

Estate Planning Techniques for the Low Interest Rate Environment

Interest rates are at historic lows. Many gift transfers are valued using “Applicable Federal Rates” (“AFRs”) or a general discount rate, referred to as the “Section 7520 rate”, published by the Internal Revenue Service. The AFRs decline with prevailing interest rates. This Alert discusses estate planning techniques that these low interest rates help or hurt.

Intra-family Loans

HELP

The IRS generally treats a donor who loans funds to a family member without interest or at a below market interest rate (below the relevant AFR) as making a gift. The AFRs are currently very low, however. For example, the May 2009 annual AFR for a 3- to 9-year loan is only 2.05%.

Low interest loans can facilitate purchase of interests in a family business or for paying down higher-interest rate debt. The lower the AFR, the less the family member must pay to the wealthier generation, and the more that remains with the donee.

Grantor Retained Annuity Trusts (GRATs)

HELP

A grantor retained income trust or “GRAT” is an irrevocable trust to which the “grantor” transfers assets in exchange for an annuity, for a period of years. At the end of the trust term, the remaining trust assets pass to “remainder” beneficiaries—typically, family members. The annuity amount usually is set so that no gift is made to the family members (a “zeroed out GRAT”). If the trust assets appreciate enough, family members receive a tax-free gift; if the assets don’t, or they drop in value, they are simply returned to the grantor, who can try again with another GRAT.

How much appreciation is enough? It depends on the Section 7520 rate. If the trust assets appreciate more than the then-current Section 7520 rate when the GRAT is established—for May, 2.4%—the family members wind up with a tax-free gift.

Sale of Assets to Trust

HELP

An individual also can reduce or eliminate federal gift taxes on intra-family transfers by selling family assets to the younger generation. Often, the wealthier generation accomplishes the sale using a trust with younger generation beneficiaries, and the trust pays for the family assets over time, with interest.

The required interest rate again is determined using the AFR. As with an intra-family loan (discussed above), the lower the AFR, the less that the younger generation must repay to the wealthier generation and the greater the benefit to the younger generation.

Charitable Lead Annuity Trusts (CLATs)

HELP

If the trust is a “defective grantor trust” (meaning the “grantor” remains the owner for income tax purposes), the sale doesn’t trigger capital gains or income taxes, reducing the tax cost of this strategy.

A charitable lead annuity trust or “CLAT” is similar to a GRAT, in that it pays an annuity for a period of years and then distributes the remaining trust assets to family member “remainder” beneficiaries. It is different, however, in that the annuity is paid to a charity rather than to the grantor.

Low interest rates—the historically low Section 7520 rate—can make use of a CLAT beneficial to younger generation family members. Also, the annuity paid to the charity qualifies for a charitable income tax deduction. Some grantors use CLATs to replace annual gifts to their favorite charities, passing assets to the younger generation family members with little or no gift tax.

Charitable Remainder Annuity Trusts (CRATs)

HURT

A charitable remainder annuity trust or “CRAT” is the mirror image of a CLAT, because the grantor retains an annuity for a period of years, with a charity as remainder beneficiary. Low Section 7520 rates result in a lower charitable deduction for the charitable gift. Therefore, CRATs are hurt in a low interest rate environment.

Qualified Personal Residence Trust (QPRT)

HURT

The same is true for qualified personal residence trusts or “QPRTs”. The grantor transfers a principal residence to the trust and retains the right to live there for a term of years. After the trust term, the residence passes to younger generation family members. The grantor’s retained right to live in the residence is valued based on the Section 7520 rate—the lower the Section 7520 rate, the smaller the value of the non-taxable retained interest and the larger the gift to the younger generation.

Values of some real estate have dropped substantially, however. Even though the Section 7520 rate is at a historically low level, for certain residences a QPRT is still a good idea.

Michael D. Carrico
206.624.3600
mcarrico@riddellwilliams.com

James W. Minorchio
206.624.3600
jminorchio@riddellwilliams.com

Douglass A. Raff
206.624.3600
draff@riddellwilliams.com

Ryan D. Rein
206.624.3600
rrein@riddellwilliams.com

Riddell Williams P.S.
1001 Fourth Avenue, Suite 4500
Seattle, WA 98154-1192
www.riddellwilliams.com

Telephone: 206.624.3600

Facsimile: 206.389.1708