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Many Estate Planning Strategies Provide Benefits in Low-Interest-Rate Environment

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Interest rates are lower than they have been in years. For May, the federal Section 7520 rate was 3.2 percent, down from 5.6 percent one year ago, though for July and August the rate climbed to 4.2 percent. 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 most 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 notes (SCIN), and private annuities.

Beat the Section 7520 Rate

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. But GRATs have several disadvantages. The annuity must be paid even if the trustee has to use the trust corpus or borrow funds to pay it. 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 that no tax is saved and attorney fees are 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 simply inherited the property at the grantor's death.

Table 1 shows an example of a GRAT for a taxpayer who has not made any taxable gifts and has a $1 million gift-tax exclusion remaining, using the May 2007 Section 7520 rate of 5.6 percent.

Table 1:	GRAT for Taxpayer with No Taxable Gifts and $1 Million Gift-Tax Exclusion
Grantor transfers $1,500,000 in property to trust	
May 2007 Section 7520 rate of 5.6%, present value of $1 annuity factor for five years is 4.2586	
Need $500,000 value for retained interest (assumed remaining unified credit equivalent of $1,000,000)	
Required annuity: $500,000/4.2586 = $117,409	
Set annuity rate of 7.83% ($117,409/$1,500,000)	
Value of property transferred	$1,500,000
Present value of $117,409 annuity discounted at 5.6%	(500,000)
Gift of remainder interest	$1,000,000

Example 1. In this example, the $1.5 million principal and any appreciation is transferred at no gift-tax cost. If the grantor outlives the term of the GRAT, the five-year annuity will increase his or her estate by $587,045. However, the grantor can gift the $117,409 annuity annually to multiple beneficiaries. Income in excess of 7.83 percent annually will be out of the estate. But as previously noted, if the grantor dies during the GRAT term, the entire value in the trust will be brought back into the estate and the trust must pay the annuity even if there is no income. The remainder value in the GRAT depends on the annuity rate and term. A higher payout rate increases the value of the annuity and decreases the value of the gift, whereas a lower payout rate decreases the value of the annuity and increases the value of the gift.

Example 2. If we instead assume an August 2008 Section 7520 rate of 4.2 percent on the transfer of $1.5 million to the GRAT with a $1 million remainder interest, the required annuity would only be $112,946. The lower Section 7520 rate decreases the amount of the annuity needed to reach the $1 million gift-tax exclusion level, eliminating the gift-tax obligation. The amount of income the trust assets must produce to meet the annuity obligation is also decreased.

Example 3. Finally, if we assume a Section 7520 rate of 4.2 percent but keep the annuity rate at $117,409 (the level we calculated at a 5.6 percent rate), the transfer of $1.5 million to the GRAT decreases the potential gift liability for the annuity and reduces the gift of the remainder interest to $982,242.

Some taxpayers do not have gift-tax exclusion remaining because they have made more than $1 million in gifts. 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 $1.5 million transfer over five years is $352,228 at a 5.6 percent Section 7520 rate, or $338,838 at a 4.2 percent Section 7520 rate.

Defective Grantor Trusts Advantageous

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 Revenue Ruling 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 ruling 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 Revenue Ruling 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.

In light of the low-interest-rate environment and Revenue Ruling 2008-22, sales to IDGTs will be more commonly used as an estate-leveraging technique. One way to implement this strategy is for the grantor to transfer 10 percent of the value of property to be sold to the IDGT and then sell 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 an 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. But with an IDGT, the gain is deferred as the annuity is paid over the life of the individual by the trust.

Unwise Strategies for Low Interest Rates

Some estate planning strategies are adversely affected by low interest rates. (Table 2 shows how different strategies are affected by low interest rates.) These strategies include qualified personal residence trusts (QPRTs) and charitable remainder annuity trusts (CRATs). QPRTs are similar to GRATs, but 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.

Table 2: Estate Planning Strategies Affected by Low Interest Rates

Benefited	Unaffected	Adversely Affected
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		

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 percent, and a 10 percent interest in the assets has to pass to the charity. In a low-interest-rate environment, the 5-percent-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.

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.