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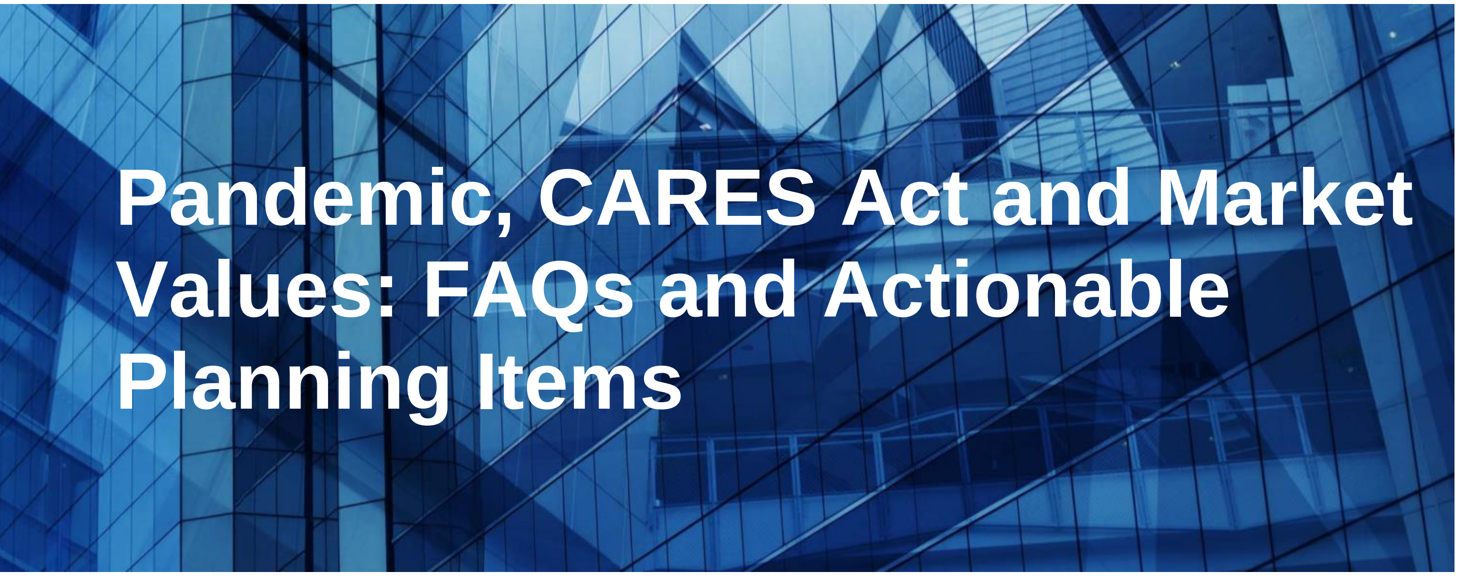

Pandemic, CARES Act and Market Values: FAQs and Actionable Planning Items

Wealth and Estate Planning Strategists

Family Office Resources

Q: What are the key elements that make the current environment ripe for tax planning?

A: The convergence of low valuations, low interest rates and tax stimulus legislation has created attractive income and estate planning opportunities for high net worth clients.

Q: What are some specific tax law changes that contribute to current income tax planning opportunities?

A: The recent COVID-19 legislation (the Coronavirus Aid, Relief, and Economic Security Act, or “CARES Act”) provides relief in a number of ways that allow taxpayers to reduce taxable income and/or generate refunds currently. For example, there have been changes to qualified retirement account rules, including a waiver of 2020 required minimum distributions (RMDs) for defined contribution qualified retirement plans and IRAs and favorable rules relating to early withdrawals. These rules allow clients to potentially lower their income tax liabilities and generate more cash flow. In addition, under the CARES Act, individuals and corporations can benefit from greater tax deductions for certain qualified charitable contributions, thereby reducing taxable income. Further, the CARES Act includes a number of stimulus provisions for small businesses, including income tax provisions related to NOLs and other business deductions for both current and prior years that may result inadditional tax savings and refunds.

Q: Given the tax legislation and devaluation of the market, what strategies should clients consider with their tax and legal advisors?

A: From an income tax perspective:

- **Consider Converting a traditional IRA to a Roth IRA:** A conversion triggers ordinary income. The market downturn may mean that a traditional IRA could have had a significant decrease in value. This could reduce the income tax consequences of making the conversion. Additionally, the taxable income recognized as a result of the Roth conversion can potentially be offset by capital losses, which can generally offset ordinary income up to $3,000 per year. In addition, there may be excess deductions from charitable contributions or business loss deductions that can potentially be used to offset the taxable income recognized as a result of a Roth conversion.
- **Offset taxable income with increased charitable contributions:** Cash contributions to a public charity in 2020 are deductible up to 100% of an individual's adjusted taxable income.
- **Reset tax basis:** Clients can sell gain assets at a lower value and immediately repurchase the asset, effectively increasing the tax basis. The gains can be offset with losses elsewhere in the portfolio and/or charitable contributions. Note that the wash sale rules referred to below do not apply to gain-triggering sales.
- **Realize losses and wait 31 days to repurchase identical securities:** The wash sale rules prohibit a taxpayer from taking a loss on the sale of securities, when substantially similar securities are acquired during the period beginning 30 days prior to the sale and ending 30 days after the sale. In order to avoid a wash sale, a reacquisition can be delayed until the 31st day after the sale. If the client desires to participate in an upturn in the market with respect to the particular stock that is sold and still avoid the wash sale rules, they may consider the purchase of an ETF that tracks the sector of the stock that is sold. If it appears the market will not rebound before the expiration of the 31-day period, then the sale and repurchase might be done near the same price, with little change in the client's economic position. The loss can be used to offset gains elsewhere.
- **529 Plans:** Due to the closure of educational institutions some clients may have received a refund for educational costs for which they used 529 Plan funds. Normally they would be able to return these funds to the Plan within 60 days of the refund without any income tax consequences. The IRS has extended the 60 day period to the later of 60 days or July 15, 2020, but only for taxpayers whose 60-day period ended on or after April 1, 2020.
- **Loss Realization:** An elderly client that is afflicted with COVID -19 and is not likely to recover may consider selling any loss securities in order to realize the loss before death. Upon death any loss will be lost as a result of the adjustment of the cost bases to the date of death value.

Q: Why has there been a recent resurgence of interest in estate planning?

A: At a basic level, we are in the middle of a serious health pandemic and unfortunately we all are worried about the health of ourselves and our loved ones. Estate planning, at its core, is designed to address and make efficient situations of incapacity and death. To that end, clients should ensure that every adult (age 18 and over) in their household has the basic planning documents in place. Those documents include Wills, Revocable Trusts, health care directives and powers of attorney.

Q: What are the tax benefits of more sophisticated estate planning techniques in this current environment?

A: One goal of estate tax planning is to remove appreciating assets from the taxable estate via gifting or other transfers, so that all appreciation from the date of the gift onward passes to the next generation without gift and estate tax. The more a particular asset appreciates after the transfer, the more impact the planning will have from a wealth transfer perspective. Now that recent market volatility has knocked stock prices off their highs and has economically affected most businesses, there may be more gifting opportunities. At a minimum, clients should consider taking advantage of the existing exclusions from the gift tax:

- **Annual Gift Tax Exclusion:** In 2020, taxpayers can gift up to $15,000 to any number of beneficiaries, gift tax-free. Taxpayers may wish to consider making these gifts in trust for the intended beneficiary/beneficiaries with assets that are expected to increase significantly in value.
- **Utilize Remaining Lifetime Gift/Estate Tax Exemption:** In 2020, the federal gift and estate tax exemption is $11.58 million per person ($23.16 million for a married couple). In 2026, the base exemption is set to decrease from $10 million to $5 million, indexed for inflation after 2011. Clients should consider utilizing their remaining exemptions by gifting appreciating assets.
- Clients also should review any gifting strategy with their tax and legal advisor to determine the income tax consequences of gifting particular assets.

Q: The federal gift tax exemption is quite high. What if clients are apprehensive to part with such a large sum?

A: Consider a SLAT: It may be beneficial for some clients to use a portion or all of the available exemption to fund a Spousal Lifetime Access Trust (“SLAT”). A SLAT is a trust for the primary benefit of the grantor’s descendants, but also includes the client’s spouse as a permissible beneficiary. If there ever is a need for funds, a distribution may be made to the spouse to bring assets back into the household. However, the grantor spouse will lose indirect access to the trust funds in the event of divorce or if the beneficiary spouse dies. For technical tax reasons, SLATs are challenging in community property states.

Q: Does the current low interest rate environment create estate planning opportunities?

A: Many wealth transfer techniques are dependent upon federal interest rates. Certain techniques have a greater chance of tax efficient wealth transfer when interest rates are low:

- **Loans to family members at the Applicable Federal Rate.** The IRS scrutinizes loans between family members carefully to determine whether the transaction may be a disguised gift. One mark of a disguised gift is when the lender charges below market interest. The IRS considers interest charged at the Applicable Federal Rate, or AFR, to be sufficient. AFRs are published by the IRS monthly. If the borrower can invest the borrowed funds and achieve a greater return than the interest due, the excess wealth will pass to the borrower gift tax-free. This technique may result in greater wealth transfer when interest rates are low.
- **Self-Cancelling Installment Note (SCIN):** A SCIN is basically a promissory note – generally issued in connection with a sale such as described above – that includes a provision that cancels the note in the event that the seller dies before all amounts are paid under the note. The buyer owes nothing more on the note in this circumstance and the value of the note is eliminated from the

seller's estate. In order for the cancellation feature to be respected it must be a bargained for element that is reflected as either a "principal risk premium" (above market value) or an "interest rate premium" (above market interest rate). Considering today's historically low interest rates (and possibly depressed market values) the addition of a SCIN feature should be considered in connection with a sale involving a promissory note given by a family member.

- **Sale to a Grantor Trust:** A "grantor trust" is a type of trust that is structured so that all items of income and loss associated with the grantor trust are tax reported by the grantor (most frequently the one who established the trust, the "grantor"). Because the trust is indistinguishable from the grantor for income tax purposes, the grantor can sell assets to the trust in exchange for a promissory note without triggering a gain or loss on the sale. As mentioned above, the note must bear sufficient interest so that the sale is not deemed a gift. Further, the interest paid by the trust to the grantor on the note will not result in taxable income to the grantor. Despite the income tax treatment, in the case of intentionally defective grantor trusts, the grantor trust is considered to be a separate entity for gift and estate tax purposes. This means that the grantor remains responsible for the income tax liability generated on the trust assets, even though those assets are removed from the grantor's taxable estate. The tax payments, which are effectively additional transfer tax-free gifts to the trust each year, allow the trust assets to appreciate more rapidly on an after-tax basis. That fact, combined with the low interest rate to be repaid to the seller, allows greater wealth transfer.

- **Grantor Retained Annuity Trusts (GRATs):** A GRAT is a wealth transfer technique through which the grantor contributes assets to a trust that are expected to appreciate. The trust agreement provides the grantor with an annuity for a term of years. Generally, the annuity stream is equal in value to the assets that are contributed to the trust plus a certain assumed growth rate so that at the time the GRAT is created there is no gift element. The assumed growth rate is based on the monthly published AFR rates described above (often referred to as the "7520 Rate" from the Internal Revenue Code Section 7520). Any growth in excess of the 7520 rate will pass to GRAT beneficiaries (usually children) or trusts for their benefit at the end of the annuity term free from any gift tax.

  The 7520 rate is at a record low of 0.8% in May 2020. This means that the assets contributed to a GRAT in May would only need to grow more than 0.8%/year over the GRAT term for the GRAT to be successful.

Q: Should clients be revisiting existing planning structures?

A: Yes. Many existing structures can be revised to make them more efficient.

- **Re-GRAT:** Existing GRATs may "fail," meaning that the assets in the GRAT have declined in value such that all GRAT assets eventually will be returned to the grantor as annuity payments and because there is no appreciation, no assets will pass to the beneficiaries at the end of the annuity term. In that event, the grantor may "swap," or substitute, assets (such as cash) with the GRAT in order to "re-GRAT" the depreciated assets at the lower value, providing an opportunity for the new GRAT to be successful.

- **Refinance Intra-Family Notes:** If a client has existing intra-family debt, they can consider refinancing old notes at new lower interest rates so long as the debt instrument allows. Some practitioners believe that a note can be refinanced so long as prepayment is permitted. Others say that best practices call for some element of consideration to be furnished to the lender, such as pre-payment of a portion of principal, and/or shortening the term. A client considering this strategy should consult their tax advisor for advice specific to their situation.

- **Business Valuation:** Many estate planning strategies involve the gifting or sale of privately held business interests. In connection with these gifts or sales a valuation of the business is frequently required. On account of today's depressed economic conditions as well as situations involving the specific business (loan taken out to support the business) it may be an opportune time to obtain a business valuation that can be used to support a lower value for gifting or sale purposes

Q: Are there any other tax planning considerations to note?

A: Yes.

- **Consider alternate estate tax valuations:** Executors of taxable estates should consider whether to use alternate valuation date. Generally, the value of a decedent's assets as of the date of his/her death is used to assess the estate tax liability. The Executor may elect to use the value of the estate as of the 6-month anniversary of the date of death if the value of the estate and the amount of tax due would decrease as a result.
- **Review GST tax exemption allocations:** Certain trusts are exempt from the generation-skipping transfer tax when assets pass to grandchildren and to more remote descendants based on elections made on a gift tax return. If a return was not filed or the proper elections were not made, GST exemption may be allocated based on current market values.

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