Finding Diamonds in the Rough: Estate Planning in Turbulent Times

Legal Alert

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The general goal of estate planning is to transfer assets or future appreciation at little to no tax cost. With the current federal estate tax exemption of $11,580,000 per person, a lot of individuals do not need to engage in this type of planning. While the exemption is currently scheduled to decrease to approximately $6,000,000 in 2026, a married couple could still transfer approximately $12,000,000 of assets without incurring this tax. However, with the recent passage of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), and with more stimulus bills to come, Congress may soon look for ways to reduce these deficits. This will undoubtedly lead to discussions about raising taxes.

While all of the turmoil in the world has created a strong level of uncertainty, it has also created opportunities for estate planning techniques. This is a result of the combination of depressed asset values and low interest rates. For example, many estate planning techniques are based upon federally mandated interest rates, often referred to as Section 7520 rates. For the month of May 2020, the benchmark interest rate will be 0.8%... an historic low. When this interest rate is combined with depressed asset values, estate planning opportunities are possible if you believe that assets will appreciate at a rate higher than 0.8%.

These planning opportunities are based upon shifting future appreciation out of your estate at the lowest tax rate possible. This may be important even if your estate is below the current federal exemption if you believe that this exemption may be reduced in the future. Additionally, it is also possible to avoid some state inheritance taxes.

In this regard, please consider the following estate planning techniques:

GRANTOR RETAINER ANNUITY TRUST (GRAT)

A GRAT is a technique where assets are transferred to a trust and the person contributing the assets retains the right to receive distributions from the trust for a certain length of time (the "trust term"). The amount of the gift is based upon what the ultimate recipient will receive upon the expiration of the trust term. The term can be long or short, and two factors determine the value of the gift at the time the assets are transferred into the trust. First, as you increase the length of the trust term, the value of the gift to the recipient will decrease. This is essentially a time/value-of-money concept. The second factor relates to the amount of distribution which the donor wants to retain. Increasing retained distributions to the donor will decrease what is ultimately left for the beneficiaries to receive.

To take this technique to the extreme, there is the technique referred to as a "Walton GRAT" (also known as a "Zeroed-Out GRAT"). Under this approach, the donor transfers assets to a trust and receives the right to receive assets equal to approximately 50% of the trust's asset value for a two-year period. Based on the mathematics of this approach, there would be little to nothing left over at the end of the term. The benefit occurs where the assets appreciate at a rate higher than the federally mandated interest rate (0.8% for the month of May 2020). If the assets appreciate at a rate higher than this interest rate, then value can be transmitted to the trust beneficiaries at no gift tax cost.

This technique is particularly attractive right now due to current depressed asset values and a low interest rate.

INSTALLMENT SALE TO A POTENTIALLY DEFECTIVE GRANTOR TRUST (IDGT)

This technique is based upon a family selling an asset to a trust and using the income from the trust to repay the loan (or at least the interest on the loan). By structuring the trust as a "grantor trust", the grantor will not recognize any federal income taxes upon the sale of this asset. Please note that some states, such as Pennsylvania, do not recognize grantor trust status, and capital gains will have to be recognized if it is a Pennsylvania based asset (New Jersey, by comparison, does recognize grantor trusts, so this will not be an issue in New Jersey). However, if the value of the asset being sold is low at the present time, and you are comfortable that the income generated from the asset will satisfy the installment obligation, this is a good way to transfer appreciation to your heirs.

CHARITABLE LEAD ANNUITY TRUST (CLT OR CLAT)

Under this technique, assets are transferred to a trust, and a charity receives the income from the asset based upon the IRS interest rate. Upon the expiration of the trust term, the assets are distributed to the trust beneficiaries. As with the GRAT, if the assets appreciate at or above the IRS interest rate, the ultimate beneficiaries can receive value at a reduced transfer tax cost.

All of these techniques require further discussion in order to understand the pros and cons associated with each approach and how to leverage these techniques to enhance your estate plan. However, the unusual combination of low interest rates and low asset values does present planning opportunities that are worth considering.

For more information on the material presented in this alert, please contact Jonathan Ellis, or any member of Flaster Greenberg's Trusts & Estates Practice Group.

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