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## Planning with Low Interest Rates and Temporarily Reduced Asset Values

As a result of the global pandemic, many clients have seen the value of their asset holdings or closely held business temporarily (we hope) reduced. Also, the minimum interest rates that the Internal Revenue Service publishes each month have reached historic lows for May of 2020. Finally, we're in a presidential election year, and there could be a change in the gift, estate, and generation-skipping transfer tax exclusion amounts in 2021. As a result of all these factors, now may be the time for clients to utilize estate planning techniques to help save your family gift, estate, and income taxes.

The May 2020 Applicable Federal Rates are:

- Short-term is 0.25% for loans with terms less than three years
- Mid-term is 0.58% for loans with terms of three to less than nine years
- Long-term is 1.15% for loans with terms nine years or more
- 7520 rate is 0.80%

### Intra-Family Loans

Individuals can take advantage of the minimum federal rates by making loans to family members or refinancing existing loans. Low interest rate loans can also be combined with gifts, resulting in larger transfers without incurring any taxes (discussed below).

### Grantor Retained Annuity Trust

One typical transaction that includes the interest rate element is a grantor retained annuity trust (GRAT). A GRAT is an irrevocable trust that can be structured to make gifts to family members without using lifetime gift tax exemption. The individual who creates the trust receives annuity payments for a set term of years (minimum term is two years). At the end of the annuity term, the assets remaining in the GRAT are

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distributed to the trust beneficiaries. The effectiveness of using GRATs increases when interest rates are low, as the individual who creates the trust assumes the assets put into the GRAT will appreciate in value above the section 7520 rate, which is 0.80% in May of 2020, so the hurdle rate to beat is very low.

### **Intentionally Defective Grantor Trust**

Another typical transaction is a sale to an intentionally defective grantor trust (IDGT). This technique starts with an initial seed gift to the IDGT (generally 10% of the value of the property to be sold to the IDGT), followed by a subsequent sale of assets to the IDGT in return for a promissory note with interest payable at the AFR. The IDGT is designed to exclude the trust assets from the estate of the individual who created the trust, but it is “defective” for income tax purposes (income will be taxed to the individual creating the trust). This technique is a way to give beneficiaries the benefit of the appreciation on the trust assets.

If the IDGT is structured properly to tax advantage of generation skipping transfer tax exemptions, it can continue for the benefit of multiple generations without incurring additional estate, gift, or generation skipping taxes. These trusts are often referred to as a “Dynasty Trust” or “Endowment Trust.” Many individuals also prefer trusts because they can be structured to help protect trust assets from the reach of former spouses of beneficiaries in the event of divorce and from a beneficiary’s creditors (a rising concern in the current turbulent economic environment).

Many individuals have existing promissory notes owed back to them from previously created Dynasty IDGTs, often with a balloon principal payment that would be coming due in 2020 or 2021 if the original financing used a note with term just under nine years to take advantage of the mid-term rates in 2011 and 2012. With the May 2020 long-term AFR at 1.15%, a refinance of those existing note(s) should be considered with a due date greater than nine years from the date of refinance. A refinance should not be done without providing the lender some additional consideration for agreeing to give the borrower (the IDGT) a lower interest rate. Consider selling additional assets to the IDGT or having the IDGT make a more than de minimus principal payment in order to induce the lender to refinance at the lower rate.

The use of the sale technique also provides flexibility in the event the existing gift tax exemptions are lowered earlier than the existing sunset date of December 31, 2025. If the gift tax exemption were to be reduced as a result of the November 2020 elections, for example, an amount of the promissory note equal to a taxpayer’s remaining gift tax exemption at the higher level could be quickly gifted to the IDGT, thus cancelling the portion of the promissory note gifted. An outstanding promissory note also provides flexibility to get low-basis assets from the IDGT back to the grantor of the IDGT who is owed the note. The prepayment of the note with the low-basis assets allows the grantor to receive an income tax basis adjustment if the assets then remain in the grantor’s estate until death, but it is neutral from an estate tax standpoint because the grantor is essentially swapping one asset in the grantor’s estate (part of the note) for other assets (the low basis assets in the IDGT).

### **Charitable Lead Annuity Trust**

One more option, for those charitably inclined, is a charitable lead annuity trust (CLAT). This trust is similar to the GRAT, but a charity or charities receives the annuity payments instead of the individual who created the trust. At the end of the charitable lead term, family members can receive assets remaining in the CLAT. If the investment performance of assets in the CLAT beats the IRS assumed rate of return, which is the 7520 rate of 0.80% in May 2020, the trust’s investment return above that low rate goes to the benefit of the family members who receive the assets at the end of the term of the CLAT.

A multitude of wealth transfer techniques exist that can be tailored to fit your specific situation. If you have been contemplating making lifetime gifts, but you have concerns about taxes, a beneficiary's ability to be a good steward of your assets, or your ability to retain your standard of living after making gifts, contact one of Michael Best's Wealth Planning attorneys to analyze your specific circumstances.

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