

Estate Planning During COVID-19: IRS Announces Low Interest Rates

COVID-19 has created unprecedented economic challenges. These challenges have depressed market values and the government has responded, in part, with slashing interest rates to historically low levels.

In Revenue Ruling 2020-11, the IRS announced the May 2020 Federal interest rates, which are at record low levels. The Section 7520 rate (the interest rate used to determine the transfer tax value of annuities, life estates and reversionary interests) is 0.8%, and the Applicable Federal Rates (or “AFRs”) (the minimum safe-harbor interest rates for intra-family loans) is 1.15% for the long-term AFR (repayment term of more than nine years), .58% for the mid-term AFR (repayment term of between three and nine years) and .25% for the short-term AFR (repayment term of up to three years), all based on annual compounding of interest. These very low interest rates have created unique estate planning opportunities.

Even absent low interest rates, now may be a unique time for gift planning given the market volatility that we have been experiencing since this crisis began. To the extent values on gifted property are depressed, all future appreciation will be outside of the donor’s taxable estate for estate tax purposes. In addition, to the extent property transferred consists of minority or non-controlling interests in closely held entities or other illiquid assets, it may be possible to discount the value of the property for gift tax purposes, thus getting more property out of the estate for estate tax purposes.

With respect to leveraging low interest rates, there are several estate planning techniques that can be used. Intra-family loans are the simplest technique and are ideal for providing cash to younger generations or other family members. With an intra-family loan, a borrower lends an amount to a family member. The family member pays back the loan with the low IRS interest rates. The loan, if properly structured, is not a taxable gift and any appreciation in the amount loaned in excess of the interest remains the property of the borrower.

Other techniques that benefit from this low interest rate environment include Grantor Retained Annuity Trusts (or “GRATs”) and sales to Intentionally Defective Grantor Trusts (or “IDGTs”), among others.

In a GRAT, a donor transfers property to a trust, but retains an annuity for a set term. The total value of all annuity payments back to the donor reduces the amount of the gift involved in creating the GRAT. A GRAT can be utilized without using any gift tax exemption (depending on the annuity amount). The larger the amount of the annuity,

the smaller the taxable gift. After the term, any balance in the GRAT passes to the beneficiaries or to further trusts for their benefit. All appreciation in excess of the very low Section 7520 rate is outside of the donor's estate for estate tax purposes. A GRAT is not an ideal vehicle for generation-skipping transfer tax ("GST tax") purposes.

The sale to an IDGT technique involves the sale of property to a trust in exchange for a promissory note, with interest at the applicable AFR. Again, to the extent the property increases in value in excess of the very low AFR, all of that appreciation is outside of the donor's estate for estate tax purposes. This technique often involves a gift to the trust prior to the sale, in an amount equal to approximately 10% of the value of the property being sold. In addition, IDGTs can be GST tax exempt. So, this technique is well suited for transferring assets that are intended to pass to grandchildren and younger generations.

Both techniques have additional requirements and ramifications, and professional help is strongly recommended.

The federal estate and gift tax exemption is currently at \$11.58 million per person (which equates to \$23.16 million for a married couple). Those exemptions are indexed annually for inflation, but absent further Congressional action, are scheduled to be cut in about half in 2026. This may create an incentive to accelerate gift and estate tax planning, depending on personal objectives and assets.

Of course, given the prominence of social distancing measures, there are certain logistical challenges in the actual execution of any trust or other legal documents. However, many states, including New York, have allowed for "virtual" notarization and witnessing of legal documents, facilitating this kind of planning.

UPDATE: In Revenue Ruling 2020-16, the IRS announced the September 2020 Federal interest rates, which again are extremely low. The Section 7520 rate is 0.4%, the long-term AFR is 1%, the mid-term AFR is .35% and the short-term AFR is .14%, all based on annual compounding of interest.

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Please feel free to contact either of the persons listed below if you have any questions on these important developments:

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