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Three Ways to Minimize Your Estate Tax

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A major goal of estate planning is to minimize taxes during the transmission of wealth from one generation to another. Current historically-low interest rates environment presents unique opportunities to transfer wealth to children and more remote descendants.

For transfer tax purposes, virtually all forms of gifts are valued pursuant to one or more rates published by the Internal Revenue Service (IRS), which in turn are determined by current market conditions.

There are three tools you can use to minimize estate tax. Two of them – Grantor Retained Annuity Trusts (GRATS) and Charitable Lead Annuity Trusts (CLATS) – utilize the rates published by the IRS pursuant to Section 7520 of the Internal Revenue Code.

Rates Set By Internal Revenue Code

An excerpt of the historical Section 7520 rates is below, for each year determined for the month of January.

Year	Rate:
1990	9.6%
1995	9.6%
2000	7.4%
2005	4.6%
2010	3.0%
2012	1.4%

The third technique is to create a sale to an Intentionally Defective Grantor Trust (IDGT). The Applicable Federal Rate (AFR) is used to determine whether a gift is involved and the size of it, as prescribed by the IRS pursuant to Section 1274 of the Code.

An excerpt of the historical Section 1274 rates is below, again for each year determined for the month of January.

Year	Short Term	Mid Term	Long Term
1998	5.70%	5.93%	6.13%

2000	5.88%	6.21%	6.45%
2005	2.78%	3.76%	4.76%
2010	0.57%	2.45%	4.11%
2012	0.19%	1.17%	2.63%

All three techniques are detailed below.

Grantor Retained Annuity Trust

A GRAT involves the transfer of property expected to appreciate in value to a trust pursuant to which the grantor retains the right to an annuity in an amount set forth initially in the trust document. At the end of the term of the GRAT, the property remaining in the trust passes to donees selected by the grantor initially, usually in a lower generation than the grantor. The determination of whether a gift is made is determined with reference to the Section 7520 rate. If the property in trust increases in value more than the Section 7520 rate, it is possible to transfer substantial wealth to the next generation.

For example, a Grantor contributes property (or money) having a value of $1,000,000 to a GRAT, reserving an annuity of $100,000 per year for five years. Assume that the trust produces annual income of five percent of the value of the trust and appreciates in value by ten percent per year. Regardless of the Section 7520 rate, the next generation will receive property with a value of $1,355,731. The amount of the taxable gift depends on the Section 7520 rate at the time of inception of the trust as shown below:

Section 7520 Rate	Amount of Taxable Gift
1.40%	$520,330
5.00%	$567,050
10.00%	$620,920

The current low interest rate environment also increases the potential benefits of a "zeroed-out" GRAT. In a zeroed-out GRAT, the total value of the annuity payments to the grantor is as close as possible to the value of the contributed property plus appreciation at the Section 7520 rate. Because the entire actuarial value of the trust is payable to the grantor, the taxable gift resulting from the formation of a zeroed-out GRAT is typically less than $1.00. If the grantor is still living at the end of the trust term, the remaining property in the trust after payment of the final annuity payment passes to the next generation gift-tax free. The annuity required to zero out the GRAT assumes a return on the GRAT investments at the Section 7520 rate, so a lower Section 7520 rate allows for lower annuity payments to the Grantor and increases the amount passing free of gift tax to the next generation. For example, using the same numbers from the example above, except for annuity payments that zero out the value of the GRAT, the annual annuity payments and the remainder passing gift tax free to the next generation are shown below:

Section 7520 Rate	Amount of Annuity	Remainder to Beneficiaries
1.40%	$208,476.60	$620,711.73
5.00%	$230,973.50	$468,276.41
10.00%	$263,796.50	$245,873.14

Charitable Lead Annuity Trust

A CLAT is a form of split interest trust with the initial interest payable to a charity and the remainder interest after a term specified at the inception of the trust that reverts to either the grantor or to or for the benefit of other non-charitable beneficiaries. The grantor is entitled to an income tax and gift tax deduction for the charity's interest if the charity's interest is in the form of a guaranteed annuity interest.

If the trust is structured as a grantor trust for income tax purposes (i.e., the grantor is treated as the owner of the trust for income tax purposes), the grantor is entitled to an income tax deduction on the inception of the trust for the value of the charity's interest.

Using the same numbers as above, assume that the grantor contributes property worth $1,000,000 to a CLAT, which provides an annuity of five percent per year to charity for ten years. The table below illustrates the amount of the income tax deduction at various levels of the Section 7520 rate.

Section 7520 Rate	Amount of Deduction
1.40%	$463,560
5.00%	$386,085
10.00%	$307,230

Intentionally Defective Grantor Trust

An IDGT is a trust which is disregarded for income tax purposes but which is respected for transfer tax purposes. Its principal use is to transfer property likely to appreciate in value more than prevailing interest rates without incurring income tax on its disposition. A common use for IDGTs is to sell appreciated property to the trust in exchange for an interest-bearing promissory note.

There are several techniques for creating a trust which will be disregarded for income tax purposes but respected for transfer tax purposes. One commonly used technique is to provide in the trust document a power in the trustee (who cannot be the grantor) the ability to add charitable beneficiaries to the trust.

While there is no statutory safe harbor for the interest rate to be borne by the promissory note, most practitioners believe that using a rate at least equal to the AFR will protect such a sale from being questioned by the IRS, especially if the borrowing entity has at least ten percent equity in the transaction and the transaction is adequately secured.

The table below illustrates the results of creating an IDGT with an initial principal of $100,000 and selling to the trust property with a value of $1,000,000, taking back a ten-year note providing for interest at the rate equal to the long term AFR and payable in equal annual installments of principal and interest. It is further assumed that the property in trust produces income equal to nine percent of the beginning of year value of the trust. The amount of the gift is the same in all scenarios, which is the $100,000 initial equity in the trust.

Long Term AFR	Amount Remaining When Note is Fully Paid
2.50%	$868,174
4.00%	$730,950
6.00%	$539,868

What You Should Know

As can be seen, the current low interest rate environment is very conducive to the tax-free transmission of wealth. This type of planning has recently taken on increased urgency, as all of the techniques described above have been targeted for statutory elimination or curtailment and their continued availability is uncertain.