic environment. If you expect to have exposure to federal estate taxes and are looking to transfer wealth to family members, a low-interest rate environment can offer significant planning opportunities.

This update outlines three estate planning strategies to help take advantage of low interest rates and increased estate exemptions. Proposed tax legislation could reduce or eliminate many of the benefits described below. Please consult your estate and tax advisor before proceeding with any of the strategies explained below.

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How do interest rates affect estate planning techniques?

Each month the IRS publishes an applicable federal rate (AFR) that can be used for personal intra-family loans, as well as certain related discount rates that may be used for present value computations that apply to a variety of estate planning strategies. Both the AFRs and the discount rates can impact the related calculations and the effectiveness of the strategies. Three wealth transfer techniques, grantor retained annuity trusts (GRATs), charitable lead trusts (CLTs), and loan-based solutions, can be more effective when rates are low.

In a low interest rate environment, investors have a low hurdle rate to overcome in order to transfer surplus wealth to their beneficiaries. For example, under a GRAT, the IRS prescribes a specified interest rate, under Section 7520, to calculate the current value of a future gift. If markets are favorable and you achieve a total return greater than the hurdle rate over the term of the trust, the value transferred to the beneficiaries could be greater than the amount initially transferred and reported as a gift. Additionally, the low AFRs may allow you to act as a lender and charge a lower interest rate to your beneficiaries to transfer wealth at a more efficient rate. A rise in federal interest rates will increase the linked IRS hurdle and intra-family lending rates, making GRATs, CLTs, and inter-family loans less advantageous. In 2021, the rates have risen slightly, but the interest rates are still at a very desirable level for wealth transfer purposes.

Three wealth transfer strategies to help take advantage of low rate environment:

1. **GRAT—**A GRAT is a wealth transfer technique commonly used to transfer assets to a designated beneficiary. This strategy is typically considered successful when the assets placed in a GRAT appreciate at a rate that exceeds the discount rate over the term of the GRAT. To structure the transaction, a grantor transfers assets to a trust in exchange for the right to receive payments, on at least an annual basis, for a certain term. At the end of the term, any remaining assets in the GRAT pass to the beneficiaries (or are held in trust for their benefit). If the grantor survives the term, the trust principal is excluded from the grantor's estate for federal estate tax purposes and the only transfer tax "cost" of the initial funding is considered a gift for tax purposes. In times of low rates, the GRAT can be an attractive technique since there is a lower "hurdle" to clear for the GRAT to be successful. However, if a GRAT is funded with equities, market volatility can also be a key variable that impacts the ability to transfer wealth under this strategy. If the contributed assets decline in value, stay flat, or don't grow much, there is nothing left to transfer. Another point to keep in mind is that if the grantor dies before the GRAT term ends, the full value of trust assets is included in the grantor's estate and will be subject to estate tax.

2. **CLT—** A CLT is an irrevocable trust that pays a charitable beneficiary an annuity or unitrust amount for a prescribed period of time. Similar to a GRAT, a CLT is linked to the interest rate the IRS set in the month it was funded. Depending on how it was structured, a CLT may provide an income, gift, or estate tax deduction. In a CLT transaction, a donor transfers property during life (inter vivos) or upon death (testamentary) to the trust, creating an income interest in the property in favor of a charitable organization for a period of years or for the life or lives of an individual (or individuals). At the end of the term or measuring life, any remaining assets pass to family beneficiaries. The "present value" of the future transfer to family members is determined using a discount rate (the section 7520 rate) set by the IRS. Low interest rates are favorable for CLTs because they (a) set a lower "hurdle" that trust investments need to clear and (b) reduce the gift and estate tax cost of making substantial long-term gifts to family members. Keep in mind that the charitable payment must be made each year, regardless of whether the trust has generated sufficient income to fully fund the payment. Since a CLT is irrevocable, trust terms cannot be altered after assets have been transferred into the CLT.

3. **Loan-based solutions**—Low interest rate environments may be advantageous for personal, intra-family loan-based solutions where you, as the lender, can provide your beneficiaries with loans at the prescribed AFR, which may often be below commercial rates.

   - ***Intra-family Loans***. These are loans between family members, often a parent to a child or grandparent to a grandchild, in which the lender charges interest at the prescribed AFR set by the IRS. This technique may be a fit due to opportunities between loan and investment rates. For instance, if the child (as the borrower) can invest the loaned funds in a hopefully higher but variable rate of return and potentially earn a higher rate of return than the interest being paid, the difference could be a tax-free gift from the lender to the child. However, tax laws disfavor "gift loans" so it is important to work with your tax advisors and keep transactions within AFR guidelines.

     This strategy also has the potential to provide some additional monetary benefits for the family, such as keeping the interest paid on the loan in the family and mitigating any additional loan costs associated with borrowing from third parties.

   - ***Sale to an intentionally defective grantor trust (IDGT)***. This is a strategy in which a trust is created for the benefit of the seller's heirs. The seller can apply a discount to the sale price of the asset when certain factors such as lack of transferability, lack of management control, and minority or non-voting interests exist. Additionally, the trust is typically set up as a "grantor" trust, which means that the grantor is responsible for income taxes on all income and gains within the trust (even though the grantor does not receive any of that income). By paying the trust's income taxes, the grantor is essentially making additional tax-free gifts each year to the trust beneficiaries. Although there are no settled rules, many tax advisors believe that prior to the sale, the trust should be funded with cash or other liquid assets ("seed money") equal to at least 10% of the value of the amount being borrowed. The fact that the trust starts out with some capital helps bolster the economic substance of the transaction. Finally, the technique becomes even more powerful during low interest rate environments because the seller can create the promissory note with a low interest rate loan at the AFR. This has the potential to provide additional savings to the trust beneficiaries by reducing the amount of annual interest payments they must make to the seller. As with all strategies, there are potential drawbacks. These include the fact that if the grantor dies before the promissory note is paid, it will be included in the grantor's estate at death. Also, the trust must outperform the interest rate on the note during the note term or principal must be used to make interest payments (reducing assets available for the beneficiaries).

   - ***Self-canceling installment note (SCINs)***. This is a technique in which the seller sells an asset to a buyer in exchange for an installment note that is to be paid over a term of years. What makes this technique special is that the buyer's obligation to pay the note automatically ceases upon the seller's death, even if the term of the loan has not yet expired. To compensate for the risk that payments could end prematurely, tax rules require that the buyer must pay an initial sales price premium, or pay an interest rate premium over the life of the loan. If the seller lives for the full term of the loan they have effectively increased their taxable estate due to the premium paid. Also, if the sold asset does not outperform the SCIN's interest rate and valuation discount, the seller's estate may be increased if the seller survives the term of the SCIN. Also keep in mind that the costs of a SCIN can be significant, both in the form of initial set-up expenses and in terms of the cash flow the buyer will need for repaying the note.

Summary

With interest rates hovering at historical lows for the past few years, this could be a good time for families with estate tax exposure to evaluate estate planning strategies that benefit from favorable AFR and Section 7520 rates, which are still not far above historic lows. We suggest speaking with a Wells Fargo relationship manager or financial advisor, as well as your tax and legal advisors, about what is most appropriate for your individual and family situation. Please be aware that proposed tax legislation could alter or eliminate many of the benefits described above.

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