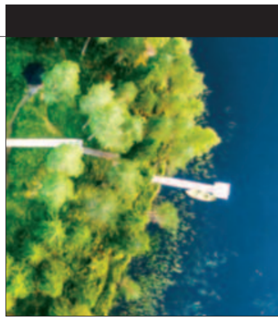

Low Interest Rate Gift Planning

A brief review of planning opportunities available in a low interest rate setting.

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While clients still have all of 2020 to take advantage of annual exclusion gifts (currently $15,000 per donee) and the increased lifetime gift tax exemption (now $11,580,000 per taxpayer[1]), practitioners may wish to recommend that clients not wait too long to take advantage of the current low interest rate gift opportunities for a number of reasons, including the advantage that once a gift is made, any future appreciation of the transferred property and any future income generated thereby will escape transfer taxes.

In addition, future legislation could limit a client's gift planning opportunities. Proposed changes that have been discussed in the past and that are likely to be discussed again include (i) eliminating "discounts" for closely-held business and real estate interests; (ii) prohibiting short-term (e.g., two-year) Grantor Retained Annuity Trusts ("GRATs") (discussed below); and (iii) limiting the benefits of "defective" grantor trusts (discussed below) and long-term "dynasty" trusts. None of these changes has been enacted yet, but practitioners may wish to strongly recommend that clients in a position to do so take advantage of their gift tax planning opportunities sooner rather than later, after considering the impact of the gifts on their donees.

Low Interest Rates

On or about the 20th of each month, the Internal Revenue Service issues the AFRs and the Section 7520 rates that are applicable for many federal income tax purposes for the following month. These minimum interest rates are a key component in many estate planning strategies, and lower rates provide significant opportunities to shift wealth to junior generations. The AFRs this spring were very low (and are anticipated to remain low). For example, the June 2020 AFR rate for a loan of less than three years ("short-term") was only 0.18%; the rate for a loan of between three and ten years ("mid-term") was only 0.43%; and the rate for a loan of ten or more years ("long-term") was 1.01%.

Given the current economic forecast, the rates may rise later in 2020. Clients therefore may wish to take one or more of the following opportunities now:

1. Establish a GRAT;
2. Make "intra-family" loans to family members, including children and grandchildren, or to trusts for their benefit;
3. "Refinance" existing intra-family loans that bear higher interest rates; and
4. If the clients have philanthropic goals, consider the following:

- Estate tax savings. A charitable lead annuity trust ("CLAT") is a

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statutorily sanctioned trust that lasts for a specified number of years and provides for specified amounts to be distributed each year to charity during the CLAT term. Like GRATs, CLATS can

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be "zeroed-out" (see below). Any growth in the CLAT assets in excess of the 7520 Rate, (which was 0.6% for June) passes to the non-charitable remainder beneficiaries (e.g., the client's children) at termination of the CLAT, free of gift or estate tax; and

- Income tax savings: A gift to charity of a "remainder interest" in a personal residence or farm produces better results with lower interest rates. Because the retained use of the realty is equivalent to a retained income stream, the lower the interest rate, the less the retained interest is deemed to be worth (and correspondingly, the more the charitable gift is worth), so the charitable contribution deduction is greater. For example, a donor age 70 who contributes the "remainder interest" in a $1,000,000 residence not subject to a mortgage to charity in June (0.6% 7520 Rate) will be entitled to an income tax deduction of approximately $919,000 (rather than approximately $480,000 at a 6% 7520 Rate).

Transfers to GRATs

By way of brief background, a GRAT is another statutorily sanctioned type of trust (similar to a CLAT) whereby the client (the "Grantor") transfers property to the trust but Retains the right to receive specified payments (Annuity) from the Trust for a specified number of years, after which the GRAT property is distributed to the client's donees. The specified payments are often structured so that, after accounting for the 7520 Rate on the property transferred into the GRAT, the present value of the payments the client is scheduled to receive will equal the value of the property transferred into the GRAT. When the annuity payments are structured in this manner, the GRAT is often said to be "zeroed-out" because the client's donees' remainder interest has no value for gift tax purposes; thus, no gift tax is payable and no gift tax exemption is used in connection with the funding of the GRAT. To the extent that the investment return on the GRAT property exceeds the 7520 Rate, value will remain in the GRAT after all annuity payments are made, thereby effecting a tax-free gift of the excess return (provided the client survives the GRAT term). Accordingly, to the extent that the investment return of a GRAT established in June 2020 exceeds 0.6%, there will be a tax-free transfer of assets to the ultimate beneficiaries of the GRAT (typically the client's children or a life insurance trust).

The currently depressed value of many securities affords an additional opportunity to benefit from a GRAT funded with those securities. In this regard, such depressed values create another significant opportunity for clients to consider: Conversion of a traditional IRA into a Roth IRA. Roth IRA investments may not only increase in value tax-free, but also are not subject to any minimum distribution requirements until the tenth anniversary of the death of the survivor of a client and the client's spouse (or later in some circumstances). Furthermore, Roth IRA distributions may be received free of income tax. A traditional IRA requires minimum annual distributions at age 72 (70½ for taxpayers who reached that age on or before December 31, 2019), except that the minimum distribution requirement had been suspended for 2020, and all distributions are subject to tax as ordinary income (including distributions resulting from capital gains). Conversion of a traditional IRA therefore may allow a client's heirs to receive the Roth IRA transfers free of income tax at any time before the tenth anniversary of the death of the client and the client's spouse.

Unfortunately, however, conversion of a traditional IRA into a Roth IRA requires the taxpayer to recognize the entire value of the IRA as ordinary income in the year of conversion. To maximize the tax benefits realized by reason of the conversion, the income taxes due should be paid from assets other than the IRA assets. The payment of those income taxes will result in a reduced estate tax because the cash used to pay those taxes will be removed from the client's estate. Thus, the more time that passes between the

[1] Scheduled to terminate in 2026, but these amounts may be drastically reduced before then, especially if there is a regime change after the November election, and in view of the need to increase tax revenue to pay for all of the CARES Act benefits.

[2] See Treas. Reg. section 1.1001-3 to review the possible income tax ramifications of reducing an existing rate.

[3] This "stepped-up" basis advantage could disappear in the future, especially if there is a regime change after the November election, and in view of the need to increase tax revenue to pay for all of the CARES Act benefits.

IRA conversion and the death of the survivor of the client and the client's spouse the more advantageous will be the result of the conversion.

Finally, if a client has created a GRAT recently that is now "underwater" due to the reduced value of the assets used to fund the GRAT, the client can "re-GRAT" the original GRAT by (i) using the client's retained swap power (discussed below) to substitute cash for the assets that have fallen in value or (ii) transfer the client's right to receive distributions from the original GRAT to a new GRAT; the value of the client's right to receive distributions from the original GRAT should not exceed the current depressed value of the original GRAT.

Intra-Family Loans

As a result of the historically low interest rates, it's also a good time to loan money to family members or trusts for their benefit. As noted above, the minimum interest rate in June 2020 for a loan of up to three years is 0.18%, and loans between three and ten years carry a minimum interest rate of only 0.43%. To the extent that the loan recipients are able to invest the borrowed funds and generate a return greater than the minimum interest rate, wealth will have been successfully transferred without any gift tax.

For example, if a loan of $1,000,000 were made for 35 months at 0.18%, and if the borrower invests that $1,000,000 in an investment earning 5% after taxes, the excess after 35 months of $144,750 will have been transferred to the borrower free of gift tax.

Finally, if a client currently holds an outstanding promissory note payable by a family member that has an interest rate significantly higher than current interest rates, the client can refinance that note now to generate additional cash for the client's donee and reduce the client's taxable income.[2]

"Defective" Grantor Trusts

Instead of making loans or gifts directly to family members, a more tax-effective option is to make loans or gifts to a "defective" grantor trust for their benefit. A "defective" grantor trust is a type of trust in which all income is taxable to the client individually, even though that income inures solely to the benefit of the trust beneficiaries. This in effect permits additional "gifts" to the beneficiaries (in an amount equal to the income taxes) without the client's being considered to have made any further taxable gifts. For example, retaining the right to later substitute other assets of equal value ("swap power") causes a trust to be "defective."

Similarly, it may also be appropriate to sell assets to a "defective" grantor trust in exchange for a low interest promissory note. No taxable gain is recognized by reason of that sale, and no taxable income is recognized by reason of the client's interest receipts. If the assets that are sold to the trust appreciate at a rate that exceeds the currently low minimum interest rate, wealth will inure to the benefit of the next generation without the imposition of any transfer tax.

Possible Disadvantages

Once a client makes a gift, the client of course loses access to that property, so clients should not give away property that they may need someday, although donors should be able to borrow funds from the gift trusts that they have established. If paying additional income taxes by reason of a "defective" grantor trust later becomes burdensome, the donor can release the "defective" feature to eliminate the imposition of future income taxes.

The recipient's income tax basis in property received by gift generally is the donor's basis; thus gifts of high-basis property are more tax-efficient. If a client has created a "defective" grantor trust with low basis assets, the client later can use its swap power to exchange cash or higher basis assets tax-free for the low basis assets originally given to that trust so that the client's heirs will be entitled to a "stepped-up" income tax basis at the client's death.[3] Clients may be able to borrow cash for this purpose.

Finally, if the donated property loses value after the gift, the donor will have used more exemption by making the gift than would be used at the donor's death.

Other Considerations

1. Clients may wish to consider revising their estate planning and health care documents now.
2. As mentioned above, the currently depressed values of many assets make this an opportune time to either (i) make gifts of those assets at reduced gift tax cost while simultaneously removing from the client's estate all future income derived from and future appreciation of the assets transferred, or (ii) to sell those assets to family members at reduced prices to "freeze" the value of the client's estate. ■