

Low Interest Rates + Lower Asset Values = Lifetime Gifting Opportunities

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Key Takeaways

- Low interest rates, decreased asset values, and political uncertainty make this the perfect time to review your estate plan.
- In these conditions, intrafamily loans, Intentionally Defective Grantor Trusts, and Grantor Retained Annuity Trusts are all worth a closer look.
- These potential solutions are an opportunity for you to transfer more assets to your heirs without increasing your tax obligations.

With everything going on in the world, reviewing your estate plan and gifting strategy may not be top of mind. But it should be. The combination of historically low interest rates and lower asset values has created a unique opportunity to transfer wealth to future generations while mitigating your tax liabilities.

Appealing Interest Rates

Some estate planning techniques involve the use of a fair interest rate, so the transfer is not considered a gift. This IRS-determined rate is known as the “Applicable Federal Rate” (AFR), and it is substantially lower than the rates assessed by commercial lenders. How much lower? Just look at the annual AFRs for May. You won’t get these rates on any bank loan.

| Short-Term (0-3 Years) | Mid-Term (3-9 Years) | Long-Term (9+ Years) |
|------------------------|----------------------|----------------------|
| 0.25% | 0.58% | 1.15% |

Taking advantage of the AFRs is an effective way to maximize the value of the transfer and minimize transfer taxes for you and your heirs.

Three Strategies

Here are three gifting strategies you may want to consider in today’s environment. Of course, the actual structures you put in place will depend on your goals and financial circumstances. We encourage you to work closely with your advisory team to evaluate your options and select the approach that makes the most sense for you.

Intrafamily Loans

Want to help an adult child buy a home? Start a business? Get back on their feet? Make an investment? Offer them a loan from the “bank of mom and dad.” With an intrafamily loan, your child receives the assistance they may not be able to get from a commercial lender and at a much better rate. Note: To reap the benefits associated with this loan, you need to document it and charge at the least the applicable AFR.



One of the primary tax benefits is that intrafamily loans don't count against your lifetime gift exemption. Additionally, you can decide to forgive a portion of the loan each year up to the annual gift exclusion (currently \$15,000 per individual, \$30,000 per couple) without triggering any gift taxes. Although, you can't document this intention when you establish the loan. Moreover, you will have to report the interest income that accrues each year whether or not the loan is paid down.

An added benefit for your child is that they get to keep any excess money earned (appreciation on the home or investment earnings) over the stated interest rate (e.g., 0.58%). The excess amount is not subject to gift taxes.

Example

In May 2016, Mary and John loaned their child \$400,000 at 2.51% interest to purchase a home. The term of the loan was nine years. Each year since inception, they've forgiven a portion of the principal and interest on the loan, and the outstanding principal four years later is now \$316,115.

In May 2020, Mary and John decide to refinance the remaining principal to take advantage of the 0.58% AFR rate, saving nearly 2% a year in interest that they would otherwise need to recognize as income. Refinancing allows more principal to be paid down each year and could extend the term to the full nine years of the new note.

Intentionally Defective Grantor Trusts

An Intentionally Defective Grantor Trust (IDGT) can be a tax-efficient way to amplify the growth of your trust because the trust assets aren't used to pay income taxes. The assets in the trust belong to your heirs for estate tax purposes, but you remain responsible for any income taxes on those assets. You can fund this trust through an outright gift or a sale in exchange for a promissory note. It's the latter where AFR comes into play. In a sale, the trust issues you an interest-bearing promissory note for the value of the assets at the appropriate AFR rate.

Common practice is to sell assets to the trust that you expect to appreciate significantly over time. Any appreciation is not taxable to your heirs while the trust remains a Grantor Trust. Given the recent financial downturn, you may have depressed assets that you expect to rebound, making them good candidates to sell to an IDGT. The hope is that as the economy recovers, these assets will increase in price, increasing the value of the trust without a corresponding uptick in taxes. This technique also removes the appreciation from your estate.

Example

In May 2020, Pam sells \$1,000,000 worth of stock to an IDGT in exchange for a balloon payment promissory note set at the current 0.58% AFR rate. At the end of the nine years, the trust needs to repay the million dollars plus the interest that has accrued.

The trust can either make annual payments of \$5,800 or pay back the entire compounded interest plus the original borrowed principal of \$1,053,428 when the term expires.

During this time, we assume the assets appreciate by an average of 7% per year, which means \$785,000 is transferred to the trust beneficiaries without incurring gift tax.

Grantor Retained Annuity Trusts (GRAT)

Like IDGTs, a Grantor Retained Annuity Trust (GRAT) is often used to transfer appreciating and high-income producing assets to heirs. The transfer is considered a taxable gift. However, the value is discounted because you retain an interest in the property and have the risk of reversion in the event you die during the term. How much of a discount depends on the interest rate set by the IRS, known as the Section 7520 rate.



The Section 7520 rate for May 2020 is currently 0.8%, which means the assets in your GRAT only have to appreciate more than 0.8% to make it an effective estate planning tool. Any appreciation above this amount (the “success proceeds”) will be tax-free. And the more the assets increase in value, the greater the benefit.

Example

David, age 65, sets up a GRAT for his children. He transfers \$1,000,000 of stock to the trust when the Section 7520 Rate is 0.8%. The term of the trust is two years.

Assuming 7% growth, in year one, he receives a return of an annuity payment from the trust for \$460,173.90. In year two, at the end of the GRAT, he gets \$552,208.60. The success proceeds of \$100,305.33 are distributed to his children.

If the assets appreciate by 10%, the annuity payments are the same, but the success proceeds increase to \$151,600.11.

Another Reason to Plan Now

In 2026, the current estate and gift exemptions - \$11.58 million for individuals and \$23.16 for married couples - will revert to 2017 levels. The 2017 exemption amounts are essentially half of what they are today. Six years may seem like plenty of time to plan, but you may not have that long. There are three election cycles before 2026, and legislators from both sides of the aisle have proposed changes to estate and gift taxes. Given the uncertainty around the elections, you may want to lock in the generous exemptions available now.

Put Our Expertise to Work for You

Our planning specialists have extensive experience helping clients implement advanced wealth transfer solutions to achieve their estate planning goals and mitigate taxes. Contact one of our advisors or visit ceritypartners.com to learn more.

Kathryn is a Partner in the Chicago office and has more than twenty-five years of experience providing comprehensive wealth management to corporate executives and high-net-worth individuals and families. She is a Certified Public Accountant, a Certified Financial Planner CFP®, and a member of the Illinois Bar.

