Lender of First Resort: 
Time to Refinance the Estate?

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Rewind to 1981: Ronald Reagan has been elected president, the term “Internet” is first mentioned, and Paul Volcker has taken the helm at the Federal Reserve. Ten-year bond yields are 15% and 30-year mortgage rates are roughly 16%. Stagflation grips the U.S. economy, with inflation hitting nearly 14% by the end of 1980. Fast forward to January 2014: 30-year mortgage rates are averaging 4%; 10-year government bonds yield 2.75%.

Not surprisingly, corporate treasurers have taken advantage of the steep decline in interest rates to refinance their balance sheets. Caterpillar, United Health Group, Johnson & Johnson (JNJ), and other blue chip businesses have been active issuers of debt since 2010, taking on new debt or refinancing old debt to lower their cost of capital. For example, JNJ sold $550 million of 2.95%, 10-year notes in August 2010. In theory, borrowers will reinvest debt proceeds within their businesses at a rate that exceeds their after-tax cost of funds or retire shares at an attractive price, both to the benefit of shareholders.

WHEN IN ROME, DO AS THE ROMANS DO?

Should not the wealthy, too, take on debt at record-low interest rates and invest the debt proceeds at a rate that exceeds their after-tax cost of funds? The temptation to borrow and arbitrage is enticing: low absolute borrowing cost, negative real interest rates, and, at least for now, a new Fed chairman, Janet Yellen, who seems to be following her predecessor’s penchant for keeping interest rates low. Some banks seem to be opportunistically embracing the use of debt to leverage portfolio returns. The answer, of course, is it depends.

For purposes of this article, our interest in debt runs along a different line: that is, should families of wealth take advantage of record-low interest rates to refinance their family balance sheet and, using the freeze features of a promissory note, and shelter future asset growth from estate tax? We are not writing about borrowing from a bank; instead, our interest is in a family structuring a long-term, intrafamily loan, written at a fixed rate (not one tied to LIBOR (the London Interbank Offered Rate)). And if the family did pursue such planning, how might the unique intrafamily mechanics and economics affect portfolio construction and tax management considerations.

WHY BORROW OR LEND AT ALL, ESPECIALLY BETWEEN FAMILY MEMBERS OR TRUSTS?

“Neither a borrower nor a lender be,” Polonius advises in Shakespeare’s Hamlet (Act 1, Scene 3). “For loan oft loses both itself and friend, and borrowing dulls the edge of husbandry.”
The elderly Polonius counsels his hotheaded, Paris-bound son, Laertes, that lending money to friends poses risk because linking debt with personal relationships can cause resentment and, in the case of default, loses the lender both his money and his friend. Borrowing, so Polonius believes, supplants thrift and leads to ostentatious living. Polonius, of course, ignores the tax or pure financial benefits of borrowing.

Consider the generation 1 (G1) wealth creator who decides to sell appreciating assets to a family trust (G2+Trust), taking back from the trust a long-term, fixed-rate, interest-only note. G1’s equity remains the same, but the family balance sheet changes. G2+Trust now holds both an investment asset and an offsetting liability to G1, one issued on favorable terms. Just as JNJ’s debt proceeds can be managed imprudently, so too can the G2+Trust trustee, making the intrafamily loan uneconomic or worse, leading to the event that worried Polonius—the trustee is forced to default on its loan.

Why Might a Family Consider Refinancing Its Balance Sheet Now?

Four reasons come to mind:

1. **Interest rates hover at near-record lows.** We are referring here to the applicable Federal rates (AFR) for transactions completed in February 2014: 1.97% for loans with a term of less than nine years and greater than three, and 3.56% for loans with a term longer than nine years. These rates assume simple annual compounding. Just as JNJ’s decision to borrow will prove economic if it can do something with the bond proceeds that produces a return that exceeds its after-tax cost of capital; likewise, and ignoring the benefit of G1 paying the G2 Trust income taxes, a family must do the same for an intrafamily loan to make economic sense.

2. **We cannot count on permanent estate tax repeal.** Although the cry for repealing the federal estate tax seems to have gotten especially loud in recent years, opposition to the so-called death tax is nothing new. Beginning with the stamp tax first imposed in 1797, taxes imposed on wills offered for probate or transfers of property at death have been repeatedly repealed only to be later resurrected in an alternate form. The estate tax seems here to stay, at least for now.

3. **Currency debasement and inflation are possible in years to come.** Although we are not predicting either will happen imminently, currency debasement and inflation may await us. Both are historically possible paths for the U.S. to reduce the costs of the massive public debts we have accumulated. The two conditions are different, but both favor the economics of the sale transaction. As we will see below, G1 (seller) holds a fixed-rate receivable in its estate that decreases in real value if higher inflation and higher interest rates ensue. Conversely, the G2-Trust holds a payable with decreasing value in real terms. Because G1 has parted with an appreciating asset in exchange for a fixed-term receivable, one that might ultimately be subject to estate tax, the IRS is potentially the inflationary loser.

4. **Higher interest rates in the future are probable.** As mentioned, long-term bond rates have fallen from 15% in 1981 to just shy of 3% today. Families who are comfortable selling assets and holding debt might consider doing so now, while rates are low.

What is the Intrafamily Refinancing Transaction?

Four overly simplified steps:

1. An intentionally defective grantor trust (IDGT) with a gift for appropriate seed capital (adequate capitalization) is formed and funded.

2. Grantor sells appreciating asset to IDGT (there should be no gain on the sale because of the grantor trust status).

3. IDGT issues a note on commercially reasonable terms using the stated AFR interest rate. The note can be interest-only.

4. If properly structured and the debt is respected by the IRS, on maturity of the note, the asset portfolio return that exceeds the interest rate on the note should pass free of estate (and possibly, generation-skipping tax) to lower-generation family members.

**Example.** Consider a couple, husband age 55 and wife age 50 (G1), that are considering whether to shelter the future growth on $20 million of their wealth from
They have, to date, used 100% of their gift and generation-skipping transfer (GST) tax exemptions ($5,340,000 per person in 2014). Their wealth substantially exceeds $20 million and they are not currently charitably inclined. They expect their portfolio to appreciate at a 6% rate.

They meet with their attorney to consider three different wealth transfer options:

a. Gift $20 million now to a trust for G2. Pay $8 million in gift taxes (40% × $20 million) to do this.
b. Do nothing now and give $20 million to G2 later; keep the $8 million gift taxes in their control and pay estate taxes later.
c. Gift $20 million now to a trust for G3 only; pay gift tax and GST tax. Total cost: about $19.2 million.8
d. Do nothing and leave $20 million and gift-GST dollars paid in c (above) to G3 trust at death through their estate. Pay estate taxes and GST taxes later.

Exhibit 1 compares choices a and b for G2—that is, $8 million gift tax paid versus waiting to pay estate taxes. As you can see, paying gift taxes upfront results in significantly more wealth to G2 over any period of time (beyond three years).

Now consider G3 and options c and d. Option c (pay gift and GST tax today) now costs almost $19.2 million, a seemingly steep cost to transfer $20 million to the grandchildren. But consider doing nothing—letting the $20 million plus $19.2 million sit and grow, exposed to future estate and GST taxes. The numbers in Exhibit 2 might seem counterintuitive, but they are accurate.

So whether G1 wishes to benefit G2 or G3, paying tax up front is clearly the superior after-tax choice when compared to doing nothing and exposing the $20 million (and tax dollars) to future estate and GST tax. The rub, of course, is few families wish to pay gift taxes up front; even fewer are willing to prepay generation-skipping taxes. So despite clear arithmetic reasons to pay gift (or even generation-skipping taxes) early, families prefer transactions where wealth can be transferred at a lower (at least current) transfer-tax cost.

Now consider the couple making a $2 million taxable gift to a grantor trust for G2 (and G3) and then selling an $18 million appreciating asset to the trust in exchange for a 20-year, level amortization note at 3.50%. Assets are now in the trust, funded by an offsetting, low interest rate liability. G1 holds a fixed-rate receivable, an asset that will be included in its estate (if not paid off) but that amortizes over the 20-year transaction. Using the same investment assumptions (e.g., 6% growth, 20-year term, no increase in estate tax rates), the transaction economics play out as shown in Exhibit 3.

Note that the debt could also be interest-only, with a balloon payment due in year 21. And, depending on the asset sold, a valuation discount might be appropriate at point of sale. Both features can enhance the estate tax savings power of the transaction.

The first impression might be that the outright gift is more attractive: It is simpler, more certain, and presents less tax risk. As you can see in Exhibit 3, the gift results in more wealth to either the children or grandchildren. But the transfer tax cost is far, far higher than the note transaction. For G2, the gift tax cost is 10 times the gift on the note transaction ($8 million versus $800,000); for

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**Exhibit 1**

Benefit to G2 of Taxable Gift vs. Estate Tax

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**Gift** — **Transfer thru Estate**
EXHIBIT 2
Benefit to G3 of Taxable Gift vs. Paying Estate Tax

EXHIBIT 3
Estate Tax Economics of IDGT Sale Transaction

G3, the gift-GST tax cost is over 24 times ($19.2 million versus $800,000) the gift to fund the trust. When the sale transaction is compared solely to no gift planning and paying estate taxes to benefit G2 (option b) or, no gift planning and paying estate and GST taxes to benefit G3 (option d), the note transaction, subject to the tax risks discussed below, would be the clear winner.

INFLATION OR DEFLATION?

“Inflation or deflation. Tell me, if you can. Will we become Zimbabwe or will be Japan?”

There is more to examine about the transaction than estate tax savings. We have two balance sheets involved (G1 and G2+Trust). The impact of inflation and deflation must be considered for each. We also have a third party to consider—the IRS, waiting patiently to collect estate tax upon G1’s death. If you think about this transaction in an inflationary environment, G2+Trust, the debtor, is the clear winner. G1 holds a fixed-rate receivable, or a bond, in investment parlance. Just as fixed-rate bonds are inflationary losers, so too is the note receivable held by G1. When viewed from the G2+Trust’s perspective and regardless of the terms, the real value of
their liability back to G1 is decreasing each year by the amount of inflation. The opposite would occur if we went into a period of deflation, which makes the fixed-rate liability more expensive when considered from the G2+Trust’s vantage point (see Exhibit 4).

WHAT MIGHT GO WRONG?

As Polonius warns, lending money is not without risk. The liability running from G2+Trust to G1 is a real, enforceable legal obligation, one that G1 cannot forgive without potentially incurring adverse tax consequences. A number of unexpected, negative surprises could occur.

First, the asset(s) in the trust may not compound at a rate that exceeds the low note rate. Consider our example, where we show a portfolio compounding at 6% net per annum over 20 years. As we have learned from markets of late (the dot.com bust and financial-banking crisis), even conservatively positioned portfolios can suffer steep declines in price. As Exhibit 5 shows, the larger the decline in the portfolio, the greater the return must be in subsequent years to return the portfolio to even.

Second, a number of tax-related surprises can occur. For example, if G1 dies before the note has been paid off, the G2+Trust may not get to step up the basis in the assets it purchased from G1 (whereas if the trust assets were included in G1’s estate they would be afforded a step-up). Additionally, G1 may realize significant capital gains at death if the note is still outstanding and the G1’s estate may not have the liquidity to pay the tax. Next, and not insignificant, is the valuation risk. If the sale is determined by the IRS to be for less than fair market value, as finally determined for gift, estate, or GST tax purposes, a gift may occur for the difference between the promissory note amount and the audit-adjusted value. Moreover, if G1 has already used her entire gift and GST tax exemption, this may cause significant gift and GST tax to be due. Finally, because neither the statute nor regulations provide guidance for a sale to an IDGT, the IRS could revoke the Revenue Rulings on which this technique relies. Although legislative or

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**E X H I B I T  5**

Returns Required to Recoup Portfolio Declines and Service Debt

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**E X H I B I T 4**

Impact of Inflation on Real Value of Note Principal (20-Year Amortizing 3.5% Note)
regulatory changes are always a risk, most tax authorities believe that such a change would likely be prospective rather than retroactive.14

PORTFOLIO MANAGEMENT CONSIDERATIONS

We conclude by outlining several considerations and opportunities around family debt—funded, investment portfolio construction and management (considering both traditional and nontraditional asset classes) in the context of IDGT planning.

The unique grantor income tax treatment of the IDGT presents the first special consideration: Should tax-generating hedge funds be overweight in the grantor trust? Subject to fiduciary considerations, the short answer is yes, because the grantor’s payment of G2+Trust’s income tax liability both further reduces G1’s taxable estate and shifts considerable additional economic appreciation to trust beneficiaries in the form of pretax compounding (especially over long time periods). To illustrate this benefit, consider a New York City resident with 43.4% federal, 6.85% state, and 6.00% city effective tax rates. Next, consider two possible investment choices in the IDGT context: an index equity portfolio and a portfolio of long-short hedge funds, the former tax-efficient and the latter lesser so. Although holding the index equity portfolio in the grantor trust might work fine, when considered in the context of the entire family’s well-diversified investment portfolio, holding income-tax generating hedge funds in the IDGT would seem to make more sense from a tax perspective.

To illustrate this benefit, assume the New York resident taxpayer decides to invest in a long-short hedge fund returning 12% gross with reasonable 50% turnover, ½ of which is ordinary income/short-term gain (43.4% rate + state) and ½ is long-term gain (23.8% rate + state). Additionally, the fund carries a 1% management fee and a 20% performance fee. If this hedge fund is attractive pretax and would otherwise be owned by the family, holding it in the IDGT makes even more sense from an asset location perspective because G1’s payment of taxes on portfolio gains benefits the G2+Trust, without any additional gift tax being imposed. As Exhibit 6 generally illustrates, the difference between pretax and after-tax net returns may easily approach 2.0% per annum.

Assuming a $10 million investment over 20 years, this pretax compounding benefit to G2+Trust approaches $16 million;16 if the underlying hedge funds trade more often, generating higher percentages of short-term gains, the annual tax costs could easily exceed these levels.

Although locating tax inefficient asset classes in the IDGT might be wise from a transfer tax perspective, as a practical matter, certain fiduciary considerations/tensions must also be considered. The grantor of the IDGT may eventually tire of paying taxes and favor a lower tax cost investment portfolio. In some situations, a simple call or meeting with the trustee and beneficiaries might resolve this issue, but not always. Remember, even though the grantor is responsible for paying the income tax, the trustee’s loyalty and fiduciary responsibility is to the trust beneficiaries. The grantor whose request for “lower tax bills” is rebuked often has two courses of action. The grantor, through his retention of certain trust powers,17 might unilaterally be able to turn off grantor trust status, causing the trust to be responsible for paying its own income tax. Well-drafted grantor trusts also typically include a power of substitution,18 which gives the grantor the right, in a nonfiduciary capacity, to exchange assets of equivalent market value for assets

**EXHIBIT 6**

Hypothetical Pretax vs. After-Tax Returns of Active Hedge Fund Manager15
held in the grantor trust. So, with proper planning, different mechanisms may exist for the grantor to stop paying taxes on a grantor trust, but each raises unique cash flow and income tax issues.

Although the ongoing income taxation of future investment success may seem like tomorrow’s problem, there will come a day when the grantor dies and the trust is ultimately forced to pay its own taxes. This raises yet another special consideration, that is, the need to maintain a certain degree of flexibility to enable pivoting to perhaps an entirely different investment policy shortly after the grantor’s death—perhaps one leaning toward greater liquidity and higher tax efficiency versus the more hedge fund focused portfolio.

The magnitude of the AFR interest hurdle (IDGT transaction note rate) is also a major factor in the IDGT portfolio design. As illustrated, portfolio losses are difficult to re-coup; therefore, prudent risk management relative to AFR hurdle rate becomes paramount. A low AFR compound benchmark over most long-term periods (e.g., nine to 20 years) may seem like a no-brainer, even for a balanced portfolio of stocks and bonds. Over 10, 15, or 20 years, your odds of beating the low interest rate hurdle have historically been very good. But bonds, as priced today, are not likely to contribute much to the portfolio, and may in fact deliver negative returns.

Another major consideration is the cash flow burden of the IDGT transaction. The note will be either level amortization or interest-only with a balloon payment due at termination. With either (ignoring forgiveness as a means to use gift tax exclusions), G2+Trust will need to generate cash flow to service the debt obligation. In a perfect world, this requires accessing cash that comes due without needing to liquidate trust investments at inopportune times. Given bond yields today, reverting solely to coupon clipping (investing in bonds to generate income to pay interest expense) appears foolish. Distributions may also provide cash flow, but more likely than not, cash to service the debt will need to be generated by selling assets in the trust. One final alternative might be to resort to in-kind asset distributions back to G1, but this can often prove difficult to administer and sometimes inefficient from a tax planning perspective.

Lastly, G1’s philanthropic wishes enter into the portfolio and trust administration equation. If G1 is very wealthy and typically has excess cash on hand, the portfolio inside the G2+Trust might be managed in a manner that makes maximum use of the aforementioned grantor substitution power. As stated before, as long as G1 is living, and she has not renounced all her grantor trust powers, G1 and the G2+Trust are the same for income tax purposes. G1 can use cash to purchase (substitute) from the trustee (at market price) assets that have appreciated in value. Cash would end up in the G2+Trust, and lower tax basis investments would return back to G1. G1 might then donate these low basis assets to charity, taking an income tax deduction for doing so (subject to certain limitations), or consider gifting the low basis assets acquired from the G2+Trust to a charitable remainder trust, as part of a more advanced tax-deferral, cash flow, and charitable deduction planning strategy. A portfolio built with this endgame in mind might be very different from one where the donor did not have charitable goals. The former might be built more along barbell lines, holding cash-liquid assets to service the debt and tax-efficient assets (e.g., passive equity, private equity, other) with the goal of paying lower taxes and using the power to substitute assets as part of a broader income tax and charitable deduction management strategy.

As you can see, when engaging in intrafamily financing transactions, there may be many competing short-term and long-term portfolio objectives, as well as competing financial interests among the generations. Depending on the overall family wealth level, balance sheet composition, income tax situation, and current or future charitable objectives of the grantor, an IDGT portfolio can take on many forms and will most certainly need to be flexible as economic conditions and planning objectives change over time. Although the mechanics and interplay of asset selection and portfolio construction are crucial to successful planning, this exercise is always more art than science, and therefore the sheer number of possible strategies are too numerous to do justice in this article.

CONCLUSION

The current environment presents a unique estate planning opportunity for ultra-high-net-worth families seeking to sustain their wealth for the next generations. The same financing techniques employed by public company treasurers while interest rates are at their lowest can be used by families to achieve significant gift, estate, income, and generation-skipping transfer tax savings. A properly structured and managed sale of assets to an
IDGT has the potential to transfer more wealth to the next generations (and do so with much greater flexibility and less up-front tax) than an outright gift. Although economically attractive, the potential rewards need to be carefully balanced against the risks and complexities of a particular family’s circumstances.

ENDNOTES

1See Morais [2013].
2A freeze technique is a common estate planning technique that freezes the growth of the lender’s gross estate at the interest rate received on the promissory note.
3See Internal Revenue Code (IRC) § 1274(d).
4See Revenue Ruling 2014-6.
5The IDGT is considered defective for income tax purposes; however, if executed properly, it may be highly effective for estate planning purposes. The income tax defect is a result of the grantor(s)’ retaining sufficient control for income tax purposes; causing her to report all income, deductions, and credits on her individual tax return. To be effective for estate tax purposes, the grantor(s) cannot possess too much control or the assets may be includible in her gross estate.
8If a gift is made directly to a grandchild or younger generation, or to a trust that has only beneficiaries at this generation or younger, there is a generation-skipping transfer tax due if all the donor’s GST tax exemption has already been used. In our example, the GST tax on a $20 million gift is applied at the top estate tax rate of 40%; and the donor pays an additional gift tax on the GST tax paid on the donee’s behalf. Consequently, the $8 million gift tax, plus the $8 million GST tax, plus the $3.2 million additional gift tax on the GST tax paid equals $19.2 million. Therefore, it requires $39.2 million to transfer $20 million to G3 in a lifetime transfer.
10See IRC Section 108, which discusses cancellation of indebtedness income to a debtor that is relieved of a liability under certain circumstances.
11If the assets sold to the G2 trust are not included in the grantor’s estate, the basis of those assets in the trust may not be adjusted pursuant to Internal Revenue Code section 1014; however, some commentators believe that because there is no transfer from the grantor to the trust until the grantor’s death, the trust has acquired the property from a decedent and thus is eligible for a stepped-up basis.
12Although many commentators believe that there is no capital gain at death with a note outstanding, the IRS has yet to provide clear guidance on the income tax consequences of the original sale to the defective trust if the grantor dies with the promissory note outstanding. Some commentators believe that this will trigger capital gain based on the value of the note outstanding relative to the grantor’s basis at the time of the sale; others believe the entire gain is recognized irrespective of the note’s balance. Therefore, the risk of capital gain recognition at G1’s death needs to be considered.
13This risk may be mitigated through the use of formula valuation clauses. If drafted properly and accepted by the IRS, these formula valuation clauses may avoid the valuation risk in the sale to a defective trust, placing any valuation concerns on par with the automatic adjustment clause inherent in a grantor retained annuity trust (GRAT). For more on formula valuation clauses, see Estate of Christiansen v. Comm’n, 130 T.C. 1 (2008); Estate of Peter v. Comm’n, 98 T.C.M. (CCH) 534 (2009); Estate of Wandry v. Commissioner, T.C. Memo. 2012-88 (March 26, 2012); McCord v. Comm’r, 120 T.C. 358 (2003); but see Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), where reversion clauses were deemed against public policy and therefore not effective. For GRATs, see IRC section 2702 and the regulations thereunder.
14For example, see Revenue Ruling 85-13.
15Hypothetical 1% manager gross fee; 20% of net incentive manager fee; 43.8% federal short-term and 23.8% federal long-term capital gain tax rates; NYC resident taxes also applied.
16Difference in end value between $10 million @ 8.8% growth rate and $10 million @ 7% growth rate in year 20
17See IRC §§ 674(a), 675(3), 675(4)(c), 677(a), which create grantor trust status through the use of certain powers that can be renounced later by the grantor.
18See IRC Section 675(4)(c).
19Care needs to be taken that the valuation is equivalent of any asset substituted in the IDGT through the exercise of the Section 675(4)(c) power of substitution.
20Alternatively, G1 may retain these low basis assets, allowing a step-up at death for his heirs.
21The possibility of an enhanced wealth-shifting benefit—even over the highly efficient outright taxable gift strategies (illustrated as planning options a and c)—is a function of the indirect gifting associated with grantor trust income tax status over long periods of time and the ongoing ability of the grantor to transact with the G2+Trust to further charitable or other income tax basis planning.
REFERENCES


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