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Timely Estate Planning Techniques, Including "May Day" GRATs

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The current financial and political environment creates unique estate planning opportunities. Depressed stock prices and low interest rates, together with the uncertainty of the duration of the coronavirus pandemic and the outcome of the November elections, make current gifting particularly attractive. Techniques that take advantage of low interest rates include GRATs, charitable lead trusts, and intrafamily loans. Gifts to use the temporarily high gift tax exemption are also recommended. We'll use a question and answer format to explain these tax-efficient techniques.

I've heard that now is a good time to fund a GRAT. What is a GRAT? We highly recommend that our clients consider funding one or more GRATs in the near future. A grantor retained annuity trust, better known as a "GRAT," is an irrevocable trust that pays a set-dollar annuity amount to the grantor for a fixed period of years, after which the remainder passes to or for the benefit of children or others. The effect of a GRAT is to transfer to the trust's remainder beneficiaries all of the appreciation in excess of the so-called "7520 rate" (an IRS prescribed interest rate). The gift can be made without using up any gift tax exemption, and if the assets do not appreciate in excess of the hurdle rate, they are simply all returned to the donor. The only downside is the minimal legal cost of setting up the trusts, and there can be great upside in a low interest-rate environment.

Why should I fund GRATs now? The best time to fund a GRAT is when interest rates are low and asset prices are depressed or otherwise have great potential for appreciation. This alert is discussing "May Day" GRATs simply because the IRS interest rate is so low right now. The May 2020 7520 rate used to calculate GRAT payments is 0.8%, the lowest since the IRS started publishing these rates in 1989. The 0.8% interest rate is in effect for the entire month of May. Sometime in the second half of the month, the IRS will announce the June rates, at which time we will know whether June's rate will be higher, lower, or the same as May's rate. The other key factor is asset values. If you think we haven't seen the bottom of the market yet, then you might want to wait to fund a GRAT.

What if I have an existing GRAT or other grantor trust? Is there anything I should be thinking about? If an existing GRAT has underperforming assets, it might be a good idea to "freeze" the GRAT by swapping the GRAT's assets for other assets, such as cash or bonds, of equal value. It might also be good to review the income tax basis of assets in any grantor trust and, if possible, swap out low-basis assets that are currently in the trust so that those assets are included in the grantor's estate and receive a "step up" in basis at the grantor's death.

More information on GRATs, including examples illustrating how a GRAT works in different asset appreciation scenarios, can be found here.

I'm not sure a GRAT is right for me. What other techniques take advantage of low interest rates?

The low interest rate also makes this an advantageous time for intrafamily loans. Intrafamily loans can be made at the "applicable federal rate" – which is lower than commercial loan rates – without triggering any gift tax consequences. For example, if a child is buying a house, commercial mortgage rates might be 3.5% for a 30-year loan, but using an intrafamily 30-year loan made in May 2020, a parent can lend the child money to buy the house at a 1.15% rate without triggering a gift. That same rate can be used to refinance existing debt. If a shorter-term loan is needed, the May 2020 applicable federal rates are even lower. For a short-term loan (3 years or less), the rate is 0.25%, and for a mid-term loan (3 to 9 years), the rate is 0.58%.

If you have philanthropic goals, a charitable lead trust is an excellent option. The charitable lead trust is the reverse of its better-known cousin, the charitable remainder trust. In a charitable lead trust, the charitable beneficiary receives annual payments from the trust, either in the form of a specific-dollar annuity – a charitable lead annuity trust ("CLAT") – or a payment calculated as a percentage of the trust's value – a charitable lead unitrust ("CLUT"). This arrangement allows you to make meaningful, immediate provision for charities doing important work in these uncertain times. At the end of the trust term, the assets remaining in the trust are paid to your noncharitable beneficiaries (e.g., your children). The low interest rates increase the opportunity to transfer a larger remainder interest to your noncharitable beneficiaries at a lower transfer tax cost.

The unstable markets make me nervous. Is this really the right time to be making gifts?

This is an excellent time to make lifetime gifts, particularly of assets that are currently depressed in value due to market fluctuations but are likely to regain their value. The gift and generation-skipping transfer tax exemptions are historically high right now. For 2020, the Federal exemption amount is $11.58 million per person (more than $23 million for a married couple). This increased exemption level is temporary and is set to expire at the end of 2025. However, Congress could change that, either by reducing the exemption level sooner (a possibility if the Democrats win the presidential election and gain control of Congress) or by extending the expiration date or making the change permanent (a possibility if the Republicans win the presidential election and gain control of Congress). Using assets with depressed values to make gifts leverages the value of the exemptions. Gifts can be outright or in trust.

Married individuals may find it advantageous to make gifts using a spousal lifetime access trust ("SLAT"), in which the donor spouse contributes assets to a trust for the benefit of the other spouse and children and their descendants. Using a SLAT gives some comfort because if the spouse has financial requirements that exceed the couple's remaining assets, distributions to the spouse can be made. While that is not an optimal outcome from a tax perspective, it often gives couples the confidence to make gifts to use their temporarily increased exemption.

Now is also an excellent time to fund a Roth IRA or convert some of your traditional IRA assets to a Roth IRA, if you have funds available outside the IRA to pay the necessary income taxes. While contributions to a traditional IRA are deductible for income tax purposes, income tax at ordinary income tax rates must be paid on all distributions from a traditional IRA (whether required minimum distributions or otherwise) when they are taken. By contrast, contributions to a Roth IRA are not deductible for income tax purposes, but withdrawals after age 59 are generally tax-free. Even if you are not eligible to fund a Roth IRA directly due to the income limitations, you are still allowed to convert funds in your traditional IRA to a Roth IRA by paying income tax on the converted amount based on the value of the assets on the date of the conversion. The tax consequences of this distribution will be more palatable during a market downturn because the income taxes that need to be paid in connection with the conversion will be lower. Having these assets in a Roth account can have significant advantages. First, Roth IRAs do not have required minimum distributions, so you can leave the account untouched during your lifetime, preserving unneeded assets in the income-tax-free account for your heirs. Second, if you believe that your tax rates during retirement will be the same or higher than your current tax rates (especially given current low federal income tax rates), you should pay income tax on the retirement assets now rather than waiting until retirement.

Please contact us if you have questions about GRATs or any other "May Day" planning techniques.

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