Finding the Silver Lining: Estate Planning Opportunities in a Low Interest Rate Environment

May 6, 2020

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Economic factors, such as the current depressed financial markets and historically low interest rates, combine to impact and drive a variety of estate planning techniques. While the current uncertain environment may – understandably – cause many to hesitate to engage in a substantial family gifting program, these economic conditions present a unique opportunity for families to pass a significant amount of wealth to younger generations with minimal transfer tax exposure. We recommend contacting your Venable Wealth Planning counsel to discuss which techniques may provide the most viable opportunity for your particular circumstances.

This alert provides a high-level discussion of those estate planning techniques that present the greatest potential for an upside when implemented during a state of declining financial markets combined with historically low interest rates.

As a general reminder, in 2020, each individual has a combined federal estate and gift tax exemption of $11,580,000, and each married couple has a combined exemption of $23,160,000. Subject to annual inflation adjustments, this exemption will remain in place through 2025, after which time it will be reduced to approximately one-half of its value. Of course, the results of the 2020 elections and mounting federal deficits may result in an earlier and possibly more dramatic reduction in the exemption before that date.

The Applicable Federal Rate and the Section 7520 Rate

Each month, the Internal Revenue Service publishes certain market-based interest rates. These rates include the "applicable federal rates" (AFRs) and the "Section 7520" rate.

For many estate planning techniques, the AFR for any given month is the lowest amount of interest that may be charged between related parties in a loan transaction without triggering imputed income or a gift. A different AFR applies depending on the term of the loan, with the short-term AFR applying to loan terms shorter than three years, the mid-term AFR applying to loan terms three years or longer but less than nine years, and the long-term AFR applying to loan terms that are nine years or longer.

The Section 7520 rate is the rate used to calculate annuity payments and the value of life estates and remainder interests for certain estate planning techniques, such as Grantor Retained Annuity Trusts (GRATs) or Charitable Lead Trusts (CLTs), discussed below.

The May 2020 rates, announced in Rev. Rul. 2020-11, represent historic lows, with the Section 7520 rate at 0.8%, and the long-term, mid-term, and short-term AFRs set at 1.15%, 0.58%, and 0.25%, respectively.

Overview of Estate Planning Opportunities

Grantor Retained Annuity Trusts

How It Works. A Grantor Retained Annuity Trust (GRAT) is an irrevocable trust to which the creator of the GRAT (the Grantor) transfers assets and retains the right to receive fixed annuity payments from the trust for a specified number of years. After the GRAT makes the required annuity payments for the predetermined term of years, any property remaining in the GRAT passes to the designated beneficiaries (or to trusts for their benefit) free of federal estate and gift tax.

Tax and Non-Tax Considerations

- A GRAT can be a highly effective wealth transfer option in a low interest rate environment because of the greater potential for the GRAT's assets to outperform the Section 7520 rate (also commonly known as the "hurdle rate") in effect in the month the trust was created. Thus, to the extent the assets transferred to the GRAT – e.g., marketable securities or interests in commercial real estate or a closely held business – reflect current depressed values and would generate an investment return in excess of the current GRAT hurdle rate (0.8% in May 2020), the larger the potential tax-free gift to the remainder beneficiaries.

- The creation of a GRAT constitutes a current taxable gift by the Grantor to the remainder beneficiaries equal to the excess of the initial value of the contributed assets over the present value of the annuity payments to the Grantor discounted by the Section 7520 rate. The duration of the GRAT and the percentage annuity retained by the Grantor can be set so that the present value of the annuity payments retained by the Grantor equals the value of the assets contributed to the GRAT, with the result that the remainder interest (and therefore the gift) has a value of zero. The Grantor of such a "zeroed-out" GRAT makes no taxable gift and uses no gift tax exemption. So if the GRAT assets do not appreciate beyond the 7520 hurdle rate, the Grantor has not used any gift tax exemption, and the transaction is a wash. In some circumstances, it is preferable to design a GRAT so that the present value of the remainder interest of the GRAT at the creation is small (but not equal to zero), in order for the Grantor to report the GRAT contribution on a federal gift tax return (Form 709). If properly reported, the statute of limitations will begin running and, thus, limit the period of time that the IRS has to audit the GRAT transaction.

- Another advantage of a GRAT is that during the annuity period it is considered a "grantor trust" as to the Grantor. This means that the Grantor is considered the owner of the GRAT for income tax purposes and is taxed on all of the income. Payment of the income and capital gains taxes by the Grantor is, in effect, a further tax-free gift to the remainder beneficiaries, since the assets can continue to grow during the annuity term without reduction for such income and capital gains tax payments.

- The duration of the GRAT annuity period retained by the Grantor is a very important consideration. If the Grantor survives the annuity term, the property remaining in the GRAT will pass to the remainder beneficiaries, outright or in further trust, without the imposition of gift or estate tax (although there may be generation-skipping transfer tax consequences, depending on the relation of the remainder beneficiaries to the Grantor at the time of the distribution). However, if the Grantor dies prior to the expiration of the annuity term, a portion or all of the GRAT assets will be included in the Grantor's estate for estate tax purposes. Therefore, the longer the annuity term, the greater the risk that the Grantor may die during that period, resulting in estate tax liability.

- Generally, there are two philosophies to consider when determining the appropriate annuity term for the GRAT. First, in order to tighten the exposure during volatile markets and limit the mortality risk of the Grantor passing away during the

GRAT term, it may be appropriate to use a shorter-term duration for the GRAT, such as two or three years. Alternatively, and particularly in historically low interest rate environments, longer-term GRATs, such as seven-year or ten-year GRATs, may be preferable, since clients are able to lock in the low interest rates. Furthermore, where GRATs perform better than anticipated during the initial years of the GRAT term, the Grantor may choose to lock in the significant asset appreciation by purchasing the appreciated assets from the GRAT in order hedge against losing those gains in later years. Another estate planning tool is to engage in "rolling" GRATs. Under this method, when the Grantor receives an annuity payment from one GRAT, the Grantor immediately uses that payment to fund a new GRAT.

- Generally, the investment return on the assets contributed to a GRAT in the early years greatly impacts the GRAT's overall performance; therefore, it is important for clients to consult with their advisors regarding (1) whether there are assets that are suitable for use in a GRAT, (2) the right duration for the annuity period of a GRAT, and (3) the best investment strategies for the assets that are held in the GRAT. GRATs require revaluation of the trust property each year, so marketable securities are well-suited to being used in a GRAT transaction.

Sales to Irrevocable Grantor Trust

How It Works. A sale of assets to an "Irrevocable Grantor Trust" (IGT) can be another attractive tool when interest rates are low. Contributions to an IGT are completed gifts for *gift and estate tax purposes*, but the IGT's assets are treated as owned by the Grantor *for income tax purposes*. Therefore, the Grantor can sell assets that he or she owns to the trust without recognizing any capital gains, because the seller and the trust are considered one and the same for income tax purposes.

In a typical sale to an IGT, the Grantor sells an asset to the trust in exchange for a promissory note with interest calculated at the applicable AFR for the term of the note. This transaction is an "estate freeze" in the sense that the Grantor now owns a promissory note having a value equal to the fair market value of the assets sold to the trust; however, the assets in the trust and any future appreciation on such assets are removed from the Grantor's estate for estate and gift tax purposes. The Grantor pays the income tax generated on the trust assets, which is effectively an additional tax-free gift to the trust.

Tax and Non-Tax Considerations

- The Grantor must be willing to pay the taxes on all income generated by the assets in the trust, including capital gains on the subsequent sale of trust assets by the Trustee.
- One downside of the sale is that the IGT's income tax basis in the purchased assets will be the Grantor's basis prior to the sale. If the Grantor chooses to "toggle off" grantor trust status during his or her lifetime, the Grantor may recognize gain if the trust's liabilities exceed the Grantor's basis in the assets. There is some ambiguity as to the income tax consequences at the Grantor's death if the Grantor dies with the note outstanding, including recognition of gain and by whom.
- The assets should be appraised as of the date of the sale to establish the sale price, which appraisal may be costly if the Grantor is transferring closely held business interests or other hard-to-value assets. Although the transaction is not a gift, it may be prudent to file a gift tax return for the year of the sale to report the transaction.
- If the Grantor is creating a new IGT to purchase assets, it is recommended that the Grantor make a gift to the IGT prior to the sale, so that the trust has sufficient assets to serve as security for the promissory note. This gift will use the Grantor's gift tax exemption, if available, or will incur gift tax if the Grantor does not have any available exemption at the time of such a "seed" gift.

- The Grantor should also consider his or her cash flow needs prior to engaging in this type of transaction. This transaction is a completed transfer for estate and gift tax purposes, so while the Grantor receives the payments due on the note, he or she no longer has access to the assets sold to the IGT. In some circumstances, a Grantor may include his or her spouse as a potential beneficiary of the IGT in order to retain the ability to have indirect access to the assets in the IGT; however, such access would terminate on divorce or the death of the spouse.

Intra-Family Loans

A simple but effective technique in a low interest rate environment is an intra-family loan. This is particularly ideal for older generations who want to assist younger generations through either a direct loan of cash or a loan to a trust for such family member's benefit.

Making New Loans. Intra-family lending allows an individual to assist family members without making a current gift. Such loans can benefit family members who may have difficulty obtaining traditional bank loans or finding such favorable rates. They can allow the "family lender" to serve as the bank and enable a child or grandchild to purchase a home, acquire a property, or fund a new or existing business.

In order to avoid having any part or all of an intra-family loan considered a gift for tax purposes, the loan must be adequately documented and secured, and must bear an interest rate greater than or equal to the applicable monthly AFR specified for the term of the loan. The family member providing the loan will report income on the interest received from the borrower, but as long as the loan recipient is able to invest the borrowed funds and generate an investment return greater than the minimum AFR interest rate, the loan will be successful as a wealth transfer technique. The terms of the loan agreement can be structured in many ways, including as an interest-only loan with a balloon payment of principal on maturity.

Alternatively, the loan can be made to an irrevocable trust for the benefit of family members, rather than directly to individual family members. Structured this way, to the extent the loan proceeds produce a rate of return in excess of the interest rate on the loan, such excess is a tax-free transfer to the trust. In addition, if the trust is structured as a so-called "grantor trust" for income tax purposes, the interest payments on the loan will not be taxable to the Grantor, and the Grantor can pay the tax on all income and gains generated by the trust assets, allowing the trust to grow without reduction for income tax liability.

Refinancing of Promissory Notes. If there are current outstanding loans that have an interest rate higher than the current AFR rates, such as a mortgage or an existing loan to a child or grandchild, it may be beneficial to refinance those existing loans now to lock in the current lower AFT rates.

Charitable Lead Trusts

How It Works. A Charitable Lead Trust (CLT) has a structure similar to that of the GRAT, except that the income payments are made to one or more designated charitable organizations rather than to the Grantor. With a CLT, the Grantor transfers assets to an irrevocable trust, and the trust makes payments to one or more qualifying charitable organizations – either public charities or private foundations – for a fixed number of years or for the life or lives of designated individuals, or a combination of the two (the "charitable term").

At the end of the charitable term, the assets remaining in the CLT must be distributed to one or more non-charitable beneficiaries, typically the Grantor's lineal descendants (or to trusts for their benefit).

Tax and Non-Tax Considerations

- A CLT is a beneficial structure for a Grantor with philanthropic goals and a mission of benefiting charity during a significant time of need, such as the ongoing COVID-19 pandemic.
- Similar to a GRAT, the creation of a CLT constitutes a taxable gift by the Grantor to the remainder beneficiaries that is equal to the initial value of the contributed assets, reduced by the present value of the annuity or unitrust payments to be made to charity, discounted at the Section 7520 rate. Thus, as discussed above, a CLT can be structured to "zero out" at the end of the charitable term, resulting in little or no gift tax. At the termination of the charitable term of the CLT, any appreciation of the property held in the CLT in excess of the Section 7520 rate is passed on to the remainder beneficiaries of the CLT free of federal gift and estate taxes. Property contributed to a CLT is assumed to grow at a rate equal to the IRS hurdle rate in effect at the time of the transfer. Therefore, a CLT, like the GRAT, works best in a low interest rate environment, since any investment performance in excess of the hurdle rate passes free of estate and gift tax to the designated family members (or trusts for their benefit) at the end of the charitable term of the CLT.
- Using a CLT to make annuity or unitrust distributions to charities allows the charitable recipient(s) to receive benefits over an extended duration of time, as opposed to a lump sum contribution outside of the CLT structure.
- Furthermore, if a CLT is structured to qualify as a "grantor trust," then the Grantor would also receive a charitable income tax deduction (subject to applicable deduction limitations) based on the present value of the CLT's required annuity or unitrust distributions to charity in the year the CLT is created and funded. Alternatively, if a CLT is structured as a "non-grantor trust," the Grantor will not be entitled to a charitable income tax deduction on creation of the CLT; however, the CLT may claim an unlimited charitable income tax deduction for its annual distributions to charity.

Conclusion

The current low interest rate environment, combined with depressed asset values, provide a rare opportunity to find a silver lining in today's pandemic. While the notion that the "devil is in the details" is as true in sophisticated tax planning as anything else, a review of your assets may highlight opportunities to capitalize on one or more of the above techniques before the financial markets rebound and interest rates increase.

For questions or for further discussions on any of these strategies, please feel free to reach out to your wealth planning counsel at Venable.

For further reading, please refer to our prior webinar and client alerts:

Turning Limes into Margaritas: Recipes for Estate Planning You Can Use Today

Key Wealth Planning Provisions for Individuals in the COVID-19 Relief Act

Estate Planning and Coronavirus (COVID-19) Further Tips

Fiduciary Considerations during the Coronavirus Pandemic

Taking Advantage of Estate Planning Opportunities in Light of Coronavirus and Market Plunge

Additional IRS Relief – IRS Notice 2020-23 Further Expands the Postponement of Filing and Payment of Taxes for Taxpayers

Further IRS Relief – Gift Tax Extensions to File and Pay