

ESTATE PLANNING ADVISORY

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A periodic publication of our Trusts & Estates Department, the Wiggin & Dana Estate Planning Advisory is intended to inform clients and other interested persons about issues and developments in the law affecting trust and estate administration and estate and tax planning for individuals and their families, fiduciaries, investment advisors and business owners. This issue focuses on estate planning strategies involving the use of trusts and the impact of low interest rates on such trusts.

Gift and Estate Tax Strategies in Periods of Low Interest Rates

Split-Interest Inter Vivos Trusts – GRATs, GRUTs, QPRTs, CRATs and CRUTs

Gifts made during one's lifetime, whether to individuals or charities, are usually more tax efficient than testamentary gifts. Lifetime gifts allow one to remove not only the value of the gift from one's taxable estate, but also any future appreciation in the value of the gifted property. Moreover, charitable gifts made during life usually also generate state and federal income tax deductions.

Often, however, a person making a gift is not ready to fully part with the property to be gifted, particularly if it produces income (e.g., rental properties or marketable securities). In such situations, use of "split-interest *inter vivos* trusts" can accomplish two goals: preserving an on-going interest of the donor in receiving income or being able to use the trust property, while also achieving estate tax savings through the use of lifetime gifts.

The most common forms of split-interest trusts are Grantor Retained Annuity Trusts (GRATs), Grantor Retained Unitrusts (GRUTs), Qualified Personal Residence Trusts (QPRTs), Charitable Remainder Annuity Trusts (CRATs) and Charitable Remainder Unitrusts (CRUTs). These types of trusts are called "split-interest" trusts because there are two classes of trust beneficiaries. During an initial trust term, typically, the donor retains an interest in the trust property (although the

donor may establish such a trust for the initial benefit of a spouse or other individuals). After the initial trust period ends, a different beneficiary or beneficiaries, sometimes called the "remaindermen," become entitled to the trust property. Trusts are classified as *inter vivos* trusts if they are created during the donor's lifetime.

Impact of Interest Rates. As described more fully later in this Advisory, the tax advantages that can be obtained by setting up a split interest *inter vivos* trust are directly affected by the interest rate at the time the trust is initially funded. In addition, the relative attractiveness of the different trust types often directly correlates to the prevailing interest rates during the period of time the trust is in effect. The past few years have seen interest rates at historically low levels, but some advisors are predicting that interest rates may rise in the coming years. Thus, one would want to consider the impact of current and anticipated interest rates in weighing the relative merits of different forms of split-interest trusts.

General Considerations When Making Any Lifetime Gift

Gift Taxes. Lifetime gifts may be subject to the federal gift tax. Connecticut residents must also consider the impact of the Connecticut gift tax. Both the federal and Connecticut gift tax rules allow any individual to make gifts each year up to the "annual exclusion amount" to any number of separate recipients

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without triggering a current gift tax liability. The annual exclusion amount for 2002 is \$11,000 (or \$22,000 if a married couple agrees to split gifts). Any amount in excess of the annual exclusion amount is taxed at rates ranging up to a maximum federal rate of 50% and a maximum Connecticut rate of 6%. The federal system allows each person a credit that can be applied to current federal gift tax liabilities. The credit will shelter a cumulative total of \$1 million in taxable gifts, but use of the credit towards gift taxes reduces the amount of the credit available to apply toward federal estate tax liabilities. The Connecticut system does not have a credit, but exempts an additional cumulative amount of annual gifts (currently, \$25,000) from taxes (The 2002 Connecticut budget act retroactively repeated a scheduled increase in the exempt amount to \$50,000).

Present Interests vs. Future Interests. In order to qualify for the gift tax annual exclusion, a gift must be of a "present interest." Generally, this means that the recipient has the right to immediate use of the gifted property. When gifts are made in trust, however, it is very often the case that the beneficiary does not have a right to immediate use of the gifted property. (This will almost always be the case with respect to the remainder interest in a split-interest trust.) Instead, the beneficiary has a "future interest" that will take effect at a later date. If a gift is of a future interest, the donor cannot use the annual exclusion to offset any gift tax liability.

Power of Withdrawal. Gifts in trust may be deemed to be gifts of a present interest if the beneficiary of the Trust is given a power to withdraw the amount of the gift from the Trust. This power, sometimes called a "Crummey power" after a court case dealing with the issue, is routinely used with irrevocable life insurance trusts. The right of withdrawal is usually limited; typically, it must be exercised within a stated period of time (e.g., 30 days), after which time the right lapses. In most cases, a separate right of withdrawal arises each time a gift is made to the trust.

Basis in gifted property. Under current law, one potential downside of making lifetime gifts of property to individuals (as opposed to bequeathing the property to them at death) is that the recipient of the gift will generally have

a basis in the property equal to that of the donor. Thus, when the recipient sells the property, capital gains taxes will be based on the donor's "carryover" basis. Under current law, property inherited from decedents will take a new basis equal to the fair market value of the property as of the decedent's date of death. This "step up" (or "step down," as the case may be) in basis can significantly reduce capital gains taxes on any subsequent sale of the property by the recipient.

Estate Tax Repeal. Under current law, the provisions concerning the step up in basis at death are scheduled to be repealed in 2010, at which time carryover basis will be the general rule for gifts made during one's life and at death. As of 2011, however, the estate and gift tax rules as in effect in 2001 are scheduled to return. It is widely anticipated that there will be further Congressional action with respect to the federal estate and gift taxes before 2010.

Grantor Retained Annuity Trusts (GRATs) and Grantor Retained Unitrusts (GRUTs)

GRATs and GRUTs can be an especially tax-efficient way to transfer income producing property to other individuals. If a GRAT is established, the Grantor (*i.e.*, the creator of the trust) transfers property to the trust and receives in return a fixed annuity amount for a term of years or for life. A GRUT is similar, but instead of a fixed annuity, the Grantor retains the right to receive an amount equal to a fixed percentage of the trust assets, as revalued each year. (The fixed percentage is called the "unitrust amount.") The remainder left after all of the annuity or unitrust payments are made passes to the remainder beneficiary or beneficiaries designated in the trust instrument.

A Grantor may be able to realize significant tax advantages by using a GRAT or GRUT as a vehicle to transfer property. Perhaps the most important benefit is the value ascribed to the transferred property for gift tax purposes. Because the ultimate beneficiary will not receive the transferred property for some period of time, and because the Grantor retains some of the benefits of the trust property, the value of the interest passing to the beneficiary is discounted to reflect the Grantor's retained interest. In addition, any gift tax that is paid

Estate planning in periods of low interest rates and other economic stresses can present particular challenges. Attorneys in Wiggin & Dana's Trusts and Estates Department would welcome the opportunity to review your estate plan with you and discuss steps that may help you to realize your estate planning goals and intentions. Our names and telephone numbers are listed on the back page of this Advisory.

and any appreciation in the value of the transferred assets will not be taxed in the Grantor's estate.

Impact of Interest Rates on Discounted Values.

If a GRAT or GRUT is created, the Grantor must pay gift taxes on the present value of the remainder interest (i.e., the amount passing to the remainder beneficiary). The Grantor's retained interest is not a taxable transfer and is not subject to gift taxes. To determine the value of the remainder interest that is subject to tax, one starts with the fair market value of the property on the date it was transferred to

the trust, and then subtracts the value of the retained annuity or unitrust interest held by the Grantor. Valuing this projected income stream requires the use of an applicable interest rate, which for this purpose is 120% of the Federal midterm rate as determined by the U.S. Treasury. (This rate is sometimes referred to as the "Code Section 7520 rate.") The federal midterm rate is based upon the average yield of certain marketable U.S. governmental obligations. Consequently, the value ascribed to the Grantor's retained interest and the beneficiary's remainder interest is sensitive to fluctuations in interest rates.

For example, assume a Grantor transfers stock valued at \$1,500,000 to a GRAT for the benefit of the Grantor's child, and retains the right to receive a 5% annual annuity for a term of 10 years. The Grantor will receive \$75,000 in each of the next 10 years, and at the end of the 10 year period, the GRAT trustee will distribute the remaining trust principal to the child. The table below demonstrates how a decrease in the applicable interest rate results in a smaller remainder interest, and hence, a smaller taxable gift.

Amount of Transfer	Applicable Interest Rate	Retained Interest (not taxable)	Remainder Interest (subject to gift tax)	Federal Gift Tax (2002, prior to use of credit)
\$1,500,000.00	9.0%	\$480,877.50	\$1,019,122.50	\$353,640.00
\$1,500,000.00	7.0%	\$526,770.00	\$973,230.00	\$335,360.00
\$1,500,000.00	5.0%	\$579,127.50	\$920,872.50	\$314,940.00

Significantly, the value of the property for gift tax purposes may or may not be equal to the value of the property actually received by the remainder beneficiary. Ideally, the property transferred to the trust will appreciate in value at a greater rate than is needed to make the annuity or unitrust payments.

Qualified Personal Residence Trusts (QPRTs)

A QPRT is a split interest trust where the Grantor transfers a personal residence to a trust and retains the right to use the residence for a specified period of time. At the expiration of the stated time period and assuming the Grantor is still living, the residence is transferred to the remainder beneficiaries designated in the trust, either outright or in further trust for their benefit. Because of the transfer to the remainder beneficiary, the personal residence is not includable in the Grantor's taxable estate. If the Grantor does not survive the initial trust term, the per-

sonal residence is included in the Grantor's taxable estate, but a credit for the prior gift tax paid is allowed. A QPRT can be an ideal vehicle for transferring a family vacation home to children or grandchildren at a reduced tax cost.

As with a GRAT and GRUT, the retained interest of the Grantor in a QPRT reduces the value of the gift in trust for gift tax purposes. With QPRTs, however, the calculation of the present value of the retained interest includes a factor relating to the Grantor's life expectancy. Moreover, unlike GRATs and GRUTs, QPRTs may be more tax-efficient in times of high interest rates.

For example, assume a 65 year old Grantor creates a 10 year QPRT holding a personal residence valued at \$500,000. With a QPRT, a lower interest rate results in a smaller retained interest and a larger remainder interest. The remainder interest is subject to gift tax.

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	Value of Personal Residence	Applicable Interest Rate	Retained Interest (not taxable)	Remainder Interest (subject to gift tax)	Federal Gift Tax (2002, prior to use of credit)
	\$500,000.00	9.0%	\$339,450.00	\$160,550.00	\$42,176.00
	\$500,000.00	7.0%	\$306,800.00	\$193,200.00	\$52,624.00
	\$500,000.00	5.0%	\$266,650.00	\$233,350.00	\$65,472.00

Charitable Remainder Annuity Trusts (CRATs) and Charitable Remainder Unitrusts (CRUTs)

CRATs and CRUTs are split interest trusts where a charity is the ultimate beneficiary of the remainder interest. Because of the ultimate charitable use of the trust assets, the trust itself is treated as a tax-exempt entity and can buy and sell trust assets without regard to income and capital gains tax considerations. For that reason, a CRAT or CRUT can be a good way for a donor with charitable intentions to diversify a portfolio at a reduced tax cost, and, in many cases, to significantly increase the donor's current income.

In most cases, the donor (or the donor and his or her spouse) retains an interest in the trust assets for a term of year or for life. This is a non-taxable retained interest. In some cases, however, the donor will direct that the retained interest be paid to another individual, such as a child or

other person the donor wishes to provide for. In that case, the value of the retained interest is treated as a taxable gift. As with GRATs and GRUTs, the retained interest can take the form of fixed annuity payments or a unitrust payment amount recalculated annually. After the payment period is over, the then remaining trust assets pass to a charity or charities.

With CRATs and CRUTs the Grantor receives both an income tax and gift tax deduction for the present value of the charitable remainder interest, and must pay gift tax only to the extent of the non-charitable portion of the transfer (e.g., if the Grantor directs that another person receive the retained interest). Unlike GRATs and GRUTs, however, the Grantor will generally seek to value the remainder interest using the highest Section 7520 rate allowable, as the higher assumed rate of return will increase the value of the charitable remainder interest and consequently increase the amount of the income and gift tax charitable deductions available to the Grantor.

For example, assume a Grantor makes a \$500,000 transfer to a CRAT, paying an 8% annual annuity to a child for a term of 10 years. The child will receive \$40,000 a year (\$500,000 x 8%) for the ten year trust term. The Grantor will be subject to gift taxes for the value of this gift to the child, but will also be entitled to a charitable deduction equal to value of the remainder gift to a charity. As shown in the chart, the higher the applicable interest rate, the greater the Grantor's charitable deduction and the lesser the value of the taxable gift to the child.

	Amount of Transfer	Applicable Interest Rate	Taxable Transfer to Child	Deductible Charitable Remainder Interest	Federal Gift Tax (2002, prior to use of credit)
	\$500,000.00	9.0%	\$256,708.00	\$243,292.00	\$73,081.00
	\$500,000.00	7.0%	\$280,944.00	\$219,056.00	\$81,321.00
	\$500,000.00	5.0%	\$308,868.00	\$191,132.00	\$90,815.00

Although interest rates should not be the sole determining factor as to whether one creates a particular type of irrevocable trust, the above discussion illustrates that the prevailing interest rates may have a significant impact on the ultimate tax consequences, and, thus, warrants careful consideration during the planning process.