

## TAKING ADVANTAGE OF CHANGING INTEREST RATES<sup>1</sup>

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### Introduction

The IRC Section 7520 rate for September 2002 will be 4.6%. This rate is used for valuing life interests, annuities, interests for terms of years, and remainder or reversionary interests, and this rate has only dropped below 5.0% once since January 1989 (in December 2001).

Such a low interest rate, this year or in the future, will impact estate planning in a variety of ways, producing greater tax benefits for some strategies and greater tax costs for others.

### Qualified Personal Residence Trust ("QPRT")

With a QPRT, the grantor transfers ownership of a residence to an irrevocable trust retaining the right to live rent-free in the residence for a term of years (the "term period"). Upon the expiration of the term period, the residence generally is either transferred to the remainder beneficiaries, or retained in trust and rented (perhaps to the grantor), or retained for the rent-free use of the grantor's spouse.

The value of the gift upon establishment of a QPRT is the full fair market value of the residence reduced by the value of the grantor's retained interest. A lower Section 7520 rate decreases the value of the grantor's retained interest and increases the value of the remainder interest, thereby increasing the value of the taxable gift. Consider the following example:

#### Example 1:

A 55 year-old transfers his \$750,000 residence to a QPRT with a 15-year term period. If the gift occurred in September 2001 (Section 7520 rate of 5.8%), the value of the gift would have been \$256,230. If the gift occurs in September 2002, (Section 7520 rate of 4.6%), the value of the gift would be \$304,043. The lower interest rate in this case results in an additional \$47,813 of lifetime gift exemption being used by the grantor.

### Grantor Retained Annuity Trust ("GRAT")

With a GRAT, the grantor transfers ownership of an appreciating asset to an irrevocable trust retaining the right to receive an annuity amount for a term. Upon the expiration of the term, the property (including all appreciation) is generally transferred to the remainder beneficiaries or retained in trust for their benefit.

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<sup>1</sup> This article is current as of 2002. Please contact Willms, S.C. for current information on this topic.

The value of the gift upon establishment of a GRAT is the full fair market value of the contributed property reduced by the value of the grantor's retained interest. A lower Section 7520 rate increases the value of the grantor's annuity interest and decreases the value of the remainder interest, thereby decreasing the value of the grantor's taxable gift. Consider the following example:

Example 2:

A 50 year-old transfers \$1,000,000 worth of appreciating stock in his close-held business to a GRAT with a 15-year term period, retaining the right to receive \$75,000 annually during the term period. If the gift occurred in September 2001 (Section 7520 rate of 5.8%), the value of the gift would have been \$296,560. If the gift occurs in September 2002, (Section 7520 rate of 4.6%), the value of the gift would be \$239,005. The lower interest rate in this case results in a savings of lifetime gift exemption of \$57,555.

**Charitable Remainder Annuity Trust ("CRAT")**

As many of you know, a charitable remainder annuity trust ("CRAT") is a type of charitable remainder trust ("CRT") that pays out a fixed amount (the "Annuity Amount"), at least annually, to the individual beneficiaries during its term. The Annuity Amount is selected when the CRAT is created and must be at least 5% of the fair market value of the assets placed in the CRAT. With a CRAT, a higher interest rate will yield a greater income tax charitable deduction to the donor (and in cases where the donor is not the non-charitable beneficiary, will reduce the gift tax cost to the donor), because the higher rate decreases the value of the non-charitable annuity interest.

Example 3:

A 70 year-old transfers \$1,000,000 worth of low basis securities to a CRAT for his benefit. The Trust provides for a \$60,000 annual payment for his entire lifetime. If the CRAT was funded in September 2001 (Section 7520 rate of 5.8%), the value of the charitable gift would have been \$482,806. If the gift occurs in September 2002, (Section 7520 rate of 4.6%), the value of the charitable gift would be \$435,256.

**Conclusion**

Of course, this discussion does not address all estate planning strategies impacted by the interest rate change. Other estate planning strategies impacted by changing rates include private annuities and installment sales.

If you would like to discuss estate planning strategies impacted by interest rates in greater detail, please contact us at (262) 238-6996 or email us at [firm@willmslaw.com](mailto:firm@willmslaw.com).