Estate Planning
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Legal Matters®

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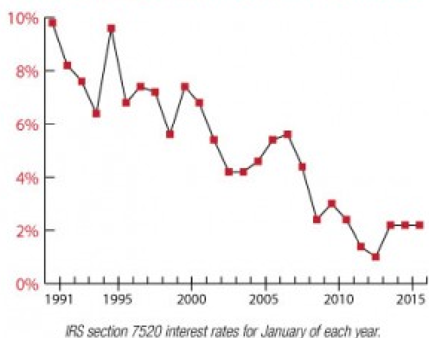
Interest rates are going up – what does this mean for your estate planning?

The Federal Reserve has begun raising interest rates. And while rates are still historically extremely low, they're probably at the start of a long, gradual increase. As a result, you might want to consider some estate planning techniques now that benefit from very low rates because an opportunity like this one might not come around again for many, many years.



Here are some ways to use the current low-rate environment to transfer assets to your heirs while avoiding estate and gift taxes:

Family loans. One idea is to loan money to a trust for your children, and then have the trust use it to make investments – or make a promising investment yourself, and then loan that asset to the trust. In return, you'll get a promissory note in which the trust promises to repay the loan with interest.

The IRS specifies a minimum interest rate, which you must observe in order for this arrangement to be considered a non-taxable loan rather than a taxable gift. However, this interest rate is near the lowest point it has ever been. As a result, you can charge minimal interest, and any investment returns above this rate will go to your children without being subject to estate or gift tax.

Installment sales. If you want to sell a family business to a trust for your children, you can arrange to be paid in installments. This is often a good idea, because the trust can use the profits from the business to pay you off over time, rather than taking out a costly bank loan.

Many people miss a tax deduction for inherited IRAs

If you inherited a retirement account, and if the estate of the person you inherited it from owed an estate tax, you might be missing a big income tax deduction when you withdraw funds from the account. Many people forget to claim this deduction.

The deduction applies not only to inherited IRAs, but also to inherited 401(k) accounts, certain stock options and unpaid dividends, pretax gains in certain annuities, and some other assets.

The idea is that the IRA (or other asset) already triggered an estate tax for the person who died. So, taxing your withdrawals from the account amounts to taxing the same asset twice. The deduction exists to prevent this double taxation.

To calculate the deduction, you have to figure out how much of the estate tax was due to the fact that the IRA or other asset was part of the estate. Divide that amount by the value of the asset (as listed in the estate tax return), and multiply this result by the amount of your withdrawals in a given year. That's your deduction for that year.

If you haven't claimed this deduction on past withdrawals, you might be able to amend your tax returns for the past three years, and get a refund.

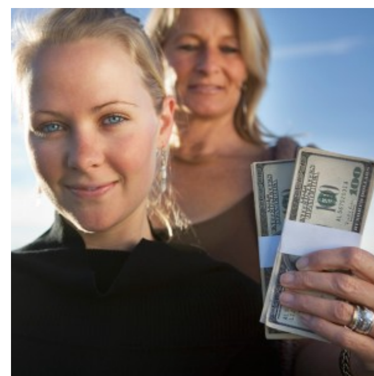
If you haven't claimed this deduction on past withdrawals, you might be able to amend your tax returns for the past three years, and get a refund. And of course, you can claim it for any withdrawals going forward.

The deduction has to be claimed on your income tax return as a "miscellaneous itemized deduction." However, unlike most other miscellaneous itemized deductions, you can claim it in full, and you're not limited to amounts that exceed 2% of your adjusted gross income. Plus, you can claim it even if you're subject to the alternative minimum tax.

However, if your adjusted gross income is over a certain threshold (which was $258,250 for single filers in 2015, or $309,900 for couples), the

Family trust could prohibit beneficiaries from going to court

People who set up trusts for children, grandchildren and other family members have a greater ability to limit the beneficiaries' right to challenge trustees' decisions in court, as a result of a new U.S. Tax Court decision.



Here's the background: You may know that you can give up to $14,000 a year to any person without incurring the federal gift tax. But that rule generally doesn't apply if you put the money in a trust for the person, because you're not giving them the money directly – in legal terms, the person doesn't have a "present interest" in the funds. So any such gift is potentially taxable.

So, how can you avoid this problem and put up to $14,000 a year into a trust without paying gift tax? A common solution is to put the money into a trust, but give the person 30 days in which he or she can withdraw the funds. Typically, beneficiaries won't actually withdraw the money, because they'll be afraid that if they do, no further contributions will be coming. But the 30-day window means the person has a "present interest" in the funds, and so you qualify to avoid the gift tax.

(A trust set up this way is often called a "Crummey trust," after D. Clifford Crummey, a Methodist minister who pioneered the idea back in the 1960s.)

The new case involved Erna and Israel Mikel, a New York couple who over time transferred

Again, you have to charge interest to the trust in order for the IRS to treat the delayed payments as an installment sale rather than a gift. But the required interest rate is very low, which means more assets will go to your children free of gift tax.

Grantor retained annuity trusts. You can put assets into a "grantor retained annuity trust," or GRAT, and then receive income from the trust (that's the annuity) for a certain number of years. When the trust expires at the end of the term, the assets remaining in the trust go to your beneficiaries.

Here's why this is good: Let's say you put $1 million worth of assets into a 10-year GRAT, and at the end of that time the value of the assets has increased to $2 million. If you had simply kept the assets for 10 years and then given them to your heirs, you'd be subject to gift tax based on the $2 million. But if you put the assets into a GRAT now, your gift tax is based on the present value, or $1 million.

But even better, that $1 million is further reduced by the present value of the income stream you'll receive over the 10 years.

And here's where interest rates come into play – when the required IRS interest rate is very low, as it is now, the present value is much higher, and your taxable gift is much smaller.

There's one large drawback to GRATs, which is that if the donor dies before the term of the trust expires, the trust assets are added back into the donor's estate, and the tax advantages are lost. For this reason, choosing the term of the trust requires some thought. The longer the term, the greater the tax savings, but the greater the risk that the donor will pass away and the savings will be lost.

There are several ways to hedge against this risk. One is with "layered GRATs." For instance, instead of setting up a 10-year GRAT, a donor could put 10% of the assets into a two-year GRAT, 10% into a three-year GRAT, 10% into a four-year GRAT, and so on until there are 10 GRATs. Then, if the donor died halfway through the term, the family would still get half the tax benefits – and the donor could lock in today's low interest rates for *all* the GRATs.

Another option is to set up a short-term GRAT (say, two or three years) with an annuity that's equal to the present value of the GRAT assets. As a result, there's no estate or gift tax at all. With interest rates being so low, the trust has to pay very little interest to the grantor – and any appreciation in excess of the interest goes to the family beneficiaries tax-free.

Charitable lead trusts. These are trusts that make a payment to a charity each year for a certain number of years, after which the remaining assets go to your family beneficiaries. They're similar to GRATs, except that the annuity goes to a charity, and you get a charitable deduction.

Some people like this idea because it's a way to benefit a charity right now, in your lifetime, rather than after you pass away.

Charitable lead trusts are a good idea when interest rates are low, because low rates mean both a larger charitable deduction and a smaller gift tax on the assets that go to your family.

Do these ideas make sense for you?

deduction is reduced by 3% of the amount over that threshold.

You should also note that this deduction applies only where the estate of the person who died paid *federal* estate taxes. If the estate also paid *state* estate taxes, you don't get a break for that.

Here's a thought: If you currently have a traditional IRA and you anticipate that state estate taxes will be owed when you pass away, this is a reason to convert to a Roth IRA. You'll have to pay income tax immediately on the conversion, but this reduces your taxable estate, and any future appreciation will be tax-free to your heirs, because they won't have to pay tax on their Roth withdrawals.

Avoid capital gains tax when selling investment property

Did you know that it may be possible to avoid paying immediate capital gains taxes when you sell an investment property? That's true if you're planning to sell the property and invest the proceeds in another property shortly afterward.

For instance, suppose you own a condo as an investment, and you plan to sell it and use the proceeds to buy another investment property. You might be able to treat the sale and the subsequent purchase as a "wash," and defer paying any capital gains tax on the first property until you sell the second property.

This is known as a "like-kind exchange," or sometimes as a "1031 exchange" (after the section of the tax code that allows this).

There are some restrictions. For instance, the second property must be of a "like kind" – although it doesn't have to be the exact same kind of property. In general, you have to identify the second property within 45 days of selling the first property, and you have to close on the second property within 180 days of selling the first property. (In some cases, though, you can identify *several* properties within 45 days, as long as you close on one of them.)

Also, the proceeds from the initial sale must typically be held by a specially qualified third party while they're waiting to be used to purchase the new property.

In certain cases, it may be possible to close on the second property even before you sell the first property.

In the past, 1031 exchanges almost always involved real estate, but people are increasingly using them for other types of investment property, such as art. However, in order to qualify for such a tax break, you would have to show that you're actually in business as an art investor – simply selling a painting in your bedroom and replacing it with a new one probably wouldn't qualify.

A 1031 exchange can be complicated, and there's a lot of technical paperwork. But it might well be worth

more than $3 million to a Crummey trust to benefit some 60 relatives.

The ruling is good news if you want to create a trust for your family, but also make it less likely that your family members will later fight among themselves.

The trust documents said the beneficiaries could withdraw the money within 30 days (which no one did). The documents also gave detailed instructions for how and when the trustee could distribute funds to the beneficiaries over time, such as to help them pay for a wedding, buy a house, or get started in a profession.

Apparently the Mikels were concerned to prevent squabbles and lawsuits within the family, because they added a clause saying that if any beneficiary were to go to court to challenge a trustee's decision, that beneficiary would be cut off and could get nothing further from the trust.

That's when the IRS pounced. According to the IRS, this "don't-go-to-court" provision invalidated the whole plan, because it meant the beneficiaries didn't really have a "present interest" in the funds. If they demanded their money within 30 days, and the trustees said no, the beneficiaries would be out of luck because they couldn't file a lawsuit, according to the IRS.

But the Tax Court sided with the Mikels. It said the "don't-go-to-court" provision didn't apply to a request to withdraw the money within 30 days; it applied only to *future* decisions by the trustees over whether to pay for a wedding, a house, tuition, etc.

The ruling is good news if you want to create a trust for your family, but also make it less likely that your family members will later fight among themselves.

However, you still need to be careful. While the federal government lost this battle, some *states* also place their own restrictions on certain types of "don't-go-to-court" provisions.

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In 2016, the federal estate tax exemption is $5.45 million – which means you can give away that much to your heirs (counting both lifetime gifts and bequests in your will) without paying any gift or estate tax.

So, these strategies might make sense for you *if*

* Your net worth is more than that amount, *or might potentially be more than that amount by the time you pass away*.

* You live in a state that imposes *state* estate, gift, or inheritance taxes (which tend to kick in at much lower amounts).

* You think Congress might eventually try to raise revenue by lowering the estate tax exemption – remember, the exemption was only $675,000 back when the previous President took office!

The advantage of using these techniques now is that if both tax rates and interest rates go up, you'll have locked in the benefits of today's low interest rates.

the effort if you can defer a significant capital gains tax.

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