A TIME FOR REFLECTION: ESTATE PLANNING DURING A MARKET DOWNTURN

Hodgson Russ Trusts & Estates Alert
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The global outbreak of COVID-19 has resulted in unprecedented public safety and economic turbulence. In response, the U.S. government is aiming to counter the economic fallout by slashing federal interest rates and proposing trillion dollar stimulus packages. While all Americans are certainly anxious in light of the economic instability, as former President John F. Kennedy once said: "In a crisis, be aware of the danger - but recognize the opportunity."

A market downturn presents a unique opportunity for high-net-worth individuals to engage in additional estate tax planning. Specifically, an economic downturn creates planning opportunities based on a combination of two factors: (i) depressed asset values (with a potential for rebound), and (ii) low federal interest rates.

In such an environment, an "estate freeze" transaction may be advisable. A freeze transaction is a broad term used to describe a transaction in which an asset is irrevocably transferred by an individual so that it will not be included in his or her taxable estate at death. As a result of the transfer, the value of the property is, for gift and estate tax purposes, effectively frozen at the value at the time of the transaction (because the transfer is subject to gift tax at today's values, rather than estate tax at future values). With depressed asset values, along with low federal interest rates, a few specific freeze transactions can be particularly beneficial:

Gift to Irrevocable Trust: One of the more basic freeze transactions is a gift of property to an irrevocable trust. A transfer of property to an irrevocable trust during life will be subject to gift tax (subject to some exceptions) on the fair market value of the property at the time of gift. On the donor's subsequent death, the gifted property will not be included in his or her estate for estate tax purposes. Thus, any appreciation on the asset from the time of the gift to the time of death will avoid the estate tax which would have otherwise been imposed. The potential estate tax savings are greater if the property is transferred at a time when its value is depressed, such as during a market downturn. Additionally, the increased gift and estate tax exemption allowed under the Tax Cuts and Jobs Act (enacted at the end of 2017) allows substantial taxable gifts (up to $23.16 million for married couples) without gift tax actually being owed. Typically, gifts to irrevocable trusts benefit descendants; however, it is also possible to include a spouse as a permissible trust beneficiary so that he or she has access to trust distributions in the future. These trusts are

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commonly referred to as "Spousal Limited Access Trusts" (or SLATs).

Intra-Family Loans: Another simple transaction that can produce good results in the current economic climate is an intra-family loan. Simply, this is a transaction in which assets are loaned to intended beneficiaries in exchange for a written promise to repay. Provided that the debt instrument charges at least the Applicable Federal Rate ("AFR"), which varies depending on the length of the loan but which is currently below 1.5% for all loans, there will be no gift tax imposed on the loan. If the funds lent to the family member are invested and grow at a rate in excess of the interest charge, the difference between such appreciation and the interest charge passes to the borrower/beneficiary free of estate or gift tax.

Grantor Retained Annuity Trust: A Grantor Retained Annuity Trust ("GRAT") is a trust arrangement whereby the grantor transfers assets to a trust, and in exchange the trust agrees to make fixed dollar annuity payments back to the grantor each year for a term of years (a GRAT term is typically two to ten years). The annuity payments do not need to be paid with cash, so if stock is contributed, it may be returned to the grantor as part of the annuity payment (and valued as of the date of the applicable annuity payment). At the end of the trust term, the remaining trust assets pass free of gift/estate tax to the named remainder beneficiaries, or can be held in further trust for their benefit.

When property is transferred to a GRAT, a determination of the present value of the required annuity payments is calculated. This calculation involves an assumed rate of return which is set by the IRS (the "7520 Rate" or the "hurdle rate"). **For April 2020, the 7520 rate is 1.2%.** If the fair market value of the property transferred to the GRAT exceeds the present value of the required annuity payments, a taxable gift of the excess is considered to have been made. Often, a GRAT is designed so that the present value of the annuity payments exactly equals the value of the property transferred to the GRAT, referred to as a "zeroed-out GRAT." When the GRAT is set-up to be zeroed-out, there are no gift tax implications to creating the GRAT, because the 7520 Rate assumes that the entire trust will be repaid to the grantor.

If the GRAT's assets appreciate over the term at a rate in excess of the 7520 Rate, the growth will pass at the end of the term to the remainder beneficiaries, tax-free. If the GRAT's assets do not appreciate at a rate above the 7520 Rate, the GRAT will return all of its assets to the grantor (in satisfaction of the annuity payments), and nothing is left for the remainder beneficiaries. While there is no upside in this event, there is also no downside. From an estate tax perspective, if the grantor lives to the end of the term, the remaining assets pass to the remainder beneficiaries and are not subject to estate tax in the grantor's estate. On the other hand, if the grantor dies during the term, the GRAT's assets are subject to estate tax at the grantor's death. However, because the grantor does not pay gift tax at the creation of the GRAT, the grantor is no worse off in this instance than if the GRAT had not been created.

GRATs are particularly attractive in the current economic environment due to the historically low 7520 Rate and significant potential for rebound in the equity markets in the coming years.

Installment Sale to Grantor Trust: In this structure, the grantor of an irrevocable "grantor trust" (an irrevocable trust for the benefit of others, but of which the grantor is treated as the taxpayer for income tax purposes) sells assets to the trust for fair market value. Typically, the purchase price will be paid by the trust in part with a promissory note issued to the grantor/seller. The note must charge at least the AFR in order to avoid classification as a gift. Because the trust is a grantor trust, both the initial "sale" and the payment of interest under any promissory note are ignored for income tax purposes (under the theories that you cannot sell assets to yourself, and cannot charge yourself interest).

A sale to grantor trust offers the same tax benefits as a zeroed-out GRAT. That is, there is no gift tax due on the sale, and the assets "sold" to the trust will not be subject to estate tax on the grantor's death. If the assets within the trust appreciate at a rate higher than the interest rate on any promissory note, such appreciation will pass to the remainder beneficiaries tax-free. As an additional benefit, unlike with a GRAT, if the grantor were to die during the term of the note, only the outstanding balance of the note would be included in grantor's estate. As with a GRAT, this technique is attractive in the current economic environment because asset values are depressed and the required AFR is very low. As a result, the potential that appreciation will exceed the hurdle rate, thus creating a substantial tax benefit, is very high.

In addition to reflecting on these estate tax planning transactions, this is also a good time for clients to reflect on their "core" estate planning documents (wills, revocable trust agreements, powers of attorney, and health care directives). The current state of the world underscores the importance of keeping these documents up-to-date. In addition, to the extent an estate plan contains a revocable trust agreement, it underscores the benefits of funding that revocable trust agreement to ensure investment decisions can be made in a timely manner after death (which, in this market, is of critical importance).

While the COVID-19 pandemic has strained financial markets, and changed our way of life for the foreseeable future, the resulting economic downturn presents, in the right circumstances, a unique opportunity to engage in certain estate planning transactions which have the potential to result in substantial gift and estate tax savings. And, from a non-tax perspective, it underscores the importance of keeping core estate planning documents up-to-date. We suggest that you reach out to your Firm contact or any member of the Trusts and Estates team, who will be happy to discuss any questions you may have or to assist with any planning.

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