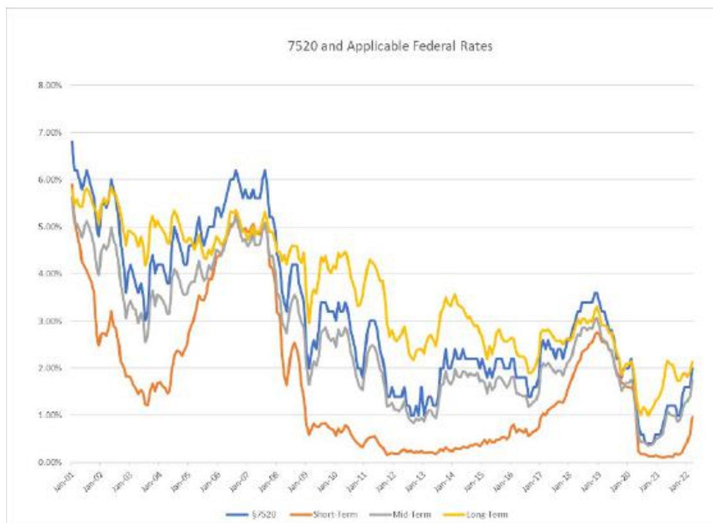
Oh, no! Increasing interest rates… is the window of opportunity closing?

In a low interest rate environment, many wealth transfer strategies become more effective. Recently, there has been an increase in key interest rates due to an increase in inflation. Since 2020, there has been a significant increase in the inflation rate – from 2.50% in January 2020 to 7.50% in January 2022. And in order to curb this increase, the Federal Reserve has needed to step in and raise key interest rates, which may an impact the effectiveness of many gifting and estate planning strategies.

Interest rates have increased? …Am I going to be able achieve my planning goals? …Am I too late? No, take advantage now despite increasing rates.

Over the past decade, the extremely low interest rate environment along with considerable business and asset value appreciation has provide many opportunities for affluent clients to transfer significant wealth to future generations. This low interest rate environment – specifically the Internal Revenue Service (IRS) rates – has resulted in a significant upside for gift and estate tax purposes. However, the fluctuation since the turn of the century has seen the IRS 7520 rate drop from a high of 6.80% (January 2001) to a low of 0.40% during the second half 2020. In addition, the short-term Applicable Federal Rate (AFR) dropped from 5.90% to a low of 0.11%.



Despite the recent significant rate increases, the IRS rates still remain low from a historical perspective, and these low rates can dramatically increase the advantages of sophisticated wealth planning. So, before rates return to historical levels, now is the time to transfer wealth!

Planning techniques to consider

The low interest rates make for an excellent opportunity to employ various estate planning techniques. The estate planning goal for many affluent clients is to maximize their transfer of wealth by using strategies that minimize their overall tax burden (i.e., income, gift, estate, and generation-skipping transfer taxes).

While life insurance alone can be the most efficient tool for transferring wealth, the following estate planning techniques are also beneficial, in many setting, but they become even more effective in the current low interest rate environment:

- Intra-family Loans
- Grantor Retained Annuity Trust (GRATs)
- Third-party Borrowing (commonly referred to as Bank Financed)
- Installment Sales
- Charitable Lead Annuity Trust (CLATs)

CAPTURE THIS UNIQUE OPPORTUNITY

The above techniques are some of the options for capturing the significant opportunity that exists today for affluent clients to transfer wealth outside their estates at lower cost. While each strategy works well on its own, many affluent clients can rely on multiple strategies, often in combination with life insurance, to allow them to best achieve their planning objectives and transfer the most wealth at the least cost with lower future estate taxes. For these reasons, now is the time for affluent clients like you to revisit these conversations with your trusted estate planning attorney and us your trusted wealth management advisors.

Additional factors to consider in planning today

- Assets transferred to a trust will not receive a step-up in basis at your death
- Unless assets are sold to a pre-existing trust with "economic substance", these strategies will require using some or all of the lifetime exemption for the "seed gift" to the trust
- Insufficient cashflow may result in the return of assets to the estate, which will reduce the effectiveness of the strategy
- Short-term plans may run the risk of refinancing at higher rates in the future

Summary of applicable interest rates

- Applicable federal rate (AFR) – The lowest interest rate allowable by the IRS for intra-family loans or installment sales.
- § 7520 rate – The rate defined under Internal Revenue Code § 7520 is used to determine the discounted value of annuities and remainder present values for transfers to GRATs, CLATs, and other planning techniques.
- Bank finance rate – The rate charged by a lending institution depending on the loan size, duration and structure. Loan rates are either variable (rate is reset annually) or fixed (rate is set with each loan for a fixed period of time). The rate is set based upon a leading interest rate index – such as the

London Inter-Bank Offered Rate (LIBOR) (which may be replaced by the Secured Overnight Financing Rate (SOFR)) or the Prime Rate – plus or minus a spread fixed upon issue for a certain duration.

Summary of planning techniques

Assuming $1 million is transferred for a period of 15 years with asset appreciation of 8.00% (ignoring taxes). The hypothetical current interest rate is assumed to be 1.00% for all techniques. The following table illustrates the impact of a 100bps and 200bps rate increase.

Planning Strategy Impact to Hiers

Rate Increase (Base Rate = 1.00%)	Intra-Family Loan	Installment Sale (assumes 30% Discount)	GRAT	CLAT
Baseline	**1,900,648**	**1,982,104**	**1,213,856**	**1,213,856**
100Bps	1,629,127	1,792,040	1,059,043	1,059,043
200Bps	1,357,606	1,601,975	897,729	897,729

Intra-family loan

One of the simplest ways to transfer wealth is to loan funds directly to a family member or entity (such as a trust or LLC) in exchange for a note. While the term of the note may be for any duration of time, affluent clients may wish to enter into a long-term arrangement to take advantage of these extremely low interest rates. The terms of the loan can be determined by the client and might involve an interest only with a balloon payment at maturity.

Installment sale

With this technique, the client (as grantor) sells highly-appreciating income-producing assets to an irrevocable trust that is structured as a "grantor" trust under the Internal Revenue Code, in exchange for a note. Similar to the intra-family loan, the note can be structured with a duration suitable for the client's planning goals and will use the appropriate AFR. The significant difference is the assets sold may be eligible for valuation discounts depending on the lack of marketability and control. Any interest on the note received by the grantor is not taxable due to the grantor trust rules.

Grantor Retained Annuity Trust (GRAT)

A GRAT is an estate planning technique which allows an affluent client to transfer assets to beneficiaries at (potentially) a greatly reduced gift tax cost. In this strategy, the client establishes a grantor trust and transfers assets to it. In exchange, the client retains the right to annuity payments from the trust, at least annually, for a number of years, relying on the § 7520 rate. A lower § 7520 rate will produce a lower annuity payment resulting in a greater remainder amount left in the trust. At the end of the GRAT term, any assets remaining in the GRAT pass to one or more beneficiaries (individuals or other trusts).

Thus, the amount of the gift to beneficiaries (for gift tax purposes) equals the value of the assets transferred less the present value of the annuity retained by the grantor.

Charitable Lead Annuity Trust (CLAT)

A CLAT is similar to a GRAT, except that the annuity payments are made to a charity rather than the client (or grantor). Like the GRAT, the remainder interest may be structured to pass to the beneficiaries of the grantor at little or no gift tax cost. If the CLAT is treated as a grantor trust, the client also may be able to claim an income tax charitable distribution deduction.

Third-party borrowing

A more sophisticated technique used to purchase life insurance inside an irrevocable trust is bank premium financing. That is, the trust borrows money from a bank (i.e., third-party) to pay an insurance premium with the assumption that the client will have a liquidity event in the near future to repay the loan. With interest rate indices at all-time lows, financing rates may be as low as 2.0%. Affluent clients who have experienced significant appreciation of assets, and who need to address their estate planning needs, can begin planning without having to liquidate assets due to the lower costs associated with the decline in interest rates.