RIDING THE INTEREST RATE ROLLER COASTER

A Review of Estate Planning Techniques for High and Low Rate Environments

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INTRODUCTION

We are in a time when economic factors such as volatile financial markets and fluctuating interest rates combine to impact the effectiveness of a variety of estate planning techniques. From 2009 through 2021, interest rates sank to and remained at historic lows. However, due to various economic pressures, rates are on the rise, and it is important for clients and advisors to consider the estate planning opportunities that are most effective in the changing interest rate environment. Certain planning strategies and structures work best when interest rates are high compared to those that are implemented in low interest rate environments. While the current uncertain environment may—understandably—cause clients to hesitate to engage in a significant gifting regime, clients should review their balance sheets with their attorneys and financial advisors and discuss whether any of the planning structures described below provide an attractive planning opportunity for the client's particular circumstances.

The primary goal of this article is to provide a high-level discussion of the estate planning techniques that present the greatest potential for upside when implemented during high interest rate environments juxtaposed to the techniques that succeed during times with low interest rates. Understanding which strategies are appropriate in the different or fluctuating environment will allow for greater utilization of your client's remaining federal estate and gift tax exemption amount.

As a general reminder, in 2022, an individual has a combined federal estate and gift tax exemption of $12,060,000, and married couples have a combined exemption of $24,120,000. Subject to annual inflation adjustments, this exemption will remain in place through 2025, after which time it will be reduced to approximately one-half of its value.

THE APPLICABLE FEDERAL RATE AND THE SECTION 7520 RATE

Each month, the Internal Revenue Service (IRS) publishes certain market-based interest rates. These rates include the applicable federal rates (AFRs) and the Section 7520 rate.

For many estate planning techniques, the AFR for any given month is the lowest amount of interest that may be charged between related parties in a loan transaction without triggering imputed income or a gift. A different AFR applies depending on the term of the loan, with the short-term AFR applying to loan terms shorter than three years, the mid-term AFR applying to loan terms three years or longer but less than nine years, and the long-term AFR applying to loan terms that are nine years or longer.

The Section 7520 rate is the rate used to calculate annuity payments and the value of life estates and remainder interests for certain estate planning techniques, such as grantor retained annuity trusts (GRATs), charitable lead trusts (CLTs), and charitable remainder trusts (CRTs), each of which is discussed below.

On October 17, 2022, the IRS released the AFRs and the Section 7520 rate for November 2022 (Rev. Rul. 2022-20), with the Section 7520 rate being 4.8 percent, and the long-term, mid-term, and short-term AFRs set at 3.92 percent, 3.97 percent, and 4.1 percent, respectively.

The current rates are neither historically low nor high. By comparison, rates experienced in 2020 represented exceptional opportunities for planning using low interest rates, when the Section 7520 rate was 0.4 percent in November 2020, and the long-term, mid-term, and short-term AFRs were 1.17 percent, 0.39 percent, and 0.14 percent, respectively. On the other end of the spectrum, rates in the early 1990s created planning opportunities for high interest rates. For instance, in June 1990, the Section 7520 rate was 11.0 percent, and the long-term, mid-term, and short-term AFRs were 9.09 percent, 9.10 percent, and 8.82 percent, respectively.

To illustrate the power of selecting a suitable planning vehicle based on the interest rate environment, let us compare the funding of a ten-year-term charitable remainder annuity trust (CRAT) with $1 million in January 2021, when the Section 7520 rate was 0.6 percent, with the same trust funded in January 1991, when the Section 7520 rate was 9.8 percent. If the annuity payment was $92,000 each year, the 2021 CRAT would have generated a taxable gift upon funding of $890,357.60 (reflective of the value of the annuity interest payable to the noncharitable beneficiaries determined by the January 2021 Section 7520 rate). The 1991 CRAT funded during the high interest rate environment would generate a $570,188.40 taxable gift upon funding. With all other aspects of the respective CRATs being equal at the time of funding, the higher Section 7520 rate generates a savings of $320,169.20 per $1 million of funding. Using the converse structure, if instead the $1 million funded a ten-year term charitable lead annuity trust (CLAT) with a $92,000 annuity payment, the January 2021 CLAT would generate a taxable gift of $109,642.40 (representing the remainder interest passing to the noncharitable beneficiaries) and the January 1991 CLAT would generate a taxable gift of $429,811.60.

TEN-YEAR TERM CHARITABLE REMAINDER ANNUITY TRUST

	7520 Rate	FMV of Trust	Annuity Amount to Noncharitable Beneficiaries	Present Value of Annuity/Taxable Gift	Charitable Deduction for Remainder Interest
January 1991	9.8%	$1,000,000	$92,000	$570,188.40	$429,811.60
January 2021	0.6%	$1,000,000	$92,000	$890,357.60	$109,642.40

TEN-YEAR TERM CHARITABLE LEAD ANNUITY TRUST

	7520 Rate	FMV of Trust	Annuity Amount to Charities	Remainder Interest/ Taxable Gift	Charitable Deduction for Lead Interest
January 1991	9.8%	$1,000,000	$92,000	$429,811.60	$570,188.40
January 2021	0.6%	$1,000,000	$92,000	$109,642.40	$890,357.60

A thorough explanation of CRT and CLT mechanics is discussed below, but the key point is that selecting the appropriate planning vehicle to complement the interest rate environment can yield very powerful results.

OVERVIEW OF LOW INTEREST RATE PLANNING VEHICLES

1. Grantor Retained Annuity Trust

How it works. A GRAT is an irrevocable trust to which the creator of the GRAT (the grantor) transfers assets and retains the right to receive fixed annuity payments from the trust for a specified number of years. After the GRAT makes the required annuity payments for the predetermined term of years, any property remaining in the GRAT passes to the designated beneficiaries (or to trusts for their benefit) free of federal estate and gift tax.

Tax and nontax considerations. A GRAT can be a highly effective wealth transfer option in a low interest rate environment due to the greater potential for the GRAT's assets to outperform the Section 7520 rate (also commonly known as the hurdle rate) in effect in the month the trust was created. Thus, to the extent the assets transferred to the GRAT (e.g., marketable securities or interests in commercial real estate or a closely-held business) reflect current depressed values and would generate an investment return in excess of the current GRAT hurdle rate (4.8 percent in November 2022), the larger the potential tax-free gift to the remainder beneficiaries.

The creation of a GRAT produces a taxable gift by the grantor to the remainder beneficiaries that is equal to the excess of the initial value of the contributed assets over the present value of the annuity payments to the grantor, discounted by the Section 7520 rate. The duration of the GRAT and the percentage annuity retained by the grantor can be structured so that the present value of the annuity payments retained by the grantor equals the value of the contributed assets to the GRAT, with the result that the remainder interest has a value of zero. The grantor of a zeroed-out GRAT makes no taxable gift and uses no gift tax exemption. So, if the GRAT assets do not appreciate beyond the Section 7520 hurdle rate, the grantor has not used any gift tax exemption, and the transaction is a wash. In some circumstances, it is preferable to design a GRAT so that the present value of the remainder interest of the GRAT at creation is small (but not equal to zero) for the grantor to report the GRAT contribution on a federal gift tax return (Form 709). If properly reported, the statute of limitations[1] will begin running

1 In general, if Form 709 is submitted and it adequately discloses the gift, I.R.C. § 6501(a) provides that the Internal Revenue Service must assess a gift tax within three years of the filing of the Form 709.

and, thus, limit the time period that the IRS has to audit the GRAT transaction.

Another advantage of a GRAT is that during the annuity period, it is considered a grantor trust as to the grantor. This means that the grantor is considered the owner of the GRAT for income tax purposes and is taxed on all of the income. Payment of the income and capital gains taxes by the grantor is, in effect, a further tax-free gift to the remainder beneficiaries, since the assets can continue to grow during the annuity term without reduction for such income and capital gains tax payments.

The duration of the GRAT annuity period retained by the grantor is a very important consideration. If the grantor survives the annuity term, the property remaining in the GRAT will pass to the remainder beneficiaries, outright or in further trust, without the imposition of gift or estate tax (although there may be generation-skipping transfer tax consequences depending on the relation of the remainder beneficiaries to the grantor at the time of the distribution). However, if the grantor dies prior to the expiration of the annuity term, a portion or all of the GRAT assets will be included in the grantor's estate for estate tax purposes. Therefore, the longer the annuity term, the greater the risk that the grantor may die during that period, resulting in estate tax liability.

Generally, there are two philosophies to consider when determining the appropriate annuity term for the GRAT. First, to tighten the exposure during volatile markets and limit the mortality risk of the grantor passing away during the GRAT term, it may be appropriate to use a shorter-term duration for the GRAT, such as two or three years. Alternatively, and particularly in low interest rate environments, longer-term GRATs, such as seven-year or ten-year GRATs, may be preferable because clients can lock in the low interest rates. Second, where GRATs perform better than anticipated during the initial years of the GRAT term, the grantor may choose to lock in the significant asset appreciation by purchasing the appreciated assets from the GRAT to hedge against losing those gains in later years. Another estate planning tool is to engage in rolling GRATs. Under this method, when the grantor receives an annuity payment from one GRAT, the grantor immediately uses that payment to fund a new GRAT.

Generally, the investment return on the assets contributed to a GRAT in the early years greatly impacts the GRAT's overall performance; therefore, it is important for clients to consult with their advisors regarding (1) whether there are assets that are suitable for use in a GRAT, (2) the right duration for the annuity period of a GRAT, and (3) the best investment strategies for the assets that are held in the GRAT. GRATs require valuation of the trust property each year, so marketable securities are well-suited to use in a GRAT transaction.

2. Sales to Intentionally Defective Grantor Trust

How it works. A sale of assets to an intentionally defective grantor trust (IDGT) can be another attractive tool when interest rates are low. An IDGT is an irrevocable trust, contributions to which are completed gifts for **gift and estate tax purposes**, but the trust assets are treated as owned by the grantor for **income tax purposes**. Therefore, the grantor can sell assets that the grantor owns to the trust without recognizing any capital gains, because the transferor and the trust are considered one and the same for income tax purposes.

In a typical sale to an IDGT, the grantor sells an asset to the trust in exchange for a promissory note with interest calculated at the applicable AFR for the term of the note. This transaction is an estate freeze in the sense that the grantor now owns a promissory note equal to the fair market value (FMV) of the assets sold to the trust; however, the assets in the trust and any future appreciation on such assets are removed from the grantor's estate for estate and gift tax purposes. The grantor pays the income tax generated on the trust assets, which is effectively an additional tax-free gift to the trust.

Tax and nontax considerations. From an income tax perspective, for the sale of assets to the IDGT to be free from capital gains tax and the interest payments on the note to not be considered taxable income to the grantor, the trust must be a grantor trust for income tax purposes. The grantor must be willing to pay the taxes on all income generated by the assets in the trust, including capital gains on the sale of the trust assets. Because the sale transaction is disregarded for income tax purposes, one downside of the sale is that the IDGT's income tax basis in the purchased assets will be the grantor's basis prior to the sale. If the grantor chooses to toggle off grantor trust status during the grantor's lifetime, the grantor may recognize gain if the trust's liabilities exceed the grantor's basis in the assets. There is some ambiguity as to the income tax consequences at the grantor's death if the grantor dies with the note outstanding, including recognition of gain and by whom.

Although by definition a sale is not a gift, it may be prudent to report the sale on a gift tax return (Form 709) filed by the grantor for the year in which the sale occurs. If the sale transaction is adequately disclosed on the gift tax return the statute of limitations will begin to run so that the IRS has a limited time period within which to review the sale and determine whether the sale price reflected the FMV of the assets on the date of the sale. Additionally, the assets should be appraised as of the date of the sale to establish the sale price. The appraisal may be

costly if the grantor is transferring closely held business interests or other hard-to-value assets.

If the grantor is creating a new IDGT to purchase assets, it is recommended that the grantor make a gift to the IDGT prior to the sale so that the trust has sufficient assets to serve as security for the promissory note. This gift will use the grantor's gift tax exemption, if available, or will incur gift tax if the grantor does not have any available exemption at the time of the seed gift. The IRS may take the position that a trust purchasing assets for a note without security is not a sale for full and adequate consideration and recharacterize the sale as a gift.

The grantor should also consider cash flow needs prior to engaging in this type of transaction. This transaction is a completed transfer for estate and gift tax purposes, so while the grantor receives the payments due on the note, the grantor no longer has access to the assets sold to the IDGT. In some circumstances, a grantor may include the grantor's spouse as a potential beneficiary of the IDGT to retain the ability to indirectly access the assets in the IDGT; however, such access would terminate on divorce or the death of the spouse.

3. Intrafamily Loans

A simple but effective technique in a low interest rate environment is an intrafamily loan. This strategy is particularly ideal for older generations who want to assist younger generations through either a direct loan of cash or a loan to a trust for a family member's benefit.

Making new loans. Intrafamily lending allows an individual to assist family members without making a current gift. Such loans can benefit family members who may have difficulty obtaining traditional bank loans or finding such favorable rates. The older generation serves as the family lender in the place of the bank and enables a child or grandchild to purchase a home, acquire property, or fund a new or existing business.

To avoid having all or a part of an intrafamily loan considered a gift for tax purposes, the loan must be adequately documented and secured and must bear an interest rate greater than or equal to the applicable monthly AFR specified for the term of the loan. The family member providing the loan will report income on the interest received from the borrower, but as long as the loan recipient is able to invest the borrowed funds and generate an investment return greater than the minimum AFR interest rate, the loan will be successful as a wealth transfer technique. The terms of the loan agreement can be structured in many ways, including as an interest-only loan with a balloon payment of principal on maturity.

Alternatively, the loan can be made to an irrevocable trust for the benefit of family members, rather than directly to individual family members. Structured this way, to the extent the loan proceeds produce a rate of return in excess of the interest rate on the loan, such excess is a tax-free transfer to the trust. For example, assume in November 2020, a parent loaned $2 million to a trust for fifteen years, utilizing the long-term AFR rate of 1.17 percent. If the loan proceeds are invested to produce a 6 percent annual return, at maturity, after repayment of the loan principal, the trust will have in excess of $2,250,000 remaining, all gift tax-free. In addition, if the trust can be structured as a so-called grantor trust for income tax purposes, the interest payments on the loan will not be taxable to the grantor, and the grantor can pay the tax on all income and gains generated by the trust assets, allowing the trust to grow without reduction for income tax liability.

Refinancing promissory notes. If current outstanding loans have an interest rate higher than the current AFR rates, such as a mortgage or an existing loan to a child or grandchild, it may be beneficial to refinance those existing loans to lock in the lower AFR rates.

4. Charitable Lead Trusts

How it works. A CLT has a similar structure to that of the GRAT, except that the income payments are made to one or more designated charitable organizations rather than to the grantor. With a CLT, the grantor transfers assets to an irrevocable trust, and the trust makes payments to one or more qualifying charitable organizations—either public charities or private foundations—for a fixed number of years or for the life or lives of designated individual(s), or a combination of the two (the charitable term). There are two forms of income payment terms for a CLT:

(1) A CLT with an annuity payment (referred to as a charitable lead annuity trust, or a CLAT), where the charitable recipient receives an annuity that is either (a) a fixed percentage of the initial FMV of the property gifted into the CLT based on the Section 7520 rate in the month the CLT is created or (b) a fixed sum

(2) A CLT with a unitrust payment (referred to as a charitable lead unitrust or CLUT), where the charitable recipient receives a fixed percentage of the net FMV of the CLT's assets, revalued each year

At the end of the charitable term, the assets remaining in the CLT must be distributed to one or more noncharitable beneficiaries, typically the grantor's lineal descendants (or trusts for their benefit).

Tax and nontax considerations. A CLT is a beneficial structure for a grantor with philanthropic goals and a mission of benefiting charity during a significant time of need.

Similar to a GRAT, the creation of a CLT constitutes a taxable gift by the grantor to the remainder beneficiaries that is equal to the initial value of the contributed assets, reduced by the present value of the annuity or unitrust payments to be made to charity, discounted at the Section 7520 rate. Thus, as discussed above, a CLT can be structured to zero out at the end of the charitable term, resulting in little or no gift tax. At the termination of the charitable term of the CLT, any appreciation of the property held in the CLT in excess of the Section 7520 rate is passed on to the remainder beneficiaries of the CLT free of federal gift and estate taxes. Property contributed to a CLT is assumed to grow at a rate equal to the IRS hurdle rate in effect at the time of the transfer. Therefore, a CLT, like the GRAT, works best in low interest rate environments, since any investment performance in excess of the hurdle rate passes free of estate and gift tax to the designated family members (or trusts for their benefit) at the end of the charitable term of the CLT.

Using a CLT to make annuity or unitrust distributions to charities allows the charitable recipients to receive benefits over an extended duration of time, as opposed to a lump sum contribution outside of the CLT structure.

Further, a CLT may be structured to qualify as a grantor trust. This means that the grantor is considered the owner of the CLT for income tax purposes and is taxed on all of the income earned by the CLT during the charitable term. As such, the assets of the CLT may continue to grow free of income and capital gains tax. The grantor would also receive a charitable income tax deduction (subject to applicable deduction limitations) based on the present value of the CLT's required annuity or unitrust distributions to charity in the year the CLT is created and funded. Alternatively, the CLT may be structured as a nongrantor trust, meaning the CLT (not the grantor) is considered the owner of the trust's assets. Structured this way, the grantor will not be entitled to a charitable income tax deduction on creation of the CLT, and the CLT will have to pay its own income and capital gains taxes; however, the CLT may claim an unlimited charitable income tax deduction for its annual distributions to charity.

OVERVIEW OF HIGH INTEREST RATE PLANNING VEHICLES

1. Qualified Personal Residence Trusts

How it works. A qualified personal residence trust (QPRT) is an irrevocable trust to which the creator of the QPRT (the grantor) transfers a personal residence and retains the right to live in the residence for a specified number of years. At the end of the QPRT's initial trust term, the residence passes to the designated beneficiaries (or to trusts for their benefit).

Tax and nontax considerations. A QPRT is generally useful in a high interest rate environment, as the grantor is retaining the right to use the residence during the trust term, so the value of the remainder is what is reported for gift tax purposes. The value of such remainder interest equals the value of the residence, less the actuarial value of the retained term interest, which is calculated using the Section 7520 rate at the time of the transfer of the residence to the QPRT. Not only does a QPRT allow for the transfer of the residence out of the grantor's estate at a reduced valuation, the QPRT also removes the future appreciation of the residence from the grantor's estate, provided the grantor survives the initial trust term.

A grantor may place up to two residences in QPRTs, with each residence funding a separate QPRT. (If two QPRTs are created, one must include the grantor's primary residence.) Mortgaged property may be placed in a QPRT; however, whether the balance of the mortgage reduces the taxable gift, whether the lender will permit the transfer, and who continues to pay the mortgage will each depend on the specific facts and circumstances. For the QPRT to be successful, the grantor must survive the initial trust term. Otherwise, the entire value of the residence will be included in the grantor's estate. The selection of the trust term is chiefly important, as the longer the term, the greater the retained interest and greater the discount on the valuation for gift tax purposes; however, the longer the term, the greater the probability the grantor's death will occur before the end of the term. As a hedge against the mortality risk, the grantor may fund two QPRTs, each holding a fractionalized interest in one residence and each with a different initial trust term. Similarly, spouses may each fund a separate QPRT with each spouse's fractionalized interest in a residence and select their own trust term based on their own life expectancy.

A QPRT is a grantor trust for income tax purposes during the initial trust term, as the QPRT rules require the grantor to retain the right to the trust income. Upon the termination of the initial trust term, the QPRT may continue as a grantor trust or a nongrantor trust, or it may terminate. At the expiration of the initial trust term, the grantor must pay the resulting owners of the residence fair market rent to continue to reside in the residence. Depending on whether the QPRT continues as a grantor trust for income taxes, the rent may or may not be taxable income to the new owners.

When drafting QPRTs, be mindful that there are additional rules governing the sale of the residence during the trust term that should be included in the trust agreement.

2. Charitable Remainder Trusts

How it works. A CRT is an irrevocable trust that pays an amount annually to an individual or individuals for a specified

term (which can be for a term of years not to exceed twenty years, for the life or lives of one or more individuals, or some combination thereof). This initial term is generally referred to as the lead interest, and, at the end of the lead interest, the CRT pays the remainder interest to one or more qualified charitable organizations. Similar to its cousin the CLT, a CRT has two forms of income payment terms:

(1) A CRT with an annuity payment (referred to as a charitable remainder annuity trust, or a CRAT) pays a fixed income stream to the designated recipients that is based on a fixed percentage of the initial FMV of the property contributed into the CRT based on the Section 7520 rate in the month in which the CRT is created. Note that this fixed percentage will not change during the course of the CRAT and no future contributions may be made to the CRAT.

(2) A CRT with a unitrust payment (referred to as a charitable remainder unitrust or CRUT) pays an income stream to the designated recipients based on a fixed percentage of the net FMV of the CRT's assets, revalued each year. With a CRUT, the designated recipient will receive distributions of a fixed percentage of a changing market value—meaning the recipient receives an income stream that fluctuates with the market value of the assets within the CRUT, thereby receiving larger distributions when the CRT investments grow and smaller distributions when the CRT investments shrink. A grantor can make additional contributions to a CRUT, unlike a CRAT.

For both CRATs and CRUTs, the annuity or unitrust payment must be fixed between 5 percent and 50 percent, and the remainder interest (that amount passing to the charitable beneficiaries) must equal at least 10 percent of the FMV of the assets contributed to the CRT as determined using the Section 7520 rate in effect at the time of creation of the CRT (or in either of the preceding two months at the grantor's option).

Tax and nontax considerations. CRTs are normally created in higher interest rate environments since they result in a higher annuity or unitrust payout to the noncharitable beneficiary. The assets contributed to the CRT are assumed to have the Section 7520 rate of return over the term of the CRT. Thus, a higher rate of return will provide more income to pay the retained annuity or unitrust amount, thereby increasing the value of the assets remaining for the charitable remainder interest.

The remainder value of the CRT determines the charitable income, estate, and gift tax deductions available to the grantor. For inter vivos CRTs, a grantor is entitled to an immediate income and gift tax charitable deduction based on two factors: (1) the anticipated duration of the CRT and (2) the assumed growth rate, known as the Section 7520 rate. For the first factor, a longer lead interest term will result in a smaller charitable deduction, and a shorter lead interest term will result in a larger charitable deduction. For the second factor, a lower Section 7520 rate provides a smaller charitable deduction because it assumes the money in the CRT will not grow as fast and, as such, there will be less left for the charity. A higher Section 7520 rate provides a greater charitable deduction because it assumes the money in the CRT will grow faster, leaving more for the charity when the lead interest term ends. The estate of the decedent who creates a testamentary CRT is entitled to an estate tax deduction for the present value of the remainder interest passing to charity based on the factors just reviewed.

The CRT itself is classified as a tax-exempt entity. As such, none of the transactions entered into by a CRT will be subject to income taxes at the trust level. Therefore, transferring highly appreciated assets to a CRT makes it the most effective since the CRT's tax status will allow the deferral of capital gain recognition. Generally, the grantor transfers the appreciated assets to the CRT and then the CRT sells the assets. Once sold, the full value of the assets can be used to produce an income stream (in the form of the annuity or unitrust payment) for the designated recipients during the lead interest term. However, upon receipt of the annuity or unitrust payment each year, the designated recipient will have recognized taxable income. Each year, the annuity or unitrust payment is deemed to consist of assets from the CRT that are first, ordinary income; second, capital gain property; and third, tax-exempt income or principal. The character of the assets remains the same in the hands of the recipient as in the CRT. Therefore, the recipient of the annuity or unitrust payment must report either the ordinary or capital gain income on the recipient's individual income tax return in the year of the receipt.

CONCLUSION

It seems likely that clients and advisors should be prepared to ride the pending interest rate roller coaster and be aware of the specific planning vehicles that work best whether interest rates continue to tick upwards or if we experience another downturn. While the notion that the "devil is in the details" is as true in sophisticated tax planning as anything else, a review of your client's assets may highlight opportunities to capitalize on one or more of the above rate sensitive techniques to seize the planning opportunities that exist or may come into being.