Wealth Transfer Planning in the Current Economic Environment

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The experience of COVID-19 has motivated, if not forced, individuals and families to assess their current estate plans. Potentially depressed asset values, ongoing market volatility, and a low interest rate environment have elevated client discussions over creative estate planning solutions. The impact of the pandemic on the economy and markets presents significant opportunities to consider for immediate action. In this article, we will discuss planning strategies that take advantage of low interest rates and depressed asset values.

Current Estate, Gift and GST Tax Exemption

The federal estate, gift and generation skipping transfer tax (GST) exemptions are currently $11,580,000 per individual. These exemption amounts are scheduled to revert to $5,600,000 (inflation indexed from 2018) on January 1, 2026. The result of the 2020 Presidential election and the current economic crisis brought on by the COVID-19 pandemic may result in these exemptions being reduced prior to the scheduled January 1, 2026 date. The "use it before you lose it" philosophy regarding estate planning utilizing current high exemptions has never been more apropos. It is important to note that some states do not conform to federal estate and gift exemptions and should, therefore, be considered in planning. There are also a handful of states that have an inheritance tax (New Jersey is one). Connecticut is the only state with a gift tax.

The Low Interest Rate Environment

Low interest rates favor certain estate planning strategies and the current interest rates required to be used for these strategies by the IRS are at or near historic lows. Low rates may allow a donor to transfer more wealth to the next generation while using zero or a minimal amount of estate, gift and generation skipping transfer tax exemption. In general, a low interest rate environment is beneficial for planning vehicles such as a grantor retained annuity trust (GRAT) or charitable lead annuity trust (CLAT). The minimum interest rates used for planning vehicles such as these are determined monthly by the Internal Revenue Service under IRC §7520. The IRC §7520 rate for May of 2020 is 0.80 percent. As a reference point, the §7520 rate in January of 2019 was 3.4 percent.

In addition, the IRS mid-term Applicable Federal Rate (AFR) for May of 2020 is 0.58 percent. This is the minimum interest rate allowed by the IRS for loans having a term of more than 3 and up to 9 years. This interest rate may be used for an intra-family asset sale or for an intra-family loan. As a reference point, the mid-term AFR rate in January of 2019 was 2.86 percent.

Utilizing these current low interest rates in conjunction with assets whose return will outperform these rates is key to the success of certain estate planning strategies.

Planning Strategies for Consideration

Intra-Family Loans

Intra-family loans are the simplest estate planning tool used to transfer wealth to future generations with no gift tax cost and very low transaction fees. With this strategy, loans are often made by the senior generation directly to a family member or in trust at the applicable AFR rate, which is substantially lower than what is available through traditional lenders. The loan will not be deemed to be a gift as long as the interest rate charged is not below this minimum IRS prescribed interest rate and the payment terms of the loan document are respected. To the extent the rate of return and appreciation on the investment of the loan proceeds are greater than the interest paid to the senior generation, a shift of wealth has occurred from one generation to the next. The value of the loan in the lender's estate is essentially "frozen" and the assets acquired by the borrowers have appreciated.

As an example, if an interest-only loan were to be made by a parent in May of 2020 to their child for a 9-year period (mid-term AFR rate) in the amount of $5 million with principal to be repaid at the end of the loan term, the minimum required interest that would be needed to be charged is 0.58 percent. Assuming the funds are invested and can earn an 8 percent annual return, the child will have approximately $9,995,000 at the end of the 9-year loan, and would have only paid a total of $261,000 in interest as well as the principal of $5,000,000. Therefore, the child would keep the difference of $4,734,000 without any gift tax consequences. (Please note that we have ignored annual income tax consequences in this analysis.) The deductibility of the interest expense paid by the younger generation will vary depending on how the proceeds of the loan are used pursuant to the interest tracing rules [Treas. Reg. §1.163-8T(a)(3)].

Other planning opportunities right now with respect to intra-family loans is to revisit existing loans and consider refinancing them at the current low rates or utilizing some exemption to forgive loans that may not be likely to be repaid.

Grantor Retained Annuity Trust (GRAT)

With a GRAT, an individual transfers property to an irrevocable trust and retains a right to receive annuity payments for a term of years that are equal to a percentage of the initial fair market value of the assets contributed to the trust (generally for a short period of years to capture market spikes). The annual annuity payment may be paid to the grantor in cash or in-kind. When the trust term ends, the remaining trust property in excess of the annuity payments is for the benefit of the trust beneficiaries. The GRAT could be structured so that no gift tax exemption is used in funding the GRAT. This is known as a "zeroed out GRAT" whereby the annuity payments the grantor receives over the term of the trust "zero out" the amount transferred to the trust. The appreciation in excess of the annuity amounts will pass to the beneficiaries of the trust free of estate and gift tax.

GRATs are often referred to as a "win or break even" technique due to the success of the GRAT relying on the appreciation of and income from the assets within the trust exceeding the annuity payments due to the grantor. Therefore, the lower the IRS interest rate and the lower the fair market value of the assets at the time of transfer, the more effective this technique can be. These trusts are ideal for assets that generate cash (interests in pass-through entities) and/or may shoot up sharply in value in the short-term.

However, if the grantor were to die during the trust term, the assets would be included in his/her taxable estate. By using a series of short-term GRATs (2 or 3 years), you can capture the upside of the market while minimizing mortality risk.

As an example, a grantor contributes $5 million to a zeroed-out GRAT in exchange for a 2-year annuity payment of $2,529,980. If the assets in the GRAT appreciate 10% over the trust term, the beneficiaries of the trust will receive $737,042 free of estate tax with a gift tax cost of the transferred assets of $1.

Sale to an Intentionally Defective Grantor Trust (IDGT)

In this strategy, an asset is sold to an IDGT in exchange for a very low interest rate promissory note. (See above discussion regarding current rates to use.) An interest in a closely-held business or a minority interest in a family limited partnership, which could be discounted in determining the fair market value, are assets that should be considered for this technique. The trust is "defective" in that for income tax purposes the income is still taxed to the grantor but for estate tax purposes, if done properly, the trust assets are not included in the grantor's estate.

In addition, since the trust is considered as owned by the grantor for income tax purposes, the sale is not a taxable event, and the interest is neither taxable to the grantor nor deductible by the trust. The sale enables the grantor to "freeze" the value of the sold assets at today's value so that all of the future appreciation post-sale and earnings in excess of the low interest rate cost are outside of the grantor's estate.

Use of a Charitable Lead Trust (CLAT)

In a CLAT, a grantor transfers assets into a trust for a specific term of years or for the lifetime of a chosen person or persons. During the term of the trust, annual payments are made to a charitable beneficiary(ies) and, at the end of the trust term, the remainder of the trust passes to non-charitable beneficiaries, such as the grantor's descendants. The annuity payment to the charitable beneficiary(ies) is based on a percentage of the initial fair market value of the assets contributed to the trust. The objective with a CLAT is to maximize the value of the annuity interest and minimize the value of the remainder interest transferred to the non-charitable beneficiary(ies) so that the remainder interest is transferred with little or no use of one's gift tax exemption.

Similar to a GRAT, the appreciation in the value of the trust assets beyond the IRC § 7520 rate in effect at the time of the transfer (0.80 percent in May of 2020 as noted above) will pass to the non-charitable beneficiary(ies) without being subject to gift or estate tax. In addition, lower interest rates decrease the value of the gift of the remainder interest passed to the non-charitable beneficiary(ies) and increase the value of the gift tax charitable deduction for the annuity interest due to the charity.

One item to note is that if the trust is structured as a grantor trust, the grantor will receive an up-front income tax charitable contribution deduction for the value of lead interest in the trust, but the grantor will also be required to pay tax on the income the trust generates. If this structure is utilized, choosing the proper asset allocation inside the trust is critical. Having the CLAT investing in assets that may generate a lot of taxable income for the grantor would not be optimal. With a non-grantor CLAT, the grantor does not get an income tax charitable deduction and the trust itself, instead of the grantor, is subject to income tax on the trust's earnings. The trust can take an income tax charitable deduction for the annuity payments made to the charity(ies).

Contact Us

Outlined above are just a few of the significant opportunities to optimize wealth transfer in a low interest rate, depressed asset value, high estate and gift exemption environment. PKF O'Connor Davies is here to help you seize these current opportunities. Please contact your engagement team for further information, or any of the partners listed below.

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