



Many Estate Planning Strategies Provide Benefits in the Current Low Interest Rate Environment

By: Randy Gardner, JD, LL.M., MBA, CPA, CFP®, Director of Education and Leslie Daff, JD, MBA



Interest rates are lower than they have been in years. For May, the Section 7520 rate was 3.2%, down from 5.6% one year ago. For July and August, the rate climbs to 4.2%. Several estate planning strategies provide benefits in our current low interest rate environment, as well as some that should be avoided.

In determining which strategies are more attractive, it is important to recognize that the lower the assumed interest rate, the less an income interest is worth, and conversely, the more a remainder interest is worth. Therefore, strategies that benefit from a low rate include trusts with remainder interests such as Charitable Lead Annuity Trusts (CLATs) and Grantor Retained Annuity Trusts (GRATs), as well as Intentionally Defective Grantor Trusts (IDGTs), charitable donations of remainder interests in farms and residences, sales using installment sales, Self-Canceling Installments nNotes (SCIN), and private annuities.

With a GRAT, a grantor transfers property to a trust in exchange for a fixed annuity for a defined term. At the end of the term the retained annuity is undervalued if the assets are expected to produce a return higher than the statutory rate. The remainder goes to a noncharitable beneficiary at the end of the term – usually a family member. CLATs are similar to GRATs, except that the annuity interest is paid to a charity.

In funding a GRAT, it is best to use property that is expected to appreciate at a rate greater than the Section 7520 rate. Disadvantages of the GRAT are that the annuity must be paid even if the trustee has to use the trust corpus or borrow funds to pay it, and if the grantor dies during the term, the portion of the trust assets needed to yield the annual annuity is included in the grantor's gross estate, possibly meaning no tax is saved and attorney fees were incurred. In addition, the beneficiary receives carryover basis in the trust assets instead of the stepped-up basis the beneficiary would have received had he or she inherited the property at the grantor's death. Some taxpayers do not have gift tax exclusion remaining

because they have made more than \$1,000,000 in gifts. In order to avoid gift tax when they establish the GRAT, they may retain an annuity large enough to reduce the value of the remainder interest to zero. The annuity needed to zero out a \$1,500,000 transfer over five years is \$352,228 at a 5.6% Section 7520 rate, or \$338,838 at a 4.2% Section 7520 rate.

Intentionally defective grantor trusts (IDGTs) are also advantageous in this low-rate environment. IDGTs are trusts designed to intentionally tax the income to the grantor instead of the trust because of the compressed tax rates applicable to trusts. Usually irrevocable and subject to gift tax, the grantor (not the trustee) is typically given some minor power that does not have estate tax consequences. Consequently, the trust is "defective" for income tax purposes and taxed as a grantor trust, but it is effective for estate tax purposes – not causing estate tax inclusion. The minor power given to the grantor can include the power to acquire trust property by substituting other property of equivalent value and the power to borrow from the trust without adequate security.

In Rev. Rul. 2008-22, the IRS bolstered the efficacy of this technique when it held that the trust corpus would not be includible in the grantor's gross estate under IRS Code Sections 2036 or 2038 if the grantor retained the power to acquire property from an irrevocable trust by substituting other property of equivalent value. This ruling refers to the Tax Court holding in *A. Jordahl Est.* (TC, 1975), where the grantor, while serving as trustee, retained the power to substitute trust assets. In *Jordahl*, the grantor's fiduciary duties prevented him from exercising the substitution power to deplete the trust or shift benefits among beneficiaries. The IRS determined in Rev. Rul. 2008-22 that a grantor who was not bound by the fiduciary obligations of a trustee could hold a substitution power without causing the trust corpus to be includible in the grantor's gross estate, provided that certain limitations and requirements are placed on the trustee through local law or the trust instrument itself.

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In light of the low interest rate environment and Rev. Rul. 2008-22, sales to IDGTs will be more commonly used as an estate-leveraging technique. One way to implement this strategy is: 1) Grantor transfers 10% of the value of property to be sold to the IDGT, then 2) the Grantor sells income-producing property or a family limited partnership (FLP) interest to the IDGT in exchange for an installment note, claiming discounts and using the Section 1274 interest rate (even lower than the Section 7520 rate). Although the initial transfer is subject to gift tax, the sold property is out of the estate and the annual trust income is taxed at the grantor's tax rate, not the compressed trust tax rates.

Using a private annuity rather than an installment sale enhances this strategy because, like a SCIN that terminates at the seller's death, the trust makes payments only over the grantor's life expectancy. Contrary to popular belief, private annuities are not dead completely. The IDGT can offer a private annuity (rather than an installment note) in exchange for the property. Proposed Regulations (REG -141901-05, 71 Fed. Reg. 61441) revoke the "open transaction" doctrine for certain annuity contracts. This Regulation applies to annuities issued by individuals after April 18, 2007, but not trusts. For annuities between individuals, gain is recognized at the time of the exchange, not deferred over the life of the annuity. However, with an IDGT, the gain is deferred as the annuity is paid over the life of the individual by the trust.

Estate Planning Strategies Affected by Low Interest Rates:

<u>Benefited</u>	<u>Unaffected</u>	<u>Adversely Affected</u>
Grantor Retained Annuity Trusts (GRATs)	Charitable Lead Unitrust (CLUT)	Charitable Remainder Annuity Trust (CRAT)
Charitable Lead Annuity Trusts (CLATs)	Charitable Remainder Unitrust (CRUT)	Grantor Retained Interest Trust (GRIT)
Intentionally Defective Grantor Trusts (IDGTs)	Grantor Retained Unitrust (GRUT)	Qualified Personal Residence Trust (QPRT)
Charitable Donations of Remainder Interests in Farms or Residences		
Sales Using Installment Sales		
Self-Canceling Installment Notes		
Private Annuities used in conjunction with an IDGT		

Some estate planning strategies are adversely affected by low interest rates. These strategies include Qualified Personal Residence Trusts (QPRTs) and Charitable Remainder Annuity Trusts (CRATs). QPRTs are similar to GRATs. However, rather than retaining an annuity interest, the grantor retains the right to live in his or her home, with the remainder interest passing to beneficiaries. A lower interest rate increases the value of the remainder interest and thus the associated gift tax.

CRATS are also similar to GRATS, except with a CRAT the remainder interest passes to charity. CRATs must meet additional thresholds. The annuity has to exceed 5%, and a 10% interest in the assets has to pass to the charity. In a low-interest-rate environment, the 5% or greater payment stream may exhaust the trust assets. In a low-rate environment, although the taxable income to the beneficiary may decrease, CRATs are disfavored because the charitable deduction is lower and meeting the statutory minimums is more difficult.

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Finally, strategies relatively unaffected by lower interest rates include Grantor Retained Unitrusts (GRUTs), Charitable Remainder Unitrusts (CRUTs), and Charitable Lead Unitrusts (CLUTs). These strategies are not affected by a low- interest- rate environment because distributions are based on a percentage of assets annually, not an annuity.

Conclusion:

Keeping in mind that the lower the interest rate, the less an income interest is worth, and conversely, the more a remainder interest is worth, planners can help clients take advantage of the low-interest-rate environment by implementing estate planning strategies focused on remainder interests, such as GRATs, CLATs, and IDGTs. Interest rates are already starting to rise and may not be at these advantageous levels for long.

Randy Gardner is a Professor of Tax and Financial Planning at the University of Missouri-Kansas City and the Director of Education for WealthCounsel, LLC.

Leslie Daff is an estate planning attorney practicing in Laguna Beach, CA.

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