

Estate Planning

Estate planning in a rising interest rate environment.

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Interest rates have been gradually rising in recent months and additional interest rate hikes are anticipated.

	September 2016	September 2017	September 2018
Short-Term AFR (annual)	0.61%	1.29%	2.51%
Mid-Term AFR (annual)	1.22%	1.94%	2.86%
Long-Term AFR (annual)	1.90%	2.60%	3.02%
Section 7520 rate	1.40%	2.40%	3.40%

Rising interest rates

Rising interest rates could impact the benefit that certain estate planning strategies provide to high net worth individuals from a transfer tax perspective. A wide variety of wealth transfer techniques involve split-interest gifts or similar strategies whose potency is heavily dependent on prevailing interest rates—most commonly the applicable federal rate (AFR) or the rate prescribed in the Internal Revenue Code Section 7520 (7520 rate).

While the effectiveness of some strategies will suffer as interest rates rise, other, long-forgotten strategies, may become more effective.

Techniques that suffer from rising interest rates

INTRA-FAMILY LOANS: With an intra-family loan, the senior generation transfers funds to the younger generation in exchange for a properly

documented promissory note. For the IRS to respect the transfer as a loan and to avoid gift tax implications, the note must generally bear adequate interest at the AFR. If the growth rate of the assets transferred outperforms the AFR, any appreciation in excess of the AFR constitutes a gift-tax free transfer from the senior generation to the younger generation.

This technique works best when interest rates are lower as it allows for the transfer of more appreciation gift-tax free. As interest rates rise, the potential for a tax-free gift is reduced.

INTENTIONALLY DEFECTIVE GRANTOR TRUST INSTALLMENT SALE:

In an installment sale to an intentionally defective grantor trust (IDGT), the senior generation sells an appreciating asset to a grantor trust for the benefit of the younger generation in exchange for a promissory note bearing interest at the AFR.

To help ensure that the sale is respected by the IRS, the grantor also makes a “seed gift” to the trust, typically equal to at least 10% of the value of the asset that is to be sold to the trust. Because the trust is structured as a grantor trust, generally no gain is triggered when the grantor sells the asset to the trust and no taxable interest is generated when the grantor receives interest payments with respect to the promissory note. If the asset sold to the trust appreciates at a rate in excess of the AFR, the excess appreciation is effectively transferred gift-tax free.

As with intra-family loans, this technique works best when interest rates are lower as it allows for the transfer of more appreciation gift-tax free. As interest rates rise, the potential for a tax-free gift is reduced.

GRANTOR RETAINED ANNUITY TRUSTS: With a grantor retained annuity trust (GRAT), the grantor transfers assets to a trust and the trust pays the



grantor an annuity for a fixed number of years. At the end of the annuity term, assets pass for the benefit of the younger generation, provided that the grantor survives the term of the trust. The difference between the value of the assets transferred to the trust and the present value of the annuity payable to the grantor constitutes a taxable gift; however, most GRATs are structured to “zero-out” and result in little to no taxable gift. The present value of the grantor’s annuity interest takes into account the 7520 rate, which results in a larger annuity interest when interest rates are lower (resulting in a smaller gift) and a smaller annuity interest when interest rates are higher (resulting in a larger gift), all other things being equal. If the investments in the GRAT outperform the 7520 rate, a successful tax-free gift is made to the younger generation.

CHARITABLE LEAD ANNUITY TRUSTS:

With a charitable lead annuity trust (CLAT) the grantor transfers assets to a charitable trust. During the term of the trust, annuity payments are made to charity. At the end of the annuity term payable to charity, the remaining assets pass to the grantor’s non-charitable beneficiaries. The present value of the

annuity takes into account the 7520 rate. The difference between the value of the asset transferred to the trust and the present value of the annuity constitutes a taxable gift; however, CLATs are often structured so that the value of the gift is zero or near zero. As with GRATs, a lower 7520 rate results in a larger annuity interest for the charity and a higher 7520 rate results in a smaller annuity interest for the charity, all other things being equal. If the investments in the CLAT outperform the 7520 rate, a successful tax-free gift is made to the younger generation.

Techniques that benefit from rising interest rates

QUALIFIED PERSONAL RESIDENCE

TRUSTS: With a qualified personal residence trust (QPRT), the grantor transfers his or her personal residence (or vacation home) to a trust. The grantor retains the right to continue living in the property for a term of years, and at the end of the term, the grantor must vacate the property or pay fair market value rent. At the end of the QPRT’s term, trust assets transfer to the younger generation provided that the grantor survives the term of the

trust. The difference between the value of the residence and the present value of the grantor’s retained right to live in the residence constitutes a gift to the younger generation. The value of the grantor’s retained interest takes into account the 7520 rate. A higher 7520 rate will result in a higher value for the retained right to utilize the residence and a lower taxable gift to the remainder beneficiaries, all other things being equal.

CHARITABLE REMAINDER ANNUITY

TRUSTS: With a charitable remainder annuity trust (CRAT), the grantor transfers property to a trust and receives an annuity. At the end of the annuity term, the remaining trust assets pass to charity. When making a transfer to a CRAT, the grantor is generally entitled to a charitable income tax deduction equal to the value of the charitable gift. The value of the charitable gift is the difference between the value of the assets contributed to the CRAT and the value of the annuity interest retained by the grantor. The value of the grantor’s retained annuity interest takes into account the 7520 rate. With a higher 7520 rate, the present value of the grantor’s retained interest will decrease and the value of the remainder charitable gift will increase, resulting in a higher income tax deduction, all other things being equal.

While interest rates have been rising and are anticipated to increase further, they are still near historic lows. As a result, the present may be an opportune time to lock in wealth transfer strategies that benefit from lower interest rates. It may also be a good opportunity to evaluate estate plans with advisors and explore long forgotten strategies that may become increasingly effective as interest rates continue to increase.



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Eva joined The Nautilus Group in 2014 to assist with the development of estate and business plans. She also performs advanced tax research. Eva graduated summa cum laude with a BS in economics and finance from The University of Texas at Dallas. She earned her JD, with honors, from Southern Methodist University, where she served as a student attorney and chief counsel at the SMU Federal Taxpayers Clinic. She received her LL.M. in taxation from Georgetown University Law Center. Prior to joining Nautilus, Eva worked in private practice in tax controversy, business law, and litigation.