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WEALTH MANAGEMENT TRUSTS & ESTATES

Estate Planning Tools to Put to Work in a Higher-Interest Rate Environment

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INTRODUCTION

The federal funds rate was raised to 2.5 percent at the end of 2018, and it is expected to continue to rise in the coming months and years. The federal funds rate has a direct affect on many other interest rates which can ultimately impact one's estate planning goals. Specifically, as interest rates rise, there will be corresponding increases in the Applicable Federal Rate as well as the rate prescribed by Section 7520 of the Internal Revenue Code (the Section 7520 rate), both of which are used to determine the tax implications of certain gifts and other transfers for federal transfer tax purposes.

Accordingly, estate planning practitioners and other advisers should clearly contemplate how interest rate sensitive planning techniques are impacted in this changing environment. This article will explore selected gift and estate planning techniques that tend to perform better in a higher-interest rate environment and are therefore most likely to gain traction moving forward.


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> *CRATs and CGAs will most likely be the most popular tools that estate planners reach for on behalf of their clients in a higher-interest rate environment, but practitioners should also contemplate the use of QPRTs, which may have fallen out of favor when interest rates were low but are certainly a more viable option now.*

CHARITABLE REMAINDER ANNUITY TRUST

A Charitable Remainder Annuity Trust (CRAT) is an

estate planning vehicle where the donor contributes assets to an irrevocable trust which pays a fixed annuity to the donor (or other beneficiary) for a term of years and then distributes the remainder to a designated charity at the end of the term. In order to qualify as a CRAT under the Internal Revenue Code (the code), the trust must satisfy certain requirements, two of which are relevant to this discussion: the annuity amount must be at least 5 percent, but no more than 50 percent, of the initial fair market value of the property contributed to the trust; and the value of the charity's remainder interest must be at least 10 percent of the initial fair market value of the property contributed to the trust. The code also requires that on the date the CRAT is created, it must pass the "probability of exhaustion test" which is explained in more detail below. Nonetheless, if a donor can satisfy these requirements, then utilizing a CRAT will be advantageous for several reasons, including the receipt of fixed income payments and the ability to avoid payment of capital gains tax on the transfer of appreciated assets. Additionally, in funding a CRAT, a donor is ultimately reducing the size of his taxable estate, while at the same time gaining the personal satisfaction of benefiting a charity important to him. Lastly, and perhaps most attractive, is the charitable deduction available to the donor for income tax purposes, which is equal to the actuarial value of the remainder interest passing to the charity.

In a high interest-rate environment, a CRAT is even more advantageous; not only do high interest rates tend to produce a higher deduction, but they make it easier to satisfy the IRS requirements referenced above. With CRATs, the actuarial value of the remainder interest is valued at its present value using the Section 7520 rate. When the Section 7520 rate is higher, the value of the donor's retained interest becomes lower. As a result, the charity's remainder interest increases (making it easier to satisfy the 10 percent requirement) which ultimately increases the donor's charitable deduction.

As mentioned above, the code requires that a CRAT also pass the "probability of exhaustion test." This means that on the day the trust is created, there must be no more than a 5 percent probability that the trust will be exhausted before termination. This test is addressed at length in IRS Revenue Ruling 77-374, but essentially, in order for a CRAT to pass this test, the Section 7520 rate must be equal to or greater than the percentage used to determine the annuity payment (the minimum of which must be at least 5 percent). However, the low interest rates of recent years have made it nearly impossible for donors to pass this test. Although the IRS has provided practitioners with language to include in trust instruments to remedy this issue, it is only a recent solution, and will not be necessary when interest rates reach 5 percent or higher.

It is important to note here that the tax legislation passed at the end of 2017 limits the usefulness of charitable deductions for many taxpayers due to the increase in the standard deduction. This is less likely to be a concern for the category of clients who might be considering a CRAT, however, as the deduction generated by a CRAT is likely to exceed the standard deduction threshold.

CHARITABLE GIFT ANNUITIES

Another estate planning technique that works well in a high interest-rate environment is the use of a charitable gift annuity (CGA). A CGA is a contract between a donor and a charity where the donor makes a gift to the charity in exchange for a fixed stream of income; at the end of the donor's life, the charity receives the remainder

of the gift. Basically, the CGA provides the same function as a CRAT without the expense of creating and administering a trust. In the CGA context, the donor's gift is set aside in a reserve account and invested by the charity. The annuity payment that the donor receives varies among charities, and is based on several factors, such as the size of the gift and the donor's age. Although the annuity payment is a fixed amount, it is interesting to note that the payment is guaranteed by the charity no matter how the investments perform, because it is backed by all of the charity's assets, not only the donor's gift.

Given the similarities between CGAs and CRATs, CGAs are attractive for the same reasons CRATs are when interest rates are high, i.e., larger charitable deductions. Here, the charitable deduction equals the amount of the donor's contribution in excess of the present value of the retained annuity. In addition, the donor will also receive more income as interest rates continue to rise than they would have in past years. This is because the maximum rates of return relied on by most charities are established by the American Council on Gift Annuities (ACGA), which monitors certain interest rates that underlie the investment return assumptions used to create their rate schedules. Given the rise in interest rates, the ACGA recently increased its suggested maximum payout rates for the first time since 2012. According to the ACGA, if interest rates continue to rise, they expect to increase their suggested rates again in one to two years.

QUALIFIED PERSONAL RESIDENCE TRUST

A Qualified Personal Residence Trust (QPRT) is yet another estate planning technique which operates in the same way as a CRAT, albeit with different assets and remainder beneficiaries. With a QPRT, the grantor transfers his primary home or vacation home into a trust while retaining the right to live in the home for a term of years; at the end of the term, the home passes to the remainder beneficiaries (often the grantor's descendants, for example) free from gift and estate tax liability. Like a CRAT, computing the present value of the beneficiaries' remainder interest is determined by the Section 7520 rate. Therefore, when interest rates are higher, the value of the gift of the grantor's home is lower, which ultimately lowers the potential gift tax.

CONCLUSION

Interest rates are on the rise and this trend is expected to continue for the foreseeable future. CRATs and CGAs will most likely be the most popular tools that estate planners reach for on behalf of their clients in a higher-interest rate environment, but practitioners should also contemplate the use of QPRTs, which may have fallen out of favor when interest rates were low but are certainly a more viable option now. ●