

Planning Opportunities: Taking Advantage of Low Interest Rates

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In a world where one can enjoy some 127 different flavors of soft drinks at the push of a button, it is fair to think that one flavor does not satisfy all. The same is true when it comes to wealth transfer. In fact, there are beneficial planning strategies for different types of assets and different strategies for various economic environments. These factors, combined with varying degrees of complexity, make it challenging to both understand and navigate the planning process to find what is best for you and your family. When considering planning opportunities, any transfer or tax strategy should be evaluated in light of your family's primary goals, objectives, and stewardship intent.

In a low interest rate environment like we have today, individuals and families can take advantage of particular strategies that leverage low interest rates in order to transfer wealth and effectively "freeze" estate values with little to no gift tax. These strategies can be particularly helpful for an individual who has used up all their lifetime exemption. If structured properly, these strategies can offer tremendous financial

benefits for families and be aligned with a family's particular stewardship principles, charitable goals, estate tax savings plans, and multi-generational family engagement objectives.

While this is not meant to provide an exhaustive list or be a substitute for specific, professional guidance, we believe it is helpful to explore a few of the common strategies and vehicles used today to achieve some of these goals. Below we consider intra-family loans, installment sales to grantor trusts, grantor retained annuity trusts, and charitable lead annuity trusts.

Intra-family Loans

Sometimes, the simplest approach is best. With the uncertainty that prevails in the tax code and financial markets today, individuals and families may find comfort in a straightforward approach to generational wealth transfer. Intra-family loans are one of the more convenient methods to shift appreciation to subsequent generations within the family.

The general concept seeks to arbitrage current low interest rates with higher expected future growth rates. Lending assets with higher anticipated appreciation to subsequent generations (outright or in trust) “freezes” the value of the loaned assets to the lending generation for estate tax purposes, and allows any future appreciation on those assets in excess of the interest cost to accrue to the borrowing generation.

In its simplest form, a member of the senior generation makes a cash loan to a member of the next generation who in turn purchases assets expected to appreciate in value. The loan should be officially documented by a written promissory note and signed by all parties. The terms can be customized and can even provide for interest-only payments for a specified term of years with a balloon payment at maturity. To substantiate the loan, payments should be made consistently and timely. The IRS even designates the minimum interest rate it will respect for a loan in its monthly Index of Applicable Federal Rates. Commonly called the “AFR” rates, they are set by loan term length: short-term (0 – 3yrs), mid-term (3 – 9yrs), long-term (9 – 30yrs).

If the assets purchased with the loan proceeds appreciate at a rate in excess of the

loan interest, the excess return accrues to the borrower (the next generation family member) gift and estate tax free.

It is important to recognize that the interest received from the borrower will be taxable income to the lender; the interest paid by the borrower may or may not be deductible by the borrower, depending on the use of the funds.

How does this work?

Example: Assume a parent lends \$1 million to a child in exchange for a promissory note with a 9-year interest only term at 0.62% interest and balloon principal payment due at maturity. The child turns around and invests the cash in an asset that earns 8% annually on a pre-tax basis. After paying the balloon payment at maturity the child would still have \$921,582, which is the compounded growth on the \$1 million investment in excess of the annual interest payment. Wow! The table below provides a summary.

Year	Beg. Balance	\$ Return	Note Payment	Ending Balance
1	\$1,000,000	\$80,000	(\$6,200)	\$1,073,800
2	\$1,073,800	\$85,904	(\$6,200)	\$1,153,504
3	\$1,153,504	\$92,280	(\$6,200)	\$1,239,584
4	\$1,239,584	\$99,167	(\$6,200)	\$1,332,551
5	\$1,332,551	\$106,604	(\$6,200)	\$1,432,955
6	\$1,432,955	\$114,636	(\$6,200)	\$1,541,392
7	\$1,541,392	\$123,311	(\$6,200)	\$1,658,503
8	\$1,658,503	\$132,680	(\$6,200)	\$1,784,983
9	\$1,784,983	\$142,799	(\$1,006,200)	\$921,582

Installment Sale to a Grantor Trust

An installment sale works very similarly to an intra-family loan, but with some added complexity. First, while the lender (seller) remains the same (typically the senior generation), the borrower (purchaser) is now a grantor trust that the lender (seller) established; second, the sale typically involves assets other than cash.

What is a grantor trust?

In this situation, an irrevocable trust is established with special access or control provisions retained for the grantor (e.g. the right to substitute property of the trust) such that the IRS does not recognize the transfer for income tax purposes and any income earned by those assets is taxable to the grantor (or maker) of the trust. The transfer is respected by the IRS for estate planning purposes, and when structured properly the assets held in this trust grow outside the grantor's estate. In addition, the grantor's estate is further reduced each year by the income taxes paid on income earned from assets in the trust.

Although setting up a grantor trust and funding it with seed capital add complexity to the plan, this planning structure allows for greater control and creditor protection as the beneficiary does not have direct and unlimited access to the assets. Additionally,

the sale transaction is not a taxable event to either party since the IRS deems each party on both sides of the sale to be the same taxpayer. These benefits can be further enhanced using non-cash assets that can be sold to the trust at a discounted value.

How does this work?

Example: Assume a parent sells \$1.5 million partnership interest to a grantor trust the parent established for a child. The partnership interests had a discounted value of \$1 million. The sale is in exchange for a promissory note with a 9-year interest only term at 0.62% interest and a balloon principal payment due at maturity. The partnership interest appreciates at an assumed 8% rate annually on a pre-tax basis. After paying the balloon payment at maturity, the trust would still have a partnership interest valued at \$1,921,084, which is the compounded growth on the \$1.5 million partnership in excess of the annual interest payments and the \$1 million principal payment at maturity. Wow! The table below provides a summary.

Year	Beg. Balance	\$ Return	Note Payment	Ending Balance
1	\$1,500,000	\$120,000	(\$6,200)	\$1,613,800
2	\$1,613,800	\$129,104	(\$6,200)	\$1,736,704
3	\$1,736,704	\$138,936	(\$6,200)	\$1,869,440
4	\$1,869,440	\$149,555	(\$6,200)	\$2,012,796
5	\$2,012,796	\$161,024	(\$6,200)	\$2,167,619
6	\$2,167,619	\$173,410	(\$6,200)	\$2,334,829
7	\$2,334,829	\$186,786	(\$6,200)	\$2,515,415
8	\$2,515,415	\$201,233	(\$6,200)	\$2,710,448
9	\$2,710,448	\$216,836	(\$1,006,200)	\$1,921,084

Zeroed-Out Grantor Retained Annuity Trust (“GRAT”)

A GRAT is an irrevocable grantor trust in which the grantor contributes assets to the trust and retains the right to receive an annuity payment from the trust for a specific term (generally 2 to 10 years). Considered a grantor trust for income tax purposes, income produced by the trust is taxable to the grantor, which helps the assets within the trust grow without the drag of income taxes being paid out of the trust assets. When the trust term ends, if assets have outperformed the IRS hurdle rate (the assumed rate of return), the excess appreciation is passed on (outright or in trust) to the trust beneficiaries estate and gift tax-free—as long as the grantor outlives the trust term. If the total annuity payments amount is set to equal the value the grantor originally contributes to the trust, plus interest, the IRS will set the gift value of the contribution to the trust at zero (hence the term “zeroed-out”) and the grantor will not be deemed to have made a taxable gift on the assets placed in the trust.

While attorneys often recommend two or three year terms for GRATs, it should be noted that short-term GRATs have been on the short list of planning strategies that may be subject to changes as Congress considers new tax proposals.

Like the installment sale, the transfer of the property to the GRAT and the ensuing annuity payments will not incur income taxes. However, there are economic differences between the two strategies that should be considered. First, in a “zeroed-out” GRAT, the annuity payments are not “interest only” thus reducing the effect of leverage on returns. Second, there is limited risk in GRAT planning, as assets will simply be returned to the Grantor’s estate if the hurdle rate is not cleared or if the grantor dies before the end of the term. Considering these differences, individuals will often create a number of short-term GRATs or even a series where subsequent GRATs are funded through the annual annuity payments of prior GRATs.

How does this work?

In a low interest rate and volatile market, a managed GRAT program can offer incredible benefits. Consider the typical path of the price of a share of stock. It may have an expected return of 10% with a standard deviation of 25%. What this means is that in any year we would expect the stock price return on the year to be within a range from -15% to 35%. However, the path of that return can be quite volatile. A managed GRAT program uses the grantor’s power of substitution to swap assets to lock in gains or to re-GRAT those assets that have fallen in

value. Remember, if the hurdle rate is not cleared, the assets are simply returned to the grantor.

When funding a GRAT, assets with a current low valuation but with potential for high appreciation are best. Additionally, it is often best to isolate volatile assets and concentrated positions within a single GRAT.

Zeroed-Out Charitable Lead Annuity Trust (“CLAT”)

For individuals and families who desire a charitable component to their estate plan, a CLAT can be a powerful choice in a low interest rate environment. A CLAT functions in a similar manner as a GRAT with one main caveat: the annuitant is a charity rather than the grantor. This difference is significant in that this plan serves to reduce an individual’s estate rather than “freezing” the value. When establishing a CLAT, the donor/grantor can choose the term, the payment “annuity” amount, and the beneficiaries. A “zeroed-out” CLAT sets the present value of all annuity payments (based on the current IRS interest rate) equal to the value of the donated property, plus the applicable interest rate, which allows for the donor to receive a 100% deduction of the fair market value of the donated property. There may be additional income tax benefits by using

highly appreciated assets to fund the CLAT. After the annuity term, the remaining assets in the CLAT pass either outright or in further trust for the benefit of future generations of the family (the remainder beneficiaries of the trust).

While the income tax benefits to such philanthropic planning may be enticing, one must be comfortable relinquishing control, income, and use of these assets. Nevertheless, for philanthropically oriented families, considering a CLAT can be a very useful tool to transfer appreciation to future generations without paying gift tax.

How does this work?

Example: Assume a gift of \$1 million is made to a 20-year term zeroed-out CLAT. Further assume that the IRS applicable rate is 0.80% and the cash is invested to produce a 5% return. The computation of the annuity payment is beyond the scope of this discuss, but the charity will receive annual payments of \$54,306 for 20 years (\$1,086,118 total) and the remainder beneficiaries should receive \$857,621 at maturity.

Year	Beginning Balance	5% Growth	Charity Payment	Ending Balance
1	\$1,000,000	\$50,000	(\$54,306)	\$995,694
2	\$995,694	\$49,785	(\$54,306)	\$991,173
20	\$868,502	\$43,425	(\$54,306)	\$857,621
Summary:	\$1,000,000	\$943,739	(\$1,086,118)	\$857,621

Bringing it all together

With interest rates rising off recent lows and changes to tax policies likely on the horizon, there may not be a more opportune time to revisit your estate and wealth transfer plan. While there is no certainty on when rates will level off or which tax policies will be changed, we believe it is always prudent to assess your options sooner rather than later.

In addition to the benefit of shifting appreciation out of one's estate, intra-family loans and installment sales provide flexibility for those who have unused exemptions but are unsure about how much they are ready to pass down to future generations. As family circumstances or tax policies change, loans can be paid back (providing liquidity to the lender) or forgiven (creating a completed gift from the lender).

As mentioned above, GRATs have long been on the political chopping block. With the power to substitute assets between the grantor and the GRAT, one might not only consider the two-year example above, but also creating a series of 2, 3, 4, 5,...,10 year maturity GRATs this year to continue the rolling GRAT concept which may remain grandfathered under current law.

Lastly, if the benefits of the zeroed-out CLAT sound appealing but you desire to incorporate a greater level of flexibility with regard to the charitable beneficiary of the trust, consider pairing the CLAT with a donor-advised fund to optimize your giving strategy. A donor-advised fund ("DAF") is a dedicated account administered by a public charity for the sole purpose of managing charitable donations on behalf of individuals and families (donors). Using a DAF allows the donor to direct charitable gifts to a qualified charity (or charities) and to change the gift amounts and/or charitable beneficiaries over time.

To be certain, the current environment is fertile ground for planning when considering the historically low level of interest rates and currently generous gift and estate tax laws.

Please consider reaching out to us to further explore your goals and objectives and to allow us to help you create and implement plans that will help you achieve these goals and objectives.



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Prior to joining Chilton Trust, Thomas served as a Principal and Senior Client Advisor at Bessemer Trust where he led a team that advised and implemented strategies for clients in the areas of investment management, estate planning/wealth transfer, tax planning, and philanthropy. He was a senior member of the firm's Officer Committee and Florida Trust Committee. Thomas began his career with an investment focus as a Portfolio Analyst with a Sarasota based RIA and later as a Portfolio Manager with Northern Trust.

Thomas received his MS Finance from the Kelley School of Business at Indiana University and BS Finance from the Lutgurt College of Business at Florida Gulf Coast University, where he graduated Magna Cum Laude. Additionally, he has earned the CFA Charterholder designation and is an honors graduate from the Cannon Trust School. He is a member of the CFA Institute and CFA Society of Naples, where he served as a past board member. Thomas enjoys teaching and mentoring and has served as an adjunct professor of Finance at Florida Gulf Coast University and remains actively involved with the college of business as a mentor and guest speaker. Thomas resides in Naples, Florida with his wife and three children.

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