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Estate planning in a low-interest-rate environment

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Low interest rates create planning opportunities for estate planning and their clients. The techniques benefited by the current low interest rates include intra-family loans, SCINs, installment sales to grantor trusts, GRATs, CLATs and charitable gifts of personal residence remainders. With each of these techniques one concept is essential; the less the income interest is worth (due to low interest rates) the more the remainder interest is worth. This article discusses the mechanics of these techniques and how they flourish in a low interest environment.

Intra-Family Loans

An intra-family loan is precisely what one might expect it to be. It is simply a loan between family members. Like the majority of other loans, the borrower is required to repay the lender with interest. The interest is calculated using the Applicable Federal Fate ("AFR") in effect for the month of the loan, and based on the duration (or type) of the loan. An intra-family may be a good investment opportunity if the AFR is low if the borrower can re-invest the borrowed money into an asset with a rate of return higher than the AFR. The growth on the borrowed asset, to the extent that it surpasses the AFR may be retained by the borrower transfer tax free. Additionally, a period of low AFRs provides a great opportunity to refinance existing loans.

SCINs

A self cancelling installment note, or "SCIN", is a promissory note that due to a "cancelled at death" provision is cancelled on the death of the holder along with all future payments owed to the holder. Depending on how much is still owed to the holder at the owner's death, this can be a huge financial boon to the borrower.

One variety of SCIN is an "interest only" SCIN. With an interest only SCIN, only interest payments calculated in accordance with the AFR (see chart above) are paid over the life of the SCIN. This leads to a large balloon payment at the end of the SCIN term. Therefore, if the holder dies before the balloon payment is due, the balloon payment will not occur and a substantial amount of money will not be returned holder's estate (is transferred to the borrower transfer-tax free). It is also worth noting that the implementation of a SCIN is a particularly effective "estate freezing" technique when both asset values and interest rates are low. Once the asset is sold by the holder, the holder's estate escapes all future asset appreciation. Additionally, if the value of the asset sold by the holder had decreased prior to the sale, the amount owed back to the holder would correspondingly be lowered. And if interest rates are low and an interest only SCIN is used, the payments back to the holder will be further diminished. There are a few additional benefits of a SCIN: (1) a SCIN allows the holder to sell an asset with a low tax basis and prorate the capital gain on the asset over the term of the note; (2) a SCIN creates cash flow for the holder, which is especially useful for someone retiring from a family business.

Installment Sales to Grantor Trusts

An installment sale to an intentionally defective grantor trust ("IDGT") can move substantial wealth if the assets sold to the grantor trust outperform the promissory note given to the seller/grantor. To utilize such a technique, the grantor creates and funds an irrevocable grantor trust. Next, the grantor sells assets (ideally highly appreciating assets) to the grantor trust. The trust will be able to purchase these assets from the grantor using the small seed gift that was gifted to and will owe future payments to the grantor for the remainder. The Trustee of the grantor trust executes a promissory note in favor of the grantor/seller. Ideally, the promissory note is structured as an interest only SCIN. In this low interest rate environment, the interest is nominal on such a note. The difference between the payments on the promissory noted and the appreciation of the assets in the grantor trust pass on to the trust's beneficiaries gift tax free.

GRATs

A grantor retained annuity trust, or "GRAT," is a trust (generally with a short duration, i.e. two to three years) to which a grantor transfers assets and retains the right to be paid an annuity from the trust for a certain number of years. The annual annuity amount is based on the initial fair market value of the assets transferred to the trust and the § 7520 interest rate (or "hurdle rate"). At the time the trust is created and the annual annuity payment is calculated, the size of the gift to the remainder beneficiary is determined. At the end of the term, and if the grantor outlives the GRAT, the assets remaining in the trust after all of the annuity payments are made pass outright to (or in trust for) the trust's remainder beneficiary. If the assets in the GRAT appreciate faster than the § 7520 interest rate, more assets will remain in the GRAT than originally calculated. These assets will pass on to the remainder beneficiary gift tax free.

In a low interest rate environment, the re-

quired annual annuity is decreased and the § 7520 hurdle rate is easier to surpass. This means that there is a greater likelihood that the assets in the GRAT will appreciate at a rate higher than the § 7520 rate, leaving a surplus of assets in the GRAT at termination and increasing the remainder interest. The GRAT may be used for many types of assets, but it is best utilized for assets that will experience a large growth spike, or will receive a valuation discount, such as limited or restricted interests.

The following demonstrates the unique historic opportunity provided by the current interest rate environment:

CLATs

A CLAT is a "split-interest" trust with both charitable and non-charitable beneficiaries. Under the terms of the trust, a charity (which could include a private foundation or a donor advised fund) receives a fixed annuity payment for a period of years and then the trust's remainder is distributed to a non-charitable beneficiary. Generally, the grantor will attempt to zero-out the remainder interest when the CLAT is created, so as to avoid gift tax upon the creation of the CLAT. Then, at the end of the term, the remaining assets (if any) are transferred to the trust's beneficiary (generally the grantor's children) without gift tax consequences. Therefore, assuming interest rates are low and that the CLAT is zeroed-out, the annuity being paid to the charity is lowered by the interest rate, which in turn increases the amount of the remainder going to the non-charitable remainder beneficiary without gift tax consequences.

Charitable Gifts of Personal Residence Remainders

A donor can make a gift of a remainder interest in the donor's private residence to charity upon the donor's death. In order to do so, a donor must make an irrevocable transfer of the remainder interest in his or her property, but the donor retains lifetime use of the property. This would qualify for an income tax charitable deduction and would remove the residence from the donor's estate. Then, when the donor dies, the home would pass on to the charity. The benefits of donating the remainder interest in a home to charity are two-fold: (1) there is the immediate income tax benefit from the charitable deduction; (2) there are future estate tax savings from the removal of the property from the estate of the donor. Additionally, as the charitable deduction is based on the remainder interest, the charitable deduction increases when interest rates are low. ■

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