Beacon Trust
INNOVATING WEALTH STRATEGY

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How Current Interest Rates Impact Your Estate

As current IRS interest rates are at all-time lows, this may be an opportune time to think about creating or re-financing private loans or transferring wealth from your taxable estate. There are two types of interest rates that are relevant to estate planning that should be considered when timing the execution of wealth transfer transactions.

Estate Tax Techniques Involving Use of the Applicable Federal Rate (AFR)

The first type is the interest rate that applies to loans, including intra-family loans. In this regard, the AFR, which is published monthly by the IRS, represents the minimum interest rate that the IRS allows for private loans. If the interest rate on a loan is lower than the applicable AFR, it may result in an unexpected taxable event for the involved parties. There are three AFR tiers based on the repayment term of a family loan:

(1) Short-term rates, used for loans with a repayment term up to three years (September 2020 rate is 0.14%).

(2) Mid-term rates, used for loans with a repayment term between three and nine years (September 2020 rate is 0.35%).

(3) Long-term rates, used for loans with a repayment term greater than nine years (September 2020 rate is 1.00%).

When selecting the appropriate AFR, a lender should consider the AFR for the term of the loan during the month in which the loan is made.

Why does this matter now? A loan to a family member enjoys a greater tax benefit in a low-interest rate environment because there is less interest that is required to be paid to the lender, allowing the lender to receive less taxable interest income without triggering gift tax or imputed interest consequences.

More sophisticated estate planning techniques can also benefit from these historically low AFR rates. One example of this would be an installment sale of assets by the grantor of an Intentionally Defective Grantor Trust (IDGT) to that trust in exchange for a promissory note. Although the terminology can initially be bothersome, an IDGT is simply a trust that is classified as a grantor trust for income tax purposes, but not for gift and estate tax purposes. Similar to intra-family loans, the promissory note from the trust to the grantor is required to bear interest at the AFR in order to avoid gift tax consequences. With current interest rates being at record-lows, the grantor will be required to remove less assets from the trust in the form of annual interest payments, allowing more trust assets to pass to the beneficiaries. The longer the term of the promissory note, the greater the benefit of low interest rates.

Estate Tax Techniques Involving Use of the § 7520 Rate

The second type of interest rate that has estate planning ramifications is the Internal Revenue Code § 7520 rate. This rate is also set monthly by the IRS and equals approximately 120% of the mid-term AFR.

The § 7520 rate is used to discount the value of annuities, life estates, and remainders to present value. Generally, the § 7520 rate for the month in which the gift is made is the rate that is used to calculate the present value and does not change during the trust's term as interest rates fluctuate. The September 2020 rate is 0.40%. By reference, the September 2019 rate was 2.2%, a decrease of 82%!

One popular estate planning technique involving use of the § 7520 rate is a Grantor Retained Annuity Trust (GRAT) which involves a transfer of assets to a trust that requires recurring payments to the grantor throughout the trust term. Such payments serve to reduce the gift tax value of the assets transferred to the trust, which is assumed to grow at a rate equal to the § 7520 rate. Returns on trust assets in excess of the § 7520 rate could result in a remaining balance available to the beneficiaries of the trust larger than the assumed balance based upon a growth rate equal to the § 7520. As such, GRATs are generally more appealing in a low-interest rate environment since a lower hurdle is established for efforts to achieve a higher growth rate.

A second type of trust, the Charitable Lead Annuity Trust (CLAT), also benefits from lower interest rates and may be a viable gifting strategy for the charitably-inclined. Like a GRAT, a CLAT involves a transfer of assets to a trust that requires recurring distributions, but in this case the distributions are made to a qualified charity rather than the grantor. As such, a charitable deduction may be claimed up front equal to the present value of the charitable annuity at the time the CLAT is created, which is calculated using the § 7520 rate. Therefore, the lower the interest rate, the higher the current year charitable deduction.

These are just some examples of how prevailing interest rates have an impact on estate planning. Many other strategies may also benefit from the current low interest rate environment. To understand how this historically low interest rate environment can benefit you, please contact a member of your Beacon Trust team. The breadth of services we offer allows our advisors to work together across multiple financial disciplines to find insights like these tailored to fit your specific needs.

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