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Leveraging gifts in a low interest rate environment to save on estate taxes

TAXING MATTERS

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Interest rates are at historic lows. For taxpayers interested in estate planning, low interest rates provide an opportunity to leverage the value of gifts.

Taxpayers may accordingly wish to consider making leveraged gifts now to potentially save on estate taxes in the future. In this article, we explain the opportunity presented by the current low interest rate environment for gifts using Grantor Retained Annuity Trusts, or GRATs.

First, some background. Although interest rates are at historic lows, the federal estate and gift tax exemption (the "exemption") is at an historic high. The exemption for this year is $11.58 million per person and $23.16 million for a married couple.

But this level of exemption is not set in stone. The exemption was increased by the Tax Cuts and Jobs Act of 2017 and the increase is scheduled to sunset in 2026 if Congress does not extend it or make it permanent. If the increased exemption sunsets, the exemption will revert back to pre-increase levels: probably somewhere in the range of $6 million for individuals and $12 million for married couples.

And, if Joe Biden wins the Presidential election this year, there is a possibility that the exemption could be lowered sooner. In the Democratic presidential primary, several candidates, including Bernie Sanders, had proposed lowering the exemption to $3.5 million, i.e., below even the anticipated post-sunset level. Although Joe Biden, the presumptive Democratic candidate, has not released a detailed estate tax plan, it is not unreasonable to suppose that a Democratic administration could bring a lower exemption.

In addition, regardless of the outcome of the Presidential election, there is another reason to suspect that the exemption could be lowered sooner. The federal and state governments have spent at unprecedented levels to combat the COVID-19 pandemic. Revenue will be needed to counter the spending. As revenue-boosting measures are discussed, it seems likely that estate tax reform will be on table. In fact, the estate tax has a history of raising revenue for the country in times of crisis. For example, the essentially modern version of the estate tax was enacted in 1916, in time to raise revenue to help fight World War I.

With this background in place, we can turn to gifting. In light of the exemption's uncertain future, taxpayers who are able to do so can make large gifts now to lock in the current increase.

In terms of gifting, the simplest way to make a gift is an outright gift. If a taxpayer gives $10 million in cash to another person, outright, the taxpayer has given away $10 million and has used $10 million in exemption.

But low interest rates can be used to leverage the gift: a taxpayer can use low interest rates to potentially give more property away to his or her chosen beneficiaries using less exemption.

Many different estate planning techniques can be successfully utilized in a low interest rate environment. For this article, we will focus on the Grantor Retained Annuity Trust, or GRAT. In a GRAT, the trust creator, i.e., the grantor, creates a trust. The grantor is the initial beneficiary of the trust and receives an annuity each year over a set term, e.g., five years, ten years, etc. At the end of the term, the remaining balance of the GRAT passes to the grantor's chosen remainder beneficiaries, typically his or her children.

Just like any other gift transfer, at the time the GRAT is created, the IRS needs to value the gift that is made. But, unlike simple outright gifts, if the grantor transfers $10 million to the GRAT, the gift is not the entire $10 million because the grantor has not actually given the entire amount away. The grantor has retained the right to receive the annuity over the selected term, which decreases the amount of the gift. Technically, the gift here is only the amount that passes to the remainder beneficiaries after the grantor's annuity term expires.

Here is where interest rates come in. When the GRAT is created, the respective values of the grantor's interest and the remainder beneficiaries' interest are determined using interest rates set each month by the IRS. This is a hypothetical valuation: what the remainder beneficiaries actually receive when the grantor's annuity term expires has no bearing on the value of their interest for this purpose. Generally, as interest rates go down, the value of the grantor's interest goes up and the value of the remainder beneficiaries' interest, i.e., the actual gift for tax purposes, goes down.

Consider this example: The IRS's June 2020 interest rate for valuing a GRAT is at a once-in-lifetime low — an eye-popping 0.6%. You read that right: zero point six percent. Using this interest rate, if a grantor transfers $10 million to a GRAT and retains the right to receive a 5% annuity annually over ten years, the IRS's calculation determines that the grantor has only made a gift of about $5 million, or roughly only half of the actual transfer. But if the GRAT grows at a reasonable 7% each year over the grantor's annuity term, the remainder beneficiaries can expect to receive over $12 million even after payment of the annuity, which is more than twice the amount of exemption the grantor used to make the gift!

As this example shows, low interest rates can be used to powerfully leverage the value of a gift for estate and gift tax purposes. In light of the uncertainty surrounding the exemption, taxpayers may wish to consider making such gifts now to lock in the current increase.

Low interest rates, and the Trump administration, may not be here forever, so this offer may end soon. Individuals interested in taking advantage of this uniquely favorable environment for GRATs should consult with their tax advisors.

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