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TOPIC: Shifting Gears? Rising Rates and Legacy Planning.

MARKET TREND: Interest rate changes may reinvigorate certain legacy and charitable planning opportunities.

SYNOPSIS: Interest rates factor into the performance of many legacy and charitable planning approaches. Family loans, installment sales to grantor trusts, grantor retained annuity trusts, and charitable lead annuity trusts have become increasingly familiar to many clients and advisors, as these approaches typically favor a low rate environment. If federally-set interest rates continue to creep upward, however, there may be renewed interest in planning that benefits from a higher rate environment, including qualified personal residence trusts and charitable remainder annuity trusts, making a better understanding of these techniques and their potential benefits desirable.

TAKE AWAYS: Relatively small shifts in applicable interest rates can have a disproportionate effect on the performance of rate-sensitive legacy planning. Appreciating the potential economic impact of the rate changes, and how other factors such as payment structure, term selection, and asset valuation also can complement overall performance, may help clients and advisors to better customize the planning to achieve the intended goals.

LEGACY PLANNING & RATE SENSITIVITY

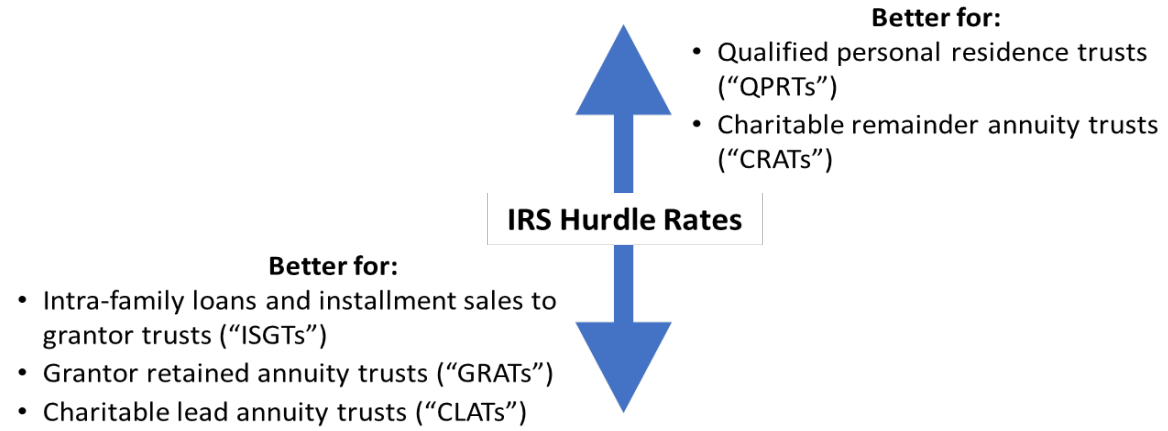
Hurdle Rates. With the Federal Reserve raising its benchmark interest rate multiple times in 2018, and many experts forecasting further interest rate hikes in 2019, we may see increases in two federally-set interest rates that directly impact several legacy planning strategies:

- **Applicable Federal Rate ("AFR").** The AFR under Internal Revenue Code ("**Code**") §1274 is published monthly and generally sets the minimum rate at which a loan must charge interest to avoid classification as a "below-market" loan. Separate AFRs are set for short-term loans (3 years or less), mid-term loans (3 to 9 years), and long-term loans (over 9 years). Below-market loans will result in imputed interest based on the difference in the actual loan rate and the appropriate AFR, which, in the legacy planning context, may trigger income and transfer tax consequences.

- **7520 Rate.** The 7520 rate also is set monthly and used to determine the present value of an annuity or a life, term-of-years, remainder, or reversionary interest under Code §7520. It is fixed at 120% of the annual mid-term AFR for the month in which the valuation date falls.

These hurdles rates had steadily declined over the past few decades in tandem with drops in the Federal Reserve's benchmark funds rate. For example, the 7520 rate dropped 10% from 1990 to 2012, from 11% to 1%. Since 2012, however, rates have inched higher, with the 7520 rate hovering between 3.2% - 3.6% since June 2018.

Affected Planning. These hurdle rates impact several common lifetime legacy and charitable planning techniques, with some better served by lower rates than others:



Shifts in the IRS hurdle rates can directly affect the economics of these planning approaches, as illustrated below.[1]

MOVE NOW ON LOW RATE PLANNING

If rates continue to trend incrementally upwards, clients interested in family loans, ISGTs, GRATs, and CLATs may want to act now to lock in current rates.

Family Loans and ISGTs. With a family loan, an individual lends money to a family member in exchange for an installment note bearing interest at the appropriate AFR. With an ISGT, an individual ("grantor") sells an asset to his or her grantor trust at its fair market value ("FMV") in return for an installment note, again with interest at the AFR.[2] Assuming the note's value equals the FMV of the assets sold, the ISGT should not constitute a taxable transfer for federal gift or generation-skipping transfer ("GST") tax purposes.

Family loans and ISGTs only transfer asset appreciation over the AFR out of the lender's or grantor's estate without estate or other transfer taxes. If asset growth matches or is lower than the AFR, there is no wealth transfer. Accordingly, a lower AFR can increase the likelihood that some asset appreciation will be transferred and lowers the total interest paid to the grantor (and ultimately included in the grantor's estate).

> ***Example 1:*** Alicia sells $10 million of closely-held stock to an existing grantor trust[3] benefiting her descendants in exchange for a 15-year, interest-only note. Over the note term, the assets earn a 7% net annual return. A higher long-term AFR (2.64% in December 2017; 3.31% in December 2018; possibly 4% in the future) reduces the overall value left to the trust beneficiaries.

Long-Term AFR	2.64%	3.31%	4.00%
Value to Trust at End of Note	**$10,956,254**	**$9,272,609**	**$7,538,707**

GRATs/CLATs. A grantor creates a GRAT by funding an irrevocable trust that pays the grantor an annuity for a specified term, calculated based on the 7520 rate in the month of creation. At the end of the annuity term, any remaining trust assets pass to the GRAT's remainder beneficiaries, without estate tax if the grantor survives the term.[4] With a "zeroed-out" GRAT, the present value of the annuity payments, based on the applicable 7520 rate, equals the FMV of the assets contributed to the GRAT, meaning there should be no taxable gift upon creation.

A CLAT resembles a GRAT, except that a charity, not the grantor, receives the annuity payments for the specified term, and the grantor's survival of the CLAT term is not required to remove the assets from his or her estate. Further, unlike a GRAT, a CLAT can use the 7520 rate set for the month of its creation or from one of the prior two months, providing some flexibility to choose a lower rate, if available. Funding the CLAT also can provide the grantor with a current income tax charitable deduction, if structured as a grantor trust for income tax purposes.[5]

As both GRATs and CLATs require appreciation of trust assets in excess of the 7520 rate to pass wealth to the remainder trust beneficiaries, a lower rate may boost the remainder's value.

> ***Example 2:*** Brian sets up a 7-year GRAT, transferring $7 million in high-yield assets to the trust. The GRAT will make level annual annuity payments to Brian having a total present value $7 million (i.e., a zeroed-out GRAT), so there is no taxable gift upon creation. The net annual growth on the trust assets over the GRAT term is 7%. A 1% to 2% increase in the 7520 rate (e.g., 2.6% in December 2017, 3.6% in December 2018, possibly 4.6% in the future) can significantly reduce the amount left to the GRAT's remainder beneficiaries.

7520 Rate	2.6%	3.6%	4.6%
Value to Remainder Beneficiaries	**$1,663,356**	**$1,296,264**	**$922,625**

TAKE A NEW LOOK AT HIGHER RATE PLANNING

Planning techniques such as QPRTs and CRATs may have been overlooked in the past years due to the pervasiveness of the low rate environment. If IRS hurdle rates continue to rise, however, we may see renewed interest in these approaches, making a better understanding of their operations and benefits desirable.

QPRTs. With a QPRT, the grantor transfers a personal residence (e.g., a principal or vacation residence) to an irrevocable trust. The grantor retains the right to live in or use the residence for a specified term, after which, if the grantor survives, the residence passes to the designated remainder beneficiaries. Upon creation, the grantor makes a taxable gift equal to FMV of the residence, less the present value of the grantor's retained right to use the residence for the specified term, determined using the 7520 rate.

At expiration of the QPRT, the residence passes without additional gift taxes to the QPRT's remainder beneficiaries, and its FMV is removed from the grantor's estate, but only if the grantor survives the QPRT term. Further, if the grantor wishes to continue to use the residence, he or she must pay fair market rent to the remainder beneficiaries (although this can allow the transfer of additional assets (i.e., rental payments) without transfer taxes).

Application of a higher 7520 rate at creation of the QPRT can be beneficial from a gift tax perspective because it increases the present value of the grantor's right to live in the residence, thereby reducing the value of the taxable gift made to the QPRT's remainder beneficiaries.

> ***Example 3:*** Cathy, age 68, creates a 10-year reversionary QPRT naming her children as the remainder beneficiaries. She transfers her Florida

vacation residence, worth $2 million, to the QPRT. An increase in the 7520 rate reduces the taxable gift Cathy makes upon the QPRT's creation:

7520 Rate	2.6%	3.6%	4.6%
Taxable Gift to Remainder Beneficiaries	**$1,124,360**	**$1,020,420**	**$926,960**

CRATs. CRATs are a type of tax-exempt charitable remainder trust. With a lifetime CRAT, a grantor creates and funds an irrevocable trust during life. The CRAT distributes a stated annual annuity amount to selected non-charitable beneficiaries, which may include the grantor and/or the grantor's spouse. The annuity amount is typically calculated as a percentage and must be at least 5%, but not more than 50%, of the net FMV of the assets initially contributed. The annuity may be paid for: (1) the lifetimes of the non-charitable beneficiaries; (2) a term of up to 20 years; or (3) the shorter or longer of these time periods. At expiration of the CRAT's annuity term, the remainder passes to one or more charities selected by the grantor, such as public charities, private foundations, donor advised funds, etc.

As a tax-exempt charitable trust, a CRAT is exempt from income, capital gains, and net investment income tax. Accordingly, if a CRAT is funded with, and subsequently sells, highly appreciated assets, it will not recognize taxable gain or net investment income (although the non-charitable beneficiaries will incur income and net investment income tax on the CRAT distributions).[6] Further, with a lifetime CRAT, the grantor may obtain a charitable income and gift tax deduction equal to the initial FMV of the CRAT assets less the present value of the annuity payments, determined using the 7520 rate for the month of the CRAT's creation (or for either of the two preceding months, as the grantor elects).[7] A higher 7520 rate provides a greater discount in calculating the present value of the annuity interest of the non-charitable beneficiaries, thereby increasing the value for the charitable remainder interest and generating a larger charitable deduction.

Example 4: Doug contributes $10 million of appreciated stock to a 10-year CRAT, which pays him a 10.3% annual annuity. The deductible value of the CRAT increases with the 7520 rate.

7520 Rate	2.6%	3.6%	4.6%
Deductible Charitable Remainder	**$1,031,790**	**$1,476,956**	**$1,889,780**

MANY MOVING PARTS

IRS hurdle rates are just one of many factors affecting these legacy planning approaches, which provides other opportunities to complement or offset rate changes and enhance overall performance.

- **Payment Structure.** Adjustments in the payment amount or timing under a particular plan also can alter the economics. For example, with a CRAT, smaller annuity payments lessen the present value of the non-charitable beneficiaries' annuity interest, generating a larger charitable remainder value and increasing the value of the charitable deduction. In addition, the ability to delay payments may improve performance. For instance, principal payment on a family loan or in an ISGT can be deferred by using an interest-only note. GRATs and CLATs also can structure their annuity payments to increase annually each year (up to 20% each year for GRATs), effectively backloading annuity payments so the assets can grow within the GRAT or CLAT for a longer period. This delay may generate a larger GRAT/CLAT remainder if the assets experience early growth or appreciate at a relatively constant rate over the annuity term.

  Example 5: Recalling the facts from Example 2, Brian contributes $7 million to a 7-year zeroed-out GRAT, but now: (1) the applicable 7520 rate is 3.6%; and (2) the GRAT's annuity payments to Brian will increase annually by 20%. This payment structure allows the GRAT to pass greater value to the remainder beneficiaries (assuming a 7% annual net growth rate).

7520 Rate (3.6%)	Level Annuity	Backloaded Annuity
Value to Remainder Beneficiaries	**$1,296,265**	**$1,525,220**

- **Term.** The term selected for the plan also plays a role in performance. For instance, a grantor may want a shorter CRAT term if the goal is to generate a larger charitable remainder deduction. A longer term may be preferred for a QPRT, however, as it reduces the value of the taxable gift made to the remainder beneficiaries. In many cases, the term selection will be influenced by the grantor's life expectancy, especially if the grantor's survival is critical to preventing assets from being returned to the grantor's estate (as with GRATs and QPRTs).

- **Asset Valuation.** The value of assets used in funding these planning approaches, including the availability of any valuation adjustments, also can improve the performance of planning relative to the IRS hurdle rate.

  Example 6: In Example 1, Alicia sold $10 million of closely-held stock to a grantor trust in exchange for a 15-year, interest-only note. Assume the note bears interest at a long-term AFR of 3.31%. Compare the value left to the trust after repayment of the note if a 20% adjustment applies to the stock's value for lack of control and marketability:

Long-Term AFR (3.31%)	No Valuation Adjustment	Valuation Adjustment

Value to Trust at End of Note	$9,272,609	$12,936,150

- **Monitoring**. Given these many variables, on-going review and management are critical for most rate-sensitive plans to achieve their goals. Accordingly, these plans should be regularly monitored to review investment performance and the need for any changes to the investments or the structure of the planning, such as exercising a substitution power to remove and replace trust assets with assets of equivalent value, to re-finance, extend, or prepay a note, etc.

TAKE-AWAYS

Relatively small shifts in applicable interest rates can have a disproportionate effect on the performance of rate-sensitive legacy planning. Appreciating the potential economic impact of the rate changes and how other factors, such as payment structure, term selection, and asset valuation, also can complement overall performance, may help clients and advisors to better customize the planning to achieve the intended goals.

NOTES

[1] See generally, Sarah Kahl, "Estate Planning with Interest Rate Hikes," *Wealth Management*, July 26, 2018; Michele A.W. McKinnon, "What's a Donor to Do? Planned Giving in a Changing Tax Landscape," *52nd Annual Philip E. Heckerling Institute on Estate Planning*, January 25, 2018; Carlyn S. McCaffrey, "Getting Gratifying GRAT Results," *51st Annual Philip E. Heckerling Institute on Estate Planning*, January 10, 2017; Bradley W. Lard, "Low Interest Rate Is High Time for Some Estate Planning Ideas," *Estate Planning Journal*, Vol. 42, No. 07 (July 2015). Note that a full discussion of all the technical requirements and potential tax ramifications of these planning concepts is beyond the scope of this article.

[2] Charging the appropriate AFR is necessary to avoid making an unintended gift.

[3] If a new grantor trust is used for the ISGT, the grantor is often advised to make a "seed" gift to the trust or use another method (such as personal guarantees from the trust beneficiaries) to capitalize the trust before the sale.

[4] Otherwise, most, if not all, of the GRAT assets generally will be includible in the grantor's estate.

[5] The ability to take a full deduction for the amount contributed to a grantor CLAT in a given calendar year will be subject to the various percentage and other limitations and requirements imposed on charitable income tax deductions. CLATs also can be structured as non-grantor trusts for income tax purposes, in which case the trust grantor would not receive an income tax deduction for his or her contribution to the CLAT (although the CLAT would receive an income tax deduction for its charitable distributions).

[6] The distributions to the non-charitable beneficiaries will retain the income and net investment income characterization they had in the CRAT, based on a tiered income tax system.

[7] A CRAT must be structured so that the present value of the charitable remainder interest (as determined using the 7520 rate) is at least 10% of the initial FMV of the property placed in the CRAT.