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Now Is the Time for Estate Planning: How to Leverage Low Interest Rates and a Temporarily Favorable Tax Landscape

The COVID-19 pandemic has brought interest rates to historic lows which, when combined with the historically high federal gift tax exemption, provides an unprecedented window of opportunity for estate planning.

Key rates in estate planning include the applicable federal rate (AFR) and the Internal Revenue Code Section 7520 rate. The AFR is the lowest interest rate that can be charged on a loan between related parties without gift tax consequences or imputed income. The 7520 rate is the rate for determining the present value of an annuity, life interest for a term of years, or remainder or reversionary interest.

In response to fears of a pandemic-driven recession, the Federal Reserve reduced interest rates to historic lows. For August 2020, the AFRs are just 0.17% for short-term loans (≤ 3 years), 0.41% for mid-term loans (>3-9 years), and 1.12% for long-term loans (>9 years), and the 7520 rate is only 0.4%.[1] To put this in perspective, in August 2007 (before the recession), the AFRs were 5.0% short-term, 5.09% mid-term, and 5.31% long-term and the 7520 rate was 6.2%.[2]

At the same time, the highest-ever federal gift tax exemption is in effect. The Tax Cuts and Jobs Act of 2017 doubled the gift, estate and generation-skipping transfer tax exemption to $10 million per individual, indexed for inflation, and is now $11,580,000 (a combined $23,160,000 for married couples).[3] This is scheduled to sunset on December 31, 2025, when the exemption is scheduled to revert to the previous exemption of $5,000,000, indexed for inflation.

Taking advantage of this high exemption now is crucial, given the unpredictability of the November elections and the mounting federal deficit, each of which could lead to an earlier reduction in the exemption and to further tax law changes that may limit the estate planning techniques discussed in this article.

Gifting

Clients who have available exemption amounts should consider making current gifts, particularly of depressed assets that are likely to appreciate. Gifts can be further leveraged with assets that can be discounted for lack of control and for lack of marketability, as with gifts of minority interests in closely held family businesses, further reducing the value of the gift and, accordingly, the use of the exemption.

The current New York estate tax exemption is $5,850,000 and is indexed for inflation. Unlike federal tax law, however, New York has no gift tax (but adds back to the gross estate of a resident decedent gifts made within three years of death). The benefits that New York residents derive from making gifts now include the insulation of the gifted property from New York estate tax, and the possibility of lowering the taxable estate below the $5,850,000 exemption amount (provided the donor survives three years).

Non-Gifting Strategies


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Two strategies for high-net-worth clients and those who have already exhausted their federal gift tax exemption are (i) the creation of a grantor retained annuity trust (GRAT), and (ii) the sale of assets to an intentionally defective grantor trust (IDGT). For high-net-worth clients, the lifetime gift tax exemption will cover only a fraction of the assets that will eventually be transferred, and these strategies can be structured to reduce a taxable estate with minimal or no use of the exemption.

IDGTs and GRATs are essentially estate freeze techniques that exploit the difference between the AFR rates used in estate planning calculations and the actual rate of performance of the transferred assets. Although both GRATs and sales to IDGTs have many factors in common, there are differences, and often one strategy is superior to the other. Ultimately, which technique to use must be evaluated on a case-by-case basis, with a view to the mathematics in each situation.

Grantor Trusts

Both GRATs and IDGTS utilize grantor trusts. The tax laws governing grantor trusts treat the grantor (i.e., the creator of the trust) as the owner of the trust assets for income tax purposes.[4] This has several important estate-planning implications.

First, because the grantor must pay the income taxes on the trust income, as he is considered to be the owner of the trust property, the trust assets will grow free of income tax. The grantor is, in effect, making a "gift" of the income tax that would otherwise be borne by the trust (or its beneficiaries), but without utilizing any gift tax exemption.

Second, as discussed below, assets can be sold by the grantor to the trust, often at a discounted value, without the imposition of income tax or use of the exemption, even if the assets sold have appreciated.

Finally, if the trust includes a power allowing the grantor to reacquire trust corpus by substituting other property of equivalent value,[5] i.e., a "swap power," the grantor can exchange low-basis assets held in the trust for cash or high-basis assets held by the grantor without the imposition of income tax. This allows a step-up in basis on the assets transferred back to the grantor when later inherited by the grantor's heirs as part of the grantor's estate.

Sales to Intentionally Defective Grantor Trusts

One planning technique that works well with low interest rates is an installment sale by a grantor of assets to an IDGT in exchange for the IDGT's promissory note with interest payable at the AFR. Depending on the expected cash flow of the assets sold, the note may be structured with a balloon payment. Since the IDGT is a grantor trust, there is no capital gains tax when the assets are sold by the grantor to the IDGT because the grantor is effectively viewed as selling the assets to herself.

Funding the IDGT with income-producing assets is ideal since such income will allow the IDGT to service the promissory note without needing to make note payments to the grantor in-kind, i.e., with a portion of the assets originally sold to the IDGT. Making note payments in-kind would require obtaining an appraisal each time in-kind assets are used for payment.

In a sale to an IDGT, the assets sold are removed from the grantor's estate and frozen at the value of the promissory note. To the extent that the income earned on the IDGT assets plus all post sale appreciation (including the amount of the discount) exceeds the AFR, all such excess income and appreciation will remain in the IDGT and pass to the beneficiaries free of estate tax. This strategy is particularly effective with closely held family business interests and real estate.

Typically, a grantor creates an IDGT and funds it with a gift of cash or other assets equivalent to approximately 10% of the value of the assets to be sold to the IDGT. This "seed" funding is often recommended to substantiate that the sale is an arm's length sale. The seed money gifted will utilize a portion of the gift exemption. For clients with no exemption remaining, the grantor can obtain personal guarantees in lieu of seed funding.

The grantor can allocate a portion of his generation-skipping transfer tax ("GSTT") exemption to the seed money gifted to the trust, thereby shielding any future appreciation from generation-skipping transfers. For this reason, IDGTs are often structured as multi-generational dynasty trusts. Dynasty trusts take advantage of the federal GSTT exemption by removing family wealth from the transfer tax system for as long as the trust is in existence.

Grantor Retained Annuity Trusts

A GRAT is an irrevocable trust to which a grantor transfers assets while retaining the right to receive fixed annuity payments for a specified term. GRATs are most effective when interest rates are low. The gift is computed by subtracting the actuarial value of the retained annuity from the fair market value of the assets transferred to the trust. In order to determine the value of the retained annuity, the IRS assumes that the rate of return will equal the 7520 rate. Thus, if the combined growth and income on the assets transferred to the GRAT outperforms the 7520 rate (currently just 0.4%), the increase above the 7520 rate passes to the beneficiaries (or trusts for their benefit) free of gift and estate tax.

GRATs can be structured to provide for increasing annuity payments of up to 20% per year, allowing the grantor to receive smaller annuity payments in the early years of the GRAT term, leaving more assets in the GRAT to appreciate.[6]

If the grantor dies during the GRAT trust term, the lesser of the value of the trust corpus or the value of that portion of the corpus necessary to satisfy the retained annuity must be included in the grantor's gross estate. Practically, this means that the entire trust property will likely be included in the grantor's estate.

Rolling GRATS and Zeroed-Out GRATS

A common type of GRAT is a "zeroed-out" GRAT, for which the annuity is structured to produce no gift or a nominal gift. In order to "zero out" a GRAT, the annuity payment is calculated so that the present value of the annuity payments is nearly equal to the fair market value of the contributed assets. If the assets transferred to the GRAT outperform the 7520 rate, this excess growth and income is transferred estate tax free to the remainder beneficiaries, but if the assets do not outperform the 7520 rate, there is little downside.

Clients can also use rolling GRATs which are a series of short-term GRATs intended to increase efficiency and reduce the risk of the assets being included in a grantor's estate if the grantor does not survive the term. For example, rather than funding a six-year GRAT, the rolling GRAT strategy would replace this with a series of three two-year GRATs. This technique is best at capturing the upside in a volatile market.

Short-term rolling GRATs work especially well with marketable securities. Because marketable securities are publicly traded, the fair market value is readily determined. Accordingly, the annual annuity payments can be paid to the grantor in-kind, i.e., with marketable securities, without the need for an appraisal and without the reliance on income to meet the annuity payments.

Now is the Time to Plan

In addition to the very real possibility that the federal gift tax exemption may be decreased before 2025, other changes may be on the horizon, especially in light of the $2 trillion stimulus package. Numerous proposals have been set forth to limit the estate planning techniques discussed in this article. Among others, there have been proposals to limit the benefits GRATs can provide by prohibiting short-term and zeroed-out GRATS; to eliminate discounts for closely-held business and real estate interests; and to limit the benefits of IDGTs and dynasty trusts.

With historically low interest rates, depressed asset values, and a record high federal gift tax exemption with no certainty as to how long the exemption will remain in place, now is the optimal time for estate planning.

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1. Rev. Rul. 2020-15, I.R.B. 2020-32.
2. Rev. Rul. 2000-38, 2000-2 C.B. 157.
3. Pub. L. No. 115-97, enacted December 22, 2017.
4. The grantor trust rules are set forth in Sections 671–78 of the Internal Revenue Code and were originally enacted in order to prevent abuses by taxpayers who were shifting income to taxpayers in lower income tax brackets.
5. I.R.C. § 675(4)(C).
6. Treas. Reg. §25.2702-3(b)(1)(ii) (as amended in 2005).