WILMINGTON TRUST

MEMBER OF THE M&T FAMILY

Integrating Estate Planning and Borrowing

Uncovering opportunities under today's current tax laws

Andrew J. Horwitz, CFP®
National Director, Wealth Strategies
Wilmington Trust, N.A.

Alvina H. Lo
Chief Wealth Strategist
Wilmington Trust, N.A.

Key Points

- Today's current tax environment offers the potential for high-net-worth individuals and families to pass wealth free of estate, gift, and generation-skipping transfer taxes, while increasing the importance of income tax planning
- Borrowing or leverage strategies can be important components to protect significant wealth for your family by working to mitigate risk and taxes
- Complex leverage strategies typically require a customized approach to your situation by all members of your wealth management team

The Tax Cuts and Jobs Act passed in 2017 necessitated a reevaluation of many individual's estate plans. It significantly increased the ability of high-net-worth individuals and families to pass wealth free of estate, gift, and generation-skipping transfer (GST) taxes, while increasing the importance of income tax planning due to changes to income tax rates and brackets, as well as standard and itemized deductions.

Many of these beneficial changes are set to expire at the end of 2025, so it may be imperative to evaluate your overall family wealth plan—particularly if it incorporates existing trust planning—with today's tax laws in mind. In many cases, borrowing or leverage can be an important component to your existing estate planning strategies by improving or creating tax management opportunities. This article seeks to quantify the enhanced benefits of leverage in the following situations: (1) locking-in the appreciation of assets in a grantor retained annuity trust (GRAT) to help mitigate potential downside investment risk; (2) "restarting" a "failed" GRAT seeking to capture future upside potential; and (3) substituting high basis assets into an intentionally defective grantor trust (IDGT) for low basis assets to preserve the potential step-up in basis at the grantor's death. It is important to keep in mind that each situation is unique, and there is no one-size-fits-all approach to using leverage to accomplish your planning objectives.

Grantor trusts generally

A grantor trust is a type of trust in which the trust owner (grantor) relinquishes ownership of the assets placed in the trust but is treated as the owner of the trust assets for income tax purposes (including tax liability, deductions, and credits against tax). Creating this type of trust is a common estate planning strategy for high-net-worth individuals and families, particularly when funded with assets that have low income tax bases relative to their fair market value. Use of this strategy may result in income and estate tax savings when the grantor trust is irrevocable.

Irrevocable grantor trusts may be created for both tax and non-tax reasons. A few of the major benefits of creating such a trust are: (1) when you, as the grantor, make a gift or sell assets to the trust, you are allowed to pay the income taxes on the trust assets, thus allowing the assets held inside the trust to grow income tax free; (2) such income taxes paid are not considered a gift to the beneficiaries of the trust (hence preserving your lifetime gifting exemption) and do not cause inclusion of the trust assets in your estate; and (3) you can swap or substitute your assets with trust assets without any income tax consequences provided the assets swapped are of equivalent value.

Grantor retained annuity trust

A GRAT is a popular method of transferring the growth of assets held in trust to future generations at a greatly reduced gift tax cost. The grantor transfers assets that are expected to appreciate significantly over a period of time such as 3, 5, or 10 years in return for a series of fixed annuity payments. The hurdle rate, or 7520 rate as it is commonly called, is used to determine the amount of the annuity payment that is required to be disbursed by the GRAT to the grantor. The value of the annuity payments retained by the grantor is subtracted from the value of the assets transferred to the GRAT in determining the value of the remainder interest passing to the beneficiaries outright or in further trust. When GRAT assets appreciate faster than the hurdle rate, the GRAT can successfully pass this difference to the beneficiaries gift and estate tax free. A common way to provide for the GRAT to grow is to have lower annuity payments in the earlier years. With this approach, the GRAT would then provide for annual increases in the annuity payment of up to 20% in each of the remaining years to satisfy the distribution requirements.

Locking-in a GRAT with leverage: A strategy to help protect appreciation from downside risk. A successful GRAT is one that has grown in value so that it has assets remaining at the end of the term after all annuity payments are made to the grantor. Often, a GRAT's value may surge early through strong performance only to experience a significant downturn later in its term, reducing the strategy's overall effectiveness. The lock-in GRAT seeks to protect the early appreciation from the potential for downside risk later in the term. The grantor substitutes or swaps assets of equivalent value that have low volatility for the riskier and highly appreciated GRAT assets. When the grantor does not have the liquidity or low volatility assets to accomplish the substitution, borrowing may provide a solution.

Continued

Example 1

Figure 1 illustrates the successful GRAT with early significant appreciation. Let's assume the grantor establishes a GRAT with the following facts:

- Term: 5 years
- Initial transfer to GRAT: $10,000,000
- Growth rate of GRAT assets: 5.5% growth in years 1, 4, and 5, 20% returns in years 2 and 3
- Annuity payments increase by 20% per year
- Hurdle rate: 3.4%
- GRAT remainder: $3,834,930 that passes free of gift and estate tax to the beneficiaries

Figure 1
Successful GRAT with early appreciation

Year	Principal	Return	Growth	Required Payment	Remainder
1	$10,000,000	5.5%	$550,000	$1,501,929	$9,048,071
2	$9,048,071	20.0%	$1,809,614	$1,802,314	$9,055,371
3	$9,055,371	20.0%	$1,811,074	$2,162,776	$8,703,669
4	$8,703,669	5.5%	$478,702	$2,595,331	$6,587,040
5	$6,587,040	5.5%	$362,287	$3,114,397	**$3,834,930**

Example 2

Using the same facts in Example 1, except the GRAT assets decline 20% in value years 4 and 5, the remainder passing to the beneficiaries after all annuity payments is reduced significantly to $379,687 (Figure 2). Although the GRAT is still successful because there is a remainder available to the beneficiaries, the significant losses experienced in the GRAT's later years reduced its effectiveness by $3,455,243, or 90%.

Figure 2
GRAT assets decline 20%

Year	Principal	Return	Growth	Required Payment	Remainder
1	$10,000,000	5.5%	$550,000	$1,501,929	$9,048,071
2	$9,048,071	20.0%	$1,809,614	$1,802,314	$9,055,371
3	$9,055,371	20.0%	$1,811,074	$2,162,776	$8,703,669
4	$8,703,669	–20.0%	–$1,740,734	$2,595,331	$4,367,605
5	$4,367,605	–20.0%	–$873,521	$3,114,397	**$379,687**

What if the grantor decides at the end of year 3 to substitute low risk assets of equivalent value to lock-in the appreciation and reduce the possibility of loss in years 4 and 5? At the end of year 3, the GRAT's value is $8,703,669 (Figure 3). If the GRAT includes substitution powers, the grantor may substitute assets with the GRAT with no income tax consequences. In this case, the grantor may substitute $8,703,669 of cash (or other low volatility assets) in exchange for assets of the same value in the GRAT. If the grantor is illiquid, does not wish to deploy, or does not have low-risk assets for this purpose, he or she may borrow the $8,703,669 from a bank. To repay the loan, the grantor may use the remaining GRAT payments and interest and dividends on the riskier assets received from the substitution.

The result: By locking-in the appreciation, the GRAT's remainder after all annuity payments increased to $2,993,941 (Figure 3) even if we assumed no growth of the substituted assets in years 4 and 5. The cost of borrowing (interest expense) is $491,758. Therefore, the net benefit from the lock-in equals $2,502,183 ($2,993,941 minus $491,758). The lock-in strategy may be one to consider where the assets have appreciated significantly but return volatility is or may be expected during the remaining GRAT term.

Figure 3
Locking-in appreciation

Year	Principal	Return	Growth	Required Payment	Remainder
1	$10,000,000	5.5%	$550,000	$1,501,929	$9,048,071
2	$9,048,071	20.0%	$1,809,614	$1,802,314	$9,055,371
3	$9,055,371	20.0%	$1,811,074	$2,162,776	**$8,703,669**
4	$8,703,669	0.0%	$0	$2,595,331	$6,108,338
5	$6,108,338	0.0%	$0	$3,114,397	**$2,993,941**

For illustrative purposes, the same 3.4% 7520 hurdle rate was used.

Continued

Figure 4
GRAT fails

Year	Principal	Return	Growth	Required Payment	Remainder
1	$10,000,000	5.5%	$550,000	$1,501,929	$9,048,071
2	$9,048,071	5.5%	$497,644	$1,802,314	$7,743,401
3	$7,743,401	5.5%	$425,887	$2,162,776	$6,006,512
4	**$6,006,512**	–20.0%	**–$1,201,302**	$2,595,331	$2,209,879
5	$2,209,879	5.5%	$121,543	$3,114,397	**$0**
	$4,805,210 GRAT asset value after decline				

Fixing a failing GRAT: Using leverage to allow time for an asset to recover in value. In the lock-in GRAT, the grantor locked-in the appreciation of assets before the downturn in performance. But what if the lock-in did not occur and the downturn in the asset values did? It is possible the GRAT will ultimately fail. A failing GRAT is one where the annuity payments will exceed the GRAT assets some time during the term, or the remainder left for the beneficiaries is so small that the strategy was not worth the cost.

Example 3

The following example illustrates the use of leverage to fix a failing GRAT:

- Term: 5 years
- Initial transfer to GRAT: $10,000,000
- Growth rate of GRAT assets: 5.5% growth in years 1, 2, 3, and 5 and a 20% loss in year 4
- Annuity payments increase by 20% per year
- Hurdle rate: 3.4%
- GRAT remainder: Fails–Could not fully make the last annuity payment

Figure 4 demonstrates that in year 5, the GRAT would not have enough in assets to make the full last annuity payment to the grantor, resulting in a $0 remainder. In fact, the grantor would need a 41% return in year 5 for the GRAT to have a small remainder ($1,531). In our example, let us assume the grantor believes that such a 1-year return is unlikely but a return of 15% per year over 3 years might be reasonable. Although the grantor believes in the asset appreciation potential, there simply is not enough time in the remaining term of the GRAT for the asset to recover to consider the strategy a successful one. As a potential solution, the grantor creates a new GRAT, let's call it GRAT2, for a 3-year term. At the end of year 4 and before the annuity payment, the GRAT assets have declined in value to $4,805,210 (Figure 4). The grantor borrows this amount to substitute into the GRAT and uses the depreciated assets to fund GRAT2. If the asset grows as planned, GRAT2 will appreciate to $1,439,907 (Figure 5) and can be passed to the beneficiaries free of gift and estate tax. Interest costs over the 3 years would be $159,532 using a secured personal line of credit at a hypothetical rate of 3.32%.

By utilizing the lock-in strategy, we were able to turn an otherwise failing GRAT into a successful one where $1,439,907 passes gift and estate tax free to the beneficiaries.

Figure 5
Turning a failing GRAT into a successful one

Year	Principal	Return	Growth	Required Payment	Remainder
1	$4,805,210	15.0%	$720,781	$1,416,588	$4,109,403
2	$4,109,403	15.0%	$616,410	$1,699,906	$3,025,907
3	$3,025,907	15.0%	$453,886	$2,039,887	**$1,439,907**

For illustrative purposes, the same 3.4% 7520 hurdle rate was used.

Intentionally defective grantor trust

In this common estate planning strategy, the grantor makes a completed gift to an irrevocable trust to remove future appreciation from the estate for estate tax purposes. Typically, the grantor will also allocate an equivalent amount of GST tax exemption so the trust can grow for future generations without being subject to both estate and GST taxes. By retaining certain trust powers (i.e., the power to substitute assets of equivalent value) the grantor will continue to be the owner of the IDGT assets for income tax purposes. The IDGT takes the tax basis of the grantor for any assets gifted to it. The tax basis of an asset is generally its cost basis. Unlike an individual holding appreciated assets at death, the IDGT does not receive a step-up in basis at the grantor's death. A step-up in basis is the adjustment of the tax cost of an asset to its higher fair market value at the death of the individual. A step-up in basis is important as it has the potential to eliminate some or all of the unrealized gains when the asset is sold.

Continued

Figure 6

Locking-in IDGT with leverage

IDGT for Highly Appreciated Assets		Borrowing Terms & Net Benefit	
Basis	$1,000,000	Loan Principal	$12,000,000
Market Value	$12,000,000	Interest Rate	3.32%
Unrealized Gain	$11,000,000	Cost of Borrowing	–$398,400
23.8% Tax Rate[1]	$2,618,000	**Net Savings (Tax[1])**	**$2,219,600**

[1] Long-term Capital Gains (20%) and Net Investment Income Tax (3.8%)

Locking-in IDGT with leverage: A strategy to protect the benefit from the step-up in basis at death. In this scenario illustrated by Figure 6, the grantor establishes an IDGT to grow assets free of estate and GST taxes. The grantor gifted cash of $1,000,000 to the IDGT that over time grew to $12,000,000. As a result, the IDGT has unrealized gains of $11,000,000 with a potential federal income tax of $2,618,000 (20% long-term capital gain plus 3.8% net investment income tax). The grantor would like the IDGT assets back to lock-in the low basis for step-up at death to eliminate the potential tax on the unrealized gains. The grantor structures a personal secured line of credit for $12,000,000 at a rate of 3.32% and substitutes cash for the low basis assets in the IDGT.

If the grantor then dies and we assume it takes a year for the estate to repay the loan, the following occurs:

- One-year interest expense of $398,400
- Potential income tax savings (capital gain and net investment income tax) as a result of the step-up in basis is $2,618,000
- Net benefit of the strategy of $2,219,600 after repayment of the interest expense
- IDGT's basis is now $12,000,000
- Loan could possibly be repaid from the estate with other assets or selling the assets that received the step-up in basis

In the above example, basis was successfully managed and by reducing significant capital gains taxes, the trust is left with more cash to then invest for the beneficiaries without the built-in tax drag. This approach allowed the grantor to increase the amount that passes free of estate, gift, and GST taxes for current and future beneficiaries.

Deducting investment interest

It may be possible for the grantor to deduct the interest on the borrowed amount in the above GRAT and IDGT scenarios as an investment interest expense. If the cash substituted into the GRAT or IDGT was then used to purchase investment assets, it may be possible for the grantor to deduct the interest as an investment interest expense on the loan. Remember, the GRAT/IDGT is a grantor trust and income tax attributes (income, deductions, and credits) would be associated with the grantor. Generally, investment interest expense may be deducted if the borrowed proceeds are used to purchase property held for investment. Another way to view it is that the property purchased will be expected to appreciate in value or produce investment income. It is unlikely that using the borrowed proceeds to purchase Certificates of Deposit, or other cash equivalents, would be considered "property acquired for investment." Additionally, you would not be able to deduct the interest for property purchased that produces non-taxable income such as tax-exempt bonds. However, the grantor may be able to directly use the borrowed cash to first purchase property held for investment and then substitute it into the GRAT. This method may allow the grantor to deduct the investment interest expense on the loan. It will be important to work with your tax advisor, investment manager, and wealth management team to determine the types of investments that may be deductible as an investment interest expense, limitations on this deduction, and which approach makes sense for your situation.

Utilizing leverage in your wealth planning can provide new options to help preserve your wealth for your family and future generations. The borrowing discussed in this article requires a customized approach to your situation by all members of your wealth management team, including your bank, wealth strategist, attorney, and accountant. Together, your team can look at your entire balance sheet, current and future cash flows, loan structures, ongoing liquidity needs, markets, and overall estate plan to tailor strategies to help work toward accomplishing your goals.

Continued

Andrew J. Horwitz, CFP®
National Director, Wealth Strategies
Wilmington Trust, N.A.
717.255.2179
ahorwitz@wilmingtontrust.com

As part of the Wilmington Trust Emerald Family Office & Advisory® team, Drew is responsible for developing customized wealth management strategies and financial plans for prominent individuals, families, and business owners. His areas of expertise include estate and retirement planning, insurance planning, investment planning, education planning, business succession planning, legacy planning, and philanthropic planning.

Drew holds a JD from Widener University School of Law and a bachelor's degree in health policy and administration from Pennsylvania State University. He holds his Pennsylvania Life, Variable Annuities, Accident, and Health licenses.

Drew authored several thought leadership articles and podcasts for Wilmington Trust, and has been quoted in local and national publications and websites for his keen insights on financial and estate planning. Drew is a member of the Financial Planning Association for the Central Pennsylvania Region and the Pennsylvania Bar Association.

Alvina H. Lo
Chief Wealth Strategist
Wilmington Trust, N.A.
212.415.0567
alo@wilmingtontrust.com

As part of the Wilmington Trust Emerald Family Office & Advisory® team, Alvina is responsible for wealth planning, family office services, and thought leadership development for Wilmington Trust's Wealth Management division. She oversees a national team of wealth strategists, family office services professionals, and thought leadership experts, who together, serve as advisors to high-net-worth individuals and families, business owners, entrepreneurs, and foundations.

Alvina is a Fellow of the American College of Trust and Estate Counsel (ACTEC), a highly selective group of peer-elected trust and estate attorneys in the U.S. and abroad. She was named as a recipient of the 2021 Outstanding 50 Asian Americans in Business Award by the Asian American Business Development Center. She was also recognized by Crain's New York Business as one of their Most Notable Women in Financial Advice in 2020.

