

CLIENT MEMORANDUM

Estate Planning Opportunities While Interest Rates Remain Low

August 9, 2016

AUTHORS

David J. McCabe | David J. Posner

Interest rates remain near historic lows, and this is reflected in the Applicable Federal Rate (“AFR”), the rate often used in connection with a sale to a grantor trust (a “Sale”) or an intra-family loan. The AFR for obligations with a nine-year term is currently 1.18%. The Internal Revenue Code Section 7520 “hurdle rate” for grantor retained annuity trusts (“GRATs”) and certain split-interest trusts, which is derived from the AFR, is also at a near historic low of 1.40%. Sales and GRATs are particularly attractive in low interest rate environments—so much so that even a small increase in rates could significantly undermine their efficacy. Since it is uncertain when and by how much interest rates will rise in the near term and because the Administration’s tax proposals for a number of years have included various measures that would dramatically limit the benefits of these estate planning techniques, we believe it is prudent to take advantage of the low rates now, before such rates increase and/or a new Administration is able to enact such restrictions. Below is a brief summary of two such estate planning techniques that may be particularly attractive for you in this environment.

GRAT

A GRAT is a trust to which you contribute property and retain the right to receive a fixed amount (the “Annuity Payment”) payable annually for a specified term of years (the “Term”). Essentially, all property contributed to the GRAT is returned to you in the form of Annuity Payments. At the end of the Term, after the final Annuity Payment is made to you, the GRAT terminates and any remaining principal is paid to your children or to trusts for their benefit.

Estate Planning Opportunities While Interest Rates Remain Low

Continued

For gift tax purposes, the value of the gift to the GRAT is equal to the fair market value of the property contributed to the GRAT less the present value, using the § 7520 rate as the discount rate, of your right to receive the Annuity Payments for the Term. We generally structure the Annuity Payments so that the present value of the annuity stream is equal to the fair market value of the property transferred to the GRAT, resulting in no gift to the GRAT for gift tax purposes. You can further leverage the gift to the GRAT if discounts are used to determine the fair market value of the assets transferred thereto.

At the end of the GRAT Term, any property remaining in the GRAT passes to your children, either outright or in further trust, free from gift tax. The amount remaining in the GRAT will be the growth (appreciation and income) on the investments in excess of the § 7520 rate during the Term. If the GRAT investments do not outperform the § 7520 rate, all of the GRAT property will be returned to you as Annuity Payments and nothing will be left in the GRAT at the end of the Term to pass to your children. Note, however, that for the GRAT to work, not only must the investments outperform the § 7520 rate, but also you must survive the Term. If you die during the Term, the assets in the GRAT will be included in your taxable estate as if you had never created the GRAT. To minimize the mortality risk, we generally recommend the creation of several successive two-year GRATs, rather than one GRAT with a long term. The successive two-year GRATs are commonly referred to as “rolling GRATs.”

Sale

A Sale to a grantor trust is another method of transferring the appreciation on property to your descendants. If you utilize this technique, you will sell property to an existing grantor trust of which you are the grantor (the “Trust”) in exchange for a promissory note (the “Note”). The face amount of the Note will be the fair market value of the property sold to the Trust. Depending on the assets sold, the fair market value may reflect certain discounts for lack of marketability and lack of control. The Note typically provides for the payment of interest annually during its term and a balloon payment of principal at the end of the term. The interest charged on the Note must equal or exceed the AFR for the relevant term, and the terms of the Note must be similar to other arm’s-length sale transactions. Since the Trust is a grantor trust, there will be no gain recognition on the sale of property to the Trust, and the interest you receive on the Note will be ignored for income tax purposes. To the extent that the Trust assets earn income or appreciate in value in excess of the AFR, all such growth inures to the benefit of the Trust, without any gift tax being owed.

The Sale technique offers several advantages over the GRAT. For example, generation-skipping transfer (“GST”) tax planning is available with a Sale, whereas it is not available with a GRAT. In addition, a Sale generally outperforms a GRAT since the AFR (for a short-term or mid-term Note) is less than the § 7520 rate, and the annual payments back to you are smaller with a Sale than with a GRAT. However, there are additional risks associated with the Sale. A Sale, unlike a GRAT, is not a statutory technique approved by the IRS. Furthermore, if the property sold to the Trust declines in value while the Note is outstanding, the Trust will need to use its existing equity to repay the Note.

Estate Planning Opportunities While Interest Rates Remain Low

Continued

Please contact us if you are interested in learning more about these techniques. There are pros and cons associated with each, which we are happy to discuss with you in further detail, and the choice of technique will be guided by your particular circumstances.

If you have any questions regarding this memorandum, please contact David J. McCabe (212-728-8723; dmccabe@willkie.com), David J. Posner (212-728-8780; dposner@willkie.com) or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is an international law firm with offices in New York, Washington, Houston, Paris, London, Frankfurt, Brussels, Milan and Rome. The firm is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our fax number is (212) 728-8111. Our website is located at www.willkie.com.

August 9, 2016

Copyright © 2016 Willkie Farr & Gallagher LLP.

This memorandum is provided by Willkie Farr & Gallagher LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum may be considered advertising under applicable state laws.