

THOUGHT LEADERSHIP

LEGAL UPDATES

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Planning Strategies for a Low-Interest Rate Environment

Many estate planning strategies involve leveraging low interest rates in order to transfer the appreciation of an asset to beneficiaries free from transfer taxes.

Generally, these techniques enable senior family members to (1) “freeze” the value of assets that would otherwise be included in their estates for estate tax purposes, and (2) transfer the appreciation to younger family members or trusts for their benefit.

Intrafamily Loans

The simplest planning strategy for a low-interest rate environment is to make a direct loan to an individual or a trust. The loan can be structured as an interest-only loan with a balloon payment due on maturity. If assets purchased by the borrower with the loan proceeds appreciate more than the interest rate paid on the loan, the excess passes to the borrower free of transfer taxes. This structure uses the relevant Applicable Federal Rate (AFR), depending on the maturity date of the loan. Additionally, a portion of the loan may be forgiven each year using the lender’s annual gift tax exclusion amount, currently \$16,000 per person (scheduled to increase to \$17,000 per person in 2023).

Installment Sales to Intentionally Defective Irrevocable Trusts

A more sophisticated lending strategy is an installment sale to an Intentionally Defective Irrevocable Trust (IDIT). A senior family member (the “grantor”) starts by creating an IDIT and naming younger family members as the beneficiaries of the trust. Thereafter, the grantor sells assets at their current valuation to the IDIT in exchange for a promissory note charging the AFR in effect at the time of the sale. While the promissory note can include favorable repayment provisions, certain formalities must be observed to ensure that the transaction will be treated as a bona fide sale by the IRS. If done correctly, the

grantor should not use any of his or her available exemption amount when selling assets to the IDIT. Appreciation of the assets in excess of the AFR will be shifted outside of the grantor's taxable estate.

Another advantage of an IDIT is that it can be structured as a "grantor trust" for income tax purposes, which means the grantor of the IDIT (rather than the trust) is responsible for paying the trust's income taxes. This allows the trust assets to grow more rapidly than they would net of income taxes, and therefore, maximizes the amount of wealth ultimately transferred to the IDIT beneficiaries. Additionally, because the grantor is treated as the owner of the IDIT assets for income tax purposes, the sale transaction and the interest payments made by the IDIT to the transferor are not subject to income tax.

Grantor Retained Annuity Trusts

In a low-interest rate environment, a Grantor Retained Annuity Trust (GRAT) strategy could be implemented to (1) transfer appreciating assets to the next generation with little to no use of the transferor's exemption amount, and (2) allow the grantor to retain a stream of income.

To start, an individual (grantor) gives assets to the GRAT in exchange for a right to annuity payments plus interest for a term of years. The GRAT also designates remainder beneficiaries who will receive the remaining assets of the GRAT after the annuity term ends. The annuity payments provide income to the grantor during the term and pay back the value of the original gift made to the trust, plus interest calculated at the Section 7520 rate.

The estate planning benefit comes at the end of the annuity term. Assuming the grantor survives the term, if the trust assets achieve a total net return in excess of the Section 7520 rate, there will be a savings in transfer tax. This is because the amount that ultimately counts as a gift to the beneficiaries for transfer tax purposes is limited to the value of the original gift to the GRAT, minus the annuity payments and interest returned to the grantor over the term (the net amount). In reality, the remainder that the beneficiaries receive is the net amount (even if zero) plus the excess growth beyond the Section 7520 rate that was not required to be paid back to the grantor in the form of the annuity. At a low Section 7520 rate, this could allow assets with the potential for significant appreciation to be transferred without utilizing the grantor's exemption amount.

Charitable Lead Annuity Trusts

Another estate planning technique that is favorable for both charitable giving and generational wealth transfer is making gifts to a Charitable Lead Annuity Trust (CLAT). A CLAT is mechanically similar to a GRAT, except the annuity payments and interest during the initial term are paid to a charity rather than to the grantor of the trust. Many families name their private foundation as the charitable

beneficiary during the term of the CLAT, which provides an effective mechanism for achieving family philanthropic goals and educating younger generations about charitable giving.

The grantor decides what asset(s) to give to the CLAT and what charity should receive the annuity payments and interest. The grantor also names non-charitable remainder beneficiaries (typically the grantor's descendants) to receive the remaining trust property after the initial term ends. Just like with a GRAT, the annuity amount is calculated using the Section 7520 rate and the benefit is realized when the annuity term ends. The lower the Section 7520 rate, the smaller the amount that must be paid to the charitable lead beneficiary, leaving a larger remainder interest for the non-charitable beneficiaries. At current interest rates, the grantor can transfer appreciating assets without utilizing any of his or her exemption amount, all while giving to charity.

Contact Us

If you have questions or would like to discuss how these low-interest rate strategies can be used to help meet your planning goals, please contact a member of the Husch Blackwell Private Wealth team or your Husch Blackwell attorney.

Read about strategies appropriate to high-interest rate environments.