Estate Planning Strategies in a Low-Interest Rate Environment

In this current low interest rate environment, there are some very effective estate planning strategies for transferring substantial assets to the next generation of beneficiaries with minimal gift tax. These strategies include:

- Loans to family members and loans and sales to grantor trusts
- Grantor retained annuity trusts ("GRATs")
- Charitable lead annuity trusts ("CLATs")

These strategies are designed to "freeze" the value of the transferred assets and shift income and appreciation of the assets in excess of the published interest rates to children or more remote beneficiaries with little to no gift tax.

Intra-Family Loans and Loans to Grantor Trusts

Intra Family Loans

One of the most basic forms of an intra-family loan would be for a parent to lend funds to a child at the lowest interest rate that is allowed under the Treasury Department's safe harbor rates for loans. This rate is more commonly known as the applicable federal rate ("AFR"). The AFRs for the month of January, 2009 are as follows:

Short-term loans (up to 3 years) .81%
Mid-term loans (more than 3 years and up to 9 years) 2.06%
Long-term loans (more than 9 years) 3.57

Advantage

If the total return of the assets loaned to a child exceeds the interest rate charged on the loan (i.e. AFR), the excess will be transferred gift tax-free to the child. However, unlike a GRAT or a CLAT, described below, if the total return is less than the AFR, a child must repay the loan from the child's individual assets.

Income Tax

The lender (the parent) would report interest payments as income and, generally speaking, the recipient of the loan would be able to deduct the interest payments for income tax purposes if the loan is made in connection with the acquisition of a principal residence or an investment that produces taxable income.

Loans to Trusts

The donor may also make a low interest rate loan to a new or existing trust for the benefit of family members. The trust can be drafted as a "dynasty trust" or generation-skipping trust that is designed to benefit multiple generations of family members. The trust, however, should hold sufficient assets other than the proceeds from the loan so that the IRS respects the loan transaction and does not recharacterize the loan as a gift.

Loans to Grantor Trusts

The trust to which the loan is made may and often should be drafted as a "grantor trust". This means the trust would be treated as the grantor's alter ego for income tax purposes and all income and capital gains earned by the trust would continue to be reported on the grantor's individual income tax return. However, this payment of income taxes by the grantor, is an indirect non-taxable gift to the Trust (and children) and allows the trust to grow income-tax free. In addition, a loan by the grantor to the trust will have no income tax consequences, so that the grantor will not report the interest as income and the trust will not deduct the interest.

Family Limited Partnership

The advantages of low interest rate loans can be enhanced through the use of a Family Limited Partnership. If a parent has already created or wants to create a family limited partnership, an interest in the family limited partnership can be sold to a grantor trust in exchange for cash and a note (effectively a loan). The grantor initially funds the grantor trust with cash or property that creates a small taxable gift and then sells an interest in the partnership to the grantor trust in exchange for an installment note bearing interest at the AFR.

Because the trust is a grantor trust, the grantor does not recognize gain or loss on a sale of the family partnership interests to the Trust. Similarly, the grantor pays no tax on the interest payments received on the note; however, he or she pays tax on all of the trust's income. If the grantor dies during the term of the note, the IRS might argue that the gain should be recognized. However, the grantor's estate may be able to defer the gain under the installment-sale rules.

The sale of an interest in a family limited partnership can be particularly effective if the partnership interest purchased by the grantor trust is valued at a discount due to lack of marketability and the purchaser's lack of control, which reduces the fair market value of the transferred assets, the amount of the taxable gift and the promissory note.

Grantor Retained Annuity Trusts

A GRAT allows a grantor to transfer significant assets to family members with very little transfer tax consequences and retain almost all of the income from the transferred asset for a period of years. Under a GRAT, the grantor transfers assets to an irrevocable trust and retains the right to receive a fixed annuity for a term of years. The annuity is designed to return to the grantor the entire amount of the initial gift plus interest at the AFR. The AFR for a GRAT is equal to 120% of the mid-term Treasury rate (2.4% for the month of January, 2009). At the end of the GRAT term, when all of the annuity payments to the Grantor have been made, the remaining assets in the GRAT pass to designated beneficiaries (i.e. children) outright or to trusts for their benefit, free of transfer taxes.

Rate of Return of Assets transferred to a GRAT vs. AFR

The assets transferred to the GRAT, ideally assets expected to appreciate significantly over the term of the GRAT, may consist of cash, stocks, mutual funds, real estate, or other investment and income producing property. In order for the GRAT to be successful, the total return on assets transferred to the GRAT must exceed the AFR. Therefore, with the current AFR set extremely low, it is easier for a GRAT to outperform the AFR and transfer the excess appreciation in investment assets to designated beneficiaries.

If the total return of the GRAT assets is less than or equal to the AFR, the entire GRAT property will be returned to the grantor, but at no cost to the grantor, other than the cost of creating the GRAT and any loss in value in the GRAT assets.

Grantor Does Not Survive GRAT Term

If the grantor should pass away during the GRAT term, the remaining trust assets are includible in the grantor's gross estate and subject to federal estate tax. There is no tax benefit (or tax cost) associated with the gift.

Nominal Gift

The amount of the taxable gift (the remainder interest) is computed by subtracting the present value of the annual annuity payments to the grantor from the fair market value of the assets transferred to the GRAT. The annuity, however, can be structured so that its value absorbs almost the entire value of the assets transferred to the GRAT. Consequently, the present value of the beneficiaries remainder interest will be almost zero, and the value of the taxable gift is minimal.

Grantor Trust Status

The GRAT is also treated as a grantor trust for income tax purposes. As previously discussed, because the grantor pays the income taxes on trust income, the trust will grow income-tax free and the payment of the taxes by the Grantor is in effect a tax-free gift to the children.

GRAT Property and Term

When creating a GRAT one should consider (1) the type of property transferred to the GRAT and (2) the duration of the GRAT term. A grantor should fund a GRAT with property that he or she believes will appreciate at a rate that exceeds the AFR. With respect to the term of the GRAT, a longer-term GRAT locks in the current low interest rate, however, a series of short-term GRATs, or "rolling GRATs" may be more effective if the rate of investment return is expected to fluctuate.

Rolling GRATs

The utilization of rolling GRATs allows the grantor to roll the assets out of one GRAT and into the next GRAT. For example, if after the first year of GRAT the grantor receives back stock that has not increased in value, but the grantor believes will increase in value in the future, the grantor can create a second GRAT. This second GRAT will have similar terms as the first GRAT although the AFR may have changed. The grantor can then take the assets which were distributed back to him from the first GRAT, add some additional assets and start a second GRAT.

Separating GRAT Assets

Another GRAT strategy involves the isolation of different securities or a collection of similar securities in separate GRATs. This can maximize the likelihood of a successful GRAT and eliminate the poor performance of a few stocks dragging down an otherwise well-performing GRAT.

Staggered Annuity Rate

The annuity payable to the grantor does not have to be constant over the GRAT term. The annuity may be established by a formula which increases the annuity by up to 20% of the previous year's annuity. This can maximize the amount assets available for the GRAT to invest during the early years of the GRAT term.

Generation Skipping

Another advantage of GRATs is that a grantor's generation-skipping transfer tax exemption ("GST Exemption") can be allocated to the GRAT. The grantor's GST Exemption cannot be allocated to a GRAT when it is created; however, it may be allocated at the end of the GRAT term to any amounts passing to the remainder beneficiaries. In order to allocate the grantor's GST Exemption, the remainder beneficiary of the GRAT should be a trust designed to benefit grandchildren and more remote descendants. In 2009 the GST Exemption will be increasing to $3.5 million and Federal gift tax exemption will remain at $1 million. Therefore, a GRAT may be an efficient method for a grantor to utilize the portion of the GST Exemption that exceeds the Gift Tax Exemption without the imposition of any gift tax.

Charitable Lead Annuity Trusts

A Charitable Lead Annuity Trust or CLAT, is a highly effective way to combine philanthropy with smart tax planning. A CLAT is an irrevocable trust that pays one or more named charities a specified annuity payment for a fixed term. At the end of the term, any remaining assets in the CLAT pass to the remainder non-charitable beneficiaries, usually children.

The annuity paid to the charity is stated as a fixed percentage of the initial value of the assets transferred to the CLAT. Similar to the annuity payable to the grantor in a GRAT, the charitable annuity in a CLAT can be set by a formula designed so that the discounted present value of the annuity absorbs almost the entire value of the assets transferred to the CLAT. During the CLAT term, the charity receives the entire amount of the initial transfer to the CLAT, plus interest at the appropriate AFR, which is equal to 120% of the mid-term Treasury rate (2.4% for the month of January).

Rate of Return of CLAT Assets vs. AFR

Because the value of the charitable annuity payments is determined based on the AFR prevailing at the time of establishing the CLAT, a lower interest rate will reduce the required annuity payment to charity and increases the valuation of the remainder interest passing to the non-charitable beneficiaries (typically children). Thus a lower interest rate increases the likelihood of a substantial remainder interest passing gift tax free to the non-charitable family beneficiaries at the end of the charitable annuity term

Like the GRAT, if the assets transferred to a CLAT produce a total return in excess of the AFR during the CLAT term, there will be assets remaining in the trust to pass to the remainder beneficiaries but there will be no taxable gift. Because the annuity paid to the charity is fixed at the time of the initial transfer to the CLAT, investment performance in excess of the AFR accumulates for the benefit of the remainder non-charitable beneficiaries.

If on the other hand the assets transferred to the CLAT do not outperform the AFR, the trust assets will be exhausted through the charitable annuity payments during the CLAT term and there will be no assets remaining at the end of the CLAT term to pass to the remainder beneficiaries. This outcome, however, is the same result that would occur if the assets transferred to the CLAT were instead donated directly to the charity.

Charitable Deduction

The timing of the income tax charitable deduction received by the Grantor depends on the type of CLAT created. If the CLAT is drafted as a non-grantor trust, the Grantor receives no charitable income tax deduction on the transfer of assets to the CLAT. Although the CLAT is subject to its own income taxes, the CLAT is entitled to a charitable deduction for its payment of the annuity to the charity. The CLAT’s charitable deduction is not subject to the percentage limitations applicable to individual taxpayers and may be accelerated under certain conditions to the previous tax year of the CLAT.

If the CLAT is drafted as a grantor trust, upon the formation of the CLAT, the Grantor may be entitled to an income tax charitable deduction for the discounted present value of the charitable annuity (i.e., almost the entire value of the assets transferred to the CLAT). The unused portion of the charitable deduction may be carried forward for up to five years. If the CLAT is treated as a grantor trust, the Grantor must report all income of the CLAT on his or her individual income tax return in each year of the CLAT term and will not be entitled to a charitable deduction for annuity payments to the charity.

Grantor Does Not Survive CLAT Term

Unlike a GRAT, if the grantor dies during the term of the CLAT, the CLAT assets are not taxed in the grantor’s estate because the grantor does not retain any interests in the transferred asset. However, the initial income tax deduction taken by the Grantor (if it is a grantor trust) will be recaptured and the CLAT will continue as a separate income taxpayer, with a charitable deduction allowed for each annuity payment paid to the charity.

Conclusion

All of the aforementioned estate planning strategies have risks and benefits associated with them. Depending on one’s risk tolerance, the intended beneficiaries and type and value of assets to be transferred, a technique that is appropriate for one person may not be appropriate for another. Nevertheless, in this time of market and estate tax law uncertainty, intra-family loans, sales to a grantor trust or establishing a GRAT or CLAT, can allow you to take advantage of the current low interest rates and implement a plan that allows substantial assets to pass to the next generation of beneficiaries with minimal or no gift taxes. Further, if you believe that future income and appreciation of assets will substantially outperform the low interest rates, this significantly enhances the planning.