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A Window of Opportunity: Taking Advantage of Low Interest Rates

Low interest rates can magnify the benefits of certain wealth transfer strategies. Rates have been moving higher, but they are still historically low, creating a window of opportunity to keep family wealth in the family, mitigate potential transfer tax liability, and maximize philanthropic impact.

Many family wealth transfer strategies are more effective when interest rates are low. Though the Federal Reserve (Fed) has recently stepped up its slow march to raise rates, they are still at historic lows.¹ This opens a window of opportunity to take advantage of strategies which provide greater advantage in low-interest-rate environments, such as Grantor Retained Annuity Trusts (GRATs), Charitable Lead Annuity Trusts (CLATs), and intra-family loans. The effective federal funds rate, an interest rate influenced by the Fed, has changed over the past few decades.² The effective funds rate reached a high of 19% in June 1981 but dropped precipitously from 5% to under 1% after the Great Recession of 2007. As of this writing, May 4, 2018, it was 1.7%.

Below, we review three strategies that perform well in low-interest-rate environments. Keep in mind that personal circumstances and goals are significant factors to consider when choosing to implement a financial or estate-planning strategy. Low interest rates in themselves are not a reason to implement a strategy.

Mitigating Federal Transfer Taxes

A number of the strategies discussed below refer to federal transfer taxes such as the estate tax, the gift tax, and the generation-skipping tax. The current version of the federal estate tax was implemented in 1916 and the federal gift tax followed soon after in 1924. In the following decades, there has been substantial debate over the merits of such taxes. That debate continues today with legislative proposals to repeal the estate tax. The tax reform legislation of 2017 substantially increased federal estate and gift tax exemption levels, but the increase is temporary.³ Given the uncertainty of future legislation and the potential need for the government to raise revenue, even if a repeal were implemented, that repeal may not be permanent. It is important to understand that each of the strategies discussed below has advantages and considerations beyond mitigating federal transfer taxes and income taxes. Transfers of family wealth may help to educate future generations on how to handle wealth, protect assets from creditors, or accomplish a charitable goal.

¹ The Federal Reserve, Selected Interest Rates, April 25, 2018, Available at: <https://www.federalreserve.gov/releases/h15/>.

² Board of Governors of the Federal Reserve System (US), Effective Federal Funds Rate [FEDFUNDS], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/FEDFUNDS>.

³ Tax Cuts and Jobs Act of 2017.

Grantor Retained Annuity Trusts

The estate tax, gift tax, and generation-skipping tax are levied when wealth is transferred from one generation to the next. One common strategy for transferring wealth while mitigating federal transfer taxes is the GRAT (GRAT Example).⁴ The success of a GRAT relies in part on trust assets growing at a rate that exceeds the IRC § 7520 rate (7520 rate), which is influenced by current interest rates.⁵ A low 7520 rate maximizes the potential for success, with success being measured by

the amount of wealth that may be transferred with the lowest amount of federal transfer tax, if any, to be paid as a result of the transfer (Table 1).

Family Loans

Another way to pass on wealth to family members is through the use of loans. However, the IRS generally assumes intra-family loans are gifts.⁸ This presumption may be overcome as long as the loan is a bona-fide loan and there is a real expectation of repayment (Private Loan Example, page 3). In addition, a minimum interest rate

GRAT Example:

Sam and Emily Smith would like to make a future transfer of assets currently valued at \$10 million. For the next 10 years, they intend to receive distributions from the assets, after which they would like to gift ownership to their children. They would like to avoid any gift taxes when the transfer is made, but they have already used their lifetime gift tax exemption. A GRAT may be designed in a manner that the Smiths will receive annual distributions from the trust, pass on the remaining assets to the children in 10 years, and avoid being subject to gift taxes or using any of their lifetime exemption. One of the factors that makes this strategy more effective is lower interest rates.

Table 1
10-Year, \$10 Million Grantor Retained Annuity Trust*

Sec. 7520 Rate ⁶	Annual Distribution to Grantor	IRS Value of Remainder for Gift Tax Purposes	Actual Remainder to Family (Year 10)
3.0% (March 2018) ⁷	\$1,136,680	\$0	\$2,495,200
5.0% (Average Rate 2000-09)	\$1,295,050	\$0	\$874,260
7.8% (Average Rate 1990-99)	\$1,476,890	\$0	\$0

* "Zeroed-out" 10-year GRAT design initially funded with \$10 million, Annual distribution to grantor based on creating a zero gift tax value, assumes 2% income and 4% growth on GRAT principal.

Source: Internal Revenue Service, PNC

⁴ Refer to the article, "Grantor Retained Annuity Trusts," produced by the PNC Center For Financial Insight, for additional details on the GRAT strategy.

⁵ IRC §7520.

⁶ IRC § 7520 rate is used to determine the remainder value of a GRAT for gift tax purposes.

⁷ IRS Section 7520 Interest Rates, Available at: <https://www.irs.gov/businesses/small-businesses-self-employed/section-7520-interest-rates>.

⁸ *Harwood v. Com'r*, 82 T.C. 239, 258 (1984)

Private Loan Example:

Kevin and Joan Miller would like to start transferring some of the family wealth to their children who currently have a number of business opportunities they would like to pursue. Similar to Sam and Emily in the GRAT Example (page 2), they want to avoid paying gift taxes and have used their lifetime exemption. Instead of making gifts to their children, they make loans. A loan of \$10 million, with interest-only payments followed by a balloon payment in year nine, may provide the Millers with a means for transferring wealth to their children free of gift taxes. The lower the applicable rates, the lower the interest on the loan (Table 2).

Table 2
\$10 Million Private/Family Loan Example

Mid-Term AFR	Interest Paid Annually	Balloon Payment (End of Year 9)	Net Amount Available to Family after Payment of Loan*
.84% (Lowest Rate Since 2000) ¹⁰	\$84,000	\$10,000,000	\$5,929,520
3.07% (Average Rate Since 2000)	\$307,000	\$10,000,000	\$3,366,960
6.80% (Highest Rate Since 2000)	\$608,000	\$10,000,000	\$0

*Assumes 6% growth on loaned assets less interest paid.
Source: Internal Revenue Service, PNC

must be applied to the loan, known as the applicable federal rate (AFR).⁹ The AFR is influenced by current interest rates. The lower the AFR, the lower the interest rate. The family may invest the loaned assets such that the return they receive is greater than the interest they pay on the loan. (Table 2).

Charitable Lead Annuity Trusts

Families that wish to financially support the missions of charitable organizations or advance other philanthropic goals may seek to maximize the tax advantages of their charitable gifts. For those who plan

to make consistent annual charitable gifts, a Charitable Lead Annuity Trust (CLAT) may provide a number of advantages.¹¹ One of the primary tax benefits of a CLAT is that the donor may receive a current-year income tax deduction for charitable gifts that will be made in the future.¹² The lower the 7520 rate, the greater the tax deduction (CLAT Example and Table 3, page 4).

Other Opportunities

The strategies discussed above are just a few of the ways to take advantage of low interest rates. Other options may be available depending on your

⁹ Estate of Van Anda v. Comr., 12 T.C. 1158, 1162 (1949). The IRS may take other factors into consideration such as the existence of a written promissory loan, collateral, a fixed repayment structure, and the solvency of the debtor.

¹⁰ IRS Index of Federal Applicable Federal Rates (AFR) Rulings, Available at: <https://apps.irs.gov/app/picklist/list/federalRates.html>.

¹¹ Refer to the article, "Charitable Lead Trusts", produced by the PNC Center for Financial Insight, for additional details on the CLAT strategy.

¹² IRC § 4947. Charitable income tax deduction may be limited, see IRC § 170.

CLAT Example:

John and Jennifer Jones have regularly supported charitable organizations in their community. John would like to continue making annual charitable gifts of at least \$50,000 a year during his life. By contributing \$1 million to a lifetime 5% CLAT, with \$50,000 distributed to charity annually and the remainder passing to Jennifer after his death, John may be able to take advantage of a current-year income tax deduction even though all of the payments to charity will not be made until future years. Once again, this demonstrates that the lower the 7520 rate, the greater the income tax deduction (Table 3).

Table 3
\$1 Million Lifetime Charitable Lead Annuity Trust*

Sec. 7520 Rate	Annual Payment to Charity	Remainder to Family (Life Expectancy)*	Current Year Income Tax Deduction
3.0% (March 2018) ¹³	\$50,000	\$1,282,129	\$643,639
5.0% (Average Rate 2000-09)	\$50,000	\$1,282,129	\$539,625
7.8% (Average Rate 1990-99)	\$50,000	\$1,282,129	\$432,195

* Assumes trust has a 6% total return.

Source: Internal Revenue Service, PNC

particular goals and circumstances. For example, installment sales of business interests to a family member are more favorable for the buyer when interest rates are low. Charitable deductions for gifts of the remainder interest in a residence or farm are greater when interest rates are low as well. It is important to seek the advice of professional advisors familiar with both these strategies and your specific goals and financial situation.

Low interest rates may provide a window of opportunity to effectively achieve your wealth transfer and legacy planning goals. Since 2010 we have been in a period of historically low rates, but the Fed has recently announced a number of small increases, with the possibility of more increases in coming years.¹⁴ While the window remains open, it may be a good time to discuss these opportunities with your professional advisors.

For more information, please contact your Hawthorn advisor.

¹³IRS Section 7520 Interest Rates, Available at: <https://www.irs.gov/businesses/small-businesses-self-employed/section-7520-interest-rates>

¹⁴Board of Governors of the Federal Reserve System. Data available at: <https://www.federalreserve.gov/newsevents/pressreleases/monetary20180321a.htm>

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