A Golden Opportunity: Wealth Transfer Planning In 2020

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As we approach the end of 2020 with the distinct possibility that the upcoming election could result in tax law changes, we offer this piece to reinforce and update our thoughts on those strategies that we outlined earlier this year in a piece called “A Silver Lining: Now Might Be An Ideal Time For Estate Planning.”

Four Reasons to Focus on These Strategies Now

Temporarily High Exemptions — The exemption amounts you can gift transfer tax-free to an irrevocable grantor trust are higher now than ever, $11.58 million per person or $23.16 million using gift-splitting with a spouse. Depending on the results of the upcoming election, proposed changes to these exemptions could reduce these exemptions by more than half at such time as any new tax laws might become effective.

Historically Low Interest Rates — Interest rates continue to be at historically low levels. Although we aren’t predicting rates will rise in the near term, they can’t go down significantly from current levels, and they will increase at some point. Low interest rates greatly enhance the effectiveness of several wealth transfer planning strategies.

Potentially Depressed Asset Values — Equity markets generally have recovered from their lows in March, but prices of many individual securities have not recovered nearly as much as market indices. Moreover, the value of certain other types of assets (e.g., real estate or operating businesses) may remain depressed. Depressed asset values that are expected to eventually recover and appreciate can significantly increase the benefits of most wealth transfer planning strategies.

Time for Planning — The design and implementation of effective wealth transfer planning strategies require careful thought. While many of our clients may have time in their schedules to focus on their planning, their attorneys and CPAs may be unusually busy this year, and we expect their ability to handle new engagements will decrease as the end of the year approaches.

Three Strategies to Consider

Gifts to Grantor Trusts — Grantor trusts treat the party who creates the trust as the one who must pay all income taxes so the trust assets can grow without the burden of an income tax. Usually the goal is to gift cash or high-basis assets to these trusts. However, even lower-basis assets with sufficiently depressed values can be utilized. That said, when the value of the gifted assets rebounds, you should consider swapping cash or higher-basis assets for those original lower-basis assets. To maximize the benefits, the trust should be structured as a Dynasty Trust to eventually benefit grandchildren and more remote descendants for as long as state law permits.

Installment Sales to Dynasty Trusts — Once you have already fully utilized your available exemptions, the current low-rate environment is ideal for selling assets to a new or existing Dynasty Trust in order to freeze the depressed value of certain assets in your taxable estate. Attractive assets to sell may include interests in an operating business or investment entity, or derivative contracts that track the value of other interests. The trust should be funded with at least 10% of the value of the sale before the transaction. Any promissory note used for the funding should be secured and must use the applicable federal rate (AFR) as its minimum interest rate.

Current AFRs are extremely low and therefore advantageous. The September rates (with annual compounding) are 0.14% for short-term loans not longer than three years, 0.35% for mid-term loans between three and nine years, and 1.00% for long-term loans over nine years.

For example, if you were to sell a $10 million asset to a Dynasty Trust in exchange for a nine-year note with a balloon payment at the end of the term, and the asset grows at an annualized rate of 5%, approximately $5.13 million could be transferred to the trust at no transfer tax cost. Higher growth rates would make the strategy even more effective.

***Annuity Trusts (GRATs and CLATs*)** — Other options for transferring assets in this low interest rate environment that wouldn't require utilizing any transfer tax exemption are Grantor Retained Annuity Trusts (GRATs) and Charitable Lead Annuity Trusts (CLATs).

With a GRAT, you retain the right to receive an annual annuity for a term of years. The total annuity payments are structured to equal the current value of the asset transferred to the trust, plus required interest. These are called "zeroed-out" GRATs because the amount calculated to remain at the end of the annuity period is nominal. Any increase in the value of the gifted asset during this period (typically two years) remains in the trust to benefit a spouse and/or children. The trust cannot be used to make tax-free transfers that benefit grandchildren or more remote descendants.

Annuity trusts work especially well when the gifted asset has significant growth potential, like a specific security or interest in a partnership with a depressed value. The required interest rate for annuity trust transactions (the Section 7520 Rate) in September is 0.4%, the lowest rate since 2013. For example, if you funded a GRAT with a $5 million security or partnership interest that grows at an annualized rate of 10% for two years, over $790,000 would be transferred to children with no transfer tax due.

A CLAT would utilize essentially the same structure as a GRAT, except that instead of the grantor retaining the annuity stream, the annuity is paid to charity. The CLAT can also be "zeroed-out" and would run for a longer term. For example, using the current Section 7520 rate, a $5 million zeroed-out 20-year CLAT with a level annuity payment of approximately $260,000 and assuming 6% annual growth would result in a remainder of almost $6.5 at the end of the 20 years. Moreover, a donor advised fund (aka "DAF") can be the recipient charity for the annuity payments. If the GRAT is structured as a grantor trust, the grantor would be entitled to an income tax deduction in the year that it is set up equal to the present value of the annuity payments.

Valuations

Note that for any of these strategies, in most circumstances, current law permits the value of a gift of an asset that is subject to a lack of control or a lack of marketability to be discounted from its current fair market or appraised value based on a qualified appraisal. Applying appropriate valuation discounts to such assets can materially enhance the benefits produced by these strategies. The ability to obtain these discounts may be limited, or even eliminated, by some proposals that could be implemented in 2021.

Implementation

If you are a client of Gresham, please contact us to discuss your current estate plan, explore any of these advanced planning techniques, or consider other wealth transfer planning strategies.