Wealth Transfer Planning Now

January 3, 2024

Take-Away: With higher interest rates and expected lower market returns, it is time to reconsider some conventional wealth-shifting strategies for 2024.

Background: Until just this year low interest rates were the 'driver' for lifetime wealth transfer strategies. In an era of low interest rates, which directly impacted the applicable federal rate (AFR) that is used to value retained interests, the ability to give away future growth of existing wealth was the principal *leverage* for many estate planning strategies. However, interest rates are now up. For example, the short-term interest rate in December 2023 (0 to 3 years) is currently higher than the mid-term interest rate (3 to 9 years.) This inversion in AFR rates means that an investor is paid more interest to hold a short-term bond than an intermediate or long-term bond. Added to this change in AFRs is the consensus among prognosticators that US and global stocks will underperform over the next decade compared to historical norms, along with lower returns. All of which leads to the conclusion that using estate planning *arbitrage* to fuel wealth transfers will be a much less attractive strategy to pursue in the coming years. Consequently, some existing estate planning strategies that have worked well over the past decade + may not work so well in the future due to these changes.

> Leverage: The use of *leverage* means that the transfer of wealth in recent years, tied to the IRC 7520 rate for many estate planning strategies, meant that the transferor did not give away much of their existing wealth as they gave away the future growth of that existing wealth. The transferor only transferred principal to the extent necessary to enable the *leveraged* estate planning strategies that exploited low IRC 7520 rates. That *leveraging* was further enhanced with the use of *grantor* Trusts where the transferor retained the obligation to pay income taxes on that future growth, free of any gift tax consequences.
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> Cost of Capital: Until interest rates started to rise, the cost of capital, as reflected by the AFRs, was nearly zero. An individual who may have

hesitated to give away $12.92 million, in a low interest-rate environment, instead could lend that amount to an intentionally defective *grantor* Trust (IDGT) for the benefit of their spouse, children and grandchildren at the short or mid-term AFR. If the cost of capital was close to $0.00, the promissory note received in return by the lender could be thought of as a free (or nearly free) option to complete the gift at a future date. At any time during the note term the lender could forgive the debt, in whole or in part, with the 'stroke of a pen.' Today, the cost of capital is not zero; rather, it is more like 5% a year, and the carrying cost of the 'option' to forgive the loan is no longer negligible.

The possible impact of the loss of *leverage* (from higher prevailing interest rates) and future expected diminished investment returns on conventional estate planning strategies that increase the cost of capital are addressed below.

A. Installment Sales: A portfolio of publicly-traded securities will struggle to outperform the current AFRs over the next few years. An installment sale may still be appropriate for some asset classes like private equity that may outperform publicly traded stocks and bonds. An installment sale may continue to be superior to a gift or a grantor retained annuity trust (GRAT) when assets are sold to a multigenerational Trust that is GST exempt. An estate *freeze* with a sale of assets to an intentionally defective grantor trust (IDGT) may thus continue to help minimize federal estate taxes.

B. GRATs: A conventional grantor retained annuity trust (GRAT) will face the same *arbitrage* challenges as an installment sale too an IDGT. The December 2023 IRC 7520 interest rate 'hurdle' was 5.8% which is close to a full percentage point higher than the mid-term AFR rate that is used for estate planning strategies between 3 and 9 years in duration. Unlike an installment sale or gift, a *zeroed-out* GRAT has no adverse transfer tax consequence- no federal transfer tax applicable exclusion amount is used to establish a *zeroed-out* GRAT and its assets are merely returned to the grantor over the annuity payment term. While a GRAT may have a higher

‘fail’ rate than an installment sale of an equivalent terms due to its higher ‘*hurdle* rate,’ the consequences of such a ‘failure’ are minimal, which may make a GRAT more suitable than a sale or gift for high-risk-high potential return asset classes.

C. CLAT: Like a GRAT, a charitable lead annuity trust (CLAT) is currently much less likely to produce a positive remainder transfer tax-*free* at the end of the charitable annuity term than would have been the case a year or so ago. To minimize the risk like the GRAT a CLAT should be *zeroed-out* if an inter vivos CLAT is used, especially in this current higher interest-rate environment.

D. Gifts: Lifetime gifts might benefit going forward in an era of higher interest rates. The applicable exclusion amount is $13.61 million in 2024. It is predicted to increase to roughly $14 million in 2025 (by Bernstein) but then drop to $7.2 million in 2026. It is important to remember that Treasury Regulations provide that the cut in the donor’s applicable exclusion amount come 2026 will come first from the donors unused or *bonus* exclusion amount, without any *clawback* penalty for those donors who used more than their reset applicable exclusion amount. A donor needs to take substantial advantage of his/her enhanced exclusion amount; he/she needs to give away more than $7.2 million (if the inflation projection is correct for the reduced 2026 applicable exclusion amount.)

E. Gift-Splitting: As a result of *clawback* some married couples may not want to elect gift-splitting when making their lifetime gifts. It will be better for one spouse to ‘encroach’ upon his/her *bonus* applicable exclusion amount while it still exists to shelter a lifetime gift. In contrast, if there was gift-splitting by the spouses, that might reduce each donor-spouse’s applicable exclusion amount below the projected $7.2 million future exclusion amount. By not gift-splitting the spouses preserve the non-donor spouse’s full $7.2 million applicable exclusion after 2025.

F. Valuation Discounts: In the past several years when we experienced very low interest rates, valuation discounts were useful, but primarily unnecessary. That is because the use of *leveraged* estate planning strategies like IDGTs and GRATs were 'scalable.' A gift in Trust of $12.92 million would support a subsequent sale of 9 times that amount to an IDGT, meaning more than $116 million of value. Why invite an IRS audit by claiming a valuation discount when there was already so much *leverage* with an IDGT or a GRAT? But now, this 'scalability' comes with a significant cost of capital, and the use of a valuation discount mitigates that cost to some degree.

   Example: Assume Mike wants to sell $10 million of his assets to an IDGT in exchange for an installment note that bears interest at 4.82% per year, which is the mid-term AFR for December 2023. The annual cost of capital to the IDGT is $482,000. However, if those same assets were placed in a family limited liability company (LLC), and if a nonvoting member interest in the LLC were to be discounted by 30% due to lack of marketability and lack of control, the annual cost of capital in the installment sale to the IDGT would decrease to $337,400 This translates to an equivalent annual interest rate of 3.37% in a sale of non-discounted assets. In sum, the use of a supportable valuation discount can mitigate the negative effect of high interest rates.

   No Mortality Risk: Unlike a GRAT where there is a risk if the settlor dies prior to the complete of the annuity payment period, with a lifetime gift there is no estate inclusion risk if the donor dies after completing the gift. If valuation discounts are used, these discounts tend to help offset the economic and mortality risks posed by a GRAT, or even an installment sale to an IDGT.

G. QPRT: We will probably see many more qualified personal residence trusts (QPRTs) in the future with rising interest rates and a 50% reduction in a donor's applicable exclusion amount starting in 2026. With higher interest rates (and thus a higher IRC 7520 rate,) the settlor's retained exclusive

right to use the principal residence held in the QPRT is overvalued, and thus it reduces the value of the gift of the QPRT's remainder interest.

Example: Carol, age 65, transferred her $10 million home to a QPRT and retained the right to live in the residence for 15 years or until her prior death. If Carol made that transfer in September 2020, when the IRC 7520 rate was 0.4%, the value of Carol's remainder gift in the QPRT would have been $5.8 million. In December 2023, when the IRC 7520 rate is 5.8%, the value of Carol's gift of the remainder interest in the QPRT would be around $2.7 million.

Future Appreciation: When evaluating the benefit of rising interest rates, that is often offset, at least in part, by the current inflated value of residential real estate. But the advantage of this lifetime wealth transfer strategy is avoiding estate taxes on future growth in the residence. A successful QPRT, meaning the settlor survives the retained exclusive use period, completely removes all future appreciation in residential real estate from the settlor's taxable estate at a heavily discounted gift tax value.

Carry-Over Basis: Balanced against the QPRT's wealth-shifting benefit is the loss of an income tax basis step-up in the QPRT's residence, assuming the settlor survives the QPRT's fixed-use period. This might not be a problem with heirloom homes and cottages and recreational homes which will likely remain in the family for many decades, but it can pose a problem for a residence that will be sold either after the settlor exclusive-use period comes to a close, or after the settlor's death, if the settlor chooses to pay fair value rent for the balance of his/her lifetime to the continuing Trust that holds the title to the residence.

Estate Planning Strategies that Will be Unaffected by Higher Interest Rates: A couple of conventional wealth-shifting strategies that will probably be unaffected by rising interest rates are the following:

1. Short-term *Rolling* GRATs: A short-term, (e.g., 2-years) *rolling* GRAT that is funded with marketable stocks might be an 'all-weather' strategy that can survive most interest-rate environments. Looking at a GRAT in isolation, a high IRC 7520 rate is an obstacle to the GRAT's success. The primary benefit to a *rolling* GRAT strategy is not that it produces a series of little 'victories', but that on occasion it produces an outsized investment reward. The *rolling* GRAT strategy works because it breaks one potentially dismal and volatile period of stock returns into a series of independent, separate, two-year periods. When stock prices go up 15%, or 20%, as they do from time to time, the donor does not care much what the IRC 7520 rate happened to be at the CRAT's inception. Rather, it is the occasional big-time gains, often supplemented by a few smaller gains, that drive the *rolling* GRAT strategy; the settlor's reward when employing *rolling* GRATs is caused by strong stock performance and not low interest rates.

2. CRUTs: The mandated method to compute a charitable remainder unitrust's beneficial interests tends to undervalue the donor's retained interest and overvalue the charity's remainder interest. While the hypothetical present value of the charity's remainder interest at inception of a CRUT must be at least 10% of the total value contributed, yet if that was to be recalculated based on recent actuarial data that is used by insurance companies when issuing policies to high-net-worth individuals (and not the IRS's actuarial tables), the present value of the charity's interest is significantly less than 10%. A CRUT is one way to avoid immediate recognition of capital gain on the sale of a low basis asset and spread the recognition of that gain over the donor's lifetime, or over the joint lifetimes of the donor and his/her spouse. The longer the donor's actual (not actuarial) life expectancy, the more likely that paying tax on the deferred gain in smaller amount over that lifetime will produce greater personal wealth than paying tax on the entire gain upfront and investing the after-tax proceeds in a taxable portfolio.

Conclusion: To summarize, capital is no longer virtually free as it was in 2020 and 2021. Future investment returns are likely to pale in comparison to historical market returns according to those who closely follow the stock market. Thus, the spread between expected returns and cost of capital is the lowest it has been in many years. Employing wealth shifting strategies like IDGT installment sales and GRATs will be riskier. Strategies that do not depend on *leverage,* like gifts and valuation discounts, will be much more valuable when interest rates rise. Wealth shifting strategies like a QPRT will work more efficiently in a high-interest-rate environment. And short-term *rolling* GRATs and CRUTs will probably remain unaffected. As we counsel individuals about shifting their wealth through lifetime estate planning strategies it will be important to keep in mind this change in the planning paradigm.