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Gifting Strategies in a Low Interest Rate Environment

The good news is interest rates are at historic lows; the bad news is that interest rates are at historic lows! Maybe it's time for you to consider turning a negative into a positive for your financial situation. Given record low interest rates and the fact that income and estate taxes are likely to rise in the future, now is the perfect time to reduce your potential taxes while simultaneously achieving your wealth transfer objectives. The following strategies are based on utilizing the IRS interest factors commonly referred to as the AFR or "applicable federal rate". The AFR is a set of rates published monthly by the IRS for the purpose of establishing set interest rates for various types of transactions.

The most straightforward technique is the intra-family loan. A parent can lend a child (or grandchild) funds at the AFR applicable to the loan's term. A 3-9 year loan would utilize a fixed rate of 1.19% and a 9+ year (fixed) loan would be at 2.95% (utilizing the October 2011 annual AFRs). The child could use the funds to payoff high interest debt, like a mortgage, or make an investment in an asset that would out-pace the AFR over the term of the loan. At the end of the loan, principal is paid back to the parent and the child keeps any excess free of estate or gift taxes. Loans can also be made to trusts or family partnerships through careful planning.

> ***Historic Low Annual Interest Rates*:***
>
> *Short-term AFR – 0.16%*
>
> *Mid-term AFR – 1.19%*
>
> *Long-term – 2.95%*
>
> **(As of October 2011)*

Grantor Retained Annuity Trusts or GRATs are another way to transfer wealth utilizing current low rates. GRATs allow for the transfer of family assets at low to potentially zero gift tax cost. A parent transfers assets into a trust that requires an annuity consisting of a return of principal and interest based on 120% of the IRS mid-term AFR called the "7520" rate. The 7520 rate for October 2011 is 1.4%. After a specified term, typically longer than 2 years, the GRAT ends and whatever is left after annuity distributions goes to the GRAT's beneficiaries. By placing assets that earn more than 1.4% into a GRAT, all future growth is removed from the parent's estate and goes to the beneficiary tax-free. Keep in mind that if the parent dies before the trust ends, the assets are pulled back into the decedent's estate. But in this case, you are no worse off than if you had not done the strategy. Given this potential downside, GRATs are often structured using a laddered approach and even using different assets within each separate GRAT depending on their growth potential.

Another strategy that takes advantage of low rates is called an IDGT or an "installment sales to an intentionally defective trust". Like a GRAT, assets are transferred to a trust, but this time through a sale rather than a gift. In return for the parent's sale of assets, the trust gives back an installment note that bears interest at the AFR (based on the term of note). Most estate attorneys will recommend that the parent make a gift to the trust of at least 10% of the value of property sold to the trust. This 10% contribution will be a taxable gift, but more importantly it should thwart any IRS argument that the installment note is merely a gift wrapped in a loan's clothing.

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The installment note maybe structured as a principal and interest or interest only loan. Whatever is left after the loan is paid back flows to the trust's beneficiaries free of gift or estate tax.

Lastly, a charitable lead annuity trust "CLAT" is a method for those philanthropically minded to transfer assets to both charity and to beneficiaries in a tax efficient manner. Again, low interest rates play a key role in making this strategy successful. A parent makes a gift to the trust that pays an annuity to the charity of the parent's choice over a set number of years. In return, the parent receives a charitable deduction. This deduction is calculated by discounting the present value of the annuity payments using the IRS 7520 rate (1.4% in Oct. 2011). There also is a taxable gift calculation since assets will pass to beneficiaries at the end of the trust. The gift tax

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is based on the fair market value of assets transferred to the trust less the amount calculated to arrive at the charitable deduction. Adjusting the trust term and/or annuity amount allows the parent to tailor the charitable deduction and gift tax to their specific situation.

The real objective of all the techniques discussed above is to achieve returns that exceed the IRS required interest rate (AFR or 7520). Using assets that can exceed these historically low interest rates equates to the growth of assets transferred being removed from your taxable estate at potentially low or no gift tax cost.

The current income and estate/gift tax environment is temporary and future changes will likely go in one direction: up! Don't miss this incredible opportunity to take advantage of low interest and tax rates to improve your family's financial situation. As a financial planning expert, I've worked with many families and their estate planning attorneys across the country to take advantage of this rare opportunity. If you have any questions or comments, please feel free to contact me at info@djlfg.com.

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Douglas Lyons is a Certified Financial Planner™ (CFP®) (www.cfp.net) and Chartered Financial Analyst (CFA) (www.cfainstitute.org). Two of the "best designations" as rated by Money Magazine (*July 2011 –Advice you can trust*).

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