

How falling interest rates and the declining stock market affect tax and estate planning

Interest rates have dropped in recent months and may drop even more given the state of the economy. Lower rates can have an impact on many tax and estate planning strategies. Lower interest rates affect the income, estate and gift tax value of many types of transfers. In many cases, the drop in rates produces more favorable results for clients engaging in certain types of transactions. In other cases, however, the lower rates result in higher tax costs.

IRS valuation tables. The value of annuities (other than commercial annuities), life estates, term interests, remainders and reversions for estate, gift and income tax purposes is determined using tables issued by IRS. The value in a given month according to the tables may be higher or lower than the value in an earlier or later month because the interest factor 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.

The interest rate for April 2008 is 3.4%.

Observation: Over the past nine months from August 2007 to April 2008, the interest rate has ranged from a high of 6.2% (August 2007) to a low of 3.4% (April 2008). The rate hit an all-time low of 3.0% for transfers in July 2003 and has been as high as 11.6% (Apr. and May '89). (*These above rates are based on IRC Section 7520*)

How falling rates affect various non-charitable planning strategies:

Private annuity. Historically, private annuities have offered a number of income, gift and estate tax advantages. They 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 that 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 as determined under the IRS valuation tables, there is no gift tax due.

Observation: One huge advantage of a private annuity has been the opportunity to transfer highly appreciated property, and spread, and pay tax on, the gain over several years as annuity payments are received. Additionally, there was the prospect of being taxed on less than the entire gain if the annuitant died before the expiration of his tabular life expectancy. However, in 2006, IRS issued guidance that would knock out the income tax advantages of selling appreciated property in exchange for a private annuity. They would do this by causing the property seller's gain to be recognized in the year the transaction is effected rather than as payments are received. These rules generally would apply for transactions entered into after Oct. 18, 2006.

Entering into a private annuity when interest rates are lower results in a lower annual payment amount that the younger family member will have to make to the older family member to prevent a gift from arising on the transfer.

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

Illustration: In April 2008, Jones, age 70, transfers property worth \$1 million to his daughter in exchange for a private annuity. She must make an annual payment of \$96,752.97 to prevent a gift from arising on the transfer. This figure is determined by dividing \$1 million by 10.3356, which is the annuity factor for a 70-year old and an interest rate of 3.4%, which is the interest rate for April 2008.

Illustration: By way of comparison, had the transfer occurred when the interest factor was 6.2% as it was for August 2007, the annual payment to prevent a gift would have been \$119,323.20.

Observation: Stock values generally have been declining lately. Someone who is considering setting up a private annuity may want to fund it with stock that has undergone a steep decline in value from its high back to near its original purchase price. Such stock may be a good candidate for funding a private annuity because there would be little or no gain to report in the year of the transfer under the proposed regulations if they take effect. Also, if the market turns around as it has often done in the past after steep downturns, the transaction can achieve considerable transfer tax savings. That's because, the child will end up with a sizeable amount of property with no gift or estate tax cost imposed on the post-transfer appreciation in its value.

Observation: Even individuals who lack the means to set up a private annuity should consider that now may be a good time to transfer stock to a junior family member. With prices as depressed as they are, in many cases blocks of stock can be transferred completely free of gift tax under the umbrella of the \$12,000 annual exclusion. For example, 300 shares of stock that was previously worth, for example, \$100 per share and that is now trading for \$40 per share can be transferred to a single individual at no gift tax cost by virtue of the \$12,000 annual exclusion. Here, too, if the stock bounces back to its earlier highs or beyond, the post-transfer appreciation will escape transfer tax costs.

Grantor retained annuity trust (GRAT). 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 trust 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 lower interest rate increases the value of the annuity retained by the grantor and thus reduces the value of the gift of the remainder in a GRAT.

The post-transfer appreciation in the value of the trust assets will escape transfer tax. However, this is so only if the grantor survives the trust term. If the grantor dies during the trust term, the trust property will be included in his gross estate, which provides that property transferred by an individual during his lifetime is includible in his estate if he retains an interest for any period that does not in fact end before his death. But an individual who sets up a GRAT and dies before the end of the term would be no worse off than if he had not entered into the transaction except that he will have incurred the costs of setting up and administering the trust.

Illustration 3: In April 2008, Smith transfers \$1 million to a trust, which is to pay him an annual annuity of \$80,000 for 10 years. At the end of the 10 years, the trust property is to go to Smith's daughter. The value of Smith's retained annuity is \$668,696. This figure is determined by multiplying \$80,000 by 8.3587, which is the annuity factor for a 10-year term and an interest rate of 3.4%. The value of the gift of the remainder to Smith's daughter is \$331,304.

Observation: Because a GRAT requires the grantor's survival of the term to be effective to reduce estate tax, it may not be suitable for use by an individual with a short life expectancy as a hedge against failing to survive until greater estate tax relief is phased in. However, such an individual may be able to realize some estate tax savings by establishing a GRAT with a relatively short term that he can be expected to survive.

Illustration: By way of comparison, had Smith made the transfer when the interest factor was 6.2%, the value of the gift would have been \$416,736.

How declining rates affect various charitable planning strategies. The discussion that follows explains various charitable planning strategies and shows how they stack up under current declining rates.

Charitable remainder annuity trust (CRAT). 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. Now may not be a good time to establish a CRAT. That's because, a lower interest rate produces smaller income, gift and estate tax charitable deductions and a higher gift tax value for a gifted annuity interest.

Charitable remainder unitrust (CRUT). 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.

Charitable lead annuity trust. A lower interest rate results in a larger gift or estate tax deduction for the annuity interest going to the charity and a smaller value for any gift of the remainder interest going to a private beneficiary. Thus, it may be a good time to establish a charitable gift annuity if the grantor is going to give the remainder interest to a family member. If rates decline further, more savings can be realized by waiting. And remember, with a charitable transfer, the interest rate for the month of the transfer or for either of the two prior months can be used. Thus, one can wait and still be afforded some protection if rates unexpectedly rise instead of dropping further.