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WEALTH MANAGEMENT

Four Gifting Techniques for the Current Market Environment

Two broadly accepted maxims can be applied to estate planning today; the first is that it is better to give than receive, and the second is that there is no time like the present. Particularly in an environment where some assets are still significantly diminished in value, expediting the gifting decision can ultimately reduce your exposure to gift and estate taxes — you can effectively remove assets from your estate, preventing further appreciation of those assets, while also exhausting less of your gift tax credit.

Another powerful timing consideration in terms of gifting is today's record-low level of interest rates. With some estate planning vehicles, lower interest rates can reduce the value of gifts. Gifts of lesser value could result in greater use of the annual exclusion (currently \$15,000 per grantor per year) and greater use of the aforementioned gift tax exemption (currently \$11.58 million).

OVERVIEW

Four potential gifting strategies for consideration in this low interest rate environment are:

- Intrafamily loans – Spousal Lifetime Access Trust (SLAT) – Grantor Retained Annuity Trusts (GRAT)
- Charitable Lead Annuity Trusts (CLAT)

INTRAFAMILY LOANS

An intrafamily loan is a loan from one family member to another. If correctly drafted and administered, this type of loan can be a powerful tool for transferring wealth, free of gift and estate tax, from one generation to the next. Every intrafamily loan should be governed by a loan note that details the loan arrangement. The specifics can include, but are not limited to, whether the loan is a term or demand note, the length of the note, the applicable interest rate, the amount borrowed and the frequency of payments.

Typically, once a note is created, the lender (most often a parent or grandparent) transfers funds and the borrower begins making payments based on the agreed upon schedule. Interest payments are treated as taxable income to the lender. If the loan is used to purchase a home and is properly collateralized, the interest payments are deductible by the borrower. If the borrower is unable to repay the loan, or if interest rates drop, a note can be refinanced or principal can be forgiven and treated as a gift. However, the recipient would incur income tax consequences if the lender forgives or refinances the debt.

Intrafamily loans can be used as an attractive gifting mechanism in today's environment for many reasons. Low interest rates create a low hurdle for successful transfer. In addition, past declines in the market value of some assets could present buying opportunities for borrowers to reinvest loan proceeds. For example, if a grandparent loans cash to a grandchild and the grandchild invests the funds at a rate of return greater than the applicable federal tax rate, any funds remaining after the loan is repaid represent a successful transfer.

SPOUSAL LIFETIME ACCESS TRUST (SLAT)

A SLAT provides spouses an opportunity to transfer assets to an irrevocable trust, use some or all of their \$11.58 million gift tax exemption and maintain an indirect interest in the trust assets.

In effect, a SLAT allows spouses to use their gift tax exemption before it reverts to a lower amount in 2026 but still receive distributions from the trust. A SLAT is an irrevocable trust whereby one spouse names the other spouse and perhaps others, like the couple's children, as discretionary beneficiaries.

The transfer of assets into the SLAT is a completed gift for estate and gift tax purposes, allowing the assets in the SLAT to avoid estate taxation in the grantor's taxable estate. The trustee has discretion to make distributions to the trust's beneficiaries which includes the grantor's spouse. Thus, as long as the couple remains married and the non-grantor spouse is alive, the couple has indirect access to the trust assets as a result of the trustee being able to make discretionary distributions to the non-grantor spouse.

A SLAT can be set up by each spouse with the other spouse as a discretionary beneficiary. For example, husband can set up a SLAT with his wife as a discretionary beneficiary of his SLAT and wife can also set up a SLAT with her husband as the beneficiary of her SLAT. However, the SLATs cannot be identical. The husband's SLAT must have materially different terms than the wife's SLAT. Otherwise, the IRS will deem the husband and wife to have retained an interest causing the trust assets to be included in the grantor's estate for federal estate tax purposes.

SLATS work best when assets that are expected to significantly appreciate are used to fund the SLAT. That allows the appreciation in those assets to occur inside the SLAT and not in the grantor's taxable estate. A SLAT is a great vehicle for those who want to use their gift tax exemption before it decreases in the year 2026 but retain an indirect access to the trust's assets.

GRANTOR RETAINED ANNUITY TRUSTS (GRAT)

A GRAT is an irrevocable trust that may permit the transfer of wealth to others with little, if any, gift tax and with no estate tax. It is established by an individual grantor and is essentially a wealth transfer technique governed by Section 2702 of the Internal Revenue Code.

The grantor transfers assets to an irrevocable trust and retains the right to receive an annual annuity for a term of years specified in the trust instrument. The annuity paid to the grantor usually is fixed but may be structured to "backload" annuity payments so that they increase each year. At the expiration of the term, the trust usually terminates and the property remaining in the GRAT is distributed to a third party, known as the remainder beneficiary. Very often, the remainder beneficiary is the grantor's children or grandchildren. (Note: When a grandchild is the remainder beneficiary, the impact of the Generation-skipping Transfer Tax should also be considered).

The transfer of the property to the trust is a taxable gift by the grantor, but the annuity payments to the grantor are structured so that the value of the remainder interest and the resulting taxable gift to the remainder beneficiary will be minimized, if not eliminated.

The gift of the remainder interest is equal to the difference between the amount contributed to the GRAT and the present value of the annuity stream retained by the grantor. IRS regulations require that the annuity stream retained by the grantor be valued using the Section 7520 rate in effect on the date property is transferred to the GRAT. The Section 7520 rate is the amount the IRS assumes the GRAT will earn, and the rate is set monthly by the IRS.

The current low interest rate environment makes the GRAT a potentially attractive gifting vehicle. If your goal is to minimize the taxable gift to the remainder beneficiary, a GRAT can be very effective, provided the property transferred to or held in the GRAT appreciates faster than the Section 7520 rate. Presently, the Section 7520 rate is relatively low. So, this is a good opportunity for the growth rate of the GRAT to exceed the Section 7520 rate, and to transfer the excess growth to the remainder beneficiary free of transfer (gift or estate) tax.

Thus, in general, only assets that are expected to generate a strong return during the term of the GRAT should be considered to fund a GRAT. While the impact of losing access to assets in a volatile market, or any other market for that matter, should be considered, one of the major advantages of a GRAT is that the full original value of the asset may be re-paid to the grantor through the annuity.

CHARITABLE LEAD ANNUITY TRUSTS (CLAT)

A charitable lead annuity trust (CLAT) allows a donor to make contributions to a charitable entity for a specified number of years, while ultimately transferring assets to a future generation (at discounted transfer tax values). Depending on the terms of the trust, income generated by the trust may also be excluded from the donor's income tax liability.

CLATs are poised to be an even more attractive gifting mechanism in this current environment. The CLAT is funded by transferring assets to the trustee of the CLAT. The trustee then invests the trust assets and makes annual payments of a fixed amount to the donor's chosen charity. If the assets in the trust generate a higher return than the total amount of fixed payments, the remaining amount ultimately will transfer to the beneficiary free of gift or estate taxes. Therefore, in order to take advantage of the discounted transfer tax, a CLAT should be funded by an asset that is expected to produce strong returns during the CLAT's term.

SUMMARY

Recent market events and record low interest rates have created a unique opportunity to benefit from a gifting perspective. Expediting the gifting decision can ultimately reduce your exposure to gift and estate taxes. Strategies such as intrafamily loans, GRATs and CLATs can serve to capitalize on the ability to transfer property that is expected to have a resurgence in value, resulting in the transfer of a greater proportion of a grantor's wealth for future generations.

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