Morgan Stanley

Topics In Wealth Strategies:

Trust, Tax & Estate (TTE) Execution in Interest Rate and Financial Market Environments

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Trust, Tax & Estate (TTE) Planning Is An Ongoing Management Process

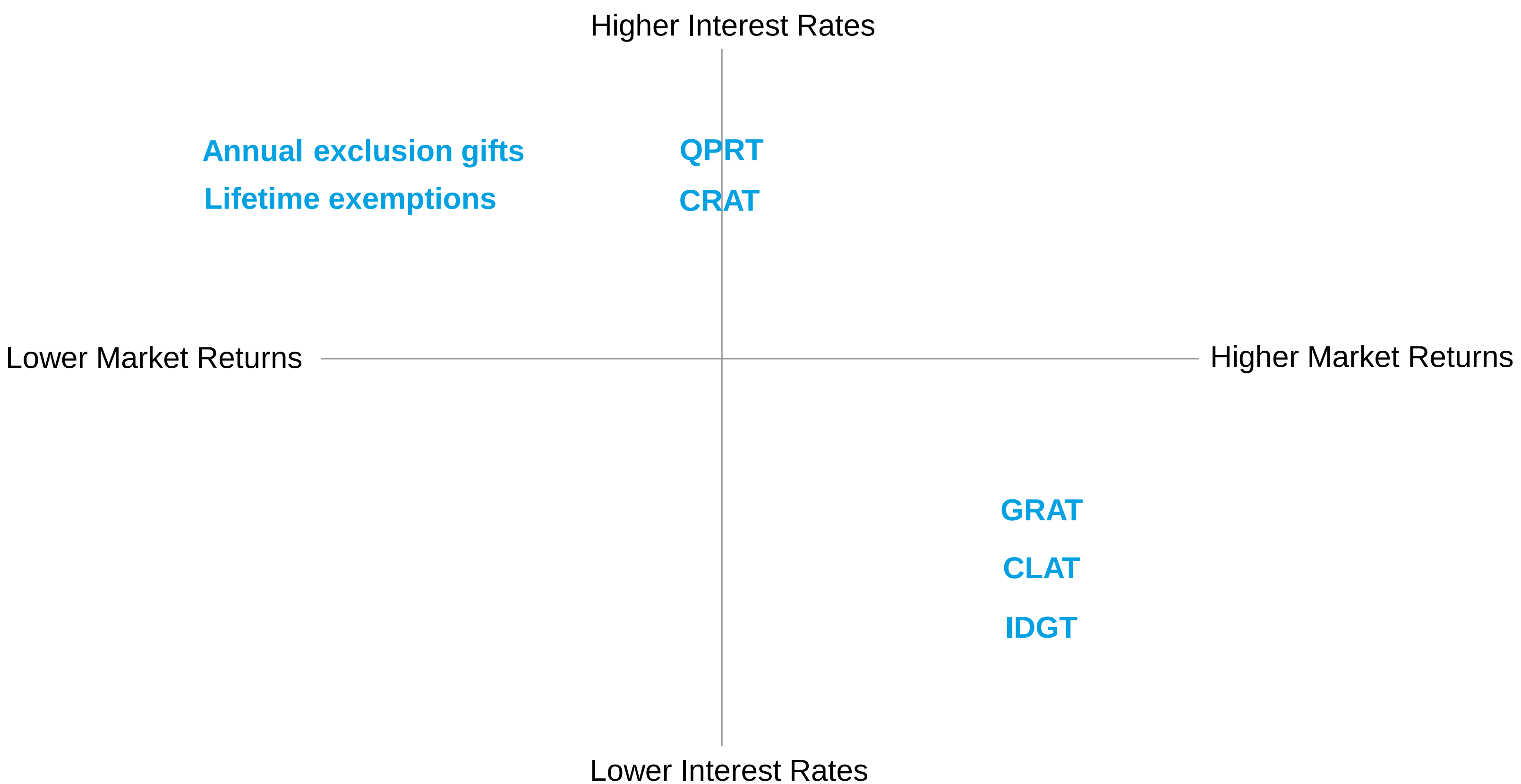
Ongoing Management TTE planning is not a static one-off exercise; rather, it requires ongoing management to maintain relevance against the backdrop of both changing and evolving life events, personal preferences and economic factors. The TTE strategy determines the capital allocation of assets across family, charity and the government. The TTE implementation drives the success of the TTE strategy by delineating between what must be executed and what might be executed according to wealth levels, thereby creating a rules-based approach to TTE planning that may be more easily communicated to investment professionals and lawyers who may assist in navigating the economic environment.

A Trust Tax & Estate (TTE) strategy has the potential to be effective if executed properly. For a successful TTE plan, it is critical to create a TTE implementation in combination with a TTE strategy.

TTE Plan = TTE Strategy + TTE Implementation

Trust, Tax & Estate (TTE) Execution in Interest Rate and Financial Market Environments

Identifying Opportunities: TTE implementation deploys the desired techniques as and when it makes sense and market opportunities arise. TTE implementation and sequencing its component parts are critical for successful execution. The key is to understand the role of life events and personal preferences as well as economic factors in determining what TTE techniques to execute and under what parameters and circumstances.



Strategies Improved by Lower Interest Rates

Grantor Retained Annuity Trust (GRAT)

Through a GRAT, a donor irrevocably transfers property to a trust for a term of years, retains an annuity interest in the trust property and makes a gift of the trust remainder to a beneficiary. The amount of the taxable gift is the market value of the property transferred to the trust less the present value of the retained annuity determined using an IRS discount rate.

- The transaction can be structured so that the present value of the retained annuity approximately equals the market value of the property transferred, making the value of the gift zero (a "zeroed-out" GRAT). A decrease in the interest rate lowers the annuity that the trust must pay to the donor.
- The GRAT produces estate and gift tax savings if trust property produces a total return (income and appreciation) in excess of the IRS discount rate (i.e. property will remain in trust for the remainder beneficiaries after the expiration of the grantor's annuity interest). A lower IRS discount rate means a lower hurdle for transfer tax savings.

Charitable Lead Annuity Trust (CLAT)

Through a CLAT, a donor irrevocably transfers property to a trust for a term of years, makes a gift of an annuity interest in the trust property to a charity and makes a gift of the trust remainder to a beneficiary. The gifts are valued using an IRS benchmark discount rate. The amount of the taxable gift is the market value of the property transferred to the trust less the value of the retained annuity.

- The transaction can be structured so that the present value of the annuity gifted to charity equals the market value of the property transferred to the trust (zeroing out the CLAT).
- A lower interest rate decreases the value of the annuity being paid to charity and increases the value of the taxable gift of the remainder.
- Like a GRAT, transfer tax savings are achieved where the property transferred to a CLAT appreciates at a rate greater than the IRS discount rate used in valuing the income and remainder interests. A lower discount rate means a lower hurdle for transfer tax savings.

Sale To A Grantor Trust (IDGT)

Through a Sale to a Grantor Trust, a donor can make a gift to a trust and continue to be taxed on trust income, because the trust is a "grantor trust."

- The grantor can sell assets to the grantor trust in exchange for the trust's interest-bearing promissory note. Because the trust is a grantor trust, neither the sale of the property to the trust nor the payments of interest to the grantor will be taxed.
- The sale to the grantor trust produces estate and gift tax savings if the trust property produces a return (income and appreciation) in excess of the interest rate on the note. For intra-family transactions, the IRS publishes the minimum interest rates that must be charged so that there is no deemed gift (of forgone interest). Separate rates are published for short-term notes (3 years or less), mid-term notes (more than 3 years but no more than 9 years) and long-term notes (over 9 years). The interest rate on the note generally is lower than the rate used in discounting the interests in a GRAT. A lower interest rate means lower interest payments to the donor and therefore a lower hurdle for transfer tax savings.

Strategies Weakened by Lower Interest Rates

Qualified Personal Residence Trust (QPRT)

Through a QPRT, a donor retains the use of a residence for a term of years and makes a taxable gift of the remainder interest. The value of the gift is the market value of the residence less the value of the retained term.

- A lower interest rate lowers the value of the retained interest and increases the value of the remainder interest. Therefore, QPRTs are more attractive from an estate planning perspective when interest rates are high.

Charitable Remainder Annuity Trust (CRAT)

Through a CRAT, a donor irrevocably transfers property to a trust, retains an annuity interest in the trust measured by a life or lives or a term of up to 20 years and makes a tax-deductible gift of the trust remainder to charity. The trust is itself tax-exempt but distributions from the trust are taxable.

- A lower interest rate produces a smaller income tax charitable deduction (and increases the value of the annuity).

Strategies Improved by Market Downturns

Gifting Growth Assets Using

- **Annual Exclusion Gifts**
- **Lifetime exemptions**

When there is a downturn in the economy, clients who are fortunate enough to be able to focus on estate planning should consider the current market and interest rate environment as an opportune time to shift assets to the next generation. The federal government places limits on the value of assets one can give, so when assets fall in value, one can give more assets. Effective estate and gift tax planning comes down to two concepts: shrink the target (the estate) by gifting growth assets.

Economic Factors: Fiscal Policy + Exemptions

Fiscal policy and the ability and need of the federal government to tax and spend underpin the prevailing federal income, gift, estate and GST tax rates as well as transfer tax exemptions and annual exclusions and charitable deductions. Depending on the health of the economy and the government, as well as the balance of power between political parties, the laws that dictate these specifications change over time thus creating and reducing potential opportunity for TTE planning.

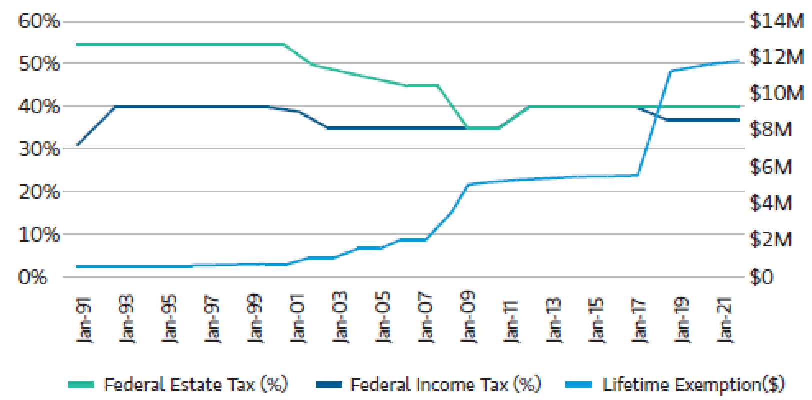
How Much TTE Planning Might Be Considered:

- Higher income and estate taxes and lower exemptions and deductions inspire more TTE planning.
- Lower income and estate taxes and higher exemptions and deductions may lead to less TTE planning.

Overview of Current Laws

	2022
GIFT (LIFETIME) AND ESTATE TAX EXEMPTION	• $12.06MM
GENERATION-SKIPPING TRANSFER TAX EXEMPTION	• $12.06MM
TOP GIFT, ESTATE, GST AND INCOME TAX RATES	• Transfer Tax 40% • Federal Income Tax 37% • Additional Medicare Tax 0.9%
TOP LONG-TERM CAPITAL GAINS AND QUALIFIED DIVIDENDS RATE	• 20% • Net Investment Income Tax 3.8%
QUALIFIED CHARITABLE CONTRIBUTION (FROM IRA FOR THOSE OVER 70.5)	• Yes
GRATS/FLP DISCOUNTING	• Unchanged

Taxes and Exemptions



Source : Exceptions- The Estate Tax: Ninety Years and Counting Darien B. Jacobson, Brian G. Raub, and Barry W. Johnson – http://www.irs.gov/pub/irs-soi/ninetyestate.pdf Taxes - http://www.moneychimp.com/features/tax_brackets.html and http://taxfoundation.org/2020-tax-brackets/

Economic Factors: Monetary Policy + Interest (“Hurdle”) Rates

Monetary policy conducted by the Federal Reserve intends to promote employment and stable prices by managing the level of short-term interest rates and the overall availability and cost to borrow. Monetary policy directly and indirectly affects interest rates across maturities of the U.S. Treasury yield curve. It is the yield curve that provides the basis for the rates specified by the Internal Revenue Service (IRS).

Hurdle rates for private and intra-family loans (AFR):

Specifically, the IRS publishes the Applicable Federal Rates (AFRs) used as the basis for setting minimum interest rates for private or intra-family loans, such as sales to intentionally defective grantor trusts (IDGTs). Depending on the term of the loan, there are three AFRs: short term, midterm, and long term. Short-term AFR rates are determined from the one-month average of the market yields from marketable obligations, such as U.S. government T-bills with maturities of three years or less. Midterm AFR rates are from obligations of maturities of more than three and up to nine years. Long-term AFR rates are from bonds with maturities of more than nine years.

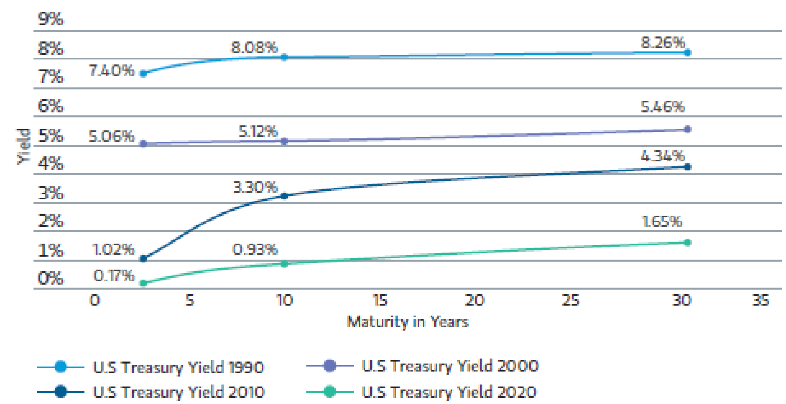
Hurdle rates for split-interest trusts (7520):

The IRS also publishes the 7520 rate used to determine the value of the respective interests of split-interest trusts, examples of which include charitable remainder trusts (CRTs), charitable lead trusts (CLTs), grantor retained annuity trusts (GRATs) and qualified personal residence trusts (QPRTs). The 7520 rate is 120% of the applicable federal midterm rate. (Source: Evans Estate Law Resources, 2020).

Which TTE Techniques Might Be Considered:

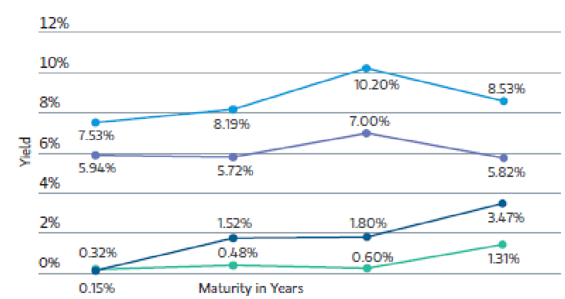
- Low interest rate environments make GRATs, IDGTs and CLTs more favorable.
- High interest rate environments make QPRTs and CRTs more favorable.

U.S. Treasury Yield Curves



Source: FactSet

AFR and 7520 Rates

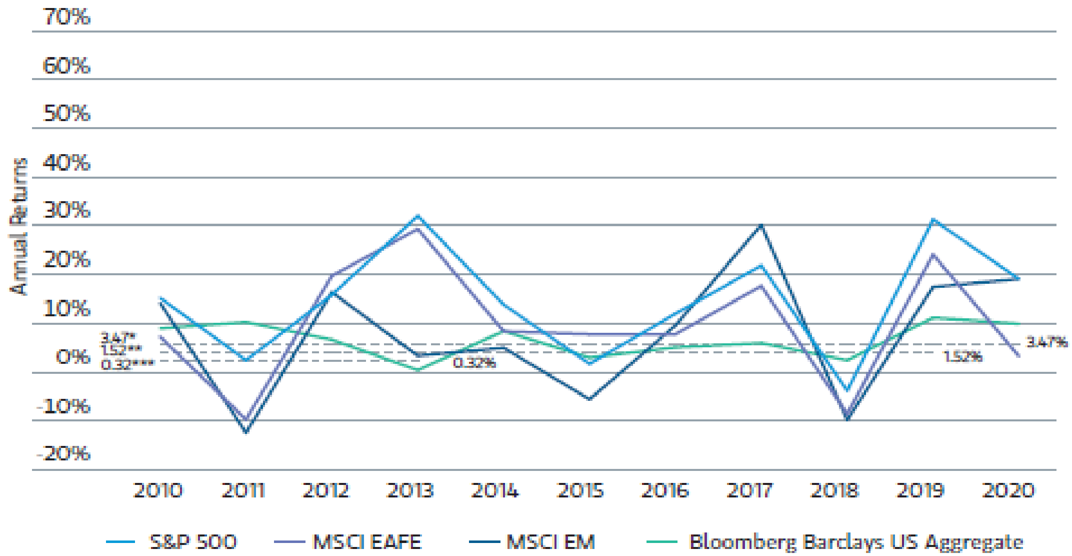


	0-3 Treasury Yield - AFR Short-Term Rate	3-9 Treasury Yield - AFR Midterm Rate	7520 Rate - 1.2 AFR Midterm	>9 Treasury Yield - AFR Long-Term Rate
December 1990	7.53%	8.19%	10.20%	8.53%
December 2000	5.94%	5.72%	7.00%	5.82%
December 2010	0.32%	1.52%	1.80%	3.47%
December 2020	0.15%	0.48%	0.60%	1.31%

Source: AFR - http://evans-legal.com/dan/afr.html 7520 - https://www.reninc.com/irs-rates-history/
Both - https://apps.irs.gov/app/picklist/list/federalRates.html

Economic Factors: Financial Markets + Asset Allocation

Financial markets drive asset class performance and risk, and as such, contribute to the efficacy of TTE planning. Each TTE technique has its own objectives and risk characteristics, which, when taken together, should contribute to and complement the overarching risk profile of the beneficiary. The determination of a risk profile and its maintenance, inclusive of the TTE planning, are critical. The opportunity lies in marrying the characteristics of both the asset classes and the TTE techniques that house the assets. To do this, care should be taken to purposefully employ asset location in addition to asset allocation and subsequent investment decisions.



*Long-term AFR Rate as of December 2010 **Midterm After Rate as of December 2010 ***Short-term AFR as of December 2010

What Asset Classes Should Be Considered in which TTE Techniques:

- Tax-inefficient asset classes within tax-exempt and deferred techniques
- Tax-exempt asset classes within taxable techniques
- Higher return and risk assets in aggressive and nice-to-have techniques
- Lower return and risk assets in conservative and must-have techniques

Timing: Putting It All Together

Finally, understanding and appreciating the impact of market timing on the interdependence of a TTE strategy (selection of TTE techniques) and TTE implementation (deployment of a TTE technique and selection and combination of asset classes) are key to successful TTE planning. Specifically, when a TTE structure is initiated over a specified time period, the IRS dictates the “hurdle” rate (AFR and/or 7520 rate), which becomes the benchmark for the investments over that time horizon. To put this into context, using historical data that is not an indication of future performance, take for example a TTE technique that was created using the long-term AFR rate as of December 2010 of 3.47%. From the following chart, one may see the annual returns of various asset classes over the subsequent decade to understand which asset classes generated returns exceeding the AFR rate of 3.47% and those that generated returns of less than 3.47% to understand the relative contribution to the success of the TTE technique.

Disclosures

This material was designed to illustrate the financial impact of a particular planning decision. It does not constitute a recommendation.

Caution: many estate techniques share the common risk of the loss of control of the assets once the gift of the assets is complete.

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