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Is It Now Time for the Rich to Refinance Their Family Balance Sheets?

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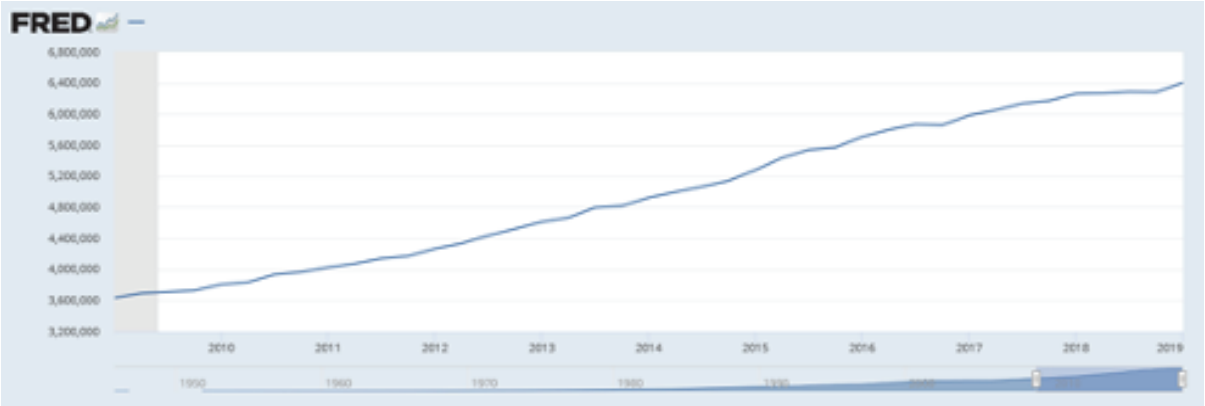
While Berkshire Hathaway's cash position has swelled to more than $122 billion, its first yen-denominated bond will soon add roughly $3.9 billion to the balance sheet. The bond maturities will range from five to 30 years and carry interest rates of 0.17 percent to 1.1 percent. Echoing action early this year (January 2019), when Berkshire Hathaway Finance Corporation issued 30-year bonds to refinance $950 million of floating-rate debt, it appears Warren Buffett, like others, feels the steep, global decline in interest rates is in the ninth inning. CFOs across corporate America have imbibed on easy money, which we see in Figure One.

Figure One: Nonfinancial Corporate Business Debt (01/2009 to 01/2019)



Source: Federal Reserve Bank of St. Louis

Should families facing estate tax exposure follow suit and refinance their family balance sheets using debt or create an attractively priced payment to reduce their federal (and state) estate tax liabilities?

Why Keep Reading?

While low interest rates can be your estate planning friend, their impact on asset prices and future returns can be your foe. We discuss:

- Different ways families can refinance their balance sheets (or create payment streams) to take advantage of interest rates as they are.
- How rising inflation impacts different wealth transfer transactions.
- Why, today, the optimal interest-rate-beating portfolio should include more than bonds and equities.

Tax Questions

What is refinancing the family balance sheet?

It means creating a debtor-creditor relationship to reduce current or future exposure to estate tax. The transaction can include a legal obligation to borrow from a bank in the future, an asset sale from a senior family member to a trust established for children or grandchildren, or, while different, a split interest trust whose creation benefits from low interest rates (and higher inflation).

What is an intra-family sale?

A senior family member sells an asset to a so-called grantor trust created for children or grandchildren. The senior then holds a note receivable, and the trust owns a new asset, offset by a note payable. The interest rate depends on the term of the loan and is published each month by the Internal Revenue Service. The long-term annual rate (for debt maturities more than nine years) for September 2019 is 2.21 percent. The note can be interest-only with a balloon payment due at the end of the note term.

Why might families consider a sale now?

Wall Street's consensus view of no inflation and low interest rates may prove to be incorrect. If the net pre-tax investment return from the asset financed by the note compounds at a rate that exceeds the applicable federal rates (AFR) of 2.21 percent in our example, the excess return can escape estate and generation-skipping tax.

What if the asset sold is a minority interest in a business or nonvoting right in a limited liability corporation (LLC)?

The true investment or transaction hurdle rate decreases if a valuation discount on the asset sold is appropriate. For example, a 30 percent discount means the effective note rate will be 1.55 percent (70 percent x 2.21 percent).

Does the note sale involve tax risks?

Yes. The trust liability is real; forgiveness of the loan would cause adverse gift-tax consequences. The grantor's death while a note is outstanding raises a tax issue that gives many attorneys cause for concern. These and other issues should be discussed in detail with your legal and tax advisors.

Aren't there more tax-certain wealth transfer strategies that benefit from low interest rates?

Two come to mind: grantor retained annuity trusts (GRATs) and charitable lead annuity trusts (CLATs). Each transaction has an annuity portion and a remainder portion. When created, the annuity portion is the discounted present value of a stream of fixed payments. With the GRAT, these come back to the grantor; with the CLAT, the payments go to charity. The interest rate for each is 120 percent times the applicable (short-, medium-, or long-term) rate, or 2.5 to 3 percent.

Investment Questions

What happens if the asset sold suffers a steep decline in market price?

Future returns must recover both the loss and interest rate to break even. An interest-only note reduces this risk, as does using assets that are eligible for a valuation discount.

How would higher inflation impact the seller, buyer, and IRS?

Higher inflation means senior's fixed rate declines in real value; conversely, inflation helps the borrower or trustee, as the liability is paid off in dollars in which real value is falling in value.

Deflation, of course, increases the cost of repaying a fixed-rate debt.

Is now a good time to bet that equities will compound at a rate greater than 2.21 percent?

Yes, they should. But it depends on the time horizon, timing, and severity of any decline in equity prices. An equity-only portfolio, to us, is not ideal.

If equities are the dominant asset class in a sale (GRAT or CLAT), what asset classes might reduce the risk of falling way behind an interest rate benchmark?

As shown in Figure Two, assets like private debt, farmland, direct real estate, life settlements, and reinsurance seem to be better equity diversifiers than bonds, at least how bonds are priced today.

Figure Two: Non-Traditional Asset Correlation to Stocks and Bonds

	Stocks	Bonds
Private Debt	0.29	0.17
Reinsurance	0.16	0.14
Life Settlements	0.11	-0.08
Farmland	0.01	-0.01
Direct Real Estate	-0.05	-0.10

Source: CAPTRUST Research. Stocks represented by the S&P 500 Index and bonds represented by Barclays US Aggregate Bond Index.

What about hedge funds?

Some might work, but net after all costs (e.g., fees, incentives, pass-through expenses, and taxes), many will fall short, even in a bear market.

What about using private (illiquid) assets?

As mentioned, their eligibility for a gift-tax valuation discount may reduce the interest rate hurdle for success. Illiquid assets often mean cash to meet required interest or annuity payments is lacking. Balloon notes can push back payment on a note liability, but future returns from private equity may be less than you think, especially now.

What about assets already levered?

Be careful. Selling an already-levered asset doubles your debt exposure.

What about S-corporation stock?

C- or S-corporation stock will work. Each raises different cash flow, tax, and structural issues.

Should income-tax-generating assets reside in a grantor trust?

When they are attractive pre-tax (net of fees), yes. But if the grantor, after the transaction, is not exposed to estate taxes, doing this is less attractive.

What about these and other (investment) questions relating to GRATs or CLATs?

Different investment, fiduciary, and tax issues exist with each. A rising rate of inflation reduces the cost of paying down a fixed stream of annuity payments, which exist in both the GRAT and CLAT. In the GRAT, inflation would harm a senior, as the value of his or her retained annuity decreases in real terms. With the CLAT, the real value of dollars going each year to charity may be less than expected.