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Estate Planning Essentials During COVID-19

Hosted By Smith, Gambrell & Russell:

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Gifts

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Federal Gift Tax Basics

- Current exemption amount is $11.58m (indexed for inflation) per person, or $23.16m per couple
- Gifts above the exemption amount are taxed to the donor at 40%
- Unless Congress acts, the exemption amount will be cut in half in 2026
- Gifts of $15,000 or less qualify for the annual exclusion
- Be aware of state transfer taxes

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Market Conditions

- June Applicable Federal Rates are at record lows making intrafamily loans, installment sales to grantor trusts, and GRATs very attractive:
  - Sec. 7520 rate: 0.6%
  - Short-term AFR: 0.18%
  - Mid-Term AFR: 0.43%
  - Long-Term AFR: 1.01%
- Rates are expected to increase in July
- While major market indices have largely recovered, some sectors of the economy continue to struggle
- Industry-specific economic issues and general market uncertainty could depress valuations for privately owned business valuations

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Gifting Considerations

- Discount values and freeze estate from further growth
- Use exemption before 2026
  - Requires a large gift
- Access
- Generation-skipping transfer (GST) tax issues
- Basis step-up at death
- Non-tax considerations

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Asset Types

- Assets to consider for gifting:
  - Life insurance policies
  - Non-voting interest in an operating business or investment entity
  - Low-value assets that could significantly appreciate
  - Marketable Securities
  - Real Estate

Intrafamily Loans

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Why Loans to Family Members

- Purchase of residence
- Starting a business
- Child wants to make an investment
- Parent wants to make an investment

Why Loans Instead of Gifts

- Estate tax exclusion already used (or plans to use it for other gifts)
- An investment, not a gift
- Avoid treating children unequally

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Why Loans Right Now

- The answer is simple: Low Interest Rates!
- Applicable federal rates, June 2020: 0.18% to 1.01%
- By comparison, June 2019: 2.36% to 2.74%
- By comparison, June 2000: 6.29% to 6.43%
- By comparison, June 1984: 10.00% to 11.25%

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How to Make a Loan

- Document it: Promissory note
- Charge interest
- Consider requiring security (mortgage, deed of trust, security interest)
- Set a clear payment schedule for principal and interest

How to Administer a Loan

- It's OK to be the Bank of Mom & Dad, but…

  Emphasize the Bank part!
- Collect payments when due
- Keep records of payments, non-payments, forgiveness
- Keep the original promissory note
- Record any mortgage/deed of trust

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Gift Tax Issues

- Avoid having the loan recharacterized as a gift
- Proper documentation
- Proper administration
- Expectation of repayment
- Ability of borrower to repay

Income Tax Issues

- Below market loan rules
- Loans with interest less than applicable federal rate, or no interest
- “Forgone interest” may be imputed gift from lender to borrower, and imputed income to lender
- Solution: Charge interest at the applicable federal rate

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Applicable Federal Rate

- Published monthly by IRS
- Short-term: 3 years or less
- Mid-term: 9 years or less
- Long-term: More than 9 years
- Compounding (monthly, quarterly, semi-annually, annually)
- Term loans vs. demand loans

Existing Loans

- Refinance existing loans
- Clean up loans with unclear documentation
- Consider forgiving interest (annual exclusion)
- Consider forgiving principal (annual and lifetime exclusion)
- Loans from irrevocable trusts

Loans in Estate Administration

- If borrower is not a beneficiary: continue or forgive
- If borrower is a beneficiary: forgive in addition to other gift/bequest
- If borrower is a beneficiary: distribute to beneficiary as part of beneficiary's share of estate/trust

Grantor Retained Annuity Trust (GRAT)

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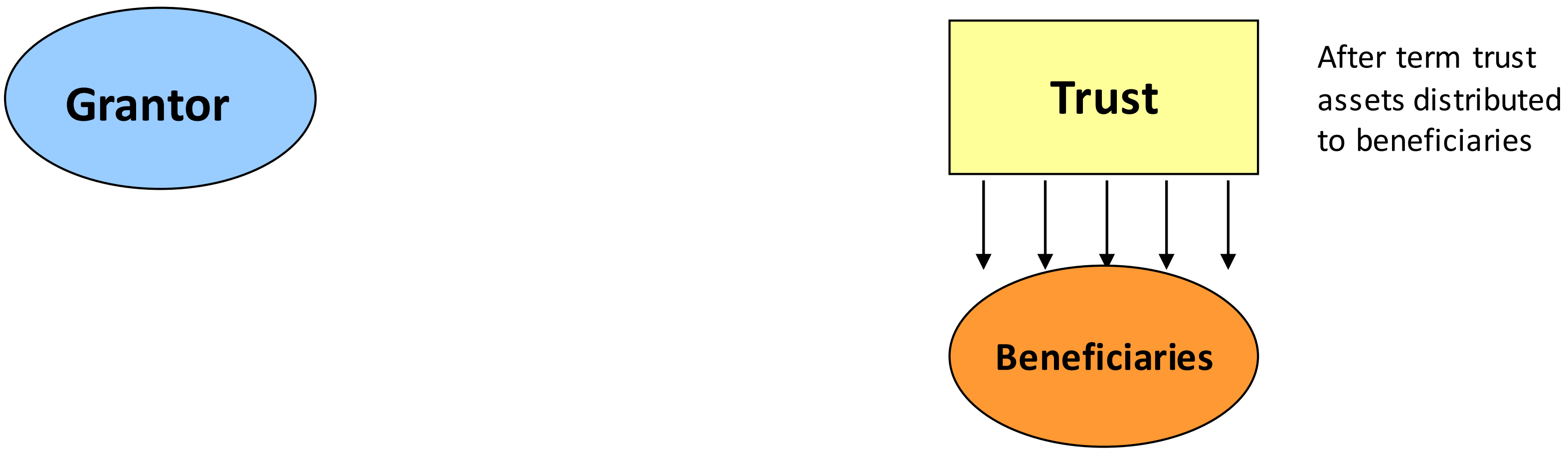
Grantor Retained Annuity Trust ("GRAT")

- Obtains a present value discount for gift tax purposes, such that the gift has an actuarial value of almost zero.
- GRAT pays the Grantor an annuity for a term of years; remainder passes to beneficiaries free of gift tax.
- The annuity paid to the Grantor is based on a rate of return which is set by the IRS (the § 7520 rate; .6% in June 2020). If the income and appreciation exceed the "hurdle" rate, the excess property will pass to the beneficiaries at the end of the GRAT term.

Grantor Retained Annuity Trust (“GRAT”)



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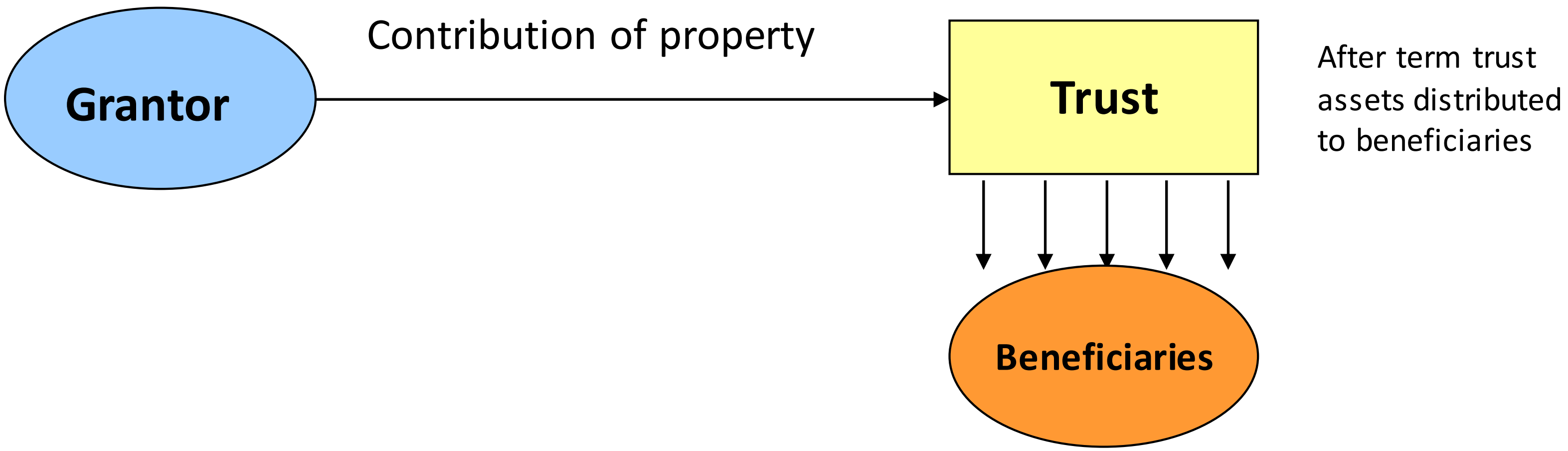

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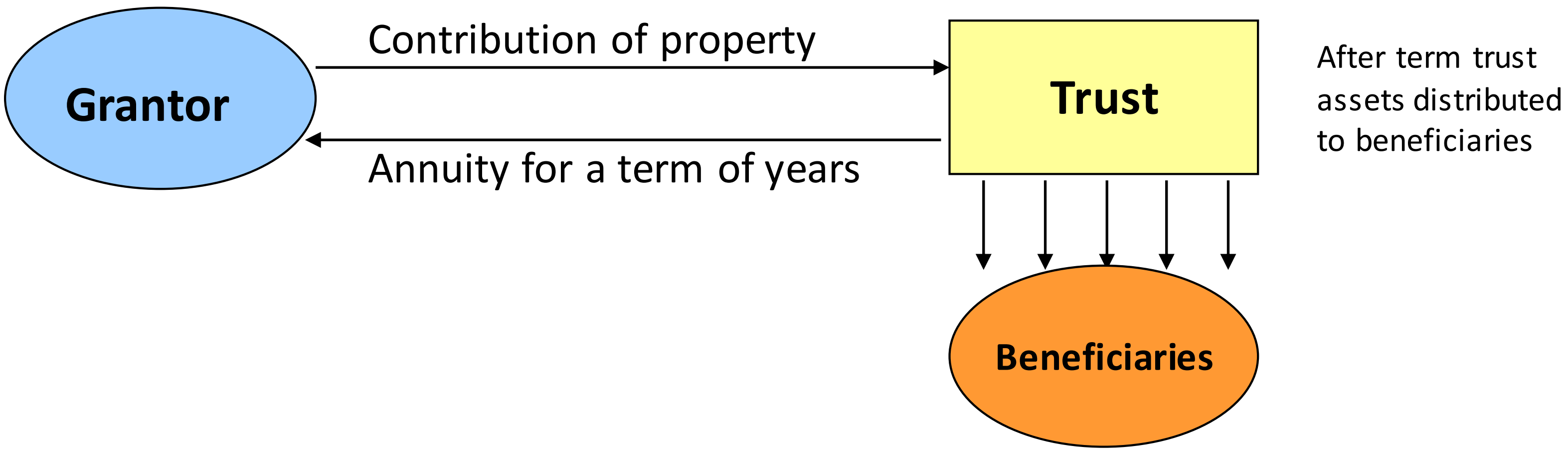

Grantor Retained Annuity Trust ("GRAT")

- In June, 2020, Mom, age 60, transfers assets worth $10 million to a GRAT retaining the right to receive an annuity of $5,045,154 for 2 years. If the assets in the GRAT appreciate by 7% per year, then at the end of the two year term, $1,005,531 will pass free of gift tax to the remainder beneficiaries.

- For gift tax purposes, the value of the gift made by Mom is $0.26.

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Grantor Retained Annuity Trust ("GRAT")

• Transfer to GRAT- June 2020	10,000,000
• Total return 6/20 to 6/21 @ 7%	700,000
• Value of GRAT – June 2021	10,700,000
• Annuity paid to Grantor	(5,045,154)
• Value of GRAT after June 2021 annuity payment	5,654,846
• Total return 6/21 to 6/22 @ 7%	395,839
• Value of GRAT – June 2022	6,050,685
• Annuity paid to Grantor	(5,045,154)
• Value of GRAT after June 2022 annuity payment	**$1,005,531**
• Tax free gift	**$1,005,531**

Sale to Grantor Trust

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What is a Grantor Trust?

- "Grantor" is the person who creates and contributes assets to the Trust
- Irrevocable trust
- Treated as "owned" by Grantor for income tax purposes (because of certain rights retained by Grantor)
- Not included in Grantor's estate for estate tax purposes

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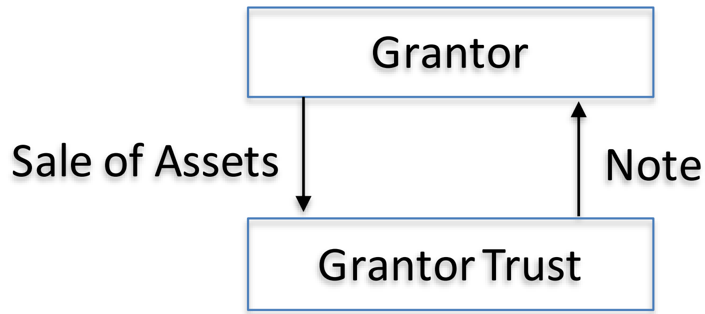
How Does It Work?



- Trust should be "seeded" with cash equal to approximately 10% of the amount of the sale price, which will be a gift.
- Grantor then sells assets to the trust in exchange for a promissory Note.
- Flexibility in how the Note is structured
  - Term: can be short term, mid-term or long term
  - Payments: can be amortized, interest only, or structured payments
  - Must charge interest at least equal to the Applicable Federal Rates ("AFR") published monthly by IRS to avoid gift tax issues
  - Current AFRs (June 2020)

Short term:	0-3 years	0.18%
Mid-term:	3-9 years	0.43%
Long term:	9 years or longer	1.01%

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Tax Implications

- No capital gain on the sale of assets to the trust, because the Grantor is considered the owner of the trust for income tax purposes.
- Grantor will pay the tax on any income earned by the trust, thereby increasing the amount of assets available to the trust beneficiaries. Also depletes Grantor's estate.
- Freezes the value of the assets sold to the trust at today's values, thereby removing the appreciation from Grantor's estate.
- Little use of gift tax exemption.

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Example

1. Gift to Grantor Trust $ 1,000,000
2. Sale to Grantor Trust 9,000,000
3. Note to Grantor:
   - Term: 9 years
   - Interest rate: 0.43% (mid-term AFR)
   - Payment: Interest only; balloon payment at end
4. Annual interest payments
5. Assume: growth at 5% annually

Year	Value	Growth	Payment	Remaining Balance – Year End
1	$ 10,000,000	$ 500,000	$ 38,700	$ 10,461,300
2	10,461,300	523,065	38,700	10,945,665
3	10,945,665	547,283	38,700	11,454,248
4	11,454,248	572,712	38,700	11,988,260
5	11,988,260	599,413	38,700	12,548,973
6	12,548,973	627,449	38,700	13,137,722
7	13,137,722	656,886	38,700	13,755,908
8	13,755,908	687,795	38,700	14,405,003
9	14,405,003	720,250	38,700	15,086,553

Value, end of year 9	$15,086,553
Principal due to Grantor	(9,000,000)
Value remaining in trust	6,086,553
Gift	(1,000,000)
Appreciation	$5,086,553

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Why to Use Sale to Grantor Trust

- Very Flexible
  - Trust can benefit spouse, children and more remote descendants
  - Grantor can allocate generation-skipping tax exemption to the gift contributed to the trust, so will eliminate GST tax on distributions to grandchildren and more remote descendants
  - Removes appreciation from estate with little gift tax cost
  - Grantor’s payment of income tax on trust income is like giving the beneficiaries a tax free investment
  - Grantor generally has the ability to substitute assets of equivalent value
  - Substitution power can be used to swap out trust assets with low basis and lock in gains
  - Can forgive portion or all of Note to make a gift

Issues to Consider

- No code section authorizes this technique
- Question about whether gain is recognized at Grantor's death
- Question about basis of assets sold
- Need to consider note payment strategies (both interest and principal)

When to Use Sale to Grantor Trust

- Asset values depressed
- Interest rates low
- Have assets expected to appreciate substantially
- Have already used most if not all gift tax exemption

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Questions?

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