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Raising Interest Rates and Legacy Planning

Situation: Interest rates factor into the performance of many legacy and charitable planning techniques. Over the past several years, the historically low interest rates, and the availability of high gift and estate exemptions have provided a unique environment for certain legacy and charitable planning techniques. Specifically, in low interest rate environments grantor retained annuity trusts (GRATs), charitable lead annuity trusts (CLATs), intra-family loans and installment sales to grantor trusts work best. However, relatively small shifts in interest rates can have a disproportionate effect on the performance of these rate-sensitive legacy planning techniques. The Increase in interest rates over the past year has changed the economics and shifted the focus to other techniques.

With the shift in Interest rates there has been renewed interest in certain legacy and charitable planning strategies that benefit from a high interest rate environment. Techniques that benefit from a higher interest rate environment include qualified personal residence trusts (QPRTs) and charitable remainder annuity trusts (CRATs). This Counselor's Corner describes some of the legacy planning techniques impacted by interest rates and the role of life insurance.

Solution: Before describing some of the most common planning techniques impacted by interest rates, we need to understand the rates used by the strategies. Two federally-set interest rates directly impact legacy planning: applicable federal rate (AFR) and §7520 rate.

Each month the Internal Revenue Service publishes short, mid and long-term AFR and §7520 rates. All the rates are calculated based on the yields of certain government debt obligations. Short-term AFR rates are determined from the one-month average of the market yields from marketable obligations such as U.S. government T-bills with maturities of three-years or less. Mid-term AFR rates are from obligations of maturities of more than three years and up to nine years. Long-term AFR rates are from bonds with maturities of more than nine years. The §7520 rate is fixed at 120% of the annual mid-term AFR for the month in which the valuation date falls.

- Applicable Federal Rate is the minimum interest rate that can be charged for loans between related parties.
- The §7520 rate is the rate used to calculate annual payments on such planning strategies as GRATs, CLTs, CRTs, and QPRTs.

Strategies for A Low Interest Rate Environment

When interest rates were low clients wanted to lock into techniques that work best in a low interest rate environment. At their core, these techniques involve lending strategies that leverage the low interest rates to transfer the appreciation on assets to younger family members at little or no gift tax.

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The federally-set interest rate reflects the hurdle that the assets growth must exceed before the strategy will work to transfer value to the younger family members. These techniques enable senior family members to “freeze” the value of the assets that they lend for estate tax purposes while passing the asset’s appreciation over the interest rate hurdle to younger family members. The lower the federally-set interest rate the greater the likelihood that some appreciation will be transferred to the younger generation as well as lowers the interest paid to the grantor (that is ultimately included in the grantor’s estate).

Techniques used in a low interest rate environment will appeal to clients with the following profile:

- Clients who have exhausted their exemption or who wish to preserve their exemption for the transfer of other assets.
- Clients who desire to obtain a basis step-up on assets at death.
- Clients who desire to retain an income stream from the transferred assets.
- Clients nervous about parting with wealth.

Techniques used in a low interest rate environment include the following:

Intra-Family Loans & Installment Sales to an Intentionally Defective Grantor Trust. These two planning techniques will work when the asset growth exceeds the AFR.

1 ***Intra-family loans***

The simplest way to plan in a low interest rate environment is for the wealthy client (lender) to make a cash loan to a younger family member (borrower) whom the client desires to benefit. The loan can be structured as an interest-only loan with a balloon payment on maturity. To the extent that the borrow on the loan earns a rate of return exceeding the AFR the lender will successfully transfer wealth.

2 ***Installment sales to an intentionally defective grantor trust***

This transaction is like an intra-family loan except with this technique the borrower is a trust created by the wealthy client. Specifically, the trust is an irrevocable grantor trust established by the wealthy client/ lender. With this technique the wealthy client sells an asset to his/her grantor trust in return for an installment note at an interest rate equal to the AFR. Like the intra-family loan this note back to the grantor can be structured as an interest-only loan with a balloon payment on maturity. Since the trust is a grantor trust the sale between the wealthy client and the trust is not recognized for tax purpose. Furthermore, as a grantor trust the wealthy client is required to pay the tax earned on the assets in the trust. As a result, the assets inside the trust grow income tax-free. To the extent the assets in the trust grow at a rate exceeding the AFR the excess appreciation accrues to the trust beneficiaries free of gift tax.

GRATs & CLATs. These two techniques will work when the asset’s growth exceeds the §7520 rate.

3 ***Grantor retained annuity trusts (GRATs)***

With a GRAT the wealthy family member (grantor) funds an irrevocable trust that pays the grantor an annuity income for a fixed period established by the grantor. This transaction is like the installment sale except the payments to the grantor cannot be interest only (must include principal and interest) and the interest rate is the §7520 rate which is higher than the short and mid-term AFRs. At the end of the trust term the value remaining in the trust passes to the designated trust beneficiaries. If the trust earns a rate of return exceeding the §7520 rate the excess amount accrues to the trust beneficiaries. However, the economic benefits of this strategy are often not as great as the sale to the intentionally defective grantor trust since the annuity payment to the grantor includes principle and is often at a higher interest rate. Individuals often create a series of short-term rolling GRATs rather than a single long-term GRAT. Often the short term GRATs are structured as "zeroed-out GRATs" meaning the present value of the annuity payment, based on the §7520 rate, equals the fair market value of the assets contributed to the GRAT, meaning there should not be a taxable gift.

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Charitable lead annuity trusts (CLATs)

This transaction is like a GRAT except a charity, not the grantor, receives the annuity income payment and funding the CLAT (structured as a grantor trust) can give the grantor an immediate charitable income tax deduction. However, in future years income paid to the charity is taxable to the grantor. This technique tends to be appealing to taxpayers with a spike in income for a single year. Of course, the ability to take the full charitable deduction for the amount contributed to the grantor CLAT is subject to the various percentage and other limitations and requirements imposed on charitable income tax deductions. Any unused deduction can be carried forward for up to five years.

Unlike GRATs, CLATs can choose to use the §7520 rate in the month of creation or the rate from one of the prior two months. CLATs can also be structured as a non-grantor trust for income tax purposes in which case the grantor does not receive an income tax deduction for the contribution to the CLAT and t is also not taxed on the trust income. Rather the CLAT reports the taxable income and receives the charitable deduction.

Role of Life Insurance

The above strategies are typically referred to as estate freeze techniques because when successful they remove the appreciation on an asset from the estate, freezing an estate at its current value. So, where the client has a taxable estate prior to implementing the strategy s/he will continue to have a taxable estate – thus a continuing need for life insurance for estate liquidity. Furthermore, since the success of estate freeze strategies are closely linked to a client's life expectancy life insurance can serve as protection if an unexpected early death occurs.

Proposed Legislation

President Biden's recently released 2024 budget would significantly change the impact of several low interest rate estate planning techniques if enacted into law. Specifically, the proposal would dramatically alter the effectiveness of GRATs and Sales to Intentionally Defective Grantor Trusts. One proposal would reduce the effectiveness of GRATs by requiring a 10-yeear minimum period and minimum 25% remainder value, thereby prohibiting the use of the popular "zeroed-out GRAT" technique. Another proposal would cause the grantor to recognize gain on the sale of appreciated assets to a grantor trust and taxes paid by the grantor of a grantor trust to be considered adjusted taxable gifts if not reimbursed by the trust.

Strategies for A High Interest Rate Environment

Over the past several years planning techniques such as QPRTs and CRATs have been ignored because of the low interest rate environment. However, as interest rates increased there has been a renewed interest in these strategies.

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Qualified personal residence trusts (QPRTs)

With a QPRT technique a wealthy grantor transfers a personal residence (principal or vacation) to a trust which benefits the grantor for a period of years and at the end of the term it passes to the remainder beneficiary. So, a QPRT is like a GRAT in that the grantor retains an interest in the trust. During the term of years, the grantor may continue to use the residence as his or her own. If the grantor wants to continue to live in the home after the period of years ends, the trust or the beneficiaries can rent it to the grantor. The initial transfer of the residence to the trust is a taxable gift of the remainder interest calculated using the applicable §7520 rate.

The higher the rate the higher the grantor's retained right to use the residence and the lower the remainder interest. So, as the §7520 rates raise the taxable gift of the remainder decreases. At the end of the grantor's retained period the residence passes without additional gift tax and is removed from the grantor's estate.

Charitable remainder annuity trusts (CRATs)

A CRAT is the reverse of a CLAT in that the grantor receives the annuity income stream in a CRAT. With a lifetime CRAT a grantor creates and funds an irrevocable trust which distributes a stated annual annuity amount to specific non-charitable beneficiaries which can include the grantor and grantor's spouse. The annuity amount is typically a stated percentage of the trust value which must be at least 5%, but not more than 50%. The annuity income may be paid for: (1) the lifetimes of the noncharitable beneficiaries; (2) a term of up to 20 years; or (3) the shorter or longer of these time periods. At the end of the period the remainder passes to one or more charities, private foundations, donor advised funds etc. To qualify the charitable remainder interest must be equal to at least 10%.

A CRAT is a tax-exempt trust. As a tax-exempt trust if the CRAT is funded with appreciated assets which are subsequently sold, the CRAT will not recognize taxable income/gain. However, the non-charitable beneficiaries will incur income tax on the subsequent CRAT distributions. Furthermore, with a lifetime CRAT, the grantor may obtain a charitable income and gift tax deduction which are determined using the §7520 rate. A higher §7520 rate provides a greater discount in calculating the present value of the annuity income interest received by the non-charitable beneficiaries, thereby increasing the value for the charitable remainder interest, and generating a larger charitable deduction. Of course, the ability to take the full charitable deduction for the amount contributed to the grantor CLAT is subject to the various percentage and other limitations and requirements imposed on charitable income tax deductions. Any unused deduction can be carried forward for up to five years.

Role of Life Insurance

Life insurance may be suggested in tandem with a charitable remainder trust. With this strategy life insurance is used to make the family whole by replacing the value of assets donated to charity with the proceeds of a life insurance policy.

Proposed Legislation

The proposed budget also negatively impacts CRATs. Under one proposal transfer of appreciated assets would result in realization of the built-in gain in proportion to the non-charitable beneficiaries' interest. So, if 90% of the trust benefits non-charitable beneficiaries 90% of the built-in gain is recognized at the time the trust is funded.

In Summary

As interest rates increased over the past year CRATs and QPRTs have gained renewed interest. President Biden's recent budget proposals will make many of the low interest rate environment techniques less effective if they become law.