



# Low Interest Rate Is High Time for Some Estate Planning Ideas

QPRTs, GRATs, IDGTs, CRATs, and CLATs: Acronyms abound when exploring interest-rate-sensitive estate planning strategies.

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**W**hen practitioners and clients think of estate planning, several goals typically come to mind: (1) identifying family members and charitable organizations to whom or for whose benefit assets are to be given; (2) ensuring that assets intended for family members are preserved and protected from creditors, the government, bad influences, or even themselves; and (3) minimizing taxes while transferring wealth to lower-generation family members. With regard to transferring wealth and minimizing taxes, “transfer taxes”—i.e., estate, gift, and generation-skipping transfer (GST) taxes—are often thought of first. Income taxes, however, can often be minimized as well through careful planning, particularly with regard to structuring charitable gifts.

Most estate planning designed to transfer wealth while minimizing taxes is accomplished during a client’s lifetime, as opposed to planning at death through a will or

other testamentary instrument. Further, a significant portion of this planning involves techniques that are sensitive to interest rate levels. Commonly used estate planning tools to transfer wealth that are interest rate sensitive include:

- Qualified personal residence trusts (QPRTs).
- Grantor retained annuity trusts (GRATs).
- Sales of assets to intentionally defective grantor trusts (IDGTs).
- Loans to family members.

Charitable planning techniques, which can also minimize income taxes and are interest rate sensitive, include:

- Charitable remainder annuity trusts (CRATs).
- Charitable lead annuity trusts (CLATs).

A general overview of each of these techniques, along with a discussion as to how interest rate fluctuations affect these techniques, is presented below.

## Interest rates that affect estate planning

A revenue ruling is published each month providing required interest rates used in conjunction with certain provisions of the Internal Revenue Code. These rates include the short-term, mid-term, and long-term Applicable Federal Rates (AFRs) under Section 1274(d). The AFRs are used in conjunction with certain techniques such as a sale of assets to an IDGT or an intra-family loan. These rates also include the rate that must be used for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or reversionary interest under Section 7520. The “7520 rate” is used for planning techniques such as QPRTs, GRATs, CRATs and CLATs.

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Each month's revenue ruling is usually published around the 20th day of the preceding month.<sup>1</sup> Therefore, during the last ten days or so of each month, a practitioner will know the current month's AFRs and 7520 rate, as well as the following month's AFRs and 7520 rate. This allows practitioners to determine whether interest-rate-sensitive transactions should be entered into during the current month or delayed until the beginning of the following month, all other things being equal. For example, if a client is creating a QPRT, a higher 7520 rate is more advantageous from a transfer tax perspective because the value of the interests retained by the client will be larger (inversely causing the value of the taxable gift to be lower). On the other hand, a lower 7520 rate is more advantageous if a client is creating a GRAT since it will presumably be easier for the assets contributed to the GRAT to outperform a lower 7520 rate (causing the assets remaining in the GRAT at the end of the term to be larger).

Under Section 1274(d), the short-term AFR applies to debt instruments with a term of three years or less, the mid-term AFR applies to debt instruments with a term of more than three years but nine years or less, and the long-term AFR applies to debt instruments with a term of more than nine years.

As described above, an AFR would typically be used for a sale of assets to an IDGT. For example, assume that in May 2015 a client sold stock in a closely held entity that is valued at \$1 million to an IDGT (of which the client's children or grandchildren are beneficiaries), in exchange for a \$1 million promissory note payable by the IDGT. The promissory note has a term of eight years, and interest is compounded and paid annually. In this instance, the interest rate for the promissory note should be,

at a minimum, 1.53% annually for the eight-year duration of the promissory note. Accordingly, the IDGT would pay interest of \$15,300 annually to the client while the loan is outstanding; this should prevent an argument that the loan is a "below-market loan" under Section 7872. If the assets now owned by the IDGT appreciate or have annual earnings of more than \$15,300, the client has effectively transferred wealth to the beneficiaries of the IDGT (i.e., the children or grandchildren).

Current AFRs are near record lows as compared to those for the last 25 years. Therefore, from an interest rate perspective, now is a very attractive time to consider estate planning techniques that benefit from low AFRs, such as an intra-family loan or a sale of assets to an IDGT.

As indicated above, Section 7520 provides that the value of any annuity, any interest for life or a term of years, or any remainder or reversionary interest shall be determined (1) under tables prescribed under Treasury Regulations and (2) by using an interest rate (rounded to the nearest 2/10ths of 1%) equal to 120% of the mid-term AFR in effect under Section 1274(d)(1), for the month in which the valuation date falls. Because techniques such as QPRTs, GRATs, CRATs, and CLATs involve retained income interests (for a term or life), retained annuity interests, reversions, and remainders, their calculations involve the use of the 7520 rate.

A table showing the 7520 rates since January 1990 is in Exhibit 1. As shown in that table, the highest 7520 rate since January 1990 was 11.0% (June 1990); the lowest 7520 in that period was 1.0% (August 2012, September 2012, November 2012, and January 2013). The 7520 rate for May 2015 is 1.8%. Not surprisingly, the 7520

rate (like the AFRs) is near a record low, also making it an attractive time to consider estate planning techniques that benefit from a low 7520 rate. One example is a GRAT, which is described below. On the other hand, the attractiveness of some estate planning techniques is limited by a low 7520 rate; an example of this is a QPRT, which is also described below.

#### QPRT

A QPRT is a trust meeting all of the requirements under Reg. 25.2702-5(c). With this technique, a client transfers his or her personal residence (either the principal residence or one other vacation residence) to a trust meeting the requirements of a QPRT.

**Tax consequences.** At the time a residence is transferred to a QPRT, the client makes a taxable gift to the trust's remainder beneficiaries, but at a lower amount (sometimes a much lower amount) than the fair market value of the residence. The reason for such result is that the QPRT lasts a specified number of years (called the QPRT term), during which the client reserves the right to live in the residence; thus, the remainder beneficiaries' receipt of the gift is deferred until the end of such term.

The client's right to live in the residence during the QPRT term is considered the client's "retained income interest." In addition, if the client dies before the expiration of the QPRT term, then the residence (and any other assets owned by the QPRT) typically reverts back to the client's estate; this is considered the client's "retained reversionary interest."

If the client survives the QPRT term, the residence (and any other

<sup>1</sup> Examples in this article are based on the May 2015 AFRs and 7520 rate, which were published in Rev. Rul. 2015-8, 2015-18 IRB 945.

<sup>2</sup> 1985-1 CB 184.

## EXHIBIT 1 7520 Rates Since January 1990

	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC
2015	2.2%	2.0%	1.8%	2.0%	1.8%							
2014	2.2%	2.4%	2.2%	2.2%	2.4%	2.2%	2.2%	2.2%	2.2%	2.4%	2.2%	2.0%
2013	1.0%	1.2%	1.4%	1.4%	1.2%	1.2%	1.4%	2.0%	2.0%	2.4%	2.0%	2.0%
2012	1.4%	1.4%	1.4%	1.4%	1.6%	1.2%	1.2%	1.0%	1.0%	1.2%	1.0%	1.2%
2011	2.4%	2.8%	3.0%	3.0%	3.0%	2.8%	2.4%	2.2%	2.0%	1.4%	1.4%	1.6%
2010	3.0%	3.4%	3.2%	3.2%	3.4%	3.2%	2.8%	2.6%	2.4%	2.0%	2.0%	1.8%
2009	2.4%	2.0%	2.4%	2.6%	2.4%	2.8%	3.4%	3.4%	3.4%	3.2%	3.2%	3.2%
2008	4.4%	4.2%	3.6%	3.4%	3.2%	3.8%	4.2%	4.2%	4.2%	3.8%	3.6%	3.4%
2007	5.6%	5.6%	5.8%	5.6%	5.6%	5.6%	6.0%	6.2%	5.8%	5.2%	5.2%	5.0%
2006	5.4%	5.2%	5.4%	5.6%	5.8%	6.0%	6.0%	6.2%	6.0%	5.8%	5.6%	5.8%
2005	4.6%	4.6%	4.6%	5.0%	5.2%	4.8%	4.6%	4.8%	5.0%	5.0%	5.0%	5.4%
2004	4.2%	4.2%	4.0%	3.8%	3.8%	4.6%	5.0%	4.8%	4.6%	4.4%	4.2%	4.2%
2003	4.2%	4.0%	3.8%	3.6%	3.8%	3.6%	3.0%	3.2%	4.2%	4.4%	4.0%	4.2%
2002	5.4%	5.6%	5.4%	5.6%	6.0%	5.8%	5.6%	5.2%	4.6%	4.2%	3.6%	4.0%
2001	6.8%	6.2%	6.2%	6.0%	5.8%	6.0%	6.2%	6.0%	5.8%	5.6%	5.0%	4.8%
2000	7.4%	8.0%	8.2%	8.0%	7.8%	8.0%	8.0%	7.6%	7.6%	7.4%	7.2%	7.0%
1999	5.6%	5.6%	5.8%	6.4%	6.2%	6.4%	7.0%	7.2%	7.2%	7.2%	7.4%	7.4%
1998	7.2%	6.8%	6.8%	6.8%	6.8%	7.0%	6.8%	6.8%	6.6%	6.2%	5.4%	5.4%
1997	7.4%	7.6%	7.8%	7.8%	8.2%	8.2%	8.0%	7.6%	7.6%	7.6%	7.4%	7.2%
1996	6.8%	6.8%	6.6%	7.0%	7.6%	8.0%	8.2%	8.2%	8.0%	8.0%	8.0%	7.6%
1995	9.6%	9.6%	9.4%	8.8%	8.6%	8.2%	7.6%	7.2%	7.6%	7.6%	7.4%	7.2%
1994	6.4%	6.4%	6.4%	7.0%	7.8%	8.4%	8.2%	8.4%	8.4%	8.6%	9.0%	9.4%
1993	7.6%	7.6%	7.0%	6.6%	6.6%	6.4%	6.6%	6.4%	6.4%	6.4%	6.0%	6.2%
1992	8.2%	7.6%	8.0%	8.4%	8.6%	8.4%	8.2%	7.8%	7.2%	7.0%	6.8%	7.4%
1991	9.8%	9.6%	9.4%	9.6%	9.6%	9.6%	9.6%	9.8%	9.6%	9.0%	8.6%	8.4%
1990	9.6%	9.8%	10.2%	10.6%	10.6%	11.0%	10.6%	10.4%	10.2%	10.6%	10.6%	10.2%

Record  
Lows

High

assets owned by the QPRT) passes free of gift taxes at such time to the remainder beneficiaries of the QPRT, who are typically the client's children. During the existence of a QPRT, a QPRT is almost always a grantor trust of the client for income tax purposes. This enables the client to take normal income tax deductions for property taxes, interest payments on a mortgage, etc. on the client's individual income tax return.

In addition, a client who survives the QPRT term is often still living in the residence when its ownership passes to his or her children. In this event, a client will likely want to continue to live in the residence. Therefore, the children often will

rent the residence back to the client using a fair market value rental amount. Clients may not be enthusiastic to pay rent for what they consider to be their residence; however, this aspect can be beneficial as it allows a client to pass additional assets (in the form of rental payments) to the client's children without the imposition of transfer taxes. One downside, however, is that such rental payments are taxable income to the children without a corresponding deduction by the client.

**Planning strategy.** A QPRT may be drafted so that the residence does not pass outright to the children at the end of the QPRT term, but

instead will be distributed to a successor trust for the benefit of the children. In addition, this successor trust can be drafted to be a grantor trust of the client for federal income tax purposes (under Sections 671 through 677). The effect of such treatment is that the rental payments to the successor trust (which now owns the residence) will not be taxable income to such trust because the trust would be disregarded for income tax purposes under Rev. Rul. 85-13.<sup>2</sup>

Reg. 25.2702-5(c) prescribes numerous requirements for QPRTs, including that the trust document must prohibit the sale of the residence back to the client during

the QPRT term. While a discussion of all such requirements is beyond the scope here, note that Rev. Proc. 2003-42<sup>3</sup> sets forth a sample QPRT that satisfies the requirements of Reg. 25.2702-5(c). Also note, however, that the sample QPRT does not contain all provisions that may be desirable in a QPRT, and it contains some provisions that are not necessary to meet the requirements of a QPRT.

The principal advantage with this technique is that if a client creates a QPRT and survives the QPRT term, it allows the client to transfer his or her personal residence (often very valuable) to family members at a smaller transfer tax cost. This is primarily the result of the following: For purposes of determining the client's taxable gift at the creation of a QPRT, the value of the client's retained income interest and reversionary interest (both described above) are subtracted from the fair market value of the residence at such time.

**Example.** A client, age 70, owns a residence valued at \$1 million. In May 2015, the client transfers the residence to a QPRT having a ten-year term. The client's right to live in the residence for the ten-year term (i.e., the "retained income interest") is valued at \$140,480 (14.048% of \$1 million). Further, if the client dies during the ten-year term, the residence will revert back to the client's estate; such right of reversion is valued at \$291,090 (29.109% of \$1 million). The client's taxable gift, using a 7520 rate of 1.8%, at the creation of the QPRT is calculated as follows:

Value of residence	\$1,000,000
Less: Value of retained right to live in residence	(140,480)
Less: Value of retained reversionary right	<u>(291,090)</u>
Value of taxable gift (remainder interest)	\$ 568,430

If the client is still living at the end of the ten-year term, the residence will pass to the client's children free of gift taxes. Therefore, if the residence is valued at \$2 million at that future date, the children receive a \$2 million residence at such time, and the client will be treated as having made only a \$568,430 gift (albeit ten years earlier).

**If the client survives the QPRT term, the residence passes free of gift taxes at such time to the remainder beneficiaries of the QPRT, who are typically the client's children.**

If instead the client dies prior to the end of the ten-year term, the client's estate receives the residence back, and the residence will be subject to estate tax on the client's estate tax return at its then fair market value. However, the estate of the now-deceased client should recover the gift tax exemption (i.e., applicable exclusion amount) used in the initial QPRT transfer or receive a credit for gift taxes paid at such time.

**Interest rate effect.** Other than the value of the residence gifted to the QPRT, the three factors that affect the calculation of the taxable gift associated with a QPRT transaction are:

1. The 7520 rate.
2. The age of the client.
3. The length of the QPRT term.

A taxable gift associated with a QPRT is *smaller* if (1) the 7520 rate *increases*, (2) the client is *older*, or (3) the QPRT term is *longer*. The effect of each of these factors on

the taxable gift makes sense intuitively:

- As the 7520 rate increases, the deemed value of the client's retained right to live in the residence also increases. Conversely, the value of the remainder interest (i.e., the client's taxable gift) given to the client's children at the end of the QPRT term decreases.
- An older client is actuarially more likely to die before the end of the QPRT term. This increases the value of the client's reversionary interest, causing the value of the remainder interest given to the client's children at the end of the QPRT term to decrease.
- When the QPRT term is longer, the value of the client's retained right to live in the residence also increases. Conversely, the value of the remainder interest given to the client's children at the end of the QPRT term decreases. Of course, a QPRT works only if a client survives the QPRT term, so the selection of the QPRT term is of utmost importance.

Exhibit 2 illustrates the effects of fluctuations in the 7520 rate on the taxable gift with a QPRT, when a client age 70 transfers a residence valued at \$1 million to a QPRT.

## GRAT

A GRAT is a trust meeting all of the requirements under Reg. 25.2702-3, and in particular, Reg. 25.2702-3(b). With this technique, a client transfers assets to a trust that meets the requirements of a GRAT. The GRAT is drafted to last a specified number of years (the "GRAT term"), and, during the

<sup>3</sup> 2003-1 CB 993.

**EXHIBIT 2**  
**Ten-Year QPRT for Client Age 70 With \$1 Million Residence**

7520 Rate	Retained Right to Live in Residence	Reversionary Interest	Taxable Gift
1.8%	\$ 140,480	\$ 291,090	\$ 568,430
3.0%	\$ 220,800	\$ 273,620	\$ 505,580
5.0%	\$ 335,060	\$ 247,820	\$ 417,120
7.0%	\$ 429,050	\$ 225,550	\$ 345,400

*Note: An arrow points from the 1.8% rate to a box labeled "Increase in 7520 Rate". Another arrow points from the 7.0% rate to a box labeled "Decrease in Taxable Gift".*

GRAT term, the client is entitled to receive fixed annuity payments from the GRAT at least annually.

The shortest term for a GRAT is often thought to be two years. These annuity payments are usually expressed in terms of a percentage of the fair market value of the assets contributed to the GRAT at the time of contribution. The annuity payments are allowed to increase or decrease from year to year, but they are allowed to increase by a maximum of only 20% from year to year. The annuity payments can be satisfied through the distribution of assets owned by the GRAT (valued at the time of the distribution), cash, or a combination of assets and cash; however, the GRAT cannot issue a note or other debt obligation in satisfaction of an annuity payment.

**Tax consequences.** If the client survives the GRAT term, then any assets remaining in the GRAT after satisfaction of the final annuity payment pass free of gift tax to the GRAT remainder beneficiaries, who are typically the client's children. Unlike a QPRT, if a client dies before the expiration of the GRAT term, the assets in the GRAT are not required to revert back to the client's estate. Instead, the GRAT

can continue for the remainder of the GRAT term, with the remaining annuity payments being paid to the client's estate and the assets remaining at the end of the GRAT term being paid to the GRAT remainder beneficiaries; this type of structure is often referred to as a "Walton GRAT," named after a Tax Court case with that name.<sup>4</sup>

Similar to a QPRT, however, if a client does not survive the GRAT term, the GRAT will usually not be effective at transferring wealth to the client's family members free of transfer taxes, because most, if not all, of the GRAT assets at the client's death will be subject to estate tax on the client's estate tax return, notwithstanding that the GRAT continues in existence for the remainder of the GRAT term. For this reason, extra caution must be taken in drafting the GRAT (as well as the client's will) when a married client establishes a GRAT and wants or needs the GRAT assets to qualify for the estate tax marital deduction in the event the client dies before the expiration of the GRAT term. In addition, similar to a QPRT, there are numerous requirements of a GRAT under Reg. 25.2702-1 *et seq.* that are beyond the scope of this discussion; therefore, considerable care should be taken in drafting a GRAT.

A GRAT should be drafted to be a grantor trust of the client

for federal income tax purposes during the GRAT term. If a GRAT is not a grantor trust during the GRAT term, then the distribution of appreciated assets of the GRAT to the client, in satisfaction of an annuity payment, will trigger capital gains under current law. However, if a GRAT is a grantor trust for income tax purposes during the GRAT term, such capital gains will not be triggered because the GRAT is disregarded for income tax purposes under Rev. Rul. 85-13.

**Planning strategy.** When drafting the GRAT, the annuity payments can be set to (almost) any level or amount the client desires. Having larger annuity payments over the GRAT term will cause the present value of the client's retained annuity interest to be larger, and conversely, the value of the client's taxable gift will be smaller. Like a QPRT, this result occurs because the value of the client's taxable gift is based on the value of the remainder interest in the GRAT, calculated by subtracting the value of the client's retained annuity interest from the fair market value of the assets contributed to the GRAT at its creation.

If the annuity payments are large enough, then their value will equal (or be close to) the fair market value of the assets contributed to the

<sup>4</sup> Walton, 115 TC 589 (2000); *acq.* Notice 2003-72, 2003-2 CB 964. See Reg. 25.2702-3(e), Example 5.

### EXHIBIT 3 Walton/Zeroed-Out GRATs and Interest Rates

Two-Year GRAT, 10% Asset Annual Growth, 7520 Rate of 1.8% in May 2015					
Year	Beginning Principal	10% Assumed Annual Growth	Subtotal	Annual Annuity Payment	Ending Principal
1	\$1,000,000	\$ 100,000	\$1,100,000	\$ 467,224	\$ 632,776
2	\$ 632,776	\$ 63,278	\$ 696,054	\$ 560,669	\$ 135,385

  

Two-Year GRAT, 10% Asset Annual Growth, 7520 Rate of 3.0%					
Year	Beginning Principal	10% Assumed Annual Growth	Subtotal	Annual Annuity Payment	Ending Principal
1	\$1,000,000	\$ 100,000	\$1,100,000	\$ 475,737	\$ 624,263
2	\$ 624,263	\$ 62,426	\$ 686,689	\$ 570,885	\$ 115,804

  

Two-Year Asset GRAT, 10% Asset Annual Growth, 7520 Rate of 5.0%					
Year	Beginning Principal	10% Assumed Annual Growth	Subtotal	Annual Annuity Payment	Ending Principal
1	\$1,000,000	\$ 100,000	\$1,100,000	\$ 490,004	\$ 609,996
2	\$ 609,996	\$ 61,000	\$ 670,996	\$ 588,005	\$ 82,991

  

Two-Year Asset GRAT, 10% Asset Annual Growth, 7520 Rate of 7.0%					
Year	Beginning Principal	10% Assumed Annual Growth	Subtotal	Annual Annuity Payment	Ending Principal
1	\$1,000,000	\$ 100,000	\$1,100,000	\$ 504,363	\$ 595,637
2	\$ 595,637	\$ 59,564	\$ 655,201	\$ 605,235	\$ 49,966

Increase in 7520 Rate

Increase in annuity and decrease in remaining trust assets

GRAT, making the taxable gift zero (or nearly zero). In fact, many GRATs currently being established are drafted to achieve this result and are referred to as “zeroed-out GRATs.” Of course, with larger annuity payments being made to the client, fewer assets will remain at the end of the GRAT for distribution to the beneficiaries (or perhaps, no assets will remain at the end of the GRAT term).

The principal advantage of the GRAT technique is that if a client survives the GRAT term, and the growth of the assets in the GRAT (by capital appreciation, income, or a combination) is greater than the 7520 rate in effect at the creation of the GRAT (on an annual basis), then assets are transferred to family members at a small (or zero) transfer tax cost.

**Example.** When the 7520 rate is 1.8%, a client transfers assets valued at \$1 million to a GRAT having a two-year term. The client retains the right to receive an annuity payment of 46.7224% of the original value of the assets contributed to the GRAT (46.7224% of \$1 million is \$467,224) at the end of the first GRAT year, and an annuity payment of 56.0669% (a 20% increase over first year) of the original value of the assets contributed to the GRAT (56.0669% of \$1 million is \$560,669) at the end of the second GRAT year. The client’s right to receive these annuity payments is valued at approximately \$1 million at the time of the asset contribution. Therefore, the client’s taxable gift is effectively zero.

Further, assume that during the two-year GRAT term, the assets

grow at 10% per year (significantly above the 7520 rate of 1.8%). Even though the taxable gift was zero, approximately \$135,385 of assets will remain in the GRAT (after the second and final GRAT annuity payment) to pass to the GRAT beneficiaries free of gift taxes. This is reflected in the first table of Exhibit 3.<sup>5</sup>

As the annual growth rate of the assets increases, the value of the assets remaining at the end of the GRAT term to be distributed to the GRAT beneficiaries will increase exponentially.

On the other hand, if the growth of the assets on an annual basis is less than the 7520 rate of 1.8%, no assets will remain at the end of

<sup>5</sup> Computations are based on Lawrence P. Katzenstein’s *Tiger Tables*.

## EXHIBIT 4 GRATs and Interest Rates

### Two-Year GRAT, 6% Asset Annual Growth, 7520 Rate of 3.0%

Year	Beginning Principal	10% Assumed Annual Growth	Subtotal	Annual Annuity Payment	Ending Principal
1	\$1,000,000	\$ 60,000	\$1,060,000	\$ 475,737	\$ 584,263
2	\$ 584,263	\$ 35,056	\$ 619,319	\$ 570,885	\$ 48,434

### Two-Year GRAT, 6% Asset Annual Growth, 7520 Rate of 7.0%

Year	Beginning Principal	10% Assumed Annual Growth	Subtotal	Annual Annuity Payment	Ending Principal
1	\$1,000,000	\$ 60,000	\$1,060,000	\$ 504,363	\$ 555,637
2	\$ 555,637	\$ 33,338	\$ 588,975	\$ 588,975	\$ —

Passes free of gift tax

No assets remain

the GRAT term to be distributed to the GRAT beneficiaries. In this event, all of the GRAT assets will have been distributed back to the client, and the client is, in effect, no worse off than if the GRAT had not been created and the client simply held the assets individually the entire time.

If the client dies before the end of the two-year GRAT term, the annuity payments continue to be paid to the client's estate (with a Walton GRAT), and most, if not all, of the assets in the GRAT at the client's death will be subject to estate tax on the client's estate tax return. However, since the client's taxable gift at the creation of the GRAT was zero, the client is, in effect, no worse off than if the client had not created the GRAT.

**Interest rate effect.** Other than the value of the assets contributed to the GRAT, the two primary factors that affect the calculation of the taxable gift with a Walton GRAT are:

1. The 7520 rate.
2. The level of the annuity payments.

A taxable gift associated with a Walton GRAT will be *smaller* if (1) the 7520 rate *decreases* or (2) the total annuity payments *increase*. The effect of each of these factors on the taxable gift makes sense intuitively:

- As the 7520 rate decreases, the value of the client's retained annuity payments is discounted less and therefore increases. Conversely, the value of the GRAT remainder interest (i.e., the taxable gift) at the end of the GRAT term decreases.
- As the total annuity payments increase, the value of the remainder interest at the end of the GRAT term obviously decreases. Again, this can even be to the point of zero or close to zero. The taxable gift associated with a zeroed-out GRAT is, by definition, zero or close to zero. This is accomplished by setting the total annuity payments to a large enough amount so that the value is equal to (or close to) the fair market value of the assets contributed to the GRAT at the time of the con-

tribution. The amount of annuity payments necessary to create a zeroed-out GRAT is, in turn, affected by the 7520 rate. As described above, as the 7520 rate decreases, the value of the retained annuity payments is discounted less and therefore increases.

On the other hand, as the 7520 rate increases, the value of the retained annuity payments is discounted more and therefore decreases. Thus, a lower 7520 rate means that the annuity payments in a zeroed-out GRAT can be lower, presumably increasing the amount of assets that would otherwise remain at the end of the GRAT term to pass to the client's family members free of estate tax. And, a higher 7520 rate means that the annuity payments in a zeroed-out GRAT must be higher to, in fact, make it zeroed-out.

The four tables in Exhibit 3 illustrate the effects of fluctuations in the 7520 rate on the annuity payments required to zero-out a GRAT and, in turn, on the amount of the remaining assets in a zeroed-out GRAT to pass to the remain-

der beneficiaries free of gift taxes at the end of the GRAT term. These examples assume a client transfers assets valued at \$1 million to a zeroed-out GRAT and the assets in the GRAT have an annual growth rate of 10%.

**Unlike a QPRT, if a client dies before the expiration of the GRAT term, the assets in the GRAT are not required to revert back to the client's estate.**

As described above, a zeroed-out GRAT will only work (i.e., a client will only be able to transfer assets to family members at no transfer tax cost) if a client survives the GRAT term and the growth of the assets in the GRAT (by capital appreciation, income, or a combination) is greater than the 7520 rate in effect at the creation of the GRAT (on an annual basis). The two tables in Exhibit 4 illustrate this concept by assuming a client transfers assets valued at \$1 million to a zeroed-out GRAT and the assets in the GRAT have an annual growth rate of 6%, which is between the assumed 3.0% and 7.0% 7520 rates in the above two tables.<sup>6</sup>

#### **Sale of assets to an IDGT**

A sale of assets by a client to an IDGT, in exchange for a promissory note issued by the IDGT to the client, is similar to a GRAT in some respects and different in other respects. It is similar in that the client's motivation for the transaction is usually that a client believes assets can be transferred that will grow in value at a higher rate of return (often a much higher rate) than the interest rate required by the IRS (i.e., either the AFR or the 7520

rate). Therefore, wealth can be transferred to family members while minimizing transfer taxes, if the actual growth does in fact exceed the IRS required interest rate. However, there are also differences; some of these differences favor a sale of assets to an IDGT over a GRAT, and some differences favor the GRAT. A few of the significant differences between the two transactions are described below.

**Anatomy of the arrangement.** The sale of assets to an IDGT typically works as follows: A client creates a trust (the IDGT) for the benefit of children and grandchildren, and the trust is intentionally drafted to be a grantor trust for income tax purposes and therefore disregarded as a separate taxpayer under Rev. Rul. 85-13. This is critical so that the sale of assets to the IDGT (and IDGT's interest and principal payments on the note) do not trigger income tax consequences to the client. The IDGT must be carefully drafted, however, so that while the client has certain powers that cause the IDGT to be a grantor trust for income tax purposes, those powers do not cause the assets of the IDGT to be includable in the client's gross estate for federal estate tax purposes. A simple example is that the client should usually not be the trustee of the IDGT.

After creating the IDGT but prior to the sale of assets, the client will typically make a gift to the IDGT to provide capital (i.e., "seed money") to the IDGT. Subsequently, the client sells assets to the IDGT in exchange for a promissory note issued by the IDGT to the client. The promissory note will often be structured as an interest-only note with a balloon payment at the end of the note's term. The term of the promissory note is typically a fixed number of years, sometimes correlated with an expected future event with respect

to the assets sold to the IDGT. For example, if interests in a closely held entity are sold to an IDGT and the entity is expected to be sold in the next five years, the term of the promissory note from the IDGT may be initially set to six years.

**Planning considerations.** It is advisable that interest be paid on the promissory note at least annually. The interest payments will be paid by the IDGT back to the client. As described above, the length of the term of the promissory note dictates the AFR to be used to determine interest payments. In the example above, a mid-term AFR would be used for a promissory note having a six-year term.

If the client dies while the promissory note is still outstanding, the IDGT technique does not automatically fail (as it likely would with a GRAT). In this event, the promissory note would be an asset includable in the client's estate for estate tax purposes, but the assets owned by the IDGT would not be subject to estate tax. Accordingly, if the IDGT assets have a greater value than the promissory note, then the transaction would be successful for purposes of the goal of minimizing transfer taxes, since the appreciated assets are out of the client's estate, replaced by the promissory note with a lower fair market value. However, to avoid uncertain income tax consequences, it is also preferable for the promissory note to be repaid by the IDGT prior to the client's death.

**Differences between a sale of assets to an IDGT and a GRAT.** As mentioned, a sale of assets to an IDGT is different from a GRAT in a number of respects. The following three differences may favor a sale of assets to an IDGT over a GRAT.

<sup>6</sup> *Id.*



1. The interest rate on a promissory note payable by IDGT (i.e., an AFR) will often be lower than the 7520 rate required for a GRAT. In such instance, more assets will ultimately pass to family members through an IDGT than through a GRAT, all other aspects being equal.
2. The client does not necessarily have to survive the term of the promissory note payable by the IDGT for the IDGT sale to be successful for transfer tax purposes. For a GRAT to work for transfer tax purposes, however, the client does need to survive the term of the GRAT.
3. An IDGT can be used for generation-skipping transfer (GST) tax planning, whereas a GRAT is not a good candidate for GST tax planning.

Other differences, however, make a sale of assets to an IDGT more uncertain than a GRAT. For instance, a sale of assets to an IDGT does not have a statutory authority like a GRAT provides. Treasury Regulations specifically provide the requirements that a GRAT must satisfy. With a sale of assets to an IDGT, there is no statutory roadmap to give a client comfort.

For example, in order for a sale of assets to an IDGT to be respected by the IRS and not potentially re-characterized as a gift by the client, it is generally agreed that the IDGT must independently have “seed money” in addition to the assets it acquires from the sale transaction. One of the reasons is so that the IDGT will be considered a “credit worthy” borrower and thus has sufficient assets to make interest payments on the

promissory note from the IDGT, without solely relying on distributions or income from the assets sold to the IDGT. However, the amount of the seed money is uncertain, although 10% to 20% of the amount of the promissory note is generally thought to be sufficient. Again, though, there is no safe harbor as there effectively is through a GRAT.

**If the client dies while the promissory note is still outstanding, the IDGT technique does not automatically fail (as it likely would with a GRAT).**

Another difference that makes a sale to an IDGT perhaps riskier than a GRAT is that the sale transaction does not necessarily possess a self-adjusting valuation formula (unlike a GRAT) in the event the assets sold to the IDGT are undervalued, which would otherwise result in the promissory note having a face value of less than the fair market value of the sold assets. In such instance, the IRS would argue that the client has made a taxable gift of (at least) the difference between the assets’ fair market value and the promissory note amount.

Additionally, a difference disfavoring sales to an IDGT is that there are uncertain income tax consequences if the client dies before the promissory note is repaid by the IDGT; that is, capital gains may be triggered upon the client’s death with respect to the unpaid note balance. Finally, if the value of the assets sold to the IDGT decreases, the client’s future projected transfer taxes could increase rather than decrease, since the IDGT would still

be responsible for the full amount of the promissory note.

**Interest rates effect.** Because a client’s goal in selling assets to an IDGT is almost always to minimize transfer taxes, it is preferable for the promissory note to have as low of an AFR as possible. A lower AFR will result in less interest being paid by the IDGT to the client over the term of the promissory note, meaning that the total value of the client’s assets that will eventually be subject to estate tax should be lower. For promissory notes with large face values or long terms, the smaller interest payments could be very significant over time.

If a sale of assets to an IDGT in exchange for a promissory note previously took place and the AFR used in that transaction is significantly higher than the current AFR (which may very well be the case as AFRs are currently at historic lows), then it may be possible to substitute a new promissory note with a lower AFR for the existing promissory note with the higher AFR, without adverse transfer or income tax consequences.<sup>7</sup>

### Other transactions

Other transactions, such as an outright loan to a family member, self-cancelling installment notes (SCIN), and private annuities, also benefit from lower interest rates. A client can make an outright loan to a family member and charge an AFR to prevent the loan from being considered a “below-market loan” under Section 7872. Care must also be taken, however, to ensure that the IRS will not take the position that the entire loan is actually a gift, especially if the client plans to forgive part or all of the balance of the loan as annual exclusion gifts to the borrower. Securing the loan with collateral and making pay-

<sup>7</sup> See Blattmachr, Crawford, and Madden, “How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note,” 109 J. Tax’n 22 (July 2008).

## EXHIBIT 5 CRATs and Interest Rates

15-Year CRAT, 5.0% Annual Annuity Payout, Assets Valued at \$1,000,000			
	7520 Rate	Annuity Interest	Charitable Remainder
Increase in 7520 Rate →	1.0%	\$ 693,255	\$ 306,745
	2.0%	\$ 642,465	\$ 357,535
	4.0%	\$ 555,920	\$ 444,080
	6.0%	\$ 485,610	\$ 514,390
			← Increase in Charitable Remainder

  

15-Year CRAT, 2.0% 7520 Rate, Assets Valued at \$1,000,000			
	Annuity Payout	Annuity Interest	Charitable Remainder
Increase in Annuity Payout →	6.0%	\$ 770,958	\$ 229,042 (Pass)
	7.0%	\$ 899,451	\$ 100,549 (Pass)
	8.0%	\$1,027,944	\$ (27,944) (Fail)
			← Fail

ments on the loan indicate that the loan is real debt rather than a gift.

A SCIN is typically used in a similar type of transaction described above with regard to the sale of assets to an IDGT, except that a SCIN also has a “risk premium” added to it, in the form of either a higher interest rate or a larger principal balance due than what was originally borrowed/purchased. If the client dies before the SCIN is fully repaid, then the remaining obligation is cancelled. The risk premium described above is designed to compensate for the mortality component involved in the transaction. A lower AFR will also benefit a SCIN.

With regard to a private annuity, a higher interest rate means larger annuity payments back to the client, so it is also advantageous for a private annuity transaction to be entered into when low interest rates are in place.

### CRAT

A CRAT is a trust meeting the requirements of Section 664(d). Those include annuity payments being made at least annually to one

or more individuals, at least one of which is not a charitable organization. A CRAT may last for either a specified term of years (not to exceed 20 years) or the life or lives of individuals to whom annuity payments are made from the CRAT. For example, if a client created a single-life CRAT for himself, the client would be entitled to receive fixed annuity payments, made at least annually, from the CRAT during the remainder of the client’s lifetime.

**Anatomy of the arrangement.** The annuity payments from a CRAT are usually expressed in terms of a percentage of the initial fair market value of the assets contributed to the CRAT. The annual payments must not be less than 5%, and not more than 50%, of the initial fair market value of the assets contributed to the CRAT. At the end of the CRAT term, any remaining property in the CRAT is paid to one or more qualified charitable organizations.

In order for a CRAT to qualify under Section 664(d), the present value of the charitable remainder

interest at the time of contribution must be at least 10% of the initial fair market value of the assets contributed to the CRAT. Also, Rev. Rul. 77-374<sup>8</sup> requires that the probability that the CRAT assets will be exhausted before the charitable remainder interest vests with the charities must be less than 5%.

While a discussion of all of the requirements for establishing a CRAT is beyond the scope here, note that the IRS has issued several revenue procedures setting forth sample CRATs meeting the necessary qualifications;<sup>9</sup> these include sample CRATs for a term of years and for one or two measuring lives, both for lifetime (i.e., inter vivos) CRATs, and testamentary CRATs.

**Planning considerations.** Because the remaining assets owned by a CRAT at the end of its term pass to charitable organizations, a CRAT is not a vehicle for transferring wealth to family members in younger generations. However, CRATs do have attractive features,

<sup>8</sup> 1977-2 CB 329.

<sup>9</sup> See Rev. Proc. 2003-53, 2003-2 CB 230, through Rev. Proc. 2003-60, 2003-2 CB 274.

## EXHIBIT 6 CRATs, Interest Rates, and Client Age

### Lifetime CRAT, 2.0% 7520 Rate Assets Valued at \$1,000,000, 5.0% Annual Annuity Payout

Client Age	Annuity Interest	Charitable Remainder	Probability of Exhaustion of CRAT
65	\$ 714,725	\$ 285,275	19.076% (Fail)
68	\$ 641,725	\$ 358,275	11.133% (Fail)
71	\$ 569,625	\$ 430,375	5.501% (Fail)
72	\$ 545,950	\$ 454,050	4.162% (Pass)

FAIL

including that appreciated property may be sold without immediately triggering capital gains to the client. During the existence of the CRAT, however, such income untaxed to the trust is passed out to the non-charitable beneficiaries of a CRAT under the “tier system.”

Another advantage of a CRAT is that a charitable deduction may be available for income, gift, or estate tax purposes when a gift to a CRAT is made. Overall, a gift to a CRAT can provide a stream of distributions to a client or family members over the term of a CRAT, with possible tax deductions stemming from the CRAT’s charitable remainder interest.

With regard to the calculation of the present value of the charitable remainder interest, Section 7520(a) allows a taxpayer to choose the 7520 rate in effect during either of the two months preceding the contribution of assets to the CRAT, in addition to the 7520 rate in effect for the month of the contribution. For a CRAT, it is advantageous to use a higher 7520 rate to calculate charitable deductions, as illustrated below.

**Example.** In May 2015, a client owns assets valued at \$1 million and wants to transfer them to a CRAT.

<sup>10</sup> Note 5, *supra*.

The client decides on a 15-year term CRAT, with annual annuity payments to the client of \$50,000 during the existence of the CRAT. The 7520 rates for March 2015, April 2015, and May 2015 are 1.8%, 2.0%, and 1.8%, respectively.

Because of the rule allowing a taxpayer to choose the 7520 rate for either of the two preceding months in which the CRAT contribution occurs, the client can use the higher April 2015 7520 rate, rather than the lower May 2015 7520 rate, which will result in a larger charitable deduction as shown below. Using April 2015’s 7520 rate of 2.0%, the value of the client’s retained annuity interest is \$642,465, and the value of the charitable remainder interest is \$357,535.<sup>10</sup>

**Interest rate effect and other factors.** Other than the value of the assets contributed to the CRAT, the three factors that affect the calculation of the charitable remainder associated with a CRAT for a *term of years* are:

1. The 7520 rate.
2. The level of annuity payments payable from the CRAT.
3. The length of the CRAT term.

The value of the charitable remainder interest (and thus tax

deductions) associated with a CRAT will be *larger* if (1) the 7520 rate *increases*, (2) the total amount of the annuity payments is *smaller*, and (3) the CRAT term is *shorter*. The effect of each of these factors on the charitable remainder makes sense intuitively:

- As the 7520 rate increases, the value of the retained annuity payments is discounted more and therefore decreases. Therefore, the value of the charitable remainder interest increases.
- If the total of the annuity payments decreases, then obviously the present value of the client’s retained annuity payments will decrease, causing the value of the charitable remainder interest to increase.
- When the CRAT term is shorter, the present value of the client’s retained annuity payments obviously will decrease, causing the value of the charitable remainder interest to increase.

The first table in Exhibit 5 illustrates the effects of changes in the 7520 rate on the value of the charitable remainder interest (and therefore tax deductions) associated with a CRAT, when a client transfers assets valued at \$1 million to a 15-year

## EXHIBIT 7 Effect of 7520 Rate on CLAT

### Five-Year CLAT, 10% Asset Annual Growth, 7520 Rate of 1.8%

Year	Beginning Principal	10% Assumed Annual Growth	Subtotal	Annual Annuity Payment	Ending Principal
1	\$1,000,000	\$ 100,000	\$1,100,000	\$ 210,931	\$ 889,069
2	\$ 889,069	\$ 88,907	\$ 977,976	\$ 210,931	\$ 767,045
3	\$ 767,045	\$ 76,704	\$ 843,749	\$ 210,931	\$ 632,818
4	\$ 632,818	\$ 63,282	\$ 696,100	\$ 210,931	\$ 485,169
5	\$ 485,169	\$ 48,517	\$ 533,686	\$ 210,931	\$ 322,755

### Five-Year CLAT, 10% Asset Annual Growth, 7520 Rate of 3.0%

Year	Beginning Principal	10% Assumed Annual Growth	Subtotal	Annual Annuity Payment	Ending Principal
1	\$1,000,000	\$ 100,000	\$1,100,000	\$ 218,355	\$ 881,645
2	\$ 881,645	\$ 88,165	\$ 969,810	\$ 218,355	\$ 751,455
3	\$ 751,455	\$ 75,145	\$ 826,600	\$ 218,355	\$ 608,245
4	\$ 608,245	\$ 60,824	\$ 669,069	\$ 218,355	\$ 450,714
5	\$ 450,714	\$ 45,071	\$ 495,785	\$ 218,355	\$ 277,430

Passes free of gift tax

Passes free of gift tax

CRAT and reserves 5% annual annuity payments (\$50,000 per year).

As indicated in that table, as the 7520 rate increases, the present value of the charitable remainder interest also increases. Conversely, as the 7520 rate decreases, the present value of the charitable remainder interest decreases. For a 15-year term CRAT with the lowest possible annuity payout rate of 5%, there is little danger that the CRAT will fail any of the tests for a CRAT described above.

If the above example remains the same, however, except that the annual annuity payment is increased to 8% and the 7520 rate is assumed to be 2.0%, the CRAT would fail the requirements of Section 664(d), because the value of the remainder interest would fall below 10%. This is shown in the second table of Exhibit 5.

Similarly, a *lifetime* CRAT for a client 71 years of age or younger

would fail the 5% probability of exhaustion requirement of a CRAT when the 7520 rate is only 2.0%, as illustrated in Exhibit 6. Clearly, as interest rates decrease, it becomes more difficult for a CRAT to satisfy the baseline tests for a CRAT described above.

### CLAT

A CLAT is a trust similar in some respects to a GRAT; however, instead of fixed annuity payments payable to the client, they are instead payable to a charity or charities, often for a specified term of years. The period during which the fixed annuity payments are payable to a charity or charities is called the CLAT term. At the end of the CLAT term, the remaining trust assets, if any, are distributable to noncharitable beneficiaries.

A CLAT created during a client's lifetime can be structured as a grantor trust or as a nongrantor

trust for income tax purposes. Whether a CLAT is a grantor trust for income tax purposes affects who pays the tax on the CLAT's taxable income, how the charitable income tax deduction is calculated and when it can be taken, and other income tax issues.

Like a GRAT, a CLAT can be "zeroed-out" so that the client is not treated as making a taxable gift upon the creation of the CLAT. This is accomplished by setting the level of annuity payments paid to the charities to be large enough so that the total present value of the payments is equal to the fair market value of the assets contributed to the CLAT. In this event, assets pass free of transfer taxes to family members, assuming the CLAT assets experience annual growth in excess of the 7520 rate (again, similar to a GRAT).

A CLAT is different than a GRAT in that it is often established with a

term that is longer than a few years, as opposed to GRATs, which often have terms of only a few years. Note that a CLAT is not subject to the same limitations as a CRAT for minimum-payout and maximum-payout requirements or term limits. Thus, clients may choose any guaranteed annuity or fixed payout percentage, and a term CLAT may last for longer than 20 years.

**Interest rate effect and other factors.** Other than the value of the assets contributed to the CLAT, the two primary factors affecting the calculation of the taxable gift involved with a transfer of assets to a CLAT are:

1. The 7520 rate.
2. The level of the annuity payments.

A taxable gift associated with the remainder interest in a CLAT will be *smaller* (1) if the 7520 rate *decreases* (because the charitable annuity interest will be discounted less and therefore will have a greater value), and (2) the annuity payments are larger. The effect of these factors on the taxable gift makes sense intuitively; see the discussion of a GRAT above. In sum, a CLAT can be an effective tool to accomplish charitable gifting goals but also provide an opportunity for assets to pass to children free of transfer taxes, depending on the performance of the CLAT assets during the CLAT term.

**Example.** In May 2015, a client owns assets valued at \$1 million and wants to transfer them to a CLAT. The client decides on a five-year term CLAT, with annual annuity payments of \$90,000 (i.e., a 9%

annual annuity) paid to a charity during the CLAT term. The 7520 rates for March 2015, April 2015, and May 2015 are 1.8%, 2.0%, and 1.8%, respectively. A special rule allows a taxpayer to elect to use the 7520 rate for either of the two preceding months in which the assets are contributed to the CLAT.

**The present value of the charitable remainder interest at the time of contribution must be at least 10% of the initial fair market value of the assets contributed to the CRAT.**

Here, the client would choose to use May 2015's 7520 rate (1.8%) rather than April 2015's 7520 rate (2.0%), increasing the potential for additional assets to remain in the trust following the satisfaction of the annuity payments. Using May 2015's 7520 rate of 1.8%, the present value of the charitable annuity interest is \$426,681 ( $\$90,000 \times 4.7409$  (annuity factor)), and the value of the remainder interest (and hence the taxable gift) is \$573,319.

If the annual annuity payment is increased to \$210,931 (rounded), the value of the remainder interest and hence the taxable gift is reduced to zero. This type of increased annuity payment described above is a zeroed-out CLAT. Assuming the investments inside the zeroed-out CLAT grow at 10% each year, there will be approximately \$322,000 of assets remaining in the CLAT at the end

of its five-year term to pass to the client's children free of gift taxes.

Exhibit 7 illustrates the effects of fluctuations in the 7520 rate on the annuity payments required to zero-out a CLAT and, in turn, on the amount of the remaining assets in a zeroed-out CLAT to pass to the children free of gift taxes at the end of the CLAT term. These examples assume a client transfers assets valued at \$1 million to a five-year CLAT, with an annual annuity payment of a sufficient amount to zero-out the CLAT, and the assets have an annual growth rate of 10%.<sup>11</sup>

### Conclusion

The low interest rates currently in effect can provide significant estate planning opportunities, providing an incentive for clients to move forward and implement a variety of techniques to transfer wealth. When interest rates fluctuate from month to month, and statutes allow taxpayers to choose among the current month's rate or that of prior months, the following principles should be considered:

- With a QPRT, the taxable gift is smaller as the Section 7520 rate *increases*.
- With a GRAT, the taxable gift is smaller as the Section 7520 rate *decreases*.
- A sale to an IDGT and intra-family loans are more attractive as the AFR *decreases*.
- With a CRAT, the charitable remainder/deduction is larger as the Section 7520 rate *increases*.
- With a CLAT, the taxable gift is smaller and the charitable deduction is larger as the Section 7520 rate *decreases*. ■

<sup>11</sup> *Id.*