

UNIQUE ESTATE PLANNING OPPORTUNITIES AMID COVID-19

First and foremost, we hope that all of our clients and friends are safe and healthy. Over the last few weeks, the COVID-19 pandemic has dramatically affected our day-to-day lives and the global economy. While all of us have many concerns and issues that are admittedly more important than tax planning, we would be remiss if we did not bring to your attention the unique estate planning opportunity that has developed in the midst of this crisis. Specifically, individuals may capitalize on the dramatic dip in asset values and historically low interest rates to move more wealth out of their estates, utilizing less estate and gift tax exemption and paying lower total transfer taxes. Moreover, the current lifetime exemption amounts are set to be cut in half at the end of 2025 unless Congress and the President affirmatively extend those amounts or make them permanent. If you are in a position to move assets to your descendants and are potentially subject to the estate tax, circumstances may never again be this favorable.

DIP IN ASSET VALUE

Generally, when an individual transfers an asset out of his or her estate to family members or irrevocable trusts, the value of the transferred asset is essentially “frozen” for gift and estate tax purposes at the time of such transfer. Any appreciation of the value of the asset after the transfer passes free of gift and estate tax. Thus, transfers while asset values are depressed create the potential for the tax-free transfer of wealth when asset values later appreciate. Traditional estate planning techniques may be rendered that much more effective where individuals are able to transfer more assets, or use less estate and gift tax exemption, in making transfers. Of course, there is no need to remind any of our readers that asset values across the board have plummeted in the last few weeks.

HISTORICALLY LOW INTEREST RATES

The gift component of various estate planning strategies is determined by reference to current interest rates set by the Treasury (often referred to as the “Applicable Federal Rate” or simply the “AFR”). Such estate planning strategies are most effective where the rate of return/appreciation of the assets transferred outpaces the AFR. Where interest rates are low, it is easier for the rate of return of transferred assets to outpace the effective interest rate and for additional wealth to pass free of gift and estate tax. Not surprisingly, the short-, mid-, and long-term AFRs are at all-time lows. The long-term AFR for obligations of nine years or more is now 1.44%.

ESTATE PLANNING STRATEGIES

A few estate planning strategies that take advantage of depressed asset values and/or the low interest rate include:

Gifts of Assets. Individuals may capitalize on available gift tax exemption by transferring assets with depressed values to family or irrevocable trusts. Where an individual does not have lifetime gift and estate tax exemption remaining, the transfer of assets with depressed values may result in less gift tax paid on the transfer of such assets. For individuals with some remaining lifetime exemption remaining, the collapse of asset values has a silver lining: the ability to transfer more of those assets without paying gift or estate tax.

Sale of Assets to Trusts. Assets with depressed values may also be sold to trusts in exchange for a promissory note with an interest rate at least equal to the AFR. This strategy is particularly beneficial for individuals who do not have enough remaining lifetime exemption to cover the value of the assets the individual wishes to transfer, and the assets to be sold are anticipated to have a rate of return higher than the interest rate on the promissory note. (Note: Where the sale is between a grantor and a grantor trust, no gain or loss for income tax purposes will be triggered by the sale of the asset to the trust.) The combination of low asset values and the low AFR could make the sale of assets particularly attractive.

Intra-Family Loans. A loan between family members is not considered a gift where the interest on the loan is at least equal to the AFR. Thus, to the extent borrowed funds are invested and produce a rate of return higher than the interest rate on the loan, the borrower retains the excess return, free of gift tax.

Grantor Retained Annuity Trust. With a grantor retained annuity trust (“GRAT”), the grantor transfers assets to a trust, which pays an annuity for a fixed number of years, and any assets remaining in the trust at the end of the trust term pass to remainder beneficiaries. To the extent a GRAT is structured to “zero” out, little or no gift tax will be due as a result of the transfer of assets to the trust, and any appreciation on the transferred assets in excess of the AFR will pass to remainder beneficiaries free of gift tax. Again, the combination of depressed asset values and low AFR could make a GRAT extremely attractive.

We hope that the current state of the financial markets is short-lived and that a rebound is around the corner. In the interim, consider the foregoing options to capitalize on temporarily depressed asset values, low interest rates, and favorable transfer tax laws to shift wealth to the next generation with minimal transfer tax impact.

Please don't hesitate to contact a member of the Thompson & Knight Estate Planning team to discuss how the above options can be incorporated into your estate plan.

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This Client Alert is sent for the information of our clients and friends. It is not intended as legal advice or an opinion on specific circumstances. Furthermore, due to the rapidly evolving nature of the COVID-19 pandemic, you should consult with counsel for the latest developments and updated guidance.

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