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Tax, Benefits, and Private Client

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Update: Low Interest Rate Gift Planning

Current very low interest rates create significant opportunities to shift wealth to junior generations.

While you still have all of 2020 to take advantage of annual exclusion gifts ($15,000 per donee) and the increased lifetime gift tax exemption (now $11,580,000 per taxpayer[1]), we recommend that you not wait too long to take advantage of the current low interest rate gift opportunities for a number of reasons, including the advantage that once a gift is made, any future appreciation of the transferred property and any future income generated thereby will escape transfer taxes.

In addition, future legislation could limit your gift planning opportunities. Proposed changes that have been discussed in the past and that are likely to be discussed again include (i) eliminating "discounts" for closely-held business and real estate interests; (ii) prohibiting short-term (*e.g.,* two-year) Grantor Retained Annuity Trusts ("GRATs") (discussed on page 2); and (iii) limiting the benefits of "defective" grantor trusts (also discussed on page 2) and long-term "dynasty" trusts. None of these changes has been enacted yet, but for those in a position to do so, we strongly recommend that you take advantage of your gift tax planning opportunities sooner rather than later, after considering the impact of your gifts on your donees.

Low Interest Rates

On or about the 20th of each month, the Internal Revenue Service issues its "Applicable Federal Rates" ("AFRs") that are applicable for many federal income tax purposes for the following month. These minimum interest rates are a key component in many estate planning strategies, and lower rates provide significant opportunities to shift wealth to junior generations. The AFRs for April 2020 are very low (and might be even lower in May): The rate for a loan of less than three years ("short-term") is only 0.91%; the rate for a loan of between three and ten years ("mid-term") is only 0.99%; and the rate for a loan of ten or more years ("long-term") is 1.44%.

The rates could rise later in 2020. You therefore may wish to take one or more of the following opportunities now:

i. Establish a GRAT;
ii. Make "intra-family" loans to family members, including your children and grandchildren, or to trusts for their benefit;
iii. "Refinance" existing intra-family loans that bear higher interest rates; and

1. These amounts may be drastically reduced before 2026, especially if there is a regime change after the November election.

iv. If you have philanthropic goals, consider the following:

a. **Estate tax savings.** A charitable lead annuity trust ("CLAT") is a statutorily sanctioned trust that lasts for a specified number of years and provides for specified amounts to be distributed each year to charity during the CLAT term. Any growth in the CLAT assets in excess of the IRS specified rate (the "7520 Rate," which is 1.2% for April) passes to the non-charitable remainder beneficiaries (*e.g.,* your children) at termination of the CLAT, free of gift or estate tax; and

b. **Income tax savings:** A gift to charity of a "remainder interest" in a personal residence or farm produces better results with lower interest rates. Because your retained use of the realty is equivalent to a retained income stream, the lower the interest rate, the less your retained interest is deemed to be worth (and correspondingly, the more your charitable gift is worth), so your charitable contribution deduction is greater. For example, a donor age 70 who contributes the "remainder interest" in a $1,000,000 residence not subject to a mortgage to charity in April (1.2% 7520 Rate) will be entitled to an income tax deduction of approximately $850,000 (rather than approximately $480,000 at a 6% 7520 Rate).

Transfers to GRATs

By way of brief background, a GRAT is another statutorily sanctioned type of trust (similar to a CLAT) whereby you (the "**G**rantor") transfer property to the trust but **R**etain the right to receive specified payments (**A**nnuity) from the **T**rust for a specified number of years, after which the GRAT property is distributed to your donees. The specified payments are often structured so that, after accounting for the 7520 Rate of return on the property transferred into the GRAT, the present value of the payments you are to receive will equal the value of the property you transferred into the GRAT. When the annuity payments are structured in this manner, the GRAT is often said to be "zeroed-out" because your donees' remainder interest has no value for gift tax purposes; thus, no gift tax is payable and no gift tax exemption is used in connection with your funding of the GRAT. To the extent that the investment return on the GRAT property exceeds the 7520 Rate, value will remain in the GRAT after all annuity payments are made, thereby effecting a tax-free gift of the excess return (provided you survive the GRAT term). Accordingly, to the extent that the investment return of a GRAT established in April 2020 exceeds 1.2%, there will be a tax-free transfer of assets to the ultimate beneficiaries of the GRAT (typically your children). The currently depressed value of many securities affords an additional opportunity to benefit from a GRAT funded with those securities.

Intra-Family Loans

As a result of the historically low interest rates, it's also a good time to loan money to family members or trusts for their benefit. As noted above, the minimum interest rate in April 2020 for a loan of up to three years is 0.91%, and loans between three and ten years carry a minimum interest rate of only 0.99%. To the extent that the loan recipients are able to invest the borrowed funds and generate a return greater than the minimum interest rate, wealth will have been successfully transferred without any gift tax.

For example, if a loan of $1,000,000 were made for 35 months at 0.91%, and if the borrower invests that $1,000,000 in an investment earning 5% after taxes, the excess after 35 months of $123,458 will have been transferred to the borrower free of gift tax.

Finally, if you currently hold an outstanding promissory note payable by a family member that has an interest rate significantly higher than current interest rates, you can refinance that note now to generate additional cash for your donee and reduce your taxable income.

"Defective" Grantor Trusts

Instead of making loans or gifts directly to family members, a more tax-effective option is to make loans or gifts to a "defective" grantor trust for their benefit. A "defective" grantor trust is a type of trust in which all income is taxable to you individually, even though that income inures solely to the benefit of the trust beneficiaries. This in effect permits additional "gifts" to the beneficiaries (in an amount equal to the income taxes) without your being considered to have made any further taxable gifts. For example, retaining the right to later substitute other assets of equal value ("Swap Power") causes a trust to be "defective."

Similarly, it may also be appropriate to sell assets to a "defective" grantor trust in exchange for a promissory note. No taxable gain is recognized by reason of that sale, and no taxable income is recognized by reason of your interest receipts. If the assets that are sold to the trust appreciate at a rate that exceeds the currently low minimum interest rate, wealth will inure to the benefit of the next generation without the imposition of gift tax.

Possible Disadvantages

Once you make a gift, you of course lose access to that property. You should not give away property if you may need it someday, although you should be able to borrow funds from the gift trusts that you have established. If paying additional income taxes by reason of a "defective" grantor trust later becomes burdensome, you can release the "defective" feature to eliminate the imposition of future income taxes.

The recipient's income tax basis in property received by gift generally is the donor's basis; thus gifts of high-basis property are more tax-efficient. If you have created a "defective" grantor trust with low basis assets, you later can use your Swap Power to exchange cash or higher basis assets tax-free for the low basis assets originally given to that trust so that your heirs will be entitled to a "stepped-up" income tax basis at your death[2]. You may be able to borrow cash for this purpose.

Finally, if the property loses value after the gift, you will have used more exemption by making the gift than would be used at your death.

If you wish to pursue a gift-giving strategy in 2020, please call William Finestone to arrange for a meeting to discuss your questions and comments.

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2. This "stepped-up" basis advantage could disappear in the future, especially if there is a regime change after the November election.