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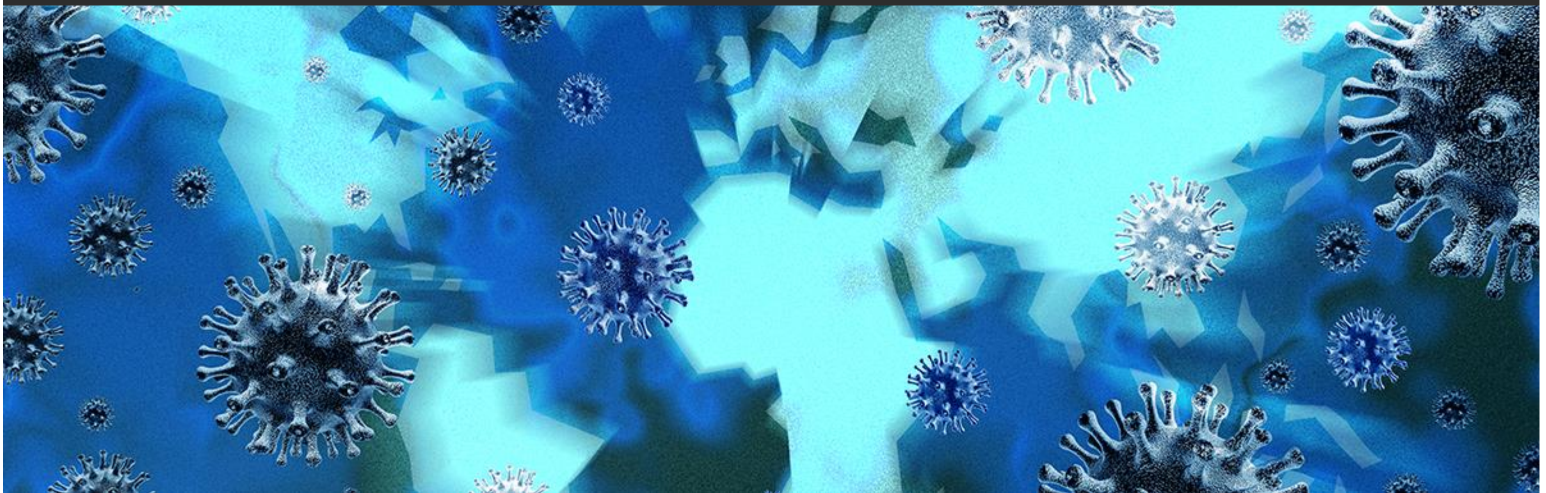
Alert | Health Emergency Preparedness Task Force: Coronavirus Disease 2019



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Uncertainty, COVID-19, and Estate Planning: A Unique Opportunity to Plan

The Coronavirus Disease 2019 (COVID-19) pandemic has created personal uncertainty for many due to living in quarantine and apart from extended family members, and financial stress due to market volatility and the unclear future for some businesses. Yet, it may be a sensible time to engage in estate planning, not only because the pandemic has shown the importance of personal planning, but also because reduced asset values and historically low interest rates enhance the ability to engage in cost-effective wealth transfers.

This *GT Alert* provides a brief overview of estate planning measures that may be considered in the current environment.

An Opportunity to Get Your Affairs in Order

Uncertain times tend to generate attention to personal planning, particularly where one's estate planning documents have not been reviewed in several years. Due to changes in personal and financial circumstances, estate planning documents may not reflect one's current intentions, or may be out-of-date relative to currently applicable law and financial status. Appointments under powers of attorney or health care directives may warrant review and reconsideration to ensure that decisions can be made on behalf of an individual who is unable to do so personally. It is also advisable to ensure that successors have been named to assure that there is someone who is able to act, and that selections of appointees, some of which may be outdated, are appropriate.

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As explained in our Alert on the effect of the SECURE Act on the disposition of retirement funds, beneficiary designations effectuating the disposition of qualified plans and IRAs may no longer achieve desired tax deferrals. The use of a trust to receive qualified plan benefits or an IRA now requires additional attention, as "stretch" payments for all but a few beneficiaries are no longer permissible. Beneficiary designations that transfer retirement benefits to trusts under one's estate planning documents may require review.

It is worth considering a review of estate planning documents, particularly the extent to which those dependent on an individual may have become more financially vulnerable and in need of support. Additional life insurance placed in trust for dependent family members may bridge the gap if personal asset values have diminished. The use of lifetime trusts for beneficiaries, rather than trusts that terminate at a stated age or ages, may potentially provide additional asset protection for family members, thus helping avoid the dissipation of wealth.

It also may be prudent to review trust governance provisions to ensure consistency with one's current intentions. This would include reviewing the appointments of trustees and whether they are still suited to carry out the responsibilities with which they have been charged. In addition, it may make sense to incorporate appropriate mechanisms to remove a trustee who is no longer in harmony with the wishes of the grantor or the family. These matters can be as important as the disposition of assets, and warrant periodic review to ensure that what is in place still accomplishes the goals for one's family.

Opportunities to Engage in Low Cost Wealth Transfers

a. Loans and Existing Promissory Notes

A relatively low applicable federal rate may provide an opportunity to make loans to more junior family members, permitting them to invest in assets that may appreciate outside the senior generation's taxable estate. Some may have outstanding debt resulting from sales of assets to grantor trusts for their families or unpaid loans made for other purposes to junior family members or to trusts created for their benefit. The current interest rate environment is favorable not only to make new loans, but also to refinance existing loans. In May 2020, the applicable federal rates are: 0.25% for a short-term loan (up to three years); 0.58% for a mid-term loan (more than three but not more than nine years), and 1.15% for a long-term loan (more than nine years).

b. GRATS

A grantor retained annuity trust (GRAT), a well-established technique that has been expressly approved by Treasury Regulations, is a trust under which an individual retains an annuity interest for a term of years and leaves the remainder to his or her intended beneficiaries. For gift tax purposes, the value of the annuity is subtracted from the value of the property contributed to a GRAT, and only the difference constitutes a taxable gift. A larger annuity, or one for a longer term, will reduce the value of the taxable remainder interest. A GRAT is a strategy that benefits from a low interest rate environment. The May 2020 Section 7520 rate used to value the retained annuity in a GRAT is 0.8%. For example, the annuity payable with respect to a $1 million contribution to a two-year "zeroed out" GRAT (if a 20% increasing annuity were selected) would be $460,170 in the first year and $552,206 in the second year for a total of $1,012,378. By contrast, if the Section 7520 rate were 4%, the total payments would be $1,062,288. If the GRAT were to last for five years, the difference in total payments would be $1,027,063 based on a 0.8% rate, as opposed to $1,139,147 based on a 4% rate.

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A low interest rate environment causes the GRAT annuity to be much more valuable (actuarially) than it would be if interest rates were higher. In addition, the exceptionally low hurdle rate and volatile markets may create a unique opportunity to capture and lock in appreciation in the GRAT assets without material gift tax exposure. If asset values are depressed, the opportunity may be even greater. It is generally more advisable for a GRAT term to be as short as possible to avoid the offset of short-term increases in value by a subsequent downturn. That risk, however, can potentially be managed by engaging in asset substitutions, so that perhaps using a longer term GRAT may be viable, thus locking in the low Section 7520 rate for a longer period, and allowing asset values to recover. Legislation that would reduce the effectiveness of GRATs by requiring a minimum term and a minimum remainder value has been introduced in the past few sessions of Congress.

c. Creating Trusts

The high federal estate, gift, and generation-skipping transfer (GST) tax exemptions (each currently $11,580,000) are scheduled to be reduced to $5,000,000 indexed for inflation in 2026. That reduction could take place sooner, as the current economic and political climate creates a need to raise tax revenues to pay for stimulus programs. Legislative proposals to significantly increase estate, gift, and GST tax rates have been introduced.

A married couple may have a greater opportunity to make use of these tax exemptions by having each spouse create an irrevocable trust creating a lifetime interest in the trust for the other spouse, either at inception or in the future. There are ways to structure spousal trusts to obtain the benefits they afford without causing the trust assets to be included in the taxable estate of either spouse. It is not possible, in funding the trusts, to use only the enhanced portion of the exemption (in other words, the amount in excess of $5,000,000, indexed). In order to obtain the benefits (if a reduction in exemptions does occur), transfers in excess of the anticipated reduced exemption amount, and preferably the entire amount, would need to be used.

If asset values are depressed, and additional structuring is done by using family entities and transferring minority interests, there is significant potential for removing substantial wealth from the couple’s taxable estates.

d. Allocating Available GST Exemption

Even if an individual is not able to make new asset transfers, if prior transfers have been made to trusts that are not exempt from GST tax, it may make sense to consider making a late allocation of GST exemption to an existing trust. Particularly if asset values are depressed, an allocation of GST exemption to an existing trust can be an efficient way to reduce or eliminate the future application of transfer tax to the trust estate. If the trust provides for termination during the lifetimes of the current beneficiaries, the trust can potentially be decanted, using available state legislation, to a trust that continues for multiple generations prior to making the trust GST exempt.

A married couple may also consider forming a marital deduction trust for one or both spouses to permit the current allocation of GST exemption. Even though a marital deduction trust requires the current payment of trust accounting income to the spouse who is the beneficiary of the trust, the potential future growth of the trust principal may still provide an opportunity to reduce transfer taxes on assets passing to the family.

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e. Selling Assets to a Grantor Trust

An installment sale to a grantor trust is a possible way to remove assets from one's gross estate at a reduced tax cost. The settlor would form and fund a trust with a portion of his or her gift tax shelter and apply GST exemption, so that the trust assets would never be subject to transfer tax. If the trust is structured so that it is a "grantor" trust for income tax purposes, the settlor remains the taxpayer for income tax purposes and must report all the trust's income, losses and credits on the settlor's personal income tax return. Appreciated assets, however, may be sold to the trust without recognizing a capital gain. In addition, the trust estate will be enhanced each year by the grantor's payment of income taxes on the assets in trust, thereby permitting the trust estate to grow income tax-free.

In the current environment, with values depressed and interest rates at historic lows, there is substantial potential to remove wealth from the settlor's gross estate using a sale to a grantor trust. Case law developments indicate that an improperly structured trust may not permit a grantor to discontinue grantor trust status without special provisions in the trust instrument. Therefore, careful attention to the structure of a grantor trust is important, in order to protect the grantor if the tax burden becomes too great.

f. Charitable Planning Using a Charitable Lead Annuity Trust

A charitable lead annuity trust (CLAT) permits an individual to provide assets for charity for a period of years, while retaining the opportunity to leave the remainder interest in the trust to family members free of gift tax. As in the case of a GRAT, the higher the amount of the annuity and the longer its term, the greater its actuarial value for tax purposes, thereby reducing the value of the taxable gift of the remainder interest. Also, as with a GRAT, the value of the annuity interest in a CLAT is higher when interest rates are low. This means that the annual payments to charity will be relatively lower, potentially improving the chances of creating a substantial remainder interest for family members.

For example, if an individual were to create a CLAT in May 2020 with $1,000,000 for a 20-year term, increasing the annual payments to charity by 20% a year, and the trust assets actually appreciated at a rate of 5% a year, more than $1,200,000 would be delivered to the family at the end of the 20-year term without the payment of a gift tax.

If one is financially able to make charitable donations, a CLAT, even one payable to one's own donor advised fund or private foundation, may potentially provide significant benefits, not only to charities in need, but also to one's family.

Retirement Plan Beneficiary Designations

As discussed in the *GT Alert* on the SECURE Act, significant changes were made to the manner in which retirement plan benefits may be distributed to a participant's beneficiaries. The most significant changes involve plan benefits that are intended to benefit individuals other than the participant's spouse. For most of those beneficiaries, the plan or IRA must be distributed in full to the beneficiary by the tenth year following the participant's death. Many individuals wishing to dispose of their plan benefits in trust for their family may have previously used so-called "conduit trusts" to receive plan benefits on behalf of their family members. A conduit trust requires all plan benefits to be distributed to the trust beneficiary upon receipt.

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When plan benefits could be withdrawn over the beneficiary's life expectancy, a conduit trust may have worked well. But, under the SECURE Act, except in the case of a minor child (or a disabled or chronically ill person), a "conduit trust" for an individual other than a surviving spouse would cause the entire plan to be distributed to the beneficiary of the trust no later than the tenth year following the participant's death. Therefore, an individual who wishes plan benefits to remain in trust may want to review beneficiary designations in light of the new law.

Extension of Filing and Payment Deadlines

IRS Notice 2020-23 provides that taxpayers have additional time to file gift, estate, and GST tax returns due after April 1, 2020, and before July 15, 2020, and to pay the taxes due. In addition, the time for filing a request for an extension of time to file is also extended to July 15, 2020, but the extended due date remains six months from the original due date. There is no extension of time for making a late allocation of GST exemption, because a late allocation takes effect on the date of filing.

For more information and updates on the developing COVID-19 situation, visit GT's Health Emergency Preparedness Task Force: Coronavirus Disease 2019.

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