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Ultra-Low Interest Rates and Depressed Asset Values Create Significant Estate Planning Opportunities

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COVID-19 has caused serious health and economic issues, but while society is still dealing with safeguarding heath, life after the economic shutdown is now being discussed. For individuals with means and willingness to do so, the current ultra-low interest rates and depressed asset values create unique opportunities to transfer significant amounts of wealth on very favorable tax terms.

Strategies to minimize gift and estate taxes frequently involve making lifetime gifts. Some tax reduction techniques become more effective when interest rates fall, while other techniques become less effective. Similarly, the effectiveness of most estate planning techniques is enhanced when assets that have depressed values and expected to rebound in value are utilized. This article highlights techniques that are especially effective now, in the current environment of ultra-low interest rates and depressed asset values.

Background

The federal government currently imposes an estate tax at a rate of 40 percent on estates greater than $11.58 million (although this amount is scheduled to decrease by 50 percent in 2026). The State of Illinois imposes an estate tax at an overall rate of 16 percent on estates greater than $4 million. In order to reduce the burden of these taxes, many individuals enter into transactions during lifetime that have the effect of removing assets from their taxable estates. When a particular transaction constitutes a "taxable gift," it has the effect of using a portion of the individual's exemption from estate and gift tax.

Simple Outright Gifts

A simple and effective planning opportunity is to make gifts of assets with depressed values, locking in the lower valuations and reducing the amount of exemption needed to shield the transfer from gift tax (assuming the gifted assets increase in value). While such gifting can be very effective, other techniques can provide significantly more leverage.

Leveraged Techniques

Many estate planning techniques involve leverage and valuations based upon actuarial assumptions,

including interest rates. For many techniques, low interest rates can result in lower gift tax valuations, reducing the exemption needed to transfer an asset to a descendant or other beneficiary.
The relevant interest rates are promulgated by the IRS and depend on prevailing rates in the market, which in turn are strongly impacted by the actions of the Federal Reserve.

For promissory notes, the "Applicable Federal Rate" or "AFR" is the minimum rate of interest that must be charged in order for the transaction to not be considered a taxable gift. The IRS recently announced the following AFRs for May 2020, all of which are all-time lows:

- Short-term AFR (term of three years or less): 0.25 percent
- Mid-term AFR (term more than three years and up to nine years): 0.58 percent
- Long-term AFR (term of more than nine years): 1.15 percent

Other transactions involve the creation of an annuity, or a stream of payments in the future. The interest rate used to value such interests is the "7520 rate." The IRS recently announced that the 7520 rate for May 2020 will be 0.8 percent, an all-time low.

Intra-Family Notes

With an intra-family note, an individual loans money to a family member or to a trust for a family member, generally at the lowest rate that will not cause a gift (the AFR). In each case, the hope is that the borrower invests the borrowed funds and achieves a rate of return greater than the AFR – resulting in a transfer that does not use any estate or gift tax exemption. When the AFR is lower, it is easier for the investments to clear the "hurdle rate." Therefore, now is a good time for an intra-family note strategy.

Sales to Intentionally Defective Grantor Trusts

Another technique is for an individual to sell assets to an "intentionally defective grantor trust" in return for a promissory note. An "intentionally defective grantor trust," or "IDGT," is a trust that is not includible in the transferor's estate for estate tax purposes, but is treated as a "grantor trust" as to the transferor for income tax purposes (the desired "defect"). As a result, when assets are sold to a properly structured IDGT, the sale will not result in any capital gains tax. The outstanding value of the promissory note will be includible in the individual's' taxable estate at death, but the transferred asset – and any appreciation thereon – will not be subject to estate tax.

Now is an especially favorable time for a sale to an IDGT, for two reasons. First, if the value of an asset is depressed, it will have a lower value for transfer tax purposes, meaning that the promissory note will be for a lower amount. Moreover, if the asset is an interest in a closely held business, additional discounts for lack of marketability and lack of control may also be available. Second, the low AFR means that the interest rate on the promissory note can be lower. This results in reduced payments back to the original transferor, reducing the burden of estate tax.

Refinancing Notes

Refinancing existing higher interest rate notes that were issued as part of an intra-family note

strategy or a sale to an IDGT with notes at the current prevailing interest rates is also a possibility. The IRS has not issued guidance on this issue, and there is some concern that simply replacing an existing note with an identical note carrying a lower interest rate could result in negative estate or gift tax consequences. However, this risk can be mitigated by changing the terms of the refinanced note, such as shortening the term of the note, or having the borrower make a prepayment of principal, reducing the lender's risk on the note, and justifying a reason for the refinancing other than to obtain estate and gift tax advantages.

Refinancing can result in substantial transfer tax savings. For example, suppose that an individual's estate will be subject to both federal and Illinois estate tax, at a combined effective rate of 48 percent, and that the individual made a $1 million, nine-year loan to a family member or IDGT in May 2019, at the then effective mid-term AFR of 2.37 percent. The total interest payments made over the life of the loan would be $237,000, and the estate tax on this amount would be $113,760.

If the individual refinanced the note in May 2020, the AFR would be 0.58 percent. In order to induce the lender to refinance, and to reduce the risk of the strategy, suppose that the borrower prepays $100,000 of principal. The total interest payments made over the life of the loan would then be $71,260, and the estate tax on this amount would be $34,304.80 – a tax savings of $79,555.20.

Grantor Retained Annuity Trusts

In a "grantor retained annuity trust," or "GRAT," an individual transfers assets to a trust that provides for an annuity payment to be made back to the individual. The amount of the annuity payments can be set such that the gift tax value of the annuity payments equals the gift tax value of the assets transferred – a so-called "zeroed out"" GRAT, for which the individual does not have to use any of his or her estate and gift tax exemption. The 7520 rate determines the amount of annuity payments that must be made in order to "zero out" the GRAT. Like the other strategies discussed above, a GRAT is essentially a "hurdle rate" strategy. If the appreciation of the assets in the GRAT is greater than the "hurdle rate" – in this case, the 7520 rate of 0.8 percent – then any excess appreciation passes to the remainder beneficiaries without using any estate or gift tax exemption.

As with a sale to an IDGT, now is an especially favorable time to fund a GRAT, for two reasons. First, if the GRAT is funded with depressed assets, those assets may be more likely to appreciate going forward and clear the hurdle rate. Second, the hurdle rate itself is now at an extreme historic low (0.8 percent). In other words, in order for the GRAT to succeed, the GRAT assets would only have to appreciate at a rate greater than 0.8 percent per year.

Even if the assets in the GRAT do not appreciate faster than the hurdle rate, the assets would simply return to the individual creating the GRAT, and, no exemption would have been utilized with this technique, putting the individual in the same position had he or she done nothing. Thus, GRATs are sometimes described as having potential great "upside" but no "downside" (other than the fees and administrative expenses involved in establishing the GRAT).

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