Making the Most of a Downturn: Estate Planning Opportunities in a Low Interest Rate and Low Value Environment

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Covid-19 Impact on Estate Planning Environment

Exemption Amounts

- The current gift and GST exemption amounts remain high: $11,580,000/person in 2020.
- Scheduled to sunset to $5,000,000 (indexed for inflation) in 2026.
  - But with no clawback, per Treas. Reg. 20.2010-1(c).
- **November elections could lead to changes.**

Volatile Stock Market and Uncertain Economy

- Market uncertainty as a result of coronavirus.
- While the stock markets, in general, have largely regained the losses incurred in March due to COVID-19, many industries continue to be negatively impacted (Communications, Consumer Discretionary, Energy).

	June 8, 2020	February 20, 2020	4-Month Change
S&P 500	3,232	3,373	↓
Dow Jones Ind. Avg.	27,572	29,220	↓
NASDAQ Composite	9,924	9,751	↑
NYSE Composite	12,836	14,061	↓

Covid-19 Impact on Estate Planning Environment

Closing Stock Price		
	June 8, 2020	February 20, 2020
Carnival Corp.	$24.91	$42.50
Nordstrom	$23.56	$40.56
Xerox	$19.87	$36.31
Schlumberger	$23.65	$34.06
Delta Airlines	$36.97	$58.38

- Mandatory closures, quarantines, fear and other factors have slowed the economy and decreased valuations and increased risk of a wide range of businesses and property, especially closely-held businesses.

Covid-19 Impact on Estate Planning Environment

Low Interest Rates

- Federal Reserve further reduced nearly historic low interest rates to help stabilize the economy during this pandemic. Likely to continue this policy.
- Could result in lowest rates in history.

Annual Rate	June 2020	June 2018	June 2015
Short-term AFR	0.18%	2.34%	0.43%
Mid-term AFR	0.43%	2.86%	1.60%
Long-term AFR	1.01%	3.05%	2.50%
§7520 rate	0.60%	3.40%	2.00%

Political Uncertainty

Joe Biden

Income Tax

- Increase top capital gains rate to 39.6% for income above $1 million.
- Restore top ordinary tax rate to 39.6% for income above $400k
  - Example (ordinary rates, single taxpayer):

Income	Current Rate	Biden Rate
$0-$9,875	10%	10%
$9,876-$40,125	12%	12%
$40,126-$38,700	12%	12%
$38,701-$85,525	22%	22%
$85,526-$163,300	24%	24%
$163,301-$207,350	32%	32%
$207,351-$250,000	35%	35%
$250,001-$400,000	37%	37%
$400,001-$518,400	37%	39.6%
$518,401-$2,000,000	37%	39.6%
$2,000,001-10,000,000	37%	39.6%
>10,000,000	37%	39.6%

Source: https://www.forbes.com/sites/anthonynitti/2020/03/06/tale-of-the-tape-comparing-the-tax-plans-of-joe-biden-and-bernie-sanders/#4794ab324443

Estate Tax

- Eliminating basis step-up, taxing unrealized appreciation at death.
- Returning estate tax exemption to $3,500,000.
- Returning estate tax rate to 45%.

How Do You Approach This with Clients?

- Virtually everyone feels financially vulnerable in these uncertain times, and estate planning might not be their main focus right now.
- Focus on the opportunity and the possibility that the landscape could change in November.
- Focus on long-term family mission.
- Start with the basics.
- Basic economics: $1,000,000 9-year balloon loan at mid-term AFR:

Return	Fair Value	Loan Cost	Net Fair Value (9 years)
2%	$1,195,093	$1,039,372	$155,721
4%	$1,423,312	$1,039,372	$383,940
7%	$1,838,459	$1,039,372	$799,087
10%	$2,357,948	$1,039,372	$1,318,576

Valuation Considerations in Uncertain Times

- Valuation Date: What was known or knowable, and when?
- Valuation Considerations:
    - Effect on business: good, bad or neutral?
    - Rebound and recovery
    - Mitigation through capital infusion, forgivable loans, expense-cutting, etc.
    - Normalization Adjustments
        - How are forgivable (or unforgivable) loans treated?
        - How did company (if in existence) survive/handle prior crises (crash of 1987, 2008 recession, 9/11, etc.)
- Valuation Approaches
        - Valuation variables: income and market approaches
        - What is the new norm for expected <u>future</u> cash flow?
        - Public and private markets

Planning Techniques in a Depressed Economy

- Annual Exclusion Gifts
- Fund Irrevocable Trusts with Exemption Amounts
- Implement Grantor Retained Annuity Trusts
- Intra-Family Loans
- Note Sales to Intentionally Defective Grantor Trust
- Charitable Lead Annuity Trusts
- Late Allocation of Generation-Skipping Transfer Tax

Annual Exclusion Gifts

- Annual tax-free gift of $15,000 per person ($30,000 for married couples) excluded from lifetime gift tax exemption amount.
- Rather than making these gifts in cash, client can leverage these gifts by using marketable securities while value is low and take advantage of the appreciation when the market recovers.

Fund Irrevocable Trusts with Exemption Amount

- Current gift and generation-skipping transfer tax exemption amount is $11,580,000 ($23,160,000 for married couples).
  - Scheduled to sunset in 2026 and revert to $5,000,000 ($10,000,000 for married couples), adjusted for inflation.
  - Exemption could be lowered sooner based on election results.
    - Joe Biden has advertised a repeal of the TCJA, bringing the federal exemption back to $3,500,000, and proposed eliminating the stepped-up basis on death.
- Take advantage of high exemption amounts.
  - Treasury Regulation 20.2010-1(c): No clawback.
- Funding a trust with assets while the values are low will allow clients to leverage the gift's future appreciation when the market rebounds (especially Grantor Trusts).

Grantor Retained Annuity Trusts

The time is right to create GRATs.

- The down market, coupled with a low interest rate environment, increases the effectiveness of a GRAT.
  - Current annual interest rate for June is 0.6%, compared with 2.8% in June of last year.
  - Fund with low-value assets. When assets that have temporarily declined in value rebound, they will generate a higher gift-tax-free remainder for trust beneficiaries.
- Example: fund 3-year zeroed-out GRAT with an asset whose value has declined from $10,000,000 to $7,000,000 but is expected to rebound within the GRAT term to $10,000,000, with a 0.6% § 7520 rate:

	Normal Environment	Depressed Environment
Starting value	$10,000,000	$7,000,000
Growth	5%	$3,000,000 + 5%
Annual Payment	$3,373,363	$2,361,354
Remainder	$941,723	$3,659,206
Taxable Gift	$2.72	$1.91

Grantor Retained Annuity Trusts - Continued

Clients with current GRATs

- GRATs that were created in the past year or two may fail due to the decline in stock position and other asset values.
- Discuss options with clients:
  - Annuity payments can be “re-GRATed” once distributed out of the GRAT.
  - In the alternative, be proactive and swap out assets whose value has declined (if permitted) and immediately re-GRAT them.

Grantor Retained Annuity Trusts - Continued

- Should longer-term GRATs be considered?
- The potential Democratic victory in November may affect the future of the GRAT structure.
  - Under President Obama, budget proposals regularly included a minimum term for GRATs (10 years) and minimum remainder interests (gift portion of 25% of initial value)
  - Using a longer-term GRAT may provide additional advantages to the GRAT structure, particularly if interest rates continue to increase over a longer term rather than very quickly.
- The concern is that long-term GRATs have greater mortality risk than short-term GRATS.
  - If the grantor dies before the term is finished, the remaining assets go into the grantor's estate like any other taxable asset.

Intra-Family Loans

New loans

- Client makes a low-interest loan to a trust or family member.
- Borrower could then use the assets to invest and seek a greater return.
- From previous example: $1,000,000 9-year balloon loan at mid-term AFR:

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2%	$1,195,093	$1,039,372	$155,721
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Refinance current loans

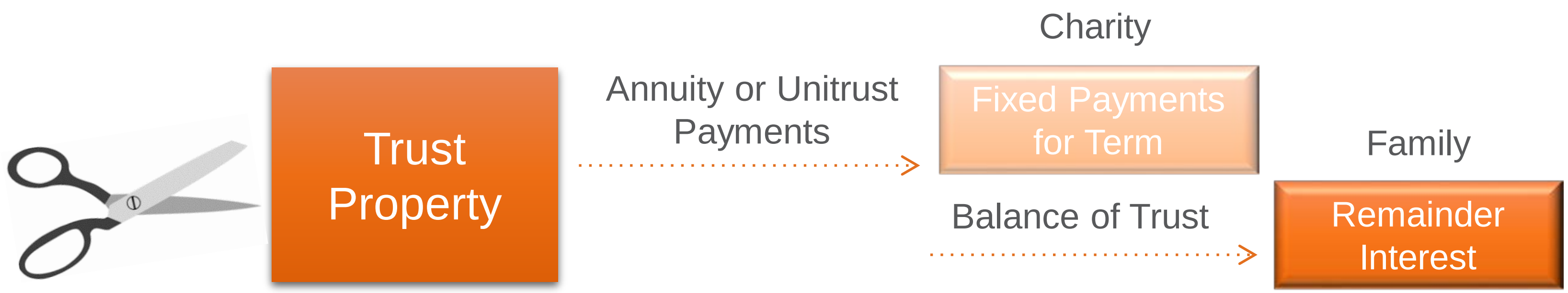
- The dramatic decline in interest rates provides an opportunity for practitioners to review prior transactions and determine whether notes can be renegotiated with a lower interest rate.
- Considerations include:
  - Ability to repay and security of the loan
  - Mere change in interest can be viewed as a gift.
  - Must use an arm's length transaction
  - Regulations §§ 20.2031-4 and 25.2512-4

Note Sales to Intentionally Defective Grantor Trusts

- Client creates a defective grantor trust and sells assets to that trust in exchange for a promissory note. The assets go into the trust and therefore out of the Grantor's estate, but with a swap power under IRC Section 675(4).
  - The Grantor can swap out low-basis assets for higher-basis assets to take advantage of IRC Section 1014(a).
- With historically low interest rates, the trust will pay less in interest than it might have in other times.
- This enhances the value of the overall wealth-shifting technique, similar to using a GRAT, but without the mortality risk.
  - Additionally, GRATs use the Section 7520 rate to determine the value of the gift, which is slightly more than the AFR (specifically, 120% of the midterm AFR, rounded to the nearest two tenths of a percent), while an IDGT note uses the applicable AFR.

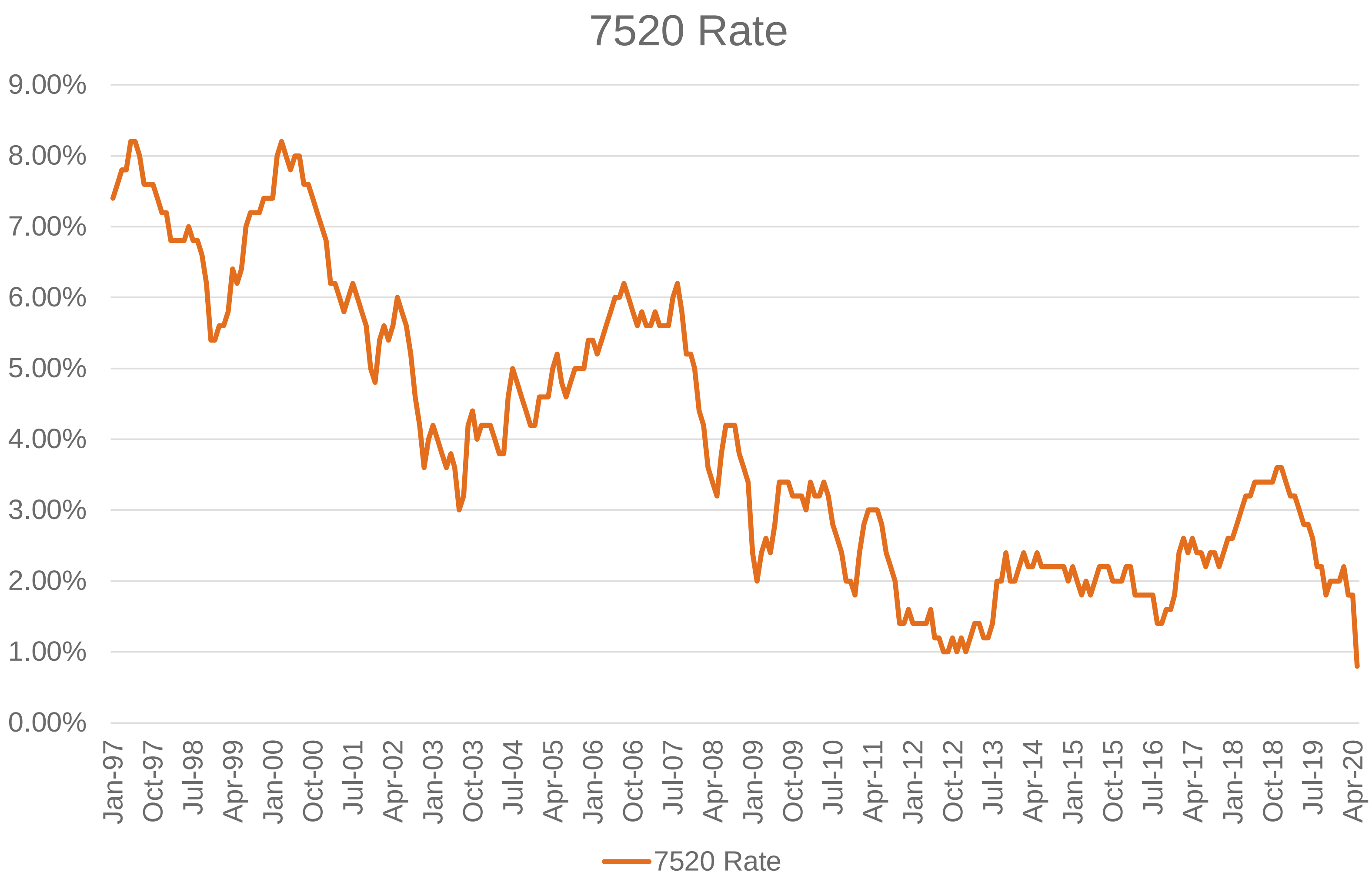
Charitable Lead Annuity Trusts (CLATs)

- Similar to a GRAT, but the annuity is paid to a charity. A CLAT is a “Split Interest Trust,” where the beneficial interests are divided into charitable and non-charitable interests.



- Charitable interest “leads”.
- Donor may retain the remainder interest or give it to other beneficiaries.
- Planning may be “inter-vivos” or “testamentary”.
- Potential for substantial savings in income, estate and gift taxes.

Historically low 7520 rates make this an ideal time to consider a CLAT.



Income Tax Benefits of Charitable Lead Annuity Trusts Grantor or Non-Grantor

	Grantor CLAT	Non-Grantor CLAT
Who pays income tax?	Donor	Trust
Who gets a deduction?	Donor	Trust
When is the deduction?	When trust is created	When income is paid to charity
How much deduction?	Present value of payments to charity	Amount actually paid to charity

CLAT Example: "Zero-out" CLAT - How Big is the Annuity?

- Annuity % depends on trust term and interest rate
- Uses § 7520 rate in effect <u>at inception</u> (or prior two months)
- If low rates rebound and actual growth exceeds 0.6%, the family "wins"
- If the CLAT is funded with $1,000,000 and grows 5% per annum:

Term	Annuity Payout	Charitable Deduction	Family Remainder
5 years	$203,620	$1,000,000	$151,152
10 years	$103,330	$1,000,000	$329,221
20 years	$53,210	$1,000,000	$893,859

- Asset with depressed value expected to "rebound" will improve return to family

Late Allocation of GST Exemption

- GST exemption is currently high ($11,580,000).
- Current value of assets in the trust may have declined, providing an opportune time to make a late allocation.
  - Reg. Sections 26.2632-1(b)(4)(ii) and 26.2642-2(a)(2)
- For a trust with an inclusion ratio greater than zero, essentially allocate available GST exemption equal to: [TRUST value] x [inclusion ratio]

Biography: Kenneth J. Pia, Jr.

Kenneth J. Pia, Jr. is a partner in the Business Valuation Services group. With more than 25 years of professional business valuation and litigation support experience, Mr. Pia has developed a national reputation working on a wide range of complex valuation engagements. He has performed valuations of businesses and partial business interests for a variety of purposes including, but not limited to, family law matters, employee stock ownership plans, business damages, buy-sell agreements, shareholder litigation, estate and gift tax matters, and buying and selling businesses.
Mr. Pia is heavily involved with the American Society of Appraisers (ASA). He is the chairperson of the ASA's Business Valuation Committee, is a member of the National Business Valuation Education Committee, and teaches nationally for the ASA's accreditation program. Mr. Pia is also a charter member of the American Academy of Matrimonial Lawyers Foundation's Forensic & Business Valuation Division and was recently named to the American Academy for Certified Financial Litigators Advisory Board for New York and Connecticut.

Mr. Pia is a frequent speaker on business valuation topics on the national and local levels for numerous professional organizations, including the American Bar Association, American Institute of Certified Public Accountants, American Academy of Matrimonial Lawyers, and National Center for Employee Ownership. In addition to teaching for the ASA's accreditation program, he previously instructed for the American Institute of Certified Public Accountants' Certificate of Educational Achievement (CEA) program in business valuation. He is also an Adjunct Professor at Quinnipiac University. Mr. Pia has technically reviewed publications on divorce finance and taxation for the American Bar Association, as well as several books on business valuation. In 2007, he was appointed as one of two appraisers to the State of Connecticut's Eminent Domain Task Force, established to determine the methodologies to be used in the calculating lost intangible economic value of businesses due to the state exercising domain rights.

Mr. Pia has been qualified as an expert witness in Federal District Court and the State Courts of Connecticut and New York, as well as various arbitration proceedings. He has also rendered extensive services relating to court testimony.

Mr. Pia is on the State of New York Courts' list to receive court appointments in the following counties: New York, Kings, Richmond, Queens, Nassau, Suffolk, and Westchester. He has received court appointments in New York and Connecticut.

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- Business Valuation
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- Matrimonial Litigation
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- Employee Stock Ownership Plans

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Biography: Louis Piscatelli

Lou is a partner in the private client and tax team.

He concentrates his practice on estate planning and administration, income tax planning and commercial transactions with a particular emphasis on planning for closely held businesses. His work for clients focuses on a variety of matters, that touch on creating wealth and business succession structures to general legal business advice and spans a wide range of industries including real estate, manufacturing, and professional services.

In addition to serving as Managing Partner for the New Haven office, Lou leads the Firm’s Trust & Estates department on the East Coast.

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