Transfer Taxes Stay but Low Interest Rates May Go

by Dennis C. Reardon, JD, LLM, CLU, ChFC

Abstract: We have just seen pronouncements by the Federal Reserve that lead to the conclusion that interest rates will be rising in the future. This column spells out planning opportunities in a low-rate environment. The planning opportunities cited in this column will not vanish overnight. However, those now persuaded to act should put plans in motion sooner, rather than later.

About ten years ago, we began to see mortgage rates drop to a level not seen since the Eisenhower era. In the ensuing years of the housing boom and bust, rates have dropped even lower. The cost of capital to a qualified borrower is about as low as it can possibly be. With respect to estate planning, and for broader financial planning, low interest rates offer a wonderful opportunity for a wide variety of planning techniques. These techniques, in conjunction with the reduced rates, have been low-hanging fruit for those inclined to the advantages presented. However, up until recently, the appetite for that fruit was spoiled by lingering indigestion from stock market losses and plummeting residential real estate values. Nonetheless, as I write this column, the stock market's advances this year have generated more widespread optimism and home buyers have surfaced in greater numbers. Our present interest rates surely won't be with us forever, so what might you tell your clients that will enable them to "seize the day" for planning purposes?

You might tell them that this could be a very beneficial period for making gifts, sales, and loans to their children and grandchildren, or to entities dedicated to them. Planning opportunities are now abetted by powerful tailwinds. In addition to large estate and gift tax exemptions, these tailwinds are low interest rates, and growing optimism about the future of the American economy in general, and the stock market in particular.

Low Interest Rates

Let's start with the fundamentals: interest rates can't really go much lower; the Federal Reserve has been driving the pile to keep them low, and rates should remain relatively low for at least a while longer. As discussed below, low rates can greatly enhance planning techniques, so that financial success can be realized at a lower "hurdle rate." Most of the estate and financial planning transactions I refer to in this column are between family members. The tax law, per IRC Sections 1274 and 7520, allows related individuals who engage in various transactions to use benchmark rates, such as the Applicable Federal Rate (AFR), that are lower than the rates available to the most qualified borrowers of the most rate-competitive institutions. In June 2013, the Section 7520 rate was 1.2%; the AFR was 0.18% for short-term, 0.95% for midterm, and 2.47% for long-term, transactions (with annual interest payments). Let me pause for a moment and add that I recognize the value of having the kids fend for themselves and not be dependent on mom and dad. However, one aftermath of the 2008 financial debacle has been a tightening of credit standards so that, more than ever perhaps, lenders deem those who need not borrow to be much more desirable than those who must borrow. Apart from transmitting family values and financial lessons, low AFRs make tax savings and wealth perpetuation easier to achieve. With the revitalization of the housing market and the suppressed demand of many younger people who might have bought sooner, intrafamily loans for down payments or second mortgages can greatly help the cause. Commercial mortgage rates may be low, but AFRs are surely lower. Better yet, interest-free loans are made even more possible by the increased gift tax annual exclusion and exemptions.

And, what was that about the hurdle rate? Consider this: if, for a given transfer such as a gift of securities to a grantor-retained annuity trust (GRAT) or a sale to an irrevocable grantor trust (IGT), the AFR had been 4 percent, projected growth over a period might be 8 or 9 percent. The same 4 to 5 percent spread can now be realized by the trust beneficiaries free of gift and estate tax. Correspondingly, if the midterm AFR is now about 1 percent, projected growth at 5 or 6 percent would provide a comparable amount for the beneficiaries.

Increased Gift Tax Exemption and Annual Exclusion

Any gift for the benefit of the next generation(s), however made, naturally requires a reminder that it won't be coming back to the donor. Many clients who can otherwise afford to make a gift may be constrained by that thought, and may be more comfortable transferring assets by means of a loan or a sale. Then, too, having an annual exclusion of $14,000 per donee can go a long way for those who would sooner wade into the water with annual gifts than jump in with the bigger splash of a GRAT gift or IGT sale. In recent years, cases such as *Hackl v. Commissioner* (a Tax Court case which disallowed the annual exclusion for gifts of limited liability company [LLC] interests) have made annual exclusion gifts dicey when certain types of assets or property interests have been transferred. Gifts of family limited partnership or LLC interests, or gifts of hard-to-value assets, may not qualify as present interest gifts. When possible, relatively smaller gifts may best be made in cash. Let the transfers of larger assets or limited partnership interests be completed without extra effort to qualify them as present interest gifts, and use cash (or high-basis marketable securities) for smaller gifts.

The advent of the indexed $5 million gift tax exemption narrows the demographic of those who are concerned about future estate tax liability. At the same time, the very affluent who made large gifts at the end of 2012 might as well capitalize on the opportunity indexing offers to make continuing gifts that will consume the exemption as it increases. In 2013, the exemption increased by $130,000 to its current level of $5.25 million. A similar increase next year and in succeeding years enables more value to be shifted for those who can afford to part with it and are reluctant to leave 40 percent of that amount to the government.

For that matter, if you believe that we have an estate tax for the indefinite future, you might encourage those who are especially affluent to make gifts that are designed to incur gift tax to the donor. When the Bush administration introduced jumping estate, gift and generation-skipping tax exemptions, and the "peekaboo" estate tax repeal, suggesting that gift tax be paid to reduce an estate tax that may disappear would have been indefensible. Now, it may be a wise move if one accepts the political risk of a reversal on the tax law and can tolerate paying gift tax today rather than having the estate tax paid by one's beneficiaries tomorrow. The reason why paying the gift tax may be advisable is that the gift tax is exclusive, whereas the estate tax is inclusive. For example, suppose that Chatsworth has completely exhausted the $5.25 million gift tax exemption by making gifts of that amount. If he then makes a $1 million taxable gift, $400,000 of gift tax–at a 40 percent rate–will be payable. If Chatsworth decides not to make the gift and dies, the $1.4 million that he still owns will result in $560,000 of estate tax to be incurred at the same 40 percent rate. While the math is undeniably positive for the taxpayer, many individuals will balk at making lifetime payments that could be paid by their beneficiaries after they have gone to their rewards. Another factor to consider is that if a lifetime gift is made, the gift tax will be removed from the donor's estate, provided that the donor survives the transfer by at least three years. Generally, anyone planning to make a larger gift should be well informed of the overall tax and financial risks and benefits that accompany the transfer.

Income Tax Leverage

Many financially successful clients with children who are somewhere in the "young adult" category may have a broader view of family wealth. The American Taxpayer Relief Act of 2012 (ATRA) has raised income tax rates on the highest earners, and has introduced new ways for the government to take a larger bite out of investment income. The 3.8 percent Medicare tax on investment income earned by joint filers with modified adjusted gross income over $250,000 provides teeth for that bite. Those paying higher rates on earned income, with reduced itemized deductions and personal exemptions, not only pay higher rates on long-term capital gains, but also pay the additional 3.8 percent tax on their net investment incomes. Taxable trusts also pay a severe price if the trustee chooses to accumulate income, rather than distribute it to beneficiaries. In 2013, a taxable trust is subject to the 39.6 percent federal income tax rate on taxable income above $11,950. Taxable income above that level brings with it the 20 percent tax rate on long-term capital gains and the 3.8 percent Medicare tax rate on net investment income, as well.

In certain contexts, the tax rates introduced by ATRA present a new paradigm for tax planning. A nonmarital trust for the benefit of a surviving spouse had been more likely to accumulate and reinvest income when income tax rates were lower and estate tax rates were higher with lesser estate tax exemptions. Now, income distribution may be more freely made if the beneficiary's income tax bracket is lower than the trust's (and the spouse may have ample estate tax exemption available). Investment advisors working closely with trustees and trust beneficiaries must adjust their sights to ensure that the amount and character of income produced can achieve tax efficiency within the structure of the trust. A parent who makes a low interest rate loan to a child should be advised as to the tax consequences the child will face if the borrowed funds are invested, rather than consumed.

Summary

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