PALLAS
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Planning Commentary

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Financial Planning During The Market Downturn

As I write this, we are experiencing the world-wide pandemic that is COVID-19, commonly known as the coronavirus. In addition to the ominous health risks, this global crisis has wreaked havoc in the stock market and has had a devastating impact on the U.S. economy. We, at Pallas Capital Advisors, are doing everything we can to keep our employees, family members, and communities safe.

Thanks to good planning when we launched the firm, we are fully operational whether we are on-site, or as is the case now, working remotely. History tells us that markets will recover – eventually, and our investment team is working overtime to be able to take advantage of opportunities when the time is right.

Speaking of planning, the current extremely low interest rate environment, and depressed asset valuation levels present real opportunities for those individuals and families who believe that recovery will happen, and proactive estate planning is still vital to help them meet their objectives.

Market Crash - Now is a better time to consider Roth IRA conversions

When we published our commentary about the SECURE Act a couple months ago, we cautioned people against rushing to Roth conversions, since there was a risk of a severe market correction after incurring income tax on the converted amounts. Turns out, we were probably right.

But all of that has changed now. Markets have given back nearly all gains achieved since the beginning of the Trump administration. It makes more sense to perform these conversions now when markets are down and when the client's income could also be down due to depressed asset values.

Interest rates are (once again) at historic lows

It is important to take interest rates into account when considering your wealth transfer options. That's because interest rates influence how wealth transfers are valued for tax reporting purposes.

- **The applicable federal rate (AFR) and the §7520 rate:** Each month, the Internal Revenue Service publishes short-, mid- and long-term rates (the Applicable Federal Rates, or AFRs) and the §7520 rate. The AFRs reflect the minimum interest rate that must be charged for loans between related parties; the §7520 rate, which is 120% of the mid-term AFR, is used to calculate annual payments for certain estate planning techniques including GRATs, CLTs, CRTs and QPRTs. (Read on for a description of these techniques.)

  On Sunday, March 15, in a dramatic and emergency action to support the U.S. economy during the coronavirus pandemic, the Federal Reserve cut its target interest rate to near zero. The unexpected and faster-than-expected rate cut is on the heels of the Fed's emergency 50 basis points rate cut on March 3rd – and that cut was the first time since October 2008 that our central bank decided to go ahead with a cut in between scheduled policy meetings.

  The AFRs and §7520 rate are calculated based on the yields of certain government debt obligations, and the target federal funds rate has a direct impact on these yields.

Strategies that are most effective in a low interest rate environment

- **Intra-family loan:** A simple way to transfer value to the next generation in a low interest rate environment is to make a cash loan to the person whom you wish to benefit. The loan can be structured as an interest-only loan with a balloon payment on maturity; if the assets purchased by the borrower with the loan proceeds appreciate more than the interest rate paid on the loan, the excess passes to the borrower free of gift tax.

  You are generally required to charge an adequate interest rate on the loan for the use of the money, or interest will be deemed to be charged for income tax and gift tax purposes. However, with the current low interest rates, you can provide loans at a very low rate, and family members can effectively keep any earnings in excess of the interest they are required to pay you.

  This structure uses the relevant AFR. (The short-term AFR is used for loans with maturities from daily demand loans up to three years; the mid-term AFR is used for loans from three years up to nine years in maturity; and the long-term AFR is used for loans longer than nine years.)

  Potential drawbacks exist, however. Parents or children (or both) might not be comfortable in this type of lending relationship, and gift taxes may arise if interest payments fall behind. In addition, unlike a bank loan, the borrower cannot establish a credit rating through this kind of lending relationship.

- **Installment sales to family members**: If you enter into an installment sale with family members, you can generally defer the taxation of any gain on the property sold until the installment payments are received. (However, if the family member resells the property within two years of your installment sale, any deferred gain will generally be accelerated. The two-year limit does not apply to stocks that are sold on an established securities market.) With the current low interest rates, your family members can pay for the property in installments while paying only a minimal interest cost for the benefit of doing so.

- **Installment sale to an Intentionally Defective Grantor Trust (IDGT):** Selling property that is expected to appreciate to an irrevocable grantor trust is another potentially attractive planning strategy in a low interest rate environment. The grantor receives a promissory note with interest payable at today's low interest rate (the relevant AFR). As with the loan technique, if the property sold to the trust earns a higher rate of return than the interest payable on the note, the excess represents a tax-free transfer to the trust. The property that is sold to the trust should generate enough cash flow to pay down the note.

- **Grantor Retained Annuity Trust (GRAT):** A GRAT functions like an installment sale to an IDGT, except:

  1. the annual payments to the grantor cannot be interest-only and must be fully amortized over the term of the GRAT *and*

  2. the §7520 rate (which is higher than the short- and mid-term AFRs) must be used.

  Appreciation over the §7520 "hurdle" rate accrues to the trust beneficiaries free of gift and estate taxes. The lower the hurdle rate, the larger the potential tax-free gift. A GRAT can be an excellent wealth transfer option in a low interest rate environment because of the greater potential to outperform the hurdle rate than in a high interest rate environment.

  The economic benefits of this strategy are often not as great as that of the installment sale strategy, since the annuity often includes portions of both interest and principal. As a result, individuals often create a series of short-term, rolling GRATs (the donor funds a new GRAT each year with the annuity from the previous GRAT) rather than a single, longer-term GRAT, to increase the wealth transfer benefits and hedge against and capitalize on market volatility.

- **Charitable Lead Annuity Trust (CLT):** With a CLAT, you transfer property to a trust, giving a charity the right to annuity payments for a term of years. After the trust term ends, the remaining trust property passes to your designated beneficiaries, such as family members. If the CLAT is structured so that you are taxed on trust income, you receive an up-front income tax charitable deduction for the gift of the annuity interest.

Like a GRAT, the §7520 rate must be used for this structure and asset appreciation over the §7520 rate passes to the trust beneficiaries gift tax free. A CLAT works best in a low interest rate environment because any investment performance in excess of the hurdle rate passes tax free to the family members at the end of the trust's term. The lower the rate, the larger the potential tax-free transfer.

Strategies less effective in a low interest rate environment

- **Qualified Personal Residence Trust (QPRT):** You transfer your personal residence to a trust, retaining the right to live in the home for a period of years, after which the residence passes to your designated beneficiaries, such as family members. (If the grantor wants to continue to live in the home, the trust or its beneficiaries can rent it to the grantor.) The initial transfer to the QPRT is a taxable gift of the remainder interest, calculated using the §7520 rate. The higher the rate, the higher the value of the grantor's right to use the residence as his or her own during the term of years, and the lower the future remainder interest. So as the §7520 rate increases, the taxable gift decreases, making the QPRT a more attractive strategy at higher interest rates.

- **Charitable gift annuity:** You transfer property to a charity in return for the charity's promise to make annuity payments for your life (or for the lifetimes of you and your spouse). You receive a current charitable deduction for the gift of the remainder interest. The lower the interest rate, the lower the amount of your charitable deduction. Also, charities have generally been forced to reduce payout rates offered because of economic uncertainties and the low-interest-rate environment.

- **Charitable Remainder Annuity Trust (CRT):** The grantor receives an annuity from the CRT for a term of years, and charity receives whatever remains at the end of the term. Here, the value of the remainder, calculated using the §7520 rate at the time the grantor creates the trust, gives the grantor an income tax charitable deduction.

  The present value of the remainder that will pass to the charity -- which must be at least 10% of the value of the transferred assets as determined using the §7520 rate -- is deductible as a charitable contribution for income tax purposes. The higher the §7520 rate, the higher the value of the charitable interest and the more likely that the CRT will pass IRS review.

  Transferring highly appreciated assets to a CRAT will make it most effective, since a CRAT's tax status will allow the deferral of capital gain recognition.

Strategies generally less impacted by low interest rates

- **Charitable remainder unitrust:** You transfer property to a trust, retaining a stream of payments for life or a number of years, after which the remainder passes to charity. You receive a current charitable deduction for the gift of the remainder interest. Interest rates have no effect if payments are made annually at the beginning of each year, and low interest rates have only a minimal detrimental effect if payments are made in any other way.

Conclusion

Different estate planning techniques work better when interest rates are at different levels (high vs. low) or on different trajectories (rising vs. falling). Knowing what techniques are appropriate for which environments can make your planning more efficient.

During this health crisis, we continue to focus on helping our clients obtain their estate planning objectives. Of course, there are many factors to consider when deciding on any of these types of strategies – and they are too numerous to review in this brief summary. Please contact the financial planning team at Pallas Capital Advisors to discuss estate planning in the current interest rate environment or any other aspect of your financial planning objectives.

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