ROBERTS & HOLLAND LLP

NEW YORK
(212) 903-8700

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(202) 293-3408

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ESTATE & GIFT TAX PLANNING NEWSLETTER

ESTATE PLANNING OPPORTUNITIES IN TIMES OF ECONOMIC UPHEAVAL

By: Stuart J. Gross, Quincy Cotton and Bonnie J. Daniels

The coronavirus pandemic has upended life as we know it, wreaking havoc on local and global economies, slashing investment portfolio values, and driving down interest rates to almost zero. At the same time, the federal estate and gift tax exemption amount is at a record high. The unique intersection of depressed asset values, low interest rates and a high exemption amount opens up important estate planning opportunities.

Today's federal gift and estate tax exemption amount is approximately $11.58 million, double what it was in 2017 and double what it will revert to in 2026 absent a change in law (there is speculation that the exemption could be reduced sooner, depending on the 2020 election). Treasury regulations clarify that a gift that uses the current exemption amount will not later be "clawed back" upon the death of the donor after the exemption amount has been reduced. Accordingly, there is a "use it or lose it" aspect to current gift and estate planning for individuals with taxable estates.

Gifts are particularly tax-efficient for New Yorkers for two reasons. First, New York imposes an estate tax with a top rate of 16% but does not impose a gift tax (however, gifts within three years of death are "added back" for New York estate tax purposes), and gifts do not use up any New York exemption. Second, the New York estate tax exemption amount, currently $5.85 million, rapidly phases out for taxable estates exceeding the exemption amount. There is effectively no exemption for a New York taxable estate that exceeds the exemption amount by 5% or more. This "cliff" effect means that a taxable estate in excess of about $6.14 million (today) is subject to New York estate tax in full even though a taxable estate of $5.85 million would not owe any New York estate tax. Thus, gifting assets (and surviving the gift by three years) reduces the assets subject to New York estate tax at no New York gift or estate tax cost.

The present economic conditions combined with the gift and estate tax rules described above present significant estate planning opportunities. Assets with depressed values that are expected to rebound can be ideal assets to gift. In addition, estate planning techniques that shift future appreciation to future generations without generating gift or estate tax are particularly effective in a low interest rate environment. One extremely simple technique is an intra-family loan. Suppose Senior has an investment opportunity that she believes has significant upside potential. Rather than making the investment herself, Senior lends funds to Junior and Junior makes the investment. The loan must bear interest at the minimum IRS interest rate for the month the loan is made. These "applicable federal rates" (AFRs) have been low for a quite a while, but they have plummeted to new depths for loans made in May, 2020: a paltry 0.58% for a loan of more than 3 and up to 9 years! The rate is 0.25% for a loan of up to 3 years and 1.15% for a loan of more than 9 years.

A more sophisticated technique that takes advantage of low asset values and low interest rates is a sale to a so-called "intentionally defective grantor trust," or IDGT. Transfers to the IDGT are completed gifts for gift tax purposes (therefore not included in the donor's estate for estate tax purposes), but the donor continues to be treated as the owner of the IDGT assets for income tax purposes. This produces extremely favorable results. Suppose Senior already owns the investment with significant upside potential described above. She can transfer that investment to an IDGT in exchange for the trust's 9-year promissory note with interest at 0.58%. This freezes the value in Senior's estate at the amount of the promissory note. The IDGT benefits from all appreciation in excess of the 0.58% interest rate, free of gift or estate tax. Because of the special income tax status of the IDGT, (i) there is no capital gains tax on the sale of assets to the trust for the note, (ii) there is no income tax on interest paid to Senior on the note, and (iii) Senior continues to pay income tax on income earned by the underlying assets even though that income is received by the IDGT (not Senior).

It is important that the IDGT have sufficient seed capital to create a reasonable debt-equity ratio (ideally, the debt should not exceed 80% of the value of the trust assets, although more aggressive taxpayers often go up to a 90% ratio). This seed capital may be gifted to the trust at the time of the transaction: the gifted portion is sheltered by Senior's gift tax exemption and the excess of the value over the gift is sold for the promissory note. One feature of the transaction that is important to understand is that the trust succeeds to Senior's income tax basis in the transferred assets (including the portion that is sold for the trust's promissory note), and there is no "basis step-up" at death for assets not included in Senior's estate for estate tax purposes. For this reason, this technique may not be the best choice for assets with extremely low basis or that are subject to debt in excess of basis (such as a partnership interest with a negative tax capital account).

Another technique that freezes the donor's assets at current values is the grantor-retained annuity trust, or GRAT. In this technique, the donor transfers assets to the GRAT in exchange for the right to receive a stream of annuity payments for a stated period (usually two years). The donor's gift occurs on the date the GRAT is funded. The amount of the gift determined for gift tax purposes is the excess (if any) of the value of the assets transferred to the GRAT over the value, based on the IRS rate for GRATs for the month of the transfer, of the stream of annuity payments that will be paid by the GRAT to the grantor. Often, the annuity payment is determined under a formula designed to cause the two values to be effectively the same, resulting in a gift tax value of zero (sometimes referred to as a "zeroed-out GRAT"). The subsequent appreciation of the GRAT's assets during the term the annuities are being paid does not affect the initial gift tax value of zero. Whatever value remains in the trust after the final annuity payment has been made to the grantor passes to a new trust (usually structured as an IDGT) for the benefit of the donor's family members entirely free of gift and estate tax.

The May 2020 rate for a GRAT is an extraordinary 0.8%. Thus, assets transferred to a GRAT in May need only appreciate at a rate greater than 0.8% per year in order for the GRAT to achieve its objective. The higher the appreciation, the better the result, without any change to the amount of the taxable gift. If for any reason the assets do not appreciate, the donor receives them back in the form of annuity payments and is no worse off than if she had not created the GRAT (sometimes described as "head's you win; tails you break even"). Furthermore, the assets comprising each annuity payment can be contributed to a new zeroed-out GRAT (with the terms determined based on asset value and IRS rate in effect at that time), with the potential to capture the appreciation during the next period. While longer term GRATs are permissible, a short (e.g., 2-year) period maximizes the potential of capturing the upside when it occurs. The short period also mitigates the mortality risk, since the assets of a GRAT (unlike the assets of an IDGT) are included in the donor's estate if she dies during the annuity term. Note that even if the donor has already exhausted her gift tax exemption amount, the zeroed-out GRAT described above can achieve a significant transfer of value to the next generation without gift or estate tax.

These are just a few of the many opportunities for estate planning during the current volatile and uncertain times. Each estate planning technique brings its own set of considerations, including its intersection with business planning, family goals, and income tax planning. If you would like more information on estate planning generally or on any of the specific items discussed in this update, please contact any member of our Estate Tax Planning Practice Team.

Our Estate Tax Planning Practice Team

Stuart J. Gross	(212) 903-8723	Email Address
Mark David Rozen	(212) 903-8743	Email Address
Quincy Cotton	(212) 903-8739	Email Address
JoAnn Luehring	(212) 903-8731	Email Address
Lionel Etra	(212) 903-8721	Email Address
Debra G. Kosakoff	(212) 903-8735	Email Address
Jessica G. Weinberg	(212) 903-8750	Email Address
Bonnie J. Daniels	(212) 903-8701	Email Address