STRADLEY RONON

Estates Advisory

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Transferring Wealth During the COVID-19 Crisis

As COVID-19 continues to present significant challenges to our health care system and the economy, we would like to assure you that we are here for you, and we are committed to helping you navigate these uncertain times as they may relate to your estate and wealth planning.

During the past several weeks, individuals watched as the values of their assets dramatically declined in an uncertain and tumultuous economic climate. Economists predict that the economy will recover. Meanwhile, the combination of the precipitous drop in asset values and historically low-interest rates is providing an unprecedented opportunity for business owners and individuals who own significant stock portfolios to transfer the future growth and appreciation of such assets at significantly reduced estate and gift tax costs. We summarized below several strategies we regularly design and implement for our closely-held business clients and clients who have significant publicly-traded stock portfolios.

1. **Intentional Grantor Trust**

An intentional grantor trust (IGT) allows the creator (Settlor) of the IGT to "freeze" the value of the contributed assets (e.g., low-value business interests or stock) and thereby take advantage of the currently depressed values. By a combination of gifting and selling assets to the IGT, the Settlor removes assets from his/her estate for Federal estate tax purposes yet continues to be treated as the owner of the transferred assets for Federal income tax purposes (making the IGT a "grantor trust" for income tax purposes). By paying the income taxes on the IGT's income, the Settlor is (a) effectively making tax-free gifts to the IGT in the amount of the taxes due on the IGT's income; and (b) further reducing the size of the Settlor's estate for Federal estate tax purposes.

To freeze the value of business interests or stock, the Settlor sells such assets to an IGT (which will have been pre-funded with a small amount of seed money – usually 10% of the sale price) in exchange for a promissory note. Since the IGT is a grantor trust for income tax purposes, there is no capital gains tax when the assets are sold by the Settlor to the IGT because the Settlor is effectively treated as selling the assets to himself/herself. The promissory note will provide for interest at the Applicable Federal Rate (AFR). If the assets in the IGT are able to earn income at a rate in excess of the AFR, the excess income will remain in the IGT and will pass to the beneficiaries of the IGT free of Federal estate and gift tax at the Settlor's death.

After the sale to the IGT, only the value of the promissory note is included in the Settlor's estate for Federal estate tax purposes. The value of the business interests or stock, and most importantly, the appreciation in the value of such assets, remains in the IGT and will ultimately pass to the beneficiaries of the IGT free of any gift or estate tax at the Settlor's death.

2. **Grantor Retained Annuity Trust**

When creating a grantor retained annuity trust (GRAT), the Settlor makes a gift (ideally, a gift of low-value assets, such as publicly-traded stock, which the Settlor expects will appreciate significantly in value) to the GRAT in exchange for an annuity paid to the Settlor for a set term of years (characteristically two years). The value of the Settlor's gift to the GRAT is equal to the value of the remainder interest in the GRAT, not the value of the assets transferred to the GRAT. Because the Settlor cannot make a gift to herself/himself, the value of the remainder interest is calculated by taking the fair market value of the assets the Settlor transfers to the GRAT and subtracting away the present value of the annuity payments which the GRAT pays back to the Settlor. This calculation allows the Settlor to increase the size of the annuity payments in order to reduce the size of the remainder interest. Ideally, the remainder interest should be as small as possible so that the Settlor uses the smallest amount of Settlor's lifetime gift tax exemption amount to offset the gift of the remainder interest (i.e., in a "zeroed-out GRAT," the remainder interest can be reduced to nearly zero so that very little lifetime gift tax exemption is used).

If the value of the property transferred to the GRAT increases significantly in value during the term of the GRAT, at the end of the GRAT term, most of the appreciation (i.e., the amount of growth in excess of the AFR) passes to the remainder beneficiaries (e.g., children) free of any additional Federal gift or estate tax. For the GRAT to be effective, the Settlor must survive the term of the GRAT. If the Settlor dies during the term, the assets in the GRAT are includable in the Settlor's estate for Federal estate tax purposes. However, if the Settlor did not create the GRAT, those assets would have been included in the Settlor's estate in any case. Hence, the GRAT strategy is a "heads you win, tails you don't lose" structure.

The gift tax calculation performed in creating a GRAT uses the AFR to determine the annuity payable to the Settlor (which rate, set monthly by the IRS, is currently at a near-historic low of 1.2% in April 2020). The lower this AFR rate, the smaller the gift to the remainder beneficiaries and the more likely that the GRAT will be successful in passing appreciation to the remainder beneficiaries at the end of the GRAT term.

Similar to an IGT, a GRAT is also a grantor trust for income tax purposes. Thus, the assets in the GRAT are not depleted by the payment of income taxes, and the Settlor's payment of the income taxes has the effect of additional tax-free gifts to the GRAT beneficiaries in the amount of the income taxes paid.

3. **Loans at Reduced Interest Rates**

As discussed above, AFR rates are currently low. Such reduced rates provide an opportunity to make low-interest loans to family members or family trusts. Such reduced rates may also make refinancing an existing loan an attractive option.

4. **Gifting Low-Value Assets**

We urge our clients to also consider making outright gifts at this time while asset values are low. By way of example, if you are able to gift a low-value asset today that is likely to be worth substantially more one year from now, it may be advantageous to transfer that particular asset in the near term in order to use as little of your gift and estate tax exemption amount as possible.

While the gift and estate tax exemption amount is currently $11,580,000 (or $23,160,000 taking into account the use of both spouses' exemptions for married couples), under current law, such amount is scheduled to decrease on Jan. 1, 2026, to $5,000,000 (which amount will be adjusted for inflation). Furthermore, the reader should note that this election year could bring changes to the estate and gift tax exemption law well in advance of Jan. 1, 2026. Current low asset values, coupled with the uncertainty surrounding the future state of the federal gift and estate tax exemption amount, makes this an important time to consider gifting assets.

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If you would like to discuss any of the above strategies or any other aspect of your estate planning, please contact Tara M. Walsh at 484.323.1357 (twalsh@stradley.com), John C. Hook at 215.564.8057 (jhook@stradley.com), or any other member of our Trusts and Estates Group. Above all, please stay safe and healthy.