

TYPES NOT MAPPED YET May 08, 2020 | TTR not mapped yet | Lacey R. Searfoss, Jacqueline A. Dimmitt

How COVID-19 presents estate planning opportunities

Due to COVID-19, the world has changed dramatically in a short amount of time, including pandemic fears, a global economic slowdown and uncertainty as to when the economy will fully recover. The economic downturn puts more focus on creating long-term financial security for families and family-owned business. Depressed asset values and historically low interest rates provide unique and prudent opportunities for families to minimize estate and gift taxes.

Transfer taxes

Under current federal law, each individual can transfer \$11.58 million (indexed for inflation annually) in combined lifetime gifts and transfers at death before incurring federal estate, gift or generation-skipping transfer ("GST") taxes. A 40 percent estate or gift tax is imposed on transfers in excess of the \$11.58 million exemption. However, the transfer-tax free exemption is scheduled to be cut in half after 2025 as a part of the budget balancing required to pass the Tax Cuts and Jobs Act in 2017. Of course, because the exemptions are set by federal law, their future will likely also depend on the 2020 presidential and congressional elections.

Opportunities

On April 30, the Dow Jones industrial average closed at 24,345, down about 15% for the year. Hopefully that lost value will be regained as our economy starts to recover. Planning techniques such as GRATs and CLATs allow transfer of that future appreciation to the next generation for minimal, if any, transfer tax or use of exemption. Currently depressed asset values also make other estate planning opportunities worth considering.

GRATs

Grantor retained annuity trusts ("GRATs") are effective, low-risk mechanisms to transfer future appreciation in assets to children, without transfer tax or use of exemption. The strategy works as follows:

An individual transfers marketable securities or an interest in a closely-held business to an irrevocable trust. The individual retains the right to receive from the trust annual annuity payments for the term of the trust. The total value of the retained annuity payments is determined by reference to an interest rate set monthly by the IRS known as the "7520 rate" and the annuity is usually set at an amount that, discounted by the 7520 rate, equals the value of assets transferred to the GRAT. Because the individual has retained the full value of the transferred assets, little or no gift is being made for gift tax purposes to children who will receive the trust assets at the end of the trust term. If the individual survives the trust term, any remaining trust assets pass at that time to family members free of gift or estate tax.

Here's the reason why now is such an opportune time to create GRATs. In order for the GRAT to transfer appreciation in the GRAT assets to children, the rate of return on the assets transferred to the GRAT must exceed the 7520 rate as of the date the GRAT is created. The more the rate of return exceeds the 7520 rate, the more appreciation is transferred to children. Given the historically low 7520 rate for May (0.8%, the lowest 7520 rate ever) and the potential recovery of the equity markets as economies begin to reopen, this is the time to consider GRATs.

CLATs

A similar technique to GRATs for those with charitable interests is the Charitable Lead Annuity Trust ("CLAT"), except there the annuity is payable to charity rather than the individual. Just like GRATs any remaining trust assets after the annuity payments to charity pass to children at reduced (potentially zero) gift tax cost.

Gifts

Of course, there are simpler ways to reduce the estate tax burden. Individuals who are in a position to give wealth to their descendants now, rather than at death, can use gift tax exemption and GST tax exemption to transfer assets to an irrevocable trust for the benefit of descendants. Because gifts are valued for gift tax purposes at the time the transfers are made, the advantage of transferring assets now is that all post-transfer appreciation is removed from the individual's estate and is not included in the value of the gift. When assets appreciate dramatically after being transferred to the trust, this simple strategy can be a powerful tool for reducing estate tax in this down market by capturing all post-gift appreciation in the trust rather than in the individual's estate. Hopefully, we'll see these dramatic increases as we return to something more like "business as usual."

Gifts may have two other benefits:

1. Because the gift and estate tax exemption may decline dramatically in the next few years, use of it now through lifetime gifts can be a way to lock in the exemption which would otherwise be lost.
2. Wealthier individuals able to make substantial gifts can reduce their estates even more by making gifts large enough to incur gift tax. Because the gift tax is removed from the estate, payment of gift tax is actually cheaper than payment of estate tax.

Intra-family Loans

For individuals who don't want to use their estate and gift tax exemptions or pay gift tax, low interest rate loans may be an attractive alternative to gifts as a way to move appreciation from an individual's estate and into the hands of their children. Low interest loans are similar to GRATs in that the individual lender receives payment back to the principal of the loan just as a GRAT pays an annuity. To avoid a disguised "gift" and imputed interest income, interest on the loan should be at least at the Applicable Federal Rate ("AFR"). The current AFR for a term loan for May for less than nine years is 0.58% and for less than three years is 0.25%, so now is an excellent time for intra-family loans so the borrower can invest the borrowed funds as the markets recover and retain the total return on the funds after payment of interest and principal on the loan. For the same reason, individuals with existing loans with higher interest rates may wish to refinance those loans to reduce interest paid by the borrower.

Exchanging Assets

Finally, for individuals with GRATs or other existing irrevocable trusts as a part of their estate plan, there may be an opportunity for some planning as a result of the current condition of the markets. Many irrevocable trusts grant a "swap" power to the grantor allowing the grantor to exchange assets of equivalent value with trust assets. The swap power is commonly used as part of an estate planning strategy which causes a trust's assets to be taxed to the grantor for income tax purposes while being a completed gift for gift tax purposes (commonly used with the type of gift trust described above). Assets which individuals expect will increase in value are candidates to be swapped with assets held in the trust that have levelled off or may decline in value. Once the assets have been swapped, the appreciation in the assets now in the trust will stay there, effectively transferring additional assets to the trust without additional gift or GST tax cost. The market downturn presents an opportunity to swap currently depressed-value assets with the trust in exchange for relatively "stable" assets. That said, picking winner and loser assets is always tricky—especially during periods of market volatility. Individuals should also always ensure that the assets on each side of the ledger are truly of an equivalent fair market value so as not to inadvertently contribute to or take a distribution from the trust.

The swap power also allows for some income tax planning for certain individuals in circumstances in which an individual holds assets with a high basis and the trust holds assets with the same fair market value but a low basis. The individual can swap the high basis assets in exchange for low basis assets of the same value. Then, at the individual's death, when the low value assets are included in the individual's estate, those assets will receive a step-up in basis, eliminating capital gains taxes which would have been due when the assets were sold.

Conclusion

There are, of course, additional strategies not mentioned here for individuals to reduce their taxable estates. The above tools are simply a selection of particular methods uniquely well-suited to our current circumstances in which interest rates are historically low and asset values are depressed.

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