

CASSIN & CASSIN LLP

711 THIRD AVENUE
NEW YORK, NEW YORK 10017

212-972-6161

CASSINLLP.COM

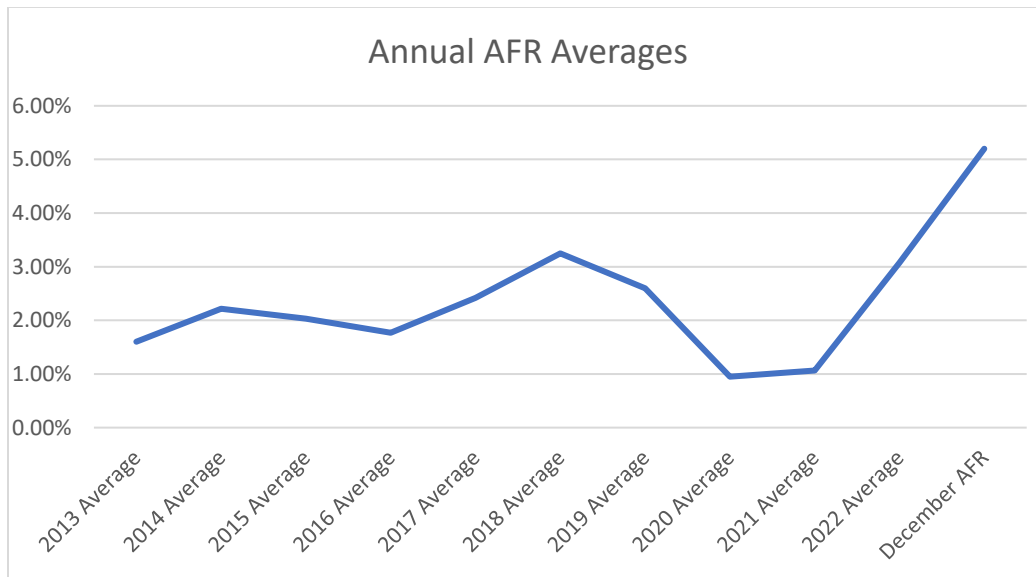
To: Clients & Friends
From: Mari J. Galvin, Partner
Practice Chair, *Trusts and Estates*

Changing Times: Rising Interest Rates and What Clients should consider before “the Sunset”

NEW INTEREST RATE ENVIRONMENT—GRATs, CRUTs and other strategies

There are several estate planning strategies that are affected by interest rates. Among them are trusts that utilize an interest rate prescribed by the Internal Revenue Service (IRS)¹ to value the initial ‘income’ interest and the ultimate remainder interest. The most commonly used strategies are split-interest trusts, such as the grantor retained annuity trust (GRAT) and charitable remainder unitrust or annuity trusts (CRUT or CRAT).

The chart below illustrates the upward trend of the IRC Applicable Federal Rate (AFR) from a low during August thru November of 2020 of 0.4% to the current December 2022 rate of 5.2%.



Each month, the IRS publishes short-, mid-, and long-term rates, known as the Applicable

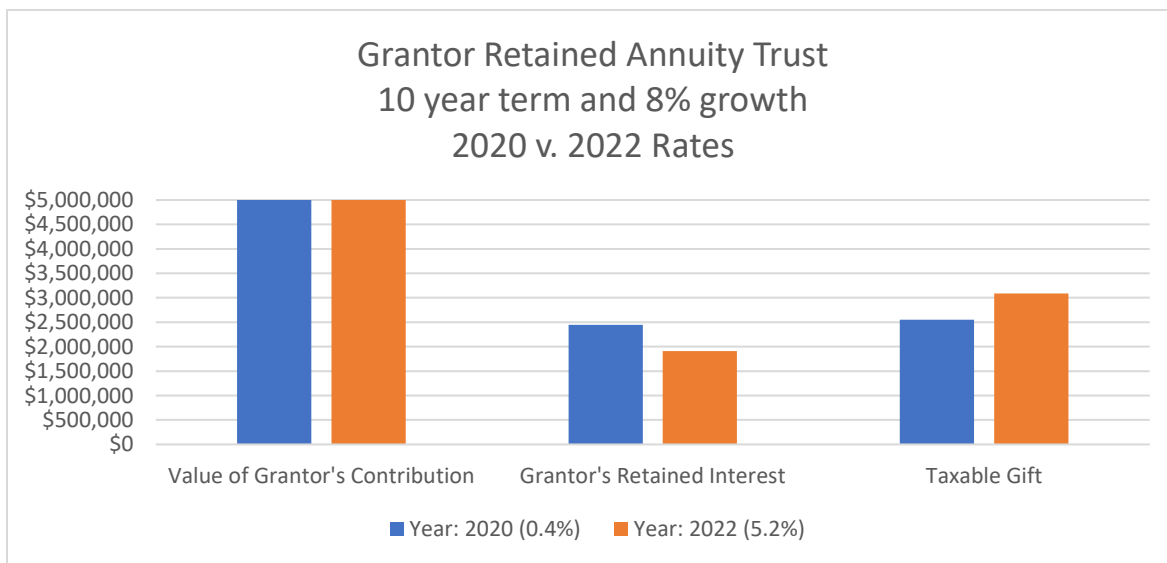
¹ See IRC Section 7520 and Rev. Rule 2022-20.

Federal Rates (“AFR”) that reflect the minimum interest rate that must be charged for loans between related parties. Split-interest trusts are valued using the Internal Revenue Section 7520 rate, which is 120% of the AFR mid-term rate. As a result, steadily rising interest rates have a direct impact on certain estate planning vehicles. Individuals and their planners need to take stock of the changing opportunities that are affected by rising interest rates and consider making large gifts now to lock in interest rates at their current level and in advance of the Tax Cuts and Jobs Act’s (TCJA’s) sunset provision that will eliminate the doubling of the federal gift and estate tax exemption amount on December 31, 2025 from \$12.92 million (effective as of January 1, 2023) to an expected \$6.8 million per person (as of January 1, 2026).

Grantor Retained Annuity Trusts (GRAT):

A GRAT is a type of split-interest trust in which the grantor contributes assets to the trust and retains the right to distributions from the trust for a term of years or, in some cases, the shorter of a term or life. Distributions can be in the form of an annuity (a GRAT) that pays either a fixed amount annually or a unitrust (a GRUT) that pays out a percentage of the trust as valued annually. For purposes of this article, all references will be to a GRAT.

The valuation of the grantor’s retained interest in a GRAT is based upon several factors, including the term, the amount contributed to the trust by the grantor, and the applicable Section 7520 rate. The valuation of the retained interest is subtracted from the amount contributed to determine the amount of the taxable gift², i.e. the remainder interest that passes to individuals upon the termination of the grantor’s interest, which is reported on a gift tax return by the grantor. As the AFR rate rises, the value of a GRAT’s taxable gift will increase. However, this is a freeze technique so the valuation reported on the grantor’s gift tax return (IRS Form 709) in the year of contribution will not be affected by subsequent increases in applicable interest rates. All appreciation will pass to the remaindermen free of estate or gift taxes; provided, however, the grantor survives the term of the trust. It is a common practice to zero out the gift by selecting a term such that the value of the retained interest is nearly equal to the total contribution, but this becomes more difficult to achieve as interest rates rise.



² See 26 U.S. Code Section 2702(a)(2) for special valuation rules in case of transfers of interests in trust.

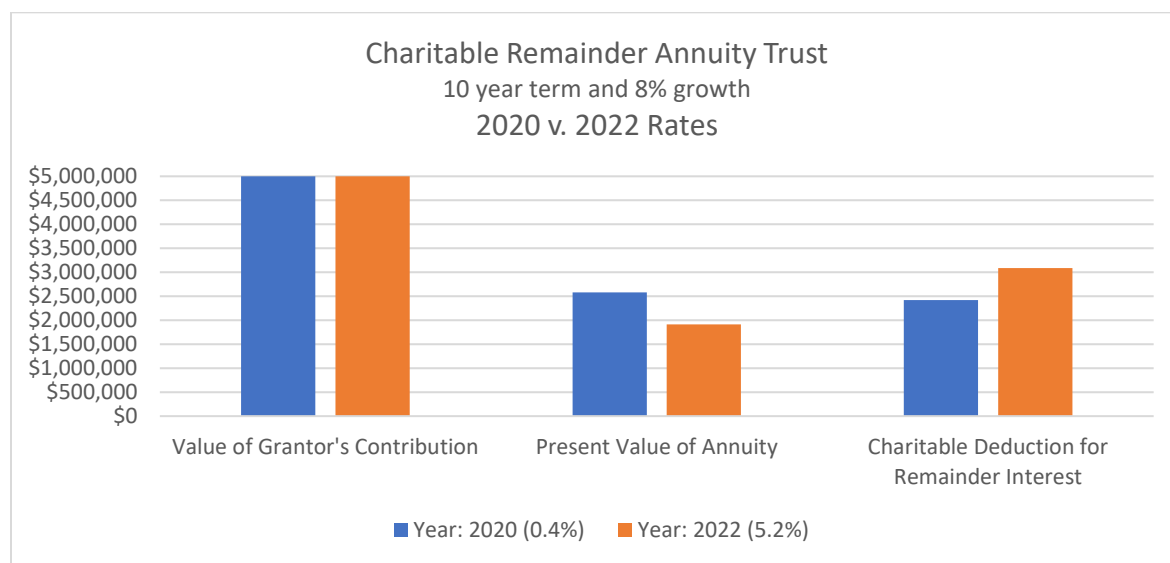
A GRAT's economic benefit is based on your assumptions for the return on assets contributed. A GRAT will succeed in transferring wealth so long as the grantor survives the GRAT term and the appreciation on the grantor's contributed assets exceeds the Section 7520 rate in effect for the month the assets were transferred to the trust. If the assets of the GRAT fail to outperform the Section 7520 rate, the assets will be returned to the grantor with little to no gift tax, meaning that the payout results in a complete return of capital. Beyond minimal administrative costs to establish and maintain the GRAT, no other adverse consequences apply. Additionally, if the grantor does not survive the GRAT term, any gift tax exclusion used upon funding the trust will be restored, leaving the grantor in no worse position for having established the GRAT.

While the benefits of a GRAT are decreasing as interest rates rise, the Section 7520 rate is not as high as it once was in 1989, when rates reached 11.6% and maintained a 7-8% range in the ten to fifteen years that followed. Consequently, since a successful GRAT need only outperform the current Section 7520 rate, individuals are still encouraged to lock in today's rate.

Charitable Remainder Annuity Trusts ("CRAT"):

Another common split-interest trust is a CRAT that pays an annuity each year to non-charitable beneficiaries. Then, upon the termination of term of the annuity, a designated charity receives the remainder interest. The grantor will receive a current an income tax charitable deduction based on the value of the remainder interest at the time of funding.

Currently, higher Section 7520 rates benefit the ability for CRATs to qualify as an effective estate planning tool. Higher rates at the time of contribution generate lower present value payouts and, therefore, larger remainder interests for charities.



In the examples illustrated in the above chart, the grantor contributed \$5,000,000 to a CRAT and received an annual annuity of \$250,000 over 10 years. In 2020, the grantor's charitable deduction would have been \$2,554,125, or 51.083% as a percentage of the amount transferred. In 2022, the grantor's charitable deduction is \$3,088,175 or 61.764% as a percentage of the amount

transferred. All other factors being equal, there is a \$534,050 increase in the grantor's charitable deduction as a result of rising AFRs.

INCOME TAX CONSIDERATIONS-tax cost basis and grantor trust status

“Step up” in Cost Basis at Death:

Current law allows accumulated gains to be passed down to heirs untaxed because the government allows a step-up in the tax cost basis of assets to the value reported on the individual's estate tax return—valued either at date of death or the alternate valuation six months after date of death.³ Assets in an irrevocable trust that are not included in a decedent's taxable estate, such as a GRAT or CRAT, will not receive a step-up in basis. The beneficiary of the remainder interest will receive trust assets with the original donor or trust tax cost basis. In the case of CRUTs and CRATs, charity(its) will receive the remaining trust assets and, therefore, will not be as negatively affected by the loss of the step-up.⁴ If you are contemplating a GRAT, you should discuss the tax cost basis of the assets being contributed to the trust with your accountant or estate planning professional.

Grantor Trusts (for income tax purposes)—added benefits without additional gift taxes:

Ordinarily, a gift is any transfer to an individual, either directly or indirectly, where full consideration (measured in money or money's worth) is not received in return.⁵ However, a GRAT is a grantor trust for income tax purposes, meaning that interest, dividends and capital gains are reported by the grantor of a GRAT (not the trust) and the grantor's payment of the trust's tax liability is not deemed a gift. As a result, the grantor is shifting more wealth to the next generation by relieving the trust from the burden of paying income taxes, which allows the trust to appreciate more rapidly. Recent legislation by the current Federal Administration has proposed attacks on grantor trust to eliminate this benefit, but such proposals have been dropped and not included in recently enacted legislation.⁶ But, see, the 2022 Proposed Regulation discussion below regarding anti-clawback regulations and the proposed special anti-abuse regulations targeting certain transfers with a retained interest.

STOCK MARKET VALUATIONS

If you create a GRAT, CRUT or CRAT, you will want to work closely with your financial advisor on the selection and transfer of assets to the trust. The use of appreciated stocks to fund these types of trust will not cause the recognition of gain at the time of contribution. If you want to maximize the number of shares transferred, you will want to fund the trust on a down market in when shares are being traded below value. Then, as the stock price increases the value of the annual unitrust amount will increase yet the valuation of the trust for gift tax purposes will not

³ See 26 U.S. Code Section 1014 basis of property acquired from a decedent.

⁴ But, see IRS Publication 598 regarding the tax on unrelated business income for private foundations and public charities.

⁵ See IRC Section 2503 *et seq.*

⁶ Another type of trust strategy not discussed in this article, but a tool frequently used by estate planners, is the intentionally defective grantor trust (IDGT), which is a completed irrevocable gift to a trust in which the grantor continues to report and pay any income tax consequences of the IDGT, and, spousal lifetime access trusts (SLATs) which can also be structured as a grantor trust.

change, i.e. it was a completed gift at the time of funding. As a result, these types of trust strategies are also referred to as “freeze” techniques.

THE ‘SUNSET’ PROVISION IN TCJA

In 2017, then President Donald Trump enacted the Tax Cuts and Jobs Act (TCJA) that (among other provisions) **temporarily** doubled the federal transfer tax exemption amount. This law contains a “sunset” provision, which means that unless the law is made **permanent** by an act of Congress the exemption will revert to its pre-TCJA level of approximately \$6.8 million per person on January 1, 2026. As of January 1, 2023, the exemption will be \$12.92 million per person.

Recall, the federal transfer tax exemption is a lifetime exemption such that it may be used during your lifetime as a credit against taxable gifts and then, upon your death, your executor may apply the remaining amount of your exemption (or all of it if you did not make any taxable gifts in during your lifetime) against your estate tax liability.

What happens if you make a large gift—a gift greater than the anticipated post-TCJA exemption amount—prior to the end of 2025 and die in 2026 or later? In 2019, the Treasury issued final regulations that provided special rules to determine the applicable credit if the used exemption amount was greater than the exemption amount available at the time of death. In essence, the result of the special rule is to allow full use of the exemption used to make pre-sunset taxable gifts—no clawback. However, Treasury Regulations noted that there would be further consideration given to anti-abuse exceptions “in circumstances where the donor continues to have title, possession, use, benefit, control, or enjoyment of the transferred property during life”. In April of this year, proposed regulations were issued that would disallow the use of the special rule (anti-clawback) unless (i) the grantor relinquishes or eliminates the retained interest or power 18 months prior to death or (ii) is de minimis, defined as transfers in which the value of the taxable portion of the transfer was 5% or less of the total value of the transfer. Stay tuned!

INFLATION ADJUSTED TRANSFER TAX EXEMPTIONS

Both federal and state governments adjust certain transfer tax exemptions annually based upon inflation. See “2023 Exemptions” table for more information and amounts for Federal, New York, New Jersey and Connecticut transfer taxes.

Under current federal law, the amount that can pass free of estate/gift taxes during a person’s lifetime, or at death, is \$12.92 million per individual, making it possible for a couple to transfer a combined \$25.84 million during their lifetime. This is up from \$12.06 million in 2022, which is an increase of \$860,000 or \$1.72 million per couple. Individuals that made full use of their 2022 Federal gift tax exemption should consider additions to existing trusts or other transfer tax strategies.

If you would like to discuss some of the wealth transfer strategies discussed in this letter, please contact us.

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