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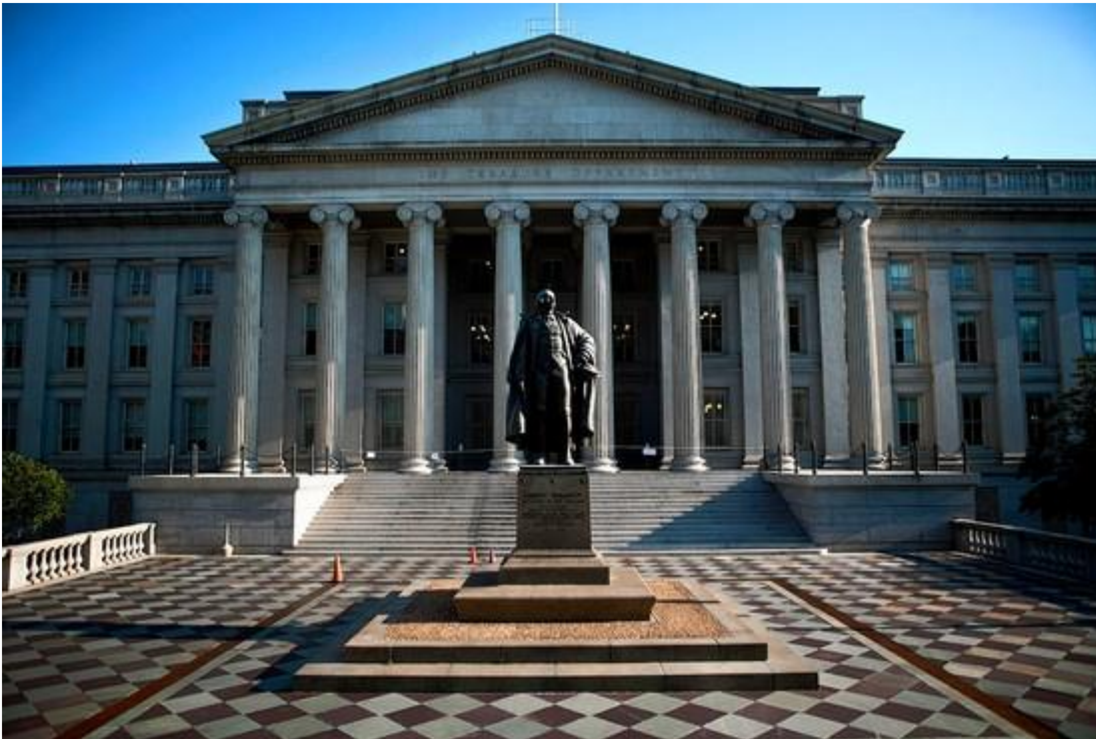
How Low Rates Can Cut Your Tax Bill

By LAURA SAUNDERS

Here is one surprise benefit of low interest rates: They can help reduce taxes.

Every month, the Internal Revenue Service resets the interest rates it allows for private loans and various estate-planning transactions carried out that month. The rates for October, issued Sept. 19, are the lowest on record.

The new short-term rate (less than three years) is 0.16%, down from 0.26% in September. The midterm rate (three to nine years) is 1.19%, down from 1.63%, while the long-term rate is 2.95%, down from 3.57%. A blended rate that applies to some estate-planning techniques is 1.4%, down from 2%.


Brendan Smialowski/Bloomberg, the U.S. Treasury in Washington.

The resets can be a boon to taxpayers looking to make lemonade out of the current low-rate environment. "The opportunity is tremendous for wealth transfer, especially with asset values low," says Richard Behrendt, a former IRS estate-tax specialist now with Robert W. Baird & Co. in Milwaukee.

For example, low interest rates make intrafamily loans especially attractive. "It's a wonderful time to lend to a child, say, to buy a house," says Carol Harrington, an attorney at McDermott, Will & Emery in Chicago.

Danny Snow of Thompson Dunavant in Memphis, Tenn., is telling clients it's a great time to review and restructure "related party" loans, such as those between family members or a small business and its owner. Some business owners borrow money from their firms informally, a practice the IRS frowns on. "Now's a great time to formalize the arrangement at low cost," Mr. Snow says.

Here are various ways to take advantage of the IRS's lower rates. Some require more professional expertise than others, but none is for do-it-yourselfers. Experts also warn against making interest-free loans, which can prompt tax snarls such as the IRS calling the forgone interest a taxable gift.

• **Make a loan to a family member.** Some families like to help children buy a first home. One strategy: Make the child an "interest-only" loan, forgiving the principal as you see fit using annual gift-tax exclusions.

Here's an example: Ramon is newly married to Anne, and his parents want to help the young couple. They lend Ramon and Anne $100,000 for 9½ years to buy a home, with the principal due at the end of the term.

At current rates, the annual interest payment due from the young couple is $2,950. The parents could forgive up to $52,000 of principal per year, tax-free, if they desire. Any taxpayer can give anyone else $13,000 a year, free of gift tax, and in this case there are two givers (the parents) and two receivers (Ramon and Anne).

The parents also could forgive the principal in smaller increments, or not at all, if they need the money. Or—if they are worried the marriage won't last—they might refrain from loan forgiveness, so that if the young couple splits up, they will be splitting a liability rather than an asset.

In order to get a mortgage-interest tax deduction for such a private loan, taxpayers need to follow details of state law, and the loan must be secured by the house, says Mr. Snow.

• **Do an installment sale.** If a buyer of, say, a small business is having trouble financing a purchase, the seller might agree to provide the financing for him. With IRS interest rates low, more of the total can count as a capital gain rather than interest income for the seller. That is good, because long-term gains are taxed at a top rate of 15% whereas interest income is taxed at a top rate of 35%.

• **Set up a GRAT.** Short for grantor-retained annuity trust, a GRAT is a structure for the very wealthy. It involves transferring assets (often stocks) to a trust for a term of as little as two years. The owner then gets an annual annuity determined by the IRS's interest rate.

By the end the term, the assets revert to the original owner, but appreciation above that interest rate goes to designated heirs free of gift or estate tax. With IRS interest rates low, the

owner's annuity is smaller than ever, and with asset values low, there is more potential for appreciation.

Mr. Behrendt notes that GRATs are sanctioned by the tax code and, if set up carefully, are virtually free of audit risk. They also are timely because Congress may change the requirements so that they are harder for older people to use.

• **Set up a charitable lead trust.** This is a technique for the wealthy who are charitably inclined. Here, a donor splits an asset so that income goes to an IRS-registered charity for a period of years, and what is left after that goes to heirs. When the trust is set up, gift tax is due on the actuarial value of what the heirs will receive. The lower interest and asset values are, the greater the chance that the heirs will wind up with an outsize share of the asset.

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About Laura Saunders

Laura Saunders continues the Journal's long tradition of intense coverage of taxes. Earlier, Laura was a Senior Editor at Forbes Magazine, where she covered tax and investments for nearly two decades. She has a B.A. from Sewanee, the University of the South, and an M.A. from Columbia University. She recently has been a Chancellor's Fellow at City University of New York's Graduate Center, studying literature and business in a Ph.D. program."