Wealth Transfer Strategies to Consider in the Age of COVID-19

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The COVID-19 pandemic has disrupted our lives and shifted our priorities in an unprecedented manner. Against this backdrop of uncertainty, though, opportunities in estate planning abound. Basic planning documents, such as Wills, Powers of Attorney and Living Wills, have been widely discussed as a result of present circumstances. However, sophisticated wealth transfer strategies, which the firm has employed on behalf of clients for years, are even more attractive and should be considered in this environment of depressed values for securities, real estate and business interests, historically low interest rates, and temporarily increased gift and estate tax exemptions. This Client Alert will highlight some of these opportunities and explain why one may wish to engage in more complex planning at this time.

Favorable Exemption Amounts

Presently, the federal estate and gift tax exemption is $11,580,000 per person. Married couples have the ability to combine their exemptions to $23,160,000 by either splitting gifts during their lives or taking advantage of a portability election upon the first to die. Under current law, these exemptions will be cut in half after 2025; given the mushrooming national debt, they could be reduced by Congress at any time before then.

The New York estate tax exemption is currently $5,850,000 per person. Unlike the federal exemption, there is no ability for married couples to combine their New York exemptions. To make matters worse, the New York State estate tax exemption phases out rapidly so that there is no exemption for a decedent whose taxable estate exceeds the exemption amount by 5% or more.

There is presently no New Jersey estate tax (though speculation persists of its potential return), but the New Jersey inheritance tax remains. Neither New York nor New Jersey imposes a gift tax.

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Outright Annual Exclusion Gifts

Any person may presently make an outright gift of cash, securities, or other property of a value of $15,000 or less annually (for a married couple up to $30,000) to any number of individuals without "using up" any of his or her estate tax exemption – these are called Annual Exclusion Gifts.

Gifts in excess of the Annual Exclusion amount are counted against an individual's estate tax exemption available at death. Since all future appreciation on the value of the gifted property is then out of the donor's estate, there is an incentive to gift property that has declined in value but is expected to rebound now.

Intra-Family Sales and Loans at Historically Low Interest Rates

In a time of depressed asset values, selling assets to family members (or to trusts for them) can be an effective planning tool. In practice, client would sell an income producing asset to a family member and, in return, take back a Note for the sale price. Typically, the sale price would be set based upon a bona fide appraisal, taking advantage of available valuation discounts. The Note would require payment of interest only for a number of years with a balloon payment at the end of the Note term.

A client will usually look to sell assets expected to appreciate and charge as low an interest rate as possible. The Internal Revenue Code provides guidance as to the acceptable interest rates that can be used in these intra-family transactions by issuing monthly Applicable Federal Rates (AFRs). The AFRs relate to the term of the loan involved. As of June 2020, the AFR for a loan of less than three years is 0.18%; the AFR for a loan of more than three but less than nine years is 0.43% and the AFR for a loan of more than nine years is 1.01%.

In an intra-family loan transaction, the client would loan a family member money at the AFR for an agreed term. The family member would then invest the borrowed amount and, if the return on the investment exceeded the AFR, when the Note matured the "profit" would be retained by the family member. This is a simple and convenient way for a wealthy parent to allow a child to take advantage of an attractive investment or business opportunity.

Families with existing intra-family Notes should consider refinancing them now at current, lower interest rates.

Grantor Retained Annuity Trusts

In a Grantor Retained Annuity Trust (GRAT) transaction, the client creates a trust and transfers assets to the trust in exchange for periodic annuity payments for a specified term. Commonly, the value of the stream of annuity payments to be received by the client is calculated to equal as closely as possible the value of the asset transferred, so that no taxable gift is made (a "zeroed out" GRAT). Thus, over the course of the GRAT term, the client gets back all of the property contributed plus some minimal interest.

If the value of the asset transferred to the GRAT appreciates at the same rate or higher than the Code Section 7520 rate (120% of the mid-term AFR) during the GRAT term, the excess appreciation will be transferred gift tax free to the person or persons designated to receive the property at the end of the GRAT term. For June 2020, the Section 7520 rate, known as "the hurdle rate," is only 0.6%.

The only risk to creating a GRAT is that if the client dies before the GRAT expires, the value of the GRAT assets at his or her death will be included in their taxable estate; the client is, of course, no worse off than if the strategy had not been tried except for incurring the costs of creating the GRAT. To limit this risk, most GRATs are structured to last for only two or three years.

Sale to an Intentionally Defective Grantor Trust

A more complex variation of an intra-family sale is an installment sale to an intentionally defective grantor trust (IDGT). The term "defective" is a bit of a misnomer, as there is nothing truly defective about the trust itself. Rather, the term relates to the trust having been designed so that transfers to the trust are completed gifts for gift tax purposes and, therefore, are not included in the client's taxable estate at death, but that the income generated by the assets in the trust is taxed to the client. Typically, a client using this strategy will establish a trust and will "seed" it with a cash gift, usually about 10% of the total value of the assets to be sold to the trust. The client then sells an income producing asset to the trust (typically a fractional interest in a property or a family-owned business) in exchange for an installment Note at the applicable AFR.

The sale to an IDGT freezes the value of the asset at the value of the promissory Note (again, a bona fide appraisal determining the value of the asset sold to the IDGT, applying available valuation discounts, will be required). Any future value appreciation in excess of the interest rate on the promissory note inures to the benefit of the IDGT without gift or estate tax consequences to the client. Further, receipt of the Note payments by the client is not a taxable event, as the client is treated as the owner of the IDGT's assets for income tax purposes, and the sale of the asset by the client to the IDGT produces no capital gains tax, as the client is treated as having sold the asset to himself or herself.

Consideration should be paid to the asset chosen to be sold in any such transaction. Since the assets sold to the IDGT will not be included in the client's taxable estate, there will be no tax-free step up in basis at the client's death. As such, assets with a very low tax basis may not be appropriate for use in such a transaction, as their future sale by the trust could result in capital gains tax liability. Funding the IDGT with income-producing assets is preferable since that income will allow the IDGT to service the promissory Note without needing to fund Note payments to the client with a portion of the assets originally sold to the IDGT.

These are several examples of popular intra-family wealth transfer strategies which work particularly well in a low interest rate environment. Opportunities to take advantage of these unprecedented and historically low AFRs and reduced asset values may not be appropriate for everyone. Thoughtful consideration must be given to a client's individual circumstances and goals in the design and implementation of any coordinated estate plan.

Our team of experienced trust and estate planning professionals remains fully operational and are working remotely to meet our clients' estate planning needs. Clients who wish to execute estate planning documents during the COVID-19 pandemic have generally been able to do so from home, taking advantage of recent legal guidance that allows remote witnessing and notarization via video conference.

Please contact the authors of this Alert with questions or to discuss your specific circumstances and estate planning needs.

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