

Interest Rate Arbitrage And Estate Planning

By Douglas W. Stein
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The 7520 rate, commonly referred to as the "applicable federal rate" (AFR), is presently the lowest it has been in a decade.

This is the best news (other than a rising stock market) that estate planners have had since the 2001 tax act. Lower interest rates affect the income, estate, and gift tax value of almost all transfers in trust, in addition to lending arrangements. For certain planning vehicles, the drop-in rates produces more favorable results and therefore increase the leverage that we can achieve for our clients.

Generally speaking, the AFR affects the value of private annuities, life estates, term interests, remainder interests and reversionary interests, among others. It also has an effect on the minimum interest rate for note sales and debt instruments under section 1274.

The AFR fluctuates monthly, and is usually published 10 days before the end of the month for the following month. Because taxpayers must use the AFR in effect at the time of a transfer (unless the transfer is to a split interest trust, such as a CRT or CLT) the early publication of the rate allows taxpayers to effectively arbitrage the AFR. In a split interest trust, the taxpayer may use the AFR for the month of the transfer or for either of the two preceding months.

GRAT v. GRUT

An individual can save estate and gift taxes by setting up a grantor retained annuity trust (GRAT).

Usually the grantor retains an annuity interest for a specified term, for life or the shorter of the two, and upon expiration of the term the trust property goes to the remainder beneficiary. Unless a "Walton style" GRAT is used, gift tax will be payable, but only on the present value of the remainder interest."

A "Walton style" GRAT has a sufficiently large annuity payment so that the grantor is treated as retaining all of the property of the GRAT therefore resulting in a zero gift tax. If a reversionary interest is retained by the grantor, the taxable gift is not reduced by the value of the reversionary interest.

In the current low interest rate environment, a GRAT becomes a very desirable tool because the lower rate increases the value of the annuity retained by the grantor, and therefore reduces the value of the gift.

If an individual has a shortened life expectancy, a term-certain GRAT can be used as a hedge against failing to survive until greater estate tax relief is phased in. However, the term must be kept very short so that the GRAT will not be included in the grantor's estate.

In addition, practitioners should consider utilizing a zeroed out GRATs (Walton style GRAT) to further mitigate any adverse gift tax consequences to short term GRATs.

A grantor retained unitrust (GRUT) is mostly unaffected by the reduced interest rates and, although they are still viable in the current environment they will not give you the same leverage that can be achieved with a GRAT. In addition, it is impossible to zero out a GRUT and therefore a taxable gift must be made whenever a GRUT is used.

GRIT v. QPRT

A grantor retained income trust (GRIT) is like a GRAT except that the grantor retains an income interest instead of an annuity interest.

If the remainderman is a qualified family member, under the Chapter 14 rules the grantor is treated as making a gift of the full value of the property. However, if a qualified personal residence trust (QPRT) is used, or if

a GRIT is used where the remainder goes to someone falling outside of the definition of a family member for chapter 14 purposes, the value of the gift of the remainder is determined under the valuation tables.

Unlike a GRAT, decrease in the interest rate lowers the value of the retained income interest and increases the value of a gift of a remainder interest. It is for this reason that

remainder decreases.

For clients with high income or large estates, the CLAT offers an opportunity to transfer substantial assets to family members at low or no transfer tax cost, as a donor can set the charity's interest to last for any permissible measuring life.

The CLAT is usually utilized when there are "hot" assets, and when the grantor has

cluding reduction of estate administration expenses, deferral of recognition of capital gains and an income stream.

In the typical private annuity transaction, a parent transfers property to a child in return for that child's unsecured promise to pay the parent a fixed income for life. During the parents' actuarial life expectancy, each payment will carry out ordinary income, capital gains and principle.

If a bargain sale takes place, the annuity will be treated as a retained life estate and therefore it will be includable in the parent's estate. If the fair market value of the property transferred in exchange for the annuity equals the present value of the annuity payments then there is no taxable gift.

In a low interest rate environment the annual payment is lower, and this structure becomes more affordable for the child. In addition, it is easier for the child to meet or exceed the assumed rate of growth (the AFR) with the underlying assets. The lower payment received by the parent is beneficial because the parents' estate tax strategy will be to gift the assets at a reduced cost, incurring no gift tax, while minimizing estate inclusion.

A private annuity is a preferred strategy for an individual with a shortened life expectancy, but who is not terminally ill. The private annuity has numerous other applications, including diversification of a portfolio, sale of a business, and creating new depreciation deductions. Since the child will receive full basis in the assets he or she receives, private annuities will likely become more important under the 2001 tax act.

Many practitioners prefer the use of an installment sale over a private annuity due to its simplicity, and because the total payments are known at the outset.

In an installment sale, usually the parent will sell appreciating assets to a child or trust and charge the minimum AFR rate permissible. This technique for deferral of gain becomes even more beneficial as interest rates drop.

Like a private annuity, this technique works best when rapid appreciation is expected. If the note is in the grantor's estate, however, then the fair market value of the note will be subject to tax.

To avoid estate inclusion many practitioners structure the note as a self-canceling installment note (SCIN). If a SCIN is used, the note looks more like a private annuity, but without the immediate increase in basis, which can only be accomplished with a private annuity.

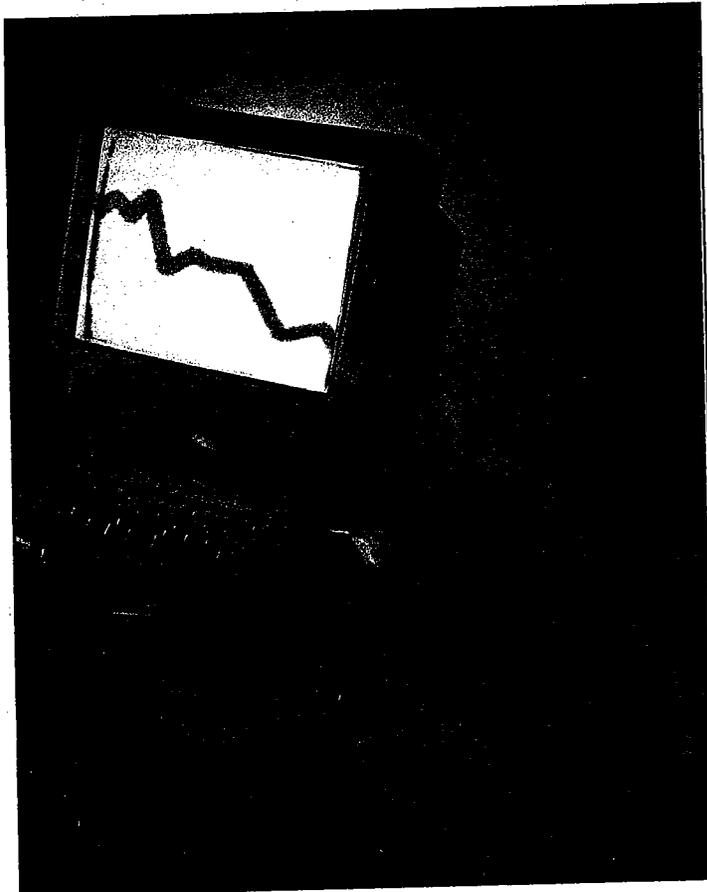
Both private annuities and installment sales are excellent techniques in our current interest rate environment. In fact, serious consideration should be given to refinancing any existing notes if the current AFR is lower than the interest rate currently being charged.

Conclusion

As Charles Dickens wrote: "It is the best of times. It is the worst of times."

Advisors need to be aware of the effect that low interest rates have on various techniques and to avoid the use of contraindicated structure unless there are other valid reasons.

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a QPRT or a GRIT is not a very effective tool for transferring wealth in the current environment. In addition, it is impossible to zero out a GRIT or QPRT, so an immediate gift tax may be triggered.

CLAT v. CLUT

For those clients who are charitably inclined, the low interest rates increase the gift or estate tax deduction when a charitable lead annuity trust (CLAT) is used.

Usually the charity has an annuity in-

terest. If a CLAT is structured to be a grantor trust the client will further reduce his or her estate by the tax due on the income generated in the CLAT.

Like a GRUT, a charitable lead unitrust (CLUT) is mostly unaffected by the reduced interest rates, and therefore they are still viable in the current environment.

With a charitable remainder annuity trust (CRAT), the donor usually retains an annuity interest and names a charity to receive the remainder at the end of the annuity term.

A CRAT can be viewed as the opposite of a CLAT insofar as the annuity interest is retained by the grantor, and the remainder goes to charity. Lower interest rates result in smaller charitable deductions, because the value of the annuity interest is increased. It is for this reason that the use of a CRAT may be contraindicated under current conditions.

A charitable remainder unitrust (CRUT) like a GRUT or CLUT is mostly unaffected by reduced interest rates because a change in interest rate does not affect the value of the remainder interest. The unitrust interest is calculated based upon a fixed percentage of the trust assets and changes in the AFR uniformly ensure to the benefit of the unitrust holder and the remainder man.

Private Annuity v. Installment Sale

A private annuity is probably the most under-utilized estate planning technique in light of the current interest rate environment.

A private annuity offers a number of income, gift, and estate tax advantages in-

Lower interest rates affect the income, estate, and gift tax value of almost all transfers in trust, in addition to lending arrangements.

terest for a specified term, for life or the shorter of the two, and upon expiration of the term the trust property goes to the remainder beneficiary. Due to the low interest rate environment the value of the income, gift or estate charitable deduction increases, and the value of the gift of the

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