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TOPIC: When Opportunity Knocks: Planning for the Harmonic Convergence of High Volatility, Low Interest Rates, and a Looming Sunset

MARKET TREND: A unique confluence of events has taken hold in the marketplace: (1) persistently low interest rates; (2) a rapid decline in asset values; and (3) an artificially higher transfer tax exemption. High net worth families should quickly assess whether the time is ripe for them to take action and plan.

SYNOPSIS: The Tax Cuts and Job Act ("TCJA") temporarily doubled federal gift, estate, and generation-skipping transfer ("GST") tax exemptions. As a result, individuals can transfer up to $11.58 million (and married couples can transfer twice that amount) to their heirs without federal transfer taxes. After December 31, 2025, the exemption will revert to $5 million (adjusted for annual inflation going back to 2010), unless Congress intervenes. Wild volatility in financial markets and exceptionally low interest rates have created a unique opportunity for families to review their use of life insurance, installment sales, grantor retained annuity trusts ("GRATs"), and other approaches for implementing business succession and legacy planning for the benefit of future generations. Not only should fresh approaches be considered, but existing frameworks should be audited for further planning opportunities.

TAKE AWAY: The window to utilize the TCJA's increased exemption amounts is scheduled to close on December 31, 2025. Against the backdrop of low interest rates and the significant volatility currently gripping financial markets, high net worth families may want to reconsider several planning approaches that may benefit multiple generations.

THE TCJA

The TCJA doubled the gift, estate, and GST exemptions from $5,490,000 in 2017 to the current level of $11,580,000 in 2020, as adjusted for inflation.[1] Effective as of January 1, 2026, the exemptions will drop back to $5,000,000, adjusted for inflation, unless Congress intervenes (the "**TCJA sunset**"). Accordingly, individuals must use or lose their increased exemptions – i.e., a client using only $5,000,000 of exemption prior to the TCJA sunset would not be able to take advantage of the extra exemption after 2025.

ANTI-CLAWBACK REGULATIONS

Proposed IRS regulations published after the TCJA have clarified that if the exemption level is lower at a client's passing that when a gift was made, no "clawback" will occur.[2]

Example 1: In 2020, Tom creates a trust for the benefit of his descendants and funds it with $11,580,000, using his available federal gift and GST exemptions. Tom dies in 2026 when the gift and GST exemptions have reverted back to $5,000,000 (adjusted for inflation). The excess of Tom's lifetime transfers over the lower applicable exemption in 2026 upon his death is notadded back to his estate for purposes of calculating his estate and GST tax liability.

PLANNING WITH LIFE INSURANCE

Recent volatility in financial markets serves as a reminder that safety is key. Times like these underscore the importance of making life insurance part of a comprehensive estate plan. Life insurance owned by an irrevocable life insurance trust ("**ILIT**") keeps policy proceeds outside of a client's estate and provides a mortality and market-based hedge if asset values are slow to recover from a slump by locking in a legacy for descendants. Many conservative products, like whole life or guaranteed products, may offer internal rates of return of roughly 4% to 5%. This return can make policy acquisitions very attractive when coupled with the fact that the investment growth within the policy is not subject to income tax, based on long-standing and appropriate tax principals.

In addition, life insurance provides an immediate source of cash for an estate. Access to such liquidity is particularly critical in times of market volatility, so that an estate is not forced to sell assets at depressed values to generate needed funds, especially when such assets are expected to recover their value. When life insurance is held in an ILIT, the trustee may loan funds to the decedent's estate to pay obligations, such as administration expenses and estate and inheritance taxes. Without access to such a loan, options to generate liquidity can be limited.[3]

Many grantors use annual exclusions to make gifts to ILITs to fund annual premium payments.[4] In light of the increased exemption amounts, clients should consider pre-funding ILITs to cover several years' worth of premium payments. Pre-funding premium payments creates opportunities to deploy annual exclusion gifts elsewhere. In addition, funding an ILIT now with a gift of depressed-value assets also moves any subsequent asset appreciation out of the donor's estate, without additional gift tax. Consider the following example:

Example 2: Don (67) and Janet (70) are a married couple with three children and seven grandchildren. Don and Janet each have $5 million of remaining lifetime gift and GST exemption. In consultation with their advisors, Don and Janet create an ILIT treated as a grantor trust for federal income tax purposes, which purchases a joint and survivorship life insurance policy on their lives with a face value of $15 million. The policy calls for annual premiums of $300,000 over the next 20 years. Don and Janet can choose to make gifts of their annual exclusion amounts to the ILIT, which grants "Crummey" withdrawal rights to each of their descendants, for a total of $300,000 per year. Alternatively, Don and Janet may consider the following:

Step 1: Pre-fund the ILIT. Don and Janet make a gift of $10 million to the ILIT to fund future premium payments and allocate a corresponding amount of GST exemption to the gift. The gift is comprised of a securities portfolio with a temporarily depressed value—a resourceful approach that allows the ILIT to capture any recovery in value and keeps such growth outside of Don and Janet's estates. If the annual returns on this $10 million of initial trust principal equal or exceed $300,000, the remaining income can be reinvested, allowing more growth in the ILIT. Since the ILIT is a grantor trust, any such growth will compound in the trust without reduction for taxes. Ultimately, the appreciation on the initial trust principal, less amounts paid as premiums, will be excluded (along with the proceeds of the policy) from Don and Janet's taxable estates. If the gift is made before the TCJA sunset, this approach also locks in the increased exemption amounts.

Step 2: Re-Route Annual Exclusion Gifts. With the premiums on the insurance policy funded for the foreseeable future, Don and Janet can now deploy their annual exclusions for further planning. They can make outright gifts to grantor trusts benefiting the children at a rate of $30,000 per year ($90,000 in total). Over 15 years and at a conservative rate of return of 3%, such gifts would ultimately transfer over $1.6 million to the children without using any gift tax exemption. Don and Janet also can create and fund specially tailored trusts benefiting grandchildren that allow for the use of the annual exclusion from gift and GST tax. At a rate of $30,000 per year ($210,000 in total), and again assuming a conservative return of 3%, such gifts would ultimately transfer over $3.9 million for the benefit of their grandchildren without additional gift or GST tax.

INSTALLMENT SALES AND INTRA-FAMILY LOANS

New Planning. Now also may be a good time to revisit planning approaches tied to the applicable federal rate ("**AFR**"). Intra-family loans are always more effective when interest rates are low, but for families with closely-held business interests, installment sales to grantor trusts can be particularly attractive in the current environment since: (1) volatile market conditions may lead to lower valuations for the operating business; (2) low interest rates reduce hurdle amounts for successful transactions; and (3) the increased exemptions present an opportunity to augment the capitalization of grantor trusts (many practitioners recommend a level of approximately 10% for a purchase transaction). Currently low asset values provide opportunities to increase the capitalization of grantor trusts, allowing the seller to transfer appreciation in both the underlying trust capital and the interests sold to the grantor trust out of his or her estate. To illustrate:

Example 3: Steve is single and owns a $150 million business that he runs with his daughter. He believes his business could sell in the next nine years, but he has no immediate plans. To facilitate succession of the business, he wishes to begin transferring business interests to a trust for his daughter and her descendants. Steve currently has $6 million of gift and GST tax exemption remaining and uses that amount to create and fund a grantor trust. Based on the 10% "rule of thumb" capitalization rate, he later sells 40% of the business interest to the trust in exchange for a nine-year secured promissory note for $60 million (the appraised value of the business interest), which provides for annual interest payments and a final balloon payment of principal. Steve completes the transfer in March 2020, locking in the mid-term AFR of 1.53%.

The low interest rate limits the trust's annual debt service obligation, allowing more assets to remain and compound within the trust. The higher gift and GST exemptions also allow Steve to increase the trust's capitalization, facilitating the sale of a greater percentage of the business interests. Assume Steve waited until after the TCJA sunset to create and fund the trust, and he had only $1 million of remaining gift and GST exemption to use to capitalize the trust. Using the 10% capitalization rule of thumb, Steve could later sell only $10 million of business interests (about 6.67%) to the trust. If Steve subsequently sold the entire company for $180 million, the trust would receive only $12 million from the company's sale, instead of the $72 million it would have received if Steve had implemented his plan before the TCJA sunset.

Existing Planning. The current circumstances also present unique opportunities to audit previously completed intra-family loans, installment sales, split-dollar loans, etc. to evaluate options for using the temporarily increased exemptions to pay-off or exit these existing transactions before the TCJA sunset. With the Federal Reserve's recent cut in interest rates, clients also may consider refinancing previously completed installment sale and loan transactions to take advantage of the lower rates.

GRATs

GRATs are another approach that clients often revisit when interest rates are low. The success or failure of a GRAT is tied to the IRS assumption that the GRAT's assets will appreciate at the "7520" rate published by the IRS each month. If, over the GRAT term, the overall asset appreciation exceeds the applicable 7520 rate, the GRAT will be successful. A higher 7520 rate requires greater annuity payments from the GRAT, meaning more appreciation is needed to "clear" the hurdle rate. Currently, however, 7520 rates are very low (1.8% in March 2020),[5] which increases the likelihood of GRAT assets outperforming the hurdle rate.

The probability of a successful GRAT also may increase when funding with large-cap, high-dividend paying stocks. The combination of high dividends (assuming yields are maintained) and low interest rates can support a GRAT's success because appreciation in share price is not necessarily needed to clear the 7520 rate. When low interest rates meet market volatility, the results can be striking if timed correctly.

Example 4: Jeff creates a five-year, zeroed-out[6] GRAT with $5,000,000 in marketable securities when the 7520 rate is 1.8%. Suppose Jeff's marketable securities have incurred a 40% decline in value prior to funding. If the securities regain that 40% decline in the first year, followed by an annual return of 10% each year thereafter, the 2020 GRAT would provide the remainder beneficiaries with ***over $3.8 million***. This amount could continue to grow in trust for the benefit of the remainder beneficiaries while remaining outside of Jeff's estate.

Year	**Earnings**	**Annuity**	**Principal**
At Creation			**$5,000,000**
Year 1	$ 2,000,000 (40%)	($1,054,652)	$5,945,348
Year 2	$ 594,535 (10%)	($1,054,652)	$5,485,231
Year 3	$ 548,523 (10%)	($1,054,652)	$4,979,102
Year 4	$ 497,910 (10%)	($1,054,652)	$4,422,360
Year 5	$ 442,236 (10%)	($1,054,652)	**$3,809,944**

If Jeff believes the GRAT's assets will recover most of their value at the beginning of the GRAT term, the GRAT agreement can vary the annuity payments to escalate by up to 20% each year. Providing for lower annuity payments in the early years permits more of the recovery in asset values to pass to the GRAT beneficiaries. In this example, providing for escalating annual annuity payments may increase the amount transferred to the GRAT's remainder beneficiaries by roughly 4%:

Year	**Earnings**	**Annuity**	**Principal**
At Creation			**$5,000,000**
Year 1	$ 2,000,000 (40%)	($713,185)	$6,286,815
Year 2	$ 628,682 (10%)	($855,822)	$6,059,675
Year 3	$ 605,967 (10%)	($1,026,986)	$5,638,656
Year 4	$ 563,866 (10%)	($1,232,383)	$4,970,139
Year 5	$ 497,014 (10%)	($1,478,860)	**$3,988,293**

Note, however, that GST exemption may not be allocated to a GRAT upon funding since the assets of the GRAT will be included in the grantor's estate if the grantor dies prior to the conclusion of the GRAT term. Accordingly, a GRAT alone generally is not efficient for GST planning.

Existing GRATs

For clients who created GRATs when asset values and/or interest rates had peaked, there are options available to take advantage of current market conditions. Annuity payments can be used to fund new GRATs as described above. In addition, the power of substitution, if built into the initial GRAT agreement, can allow the client to swap out depressed-value assets in an under-performing GRAT and fund them into one or more new GRATs that have more favorable terms (e.g., a lower hurdle rate) and the potential to benefit from any recovery in asset values.

DIRECT GIFTS

Keeping with Example 4, another option for Jeff to consider is direct transfers of the assets at their (presumably) temporarily reduced values. Such transfers could be made outright or in trust for the benefit of his descendants and the eventual appreciation would remain outside of Jeff's estate. The key differences between this approach and the use of GRATs are: (1) direct gifts require Jeff to use a significant portion of his remaining gift exemption to cover the transfers while GRATs do not; and (2) Jeff would be permitted to allocate GST exemption to direct transfers (as applicable, depending on the beneficiary) while, as noted, GST exemption generally cannot be allocated to the funding of a GRAT. This seemingly simple approach should not be overlooked because the lifetime exemptions are fixed numbers, whereas asset values can vary. Transferring lower-value assets to capture fixed exemptions is one of the core principles of most estate planning approaches.

OTHER OPTIONS

For clients who do not have enough liquidity to use some of the above approaches, additional opportunities may exist to leverage the increased exemption amounts before the TCJA sunset.

Have One Spouse Make all Gifts. To preserve flexibility for future planning, married clients should consider using only one spouse's exemption amounts to make gifts prior to the sunset. This approach would preserve the other spouse's exemption, even if reduced, for future use. To be effective, gifts from joint accounts should be avoided as they will likely be treated as being made 50% by each spouse.

Example 5**:** John and Jill are a married couple and have yet to use any of their lifetime exemptions. They each have $10 million of separately titled assets and an additional $10 million in joint accounts. John and Jill wish to transfer $10 million to their descendants prior to the TCJA sunset. If they each make $5 million gifts now from separate assets (or gift $10 million from the joint account), they will have precious little capacity post-TCJA sunset for future gifting. Further, they both will have forfeited the excess exemption available to them between now and the sunset. However, if only Jill uses her increased exemption amount to make gifts totaling $10 million, the couple will have preserved John's entire post-TCJA sunset exemption amount of $5 million (as adjusted for inflation) for later use.

Consider Spousal Lifetime Access Trusts ("SLATs")

If John and Jill desire to use all of their available exemptions but wish to preserve indirect access to their assets, they could consider a SLAT as a means of capturing more, or even all, of their available exemptions.

Example 6*:* Assume the same facts as Example 5. Jill uses $10 million of her separately titled assets to make gifts to trusts for descendants. John uses his $10 million exemption to create a trust for the benefit of Jill and their descendants. Jill serves as a co-trustee with an independent trustee. In addition to flexible distribution terms for descendants, the SLAT gives Jill the power to make distributions to herself for health, education, maintenance, or support ("**HEMS**"), while the independent trustee may make distributions to Jill for broader purposes. John indirectly has access to the SLAT assets through any distributions to Jill, but the trust assets (and any appreciation thereon) should not be includible in John's estate upon his death.

Using a SLAT helps John and Jill accomplish their dual goals of fully using their exemptions to benefit their descendants while preserving a potential escape valve for access to assets (through Jill) if needed during their lives.

Note, however, that when creating a SLAT, clients should consider advanced planning to account for divorce or the premature death of the beneficiary-spouse, which would eliminate the donor's indirect access to the SLAT's assets. Options to address this issue include acquiring life insurance on the beneficiary-spouse that is made payable to the donor or held in an ILIT for the donor's benefit and/or having the SLAT agreement define "spouse" as the person to whom the donor is married at the time rather than specifically naming the current spouse.[7]

Consider Late GST Allocations. An individual can make a late allocation of GST exemption to a trust.[8] The amount of GST exemption required to create a fully GST exempt trust after a late allocation is based on the fair market value of the trust's assets on the effective date of such late allocation. This approach can be especially useful for clients with no remaining lifetime gift exemption or no available assets to transfer.

It makes sense to review existing trusts that are not currently GST exempt. In light of recent market fluctuations, the decreased value of such trusts may allow for a late allocation to cover the entire trust principal and exempt additional assets from eventual imposition of GST tax.

Example 6: Assume that Jeff from Example 4 created a zeroed-out GRAT several years ago for which the GRAT term has expired. Suppose Jeff has $5 million of lifetime GST exemption remaining but no more lifetime gift exemption. As noted, Jeff could not allocate lifetime GST exemption to his GRAT when it was funded. The assets in the GRAT remainder trust for the benefit of his children have grown to $5 million. Jeff files a late allocation of his remaining GST exemption to that trust ensuring that those assets remain permanently exempt from GST tax before the exemption expires.

TAKE AWAY

The window to utilize the increased exemption amounts pursuant to the TCJA is scheduled to close on December 31, 2025. Against the backdrop of low interest rates and the significant volatility currently gripping financial markets, high net worth families may want to reconsider several planning approaches that may benefit multiple generations.

NOTES

[1] The method for calculating the rate of inflation was also changed by the TCJA. See WRMarketplace No. 18-01 for a more detailed discussion of this and other relevant provisions of the TCJA.

[2] See https://www.irs.gov/newsroom/estate-and-gift-tax-faqs. For a more detailed discussion of the Anti-Clawback Regulations, please see WRMarketplace No. 19-01.

[3] See WRMarketplace No. 19-18 for a discussion of the limited options for generating estate liquidity.

[4] In 2020, the annual exclusion from gift tax is $15,000 per donee or $30,000 for a married couple electing to split gifts. See WRMarketplaces Nos. 14-04 and 13-12 for a more detailed discussion of the uses and requirements for annual exclusion gifts in ILIT funding.

[5] According to recently released Rev. Rul. 2020-9, the 7520 rate for April 2020 will drop to 1.2%.

[6] A "zeroed-out" GRAT is designed to zero out the gift tax value of the GRAT's remainder interest (i.e., the present value of the annuity payment stream from the GRAT is structured to equal the fair market value of the assets transferred to the trust), which avoids a taxable gift upon funding. In this example, using a zeroed-out GRAT would generate a nominal gift of less than one dollar. See WRMarketplace No. 14-08 for a discussion of planning with GRATs.

[7] See WRMarketplace No. 15-07 for a more comprehensive discussion of SLATs, including a review of additional options and considerations for planning for divorce or the passing of the beneficiary-spouse.

[8] See Treas. Reg. §26.2642-2(a)(2).