



High Net Worth Families



ALERT

MAY 2020

Take Advantage of Historically Low IRS Interest Rates Using GRATs and Other Wealth-Transfer Tools

As we noted in our recent [client alert](#), the IRS has announced historically low interest rates to be used in connection with lifetime transfers of wealth. Together with currently depressed asset values, this creates a unique opportunity in the near term for individuals to transfer wealth through the use of Grantor Retained Annuity Trusts (GRATs), installment sales and intrafamily loans. These transfers can be set up in ways that provide peace of mind against the various risks that may cause hesitation. We highlight these planning techniques below and suggest that you consider making them part of your estate plan.

GRATs

The basic idea of a GRAT is simple. You transfer assets to a trust that pays you an annuity for a certain term of years. The total annuity payments equal the starting value of the transferred assets plus interest at an IRS-mandated rate. At the end of the term (typically two to three years, but it could be longer), all the assets remaining in the trust pass to the named beneficiaries, usually family members.

A GRAT will succeed in transferring wealth as long as you survive the GRAT term and the increase in value of the contributed assets exceeds the IRS interest rate. In May, this “hurdle” rate drops to an unprecedented 0.8%. (To put that in context, within the past two years, the hurdle rate has been as high as 3.6%.) Any appreciation in excess of the hurdle

rate passes to the next generation free of gift and estate taxes. If the assets do not outperform the hurdle rate, you will simply get them back in payment of the annuity.

GRATs have no gift tax risk. They are expressly authorized by the Internal Revenue Code, and the annuity rate is self-adjusting so that there is little or no taxable gift even if asset values are changed in an IRS audit. As long as you outlive the GRAT term, the trust property will not be subject to estate tax at your death. (If you die during the term, the result is no worse than not having created the GRAT at all.)

The current exceptionally low hurdle rate combined with depressed asset values means that the required GRAT annuity will be as low as it has ever been, so this is probably the best time in history to fund a GRAT.

What if you recently created a GRAT that is now “underwater” because its assets have dropped too much in value since you set it up? You may be able to swap cash or other assets for the GRAT assets (don’t worry; that cash will come back to you as the annuity from the old GRAT) and then simply “re-GRAT” the now-depressed assets to a new GRAT with a much lower annuity (based on the lower starting value and hurdle rate). In the current environment, the new GRAT may well be far more successful than the original GRAT.

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Installment sales and Intrafamily Loans

GRATs cannot readily be used to transfer wealth to generations younger than your children. And as noted above, there is a mortality risk in that if you die during the GRAT term, all the assets may be back in your taxable estate. A conceptually parallel technique avoids those issues: You can sell assets to a “grantor” trust for cash and an installment note, or just lend funds to a grantor trust that can then take the opportunity to acquire assets at a favorable current valuation.

As with a GRAT, any appreciation in the trust assets beyond the interest rate on the loan passes to family members free of gift and estate taxes. Moreover, the sale or loan can be to a trust that is exempt from the separate generation-skipping transfer (GST) tax, which is generally not possible with a GRAT.

To avoid adverse gift tax consequences, a minimum rate set by the IRS (known as the Applicable Federal Rate or AFR) must be charged. The AFRs announced for May are historically low: just 0.25%, 0.58% and 1.15% for short-term (up to three years), midterm (three to nine years) and long-term (over nine years) loans, respectively.

Because a grantor trust is treated as if you still owned the trust assets for income tax purposes, there is no capital gain on an installment sale, and the interest on any loans to the trust is tax-free during your lifetime. If you die during the term of the note, your estate will include only the balance due on the note and, of course, whatever has been repaid.

There is gift tax (and potentially GST tax) risk on a sale if the IRS determines that the fair market value of the assets you sold was higher than the purchase price. You can build in protection against that risk by using formulas and formal appraisals where needed, and the gift (and GST) tax exemption is so large that many people will face no risk of incurring out-of-pocket taxes.

If you’ve already made use of installment sales and other intrafamily loans in the past, it is now possible to refinance those notes at a much lower rate.

What If You Need Future Access to the Transferred Appreciation?

If you worry that, in these volatile times, you may need access to the assets you have transferred, remember that you are transferring only the future growth in value. You can hedge your bets even as to the appreciation by including your spouse as a beneficiary of the family trust that receives whatever assets remain in the GRAT at the end of the annuity period or of the grantor trust to which you sell or lend.

In addition, you can access the funds in these family trusts by borrowing without collateral, and the trustee can reimburse you for the income taxes you pay on the trust’s income and gains. Of course, if you can avoid taking advantage of these safety valves, the estate planning benefits will be more robust.

In some circumstances you can become a permissible beneficiary of the trust in the future, but this won’t work for estate tax purposes in all states, so to add this feature you may need to situate the trust in a different state and use a corporate administrative trustee in that state.

Please reach out to your Loeb estate planning lawyer if you are interested in exploring any of these estate planning opportunities..

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