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Coronavirus / COVID-19 Response Team

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Strategic Estate Planning In A COVID-19 Market

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2020 Challenges

- COVID-19 Pandemic
- Personal and family health and safety
- Business interruption
- Economic uncertainty
- Depressed asset values
  - Real estate
  - Tangible property
  - Marketable securities
  - Closely held business assets
  - Debt instruments

2020 Opportunities

Many opportunities for significant tax savings

- High federal estate tax, gift tax and generation skipping tax exemptions
- Historically low interest rates
- Depressed market values allow for greater leveraging of gifts

Estate, Gift and Generation Skipping Transfer Tax Exemptions

- Annual exclusion gifting
  - $15,000 per person per year
  - Present interest gift
- $11.58 million exemption through 2025
  - Gift tax
  - Generation Skipping Transfer Tax
  - Estate tax
- Exemption drops to $5 million adjusted for inflation in 2026 (approximately $6.5 million)
- Estate tax is "portable" i.e., surviving spouse can save spouse's unused exemption after first death

Applicable Federal Rates

- The applicable federal rate (AFR) is the minimum interest rate that must be charged for private loans between family members, trusts and related entities to prevent tax implications
- If the interest on a loan is lower than the AFR, it may result in a taxable event
  - Original issue discount
  - Imputed gift/gift tax
  - Imputed income/income tax

Historically Low Rates

- IRS Rev. Ruling 2020-11
  - **Short Term Applicable Federal Rate**
    - Loan term up to 3 years
    - May 2020 required interest rate 0.25%
  - **Mid-Term Applicable Federal Rate**
    - Loan term between 3 and 9 years
    - May 2020 required interest rate 0.58%
  - **Long Term Applicable Federal Rate**
    - Loan term over 9 years
    - May 2020 required interest rate 1.15%

Historically Low Rates

- Section 7520 rate
- Applicable Federal Rate for determining the present value of:
  - An annuity
  - An interest for life or a term of years
  - Remainder or reversionary interest
- May 2020 Section 7520 rate 0.8%

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Depressed Asset Values

- Current assets values are depressed
- Valuations factoring in additional discounts for uncertainties of COVID-19 recovery
- Many asset classes are likely to recover over time

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Tax Reduction Planning Goals

- Most sophisticated estate planning is intended to leverage the federal estate, gift and generation-skipping exemptions
- Get the most "bang for the buck" for each use of exemption
- Limit transfer tax exposure by transitioning future appreciation outside of donor's estate

Tax-Efficient Wealth Transfer Strategies

- Family Gifts and loans
- Grantor trusts
- Grantor Retained Annuity Trusts (GRATs)
- Sales to Intentionally Defective Grantor Trusts (IDGTs)
- Spousal Lifetime Access Trust (SLATs)
- Charitable Lead Trusts (CLTs)

Family Gifts And Loans

Family Gifts And Loans

- Give away assets that have depressed values
  - Direct gifts to children/grandchildren
  - Gifts in trust to children/grandchildren
  - Transfer tax is based on value of gifted assets at time of gift
  - Future appreciation excluded from donor's estate

Family Gifts And Loans

- Intra-family loans at low interest rates
  - Keeps interest in family instead of financial institution
  - Allows borrower to try and "beat" AFR rate by capturing commercial interest and returns
  - Avoid disguised gift
    - Arm's Length Terms
    - AFR interest
    - Written loan documents
    - Regular payment
  - Review existing intra-family loans to renegotiate

Grantor Trust Rules and Planning Opportunities

Grantor Trust

- A Grantor Trust is a special type of trust where the creator (and sometimes in other cases) is the income tax owner of the trust
- This is done by the creator containing certain powers over the trust assets
- If a trust is a "grantor trust," the income from the trust is taxed as if it was the donor's personal income
- All revocable trusts are "grantor trusts"
- Irrevocable trusts can be used as vehicle to accomplish leveraged gifts and sales

Grantor Trust Advantages

- Individual tax rates are generally lower than trust income tax rates
- A Grantor Trust can be a shareholder in an S Corporation
- A sale from the donor to the donor's grantor trust won't trigger capital gains tax recognition because it is treated as a sale from the donor to himself/herself
- Other transactions and powers with the trust have income tax and transfer tax benefits

Grantor Trust Advantages

- Transfers to irrevocable trusts are generally treated as completed gifts for transfer tax purposes
- Future appreciation of the asset occurs outside the donor's estate so no additional transfer tax on future appreciation
- The donor's payment of income taxes on income retained in an irrevocable trust is NOT treated as an additional gift
- Maximizes shift of income and appreciation outside donor's estate

Grantor Trust Disadvantages

- Psychology of transaction can be difficult for donor to justify; the trust beneficiaries get the benefit of the income while the donor gets the tax bill
- Cash drain to donor because donor pays income tax on income that the donor doesn't receive
- Strategies to reduce this burden:
  - Name donor's spouse as a trust beneficiary
  - Give a trust protector the right to grant the trustee the power to reimburse the donor for taxes paid on behalf of the trust
  - Include power to release grantor trust powers

Grantor Retained Annuity Trust

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What is a Grantor Retained Annuity Trust?

- Grantor Retained Annuity Trust (GRAT)
  - Strategy to leverage gift of appreciating assets
  - Irrevocable Trust for set period of time
  - During GRAT term, Grantor retains right to annuity
    - Return of principal
    - Minimum Section 7520 interest
  - Remainder above retained annuity passes to remainder beneficiaries (children, trust for children)
  - Gift tax based on actuarial calculation of future remainder interest minus retained annuity payments

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GRAT Advantages

- Statutorily blessed; low risk if setup properly
- Certain types of assets transferred to GRAT may qualify for valuation discounts
- GRAT is a Grantor Trust so the grantor pays the income taxes while the GRAT retains all income above the 7520 rate (aka "hurdle")
- Grantor retains stream of income
- Right to substitute or "swap" assets in GRAT for other assets of equivalent value

GRAT Advantages

- Payments can be weighted towards end of term (within limits) to maximize growth opportunities
- If assets underperform, Trustee can return gifted assets at FMV in satisfaction of annuity requirement
- If GRAT performance doesn't beat 7520 rate, only a small amount of gift tax exemption is used

GRAT Disadvantages

- GRAT Trustee must maintain bookkeeping and records, make prescribed payments on time, assure that tax returns are filed
- Gift tax return must be filed when GRAT is funded
- Can't allocate GST exemption until end of GRAT term
- Assets passing to remainder beneficiaries retain grantor's basis
- If grantor dies before end of GRAT term, assets are in grantor's estate

GRAT Example

- Mary has marketable securities that have declined in value but are likely to appreciate over next few years
- Mary creates a GRAT with a 4 year term and gifts $1,000,000 in marketable securities.
- Mary chooses to get back 25% each year plus the 7520 rate of .8%
- Mary reports a gift of $19,675
- Even with modest 6% annual growth rate, the remainder interest is worth $168,822 in 4 years and she only used $19,675 of exemption to transfer $168,822

GRAT Example Comments

- If Mary contributed a minority interest in a business entity, a FMV appraisal would reflect discounts for lack of marketability and lack of control, adding another layer of leverage to the gift tax applied to the transfer
- If the business make income distributions in addition to growth, or if Mary also contributed cash or marketable securities, those liquid assets could be used to satisfy the annuity payments, allowing the business interests to grow
- If Mary wanted to reacquire the business interest, she could exercise her right to substitute or "swap" the interest at FMV
- Mary can establish several GRATS holding different types of assets to "hedge" against market performance
- Once GRAT terminates, Mary can "re-GRAT") the annuity payments received into a new GRAT to shift future appreciation in excess of Section 7520 hurdle rate

Sale to Intentionally Defective Grantor Trust

Sale to Grantor Trust

- Selling assets to a grantor trust that may have a depressed value now, but is expected to appreciate in the future
- Seeding the trust with cash for the initial down payment is advisable, with balance of purchase price paid on a promissory note
- The promissory note (installment loan) takes advantage of low values and low interest rates to create a situation that can shift significant appreciation to children and grandchildren free of transfer taxes

Spousal Lifetime Access Trusts

Spousal Lifetime Access Trusts

- Spousal Lifetime Access Trust ("SLAT") is an irrevocable trust created by one spouse for the benefit of the other as well as additional family members, most commonly children and/or grandchildren
- Grantor, or "donor spouse," applies gift tax exemption to make a gift to the SLAT, and the "beneficiary spouse" is named as a current beneficiary
- While donor spouse gives up his or her right to the property transferred into the trust, the beneficiary spouse maintains access to that same property

Spousal Lifetime Access Trusts

- SLAT leverages donor's spouse's lifetime gift exemption to shift future appreciation out of married couple's taxable estate, while retaining access of trust assets through spouse as lifetime beneficiary
- Flexibility is built into SLAT provisions to allow different grantor trust powers, family member access, enhanced creditor protection, and longevity in planning (e.g. multiple generations)
- Can be coordinated with existing irrevocable trusts to provide broader platform for managing and protecting wealth and future appreciation

Charitable Lead Trust

Charitable Lead Trust

- A charitable lead trust ("CLT") is an irrevocable trust that provides annual annuity stream (lead interest) to a qualified charity, with remainder interest paid to non-charitable beneficiaries (e.g. family members)
- Comes in several different varieties, offering different financial and tax characteristics. Selecting the appropriate structure is crucial to achieving the intended results

Charitable Lead Trust

- Provides gift and estate tax benefits. Upon creation of a CLT, there is a taxable gift of the present value of the non-charitable interest (remainder interest).
- Gift tax deduction is available for present value of the charitable lead interest, which, in effect, should substantially reduce the taxable value of the remainder interest. This means you would use up less lifetime gift tax exemption than if you were to make gifts outright to your children

Charitable Lead Trust

- Value of the charitable lead interest is calculated based upon the characteristics designated in the trust, such as a term of years or life interest, the type of charitable interest, and interest rate
- Depending on the term and rate of charitable lead interest, the value of the remainder interest (the gift) may be significantly discounted, potentially to a near zero dollar value

Charitable Lead Trust

- If contribute anything other than cash or marketable securities, professional valuation will be needed to support the value of the initial gift
- By applying valuation discounts, more of value can be transferred to beneficiaries at lower transfer tax cost
- CLT can be grantor trust or non-grantor, which will determine the income tax planning of the transaction

Conclusion

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