

Planning in a Low Interest Rate Environment



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With interest rates near historical lows, we spoke with Chris Perry, senior fiduciary officer at Northern Trust in Boston, about the opportunities this environment presents for families who are planning a wealth transfer.

Q: What is a low interest rate environment?

Each month the Internal Revenue Service (IRS) announces the interest rate used to measure the present value of annuities, income interests and remainder interests for gift tax purposes. That interest rate is known as the “Section 7520 rate,” and is named after the section of the Internal Revenue Code that defines it. The Section 7520 rate now is near its historic low.

In June 1989, the Section 7520 rate was at a historical high of 11.6%; in July 2003 it was at a historical low of 3%. In May 2008, it was back at 3.2%. And in September 2008, it was at 4.2%.

Q: How does the low Section 7520 rate affect wealth transfer planning?

For certain estate planning vehicles, a low Section 7520 rate provides opportunities for transferring wealth to the next generation in a tax-efficient manner. One such vehicle is called a grantor retained annuity trust (GRAT). A GRAT is an irrevocable trust that pays the grantor an annuity for a term of years. The annuity is a percentage of the initial market value of the GRAT property and is paid out over the GRAT’s term. If the GRAT is zeroed-out — meaning the present value of the annuity equals the value of the GRAT property — funding the GRAT would have little or no gift tax consequence. If the Section 7520 rate is low, the total annual investment return of the

GRAT assets could exceed the Section 7520 rate, in which case the excess property left in the GRAT at the end of the trust’s term will pass to heirs or trusts for their benefit.

Let’s say you established a two-year GRAT in September 2008, and funded it with \$10 million. For this example, we’ll assume the annualized rate of return of the assets in the GRAT over the next two years will be 9%. In September, the Section 7520 rate was 4.2%, which means the GRAT will pay you a total of \$10,634,334 over two years. But because the assets in the GRAT will be appreciating at a rate of 9%, you still will have \$768,121 left in the GRAT at the end of the two-year term. In September 2010, this remainder interest can pass to your heirs free from gift tax.

Q: Does using a GRAT have any disadvantages or risks?

For someone focused on passing wealth to the next generation and minimizing overall transfer taxes, the GRAT has very few downsides. If the assets in the GRAT don’t appreciate more than the Section 7520 rate, the annuity would pay back all the GRAT’s assets to the grantor. In this situation, the grantor would have paid the transaction costs to create the GRAT and the administrative costs associated with maintaining it without having passed on anything to his or her heirs.



The other risk is that the grantor dies during the GRAT's term, in which case the GRAT's assets come back into the grantor's estate for estate tax purposes.

Q: When would a GRAT be most appropriate?

Anyone who wants a tax-efficient way to transfer wealth to the next generation — whether they're modifying a wealth transfer plan or just getting started — could benefit from a GRAT or other wealth transfer vehicles designed to work effectively in a low interest rate environment. But I'd advise people to seize the day. We have no guarantee that rates will stay low. By acting now, you can lock in a low interest rate. If you wait, you may lose the opportunity.

For someone who is new to the estate planning process, it is generally advisable to execute a will, a revocable trust and other related estate planning documents before thinking about more sophisticated estate planning vehicles such as a GRAT.

Q: How long can we expect the Section 7520 rate to remain low?

Nobody knows. Although the two rates are not linked, the interest rates issued by the IRS track the movement of the

federal funds rate. As the Federal Reserve increases its rates, the IRS rates typically increase as well. Because we don't know what the Fed is going to do, we can't accurately predict what the IRS will do either.

Q: What are some other techniques people can use to take advantage of the low IRS rates?

A charitable lead trust (CLT) is a trust to which a grantor who has charitable objectives makes an irrevocable gift of property. The CLT then pays the charity a "lead" or income interest for a set number of years. At the end of the CLT's term, anything left in the trust passes to the trust's remainder beneficiaries, often the grantor's heirs. As with a GRAT, the remainder beneficiaries of a CLT are more likely to receive assets from the trust when interest rates are low.

Another option is an intra-family loan, in which a parent loans money to a child in exchange for a promissory note from the child. The interest rate on the promissory note is determined by the applicable federal rates (AFRs), which, like the Section 7520 rate, are published by the IRS. The AFR represents the minimum interest rate the parent must charge on the loan in order to avoid having the loan treated as a gift by the IRS. If the child can take the money and invest it wisely so that it earns more than the AFR on the loan and ultimately pay off the note over time, then the child will benefit from any appreciation that exceeds the AFR.

You might consider an intra-family loan when helping your child buy a home. But you must remember to collect payments. If you forgive the debt, you will have made a gift to your child, and could potentially face gift or income tax consequences as a result.

Q: Do you have any other advice for people looking at their wealth transfer plans?

As with other financial and investment opportunities, you should view these kinds of estate planning techniques in the context of your larger financial picture. Also, remember it isn't enough to simply create a trust, put assets into it, and assume you're done. You can take advantage of many techniques — including investment and hedging strategies — to maximize the upside potential and minimize the possible downside with these estate planning vehicles. Consulting with your financial advisor is the best way to explore whether GRATs, CLTs or intra-family loans are appropriate, and if so, how to increase the chances that they will be effective at transferring wealth to the next generation in a tax-effective manner. ■