Interest Rate Sensitive Planning: Understanding the Value of Time

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About the Speakers

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Michael Lee is the head of William Blair & Company’s Corporate & Executive Services. He focuses on the unique issues that confront owners and executives of private and public companies. Prior to joining William Blair & Company in 2004, Michael was a tax attorney with experience in the areas of wealth, tax, and estate planning.

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Overview

Roadmap for today's discussion

- Fundamentals of Time Value
- Planning with the Applicable Federal Rate
- Planning with the Section 7520 Rate
- Conclusion / Summary

Interest rates have always been an integral part of estate planning, specifically with reference to those techniques that involve split-interest planning, sales, and loans to family members.

Fundamentals of Time Value

The Value of Time: Would you prefer $100,000 today or $100,000 in five years?

- "I'd gladly pay you Tuesday for a hamburger today. " – J. Wellington Wimpy, “Popeye”
- While the face amount is the same, the preference is to receive $100,000 today
  - The value of receiving funds in the future is "lower" than receiving funds today
  - The difference in value reflects a discount or expectation of what the value may be over time

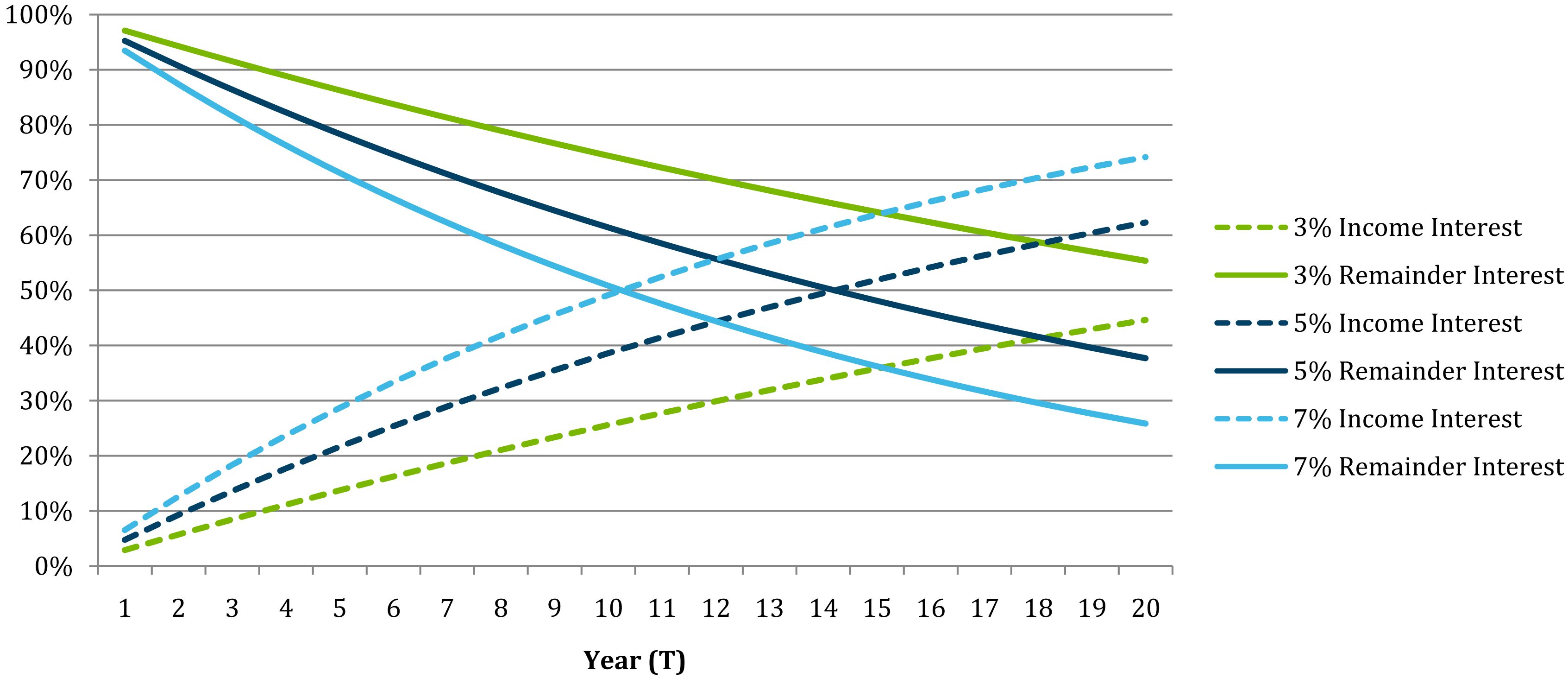
	Growth of $100,000	Receive $100,000
Today	$100,000	$100,000
In Three Years	$115,762	$86,384
In Five Years	$127,628	$78,352
In Ten Years	$162,889	$61,391

Assuming 5% rate of return

Time value reflects the potential growth (or discount) of funds

- The AFR or Section 7520 Rate reflects the element of time value

Income Interests and Remainder Interests



$$\text{Remainder Interest} = \left(\frac{1}{1+i}\right)^{T} \qquad \text{Income Interest} = 1 - \text{Remainder Interest}$$

Low Interest Rates

- Income interests retain value for longer periods of time
- Remainder interests less "valuable"

High Interest Rates

- Remainder interests decrease in value more quickly
- Income interests less "valuable"

Planning with the Applicable Federal Rate

What Is It?

Adequate interest permitted for transactions to which §§ 483 and 1274 may apply

When Does It Apply?

Deferred Payments: Payments due more than one year after the sale (§483)

Debt Instruments: Issued in consideration for the sale or exchange of property (§1274)

How Is It Calculated?

Based upon the yields to maturity of outstanding similar U.S. obligations

The AFR varies by the term of the debt instrument

Time Period	Applicable Federal Rate
Not More than 3 Years	Short-Term
Not More than 9 Years	Mid-Term
More than 9 Years	Long-Term

Tax Planning: AFR/Installment Sales

Treatment:

At least one payment received in a taxable year after the year of sale

Gain is reported as the taxpayer receives payments.

- Return of principal, seller's gain, interest
- Gain based upon "gross profit percentage"

Interest satisfies "adequate stated interest" rules:

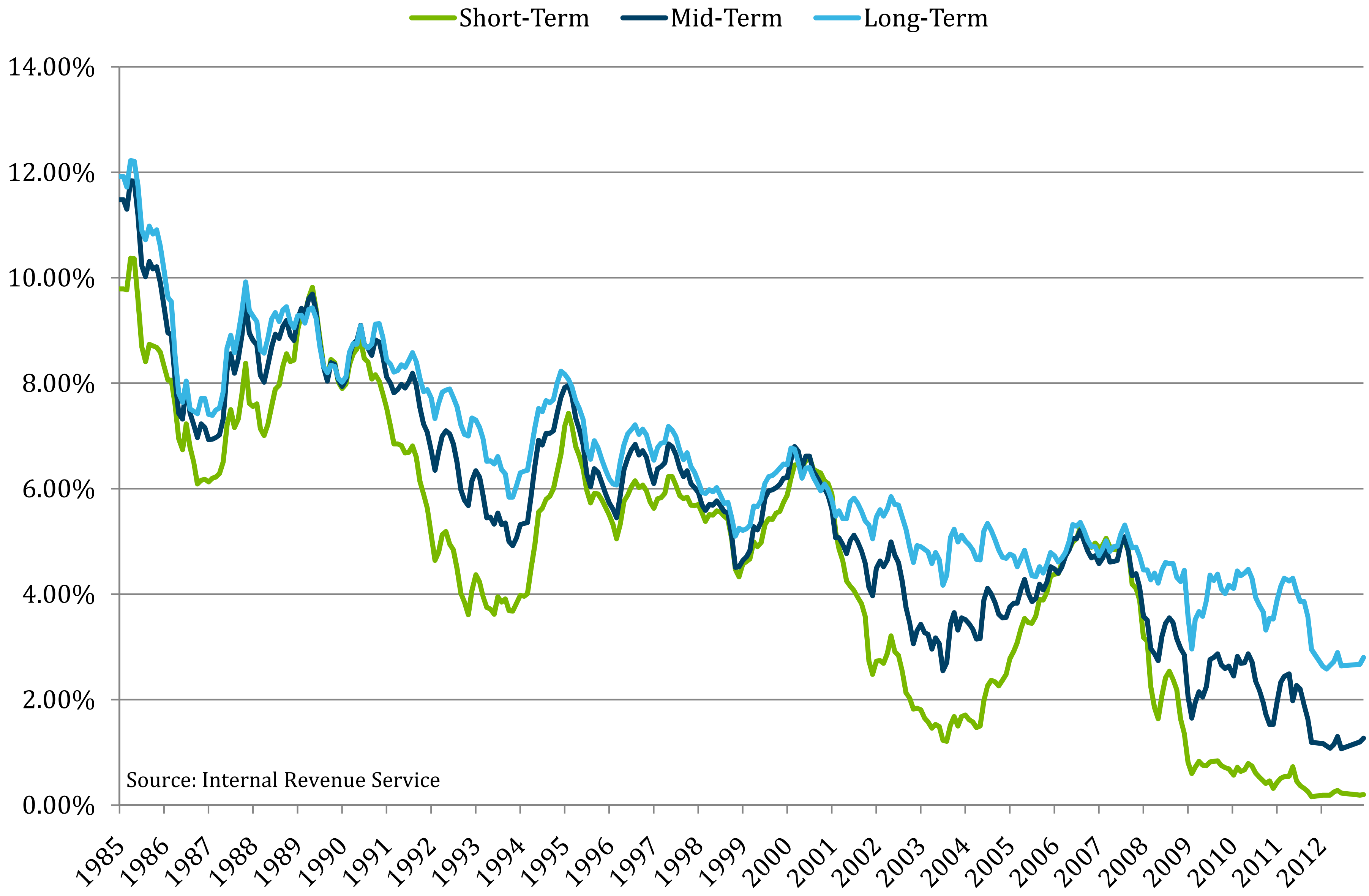
Test Rate: Lowest AFR in effect during the 3 month period ending with:

- First month of binding contract
- Month in which sale or exchange occurs

Imputed Interest Rules

- Portion of principal amount is re-characterized as interest for income tax purposes
- Increase in payment not required

Historical Applicable Federal Rates (1985-June 2012)



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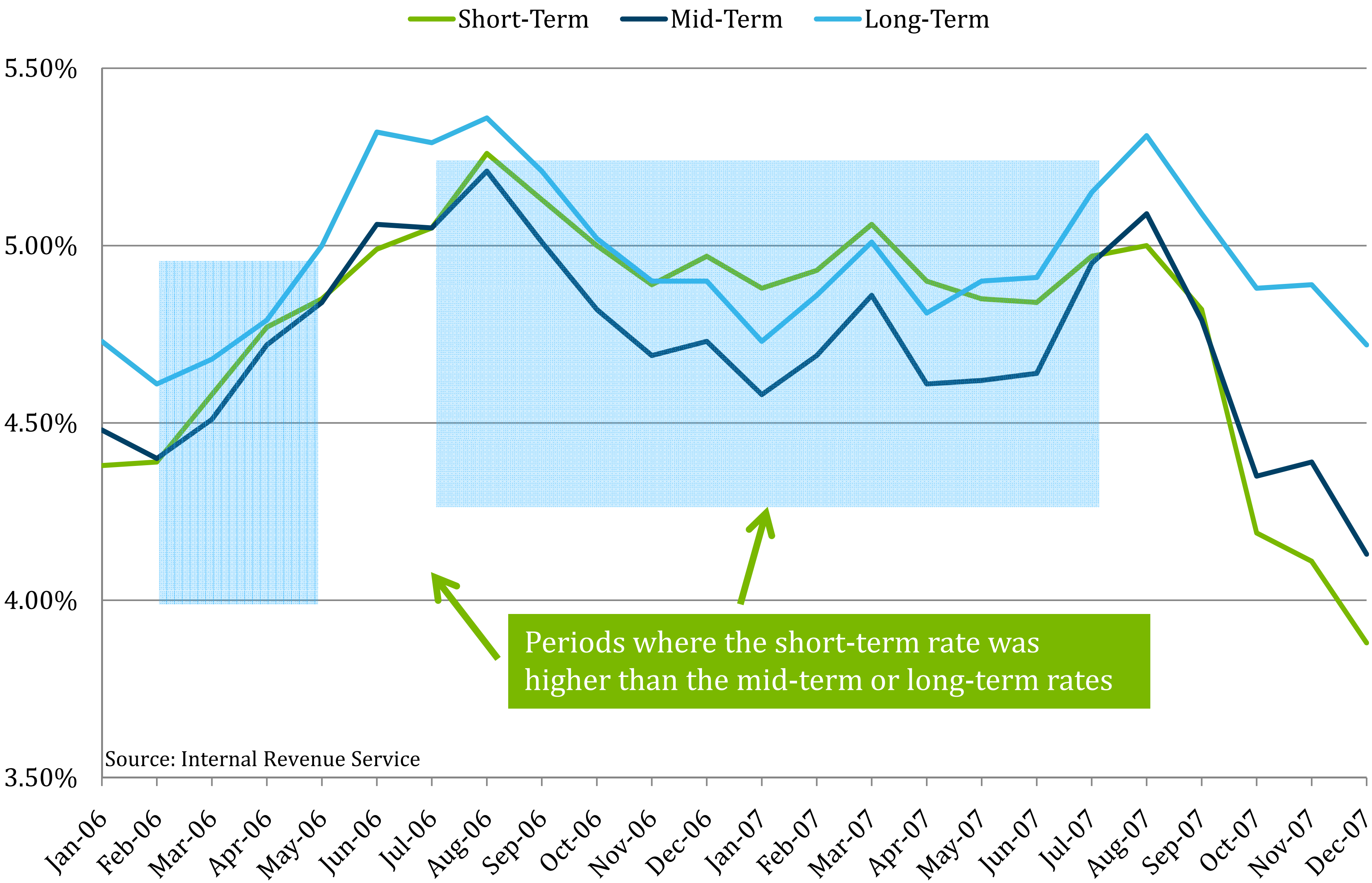
2006-2007 Saw "AFR Inversion"



Installment Sale Example

In June 2012, Billy decides to purchase a 1970 Mustang from his aunt Sally for $35,000. Sally agrees that Billy will pay her over the next five years.

Installment Sale Rules Apply

- Test Rate: 1.07%
- Annual Payment: $7,226
- Total Payments: $36,130
- Total Interest: $1,130

Mid Term AFR		
April 2012	May 2012	June 2012
1.15%	1.30%	1.07%

Suppose Sally and Billy agreed to five equal payments of $7,000?

- No adequate stated interest. Imputed interest rules apply
- Present value of five annual payments of $7,000 using 1.07% as interest rate: $33,904
    - Unstated interest amount: $1,094

Year	Principal	Interest	Balance
0		$1,094	$33,904
1	$6,637	$363	$27,266
2	$6,708	$292	$20,559
3	$6,780	$220	$13,779
4	$6,853	$147	$6,926
5	$6,925	$74	$0

Planning with the Section 7520 Rate

What Is It?

The Section 7520 rate is used to discount the value of annuities, life estates, and remainders to present value

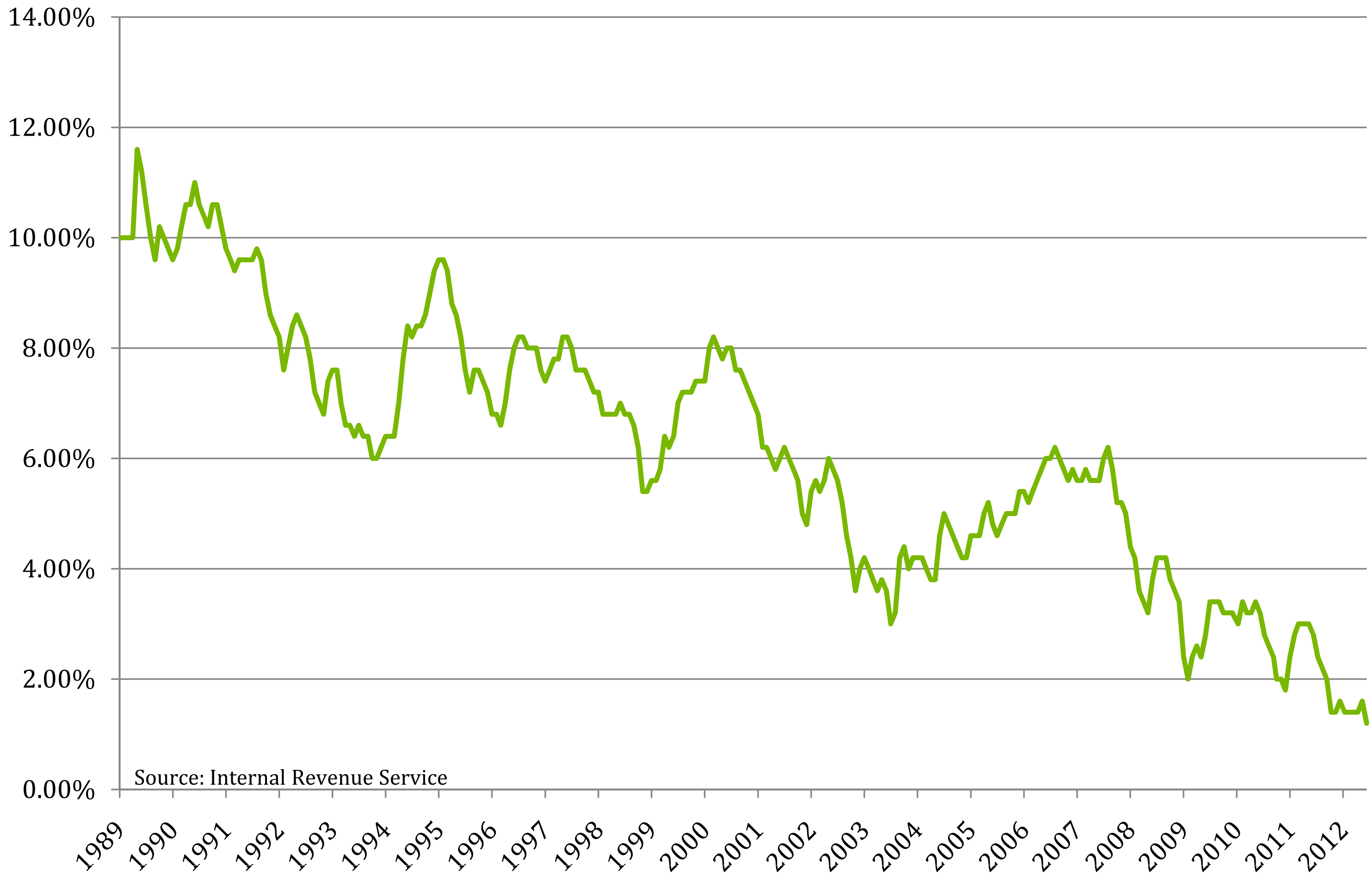
When Does It Apply?

Used in computing most actuarial interests for estate planning or transfer tax purposes

How Is It Calculated

120% of the mid-term AFR but rounded to the nearest two-tenths of one percent.

Historical Section 7520 Rates (1989- June 2012)



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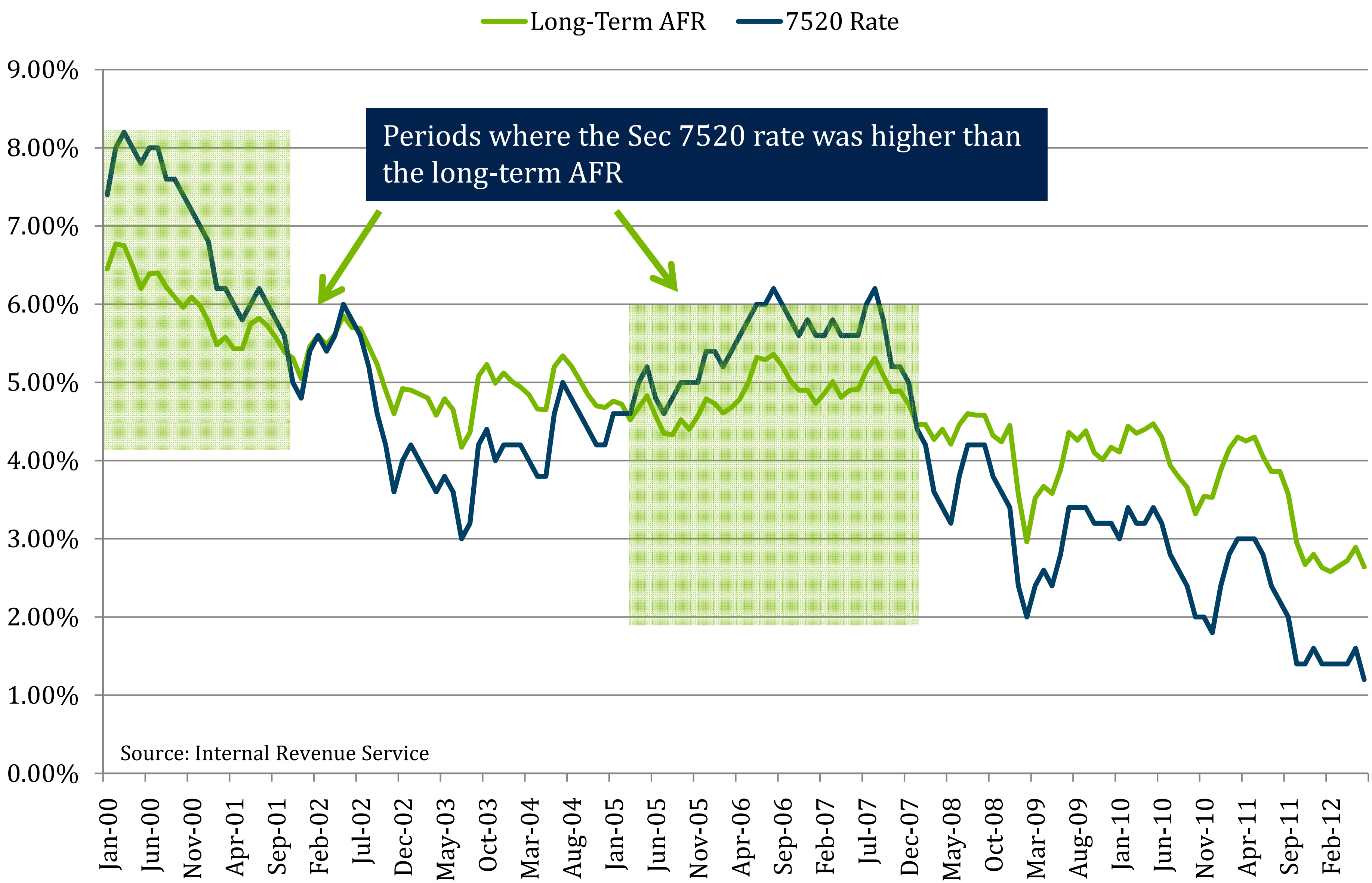
7520 Rate Inversion vs. Long-Term AFR



Grantor Retained Annuity Trusts: Overview

What Is It?

Inter-vivos transfer of property in exchange for an annuity stream

Property remaining within the GRAT after expiration of the annuity term and payments passes to remainder beneficiaries

Characterized as a "no risk" planning strategy

Application of the 7520 Rate

Grantor receives Annuity Payment

- Value of property transferred
- Annuity payment "earnings" based upon the Section 7520 rate
- Potential other retained interests (e.g. tax reimbursement)

Value of annuity interest based upon the section 7520 rate during the month of transfer

Common Thoughts

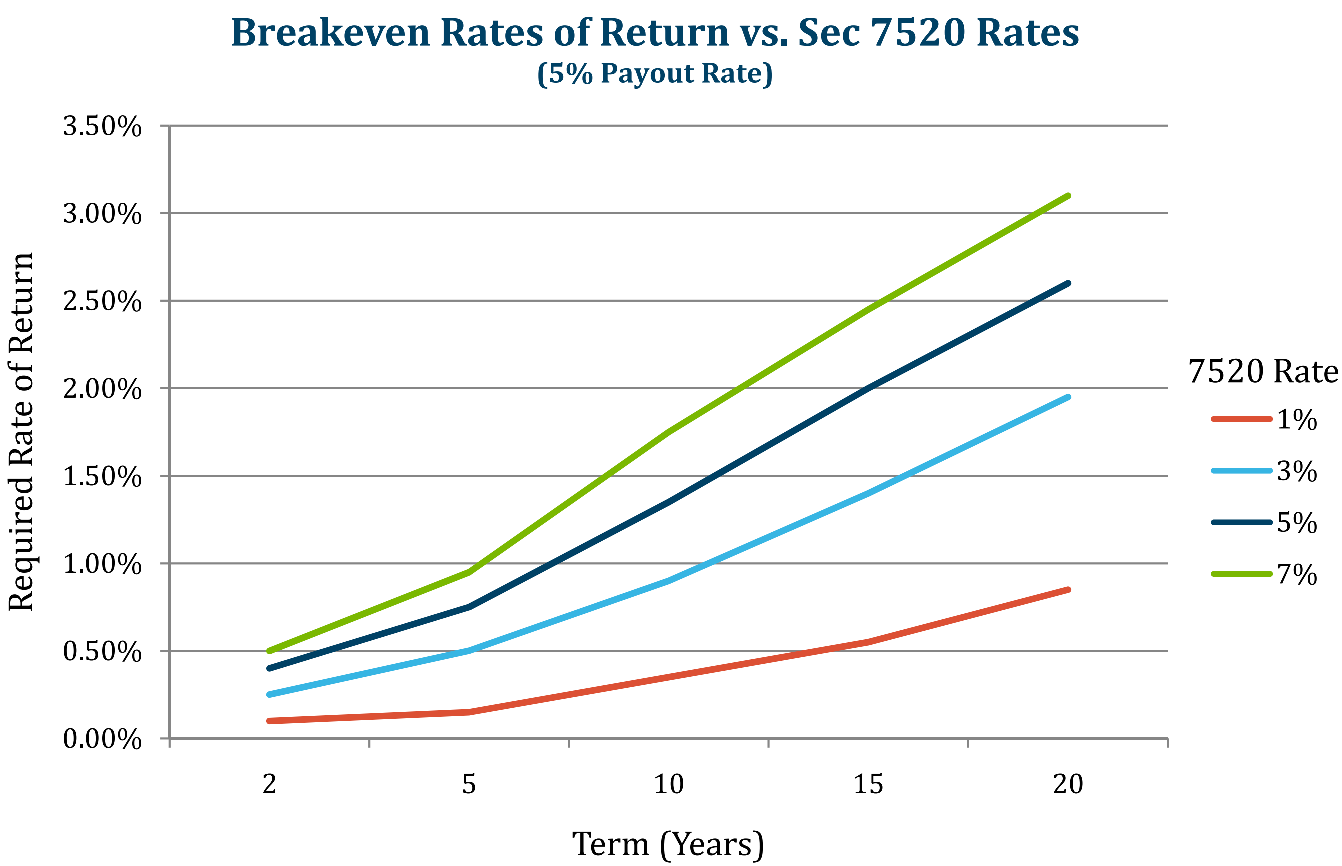
A lower 7520 rate benefits the GRAT

- Higher probability of success (performance vs. 7520 rate)
- Lower remainder interest transferred

"Zeroed Out" GRATs are a very attractive planning strategy

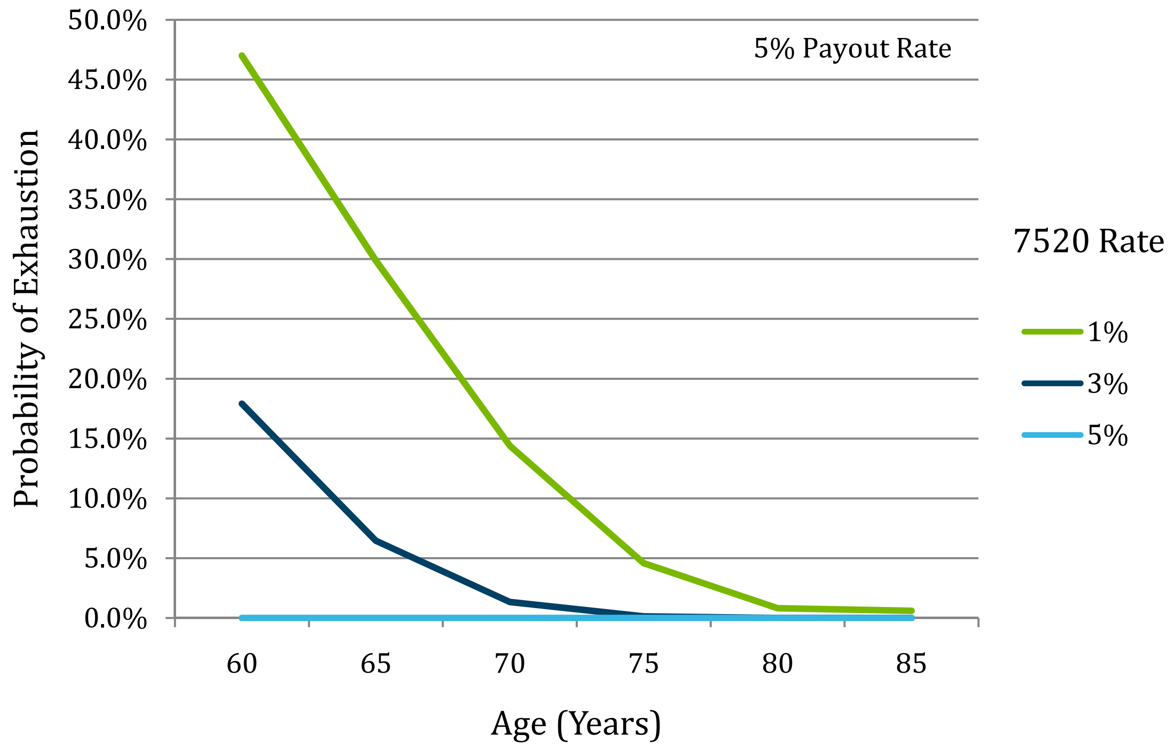
GRATS: Does the 7520 Rate Matter?

For "Traditional" GRATs, the rate of return on Trust assets can be below the Section 7520 Rate and still "succeed"



For "Zeroed Out" GRATs, the rate of return on the Trust assets must exceed the Section 7520 Rate

CRATs Are Sensitive Creatures



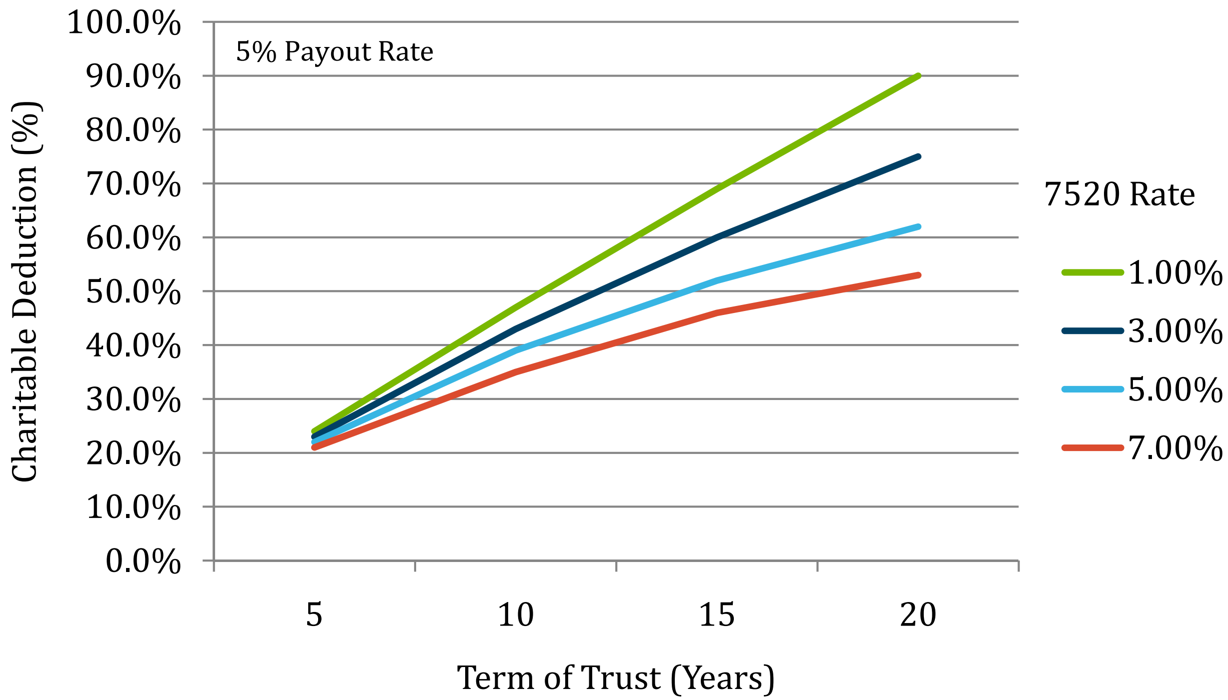
CRAT Requirements:

- Individual(s) must receive at least 5% and not more than 50%
- Value of the charitable remainder interest must be at least 10%
- Probability that the trust will exhaust before the remainder vests must not exceed 5%

Section 7520 rate effects:

- For term of years CRATs: Low rates with high payouts may cause the remainder interest to fall below 10%
- For lifetime CRATs: Low rates affect the age at which the 5% exhaustion test is satisfied

CLATs Benefit from Low Rates



CLAT Requirements:

• Guaranteed annuity payable to charity at least annually

• Unlike CRATs, no required minimum or maximum payout rates

• Grantor CLAT: Grantor taxed on all trust income

• Non-Grantor CLAT: Trust is taxed on all income and receives charitable deduction on distributions to charity

Section 7520 rate effects:

• Like Term-based GRATS, trust asset rates of return do not need to exceed the Section 7520 Rate

• CLATs may also benefit from investment of “tax savings”

CLAT with Side Fund Investment

Charitable Lead Annuity Trust (CLAT)					Side Fund Investment		
	Sec 7520 Rate	1.5%			Eff Tax Rate	24.0%	
	Charitable Ded	$461,109			Charitable Ded	$461,109	
	Remainder	$538,891					
	Starting Amount	$1,000,000			Additional Cash	$110,666	
	Growth Rate	3.0%			Growth Rate	3.0%	
	Payout Rate	5.0%					
Year	Beginning Principal	Growth	Payment	Ending Principal	Beginning Principal	Growth	Ending Principal
1	$1,000,000	$30,000	($50,000)	$980,000	$110,666	$3,320	$113,986
2	$980,000	$29,400	($50,000)	$959,400	$113,986	$3,420	$117,406
3	$959,400	$28,782	($50,000)	$938,182	$117,406	$3,522	$120,928
4	$938,182	$28,145	($50,000)	$916,327	$120,928	$3,628	$124,556
5	$916,327	$27,490	($50,000)	$893,817	$124,556	$3,737	$128,292
6	$893,817	$26,815	($50,000)	$870,632	$128,292	$3,849	$132,141
7	$870,632	$26,119	($50,000)	$846,751	$132,141	$3,964	$136,105
8	$846,751	$25,403	($50,000)	$822,153	$136,105	$4,083	$140,189
9	$822,153	$24,665	($50,000)	$796,818	$140,189	$4,206	$144,394
10	$796,818	$23,905	($50,000)	$770,722	$144,394	$4,332	$148,726

Reconciliation	
CLAT Ending Value	$770,722
Side Fund Value	$148,726
Total Wealth to Family	$919,449
% of Starting Value	92%
% of Remainder Value	171%

Don’t Forget the QPRT

The QPRT is an effective wealth transfer technique regardless of the Section 7520 Rate

Actuarial value of the retained interest does not add to the grantor’s estate

ILLUSTRATION:

Residence Value: $1 million, Sec 7520 Rate: 4.2%, Age 65, Term: 10 Years

Gift: $500,000 (approx)

The “cost” of transferring a $1 million asset was $500,000 at the end of the term

- Asset appreciates to $1.5 million: $1 million wealth transfer (3X)
- Asset remains at $1 million: $500,000 wealth transfer (2X)
- Asset depreciates to $800,000: $300,000 wealth transfer (1.6X)

Potential economic benefits are further increased by the reduction of the gross estate

PLANNING SUGGESTION: Don’t forget the drop down grantor trust

- Preserve the exclusion of gain on sale or exchange of a principal residence
- Avoid income tax liability on future rental income
- Be careful in the selection of the grantor trust powers and who purchases the residence

Don’t Forget the QPRT

The QPRT is an effective wealth transfer technique regardless of the Section 7520 Rate

Two components to the retained interest:

- Income interest
- Reversion interest

Income interest is interest rate sensitive

Reversion interest is age sensitive

7520 Rate	Age 50		Age 65		Age 75	
	Income	Reversion	Income	Reversion	Income	Reversion
2.5%	21.2%	6.4%	19.6%	21.0%	17.1%	41.8%
3.5%	28.2%	6.1%	26.1%	19.9%	22.9%	39.8%
4.5%	34.5%	5.8%	32.0%	19.0%	28.1%	38.0%
5.5%	40.2%	5.5%	37.3%	18.1%	32.9%	36.3%

QPRTs have two components to the present interest

- Regardless of age, a lower 7520 rate creates a lower retained interest
- Age and Interest rate combinations create equivalencies

Looking Forward to 2013

Estate, Gift and GST Tax

- Reduction of the exemption amount to $1 million
- Increase in the maximum tax rate to 55%
- Elimination of exemption portability

Income Tax

- Increase in ordinary income tax and capital gains tax rates
- Elimination of "Qualified Dividends"
- Reduction in AMT exemption
- Application of Medicare Tax on "Investment Income"

Legislative Concerns

- 10 year GRAT requirements
- Reconsideration of valuation issues and family limited partnerships

Flexibility and Fads

- *There is an unprecedented opportunity through the end of 2012 for thoughtful wealth transfer*
  - Increased exemption amount does not eliminate the need for thoughtful estate planning
  - Taxable gifts that benefit from the $5.12 million exemption should play a key role
  - Annual exclusion gifts, and direct gifts for education and medical payments continue to provide value
- *Flexiblity to the estate plan will remain important as estate tax laws remain in flux*
  - Balancing the needs of the surviving spouse and other beneficiaries
  - “Formula planning” should be reviewed
  - Portability: “Friend or Foe"

Successful estate planning will continue to take a broad view towards a clients' goals, wealth, and financial security as well as external factors such as interest rates, tax legislation, and market concerns

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