HUSCH BLACKWELL

Advanced Estate Planning Solutions

Responding to COVID-19

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Introduction

At present many of us are facing trying times and are concerned about the future that lies ahead for our families. One bright spot to consider, however, is that there are tools available to provide ongoing support for our loved ones, and these tools can be quite powerful, especially in times of crisis. Effective estate planning now could reap significant benefits for a family, even for generations to come—and that is certainly a comforting notion.

The current favorable conditions for generational wealth planning at this moment stem from three main factors:

- An all-time high in the available exemption from transfer taxes
- Depressed asset valuations
- Low interest rates

Transfer Tax Exemptions

Transfer tax—often referred to individually as the gift tax, estate tax, and generation-skipping transfer (GST) tax—applies at the federal level for residents of the United States and at the state level for residents of a handful of states.[1] The applicable rate for federal transfer tax is gradual but can be generally understood to be 40%.

Fortunately, the federal transfer tax has an exemption amount, currently set at $11.58 million per individual. If the taxable estate of an individual is less than the exemption amount, no transfer taxes should be due upon the individual's death. Thus, the amount that one can currently transfer free of transfer tax during life or at death is $11.58 million (or $23.16 million for a married couple with proper estate planning).

While the current exemption amount provides one of the most powerful ways to preserve wealth through generations, it only remains in effect until the end of 2025. Absent a change in law, it will be reduced by about half on January 1, 2026, down to $5 million (plus an inflation adjustment) per individual; however, it could be reduced by an earlier intervening change by Congress, as well. A change could well happen if the 2020 elections lead to a congressional power shift, or if the massive COVID-19-related economic stimulus and relief packages drive Congress to raise revenues.

The annual exclusion amount is another concept important to consider for estate planning purposes. A donor's use of the annual exclusion amount does not reduce his or her exemption amount, because these transfers are not taxable for transfer tax purposes. The annual exclusion amount is presently set at $15,000 per year, per recipient.

Key Concepts

Transfer tax refers to the combined taxes imposed on wealth transfers during life and at death.

Exemption amount refers to some or all of an individual's assets that are precluded from being subject to the transfer tax.

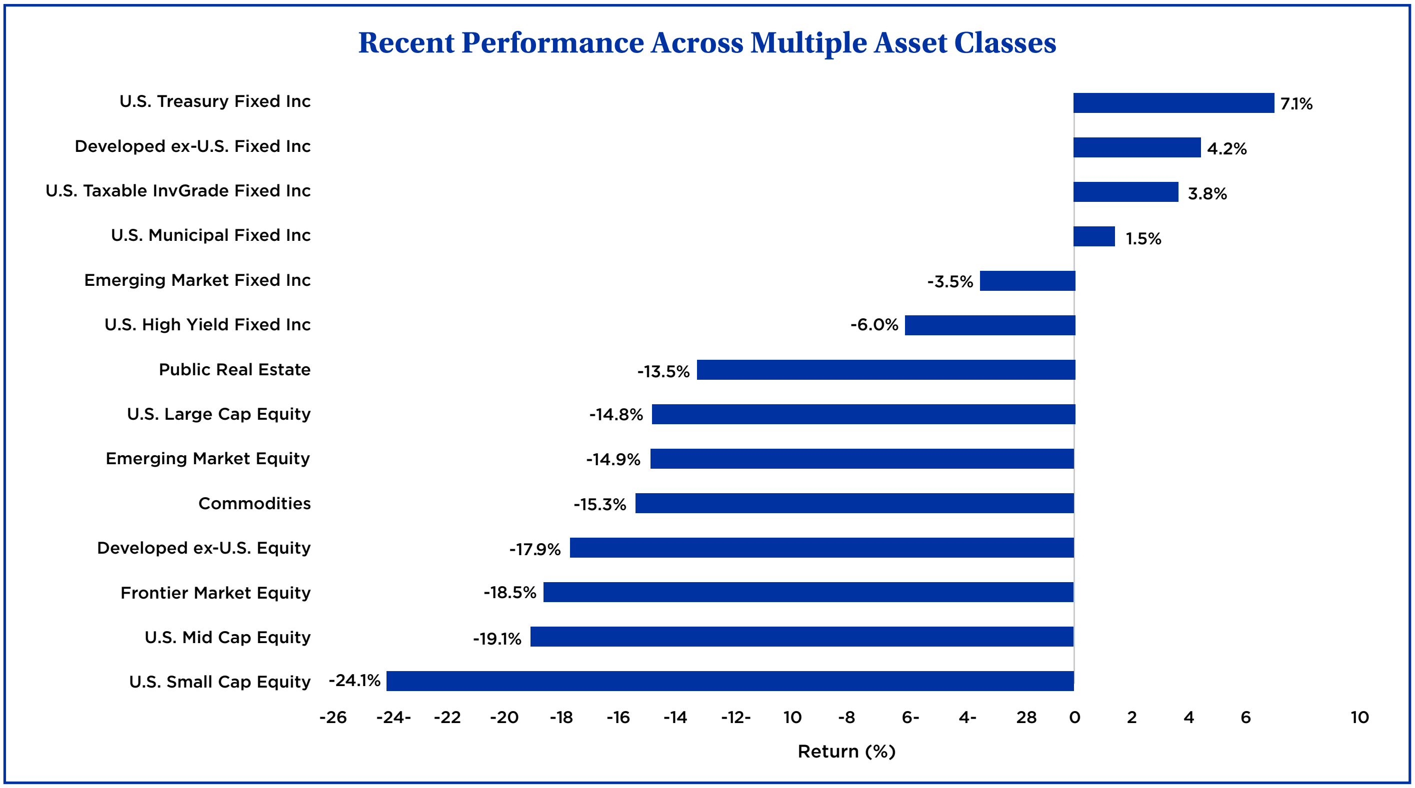
Taxable estate is the total value of assets subject to estate tax after a person dies. This is the person's total assets minus any liabilities.

Annual exclusion amount is the sum that a donor (the taxpayer making the transfer) can transfer to any number of individuals, regardless of relationship, each year without incurring gift tax.

[1] There are some narrow exceptions to the applicability of federal transfer tax. This article assumes individuals and married couples are U.S. citizens not exempt from federal transfer tax. State transfer taxes are not considered further in this article.

Depressed Asset Valuations

Generally, individual or family assets tend to have significant swings in market value over time. In cases like the current year where the global economy has stumbled, the value of marketable securities, real estate, business interests, and most other assets are considerably reduced. Sadly, this can present a challenge for the business and personal lives of the asset owners, but for estate planning purposes it presents a major opportunity.



Sources: Morningstar Direct and Wells Fargo Investment Institute, March 11, 2020. Accessed at https://www.wellsfargo. com/the-private-bank/insights/investing/wfii-investment-strategy-report/ on April 15, 2020.

Simply put, when a given asset's value is lower, it reduces the value of one's taxable estate. Such an asset can be transferred in various ways which should "lock in" the depressed value for transfer tax purposes. This permits the donor to transfer the asset while utilizing less of the donor's Exemption Amount. When the asset rebounds in value, that appreciation should no longer be part of the donor's taxable estate and should not use more of the Exemption Amount. This presents an excellent opportunity to transfer assets at lower values, leaving additional Exemption Amount available for future transfers.

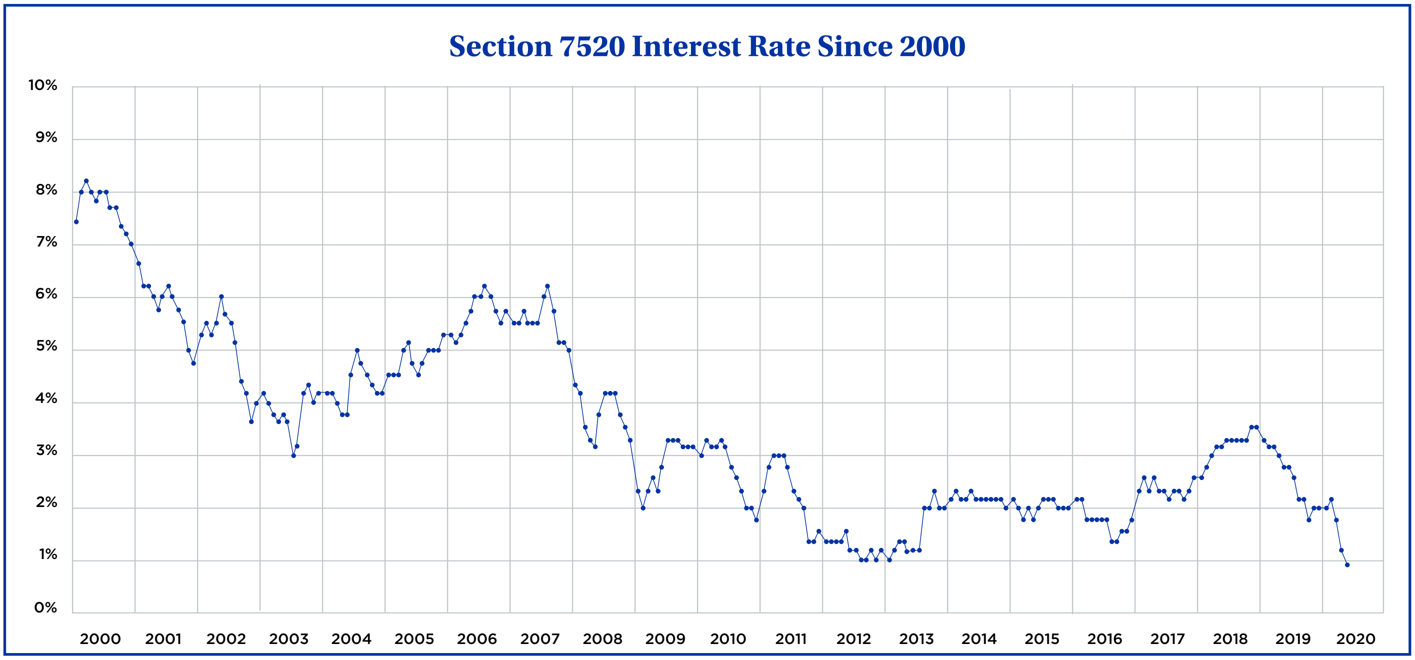
Low Interest Rates

Broadly speaking, interest rates have been historically low for some time. After a brief rise prior to the onset of the COVID-19 crisis, interest rates across the board have once again plummeted. This is favorable for generational wealth planning because the success of many advanced estate planning methods hinges on whether trust assets grow in excess of certain interest rates provided by law. To the extent assets can reliably grow in excess of such rates, the transfer tax savings can be enormous. Further, some methods made viable by low interest rates can still be useful after an individual has already transferred wealth in excess of the Exemption Amount, so they have broad applicability.

Keep in mind that assets with depressed values, as mentioned above, can provide a benefit in addition to the use of less Exemption Amount. Such assets presumably are ripe for appreciation in the years after an economic pullback, so they may be useful in the estate planning strategies that depend on the selection of assets likely to grow in excess of low interest rates.

There are generally two different interest rates important to the estate planning process: the applicable federal rate (AFR) and the Section 7520 Rate. These rates are statutory interest rates determined by the federal government on a monthly basis. The AFR is the minimum interest rate the government allows for loans between related parties. Any interest rate below the AFR rate on a related-party transaction could have adverse tax consequences. The Section 7520 Rate is 120% of the AFR for the applicable month. The AFR and Section 7520 Rate for May 2020 are set as follows:

- Long-term AFR: 1.15% (generally applies to loan terms in excess of 9 years)
- Mid-term AFR: 0.58% (generally applies to loan terms of 3-9 years)
- Short-term AFR: 0.25% (generally applies to loan terms of less than 3 years)
- Section 7520 Rate: 0.8%



Estate Planning Toolbox

Gifts to an Intentionally Defective Irrevocable Trust

One sophisticated solution to take advantage of the favorable estate planning conditions at present is making gifts to certain irrevocable trusts. Specifically, the type of trust used for such planning is often the Intentionally Defective Irrevocable Trust (IDIT). When an individual (grantor) creates an IDIT and transfers assets to it, the grantor is making a taxable gift which can be covered in whole or in part by the grantor's Exemption Amount available at the time of the gift. The assets transferred to the IDIT should not be subject to transfer taxes upon the death of the grantor and future trust beneficiaries. This is sometimes referred to as a "Dynasty Trust."

Unlike direct gifts, where the transferees receive the gifted assets in their individual names, gifts to an IDIT can allow for certain other features of control or asset protection. For example, the IDIT can be designed to (1) make investments on behalf of the beneficiaries, (2) shield assets from the creditors of the grantor and beneficiaries, and (3) provide protection from divorce orders that would otherwise divide assets.

Further, as an additional way to maximize the wealth transferred to the beneficiaries free of transfer tax, an IDIT will contain provisions that cause it to be considered a "grantor trust" for income tax purposes. Such provisions should allow the income tax attributes of the IDIT to flow through to the grantor. This is what causes the IDIT to be called "defective," but it does not undermine the transfer tax benefits of the IDIT. The grantor paying the trust's income taxes allows the trust assets to grow more than they would net of income taxes.

When a grantor pays an IDIT's income taxes, it should not constitute a taxable gift and should reduce the amount of his or her own wealth subject to transfer taxes upon death. The grantor trust provisions also allow the grantor to sell appreciated assets to the IDIT without incurring capital gains taxes. A "Trust Protector" may be given the power to amend the IDIT so that the grantor is no longer taxed on the income from the trust assets and can also provide flexibility to accommodate certain changes in the tax laws and family circumstances.

Beyond the benefits discussed above, making a gift to an IDIT also has favorable effects when depressed assets are used. Such gifts can transfer assets to trusts in a way that "freezes" their depressed value for transfer tax purposes. Appreciation of the gifted assets after the transfer to the IDIT is not subject to transfer tax.

The various risks and drawbacks in flexibility that apply to the use of IDITs and other irrevocable trusts should be reviewed carefully prior to execution.

Sale to an IDIT

Another technique to consider involves taking advantage of the low AFR through the sale of assets to an IDIT. For example, a senior member of a family (transferor) may start by creating an IDIT for the benefit of junior family members. The IDIT should hold assets prior to the sale transaction in order for it to be considered a bona fide purchaser in the sale. Accordingly, the transferor would typically make an initial gift of cash or liquid assets to the IDIT having a value equal to at least 10% of the value of assets to be sold to the IDIT.

Thereafter, the transferor can sell assets at the current depressed valuation to an IDIT in exchange for a promissory note charging the AFR in effect at the time of the sale. The promissory note could be for the entire asset value, thus requiring no cash to change hands at the time of the sale, and the note terms could include favorable repayment terms.

The promissory note should constitute adequate consideration to make such exchange a sale, rather than a taxable gift; therefore, the transferor should not use any of his or her available Exemption Amount in making the sale to the IDIT. Appreciation of the asset in excess of the current AFR (0.25%-1.15%) is shifted outside the transferor's taxable estate.

Just as with a gift to an IDIT, the transferor here can be treated as the owner of the IDIT assets for income tax purposes, making both the sale transaction and the interest payments from the IDIT to the transferor not taxable for income tax purposes.

Intra-Family Loans

Intra-family loans can have significant wealth transfer benefits when executed correctly. The AFR is typically the lowest rate that can be used for such loans, and fortunately, it is at the historic low of 0.25%-1.15% (determined by the term of the note).

Properly made intra-family loans should result in no transfer tax consequences, and if structured as a balloon note that provides for interest-only payments during the term of the loan, the recipient will receive the loan principal without having to make substantial payments during such term. It is often best to use a trust for the benefit of junior family members as the borrower on the loan. The trust can use the loaned assets for investments, purchases, and other desired expenditures inside the trust, or even allow beneficiaries to buy a home or start a business. Over the loan's term, the trust investments will likely grow, the interest payments will be low, and the principal will be returned to the lender. The appreciation beyond the AFR will have effectively been transferred to the trust for the benefit of the junior family members free of transfer tax.

Refinancing Promissory Notes

Beyond just creating intra-family loans, promissory notes are a part of many advanced estate planning methods, and generally the lowest possible interest rate is best. Again, the AFR is typically the lower limit on the interest rate that may be charged, and it is uncommonly low at present. To the extent that junior family members (or trusts for their benefit) owe senior family members funds pursuant to an existing promissory note, refinancing the note to the present lower rates to make it less expensive should be considered. By reducing the interest rate on such loans, junior family members will retain more wealth over time and retain more of the appreciation in the assets that were loaned or sold to them (or trusts for their benefit). Refinancing promissory notes can typically be done as a stand-alone transaction, so individuals and families should not be concerned that refinancing will untangle other parts of their estate plan.

Giving to a Grantor Retained Annuity Trust

A Grantor Retained Annuity Trust (GRAT) strategy could be implemented to (1) transfer appreciating assets to the next generation with little to no use of the transferor's Exemption Amount, and (2) allow the grantor to retain an income stream.

To start, an individual (grantor) gives assets to the GRAT in exchange for a right to annuity payments plus interest for a term of years. The GRAT also designates remainder beneficiaries who will receive the remaining assets of the GRAT when the annuity term ends. The annuity payments provide income to the grantor during the annuity term and pay back the value of the original gift made to the trust, plus the interest calculated at the Section 7520 Rate.

The estate planning benefit comes at the end of the annuity term. Assuming the grantor survives the term, if the trust assets achieve a total net return in excess of the Section 7520 Rate (0.8% at present), there will be a savings in transfer tax. That is because the amount that ultimately counts as a gift to the beneficiaries for transfer tax purposes is limited to the value of the original gift to the GRAT minus the annuity payments and interest returned to the grantor over the term (the "net amount"). The net amount can be designed to equal zero, resulting in no use of the grantor's Exemption Amount. In reality, the remainder that the beneficiaries receive is the net amount (even if zero) plus the excess growth beyond the Section 7520 Rate that was not required to be paid back to the grantor as part of the annuity payments or interest over the term. Given the extremely low Section 7520 Rate, this could allow substantially appreciating assets to be transferred without utilizing large amounts of the grantor's Exemption Amount.

Giving to a Charitable Lead Annuity Trust

Many charitable organizations are facing challenges during these trying times as well. One estate planning technique that is favorable for both charitable giving and generational wealth transfer is making gifts to a Charitable Lead Annuity Trust (CLAT). A CLAT is mechanically similar to a GRAT, except the annuity payments and interest during the term of years are paid to a charity, rather than back to the grantor of the trust. Many families name their Private Foundation as the charitable beneficiary during the term of the CLAT, which provides an effective mechanism for achieving family philanthropic goals and educating younger generations about charitable giving.

To start, the grantor decides what asset(s) to give to the CLAT and what charity should receive the annuity payments and interest. Just like with a GRAT, the grantor also decides the beneficiaries for the remainder, and the benefit comes at the end of the annuity term. If the trust assets achieve a total net return in excess of the Section 7520 Rate (0.8% at present), there will be a savings in transfer tax. The amount that ultimately counts as a gift to the beneficiaries for transfer tax purposes is limited to the value of the original gift to the CLAT minus the annuity payments and interest given to the grantor's preferred charity over the term (the "net amount"). But in reality, the remainder that the beneficiaries receive is the net amount plus the excess growth beyond the Section 7520 Rate that was not needed to fulfill the charitable annuity payments or interest over the term. Given the extremely low Section 7520 Rate, this could allow substantially appreciating assets to be transferred without utilizing any of the grantor's Exemption Amount, all while giving to charity.

Converting a Traditional IRA to a Roth IRA

Not all estate planning solutions require an irrevocable trust. A traditional IRA may be a major component of an individual's assets, and he or she may plan to pass it on to a spouse or descendants. Converting all or a portion of a traditional IRA to a Roth IRA is a choice with complex implications – however, it could be an attractive option in appropriate circumstances. Making such a conversion at a time when one's account balance is depressed both minimizes the income taxes due upon the conversion and allows for future growth to occur tax-free. Further, for those with other resources who may not need to draw from their IRA during life, another benefit is that the converted Roth IRA does not have required minimum distributions at any age.

Gifts to 529 Plan Accounts

Another opportunity to take advantage of depressed asset values is by giving such assets to 529 Plan accounts for the educational needs of family members. The future asset growth will be sheltered from taxation. Much like the IRA conversion strategy discussed above, how to maximize the benefit of 529 Plan accounts can be a complex choice. Giving temporarily depressed assets to a 529 Plan account could be advantageous, especially if the intended recipient is far from the age of drawing on the account. Further, a transferor can front load up to five years of his or her annual exclusion amount as a gift to a 529 Plan account. Such gift does not use the transferor's Exemption Amount, and again, the growth of the assets is sheltered from further taxation.

Husch Blackwell Private Wealth

Husch Blackwell serves a wide range of clients, from moderate estates and high-net-worth families to Fortune 500 executives and celebrities from the sports and entertainment industries. We also routinely advise donors on the creation and operation of public and private foundations, supporting organizations and charitable trusts, and we provide comprehensive legal advice to nonprofit and charitable organizations on tax and regulatory compliance and effective operation.

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- Charitable planning
- Business succession planning and exit planning
- Comprehensive tax and estate planning
- ESOP formation and exits
- Estate, gift and generation-skipping transfer tax mitigation and avoidance
- Generation-skipping trust planning
- Gift and estate tax return preparation
- Sophisticated life insurance planning
- Trust and estate administration
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Bill Horton helps individuals and families with a variety of legal objectives – from the creation of foundational estate planning documents to the implementation of sophisticated strategies that maximize tax benefits and preserve wealth for future generations. Bill also works with closely held businesses to serve their succession planning, tax planning and general business needs.

Jared Dodd designs and implements estate plans with an eye to minimizing income, gift, estate and generation-skipping transfer taxes. He also drafts and develops core estate planning instruments and advises business owners on succession plans for transferring and exiting their business.