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The Perfect Storm for Estate Planning Before Year End

The confluence of several factors—depreciated asset values caused by the COVID-19 pandemic's effect on the economy, record-low interest rates, and record-high exemption amounts—have created a perhaps once-in-a-lifetime opportunity to implement gifting strategies to reduce the tax burden on your children and descendants. However, anyone interested in taking advantage of the strategies discussed below should act without delay because a rebound in asset values and the outcome of the November 2020 election may make this "perfect storm" go away.

THE ECONOMIC IMPACT OF COVID-19

The recession caused by the coronavirus has created gift and estate planning opportunities in two ways.

Depressed Asset Values. First, asset values across all asset classes are significantly depressed, from the stock market, to real estate, to closely held businesses. Assets whose values have declined but are expected to rebound to pre-crisis values (or higher) are prime candidates for an effective gift-giving strategy. For tax purposes, gifts are valued on the date of the gift, thereby reducing the gift, estate, and/or generation-skipping transfer ("GST") exemption by that amount. Therefore, all subsequent appreciation after the date of the gift will escape gift and estate tax.

Record Low Interest Rates. Second, the pandemic has resulted in record-low interest rates, including the Internal Revenue Service ("IRS")-sanctioned interest rates (the so-called "Applicable Federal Rate" or "AFR" and the "Section 7520 Rate"), which are critical to some of the estate planning strategies discussed below. When an asset's appreciation exceeds these IRS "hurdle rates," the excess appreciation is effectively transferred as a tax-free gift to children or other beneficiaries. Therefore, these strategies are most successful when interest rates are low.

THE SCHEDULED REDUCTION OF THE GIFT, ESTATE, AND GST TAX EXEMPTIONS

Currently, the exemption amount for the gift, estate, and GST tax is $11,580,000 per taxpayer, or, effectively, $23,160,000 for a married couple, indexed for inflation. This means that an individual can make cumulative lifetime gifts of up to $11,580,000 without incurring gift or GST tax ($23,160,000 by a married couple). Any unused amount is available to eliminate estate and GST tax upon the individual's death. Additionally, a surviving spouse inherits the unused gift and estate tax exemption (but not the GST tax exemption) of the first spouse to die if an election is made on a timely filed estate tax return for the first spouse's estate. Gifts or estates in excess of the exemption amount are taxed at a flat 40% rate.

Under current law, effective January 1, 2026, the exemption amounts will be reduced in half to $5,000,000 (or effectively $10,000,000 for a married couple), adjusted for inflation back to 2010.

In addition to federal estate tax, some states impose a state-level estate tax, and to make matters more confusing, some state taxes—including New York and Pennsylvania—operate differently from the federal system.

Gifts made using today's record-high exemption amounts are protected from future tax when the exemption amounts are reduced as provided in "anti-clawback" regulations published by the IRS. These regulations contain certain ordering provisions that make it even more compelling to use the maximum amount of your exemption amount before it is reduced. ***The significance of these rules is that today's higher exemption amounts can now be used without fear of a future penalty or "clawback," but will be lost if not used before the law expires on January 1, 2026, or quite possibly sooner, as explained below***.

THE UPCOMING PRESIDENTIAL ELECTION

The upcoming election could result in changes that have a negative impact on estate planning.

Increased Taxes. First, taxes may need to be increased to raise revenue for the massive federal stimulus spending enacted in response to the COVID-19 crisis. The gift, estate, and GST taxes might be seen as "low hanging fruit" or the ideal tax to raise more revenue because it will impact only the wealthiest Americans and not those perceived to be struggling the most due to the pandemic.

Accelerated Reduction in Exemption Amounts. Second, if the democratic party wins the presidency and control of Congress in the upcoming election, many have speculated that the exemption amount might be reduced before January 1, 2026, and to an amount as low as $3.5 million. It is also possible for the tax rate to be increased from the current 40% to 55% or even higher. In addition, Joe Biden's platform proposes taxing all unrealized appreciation on a decedent's capital assets by eliminating the automatic step-up in basis at death.

Repeal of Popular Estate Planning Techniques. There have been several proposals in the past to repeal or curtail several very effective techniques, any one of which could be easily "pulled off the shelf" if the federal government looks to raise additional tax revenue. These include mandating 10-year terms for Grantor Retained Annuity Trusts, a technique addressed in more detail below; eliminating the tax advantage of grantor trusts (which permit the gift tax free payment of income tax by the creator of a trust and/or her spouse, which benefits the beneficiaries of the trust); eliminating the GST exemption for certain long-term trusts (for example, a trust with a term of 50 years or more); and limiting valuation discounts for closely held business interests.

ESTATE PLANNING TECHNIQUES TO CONSIDER IN THE CURRENT ENVIRONMENT

There are several effective estate planning structures that can be used to take advantage of depreciated asset values, record-low interest rates, and record-high exemption amounts. The ideal assets to use in implement these strategies are assets that have declined in value but are expected to appreciate in the future, such as real estate, business interests, and marketable securities, particularly where the asset held is a minority or fractional interest that may be entitled to a valuation discount, including discounts for lack of marketability and lack of control.

All of these techniques key off of the now historically low "hurdle rates"—either the AFR or the Section 7520 Rate—and are designed to remove any appreciation with respect to the gifted asset in excess of the relevant "hurdle rate" from the gift, estate, and/or GST tax regime.

Grantor Retained Annuity Trust ("GRAT")

A GRAT is an estate planning technique that allows for the transfer of appreciation of assets at minimal or no gift tax cost. With a GRAT, the grantor transfers assets into a trust for a term of years. During the term of the trust, the grantor receives an annuity payment, at least annually, of either a fixed dollar amount or a fixed percentage of the fair market value of the property placed into the trust. At the end of the trust term, any remaining principal will be distributed to the trust beneficiaries.

A gift to a GRAT will result in a taxable gift equal to the fair market value of the property placed into the trust, less the present value of the annuity payments that the grantor will receive from the GRAT. In most cases, a GRAT is structured to "zero-out," with the present value of the retained annuity interest equaling the value of the property transferred into the GRAT—meaning, the taxable gift is virtually zero!

The "hurdle rate" for a GRAT is the "Section 7520 Rate," which is 120% of the mid-term AFR. ***For June 2020, the Section 7520 Rate is only 0.6%***. Therefore, any appreciation of the GRAT's assets in excess of 0.6% per annum will pass to the GRAT's beneficiaries free of any gift or estate tax!

There are two disadvantages of a GRAT, both of which must be considered in the planning process but can be successfully managed. First, if the grantor dies before the end of the GRAT term, all or a portion of the value of the GRAT is included in the grantor's estate tax base. Second, a GRAT is less effective and therefore is not normally used as a structure for generation skipping planning.

Installment Sale to an Intentionally Defective Grantor Trust ("IDGT")

An installment sale to an IDGT is similar to a GRAT and works well in an environment with depreciated asset values and low interest rates. However, an IDGT, unlike a GRAT, can be used in conjunction with generation skipping planning. With an IDGT, a sale of property is made to a trust in return for an installment note that bears interest at the AFR. In order to avoid a potential argument from the IRS that the note is not a true debt and the loan proceeds results in a taxable gift to the trust, an amount equal to at least 10%-15% of the value of the property should be placed in the trust as "seed" money; this contribution is a taxable gift. The note may provide for installment payments over a period of time or may provide for annual interest-only payments with a balloon payment of principal at the end of the term, using the AFR as the hurdle rate. At the end of the trust term, any income and appreciation on the trust assets that exceeds the payments required to satisfy the note will pass to the trust beneficiaries free of gift, estate, and possibly GST tax.

The success of an IDGT therefore depends upon the assets in the trust achieving a rate of return in excess of the AFR. In a low interest rate environment, there is a greater chance that the rate of return will exceed the AFR and, accordingly, that the IDGT's assets will pass to the trust beneficiaries free of gift or estate tax.

An additional advantage of both a GRAT and an IDGT is that these trusts qualify as "Grantor Trusts" for federal income tax (and some but not all state income tax) purposes, which results in the trust's grantor being required to pay federal income tax on the income earned by the trust even though such payment clearly benefits the trust. The grantor's payment of the trust's income taxes is essentially an economic gift to the trust that is not treated as a gift for gift, estate, and/or GST tax purposes.

Intra-Family Loans

An intra-family loan will probably be the simplest and will likely have the lowest transaction costs of the techniques discussed in this alert. The transferor loan funds to the transferee (which can be an individual or a trust), documented by a promissory note. As long as the loan bears interest no lower than the hurdle rate (which for this technique is the AFR), the transaction will not be considered a gift. These intra-family loans work better in low-interest-rate environments because the wealthier senior generation of a family can loan cash to the younger generation at attractive interest rates. The interest rate that must be used will depend on the duration of the loan. ***For example, at the June 2020 rates, the minimum required interest rates would be only 0.18% for a loan term of three years or less, 0.43% for a loan term of more than three years but less than nine years, and 1.01% for a loan term of nine or more years***! The younger generation can use these loans to pay down higher-rate debt or make investments that they believe will yield a higher return than the hurdle rate with any returns in excess of the hurdle rate passing to the younger generation free of gift or estate tax. Existing notes with higher interest rates can be refinanced to take advantage of the lower current interest rates but only if sufficient consideration is provided by the borrower to the lender, usually in the form of a material pay down of the outstanding principal balance of the existing note.

Charitable Lead Annuity Trust ("CLAT")

For those who are charitably inclined, a CLAT, which uses the Section 7520 Rate as the hurdle rate, also works well when interest rates are low. A CLAT provides for the payment of a fixed dollar amount to one or more charitable beneficiaries for a specified period of time, at least annually, regardless of the income generated by the CLAT. The trust may be established for a term of up to 20 years or can be based on the life or lives of individuals living at the time of the creation of the trust. The amount of the charitable contribution deduction at the creation of the CLAT will be the present value of the annuity using the Section 7520 Rate. A CLAT will result in a taxable gift upon creation equal to the fair market value of the assets gifted to the trust reduced by the present value of the annuity. A CLAT works better in a low interest rate environment because a lower Section 7520 Rate will cause the present value of the annuity paid to the charitable beneficiaries to be higher, which in turn produces a larger charitable contribution deduction and a smaller taxable gift to the remainder beneficiaries. In a low interest rate environment, there is a greater chance that the rate of return will exceed the 7520 Rate, which increases the value of the assets passing to the

noncharitable remainder beneficiaries free of gift or estate tax at the end of the annuity term.

HAVING YOUR CAKE—AND EATING IT TOO!

Although this year may be the ideal time to use gift, estate, and GST tax exemptions, many individuals may be hesitant to irrevocably part with large amounts of their assets without a "safety valve" that would allow them to use the income and/or principal of those assets in the future in case of emergency. This is especially true at times, such as now, when financial futures are uncertain and for individuals who only a few months ago felt secure that they had savings in excess of their liquidity needs to cover unexpected medical or personal costs. Fortunately, it is possible to have your cake and eat it too—or in tax terms, make gifts to utilize current record-high exemption amounts without eliminating the possibility of being able to benefit from the gifted assets in the future if necessary. Discussed below are two possible structures for individuals in this segment of the population.

Spousal Limited Access Trust ("SLAT")

For happily married couples, a SLAT is an effective strategy to take advantage of today's record-high exemption amounts without eliminating access to your assets in the future. With a SLAT, one spouse (the "Donor Spouse") makes a gift of assets to a trust for the benefit of the other spouse ("the Beneficiary Spouse") along with other beneficiaries (usually, the couple's children and/or grandchildren). The trust names an independent trustee (who is likely to abide by the Donor Spouse's distribution wishes though there should be no express or implied understanding with the trustee to do so) who has discretion to make distributions of trust assets to the trust's beneficiaries, including the Beneficiary Spouse. The Donor Spouse's transfer to the trust does not qualify for the marital deduction—the desired result—because the Beneficiary Spouse has only a discretionary interest in the trust. Accordingly, the Donor Spouse's exemption amount is utilized, and the post-transfer appreciation on the trust's assets will not be subject to future gift, estate, and possibly GST tax.

If the spouses later need income and/or principal of the trust, and the independent trustee agrees, the solution is simple. The trustee makes a distribution of trust income and/or principal to the Beneficiary Spouse. Obviously, distributing assets to the Beneficiary Spouse reduces the gift, estate, and GST tax benefits associated with a SLAT and should be done only when absolutely necessary. It is for this reason that the Donor Spouse should be careful to retain sufficient assets to maintain the couple's lifestyle and only fund the SLAT with excess assets.

SLATs are ideal in intact marriages. If the marriage dissolves or if the Beneficiary Spouse predeceases the Donor Spouse, the Donor Spouse will have lost the ability for a potential return of the trust's income and/or assets.

Domestic Asset Protection Trust ("DAPT")

A DAPT is a so-called "self-settled" trust in which the creator is a beneficiary along with others, such as children and/or grandchildren, as determined in the discretion of an independent trustee. For the transfer to the trust to be a completed gift, the trust must be governed by the law of one of 19 states that permit "self-settled" trusts that do not permit the creator's creditors to reach the assets of a trust even though he or she is a discretionary beneficiary of the trust.

A DAPT is a viable solution for an individual who wants to utilize the current record-high exemption amounts without eliminating any possibility from benefiting from the gifted assets in the future. Like a SLAT, the creator should select a friendly independent trustee. Further, the creator should be careful to retain sufficient assets to maintain his or her lifestyle and fund the SLAT only with excess assets that would only be needed in case of emergency. However, unlike the SLAT, the creator does not have to rely on a spouse as part of the strategy to benefit from this technique.

DAPTs may be created by individuals who reside in states without DAPT statutes provided the trust is governed under the law of the DAPT state. Depending on state law, the trust will need to have assets situated in the DAPT state or name a local trustee, however, the local trustee's powers can be limited to certain basic administrative functions and can exclude distribution and investment decisions. Because of these requirements, the cost of implementing and maintaining a DAPT is higher than for the other techniques mentioned in this alert. In addition, the law is unsettled as to whether the asset protection advantages of a DAPT will be respected if the creator lives in a state that does not have a DAPT statute. Although it is beyond the scope of this alert, for asset protection (and possibly tax) purposes, the DAPT is most likely to be respected if it is funded well in advance of any potential creditor claims and with only a portion of a creator's assets.

CONCLUSION

We are all in the midst of a truly unfortunate perfect storm. However, anyone with a net worth in excess of the current gift, estate, and GST exemptions, or the reduced exemption lev-

els that may be in effect sooner rather than later have a unique opportunity to take advantage of this possibly once-in-a-lifetime opportunity to engage in proactive planning with the goal of reducing the tax burden on their children, grandchildren, and future generations while there is still time.

Blank Rome's Private Client team is uniquely situated to navigate the many options available under current law; law that can change at a moment's notice. We urge you to reach out to us to discuss what works best for you and to be in a position to implement your decisions before year end.

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