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Fiduciary
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Tax Perspectives

Wealth Transfer Options

Best Choices in the Current Interest Rate Environment

Investors are well advised to take into account the interest rate environment when considering wealth transfer options. Interest rates are important when establishing trusts, reviewing existing estate plans, and lending money to family members. The current rates used to value wealth transfers are near historic lows.

INTEREST RATE CONDITIONS AFFECT WEALTH TRANSFERS

The interest rate generally used to value transfers involving trusts, known as the 7520 rate, is linked to auctions of U.S. Treasury notes with 3- to 9-year terms and is calculated monthly by the IRS. The September 2011 rate is 2.0%, compared to a high of nearly 12% in 1989.
The 7520 interest rate (also called the "hurdle rate," because the goal is to beat that rate) is key to determining the potential amount that may be passed tax-free to beneficiaries on the termination of the trust.

Following is an examination of wealth transfer options that work well when created under lower interest rate conditions.

GRANTOR RETAINED ANNUITY TRUST OFFERS POTENTIAL FOR TAX-FREE TRANSFER

A Grantor Retained Annuity Trust (GRAT) is an irrevocable trust into which the grantor (creator of the trust) transfers assets and retains the right to receive, at least annually, payment of a fixed dollar amount (the annuity) for a specified term of years (GRAT term). At the end of the GRAT term, the trust's remaining assets pass to designated beneficiaries, who are generally family members, tax-free.

Tax-free Transfer to Family Members. The IRS assumes that a GRAT will grow at a rate equal to the 7520 rate at the time the trust is established. Using September 2011's 7520 rate, the IRS assumes that assets in a trust created that month will grow by 2.0% per year. The IRS does not look at the actual growth of the assets; therefore growth surpassing the assumed rate can be passed on to trust beneficiaries gift and estate tax-free. The lower the hurdle or interest rate, the larger the potential gift. For the trust vehicle to be compelling, the grantor must be willing to bet that the actual return earned will be higher than the hurdle rate. A GRAT makes an excellent wealth transfer option in a low interest rate environment because it is easier to outperform the hurdle rate than in a high interest rate environment.

Minimizing GRAT Gift Tax Costs. Setting up a GRAT can trigger a taxable gift. The IRS predicts the future value of trust assets based on the 7520 rate and subtracts the value of the annuity payments to be made to the grantor. If this calculation shows there will be assets left over at the end of the trust's term, the transfer of those assets will be treated as a taxable gift. To minimize gift tax costs, the annuity amount is generally set so that the present value of the annuity payments over the GRAT term will equal or almost equal the value of the property contributed to the GRAT. As a result there is little or no taxable gift (called "zeroing out"). The lower the 7520 rate, the lower the annuity amount needed to effect a zeroing out.

Minimizing Risk of GRAT Failure. If the grantor dies during the GRAT term, all the trust property will likely be included in the grantor's estate for estate tax purposes. In that case, no transfer tax savings will be associated with the creation of the GRAT, but the situation will be no worse than if the grantor had done nothing. To minimize the risk of death during the GRAT term, the grantor may choose to structure a series of shorter-term GRATs, rather than one longer-term GRAT. A series of shorter-term GRATs also has the benefit of, in effect, placing a series of bets—some GRATs may fail (with no downside other than lost setup costs) but others will likely succeed. This enables a grantor to capitalize on market volatility by locking in the tax-free transfers in the GRATs which outperform the hurdle rate.

A longer-term GRAT has the benefit of (1) locking in a low interest rate for the entire term of the GRAT and (2) taking advantage of current favorable law (which may change in the future) that enables a grantor to create a GRAT with little or no gift tax consequence. However, with a longer-term GRAT, it is more likely that positive and poor investment performance will offset each other over the term. This reduces the likelihood of beating the hurdle rate and successfully passing assets tax-free to trust beneficiaries.

Income Tax Advantages. Another advantage of a GRAT is that it is a "grantor trust." This means that the grantor is considered the "owner" of the trust for income tax purposes and is taxed on all of the income. Payment of the income taxes by the grantor is, in effect, a further tax-free gift to the trust beneficiaries since the trust assets can grow without reduction for income tax payments.

CHARITABLE LEAD ANNUITY TRUST OFFERS POTENTIAL TAX-FREE TRANSFER WITH A CHARITABLE BENEFIT

A Charitable Lead Annuity Trust (CLAT) is similar to a GRAT, except the annuity payment is made to charity. The annuity must be paid out periodically, at least annually, usually for a specified number of years. At the end of the trust's term, the remainder interest must be distributed to one or more non-charitable beneficiaries (usually family members). A gift tax is payable with respect to the transfer of the assets to the non-charitable beneficiaries.

Tax-free Transfer to Family Members. Like GRATs, CLATs work best in a low interest rate environment because, if the trust's investment performance exceeds the 7520 rate, the assets left in the trust at the end of the term will pass to family members tax-free. Accordingly, the lower the 7520 rate, the larger the potential gift. With a CLAT, the grantor can elect to use the 7520 rate in effect during the month of the trust's creation, or (if lower) the rate in either of the two preceding months.

If the trust's investment performance underperforms the 7520 rate, the principal of the trust will be exhausted by the charitable payments and nothing will be left for the family—but all the assets will have passed to charity.

Minimizing CLAT Gift Tax Costs. The value of the property passing to charity is calculated using the 7520 rate, and the remainder is subject to gift tax. The lower the 7520 rate, the higher the gift tax charitable deduction, which reduces the amount of the taxable gift. If the annuity payments to charity are set so they equal or almost equal the value of the property transferred to the trust, there should be little or no gift tax cost to the transfer since a gift tax charitable deduction is available for the amounts passing to charity. A CLAT is a good choice for people who want to combine their philanthropic pursuits with a wealth transfer option.

INTRA-FAMILY LENDING OFFERS POTENTIAL TAX-FREE TRANSFER WHILE LENDING A HAND

Another technique that works well in a low interest rate environment is intra-family lending, provided the loan is structured properly and fully documented. The IRS has established special interest rates for loans (known as "Applicable Federal Rates" or "AFRs"), which are set monthly. (See Table on the right).

September 2011 Applicable Federal Rates (AFRs)

LOAN TERM	Annual	Semi-annual	Quarterly	Monthly
3 years	.26%	.26%	.26%	.26%
3–9 years	1.63%	1.62%	1.62%	1.61%
> 9 years	3.57%	3.54%	3.52%	3.81%

Because these rates are considerbly lower than the average 30-year mortgage rate of 4.22% as of August 25, 2011, now may be an ideal time to lend family members money for mortgages and other purposes—and to consider *renegotiating* outstanding loans to take advantage of the current low rates.

No Gift Tax Liability. Intra-family mortgage lending can be a good way to assist family members without incurring gift tax liability. In addition to lower interest rates, other benefits include having the total interest expense over the life of the loan stay within the family instead of being paid to a bank, and allowing children with poor or no credit history to buy a home. In addition, it allows families to avoid expenses for administrative costs such as closing costs and appraisal fees. The lender can also forgive part of the loan each year up to the annual gift tax exclusion amount ($13,000 for 2011), without a gift tax consequence. This will lower the principal balance ultimately paid at the expiration of the term, and reduce the size of the loan drawing interest.

Potential drawbacks exist, however. Parents or children (or both) might not be comfortable in this type of lending relationship, and gift taxes may arise if interest payments fall behind. In addition, unlike a bank loan, the borrower cannot establish a credit rating through this kind of lending relationship.

Loan to Trust Benefiting Family Members. An intra-family loan does not necessarily have to be established for the purpose of acquiring a residence (although a benefit of doing so is the potential deductibility of the interest payments). In a low interest rate environment, a loan can be an attractive estate planning tool on its own. To the extent the borrower is able to earn a rate of return on the borrowed funds that exceeds the applicable interest rate being paid, the borrower keeps the excess without a transfer tax cost.

Ordinarily, the interest payments would be included as income on the lender's income tax return. However, it is also possible to structure the loan to a trust for the benefit of family members. If the trust is a grantor trust, which is transparent for income tax purposes, the interest payments on the loan will not have an income tax consequence. Additionally, the income and gains of the trust would be taxable to the grantor, leaving the trust to grow for the benefit of family members without reduction for income tax liability.

SALE TO GRANTOR TRUST PRESENTS ANOTHER OPPORTUNITY FOR TAX-FREE TRANSFER

Another attractive planning strategy is the sale by a grantor to a grantor trust of property that is expected to appreciate. In return, the grantor receives a promissory note, with interest payable at the current low rates previously referenced. As with the loan technique, if the property sold to the trust earns a higher rate of return than the interest payable on the note, the excess represents a tax-free transfer to the trust. The property that is sold to the trust should generate enough cash flow to pay down the note.

Seeding is Recommended. After the grantor creates an irrevocable grantor trust, the trust is "seeded" by the grantor with sufficient funds to use as a cash down payment for the purchase. The seeding is advisable in order to establish that the sale is genuine. It is generally recommended that an amount equal to at least 10% of the property be contributed by the grantor for the down payment. That 10% transfer will constitute a taxable gift, but beginning in 2011 every individual has a $5,000,000 lifetime exemption from the gift tax which can be utilized to reduce or eliminate any current gift tax cost. The seeding contribution is used by the trust to purchase the asset from the grantor, and the balance of the purchase price is payable with a promissory note, bearing interest at the minimum IRS rates.

Maximizing Leverage. It may be possible to structure the installment note as an interest-only note, with a balloon principal payment at the end of the term. In contrast to a note payable in equal installments, if an interest-only note is utilized, the principal remains in trust (and continues to appreciate in value) for the maximum period of time.

Income Tax Advantages. Since the trust is structured as a grantor trust, the grantor is treated as the owner of the trust for income tax purposes (but the trust property is not included in the grantor's estate for estate tax purposes). Due to the grantor trust status, there is no capital gain recognized when the property is sold to the trust, and the interest payments to the grantor do not constitute taxable income. The grantor is responsible for the taxes on income and capital gains generated by the trust, so the trust property can grow income tax-free.

Estate Tax Advantages. If the grantor outlives the term of the promissory note, the assets are completely removed from his estate. However, even if the grantor dies prior to full payment, only the outstanding balance of the note is includable in his estate for estate tax purposes (unlike the GRAT, which typically fails if the grantor dies during the term).

Minimizing the Risk of Gift Tax. The assets sold to the trust should be professionally appraised. If the IRS revalues the assets at a higher value than the sales price, the excess will be deemed a gift, triggering gift tax liability.

QUALIFIED PERSONAL RESIDENCE TRUST PRESENTS AN OPPORTUNITY NOT TO BE OVERLOOKED

In a qualified personal residence trust ("QPRT"), a grantor transfers a residence or vacation home into an irrevocable trust for a term of years and reserves the right to live there during the term. At the end of the term, ownership of the residence passes to the named beneficiaries, or a trust for their benefit.

Leveraged Gifting. Significant transfer tax benefits may be realized by moving property into a QPRT. For gift tax purposes, the value of the gift is not the fair market value of the property. The gift can be reduced to reflect (1) the grantor's right to live in the residence during the term of the trust and (2) the grantor's reversionary interest, which is the probability of death during the term, causing the property to revert back to the grantor. Additionally, any appreciation in the value of the residence during the term of years escapes gift and estate taxation.

The grantor must survive the QPRT term to realize the tax benefits. If the grantor does not survive the term, the fair market value of the residence is included in his or her estate for estate tax purposes. However, the grantor is in no worse position than if he did not establish the trust.

Bear in mind that if the grantor survives the trust term, ownership of the residence passes to named beneficiaries (or a trust for their benefit), and the grantor would have to rent the property if he or she wishes to continue to use it.

Interest Rate Considerations. Generally, QPRTs are not considered effective planning strategies in a low interest rate environment because the value of the retained interest is lower, which increases the size of the gift. However, the *reversionary* interest is more valuable in a low interest rate environment and housing values are currently significantly depressed. A reversionary interest with a higher value, coupled with a depressed housing value, may make a QPRT an attractive planning technique even in a low interest rate environment—particularly for older grantors.

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This article and other information on wealth management can be found at www.fiduciarytrust.com.

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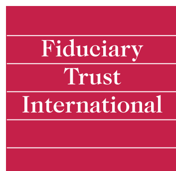

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