Estate Tax Planning Strategies in a Low Interest Rate Environment

Wealthy individuals and families are potentially subject to many types of taxes, including federal estate taxes. Depending upon the state in which they reside, they may also be subject to state level estate taxes. That presents a problem when most families' wishes are to transfer as much wealth as possible to children and grandchildren, undiminished by taxes. While the laws impacting estate taxes change frequently depending upon political and economic winds, one thing is clear—high net worth individuals and families can take advantage of the extended low interest rate environment to optimize certain wealth transfer strategies. These strategies are intended to move assets to family members or trusts that benefit family members, which will help to minimize or avoid estate taxes.

There are two sets of interest rates that are important for our discussion: (1) the applicable federal rate ("AFR") for loans (short-term is 0 to 3 years; mid-term is over 3 to 9 years; and long-term is over 9 years), and (2) the 7520 rate imposed by Internal Revenue Code ("IRC") §7520. The AFR is set monthly and is the average interest rate for similar term Treasury obligations. The 7520 rate is also set monthly and is about 120 percent of the mid-term AFR. See how the rates have gone down in recent years.

Annual Rates	January 2001	January 2011	January 2021
Short-Term AFR	5.90%	0.43%	0.14%
Mid-Term AFR	5.61%	1.95%	0.52%
Long-Term AFR	5.78%	3.88%	1.35%
7520 Rate	6.75%	2.34%	0.62%

Generally, the AFR is the minimum rate of interest that can be used, particularly between related parties, to avoid adverse gift and income tax consequences. IRC §7520 informs us that the 7520 rate is used to calculate "the value of any annuity, any interest for life or a term of years, or any remainder or reversionary interest" that an estate-planning strategy may employ.

There are four commonly used wealth transfer strategies that work well in a low interest rate environment: (1) an intra-family loan; (2) a Grantor Retained Annuity Trust ("GRAT"); (3) a Note Sale to an Intentionally Defective Grantor Trust ("IDGT"); and (4) a Charitable Lead Annuity Trust ("CLAT"). Let's briefly review each of them.

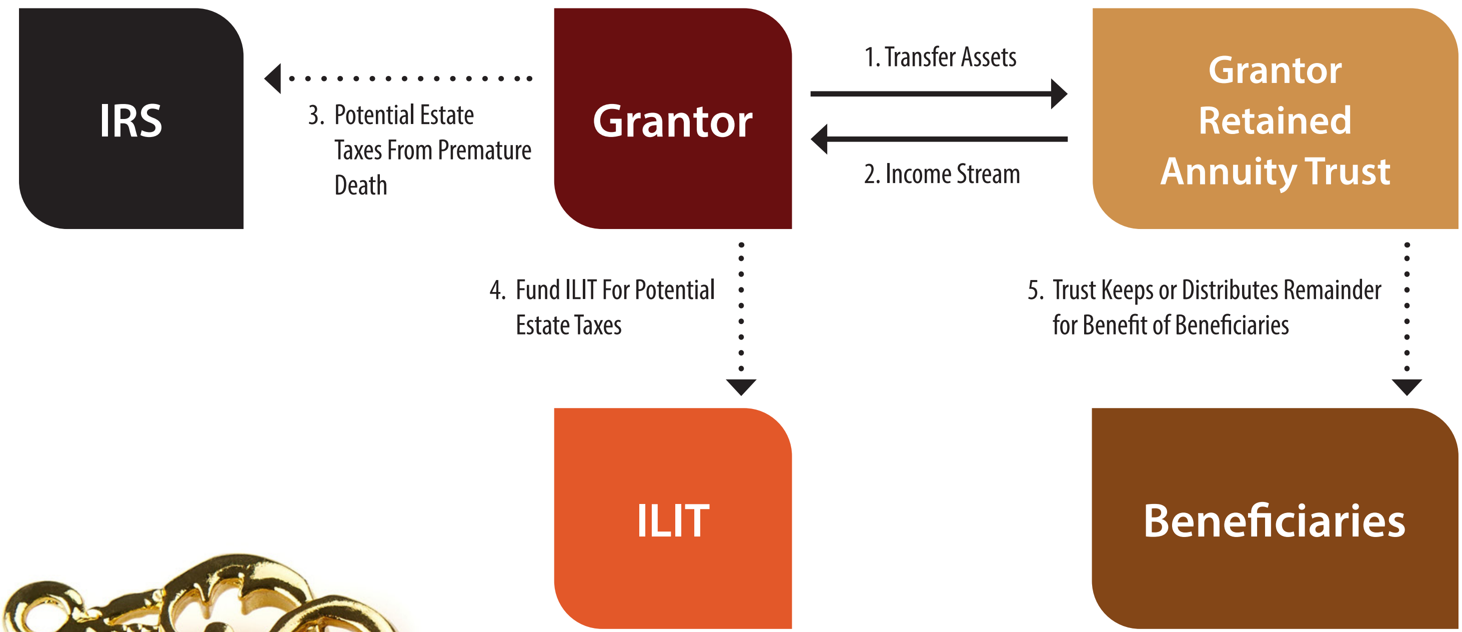
1. Intra-Family Loan

An intra-family loan is what it sounds like—a bona fide loan from one family member to another, or to a trust for the benefit of family members. The lender is typically a wealthy parent or someone in a senior generation, and the borrower is typically an adult child or a trust that benefits younger family members. Depending upon the term of the loan, the interest rate charged should be at least the appropriate AFR. Loans are typically designed to be interest-only with a balloon payment at the end of the term to maximize the potential arbitrage. The expectation is that the loan is used for some investment that generates income or grows in excess of the AFR. Thus, the lender has removed the income and growth of those assets out of his gross estate for estate tax purposes. If you're the lender, and depending upon your goals and objectives, you may even decide to forgive the loan as part of your estate plan, creating a gift, and removing assets from your gross estate in that manner.

2. Grantor Retained Annuity Trust

A GRAT is a wealth transfer technique that is guided by IRC §2702. The GRAT is an irrevocable trust known as a "split interest" trust. You, the grantor, transfer assets into the trust for a certain period of years in return for an income stream or annuity during that period (the "income interest"). At the end of the term, the remaining assets pass to the beneficiaries of the trust or remain in the trust for their benefit (the "remainder interest"). If you survive the term of the GRAT, the assets are no longer included in your gross estate for estate tax purposes. Life insurance held in an Irrevocable Life Insurance Trust ("ILIT") is often used to hedge against the possibility that you do not outlive the term of the GRAT, and the assets remain in your estate for estate tax purposes.

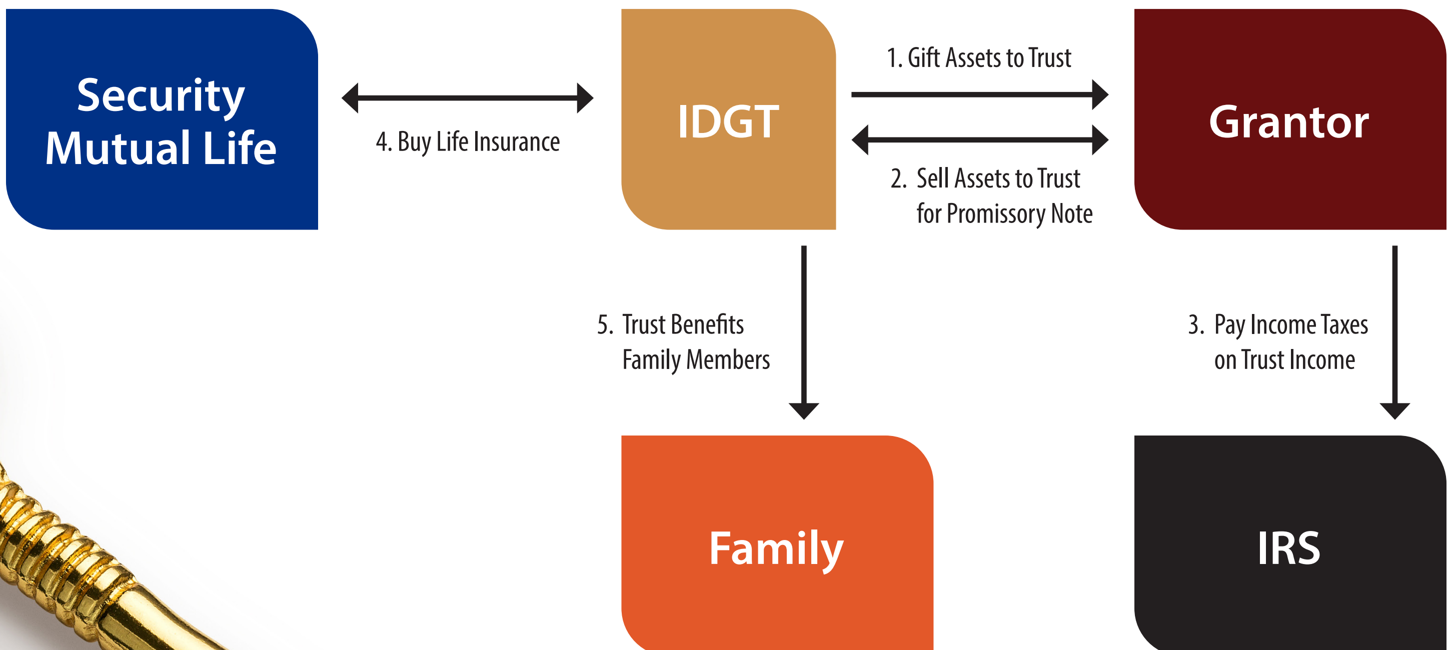
The assets you transfer into the GRAT have gift tax consequences because the remainder interest is going to your beneficiaries. However, the retention of the income interest reduces the value of the gift for gift tax purposes. The value of the gift is actuarially determined at the time the GRAT is established. The value depends upon the amount transferred, the amount of the annuity, the trust period and the discount rate in effect as represented by the 7520 rate.



3. Note Sale to an Intentionally Defective Grantor Trust

Despite the name of the technique, there is nothing wrong or defective about the IDGT. The strategy aims to take advantage of a disconnect between the income tax system and the estate tax system. While the IDGT is a trust, and therefore a separate entity from the individual grantor for estate tax purposes, for income tax purposes, the trust and the individual grantor are one and the same. The beneficiaries of the IDGT would generally be the grantor's children and other family members and descendants.

Typically, the IDGT is first funded with other assets through gifts or other wealth transfer strategies. The IDGT then purchases high-income and/or high-growth assets, such as commercial real estate or an interest in a business, from the grantor, in return for a promissory note. The appropriate AFR is used as the interest rate on the note. From an income tax perspective, the sale of the assets and the installment payments are tax-neutral events. However, from an estate tax perspective, the transaction has moved the assets—along with the future growth of, and income from, those assets—from the grantor's estate, and has "frozen" the value of the assets sold at the sales price, for estate tax purposes. The IDGT is now the owner of the assets, including all future income and growth. The income tax consequences to the IDGT for that future income is paid by the grantor, which further depletes his gross estate for estate tax purposes.

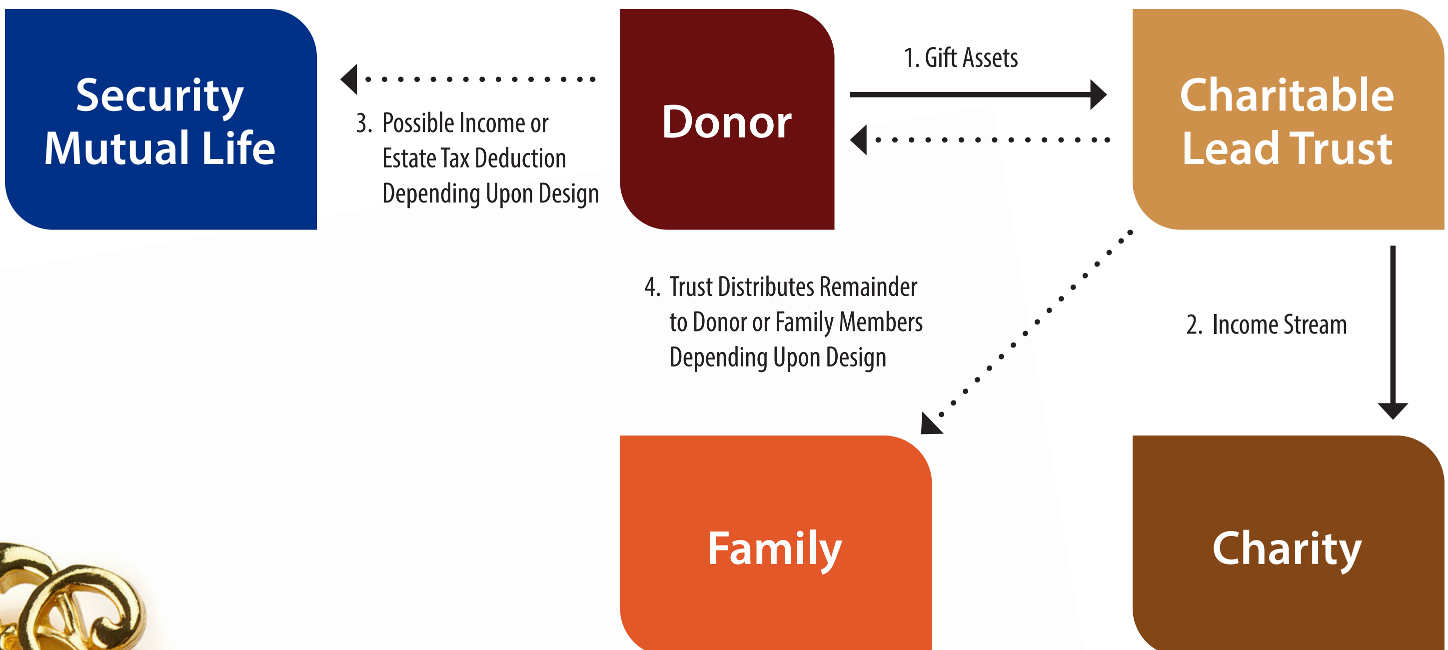


Note that the IDGT would often purchase life insurance on the grantor's life to maximize the growth and yield to the IDGT and to hedge against a potential balloon payment due on the note.

4. Charitable Lead Annuity Trust

First and foremost, the CLAT is a strategy that is used for individuals who have charitable intent. Taxes are usually not the primary reason to engage in charitable planning. Of course, having tax advantages helps. Like the GRAT, the CLAT is also a split interest trust. The donor gifts assets into the trust, which pays an income stream or annuity to a charity for a certain period of time (the "income interest"). At the end of the term, what remains in the trust is transferred (the "remainder interest"). The remainder interest can be transferred back to the donor or to family members, or it could remain in the trust for the benefit of the family members, depending upon the design of the CLAT. Each design has its own income, gift and estate tax consequences, but generally, the CLAT is designed to transfer assets to family members through the remainder interest. This reduces the gross estate and potentially minimizes or avoids gift and estate taxes.

For individuals with an expected estate tax issue, CLATs are often created at death to eliminate much or all of the estate tax through an estate tax deduction. The value of the deduction is actuarially determined at the time the CLAT is established. The value depends upon the amount transferred into the CLAT, the amount of the annuity, the trust term and the discount rate in effect as represented by the 7520 rate.



Conclusion

There are a variety of wealth transfer strategies that can help you to minimize or avoid federal and state estate taxes. Some work better than others depending upon the interest rate environment. We have briefly touched upon four common estate tax planning strategies that work well in a low interest rate environment. The strategies are much more complex than what is covered in this summary, and that's why you need to work with your estate-planning team to determine which strategy(ies) may work best for your unique situation. Your Security Mutual life insurance advisor can help assemble your team and coordinate with your estate-planning attorney and tax professional to review your situation. Contact your Security Mutual life insurance advisor today to get the process started.

For More Information Contact:

For more information on estate planning and starting the process to create an effective estate plan, please consult with your Security Mutual life insurance advisor to review and discuss your goals and objectives for your assets and your family.

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