COVID-19 Pandemic Provides Wealth Transfer and Tax-minimization Opportunities

The escalating uncertainty surrounding COVID-19 has forced many individuals to consider and address current health, market and estate planning concerns. While on the most basic level this pandemic highlights the importance of keeping estate planning documents current, it also provides wealth transfer and tax-minimization opportunities.

Review Estate Planning Documents

First and foremost, basic estate planning documents should be reviewed, and revised if necessary, to reflect current desires with respect to agents, representatives and beneficiaries. Such documents include Trusts, Wills, Financial Powers of Attorney, Powers of Attorney for Health Care and any beneficiary designations.

Current Law

Under current law, an estate exceeding an individual's estate and gift tax exemption will be taxed at 40 percent. This estate and gift tax exemption is $11.58 million per person ($23.16 million for married couples). However, per the 2017 Tax Cuts and Jobs Act, in 2026 the exemption amount will revert back to the pre-Act amount of $5 million per person, as adjusted for inflation; an amount that is projected to be approximately $6.5 million per person. While it is possible that the exemption amount and tax rates could change between now and the 2026 reversion, given today's political and economic environment, it is unlikely such changes would yield a higher exemption amount or lower tax rates than those currently in place.

The effects of economic decline and market volatility stemming from the coronavirus give rise to numerous estate planning opportunities. In general, individuals may consider taking advantage of these uncertain conditions against the backdrop of the significant estate, gift and generation-skipping transfer tax exemption currently available. To maximize the transfer of wealth and minimize its associated tax burden, an individual can leverage his or her exemption now—keeping in mind generation-skipping transfers—to achieve substantial multigenerational tax savings as economic conditions improve. The volatile economic environment may promote a donor to use his or her exemption to

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transfer beaten-down stocks and other assets, affording him or her the ability to take advantage of future appreciation. Beyond outright gifts to individuals or trusts, Grantor Retained Annuity Trusts (GRATs) and intra-family transactions are extremely attractive under slashed interest rates, and converting a traditional retirement account to a Roth account under current market conditions can save a taxpayer a significant amount in taxes.

Grantor Retained Annuity Trusts (GRATs)

In a GRAT arrangement, a grantor transfers assets into a trust and retains the right to receive an annuity stream from the trust over a term of years. After the term of years, the balance of the assets held in trust passes to the grantor's intended beneficiaries. Because the IRS values the grantor's transfer based on the annuity stream and an IRS-prescribed rate of return (the 7520 rate), the excess by which the transferred assets outperform the 7520 rate will escape estate taxation. The 7520 rate for April 2020 is 1.2 percent, down from the February and March rates of 2.2 percent and 1.8 percent, respectively. Accordingly, considering both the current slash in interest rates and market volatility, transferring an undervalued or highly-appreciating asset into a GRAT becomes an increasingly popular and effective strategy to transfer wealth and minimize one's estate tax burden.

Intra-family Transactions and Intentionally Defective Grantor Trusts (IDGTs)

Similarly, low IRS-prescribed interest rates and market volatility may offer an opportunity for individuals to originate intra-family loans, and in some cases, refinance old intra-family loans and certain sales transactions. Individuals can take advantage of the drop in the Applicable Federal Rates (AFR), structuring loans and sales so that an individual's heirs and their trusts minimize payments to the lender into the future. The 2020 mid-term (three to nine years) annual AFR rate dropped from 1.75 percent in February to 0.99 percent for April. The 2020 long-term (over nine years) annual AFR rate dropped from 2.15 percent in February to 1.44 percent for April. Children, grandchildren and other family members seeking liquidity may not desire to sell assets in a down market, and providing loans under these low interest rates can provide younger generations and other family members with the liquidity necessary to weather the volatility.

Low interest rates may also prompt individuals to consider transfers either by sale or loan to an Intentionally Defective Grantor Trust (IDGT). In an IDGT

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arrangement, a grantor transfers assets to an irrevocable trust. The trust is designed to be "intentionally defective" so that the assets transferred exist and grow outside of the grantor's estate for estate and gift tax purposes, while the income associated with those assets is taxed to the grantor—not the trust. Thus, the grantor uses his or her own assets outside of the trust to pay such income taxes, which is akin to a tax-free gift to the trust. An IDGT allows for assets to appreciate outside of the grantor's estate and free from the burden of income tax which substantially leverages the growth in the IDGT, akin to a Roth IRA. The low AFR rates may be appealing to a grantor who desires to sell an asset, such as a family business, to the IDGT in exchange for an installment note. Because the asset is outside of the grantor's estate for estate tax purposes, substantial estate tax savings can be achieved where the asset outperforms the AFR rate.

Conversion to Roth IRA

Market volatility may prompt some individuals to convert a traditional pre-tax retirement account into an after-tax Roth account. Because the traditional account is funded with pre-tax dollars and grows tax free, an individual converting to a Roth account must pay the tax on the entire amount transferred to the Roth account. The lower income tax rates under the Tax Cuts and Jobs Act paired with undervalued stocks can provide huge savings for a converting taxpayer. Under current market conditions, a taxpayer converting a traditional account to a Roth account would be paying tax on a smaller portfolio, meaning less tax paid now, and no tax paid later. Importantly, however, the potential tax savings associated with a Roth conversion is just one of many factors to consider.

If you would like more information regarding estate planning opportunities and strategies, now is the time to contact your Reinhart attorney or a member of Reinhart's Trusts and Estates Team.

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