BLAIR & POTTS
ATTORNEYS

# TRUSTS & ESTATES ADVISORY

## Estate Planning Techniques In A Low Interest Rate Environment

Interest rates remain at historic lows and it seems that rates will not be rising as quickly as most commentators once thought. Consequently, there are several estate planning techniques clients should consider to maximize the amount of assets that they can pass in a tax efficient manner. The focus of this Client Advisory is to highlight some options that are available to clients.

The common theme in all of the methods discussed in this Advisory is the "estate freeze." A client is "freezing" his or her interest in gifted or sold assets, and passing future appreciation to his or her beneficiaries. The most effective estate freeze techniques are the following:

- Intra-Family Loans
- Grantor Retained Annuity Trusts (GRATs)
- Charitable Lead Annuity Trusts (CLATs)
- Sales to Intentionally Defective Grantor Trusts (IDGTs)

Each month, the Internal Revenue Service issues the Applicable Federal Rate ("AFR") which is the minimum interest rate a client may charge on a loan and the "Section 7520" rate which is used to calculate a client's retained interest in a GRAT or CLAT. These rates will increase as interest rates increase. Consequently, it makes sense to consider an Intra-Family Loan, GRAT, CLAT or sale to an IDGT while rates remain at their current levels.

To provide some context, the June 2016 Section 7520 rate is 1.8%, and its historic high was 11.6% in 1989. The following chart shows the history of the section 7520 rate:

With these remarks in mind, we have set forth below a brief explanation of Intra-Family Loans, GRATs, CLATs and Sales to IDGTs. Each technique has its benefits, but adds some complexity to a client's estate plan. Please keep in mind that the focus of this Advisory is the potential reduction in a client's transfer tax liabilities. We are always mindful of non-tax factors when determining what makes sense for a client and his or her family.

## INTRA-FAMILY LOANS

If a child is purchasing a home, or starting a new business, clients should consider making a loan to the child to fund the purchase or business venture. The value of the loan will not increase because a client only has the right to receive payments of interest and principal. The future appreciation in the residence, or assets purchased by a child, will pass to him or her.

The loan must be memorialized in writing (a "Note") and, if necessary, can be secured by a mortgage. These steps will eliminate any future uncertainty regarding the loan and will provide clients with some protection from future marital, medical or other creditors of their children. In addition, by recording the mortgage, the child may be able to report any interest paid as a deduction on his or her personal income tax returns.

The interest that must be charged will equal the AFR in effect for the month the loan occurs. The AFR will be much less than the interest rate a child would receive from a bank or brokerage firm. The following chart sets forth the AFRs for June 2016:

| | Payments | | | |
|---|---|---|---|---|
| **Loan Term** | **Annual** | **Semi-Annual** | **Quarterly** | **Monthly** |
| 3 years or less | .64% | .64% | .64% | .64% |
| more than 3 years and 9 years or less | 1.41% | 1.41% | 1.41% | 1.41% |
| more than 9 years | 2.24% | 2.23% | 2.22% | 2.22% |

The current 15-year jumbo mortgage rate is approximately 3.625% and the 30-year jumbo mortgage rate is 3.375%. Consequently, interest rates a client must charge are considerably lower than the mortgage rates charged by banks. This will minimize interest payments a child must make during the term of the loan.

The Note can be flexibly drafted to meet a client's particular goals. For example, a client can choose the duration of the loan to minimize the interest rate. In addition, the Note can provide for payments of interest only, payments of interest and principal on a monthly basis, or a balloon payment of principal on a certain date. If the goal is to reduce a child's payments, interest only loans may be the best choice.

For many clients, an Intra-Family Loan strikes the right balance between helping, but not giving too much. Clients help by reducing a child's potential interest payments. By having a child make payments of interest and principal ensures that he or she will take responsibility for the loan's repayment.

## GRANTOR RETAINED ANNUITY TRUSTS (GRATs)

An alternative would be the creation of a GRAT. Pursuant to a GRAT, a client would transfer property (i.e., stock, bonds, closely held business interests, etc.) to a trust, while retaining the right to receive an annuity for a specified term of years. The transfer to the trust is a taxable gift, but the value of a client's right to receive the annuity payments reduces the size of the gift. Currently, GRATs can be drafted so that the value of the property transferred to the GRAT is equal to the value of the annuity payments. This arrangement is commonly referred to as a "zeroed out" GRAT. If a client survives the GRAT term, any appreciation in the trust's assets in excess of the Section 7520 rate will pass to his or her beneficiaries transfer tax-free.

The table below sets forth the amount of property that would pass to a client's beneficiaries if he or she survived the GRAT term based on the following assumptions:

1. Client contributes $5,000,000 in June 2016.
2. The 7520 rate for June 2016 is 1.8%.

| Growth Rate | Beginning Principal | Growth in Trust Assets | Annuity Payments | Remainder Passing to Beneficiaries |
|---|---|---|---|---|
| 5% | $5,000,000 | $395,693.95 | $5,139,466.00 | **$256,227.95** |
| 10% | $5,000,000 | $816,387.90 | $5,139,466.00 | **$676,921.90** |
| 15% | $5,000,000 | $1,262,081.85 | $5,139,466.00 | **$1,122,615.85** |

As the chart demonstrates, a GRAT offers clients the opportunity to pass a substantial amount of assets to their children without paying any federal or state gift taxes. A zeroed out GRAT has been approved by the Internal Revenue Service and the United States Supreme Court. Consequently, creating a GRAT provides little or no audit risk for a client.

We recommend that the GRATs be drafted for a two-year term, and the annuity payments received will be "rolled" into a new two-year GRAT. Studies have shown that a two-year rolling GRAT program increases the likelihood of passing assets to beneficiaries. The shorter term reduces a GRAT's market exposure and the rolling of the annuity payments allows clients to take advantage of any market fluctuations.

## CHARITABLE LEAD ANNUITY TRUSTS (CLATs)

If you are charitably inclined, creating a CLAT can be another attractive option. Similar to a GRAT, a CLAT provides for payments of an annuity to a charity for a term of years (the "annuity period"), with the balance distributed to your family at the end of the annuity period. The transfer of the assets to the CLAT is a taxable gift. However, the value of the charity's interest in the CLAT qualifies for the charitable deduction from the gift tax and reduces the size of the taxable gift. A CLAT can also be drafted so that the value of the charity's interest equals the value of the assets contributed ("zeroed-out CLAT").

Similar to GRATs, if during the annuity period the CLAT's assets appreciate at a higher rate than the Section 7520 rate, the excess will pass to your remainder beneficiaries free of federal estate and gift taxes. A CLAT is a good choice for clients who wish to combine the fulfillment of charitable goals with the potential transfer of wealth to family in a tax-efficient manner.

The chart below illustrates the potential benefits of creating a CLAT under the following factors:

1. Client contributes $5,000,000 to the CLAT.
2. Client's age corresponding to nearest birthday is 60.
3. The 7520 rate for June 2016 is 1.8%.
4. Charitable Term is for 20 years.

| Growth Rate | Beginning Principal | Growth in Trust Assets | Total Payments to Charity | Remainder Passing to Beneficiaries |
|---|---|---|---|---|
| 5% | $5,000,000 | $4,347,355.61 | $5,999,000 | **$3,348,356** |
| 10% | $5,000,000 | $17,456,863.68 | $5,999,000 | **$16,457,864** |
| 15% | $5,000,000 | $52,103,734.39 | $5,999,000 | **$51,104,734** |

With a CLAT, we must consider who the ultimate beneficiary of the assets will be. If grandchildren or more remote descendants are potential beneficiaries, we must consider any implications of the generation-skipping transfer tax.

## SALES TO INTENTIONALLY DEFECTIVE GRANTOR TRUSTS (IDGTs)

Another effective estate planning technique is a sale to an IDGT. The sale is a more sophisticated estate planning technique. If a client would like to make a sale to an IDGT, the following steps are necessary:

1. The Grantor creates an IDGT to be the recipient of the Grantor's gifts.
2. The Grantor will gift the IDGT with "seed" money. A number of United States Tax Court cases suggest that an IDGT should have assets equal to 10% of the assets to be purchased. The seed money provides the IDGT with assets to make future loan payments.
3. The Grantor sells assets to the IDGT, and the IDGT pays the purchase price with a Promissory Note to the Grantor. The Note will bear interest equal to the AFR.
4. The IDGT will make interest payments to the Grantor each year.

As with loans, GRATs and CLATs, sales to IDGTs limit a client's interest in the future appreciation of the sold assets to the interest rate charged on the loan. If the IDGT's assets appreciate at a higher rate than the AFR, the excess appreciation would pass to a client's descendants free of federal and state gift and estate taxes.

An IDGT is an irrevocable trust over which the Grantor retains a power that causes the income of the trust to be taxed to the Grantor rather than being taxed to the trust. This is an excellent estate planning result since during the Grantor's lifetime the trust assets will be allowed to grow undiminished by the payment of state and federal income taxes. Under current law, the payment of taxes by the Grantor is not considered an additional gift to the beneficiaries of the trust. In addition, there are no negative income tax consequences relating to the sale or the payment of interest by the IDGT to the Grantor. However, at some point, thought should be given to having the IDGT pay the Note in full to avoid any potential negative income tax consequences that could occur if the Grantor dies prior to full repayment of the loan.

## CONCLUSION

A low interest rate environment provides clients with many good alternatives to pass assets to their family in a tax efficient manner. Clients should keep in mind that for the past several years, the U.S. Congress has been looking at ways to increase revenue. With respect to GRATs and CLATs, bills have been introduced that would prevent people from creating a zeroed-out GRAT or CLAT. In addition, future changes may also require that GRATs have a minimum term of ten years. With respect to a sale to an IDGT, there have been rumblings that Congress may no longer allow future trusts to be classified as a Grantor trust for income tax purposes.

Consequently, this may be an ideal time for clients to consider an Intra-Family Loan, GRAT, CLAT or sale to an IDGT. Please contact us at 203-327-2333. We would be happy to discuss these techniques in further detail to determine if they might work well as part of your estate plan.

The Blair & Potts Trusts and Estates Advisory is a periodic publication. Nothing in this advisory constitutes legal advice, which can only be obtained as a result of personal consultation with an attorney. The information published here is believed to be accurate at the time of publication, but is subject to change and does not purport to be a complete statement of all relevant issues. U.S. Treasury Circular 230 Notice: Any U.S. federal tax advice included in this communication was not intended or written to be used, and cannot be used, for the purposes of avoiding U.S. federal tax penalties.

Four Stamford Plaza 107 Elm Street Stamford, Connecticut 06902
Telephone: 203-327-2333 Fax: 203-327-1731 email: admin@blairandpotts.com