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## ESTATE PLANNING STRATEGIES IN VARIOUS INTEREST RATE ENVIRONMENTS

Estate planning and wealth transfer techniques are impacted by economic drivers, including prevailing interest rates. Certain strategies are most effective in lower interest rate environments, like the one we are in now, while other strategies fare better when interest rates are higher. Outlined below are strategies you may wish to take advantage of now—while rates are still relatively low—as well as strategies that are best employed when interest rates rise.

### STRATEGIES TO TAKE ADVANTAGE OF WHILE INTEREST RATES ARE STILL LOW

#### Grantor Retained Annuity Trust (“GRAT”)

A GRAT is an irrevocable trust into which you transfer property—typically property with high-growth or income-producing potential—and from which you receive back an annuity payment for a fixed term. At the end of the term, any property remaining in the trust passes to remainder beneficiaries gift-tax free. The calculation of the annuity amount is derived from a discount rate published by the IRS each month, called the 7520 rate. To the extent a GRAT’s investment performance exceeds the 7520 rate, it will remain in the trust and will pass tax-free to the trust’s remainder beneficiaries. Thus, the lower the interest rate, the lower the

“hurdle” for the strategy to be successful. Accordingly, funding a GRAT makes a lot of sense in this environment. Depending on the type of asset being transferred, clients may also consider creating GRATs of various terms to capture the low rates moving forward.

#### Charitable Lead Annuity Trust (“CLAT”)

A CLAT is a tax-efficient gifting technique that charitably-inclined clients may wish to consider. It is a trust with two types of named beneficiaries: a charitable lead beneficiary, which will receive a fixed annuity payment throughout the term of the trust, and remainder beneficiaries (typically children or other family members), who receive the assets remaining in the CLAT at the conclusion of the trust term.

A CLAT may be established during the lifetime of the donor or by Will as a testamentary trust, and it creates a charitable deduction for gift or estate tax purposes. The amount of the charitable deduction is the present value of the charitable annuity at the time the CLAT is created, calculated using the 7520 rate. Thus, the lower the interest rate, the higher the charitable deduction. If the present value of the charitable annuity equals or exceeds the value of the assets transferred

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to the CLAT, no gift or estate tax is incurred at all in funding the CLAT.

### Intrafamily Loans

Intrafamily loans are ideal for parents and grandparents who want to assist younger generations of their family through either a direct loan of cash or a loan to a trust for the family member's benefit. In order to avoid having any part of an intrafamily loan considered a gift for tax purposes, it must bear interest at a rate greater than or equal to the Applicable Federal Rate ("AFR"), as published each month by the IRS.

The IRS publishes three tiers of Applicable Federal Rates depending on the repayment term of the loan:

- (1) Short-term rates, for loans with a repayment term up to three years.
- (2) Mid-term rates, for loans with a repayment term between three and nine years.
- (3) Long-term rates, for loans with a repayment term greater than nine years.

For example, for March 2019, the short-, mid-, and long-term AFRs are 2.55%, 2.59%, and 2.91%, respectively, for loans that compound annually. Thus, for an intrafamily loan made in March 2019 with a term of less than three years, annual interest of only 2.55% must be charged to avoid any portion of that loan being treated as a gift.

### Installment Sales to Grantor Trusts

A grantor trust is a trust which is recognized for federal estate tax purposes,

but ignored for income tax purposes. That means that property transferred to such a trust will not be included in the grantor's taxable estate at death, but the grantor himself will be taxed on all of the trust's income. This is, in fact, advantageous for many reasons. One benefit is that the grantor can sell assets to the trust in exchange for a promissory note, which essentially freezes the value of the assets at the amount of the note. Since the trust is not distinct from the grantor for income tax purposes, the sale of assets to the trust does not result in recognition of capital gain. This makes the strategy especially effective for highly appreciated property.

As with intrafamily loans, the promissory note from the trust to the grantor must bear interest at the AFR in order to avoid adverse gift tax consequences. A lower AFR reduces the value of the grantor's estate, making this technique most effective in lower interest rate environments.

## STRATEGIES TO TAKE ADVANTAGE OF AS INTEREST RATES RISE

### Qualified Personal Residence Trust ("QPRT")

A QPRT is used to pass a primary residence to remainder beneficiaries—usually children—with reduced gift tax consequences. The grantor of the QPRT retains the right to live in the house rent-free for a set number of years, called the "QPRT term," and then gifts the remainder interest to the beneficiaries. The taxable gift is equal to the appraised value of

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*This publication is a summary of legal principles. Nothing in this article constitutes legal advice, which can only be obtained as a result of a personal consultation with an attorney. The information published here is believed accurate at the time of publication, but is subject to change and does not purport to be a complete statement of all relevant issues.*

the residence minus the value of the grantor's right to live in the residence, as determined by a calculation involving the applicable interest rate, the grantor's age, the value of the property, and the length of the QPRT term. A high interest rate environment means a lower present value, a lower gift value, and lower gift and estate taxes. Note, however, that in order to remove the value of the residence from the grantor's estate for estate tax purposes, the grantor must outlive the QPRT term. Additionally, the taxable gift resulting from the transfer of the property into the QPRT will reduce the grantor's unified exemption from estate and gift tax.

### Charitable Remainder Annuity Trusts ("CRAT")

A CRAT is the reverse of the previously mentioned CLAT, insofar as the annuity from the trust is payable to a noncharitable beneficiary and the remainder is payable to a charitable beneficiary. The noncharitable beneficiary receiving the annuity can be anyone, but if it is not the grantor or the grantor's spouse, the present value of the annuity—which must be between 5% and 50% of the initial value of the assets—is considered a taxable gift when the CRAT is created. The present value of the remainder that will pass to the charity—which must be at least 10% of the value of the transferred assets as determined using the 7520 rate—is deductible as a charitable contribution for income tax purposes.

As with installment sales to grantor trusts, transferring highly appreciated assets to

a CRAT will make it most effective, since a CRAT's tax status will allow the deferral of capital gain recognition. However, unlike installment sales, higher interest rates are preferable since they result in a higher annuity payout to the noncharitable beneficiary.

### Grantor Retained Income Trusts ("GRIT")

A GRIT is an irrevocable trust to which the grantor transfers assets and retains an interest in all of the net income of the trust for a set term of years. When the term of years ends, or upon the death of the grantor, the remaining assets in the trust pass to the remainder beneficiaries. The value of the grantor's retained interest in the trust reduces the value of the trust for gift tax purposes, but only if the beneficiaries are not members of the grantor's family. However, "members of the grantor's family" include only the grantor's spouse and lineal descendants of the grantor or grantor's spouse and any sibling of the grantor or the grantor's spouse. Therefore, a GRIT is effective for gifts to nieces, nephews, distant relatives, friends, or others that do not fit into the definition of "members of the grantor's family." As the 7520 Rate increases, the value of the remainder interest conversely decreases and the value of the taxable gift decreases as well.

*If you have questions about gifting strategies in various interest rate environments, please contact your Wiggin and Dana attorney.*