WEALTH SOLUTIONS GROUP

Wealth Transfer Planning Opportunities in a Low Interest Rate Environment

Current low interest rates and depressed asset values—coupled with historically high estate tax exemptions—provide individuals with unique estate planning opportunities to efficiently transfer wealth to future generations with little or no gift tax cost.

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April 2020

The first few months of 2020 have presented a significant amount of change and uncertainty which will undoubtedly affect the financial positions of Americans. From a wealth transfer perspective, this tumultuous time presents an opportunity to engage in particularly effective planning strategies. Changes to the U.S. tax code under the Tax Cuts and Jobs Act of 2017, historically low interest rates, and recent declines in asset values have created an opportunity for those wishing to minimize the impact of federal estate and gift taxes. Lifetime gifting can be especially advantageous in this current environment, as can other strategies designed to maximize the use of exemptions or avoid using exemptions entirely. Several strategies which could provide significant tax advantages are highlighted below.

USE OF FEDERAL/GST EXEMPTIONS; ANNUAL GIFTING

The Tax Cuts and Jobs Act of 2017 doubled the gift, estate and generation skipping transfer (GST) tax exemption. As of January 1, 2020, individuals have a gift, estate and GST tax exemption of $11,580,000. If a decedent's estate exceeds that amount, a tax of 40% is levied on the excess. This exemption is scheduled to decrease to $5,000,000, adjusted for inflation, on January 1, 2026. The use of this exemption is not restricted to an individual's estate and, therefore, can be used throughout an individual's lifetime via gifts.

In general, assets given away during an individual's lifetime, and any growth on those assets, will not be included in such individual's estate for estate tax purposes. Appreciated assets received by gift provide a carryover basis to the recipient, so gain must be recognized by the recipient when the asset is sold. Long-term capital gains rates of 15% or 20% will apply, which is still significantly better than the 40% rate assessed on the entire value of the asset at the estate level.

In addition, separate from an individual's lifetime exemption amount, there is an annual gift tax exemption of $15,000, per year, per recipient. This means that any individual can give up to $15,000 per year to each third party, and not reduce his or her lifetime exemption amount. Only gifts made in excess of the $15,000 annual limit per recipient reduce an individual's lifetime exemption amount. Additionally, through a gift-splitting election, married couples can split the value of a gift between them, thereby doubling their allowable annual gift tax exclusion amount. For example, if a married individual gifted his son $30,000, he and his spouse can make the gift splitting election, and treat the gift as made $15,000 by him and $15,000 by his spouse.

Making a gift to a trust for the benefit of a child, as opposed to outright, can have several benefits. The trust for the child can be structured to provide some degree of control over how and when the child receives the assets, and protect the assets from a child's creditors, including divorcing spouses. The trust can also be structured in a way that can allow the parent to continue paying the income taxes attributable to the trust assets, allowing trust assets to effectively grow income tax free (discussed further below under "Sales to Intentionally Defective Grantor Trusts").

With the increased exemption amount available through 2025 and while asset values are relatively low, it may be a good time to consider lifetime gifting to reduce or even eliminate the potential estate tax liability. For individuals who have previously utilized most or all of their available exemption or who want to preserve more of their exemption for other transfers, there are numerous lifetime gifting strategies which utilize little or no gift tax exemption and are particularly effective in low interest rate environments.

INTRA-FAMILY NOTES

Another method to shift assets to the next generation is through the use of intra-family loans. The concept is simple enough: one family member makes a loan to another (a parent to a child, for example). Such a loan can be made at interest rates lower than those available on typical commercial loans, and the terms of the loan can be structured to provide for the specific circumstances of the child/borrower. To avoid the transfer from being treated as a gift, there must be an obligation of repayment (ideally with a written and enforceable agreement) and the interest charged must be at least equal to the Applicable Federal Rate ("AFR"). Each month, the IRS publishes its AFR for short-term (less than 3 years), mid-term (3 to 9 years), and long-term (more than 9 year) loans. To the extent a loan does not bear interest at the AFR, there is a deemed gift. Typically, the loan interest rate is set in the month the loan is made and locked in for the life of the loan; however, it is possible for the rate to be renegotiated, if interest rates fall, for example, as they have lately.

Intra-family loans can be a good way to assist children looking to purchase a home or start a business. In addition to allowing the child to borrow at a lower interest rate than a conventional commercial loan, this can also provide a child with poor or no credit the opportunity to buy a home or start a business. In the case of a home purchase, it also allows the child to avoid administrative costs such as appraisal fees and closing costs.

Another way intra-family loans can be beneficial is for the child to invest the funds borrowed at a higher rate of return than the interest rate of the loan. To the extent the child can earn a rate of return greater than the interest rate, the appreciation is transferred to the child free of gift tax. In addition, the loaned assets in the hands of the child can appreciate without inflating the parent's taxable estate. Meanwhile, the parent can keep their gift and estate tax exemption to use on other transfers during their lifetime and/or upon death.

In using an intrafamily loan, the parent gets to keep cash flow equal to the value of the asset, plus interest, in the form of repayments made by the child. If the parent does not need the cash owed from the note payments, the parent can use their annual exemption ($15,000 per year per recipient in 2020) and/or their lifetime exemption to forgive repayments by the child. However, forgiveness of the note should not be the intent when issuing the loan as the IRS could make the argument that the full amount of the loan at inception was truly a gift.

GRANTOR RETAINED ANNUITY TRUSTS

A Grantor Retained Annuity Trust ("GRAT") is an irrevocable trust which would pay the grantor (or their estate) a fixed annuity equal to a percentage of assets gifted to the trust for a term of years. At the end of that term, any remaining trust property (the "remainder") passes to other family members or remains in trust for their benefit. The taxable gift is calculated by subtracting the value of the grantor's retained interest from the fair market value of the property transferred into the trust.

GRATs can be set up with large retained annuity interests that reduce the value of the remainder interest to close to zero. Such GRATs are sometimes referred to as "zeroed out GRATs". To illustrate, assume a GRAT is funded with assets worth $500,000. In the case of a (nearly) zeroed out GRAT, the annuity might be valued at $499,500 and the remainder at $500, resulting in a gift of just $500. The advantage in using a GRAT is the removal of future growth from the taxable estate (along with retention of the value of assets) with little to no use of the grantor's lifetime exemption.

GRATs are more beneficial when the interest rate that the IRS uses in determining the value of the retained interest are low. The IRS assumes that the trust assets will generate a return of at least the applicable Sec. 7520 rate in effect for the month the assets were transferred to the trust (just 0.8% for the month of May 2020). Any appreciation in excess of the Sec. 7520 rate passes to the beneficiaries free of gift tax. The GRAT is considered successful if the grantor outlives the GRAT term and the rate of return on the GRAT exceeds the Sec. 7520 rate for that month. If, contrary to expectations, the rate of return on securities (or other assets) transferred to the GRAT do not exceed the Sec. 7520 rate, then everything in the GRAT will be paid out as an annuity to the grantor but, in the case of a zeroed out GRAT, the grantor will still have most or all of his or her applicable exemption amount.

Because the primary advantage of a GRAT is the removal of an asset's appreciation from the grantor's estate, GRATs should be funded with securities or other assets with a value that is currently low but expected to appreciate. In addition, the assets transferred to the beneficiaries at the end of the GRAT term will receive a carryover basis. As such, funding a GRAT with higher-basis assets is more beneficial than low-basis assets.

There are certain considerations that should be reviewed in connection with establishing a GRAT. If the grantor dies during the trust term, the value of the remainder interest is also included in the grantor's estate. Further, because a GRAT represents an incomplete gift (as the gift to the remainder beneficiaries is not complete until the end of the GRAT term), it is not a suitable vehicle to use in a generation-skipping transfer, as the value of the "skipped" gift cannot be determined until the end of the trust term. As a result, the use of this planning technique in conjunction with the GST tax exemption for grandchildren or further generations is not recommended.

SALES TO INTENTIONALLY DEFECTIVE GRANTOR TRUSTS

An Intentionally Defective Grantor Trust ("IDGT") is a type of irrevocable trust established by the grantor for the benefit of the grantor's children and future generations. Often, an IDGT is structured to benefit the grantor's children during their lifetime and to continue for future generations. These trusts are considered "intentionally defective" because trust provisions provide the grantor with certain powers which deliberately cause the IDGT to be treated as a "grantor trust" for income tax purposes <u>only</u>. The IDGT is carefully drafted to ensure that the assets of the trust are not included in the grantor's estate for estate tax purposes. As a result, the grantor is responsible for the tax on trust income, but is not considered the owner for estate tax purposes.

A sale of assets to an IDGT can offer significant transfer tax benefits in a low interest rate environment. Current interest rates combined with relatively low asset values make this technique particularly attractive. In a sale to an IDGT, a parent, for example, sells appreciated assets to the IDGT in exchange for a promissory note from the IDGT at the (currently very low) AFR. The sale price is based on the current fair market value of the asset, less any applicable discounts.

Since the IDGT is structured as a grantor trust for income tax purposes, the parent does not recognize any gain on the sale of the appreciated assets to the IDGT and does not have to report the promissory note interest payments received from the IDGT as taxable income. This allows the assets in the IDGT to effectively grow income tax-free, as the grantor is paying the income tax attributable to the IDGT with non-IDGT assets. Any post-sale appreciation will accrue to the IDGT (benefitting children and future generations) without being subject to gift or estate tax. The lower the interest rate on the promissory note, the more beneficial the sale technique is because it reduces the IDGT's payment on the promissory note.

As is the case with a GRAT, the advantage of selling to an IDGT is the removal of an asset's appreciation from the grantor's estate. Accordingly, the IDGT should be funded with assets with a value that is currently low (or potentially discounted) but expected to appreciate. In addition, as with a GRAT, the assets sold to the IDGT will receive a carryover basis, and as such, selling higher-basis assets to the IDGT is more beneficial than selling low-basis assets.

GRANTOR TRUST ASSET SUBSTITUTION

For clients that have previously established IDGTs, there may be an opportunity to exchange the assets currently held by the grantor trust with assets that have higher growth potential. Often a grantor trust provides the grantor with the power to substitute assets in the trust for assets of equivalent value, with no income tax implications. This is one of a handful of powers that renders the trust a grantor trust. Given recent market changes, it may make sense to review the current holdings of grantor trusts as well as the assets held in an individual's name to determine if assets with higher growth potential should be swapped into the grantor trust in exchange for assets with lower growth potential. However, this technique requires a careful analysis of many factors, including the basis of the assets.

CHARITABLE PLANNING AND CHARITABLE LEAD ANNUITY TRUSTS

For individuals who are charitably inclined, there are significant tax advantaged giving opportunities to consider. The Coronavirus Aid, Relief, and Economic Security (CARES) Act provided a particularly strong income tax incentive for those making charitable contributions this year. Under the CARES Act, individuals may take a charitable deduction for cash charitable contributions equal to 100% of his or her 2020 adjusted gross income.

Historically low interest rates also mean that Charitable Lead Annuity Trusts ("CLATs") are especially effective right now. CLATs are designed to provide a designated charity with annual annuity payments (equal to a specified percentage of assets contributed to the trust) for a set term, and leave the remainder interest passes to a non-charitable beneficiary, such as the grantor's children. It can be set up during the grantor's lifetime or upon the grantor's death. Much like a GRAT, a CLAT is designed to shift wealth to the remainder beneficiaries in a tax-efficient manner. One objective of the CLAT may be to maximize the value of the charity's annuity interest and minimize the calculated value of the remainder passing to the children so that trust assets are transferred with as little use of the grantor's applicable gift tax exemption as possible. Just like with a GRAT, any appreciation on the value of the assets over and above the Sec. 7520 rate (the IRS's assumed rate of return) used for the CLAT will pass to the children without being subject to gift or estate tax.

Lower interest rates decrease the value of the gift of the remainder interest passing to the children and increase the value of the charitable deduction for the annuity interest passing to the charity. As a result, the current low interest rates make CLATs particularly effective for individuals who are charitably inclined.

CONCLUSION

There are significant opportunities to transfer wealth to further generations with little or no gift tax implications in today's current environment of low interest rates and depressed asset values. Please consult with your Baird advisor for more information.