Legacy & Tax Planning in a Pandemic

April 27, 2020

A confluence of events has created an uncommon opportunity to transfer wealth and support charity: financial markets have declined because of the COVID-19 pandemic; in response, the Coronavirus Aid, Relief, and Economic Security (CARES) Act was passed; interest rates have fallen to historic lows; and the federal estate and gift tax exemption has increased to a record high of $11,580,000.

However, this window of opportunity could close quickly, as the markets and interest rates may rebound, and today's favorable transfer tax laws could change significantly if the upcoming election results in a change of political control (the current exemption is already scheduled to be cut in half after 2025, and Democrats propose further reducing the exemption to $3,500,000 while increasing the maximum estate and gift tax rate from 40% to 77%).

As a result, now is an opportune time to implement estate planning strategies that, when markets and asset values recover, will cause the growth in value to occur outside your taxable estate rather than in it, while at the same time allowing you some access to these assets and/or accomplishing your charitable goals. These strategies include a sale of assets to a defective grantor trust ("Grantor Trust") and a transfer of assets to a grantor retained annuity trust (GRAT).

In a sale to a Grantor Trust, you would sell assets to a trust created for your family, in exchange for a promissory note having an interest rate equal to the Applicable Federal Rate (AFR), which starting May 1 will range from .25% to 1.15% based upon the duration of the note. The trust pays you interest on the note every year, and the principal is paid when the term of the note expires. The assets that remain in the trust after the note is paid will be held for your family's benefit outside of your taxable estate. In essence, you get back what you sold to the trust, plus .25% to 1.15% annually, and appreciation exceeding that low annual return occurs outside of your taxable estate.

A Grantor Trust is one of which you are still treated as owning the assets transferred to the trust for income tax purposes only, which causes the sale to be disregarded for income tax purposes, and also requires you to pay the tax on the trust's income, allowing the trust assets to grow tax-free. The trust must have equity equal to 1/9 of the value of the assets sold to the trust, which can be satisfied by making a gift to the trust or by selling the assets to an existing Grantor Trust that has sufficient value.

A GRAT is a trust to which you transfer assets in exchange for an annuity for a number of years, the value of the annuity being equal to the amount transferred to the GRAT plus an annual return equal to the AFR for GRATs (0.8% in May, the lowest ever). To the extent the GRAT assets grow at a rate faster than the AFR, the excess growth will pass tax-free to family members outside of your taxable estate. Like an installment sale, you get back what you transferred to the GRAT, plus 0.8% annually, and appreciation exceeding that low annual return occurs outside of your taxable estate.

Several new options for supporting charities have also emerged. The CARES Act added an above-the-line deduction for cash gifts of up to $300 to public charities and increased limitations on cash gifts by individuals for 2020 from 60% to 100% of the donor's contribution base. The contribution base limits for corporations raised to 25% from 10% for cash gifts and to 25% from 15% for gifts of food inventory in 2020.

In addition, the depressed market and historically low interest rates make certain charitable planning techniques particularly attractive. For example, gifts to a lifetime charitable lead annuity trust (CLAT) will likely result in a lower gift tax valuation for assets ultimately transferred to the grantor's family, while providing for a stream of payments to charity now. Gifts of homes or farms to charity with a retained life estate may also be attractive where low interest rates yield higher charitable deductions.

If you desire to meet your favorite charities' urgent needs now and you do not have liquidity now, making accelerated distributions from a donor advised fund or making an IRA Qualified Charitable Distribution may be good options. Although these techniques do not offer specific tax advantages that didn't exist before the CARES Act, they offer practical solutions for funding charities during their time in need.

If you are interested in exploring these or other opportunities to transfer wealth or make charitable gifts, please contact Phil Johnson; Sheryl Morrison; Justin Whitney; Trusts, Estates & Legacy Planning Practice Group Chair Courtney Conrad; any member of the Trusts, Estates and Legacy Planning Group, or your regular Lathrop GPM contact.

This content was also featured in a recent Lathrop GPM webinar; visit the Lathrop GPM website to view a recorded version of Legacy & Tax Planning in a Pandemic.