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Estate Planning in a Changing Interest Rate Environment

When interest rates change, we rarely consider how those changes could impact an individual's estate planning strategy. Some strategies are more impactful when interest rates are relatively low, while others offer more benefits when interest rates are relatively high.

If your estate is nearing or exceeds the lifetime gift and estate tax exemption, implementing one of the strategies below could potentially reduce the size of your taxable estate. Below, we outline strategies for both sides of the interest rate spectrum.

3 STRATEGIES FOR LOW-INTEREST RATES

1. Grantor Retained Annuity Trust (GRAT)

A GRAT is an estate planning strategy that can help reduce your taxable estate by freezing a portion of your estate's value today while transferring the appreciation of those assets to beneficiaries, potentially mitigating estate and gift taxes.

As the GRAT's grantor, you start by transferring assets into an irrevocable trust, and you must designate a trustee other than yourself. In return, the grantor receives annuity payments, at least annually, which are calculated and determined by the IRS' Section 7520 rate, or hurdle rate.

If the trust is structured properly, any remaining assets will pass to your beneficiary's estate gift tax-free at the end of the trust term.

Be cautious when setting up your GRAT and choosing a term. GRAT terms vary, although they are generally set anywhere from 2-10 years. If you pass away before your GRAT term ends, the value of the remaining assets, including earnings, will be included in your taxable estate.

2. Charitable Lead Trust (CLT)

A CLT uniquely combines the two sides of a giving strategy. They allow you, as the donor, to support the charity of your choice during your lifetime while preserving assets for your beneficiary's inheritance. Like a GRAT, a CRT is an irrevocable trust that can carry the same risks as well as set up and administration costs. The primary difference between a CLT and GRAT is that instead of receiving the annuity payments yourself, you're paying it to a charity. The remaining assets will pass to your chosen beneficiaries at the end of the trust's term.

CLTs can be set up in two ways: As a grantor CLT or non-grantor CLT.

A grantor CLT treats the donor as the owner of the assets for income tax purposes. This allows the owner to take a charitable tax deduction in the year the trust is funded equal to the current market value of the transferred assets. As the grantor, you are also responsible for paying income tax on trust income during the term. Because of this, grantor CLTs are generally more appropriate for income-tax planning rather than estate-tax planning.

A non-grantor CLT treats the trust as the owner of the assets, allowing it to take an unlimited charitable tax deduction over its term. Although you, as the grantor, do not receive a charitable tax deduction for the transferred assets, you are not liable for any taxes during the term, nor is the remainder beneficiary liable for future taxes on the trust assets' appreciation

The IRS requires actuarial tables to determine the present value of the charitable annuity for tax purposes. The law requires that you apply an interest rate equal to the IRS' Section 7520 rate at the time of the CLT's creation. The lower the Section 7520 rate, the larger the value of the annuity—and the smaller the value of the remainder interest for gift-tax purposes.

3. Intrafamily Loans

An intrafamily loan can be a practical strategy to transfer the earnings on wealth to other family members without reducing the lender's lifetime exemption.

When making an intrafamily loan, you're required to charge a minimum interest rate based on the term of the loan, known as the Applicable Federal Rate (AFR). The borrower can use these loans to buy real estate, pay down high-interest debt, or invest in a business. If the borrower purchases assets that yield a higher rate of return than the loan interest rate, those gains are effectively transferred to them without impacting the lender's lifetime exemption.

Intrafamily loans are a nuanced planning strategy that can have potential tax repercussions if not executed correctly. If you want to implement an intrafamily loan, consult with a legal and tax advisor to ensure the transaction follows the IRS guidelines as a loan rather than a gift.

2 STRATEGIES FOR HIGH-INTEREST RATES

1. Charitable Remainder Annuity Trust (CRAT)

CRAT mirrors a CLT. With a CRAT, you, the donor, place assets in a charitable trust with the annuity payments paid to a chosen beneficiary for a term of years or a lifetime. At the end of the term, any remaining assets are distributed to the qualifying charity of your choice.

A benefit of the CRAT is its tax-exempt status. It is not subject to income tax at the trust level, so it is beneficial to fund the trust with a low basis or highly appreciated assets. Once the appreciated assets are in the trust, the trustee can sell the assets and reinvest them in a diversified portfolio.

The value of the annuity payment made to the non-charitable beneficiary is calculated as a fixed percentage of the initial value of the trust's assets, no less than 5%. The value of the remainder interest is calculated at the time of the trust's creation, and the donor receives an income tax charitable deduction. The value of the remainder (the amount going to the charity) must meet a minimum threshold to pass IRS requirements. When the IRS Section 7520 rate is higher, the value of the charitable interest is higher, and the more likely the trust will pass IRS review.

2. Qualified Personal Residence Trust (QPRT)

QPRT allows a homeowner to remove their personal residence from their estate by transferring the ownership to a trust. The homeowner retains the right to use the home for a specific term, but at the end of the term, the home is passed to the beneficiary of the trust

The transfer of the home to the QPRT is treated as a taxable gift of the remainder interest calculated using the IRS Section 7520 rate. The value of the gift is reduced by the value of the grantor's retained interest at the time the transfer was made. The higher the interest rate, the lower the value of that gift, and the less estate and gift tax is consumed when funding the QPRT.

These concepts outlined are complex. Work with a financial planner, estate planning attorney, and tax professional who understand all the implications of implementing these strategies, in addition to state and federal law. Revisiting these strategies is vital as law and tax implications change over time.

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