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CHIEF INVESTMENT OFFICE

Wealth Strategy Report

Estate Planning Services in a Low Interest Rate Environment

April 2020

INTRODUCTION

Just when many thought interest rates wouldn't go lower, the Federal Reserve (Fed) reversed course (from nine rate increases between 2015 and 2018) and decreased the fed funds target rate in July 2019 and again in September 2019, causing both short and midterm rates to drop. While this could be a challenge for certain investment strategies, it generally is good news for a variety of estate planning strategies. Simply put, interest rates often act as friction for certain estate planning techniques: the lower the interest rate (the less friction), the easier it may be to achieve a successful estate planning outcome. But, not all estate planning strategies benefit from lower interest rates. Some, in fact, work better in a higher interest rate environment (for instance, charitable remainder trusts, qualified personal residence trusts and grantor retained income trusts are favorable in high interest rate enviornments). Those strategies would be less effective in a low or declining rate environment. Given the environment we are in, we address several strategies that benefit from a low interest rate: Intra-family loans, sales to grantor trusts, grantor retained annuity trusts, charitable lead annuity trusts, private annuities, charitable gifts of remainder interests in a personal residence and self-cancelling installment notes.

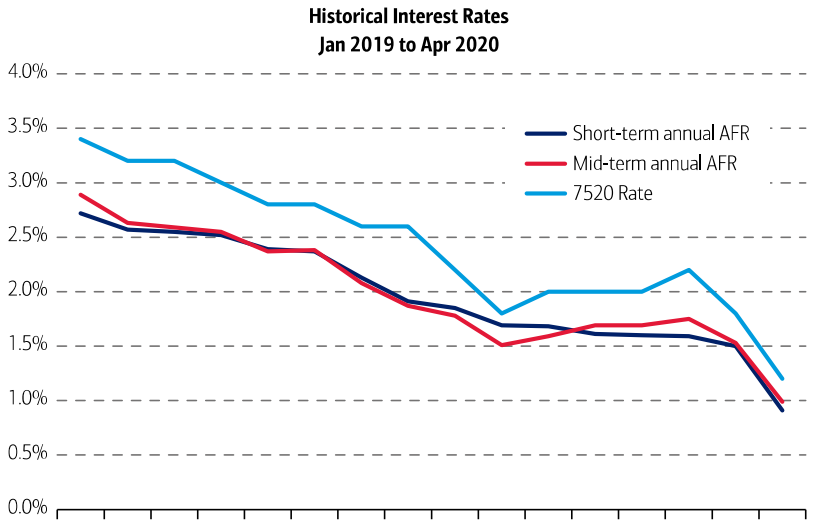
Like the interest rate yield curve, which at the time of this writing is inverted, so too are the Internal Revenue Service (IRS) published interest rates that are used for estate planning: the mid-term rate is lower than the short-term rate. Since many estate planning strategies are based on the mid-term rate, this unique inversion is a boon to those thinking about rate-sensitive estate planning strategies.

The IRS publishes numerous interest rates. The Applicable Federal Rate (AFR) and the Internal Revenue Code (IRC) Section 7520 rate (7520 Rate), both published monthly, are important for estate planning transactions.

Applicable Federal Rate

The AFR is determined by the IRS and serves as the minimum interest rate on various loans made by taxpayers. There are three different types of AFRs: short-term for notes with maturities of three years or less; mid-term for maturities between three and nine years; and long-term for notes with maturities greater than nine years. The AFR fluctuates monthly, but the rate is generally fixed for the duration of your note.

The Federal short-term rate is based on the average market yield of U.S. Treasury obligations (during a 1-month period ending on the 14th day of the month preceding the month for which the rates are applicable) with remaining periods to maturity of three years or less. The mid and long-term rates are determined in a similar manner but with the appropriate maturities.



Source: Internal Revenue Service, April 2020.

Section 7520 Rate

The IRS discount rate that applies to a Grantor Retained Annuity Trust and various other estate planning transfers is the IRC Section 7520 Rate—named after the tax code section mandating its use. It's a special rate used to discount the value of annuities, life estates and remainders to present value and is revised each month. It's equal to 120% of the midterm AFR.

If a charitable deduction is allowed for any part of the transferred property, the transferor may elect to use the Section 7520 Rate for either the current month or either of the two months preceding the month of the transfer.

ESTATE PLANNING SERVICES IN A LOW INTEREST RATE ENVIRONMENT

Many estate planning techniques are more attractive when interest rates are low. The chart below summarizes several. For certain of these strategies, we have a separate Wealth Strategy Report.

Strategy	How it works	Why it is favored in a low rate environment
Intra-Family Loan	Parent lends money to a child or a trust for the child at an interest rate at least equal to the minimum IRS interest rate required to avoid any gift tax implications. That minimum interest rate is the AFR. The child or the trust for the child uses the borrowed funds to presumably invest at a higher rate of return than the interest rate on the note. This is simple arbitrage: borrow at one rate in anticipation of investing at a higher rate.	The IRS publishes the AFR monthly. It publishes three different rates based on the duration of the loan. The lower the Treasury yields, the lower the AFR rates and therefore, the lower the interest rates that can be used in an intra-family loan. If the interest rate is low, there may be a greater chance of an investment return that could exceed the interest paid, resulting in a tax-free transfer of wealth to the child.
Sale to a Grantor Trust	Parent sells property to a trust established for the benefit of children. The trust is intentionally established as a "grantor trust" for income tax purposes. The trust pays for the purchased property with a promissory note that bears interest at the minimum IRS interest rate required to avoid a gift: the AFR rate. It is common for the trust to be funded with a "seed gift" from the Parent of 10% or more of the purchase price (to ensure the note is not characterized as equity and to protect against retaining an interest in the transferred property). The seed gift could be used as a down payment, and the promissory note could then represent the remaining 90% of the purchase price. Sometimes the promissory note calls for periodic payments of principal and sometimes it is for interest only with the full principal due at maturity. Because the sale is to a grantor trust, there are two advantageous tax results. First, the income of the trust is taxed to the Parent, not to the trust or its beneficiaries. Paying the trust's income tax provides an economic benefit to the trust but it is not considered a gift for tax purposes. Second, no capital gain is triggered by this sale of an appreciated asset to a grantor trust.	Like an intra-family loan, the goal is for the property sold to the grantor trust to earn a greater rate of return than the interest charged on the promissory note. Again, this is a form of arbitrage. The lower the interest rate that must be used for the promissory note, the more likely the arbitrage would be successful. A successful arbitrage would mean the trust will be able to accumulate wealth for the children free of gift tax. Often, the assets sold to the grantor trust are capable of being discounted (e.g. a minority interest in a family business or an interest in a family limited partnership), which can further assist in a successful estate planning outcome.

Strategy	How it works	Why it is favored in a low rate environment
Grantor Retained Annuity Trust	Parent transfers property to a trust—a grantor retained annuity trust (GRAT)—and in return retains an annual annuity for a term of years. At the end of the term, any remaining assets pass to children, either outright or in further trust. The present value of the retained annuity payments is determined by discounting those payments at an interest rate prescribed by the IRS—the 7520 Rate. Upon funding the GRAT, there is a gift equal to (i) the value of the property transferred to the GRAT, minus (ii) the value of the retained annuity payments. Generally, GRATs are structured so that there is no (or a minimal) taxable gift at the time of funding. That is, the retained annuity is set so that its present value equals the value of the assets transferred to the GRAT: a so-called "zeroed-out GRAT." GRATs are often relatively short term to avoid mortality risk: death during the term generally requires full estate tax inclusion of the trust property.	In the case of a "zeroed-out GRAT," if the GRAT's assets earn a total return equal to the 7520 Rate, the GRAT will be fully depleted after payment of the cumulative annuity amounts, leaving nothing for the remainder beneficiaries. If, however, the GRAT's assets outperform the 7520 Rate, then after all annuity payments are made there will be assets remaining in the GRAT for the children, gift-tax free. The 7520 Rate is often called a "hurdle rate." The lower the hurdle rate, the more likely the GRAT will result in a gift-tax free transfer of wealth. **Locking in today's low interest rates for use in later years: "Shelf" GRAT to Preserve Low Interest Rates** A shelf GRAT is designed to lock in current low interest rates, but give you time until you are ready to fund it with appreciating assets. A "shelf" GRAT is a GRAT that is created with a term intentionally longer than is ultimately intended. For example, if a 3-year GRAT were desired, a "shelf" GRAT might have a 5-year term. The plan for the first two years would be to fund the GRAT with an asset such as a bond portfolio that would be expected to meet, but not necessarily exceed, the hurdle rate. After two years, assuming the total investment return has done no more than equal the hurdle rate, at that time it would be a 3-year GRAT. At that point, other assets could be substituted into the GRAT in return for the current assets serving as a placeholder. It would operate like a "regular" GRAT, but with the near-record low interest rates that existed at the time the GRAT document was signed. We have a separate Wealth Strategy Report entitled Shelf GRATs.

Strategy	How it works	Why it is favored in a low rate environment
Charitable Lead Annuity Trust	The math and estate planning benefits of a charitable lead annuity trust (CLAT) are very similar to a GRAT. An annuity (either a fixed amount or a fixed percentage—or sometimes an escalating percentage) is paid each year for a term of years to a named charitable organization, after which any remaining assets pass to children, either outright or in trust. The present value of the charity's annuity is calculated based on the 7520 Rate. Upon funding the CLAT, there is a gift equal to (i) the value of the assets transferred to the CLAT, minus (ii) the present value of the charity's annuity. Generally, CLATs are structured so there is no taxable gift at the time of funding. That is, the charity's annuity is set so that its present value equals the value of the assets transferred to the CLAT: a so-called "zeroed-out CLAT."	CLATs are favorable in a low interest environment for reasons very similar to a GRAT. In the case of a "zeroed-out CLAT," if the CLAT's assets earn a total return equal to the 7520 Rate, the CLAT will be fully depleted by the charity's annuity. If, however, the CLAT's assets outperform the 7520 Rate, then after all annuity payments are made, there will be wealth remaining in the CLAT for the children, gift-tax free. As with a GRAT, the 7520 Rate acts as a "hurdle rate." The lower the hurdle rate, the more likely the CLAT will result in a gift-tax free transfer of wealth.
Private Annuity	A private annuity is a transfer of cash or property in return for a series of immediate (or deferred) periodic payments measured by your lifetime. The annuity could be payable to you by an individual, trust or other entity. If your upfront transfer is appreciated property and is made to an individual or an entity (or a non-grantor trust), other than a grantor trust, the embedded gain on the appreciated property is recognized immediately. If your upfront transfer is appreciated property and is made to a grantor trust, no gain is triggered. Thereafter, a portion of each annuity payment consists of a return of basis and interest income. If the present value of the anticipated annuity payments equals the value of the transferred cash or property, there are no gift tax consequences. The cumulative annuity payments will depend on how long the annuitant lives and may be more or less than the value of the property initially transferred. If the annuitant lives longer than life expectancy, the annuitant may receive far more than the initial value of the transferred property; if the annuitant lives shorter than life expectancy, the annuitant may receive far less than the initial value of the transferred property—an estate planning benefit.	The annuity amount is determined by not only the value of the cash/property transferred and the age of the annuitant, but also the prevailing interest rate at the time of transaction. If the transferred asset is expected to outperform the Section 7520 Rate, there is a greater chance of a successful estate planning outcome. The lower the interest rate, the lower the amount of each annuity payment (and the lower the ordinary income component of each payment).

Strategy	How it works	Why it is favored in a low rate environment
Charitable Gift of Remainder Interest in a Personal Residence	Title to your residence (not necessarily your primary residence) is transferred to a charitable organization, but with the retained right to live in the residence for your (and your spouse's) lifetime (or for a specified term of years). At the end of the specified term or upon death (or death of the survivor of you and your spouse), the residence is owned by the charitable organization. This could be a desirable strategy for those seeking to leave their residence to a charitable organization upon death. You are entitled to a current charitable income tax deduction equal to the present value of the residence less the value of your right to continue to live in the residence—an income tax deduction would not otherwise be allowed at death. The present value is determined by using the 7520 Rate for the month of the transfer (or, at your election, either of the two preceding months).	The retained use of the residence for life or a specified term is equivalent to an income stream. The lower the interest rate, the lower the value of the retained use of the residence. The lower the value of the retained interest, the higher the value of the charitable component and therefore the higher the value of the charitable deduction.
Self-Canceling Installment Note	A Self-Canceling Installment Note (SCIN) is a special Intra-Family Loan for a specified term, but where the note terminates (i.e., it "self-cancels") at the death of the lender. Typically, a Parent will be the lender and a child (or a trust for the child, which may also be a grantor trust), is the borrower. The SCIN can be part of a straightforward loan, or it can be the promissory note issued as part of a sale to a grantor trust. If the Parent/lender dies before the promissory note is repaid in full, the outstanding balance is cancelled. This provides an economic benefit to the borrower without gift-tax consequence. In a SCIN, there is a risk premium to account for the cancellation of the note at the death of the lender. This could be in the form of a higher than normal interest rate or a higher face amount on the note, or a combination of the two. The IRS has questioned the methodology and several assumptions for valuing a SCIN and as a result added considerable uncertainty to this estate planning technique. Taxpayers should consult their attorneys and tax advisors and proceed with caution.	The main economic benefit from a SCIN occurs if the Parent/lender dies before the promissory note is repaid in full. That component is not dependent on the interest rate. Nevertheless, the SCIN generally will bear interest at a premium over the market rate (the interest rate may be higher than usual to take into account that the loan will be cancelled on the lender's death). In that regard, the SCIN is like the Intra-Family Loan or the sale to a grantor trust: the lower the required rate, the better for the child/borrower. As noted, there is a cloud of uncertainty around SCINs for several reasons, including the IRS position that the actual life expectancy of the note holder should be used rather than the actuarial life expectancy.

Term of Note versus Weighted Average Maturity—If principal payments are to be made on a note in more than one year—an installment obligation—the term of the instrument is not simply its years to maturity, but rather its weighted average maturity. By accelerating or deferring payment dates, a promissory note's weighted average maturity can, for instance, shift from mid-term to short-term.

Example—On September 1, 2019, A sells property to a grantor trust in exchange for a promissory note that calls for a payment of $1,000,000 on March 1, 2029. The term of the note is 9.5 years (and its weighted average maturity is also 9.5 years), requiring the use of the Federal long-term interest rate as its minimum benchmark rate: 2.21% for September 2019.

However, if the promissory note called for a payment of $150,000 on September 1, 2024, and a payment of $850,000 on March 1, 2029, the term of the note would still be 9.5 years, but its weighted average maturity would decrease to 8.83, permitting the use of the Federal mid-term interest rate: 1.78% for September 2019.

— National Wealth Planning Strategies, Chief Investment Office

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