

NEWS ALERT

TRUSTS & ESTATES



Estate Planning is On Sale Again!

By Richard A. Marone | March 27, 2020

Twelve years ago, the nation entered the Global Financial Crisis, caused by a combination of artificially inflated real estate prices and behaviors by certain financial institutions ranging from speculative to criminal. The values of publicly traded equities, as represented by the S&P 500 Index, plummeted by approximately 38.5% despite the underlying health of many of the companies in the index. Volatility became the norm. At the same time, interest rates began to drop. The Treasury's "Section 7520 rate," which is the interest rate applicable to many estate planning strategies, dropped from a high of 4.2% in 2008 to a low of 1.0% in 2012.

Low interest rates, artificially depressed values and increased volatility – in short, estate planning went on sale. This allowed wealthy clients to create great value for their beneficiaries at much reduced, or even zero, federal gift tax cost by using leveraged estate planning tools, saving large amounts of potential future estate tax and generation-skipping transfer tax costs in the process.

Estate planning has always been about getting what you have where you want it to go with the lowest tax burden possible. Those brave enough to do this early and often beginning in 2008 accomplished these goals with great success.

Today we are again faced with artificially depressed asset values, vastly increased volatility and (happily) low interest rates. If you are fortunate enough to have assets that you intend to transfer to younger generation family members or other beneficiaries, you have another unprecedented opportunity to accomplish your estate planning goals using the tools discussed below. But this environment won't last forever. Those who planned during and after the last global financial crisis were very successful in accomplishing their estate planning goals. Those who did not plan lost the opportunity – until now.

Simple Gifts

The simplest of strategies is to give away assets now that you expect to appreciate in the future. The federal estate, gift and generation-skipping transfer ("GST") tax lifetime exemption amounts are \$11.58 million. This amount is scheduled to increase by inflation until the end of 2025, when the exemption amount will revert to a pre-2018 inflation adjusted amount of approximately half that. The Connecticut estate and gift tax exemption amount is \$5.1 million. This will increase in 2021 to \$7.1 million, in 2022 to \$9.1 million, and in 2023 it will match the federal exemption. New York has an estate tax exemption amount of \$5.85 million. This number will rise with inflation in 2021 and beyond. Massachusetts has a fixed estate tax exemption amount of \$1 million.¹

Given that these exemptions are at all-time highs, and values are depressed, the simplest effective estate planning tool is to gift assets, either outright to beneficiaries who are mature enough and not at risk, or better, into flexible long-term trusts that benefit them and their children and grandchildren. Trusts provide continuity of management as well as protection against divorces, lawsuits and bad habits. With a flexible trust that lasts for the lives of children and grandchildren, or maybe even longer, you can also eliminate federal and state estate tax on the gifted assets for several generations. These current exemption levels will be reduced dramatically in 2026, or maybe earlier if the coming election changes the balance of power in Washington, so today it's literally "use it or lose it."²

¹ Although neither New York nor Massachusetts has a gift tax, taxable gifts made during life impact the estate tax computations in these states.

² Gifted assets retain their original basis for capital gains purposes, so careful planning is required.

Intrafamily Loans

You can also benefit your children and grandchildren by lending money to them that they can then invest and earn both current income and future capital appreciation. Loans have no gift tax consequences if you charge at least the interest rate specified by federal law.³ In April, the AFRs for loans with a maturity of 9 years or longer are 1.44% if interest is paid annually and 1.43% if interest is paid semi-annually, quarterly or monthly. If your beneficiaries use the borrowed funds to invest in assets that produce a combined current and future return of greater than this rate, you have again achieved your estate planning goals. Loans can also be made to trusts for their benefit to get the same benefit and achieve the protections discussed above (see below).

Grantor Retained Annuity Trusts (“GRATs”)

A Grantor Retained Annuity Trust, or GRAT, is an irrevocable trust which you fund with your assets, retaining the right to receive them back, with interest at a minimum rate set by the IRS. This rate is only 1.2% in April. Your retained payments, called an annuity, are paid annually. This means that if the GRAT's asset growth exceeds the 1.2% “hurdle” rate fixed by the IRS, that excess passes to or in trust for your children gift tax free. GRATs are usually done for a very short term such as 2 or 3 years, because the only “catch” is that you must survive the GRAT term to reap its benefits, and because GRATs are designed to capture upward volatility.

Sales to Grantor Trusts

(Here's where it starts to get really complicated!) Assets properly transferred to an irrevocable trust usually are excluded from your estate for estate tax purposes. Yet it is possible to create such an irrevocable trust that is effective for estate tax purposes but not effective for income tax purposes – on purpose! Such a trust is called a “grantor trust” because all of the trust's income must be reported directly on the grantor's income tax returns, even though the earnings remain in the trust. It is therefore possible to sell assets to a grantor trust and not have a taxable event for income tax purposes, because you can't get taxed when you sell something to yourself.

Usually a grantor trust must pay you back for the purchased assets with a promissory note, creating estate planning leverage. As with straight intrafamily loans, in April you could lend funds to a grantor trust for a term of 9 years or more and charge interest of only 1.43% or 1.44%. Any combined current income and future appreciation in excess of that would accrue to your trust beneficiaries gift tax free. Further, if you continue to pay the income tax on the trust's income and gains, you have made another de facto gift to your beneficiaries that is not classified as a gift for gift tax purposes. The tax law makes you responsible for the income tax, so paying it is not a gift.⁴

The Time to Act is Now!

While there are no guarantees in these uncertain times, in the past broad and precipitous market declines eventually recovered nicely.⁵ If you plan when values are down, interest rates are low and volatility is high, you have a greater likelihood of achieving those estate planning goals of getting what you have where you want it to go, when and how you want it to get there, with the lowest possible tax burden.

Please contact your Murtha Cullina estate planning attorney if you would like to explore achieving your goals with the estate planning tools discussed in this newsletter.

³ This is known as the “Applicable Federal Rate” and is abbreviated “AFR.”

⁴ We usually recommend that the sale be made to a grantor trust that already has assets equal to more than 10% of the value of the assets that you intend to sell to it, so that the trust would have the money to make a down payment on the purchase. If those were assets gifted in a GST-exempt fashion, you could gain additional generation-skipping benefits.

⁵ This is not a guarantee!

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Richard A. Marone, Chair
860.240.6026
rmarone@murthalaw.com

Marcel J. Bernier
860.240.6087
mbernier@murthalaw.com

Alfred R. Casella
860.240.6048
acasella@murthalaw.com

Patrick D. Coughlin
203.653.5409
pcoughlin@murthalaw.com

George A. Dagon, Jr.
860.240.6039
gdagon@murthalaw.com

Christopher S. Fox
617.457.4082
cfox@murthalaw.com

Shera G. Golder
860.240.6188
sgolder@murthalaw.com

Robert A. Heinemann, Jr.
203.772.7781
rheinemann@murthalaw.com

Natale A. Messina
860.240.6027
nmessina@murthalaw.com

Lisa Newfield
203.772.7768
lnewfield@murthalaw.com

Lisa P. Staron
860.240.6175
lstaron@murthalaw.com

Suzanne Brown Walsh
860.240.6041
swalsh@murthalaw.com

Donna M. White
617.457.4133
dwhite@murthalaw.com