Estate and Gift Planning with Low Interest Rates - Making the Best of a Bad Situation

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Because of the current pandemic, the August 2020 applicable federal rates and section 7520 rate are at historical lows, creating opportunities for interest sensitive estate and gift tax planning. Loans to family members or trusts for the benefit of family members, and transfers to some split interest trusts, can provide enhanced benefits in a low interest environment. On the other hand, some types of split interest trusts are disadvantaged by the low interest rates.

Interest sensitive planning is dependent on the applicable federal rate and the section 7520 rate. The relevant Internal Revenue Code sections and Treasury rulings concerning the applicable federal rates ("AFRs"), section 7520 rate and loans are:

1. Section 1274(d)(1)(A) provides that the applicable federal rate is:

In the case of a debt instrument with a term of:	The Applicable Federal Rate is:
Not over 3 years	The Federal short term rate
Over 3 years but not over 9 years	The Federal mid-term rate
Over 9 years	The Federal long-term rate

2. Section 7520(a) provides the general rule that the value of any annuity, any interest for life or a term of years, or any remainder or reversionary interest shall be determined—

(1) under tables prescribed by the Secretary, and

(2) by using an interest rate (rounded to the nearest 2/10 ths of 1 percent) ***equal to 120 percent of the Federal midterm rate*** in effect under section 1274(d)(1)f or the month in which the valuation date falls.

3. Section 7872 provides rules for treatment of loans with below market interest rates, and provides that in the case of a term loan, a below market loan is any loan if the amount loaned exceeds the present vale of all payments due under the loan,

- the present value of any payment is determined as of the date of the loan by using a discount rate equal to the applicable federal rate, and

- the applicable federal rate in the case of a term loan shall be the applicable Federal rate in effect under section 1274(d) as of the date on which the loan was made, compounded semiannually.

4. Revenue Rulings: The applicable federal rates and the section 7520 rate are published monthly by the IRS in a revenue ruling, issued approximately 2 weeks prior to the end of the previous month for which the rate is being published. The AFR's are published under Table 1, and the section 7520 rate is published under Table 5.

The August 2020 rates, published in Rev. Rul. 2020-15, 2019-32 I.R.B. __ (Aug. 3, 2020), are:

Short-term AFR: 0.17%

Mid-Term AFR: 0.41%

Long-Term AFR: 1.12%

Section 7520 rate: 0.4%

Loans: The easiest way to take advantage of the low interest rate environment for estate and gift tax purposes is a simple loan to a child or grandchild taking back a promissory note using the interest rate for the appropriate term at the current low section 7872 rates.

Example: Parent loans $1,000,000 to Child on the following terms:

- Interest only payments for 9 years at current mid-term applicable Federal rate of 0.41%.
- Balloon payment of $1,000,000 in 9 years.
- During term of loan, child invests the loaned amount with a net/net growth of 5% (factoring in income, interest expense and principal growth).
- At end of 9 year term, the $1,000,000 is valued at $1,551,328.

Consideration might also be given to refinancing existing loans. Although there is no clear authority, the consensus seems to be that a refinancing should not have any gift tax consequence particularly if the refinancing is not a recurring event and if the borrower provides some consideration for the refinancing.

A low interest loan allowed by the current interest rates, used in conjunction with other existing estate planning strategies, such as making a low interest loan to a grantor trust, or making a low interest loan as part of a sale of a closely held interest to a grantor trust, makes these estate planning strategies even more effective.

Split Interest Trusts: For split interest trusts, lower interest rates generally cause a lower value of the remainder interest (an exception is the qualified personal residence trust, as discussed below). Whether low interest rates enhance or diminish the benefits associated with a split-interest trust then depends on who receives the remainder interest.

- With a grantor retained annuity trust and a charitable lead trust, the remainder interest passes to the next generation or generations. The value of gifted remainder interest is reduced by the low interest rate, so the estate/gift tax benefits are enhanced.
- Conversely, with a charitable remainder trust the remainder interest passes to charity. The value of the gift to charity is reduced by the low interest rate, so the estate/gift tax benefits are diminished.
- Although the remainder interest in a qualified personal residence trust passes to the next generation, the grantor's reversion interest at the expiration of the trust term reduces the value of the remainder interest. A low interest rate creates a lower value of the grantor's reversion interest, resulting in a higher value of the remainder interest. So the estate/gift tax benefits associated with a qualified personal residence trust are also diminished in a low interest rate environment.

The low interest rate environment provides opportunities for interest sensitive planning. Timing is everything and an even more significant factor in the success of the plan is the potential for growth in the proceeds loaned (in the case of the low interest loan) or growth in the assets contributed to the trust (in a split-interest trust). post contribution growth may be a result of regular growth in the market, or may a recovery from an overcorrected market. We saw this in first half of 2009, and again in the first half of 2020.