Summer 2020

Estate Planning Update Summer 2020 - Estate Planning Necessities and Opportunities in Today's Environment

The current pandemic is a sobering reminder of how important it is to have your affairs in order, and we hope you will take the opportunity to review your current estate planning documents to be sure they still reflect your wishes. In addition, the resulting economic tumult has led to historically low interest rates and what we hope will be temporarily low values for marketable securities and closely held businesses, both of which may create planning opportunities for those of you who are comfortable making gifts at this time.

Review Basic Estate Plan Documents

As you review your current documents, here are some questions you may want to consider:

- Are the individuals named as fiduciaries under your estate planning documents still appropriate? For example, if your children were young when you last updated your estate planning documents, you may wish to consider including one or more of them as an executor, trustee, health care agent or agent under your durable power of attorney.
- Are there charities you would like to add to your estate plan? Many of us have expanded our charitable giving during this crisis or have been the beneficiaries of charitable enterprises. You may have new thoughts on which charities to remember at your death.
- Is your revocable trust a beneficiary (either primary or contingent) of a retirement plan? If so, it may be appropriate to amend your revocable trust to be sure that withdrawals from the account after your death can be deferred for as long as possible under the new federal law.

Wealth Transfer Opportunities

Amid the detrimental consequences of the current environment lie unique wealth planning opportunities for individuals with estates that may be subject to federal or state estate taxes.

Gift and Estate Tax Overview

The current federal gift and estate tax exemption is now $11.58 million per person ($23.16 million for a married couple). This exemption is scheduled to increase annually for inflation through 2025. In general, transfers made in excess of the gift and estate tax exemption are subject to a 40 percent federal tax. The generation-skipping transfer (GST) tax exemption now also is set at $11.58 million per person in 2020, with identical inflationary increases. Under the Tax Cuts and Jobs Act of 2017, both exemption amounts are scheduled to sunset at the end of 2025, meaning that these figures will revert on January 1, 2026, to $5 million per person (plus inflation adjustments). In addition to the federal gift, estate and GST taxes, several states – including Massachusetts, Connecticut and New York – still impose a separate state estate tax with lower exemption amounts. Connecticut also imposes a state gift tax. 2020 is a unique year in that we are likely heading into a global recession coupled with a U.S. presidential election. Accordingly, 2020 may be an ideal year during which to transfer assets out of your estate at a lower value while leveraging the use of the $11.58 million exemption. If the 2020 election results in a political change in Washington, the potential exists for the estate tax exemption to be significantly reduced in 2021 or subsequent years.

Taking Advantage of Low Asset Values and Low Interest Rates

As noted above, values of marketable securities and many business interests have dropped significantly from the all-time highs of just a couple of months ago. In addition, the IRS interest rates for intra-family loans are now extremely low (ranging from 0.25 percent to 1.15 percent for loans made in May, depending on the loan term). Similarly, the IRS interest rate used to calculate certain remainder values has dropped to 0.8 percent for transactions in May. The cumulative impact of these reductions is that assets can be transferred to intended beneficiaries at a much lower cost. Today's environment is ideal for considering the following strategies. *Intra-family Loans* As noted above, applicable interest rates are exceptionally low, allowing family members to make loans to one another at low rates without gift tax consequences. For instance, a parent can lend funds to a child for up to three years and charge interest as low as 0.25 percent if the loan is made in May. Such loans allow family members or trusts to borrow funds that may be needed to buy a house, start a business or make investments. The benefit of this technique is that the growth of the loan principal in the lender's estate is frozen at the interest rate of the loan, while the increase in value of any investments made with the borrowed funds belongs to the borrower. Clients with existing loans to family members or trusts may wish to consider refinancing in order to take advantage of lower rates. As with all of the transactions discussed here, you should consult with your Day Pitney estate planning attorney before refinancing intra-family loans. *Direct Gifts to Individuals or Irrevocable Trusts* A straightforward strategy is to gift assets to individuals or to an irrevocable trust for the benefit of descendants or other intended beneficiaries. A gift to an irrevocable trust presents numerous benefits: creditor protection for beneficiaries, including protection from divorcing spouses; potential estate and GST tax savings over multiple generations; income tax benefits; consolidated management of assets; and controlled distributions to the beneficiaries by the trustee. Gifts of assets made now, while using some of the donor's lifetime estate and gift tax exemption, will freeze the gift tax value of those assets at today's low values, allowing the recipients to receive the benefit of the expected subsequent appreciation. Also, as discussed above, the current federal gift, estate and GST tax exemptions are very high but are scheduled to be cut approximately in half in 2026, when the current federal law sunsets. By making gifts large enough to use up the donor's current exemptions, the donor can capture the benefit of the current exemptions even if the exemptions are reduced in the future. *SLATs* A spousal limited access trust (also known as a spousal lifetime access trust, or SLAT) is an irrevocable trust to which a married person gifts assets from which his or her spouse may receive distributions of income and principal, typically at the discretion of the trustee. This strategy removes the assets from the grantor's estate while still affording access through the spouse as long as the parties are married and the spouse is living. The potential access may make the spouses more comfortable with making a large gift and utilizing the current exemption before a potential future decrease in the exemption amount. *GRATs* A grantor retained annuity trust (GRAT) is a technique used to transfer the appreciation of an asset in a tax-efficient manner. The grantor gifts assets to an irrevocable trust and retains the right to a fixed annuity for a specific term of years (the GRAT term). Over the GRAT term, the grantor receives back the value of the initial gift plus interest calculated at a rate determined by the IRS (0.8 percent for GRATs funded in May 2020). At the end of the GRAT term, the remaining assets (i.e., the appreciation on the assets transferred less the interest payable to the grantor) typically transfer to an irrevocable trust for the benefit of the grantor's descendants. Because the grantor has retained an economic benefit, the value of the initial gift is discounted, often down to $0, for gift tax purposes. As a result, provided the grantor survives the GRAT term, the grantor effectively gifts the appreciation on the grantor's assets with virtually no gift tax consequences. A GRAT is an ideal strategy to transfer business interests or marketable securities that are currently undervalued. The greater the growth or appreciation of the assets during the GRAT term, the larger the tax savings. In addition, as noted earlier, the interest rate used in the annuity payment calculation is historically low, making this strategy even more attractive. *For an illustration of the GRAT technique, click here.* For clients with existing GRATs that have lost value during the economic downturn, it may be possible to "swap" the assets held by the GRAT for cash or other assets of equal value owned outside the GRAT. This allows the original assets to fund a new GRAT even before the current GRAT terminates, thus taking advantage of the assets' currently low value and higher potential for future appreciation. *CLATs* A charitable lead annuity trust (CLAT) is in some ways similar to a GRAT, but the annuity payments pass to charity rather than back to the donor. It allows a charitably-minded donor to benefit from low interest rates while passing property appreciation to beneficiaries in a tax-advantaged way. To create a CLAT, a donor irrevocably transfers property to a trust for a specific term of years, during which a "lead" interest is paid to one or more charities annually. At the end of the term, the remaining property passes to noncharitable beneficiaries free of gift or estate tax. The value of the annual lead payments to charity is determined based on the number of years the lead interest lasts and interest rates determined by the IRS. In May 2020, the lowest available rate is 0.8 percent. A donor might structure a CLAT to provide fixed annual payments to charity.

Alternatively, payments can be "backloaded" over the term (each year's payment is 20 percent higher than the prior year's payment). Backloading leaves more property in the trust over the term to generate appreciation, which is better for the noncharitable beneficiaries but reduces the amount paid to charity in the early years of the CLAT. *For example, assume a CLAT is funded in May 2020 with $10 million for a 20-year lead term, with payments increasing by 20 percent each year and designed so there will be no taxable gift to the remainder beneficiaries. The trust would distribute a total of $11,335,500 to charity over its 20-year term. If the trust were to earn a steady 6 percent rate of return instead of the 0.8 percent the IRS assumes, then in addition to distributing more than $11 million to charity, the trust would have $16.8 million on hand to distribute, free of gift or estate tax, to the noncharitable beneficiaries at the end of the 20 years.* The actual results will depend on investment returns, but the low interest rate provides an important opportunity for those who are looking both to benefit charity and to pass wealth to the next generation free of gift or estate tax. *Installment Sale to an Irrevocable Grantor Trust* Structuring the sale of an asset to an irrevocable grantor trust can be an effective estate planning strategy to remove assets from your estate while preserving an income stream. When a gift or sale is made to a grantor trust, the grantor still is treated as the owner of the trust's assets for income tax purposes. The grantor, rather than the trust, pays the tax on the trust's taxable income, and transactions between the grantor and the trust are not subject to income tax. In an installment sale, the grantor "seeds" the trust with a gift and then sells to the trust additional assets that are expected to increase in value in exchange for an interest-bearing promissory note. The trust pays interest on the note (at current low interest rates, described above) and gets the benefit of the appreciation of the gifted assets during the note term. The appreciation, minus the interest paid, is removed from the grantor's estate.

Other Considerations

It is essential to understand that most techniques described above cannot be undone or reversed once completed. Furthermore, there may be some downside from an income tax perspective because the recipients of the assets (trusts or individuals) receive the grantor's cost basis in the property rather than the stepped-up basis they would receive if the same assets were transferred at the grantor's death. It is important to weigh the potential income tax disadvantages associated with a lifetime gift of an asset against the estate tax savings achieved. Before committing to any estate planning technique, it also is essential to understand the cash flow impact of any gifting strategy. We recommend that your financial adviser assist in quantifying your projected cash flow needs to help make sure you do not give away more than you can afford to, taking into account your own future needs. Remember too that the sooner you act, the more quickly the asset is removed from your control and all future appreciation will be removed from your estate.

Next Steps

The gifting opportunities discussed above have many pros and cons and may not be appropriate for every situation. We encourage you to contact your Day Pitney estate planning attorney to discuss any changes to your estate planning documents and to discuss whether any of these gifting strategies may be appropriate for you.

For more Day Pitney alerts and articles related to the impact of COVID-19, as well as information from other reliable sources, please visit our COVID-19 Resource Center. COVID-19 DISCLAIMER: As you are aware, as a result of the COVID-19 pandemic, things are changing quickly and the effect, enforceability and interpretation of laws may be affected by future events. The material set forth in this document is not an unequivocal statement of law, but instead represents our best interpretation of where things stand as of the date of first publication. We have not attempted to address the potential impacts of all local, state and federal orders that may have been issued in response to the COVID-19 pandemic. Day Pitney Estate Planning Update- Summer 2020 (pdf)