Wealth Planning Update

Planning in a New Interest Rate Environment

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In this Wealth Planning Update:

- *Families' long-term planning should take an integrated approach that considers investment goals, tax and estate planning, and economic factors. The prospect of rising interest rates in the United States will likely have an important effect on all of those planning considerations.*
- *Interest rates can be an important factor in developing tax and estate planning strategies.*
- *The recent environment of extremely low interest rates has favored so-called "leveraged" gifts.*
- *Rising rates will not mean an end to leveraged gifting and other strategies, but will require investors to plan carefully to enhance the likelihood of success when implementing these techniques.*

Many investors came of age in an era of prolonged low interest rates, and the post-recession period in recent years has brought rates to particularly low levels. The Federal Reserve's (Fed) recent action to raise short-term rates signals a change in long-standing policy, with implications for both investment and financial planning. Wealthier families use a variety of gifting techniques (both charitable and for family gifts) to accomplish their goals. These techniques depend on the interplay between interest rates and long-term investment returns.

In this update, we'll discuss the near-term interest rate and long-term investment outlook and their often-overlooked effect on financial planning decisions.

Setting the Stage: The Near-Term Prospects for Interest Rates

The Fed's one-quarter point (25 basis points) rate hike in December 2015 has many investors wondering what will come next. Will the Fed quickly bring rates back to more normal levels by raising interest rates in rapid succession, or will the process be more gradual?

The Wells Fargo Investment Institute (WFII) interest rate forecast is firmly in the gradual camp. While a number of Fed officials have stated that they anticipate four rate hikes in 2016, WFII forecasts one 25 basis point rate hike in 2016 as the Fed moves to gradually normalize rates. A number of important forces likely will limit the Fed's ability to raise rates more quickly. First, economic growth in the U.S. remains below potential and likely will stay at modest levels throughout 2016. Second, numerous international economic challenges such as slowing growth in China also may limit the Fed's ability to raise rates quickly.

The shape of the U.S. yield curve is another important consideration for investors. Inflation in the U.S. remains well below the Fed's target of two percent. WFII is forecasting a 1.4 percent rate in 2016 as wages begin to accelerate and oil prices begin to stabilize. As the Fed raises rates into this modest inflationary environment, the most likely outcome is a flattening of the yield curve. The short end of the yield curve will rise as the Fed raises rates while yields for longer maturities stay relatively flat.

In sum, the following is a base case forecast for 2016:

- The Fed will gradually raise rates in 2016 (one 25 basis point increase).
- International economic weakness and central bank divergence should limit the Fed's ability to raise rates more rapidly.
- A modest inflationary environment combined with Fed rate hikes will cause the yield curve to flatten.

Asset Class Return Expectations

In such an interest rate environment, stocks will likely outperform bonds. WFII views the weakness in stocks as a buying opportunity for long-term investors. The current aggregate dividend yield for the S&P 500 Index is higher than the 10-year U.S. Treasury Note, which is unusual and represents value in stocks. WFII remains overweight certain key segments within equities. WFII also continues to favor U.S. Large Cap stocks first and then international developed equities with particular emphasis on Europe. Finally, WFII is also overweight Real Estate Investment Trusts (REITs) and find them quite attractive from both a current yield and total return basis.

The Importance of "Leveraged" Gifting

Although families may now transfer a substantial amount of wealth free of gift or estate taxes—a total of $5.45 million per person in 2016—wealthier families continue to face potentially substantial wealth transfer taxes. Sophisticated planning approaches can provide a number of ways to leverage the exemptions and direct asset appreciation outside the donors' estate.

Most of these strategies involve a trade-off between a fixed return to donors based on prevailing interest rates, and the variable return on assets transferred outside the estate. Examples of such strategies include:

Intra-family loan. In a simple transaction, parents lend money to children (or a trust). The loan bears interest at the applicable federal rate (AFR), published monthly by the Internal Revenue Service. The AFR is based on government borrowing rates and tends to be lower than rates available from third-party lenders. Using the loan proceeds to acquire an investment, the children benefit if the return on the asset exceeds the interest payable on the loan. This type of loan can have the benefit of providing capital at lower than market rates, and keeps the interest paid within the family.

Sale of an asset for a fixed-payment note. An example of more complex intra-family financing is a sale by a grantor to an irrevocable trust in exchange for a note. If the total rate of return on property that is sold to the trust exceeds the interest rate of the loan, the excess is a tax-free transfer to the trust. The irrevocable trust can be structured as a grantor trust, so the grantor is treated as the owner of the trust for income tax purposes (but the assets are outside of the grantor's estate for estate tax purposes). If the trust is structured as a grantor trust, there is no capital gain recognized when the asset is sold to the trust, and the interest payments to the grantor do not constitute taxable income. Additionally, the grantor retains liability for the taxes generated by the trust, allowing the trust assets to grow income tax free.

Grantor retained annuity trust (GRAT). In the case of a GRAT, the grantor (creator of the trust) transfers assets into the trust in exchange for an annuity payable over a fixed time period. At the end of the term of the trust, the trust's remaining assets pass to the designated beneficiaries free of gift or estate tax. When determining the annuity to be paid to the grantor, the IRS sets a minimum rate (called the 7520 rate), which is 120 percent of the mid-term AFR. Growth surpassing the 7520 rate can be passed on to trust beneficiaries' gift and estate tax free.

Charitable lead annuity trust (CLAT). Similar to the GRAT is the CLAT, although the annuity payment, again based upon the 7520 rate, goes to charity. At the end of the trust's term, the remainder interest is distributed to one or more non-charitable beneficiaries. The grantor receives a charitable deduction on the value passing to charity, and like a GRAT, growth surpassing the 7520 rate can be passed on to trust beneficiaries gift and estate tax free.

Planning with a residence. Another irrevocable trust is the Qualified Personal Residence Trust (QPRT), where a grantor transfers a qualified personal residence into an irrevocable trust for a term of years. The grantor retains the right to live in the residence for the term, and at the end of the term, ownership passes to the beneficiaries, either outright or in a trust for their benefit. Although there are tax consequences of such a gift, the value of the gift is reduced by the grantor's right to live in the residence during the term of the trust and the grantor's reversionary interest (the probability of the grantor's death during the term of the trust). The value of the retained interest is based on the 7520 rate. As with the other strategies already discussed, any appreciation in the value of the residence during the term of the trust is passed on to the beneficiaries free of gift and estate tax.

Interestingly, the economics of a QPRT are somewhat different than with some other leveraged gifting strategies. A higher interest rate translates into a lower present value of the right to receive the house at the end of the QPRT term. Accordingly, in a rising-rate environment, using a QPRT could reduce the gift tax cost of setting up the vehicle and facilitate additional wealth transfer.

The Economics of "Leveraged" Gifting

All of the leveraged gifting strategies reviewed above have a common theme: donors retain a fixed return and transfer the potential increase in value from asset appreciation to family members. The spread between the total return and the interest factor payable to donors is the amount of wealth that transfers out of the estate.

A simple hypothetical example shows how leveraged gifting can enhance family wealth. John Doe, owner of a business, sells some shares in his company to a defective grantor trust. The shares are worth $5 million currently, and the trust pays Mr. Doe with a 9-year note bearing interest at 1.68 percent annually, the December 2015 AFR. The business grows in value at a 7 percent rate. At the end of nine years, having paid off the note, the trust will be worth over $3.18 million—in other words, Mr. Doe will have transferred that amount to his children free of any gift or estate tax. That transfer is possible because the growth in stock value exceeds the interest rate on the note.

If interest rates increase, the impact on the family will depend greatly on the return on assets. If, for example, Mr. Doe sells shares to a trust when the AFR has risen to 3 percent and the stock maintains a 7 percent growth rate, at the end of nine years the trust value will be $2.4 million. That amount is meaningfully smaller, but still substantial. If, though, asset returns increase by the same amount as interest rates, more wealth would transfer to the trust—a total of almost $3.7 million.[1] It is the total spread between asset growth and interest expense that determines the amount of wealth transferred, not simply the level of interest rates.

The importance of that spread has a number of implications for families when they engage in wealth planning. One major point is that rising rates don't mean that leveraged gifting no longer "works." But increasing rates will require families to consider carefully which strategies make sense, and to select assets that fit with their strategy.

The Impact of a Changing Yield Curve

Determining which interest rate to use is also critically important when making financial decisions. Consequently, the relationship between short-term rates and longer-term rates has a substantial planning impact. Strategies such as an outright loan, or a sale for a note, require families to select a term for the transaction. During the past several years many people have found the mid-term AFR very useful in planning, as it allows for a term of up to nine years with an attractive interest rate relative to the long-term rate (anything over nine years). In a flattening yield curve environment, it may be that the long-term rate becomes most advantageous. In the meantime, refinancing intra-family obligations before rates increase substantially may be advisable.

The evolving yield curve will also affect existing planning for many clients who have implemented GRATs. It has been common for families to set up relatively short-term GRATs (for example, two- or three-year terms). As the GRAT makes annuity payments, the donors can set up another GRAT.[2] The new GRAT's annuity amount is based on rates prevailing at that point; in other words, the wealth transfer opportunity for a new GRAT will be limited if interest rates have risen since creation of the initial GRAT. One of the implications of a rising rate environment is to determine whether a strategy that allows a family to lock in an interest rate for a longer period becomes preferable to the flexibility which GRATs can provide.

Conclusion

The changing interest rate climate and careful consideration of which assets have the greatest growth potential over the long term will be important considerations for clients as they review their planning options. In planning for wealth transfer, families should keep in mind that the most important factor is the difference between interest rates and asset returns; rising rates will not necessarily make leveraged gifting strategies unattractive. For some strategies—notably, a QPRT—rising rates will offer additional opportunities for wealth transfer. Overall leveraged gifting should remain an important tool for wealthy

[1] In the first scenario, the interest payable to John Doe was 1.68% and the return on the stock was 7%, a spread of 5.32%. If interest rates increase to 3% but the difference between the stock return and interest expense remained at 5.32%, the return on the stock would total 8.32%. Assumptions are hypothetical and for illustrative purposes only

[2] From time to time there have been proposals to require GRATs to have a minimum term, but to date Congress has never enacted such a limitation.

families but selecting the appropriate assets and strategies will become even more important than ever. In this changing planning environment, we encourage you to review your options carefully with your planning specialist as well as your legal, tax, and investment advisors.

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