PUBLICATION

Estate Planning in Low Interest Rate and Depressed Asset Environments

October 7, 2009

Although the current economy has resulted in lower asset values, it has provided a silver lining in the estate planning arena. Windows of opportunity exist for engaging in certain estate planning techniques to reduce gift tax, estate tax, and generation skipping transfer tax because of low interest rates and depressed asset values.

The success of the estate planning techniques relies heavily upon the interest rates that are set by the Internal Revenue Service on a monthly basis known as the Applicable Federal Rates (AFR), which are generally lower than commercial interest rates. The AFRs for October 2009 based upon annual compounding periods are as follows: short-term (loans with 3 years or less), .75%; mid-term, (loans with more than 3 years to 9 years) 2.66%; and long-term, (loans with terms of more than 9 years) 4.10%. Another extremely important rate known as the "7520 Rate" is equal to 120% of the federal mid-term rate. For October 2009 the 7520 Rate is 3.2% on certain transactions. The AFRs and 7520 Rate are the IRS's assumed rate of return for various purposes. Clients have the opportunity to leverage transfers to successive generations by taking advantage of the difference between the AFRs and actual rates of return realized by transferred assets. This spread between assumed growth and actual growth can pass to a successive generation without estate or gift tax. Just some of the more common techniques utilized to capitalize on the current low AFRs, 7520 Rate, and decreased asset values to make tax-efficient transfers to shift appreciation to another generation.

1. *Grantor Retained Annuity Trust (GRAT)*. A GRAT is a trust that a person (grantor) creates and transfers assets into for a term of years, the life of an individual, or the shorter of the two, and retains an annuity equal to the fixed percentage of the asset's fair market value at the time of the transfer. GRATs for a term of years are typically preferred. Children, grandchildren, or trust(s) for either are typically the remainder beneficiaries of GRATs. When the grantor transfers assets – such as publicly traded stock, real estate, or stock held in a closely held business – a taxable gift is made at the time of the transfer to the remainder beneficiaries. The taxable gift is determined by subtracting the value of the grantor's retained interest as determined by the 7520 Rate from the assets' fair market value at the time of the transfer. The annuity stream can be structured so that the GRAT is "zeroed-out" for gift tax purposes, thus resulting in a zero or negligible taxable gift. The GRAT will be successful as long as the grantor survives the term of the GRAT and the assets within the GRAT outperform the 7520 Rate. This is a particularly appealing planning technique for persons who are risk-averse with respect to tax planning. If the assets fail to out perform the 7520 Rate or if the grantor does not survive the term of the GRAT, then nothing is gained, but nothing is lost, either – the ultimate effect is the same as if the grantor has never created the GRAT.

2. *Charitable Lead Annuity Trust (CLAT)*. A CLAT combines philanthropy with tax planning. A CLAT is a trust that pays one or more named charities a specified annuity based upon the value of assets transferred to the CLAT. At the end of the CLAT term, assets remaining in the trust pass to the remainder beneficiaries without estate or gift tax. A taxable gift occurs upon the initial transfer to the CLAT in similar manner to a GRAT. Like a zeroed-out GRAT, a CLAT can also be structured so that there is no taxable gift at the creation of the CLAT. Unlike a GRAT however, it is not necessary that the grantor survive the term of the CLAT in order for the technique to be successful. An added benefit includes potential income tax charitable deductions.

3. *Qualified Personal Residence Trust (QPRT)*. The tax effects of a QPRT also depend upon the 7520 Rate and the amount of appreciation after the transfer, although it is advantageous to have a higher 7520 Rate with

QPRT as opposed to a lower rate. Because of the current depressed value of real estate, QPRTs can shift substantial appreciation of residences to remainder beneficiaries without estate or gift tax. With a QPRT, the grantor transfers a personal residence into a trust that has a fixed term and the grantor retains the right to live in the residence for the term. At the end of the QPRT's term, the residence passes to the remainder beneficiaries and any appreciation of the residence in excess of the 7520 Rate escapes estate and gift tax. The down sides of a QPRT are that the grantor must survive the term of the QPRT and at the end of the term the grantor must rent the residence from the remainder beneficiaries.

4. *Intra-Family Loans*. A person can make a loan based upon the AFR to a child, and potentially obtain estate and gift tax savings. If the family member/borrower can invest the loaned funds and achieve a rate in excess of the AFR or use the funds to refinance an existing loan that exceeds the AFR, then the intra-family loan results in a cost efficient way to make funds available to the family member/borrower while shifting appreciation to him or her. A balloon note is preferred because a larger amount of appreciation or growth can occur with the loaned funds before repayment of the principal.

5. *Sale to Intentionally Defective Grantor Trust (IDGT)*. The sale by a grantor of an asset to an IDGT has a number of complexities but has potential for very large tax savings. Using this technique, which works particularly well with real estate whose value is depressed or with stock in a closely-held business, a grantor sells assets to an IDGT on an installment basis in exchange for a promissory note at the AFR. This effectively freezes the value of the assets at the value of the promissory note, rather than allowing further appreciation of the assets to be exposed to estate tax. As long as the assets yield a return greater than the AFR, interest-only payments on a balloon note can be easily satisfied with the return on the assets within the IDGT. Once the note is fully paid, the IDGT passes its assets to remainder beneficiaries without estate or gift tax. It is not necessary that the grantor/seller survive the term of the note for this technique to be successful. If the note is unpaid upon the grantor's death, then the value of the unpaid portion of the note will be subject to estate tax rather than the transferred assets themselves. There are a number of complexities with this technique, and one potential downside is that if the assets inside the IDGT do not appreciate at a rate greater than the AFR, then the IDGT or remainder beneficiaries must utilize their own funds to repay the note.

The foregoing techniques are particularly effective given our current economic climate. Interest rates will eventually rise from the current rates, and those considering any of the techniques mentioned here should engage in the transaction sooner rather than later in order to lock-in the low interest rates or depressed asset value. We suggest that you speak with a tax professional concerning the many details, advantages, and disadvantages of the foregoing techniques to determine which of these is right for you. Note that the foregoing does not examine the income tax aspects of these transactions, as the focus is on estate and gift tax savings.