HOW RISING INTEREST RATES AFFECT VARIOUS TAX AND ESTATE PLANNING STRATEGIES

Interest rates have risen recently and many predict they will rise again in the near term. Higher interest rates may have a significant impact on various tax and estate planning strategies. Higher rates affect the income, estate and gift tax value of many types of transfers. In some cases, higher rates produce more favorable tax results for clients engaging in certain types of transactions. In other cases they result in higher tax costs. Sometimes, however, they don't affect tax costs at all. This Hot Topic examines how rising rates affect key tax and estate planning transactions and strategies so clients can move now to lock in savings, or hold off taking action to avoid unwarranted costs.

- **IRS valuation tables**

  The value of noncommercial annuities, life estates, term interests, remainders, and reversions for estate, gift and income tax purposes is determined under tables issued by IRS under Code Sec. 7520 . The value in a given month under the tables may be higher or lower than the value in an earlier or later month because the interest factor under the tables changes monthly. For charitable transfers, the interest rate for the month of the transfer or for either of the two preceding months may be used.

- **Recent rates**

  The Code Sec. 7520 interest rate for transfers in August, 2004, is 4.8%. It was at an all time low of 3% in July, 2003. Further increases are anticipated as the Federal Reserve has begun raising rates, although IRS has announced the rate will drop slightly to 4.6% for September, 2004. As noted above, higher rates hurt some strategies and benefit others.

- **Strategies hurt by higher rates**

  Higher interest rates produce less favorable results for individuals engaging in the following strategies.

  - Private annuity

    A private annuity offers a number of income, gift and estate tax advantages. It also can save estate administration expenses and offer other non-tax advantages as well. In the typical private annuity transaction, a parent transfers property to his child in return for the child's unsecured promise to pay the parent a fixed, periodic income for life. If the fair market value of the property transferred equals the present value of the annuity under the IRS Code Sec. 7520 valuation tables, there is no gift tax due. An increase in the interest rate increases the annual payment amount the younger family member has to make to the older family member to prevent a gift from arising on the transfer.

Observation: Even though the higher interest rate results in a higher annual payment to the senior family member, that member often will prefer a lower rate so as to be able to transfer more property at the lowest possible cost to the younger family member.

< Illustration 1: In July, 2003, Carl, age 70, transferred property worth $1 million to his daughter in exchange for a private annuity. Carl's daughter had to make an annual payment of $93,657 to prevent a gift from arising on the transfer. This figure was determined by dividing $1 million by the annuity factor from table S of IRS Publication 1457 (Book Aleph) for a 70-year old and an interest rate of 3.0%, which was the Code Sec. 7520 rate for July, 2003.

< Illustration 2: In August, 2004, Susan, age 70, transfers property worth $1 million to her son in exchange for a private annuity. Susan's son must make an annual payment of $107,852 to prevent a gift. His payment is much higher than the payment Carl's daughter had to make. The higher payment results from the rise in the Code Sec. 7520 interest rate to 4.8% for August, 2004.

- <u>Grantor retained annuity trust (GRAT)</u>

  An individual can save transfer tax by setting up a GRAT. The individual retains an annuity interest for a specified term at the expiration of which the property goes to a child or other individual named at the outset. Gift tax is payable but only on the present value of the remainder interest, which is the value of the property transferred to the trust less the value of the retained annuity interest. A higher interest rate decreases the value of the annuity retained by the grantor and thus increases the value of the gift of the remainder in a GRAT.

< Illustration 3: In July, 2003, Gary transferred $1 million to a trust. The trust was to pay him an annual annuity of $80,000 for 10 years. At the end of the 10 years, the property was to go to his daughter. The value of Gary's retained annuity was $682,416. This figure was determined by multiplying $80,000 by 8.5302, which is the annuity factor from table B of IRS Publication 1457 for a 10-year term and an interest rate of 3%. The value of the gift of the remainder to Gary's daughter was $317,584.

< Illustration 4: In August, 2004, Bill engages in transaction that's similar to Gary's in illustration (3). The value of Bill's retained annuity is $623,784 and the value of the gift is $376,216.

- <u>Charitable lead annuity trust</u>

  An increase in the interest rate decreases the gift or estate tax deduction for the annuity interest going to the charity and increases the value of the gift of the remainder interest going to a private beneficiary.

- <u>Charitable transfer of remainder interest in residence or farm.</u>

An increase in the interest rate decreases income, estate and gift tax deductions for a remainder interest in a residence or farm.

Observation: Taxpayers have some flexibility to deal with changing rates in connection with charitable transfers because of the rule allowing a taxpayer to use the Code Sec. 7520 rate for the month of the transfer or for either of the two preceding months.

■ **Strategies helped by higher rates**

Higher interest rates produce more favorable results for individuals engaging in the following strategies.

- <u>Grantor retained income trust (GRIT)</u>

  A GRIT is like a GRAT except the grantor retains an income interest instead of an annuity interest. Code Sec. 2702 generally treats the grantor as making a gift of the full value of the property. However, the value of the gift of the remainder is determined under the valuation tables where the trust is funded with a personal residence of the grantor or the remainder goes to someone falling outside of the definition of family member, such as a nephew or niece. An increase in the interest rate increases the value of the retained income interest and decreases the value of a gift of a remainder interest in a residence GRIT or other GRIT excepted from the Code Sec. 2702 rules.

  < Illustration 5: Carole established a personal residence GRIT in August, 2003, retaining a ten-year term interest. At the end of the 10-year period, the residence is to go to her son. The value of the residence at the time of the initial transfer to the trust is $400,000. The value of the gift of the remainder from table B of IRS Publication 1457 was $297,638.

  < Illustration 6: In August, 2004, Larry engages in a transaction that's similar to Carole's in illustration (5). The value of Larry's gift is $250,292.

- <u>Charitable remainder annuity trust</u>

  With a charitable remainder annuity trust, the donor retains an annuity interest for himself or someone else such as a family member and names a charity to receive the remainder at the end of the annuity term. The donor gets a current income tax deduction for the present value of the charity's remainder interest. A higher interest rate produces higher income, gift and estate tax charitable deductions for the charity's remainder interest. That's because the higher rate decreases the value of the non-charitable annuity interest. Thus, if the annuity interest is not retained by the donor but is given to someone else, the higher rate reduces the donor's gift tax costs.

■ **Where lower Code Sec. 7520 rates have no impact**

The following strategies are not affected by an increase in the Code Sec. 7520 rates.

- Grantor retained unitrust (GRUT)

  A change in the interest rate does not affect the value of a gift of a remainder interest in a GRUT because the retained unitrust interest is the right to receive a fixed percentage of the trust's assets and changes in rates would inure uniformly to the benefit of the unitrust holder and the remainder person.

- Charitable remainder unitrust

  A change in the rate does not affect income tax deductions for charitable remainder unitrusts or gift tax costs in connection with them.

- Charitable lead unitrust

  Estate and gift tax factors are essentially unaffected by changes in the rates.

- Pooled income funds in existence more than 3 years

  Charitable income, gift and estate tax deductions for transfers to pooled income funds that have been in existence more than 3 years are not affected by changes in Code Sec. 7520 interest rates because values of respective interests are determined with reference to the funds' own rates of return. Any personal gift arising from the transfer also is not affected by changes in Code Sec. 7520 interest rates. However, higher returns of funds which have been around for more than three years will increase the value of the non-charitable interest (either retained by the donor or given to a family member) and decrease the value of the remainder interest going to charity. Thus, the higher returns will decrease charitable deductions.