Legacy and Tax Planning Opportunities in a Pandemic

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Estate Tax Planning Opportunities in the Pandemic

- The pandemic landscape:
  - Market indexes are down.
  - Interest rates have fallen to near historic lows.
  - The economy will likely suffer a historic contraction.
  - An election looms in November.
  - The current estate and gift tax exemption is $11,580,000 and the rate is 40%. The exemption is scheduled to expire after 2025.
  - Democrats have proposed an exemption of $3,500,000 with rates ranging from 45% to 77%.
  - As bad as it seems for most purposes, the pandemic may have created the perfect storm for transferring wealth.

What to do?

- As counter-intuitive as it may seem, the pandemic may be an opportune time to give assets away to family members.
- More specifically, the focus should be on giving the <u>appreciation</u> on assets away to family members.
- If the idea of giving away assets in the middle of a crisis causes heartburn, there are ways to structure gifts so that the senior generation does not lose access to the gifted funds.

How?

Installment Sale to a "Defective Grantor Trust"

- A "Defective Grantor Trust" is one over which the creator of the trust (the Grantor) is treated as owning the trust assets for income tax purposes only.
- The trust can be created for the benefit of the Grantor's descendants as well as the Grantor's spouse.
- A person other than the Grantor should be the trustee.

Installment Sale to a “Defective Grantor Trust” (Continued)

- The trust to which assets are sold should have equity equal to at least 1/9 of the value of the assets that are sold to the trust.
- Assets will be sold to the trust in exchange for a promissory note, with the annual rate on the note dependent on the term of the note:
  - .91% for a 0-3 year note
  - .99% for a 3-9 year note
  - 1.44% for a note exceeding nine years
- At the end of the note term, any value remaining in the trust that exceeds the value of the note remains in the trust and outside of the taxable estate.

Installment Sale to a “Defective Grantor Trust” (Continued)

- Illustration
  - Dick and Jane had an estate worth $30 million prior to the onset of the pandemic, consisting mostly of liquid investments. After the market correction, their estate is now worth $20 million.
  - Dick creates a Defective Grantor Trust for the benefit of Jane and their descendants, with Jane as trustee.
  - Dick gifts $2 million of assets to the trust, and sells $18 million for a nine-year promissory note, with an annual interest rate of .99%.
  - After three years, the $20 million transferred to the trust has grown back to $30 million.
  - The trust pays Dick his original $18 million back, and the trust has $12 million that is outside of the taxable estate.
  - Jane is a beneficiary of the trust, so she would have access to the $12 million should it be needed.

Installment Sale to a “Defective Grantor Trust” (Continued)

- Notes
  - The trust can be designed as a “generation-skipping trust.”
  - Dick could forgive part of the note to make a gift to use his estate and gift tax exemption before it expires.
  - Other assets could be sold to the trust, including a family business.
  - There is risk that asset values could go down further, instead of up.

Grantor Retained Annuity Trust (GRAT)

- A Grantor Retained Annuity Trust (GRAT) is one in which the Grantor transfers assets to the GRAT in exchange for an annuity.
- Over the term of the GRAT, the Grantor will receive back what he transferred to the GRAT, plus an annual return equal to the rate in effect when the GRAT was funded (currently 1.2%).
- Any appreciation above the annual interest rate passes to family members.
- Upon termination, the remaining GRAT assets can pass outright or in further trust.
- The Grantor can be trustee of the GRAT during its term.

Grantor Retained Annuity Trust (GRAT) (Continued)

- Illustration
  - Dick and Jane had an estate worth $30 million prior to the onset of the pandemic, consisting mostly of liquid investments. After the market correction, their estate is now worth $20 million.
  - Dick creates a two-year GRAT with himself as trustee. Dick transfers $20 million of assets to the GRAT, and the applicable interest rate is 1.2%.
  - After two years, the $20 million transferred to the trust has grown back to $30 million.
  - Dick receives two annuity payments totaling $20.35 million, and $7.5 million remains in the GRAT.
  - Dick gets his original $20 million back, plus another $350,000, and $7.5 million passes to a trust held for the benefit of Jane and their descendants, outside the taxable estate.
  - Jane is a beneficiary of the trust, so she would have access to the $7.5 million should it be needed.

Grantor Retained Annuity Trust (GRAT) (Continued)

- Notes
  - There is no downside risk with a GRAT if asset values decline.
  - A GRAT has some disadvantages compared to an installment sale:
    - A GRAT is not “generation-skipping.”
    - The Grantor must survive the term of the GRAT.
    - Annuity payments to the Grantor are amortized and not interest-only.
    - Assets could be stuck in a GRAT if the estate and gift tax laws change during the GRAT term.
  - Other assets could be transferred to a GRAT, including a family business.

Income Taxes in 2020 and CARES Act

- Few remaining itemized deductions
  - Charitable deduction remains
  - SALT limitations - $10,000
- Higher standard deduction
  - $12,000 single; $24,000 married filing jointly
- CARES universal deduction for non-itemizers
  - Up to $300 per eligible individual “above the line” deduction
  - To qualified charities, e.g. pubic charities (not supporting organizations, donor advised funds (DAFs) or private foundations)
  - Gifts in 2020 – Joint Committee on Taxation Report April 23, 2020
  - Allows non-itemizers to obtain a tax benefit by making qualified charitable gifts
  - Incentivizes giving in 2020

Income Taxes in 2020 and CARES Act

- Increase in “contribution base” limits
  - Individual cash deductions: previously 60%, 100% in 2020
    - Contribution base is roughly adjusted gross income (AGI) for the year reduced by other donations during the year
    - Bunch donations, accelerate pledges and future gifts
  - Corporate limit raised from 10% to 25% for 2020 for cash and 15% to 25% for food inventory
  - To qualified charities, e.g. pubic charities (not supporting organizations, donor advised funds (DAFs) or private foundations)

Donation of Appreciated Property – Current Implications

- Generally, can (1) deduct fair market value of most long term appreciated property but (2) not recognize gain, if there is no prearranged sale
- Publicly traded stock is devalued and volatile in today's economy
  - Charitable deduction is lower for lower fair market value
  - Date of donation is date stock is possessed by charity
- Other property may have held value better to generate a reasonable charitable deduction
  - Real estate?
  - Other?

IRA Charitable Distributions (QCD) – CARES Act Implications

- Donor over age 70 ½ up to $100,000 per year per taxpayer
- Directly from IRA to public charity (not DAF or most private foundations)
- Counts as RMD if over 72
  - SECURE Act raised Required Minimum Distribution (RMD) age to 72 from 70½ but didn't change QCD eligibility age
  - CARES Act suspends RMDs for 2020
- Distribution excluded from income and no charitable deduction
- Useful for:
  - Non-itemizers
  - Donor will bump up against AGI limitations for gifts
  - If desired distribution exceeds $100,000: IRA cashes out and distributes to donor, donor then gifts cash to charity

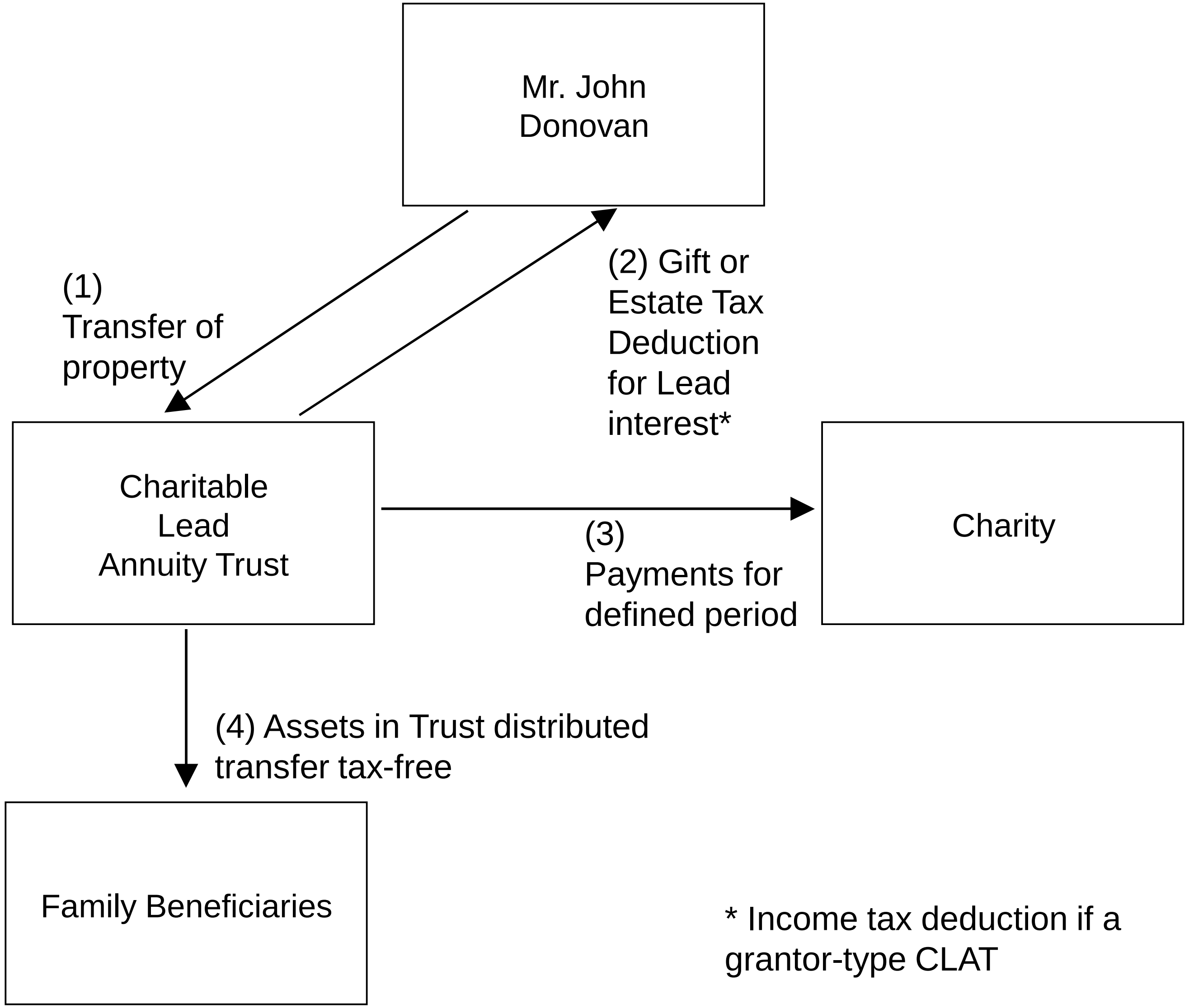
Estate and Gift Tax Overview

- $11,580,000 federal gift, estate and generation skipping (GST) tax exemptions in 2020
  - – Sunset 2025 and adjusted for inflation
- State exemptions
  - – E.g. Minnesota exemption $3,000,000 in 2020
  - – No sunset and not adjusted for inflation
- Fewer estates benefit from charitable deduction
  - – Deduction unlimited
  - – Increase in lifetime gifts for philanthropically minded
  - – Fewer testamentary gifts?

Lifetime Charitable Lead Trust

- Term endowment to charity, then to family (or donor if a grantor trust) at end of term
- Gift tax charitable deduction for lead interest; income tax charitable deduction:
  - If grantor trust, deduction for lead interest; grantor reports trust income on grantor's return
  - If nongrantor trust, no deduction but trust gets income tax deduction for payment of income to charity
- Leverage gift and estate tax exemptions
  - IRS Section 7520 interest rates – historically low
    - Annuity (CLAT) payment amount is fixed at the creation of the trust; valuation is very sensitive to changes in interest rates
    - "Unitrust" payment (CLUT), payment amount is a percentage of the assets revalued each year, so not very sensitive to changes in interest rates
  - If actual returns on assets are higher than IRS rates for a CLAT, amount passing to family is actually higher than amount subject to gift tax

Charitable Lead Trust (CLT)



* Income tax deduction if a grantor-type CLAT

Lifetime Charitable Lead Annuity Trust - Example

- Terms of CLAT
  - 5% annuity amount to charity for 20 years
  - $1,000,000 assets transferred to trust
  - Annual annuity amount $50,000
  - April Section 7520 rate 1.2% - historically very low
- Gift taxes
  - $884,365 charitable deduction for payments to charity
  - $115,635 subject to gift tax for remainder to family
  - Can “zero out” the remainder for gift taxes to family by adjusting terms
  - If trust created when Section 7520 rate is 8%, gift to family is $509,095
- Remainder to family
  - If trust generates a return of 5% = $1,000,000
  - If trust generates a return of 6% = $1,367,856

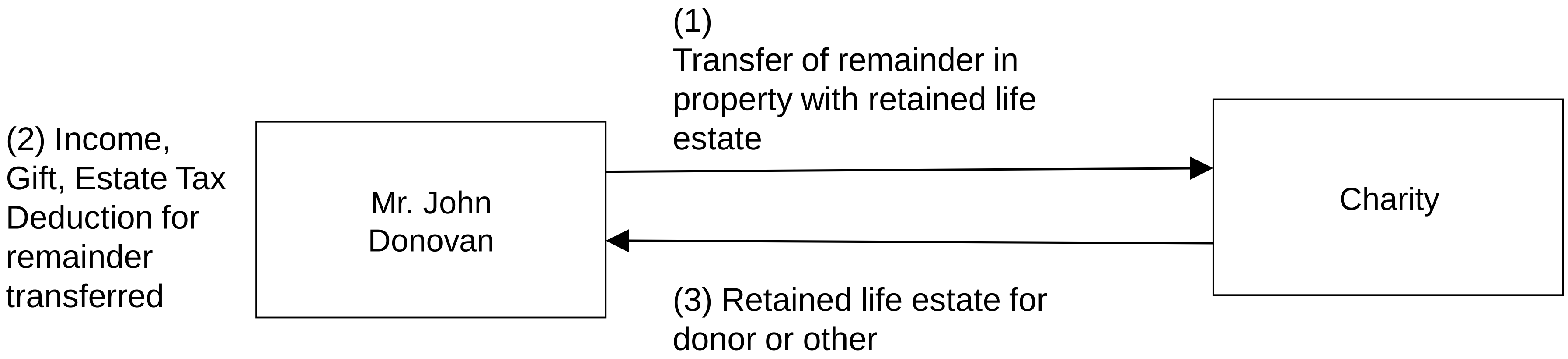
Lifetime Charitable Lead Trust - Example

- Income taxes
  - If grantor trust
    - Donor receives a charitable deduction $884,365 at creation subject to AGI limitation of 30%
    - Income of trust reported by donor on donor’s return
    - If taxes due, donor pays, leaving trust intact for family
    - Can be converted to a nongrantor trust by grantor’s release of retained powers
    - If donor dies during trust term or converts to a nongrantor, deduction may be partially recaptured by required recognition of income
  - If nongrantor trust
    - No income tax deduction for donor at creation
    - Income tax charitable deduction for trust of 100% of income paid to charity
      - Available at any time trust is not a grantor trust, even after conversion
    - This may allow greater income tax deductions overall to donor’s family

Remainder in Home/Farm

- Donor irrevocably transfers property to charity and life estate in donor or other
- Donor continues to occupy property and receive any rents
- Written agreement about obligations for expenses, maintenance
- Income and gift tax deduction for remainder given to charity
- Estate tax deduction upon death of donor for charity remainder
- If property is sold during lifetime, proceeds are shared based on actuarial calculations at that time with the Section 7520 rate then in effect

Remainder in Residence or Farm with Retained Life Estate



Remainder in Home/Farm - Example

- 65 year old donor
- Home valued at $1,000,000
- Gift of remainder interest in April 2020 when Section 7520 rate is 1.2%
- Income and gift tax charitable deduction is $813,460
  - If Section 7520 rate is 8%, charitable deduction is $318,500

Other Charitable Planning Ideas in the 2020 Pandemic

- Accelerate gifts from DAFs
  - Doesn’t come from donor’s own assets which may be devalued or from donor’s cash flow
  - No new charitable deduction, but many donors will not prioritize the charitable deduction in trying times
- Use increased cash charitable gifts to offset extraordinary income, e.g.:
  - Roth conversion in light of devalued assets and SECURE Act
  - Gain on liquidation of assets, e.g. sale of business or concentrated position

Testamentary Charitable Trusts

- Charitable remainder trust
  - Income stream to noncharitable beneficiary, e.g. spendthrift, dependent subject to estate tax
  - Charitable remainder receives estate tax charitable deduction
  - Trust is tax exempt; noncharitable beneficiary pays tax on payments
  - SECURE Act applicable to tax deferred assets
    - 10 year payments required for nonspouse, adult, nondisabled beneficiary
    - Accelerates recognition of income and taxes vs. previous “stretch IRA”
    - CRT spreads payments over beneficiary’s lifetime and pays remainder to charity after beneficiary’s death or end of term
- Charitable lead trust
  - Defer testamentary gift to family at end of stated term
    - Actuarial value of family’s interest is subject to estate tax
  - “Term endowment” to charity after death
    - Actuarial value of payments to charity is charitable deduction for estate taxes

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