UNIQUE OPPORTUNITIES APPEAR IN TIMES OF LOW INTEREST RATES AND LOW STOCK VALUATIONS

By Richard English

Commerce Family Office Managing Director Richard English collaborates closely with clients on strategies for addressing complex personal and family financial challenges that can accompany significant wealth. Many of these issues impact current and future generations. Richard has more than 30 years of experience providing comprehensive and sophisticated estate planning services to high-net-worth families. He holds a law degree from the University of Kansas and an undergraduate degree from Washington University. Richard shares his thoughts in this Commerce Trust commentary on a few opportunities for tax-advantaged wealth planning techniques that may be appropriate during the recent economic volatility.

Obviously, we are living in financially challenging times, but there are a few unique opportunities that take advantage of historically low interest rates and temporarily depressed stock valuations.

The first falls in the category of intra-family loans. While you cannot typically make an interest-free loan to a family member without adverse tax consequences, you can make a loan at a very low interest rate, if you follow certain guidelines.

Each month, the IRS publishes the Applicable Federal Rate (AFR) – the minimum interest rate that can be charged on private loans of various lengths. For the month of May 2020, these AFRs will be at or near historic lows. For loans initiated in the month of May, these rates will be as follows:

Short-Term AFR (loans of up to 3 years): 0.25%

Mid-Term AFR (loans of more than 3 years up to 9 years): 0.58%

Long-Term AFR (loans of more than 9 years): 1.15%

These rates are significantly lower than they were as recently as March.

A private loan based on a rate of interest at least as high as the AFR will avoid certain adverse tax consequences, such as imputed interest. Structured as an intra-family loan, this can allow a parent or other lender to significantly reduce the borrowing costs for a child or other family member by lending at a low rate.

A second unique opportunity concerns the sale of assets, which can take advantage of temporarily lower stock values. Some estate planning techniques involve a sale of assets in exchange for a promissory note. A common technique is the sale of an asset considered to have strong potential for appreciation. If the seller takes back a note as part of that sale, the ability to charge a lower interest rate increases the potential success of this transaction.

If the asset that is being sold has a low current value, there may be more potential for appreciation. For example, if a parent were to sell a portfolio of stocks to a trust for the benefit of his or her children, the appreciation of that portfolio after the sale would occur outside of the parent's estate.

The purchaser in these transactions is often a "Grantor" trust for income tax purposes. When structured properly, a sale to such a trust will usually avoid triggering capital gains tax.

A third opportunity is the use of a Grantor Retained Annuity Trust, or GRAT, which is different from a loan but also benefits from low interest rates. With a GRAT, the person creating the trust transfers assets that the person believes have the potential to appreciate. For a set number of years, the person receives an "annuity" payment each year from the GRAT. That payment can be made in cash or in shares of stock (which may have appreciated in value). At the end of that term of years, any assets remaining in the GRAT (after making the annuity payments) pass to the person's beneficiaries with little or no gift and estate tax consequences.

As an example, assume that Parent transfers a stock portfolio currently worth $5 million to a GRAT in May 2020. As part of the governing trust document, Parent reserves the right to receive five annuity payments, each in an amount slightly more than $1 million. Those payments are made annually, in May of each year, beginning in 2021 and ending in 2025. The annuity payments can be funded with cash, but will likely consist in large part of shares of stock from the portfolio. If the stocks remaining in the GRAT appreciate at the rate of 5% per year during the 5-year term, the assets remaining in the GRAT after the 5-year term will be worth almost $1.4 million (more appreciation yields more value, while less appreciation yields less). At that time, those assets can be distributed to Parent's children without estate or gift tax cost. This technique has the following advantages:

- It works well with assets that appreciate in value after being transferred to the GRAT. Stocks with currently depressed values may have more potential growth.
- It also works well when interest rates are low because a variation of the AFR is used to calculate the amount of the annuity payment. In order to be successful, a GRAT needs to grow at a rate greater than the rate set by the IRS. For May, that rate is 0.8% annually. The lower the interest rate, the lower the annuity amount that is required, leaving more wealth inside the GRAT for future beneficiaries.
- The risk with a GRAT, other than the costs of establishing it, is the potential for the assets to decrease in value during the term. If this were to happen in the above example, the assets would be depleted before Parent receives 100% of the annuity payments. In other words, Parent gets the stocks back (in the form of annuity payments) and is no worse off for having created the GRAT.

For clients interested in exploring these options, please contact your Commerce Trust Company relationship manager.

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Richard is a managing director of Commerce Family Office in Kansas City. He collaborates closely with clients on strategies for addressing the complex personal, family, and financial challenges that can accompany significant wealth and often impact current and future generations. Richard works to help clients integrate core values into wealth planning and decision making, translate vision and mission statements into actionable solutions, implement successful family communication strategies, and establish effective family governance structures and processes. He has more than 30 years of experience providing comprehensive and sophisticated services to multiple high net worth families. Prior to joining the Commerce Family Office team, Richard was a partner at Stinson Leonard Street serving as co-chair of the firm's Tax, Trusts, and Estates practice division. In this role, he represented individuals and families in the areas of estate planning, estate administration, and related litigation. He also represented corporate fiduciaries in connection with trust and estate administration and related litigation. Richard holds a law degree from the University of Kansas and an undergraduate degree from Washington University in St. Louis. During his practice, he was listed in The Best Lawyers in America and included in Missouri & Kansas Super Lawyers for estate planning and probate. Additionally, he is a member of the Kansas City Metropolitan Bar Association and Estate Planning Society of Kansas City as well as a fellow in the American College of Trust and Estate Counsel. Richard has served as a trustee of The Barstow School; he has also served the Blue Valley Educational Foundation, Colonial Presbyterian Church Foundation, Greater Kansas City Community Foundation, and the National Christian Foundation-Heartland in various capacities.