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The Lows and Highs of Estate Planning in a Pandemic: Making the Most of Estate and Gift Tax Opportunities in the Covid-19 Economy

Joshua M. Kaplan, and Jeffrey B. Kolodny[*]
Kleinberg, Kaplan, Wolff & Cohen, P.C.
New York, NY

INTRODUCTION

Since the onset of the Covid-19 pandemic, the defining characteristics of 2020 seem to be uncertainty and unceasing change. The economic instability resulting from an unprecedented public health crisis and our evolving response has led to recurrent highs and lows of one form or another. In addition to concerns about personal health and well-being, the disruption to our professional and economic lives has caused anxiety regarding the ability to preserve wealth and to provide for future generations. While some may wish to wait out the pandemic before engaging in estate planning, a closer examination of the current economic climate indicates that it may be an ideal time to consider several planning strategies.

This article explores how the following four circumstances (or ''lows'' and ''highs'') intersect to create conditions that are uniquely favorable for estate planning: (1) low asset values; (2) a high estate and gift tax exemption amount; (3) low interest rates; and (4) high levels of market volatility and uncertainty. Each of these factors on its own might cause advisors to encourage clients to explore new estate planning strategies. When combined, however, they create significant opportunities to efficiently transfer wealth to future generations with little or no transfer tax liability.

LOW ASSET VALUES

A universally accepted technique for the efficient use of estate and gift tax exemption is to make gifts of assets that are undervalued. The basic principal behind such planning is straightforward: use as little estate and gift tax exemption as possible to transfer assets to vehicles that allow for growth in value outside of the donor's and the beneficiaries' taxable estates. The key to effectively deploying this strategy is to be able to identify assets with low current valuations that are likely to increase in value significantly over time. In some cases, a market downturn allows gifts of publicly traded securities that will increase in value when the market rebounds. In other cases, gifts of interests in closely held businesses that are undervalued (either because they are in the early stages or due to prevailing market conditions) may be made before the market can recognize the true value of the business.

While it is difficult to measure the true impact of the pandemic on asset values in absolute terms, many assets are currently undervalued due to prevailing economic conditions. Although financial markets have rebounded in recent months, some asset classes and business sectors remain adversely affected by the pandemic. In addition, many closely held businesses still can be subject to low valuations for a number of reasons, including cash flow and liquidity issues, lack of access to credit, or market conditions that affect a particular economic sector (such as hospitality or commercial real estate).

For many taxpayers, identifying assets with lower values may not be as challenging as trying to predict which assets will increase in value as the pandemic wanes and to structure gifts so as not to inadvertently cause a current gift tax liability. While concerns about long-term value may require knowledge of specific facts regarding the gifted assets, potential gift tax li-

[*] Joshua M. Kaplan and Jeffrey B. Kolodny are Co-Chairs of the Trusts & Estates Group at Kleinberg, Kaplan, Wolff & Cohen, P.C.

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ability can be avoided through so-called ''defined value'' gifts.

A defined value gift is a transfer in which the donor makes a gift of an interest in an entity having a specified fair market value, rather than transferring a specific number of shares of a corporation or a specific percentage interest in a limited liability company. For example, a donor who wishes to make a $10 million gift may execute an instrument specifying a gift of $10 million worth of membership interests in ABC LLC, which the donor believes represents a 10% membership interest. The strength of this approach is that if it is finally determined for gift tax purposes that a 10% membership interest in ABC LLC is worth $20 million, the donor will be deemed to have transferred a five percentmembership interest. Had the donor simply made a gift of a 10% membership interest, he or she could be liable for a 40% gift tax on any amount excess of his or her remaining gift tax exemption.

Although courts have upheld the validity of defined value gifts, there is still some audit risk inherent in any such gift. Until 2012, the IRS would not respect defined value clauses. The IRS took the position that a defined value gift was against public policy, because it created a condition subsequent that could result in a transfer of assets back to the donor after the date of the gift.[1] In May 2012, the Tax Court's decision in *Commissioner v. Wandry*[2] recognized the taxpayer's ability to make a gift of the number of membership units in an LLC having a specified fair market value for gift tax purposes. Although the IRS voluntarily withdrew its appeal of the *Wandry* decision, official guidance indicates that the IRS has not acquiesced to the decision[3] and, therefore, we expect the IRS will continue to challenge the validity of defined value gifts.

While the IRS has had limited success in challenging certain defined value gifts since *Wandry,* recent case law indicates that the Tax Court will continue to look to the *Wandry* analysis when reviewing defined value gifts. In June 2020, the IRS prevailed (to an extent) in *Nelson v. Commissioner*,[4] convincing the Tax Court not to respect the valuation for a gift of limited partnership interests and to rule that the defined value clause in the gift instrument contained a condition subsequent. In rendering its opinion, the Tax Court referred to *Wandry* as precedent and specifically distinguished the case at hand. In contrast to *Wandry,* the operative instrument in *Nelson* provided that the amount of limited partnership interests transferred was to be determined by an appraisal, rather than by the value as finally determined for gift tax purposes. Although the IRS may have ''won'' the *Nelson* case in the sense that it was able to impose a gift tax, taxpayers now have a clearer roadmap for successfully structuring defined value gifts.

In order to take full advantage of current low asset values without risking payment of gift tax, taxpayers should be careful both to choose appropriate assets to give and, when making defined value gifts, to ensure that the defined value will be respected by specifying an asset value as finally determined for gift tax purposes. Even if the IRS can successfully challenge the valuation of the assets as reported on a gift tax return, the result will be a gift of a smaller interest in the closely held entity rather than the imposition of gift tax.

HIGH ESTATE AND GIFT TAX EXEMPTION

The 2020 estate and gift tax exemption is $11.58 million per person, the highest it has ever been. Under current law, this exemption amount is scheduled to increase by inflation through 2025, and on January 1, 2026, the exemption will be cut in half.[5] Recent Treasury regulations clarify that any gift tax exemption previously used in excess of a reduced exemption amount will not be ''clawed back.''[6] In other words, taxpayers will not be subject to additional transfer tax in the future if they die when the estate tax exemption is less than the amount of lifetime gifts they made free of gift tax utilizing the previously higher lifetime gift tax exemption.

As a result, many wealthy taxpayers have made or plan to make significant gifts that can utilize the high exemption amount before January 1, 2026. Under current law, it appears that the disappearing exemption is a ''use it or lose it'' opportunity to transfer significant wealth at no gift tax cost.

The Covid-19 pandemic has resulted in massive stimulus spending. Depending on the outcome of the upcoming presidential election, the balance of power could shift in Congress, which some believe may lead to significantly more government spending, backed by massive tax increases. In addition to higher income tax rates and reduced income tax deductions, an obvious way to raise taxes would be to increase estate and gift tax rates and/or to reduce the historically high gift and estate tax exemption before it sunsets at the end of 2025.

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[1] *See Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944).

[2] T.C. Memo 2012-88.

[3] IRS AOD 2012-04 (Nov. 12, 2012).

[4] T.C. Memo 2020-81.

[5] *See* §2010(c). All section references herein are to the Internal Revenue Code of 1986, as amended (the ''Code''), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[6] *See* Reg. §20.2010-1(c).

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Taxpayers who believe that there is a high risk of the reduction of the gift and estate tax exemption and have sufficient wealth and the desire to make lifetime gifts would be well advised to contact their advisors to plan for that gifting as soon as possible. Even if there is not a change of administrations in 2021, prudent planning with low value assets could still be extremely effective (as described above), especially considering the fact that under current law, the exemption will be cut in half in 2026.

With this incentive to make gifts as soon as possible, we provide some advice in connection with making gifts that taxpayers and their advisors may find beneficial.

While there are very real financial motivations to give away as much wealth as possible in an environment where transfer tax rates may increase and exemption amounts may decrease, taxpayers should remember that they are, in reality, giving away wealth. It is crucially important that a taxpayer should not impoverish himself or herself. As we have experienced all too well in the past months, the world can change dramatically with almost no warning, and taxpayers are well advised to ensure they retain sufficient assets to maintain their desired lifestyle. Of course, the decision of how much any particular individual needs depends on various factors, including, among other things, life expectancy and spending patterns. Retaining an interest in property that was previously given away, whether through the legal rights or informal arrangements, risks not only using lifetime gift tax exemption, but also estate tax inclusion.[7]

Changing circumstances have resulted in a movement towards flexibility in gifting. Gifts can be made in ways that provide maximum flexibility to the donor and the donor's family. While not perfectly efficient, spousal lifetime access trusts may provide a way to get assets to a spouse, should that be necessary. A donor of a trust can retain the power to substitute assets from a trust with assets of an equivalent value.[8] The evolution of trust decanting and the use of powers of appointment provide some ability to modify trust terms over time to adapt to changing circumstances. These techniques and others can provide comfort to a grantor who may be reluctant to lock up significant wealth in an irrevocable trust for extended periods of time.

A married couple can give double the gift tax exemption amount ($23.16 million in 2020). Even if only one spouse has the wealth to give, spouses can elect to split gifts on their gift tax returns, allowing a wealthier spouse to use the gift tax exemption of a spouse with less assets. In certain circumstances, the ability to split gifts with a spouse can be extremely effective.

Couples of less significant means that want to make gifts but do not plan to use the full amount of their gift tax exemption may benefit by intentionally *not* splitting gifts; this may allow for a larger transfer of wealth free of transfer tax. Take, for example, a married taxpayer with $20 million who has not made any lifetime gifts and wants to give away $10 million in 2020. With the current exemption at $11.58 million, the taxpayer can give the full $10 million free of transfer tax. If the taxpayer and his or her spouse elect to split gifts, each of them will have made a gift of $5 million. If the gift and estate tax exemption increases by inflation to $12 million and it is then cut in half to $6 million (either in 2026 or earlier) the married taxpayers will have a combined exemption of $2 million remaining (i.e., $6 million less $5 million used by each spouse equals $1 million per spouse). If, instead, the spouses do not split gifts, the taxpayer will use $10 million of his or her $11 million exemption. Using the same assumptions, when the gift tax exemption is cut in half, the taxpayer will have used his or her full $6 million exemption, but his or her spouse still will have his or her entire $6 million exemption remaining because none of her exemption was applied to the $10 million gift in 2020. By not splitting gifts, the couple in this example would be able to transfer an additional $4 million of wealth free of transfer tax.

LOW INTEREST RATES

For those taxpayers who have used their exemption amount or do not want to give away the full value of their assets, the historically low interest rates that we are currently experiencing also provide exceptional opportunities to transfer wealth.

The September 2020 applicable federal rates are as follows:[9]

- Federal short-term rate (loans up to three years) — 0.14%;
- Federal mid-term rate (loans more than three and up to nine years) — 0.35%; and
- Federal long-term rate (loans more than nine years) — 1.00%.

The applicable federal rates, which change monthly, are the minimum rates that must be received by a lender to avoid deemed gifts from the lender to the borrower. To the extent a borrower can achieve a

[7] *See, e.g.,* §2036, §2037, §2038.

[8] Substituting the grantor's high basis assets or cash for low basis trust assets shortly before death can be a very effective way to reduce capital gains tax exposure.

[9] Rev. Rul. 2020-16.

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return on the borrowed assets that exceeds the interest rate on a loan, that borrower earns income (or accumulates wealth) on the spread between the earned return and the interest rate paid on the debt.

Thus, to the extent a taxpayer can provide financing at very low interest rates to a family member (or a to trust for the benefit of a family member), and the borrowed assets can achieve a rate of return that outperforms the interest rate on the loan, the taxpayer is effectively able to transfer the appreciation above the interest rate on the loan to the family member (or trust) free of transfer tax. If a taxpayer makes a low interest rate loan to a grantor trust, the transaction will be even more efficient because the taxpayer will not incur income tax liability on the interest he or she earns on the loan.[10]

For example, assume a taxpayer lends $1 million to a grantor trust for his or her children in September 2020, for a term of 20 years at the Federal long-term rate of 1.00%. If the borrowed assets earn 5% over the term of the loan, the trust will have net earnings of 4% per year (i.e., 5% return less 1% interest) on the $1 million, or $40,000 in the first year. Since the trust is a grantor trust, the taxpayer will pay the income tax on the 5% return earned by the trust each year, and there will be no income tax obligation with respect to the 1% interest paid by the trust to the taxpayer. In the second year, the trust will have net earnings of $42,000 (i.e., [$1,040,000 ×.05] - [$1,000,000 × .01]). In this manner, the trust may continue to grow on a tax-free basis, each year earning income on the full amount of the assets in the trust.

While it may be tempting to lock in a long-term loan at 1.00%, a taxpayer should always consider the time horizon for any such borrowing. Loans that are only required for less than three years can be made at a low interest rate of 0.14% in September 2020, and a nine-year loan can be made at 0.35%.

Existing loans to family members (or trusts for family members) also can be refinanced in order to lock in lower interest rates. When structuring any such refinancing, the taxpayer should consider whether consideration should be provided from the borrower to the lender in exchange for the reduced interest rate.

The sale of an appreciating asset to a grantor trust is a popular way to transfer appreciation that is especially effective when interest rates are low. This technique traditionally involves a taxpayer selling an asset to a grantor trust in exchange for a cash down payment of at least 10% from the trust, with the balance of the purchase price being paid with a promissory note. Any income or appreciation in excess of the interest rate on the loan will accrue to the benefit of the trust beneficiaries. In a period such as now, when interest rates are at or near historical lows, it is that much easier for the asset to achieve a return in excess of the interest rate due on the note.

Another noteworthy benefit of the sale to a trust using an installment note is the leverage provided. Since only about 10% of the purchase price of the asset is paid to the grantor from the trust, that is the maximum amount of a gift that may be required to engage in the transaction (assuming that the trust has no other assets with which to make the down payment). For example, if a taxpayer wants to sell a $5 million asset to a grantor trust he can make a gift of $500,000 to the trust, which the trustees would in turn use as the down payment on the purchase price. The loan would be $4.5 million. In this way, the taxpayer would use only $500,000 of his or her lifetime exemption, as opposed to the taxpayer making a gift of the full $5 million value of the asset. Any appreciation in the value of the asset after the sale accrues to the trust beneficiaries is excluded from the taxpayer's gross estate. Of course, since the taxpayer also receives a promissory note as partial consideration for the sale, the value of the promissory note is an asset of the taxpayer that would be included in his or her estate.

Grantor Retained Annuity Trusts (GRATs), which are discussed in greater detail below, also can be especially effective in a low interest rate environment.

HIGH MARKET VOLATILITY AND UNCERTAINTY

In the early days of the pandemic, market volatility spiked rather quickly. For example, on March 16, 2020, the CBOE VIX Volatility Index (the "VIX") reached a peak of 82.69, up from 14.83 on February 18. Although by late August the VIX was back down to approximately 22, an uncertain economic outlook has kept investors skittish. At least one empirical study has found a correlation between the spread of Covid-19 and increased market volatility.[11]

While volatility may create opportunities for sophisticated investors to achieve greater returns, it also has the potential to enhance the efficacy of certain estate planning strategies, most notably GRATs. A GRAT is a trust to which a taxpayer makes a contribution in exchange for the right to receive a regular

[10] Since the grantor of a grantor trust is treated as the owner of the assets of the trust for income tax purposes, the loan is disregarded because it will be treated as being made from the grantor/lender to himself or herself. *See, e.g.,* Rev. Rul. 85-13.

[11] *See* Claudiu Tiberiu Albulescu, *COVID-19 and the United States financial markets' volatility,* Finance Research Letters, 101,699 (Jul. 25, 2020).

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annuity payment. If the present value of the annuity payments equals the value of the contribution to the trust (a so-called ‘‘zeroed-out’’ GRAT), then there is no taxable gift. The present value is calculated based on the §7520 rate, which is published by the IRS monthly. For September 2020, the §7520 rate is 0.4%.

Assuming the grantor survives the annuity term, any assets remaining in a GRAT after all annuity payments have been made to the grantor may pass to the grantor's descendants (or trusts for their benefit) without further gift or estate tax.[12] In other words, to the extent that assets contributed to a GRAT appreciate at a rate in excess of the §7520 rate, such excess appreciation will pass free of gift or estate tax to the remainder beneficiaries. If the GRAT assets fail to appreciate sufficiently, the assets will be exhausted through annuity payments to the grantor and the GRAT will fail. While there will be no transfer tax savings, in a zeroed-out GRAT, the grantor did not use any gift tax exemption to fund the GRAT, making the strategy at worst neutral from a transfer tax perspective.

GRATs funded during uncertain times can benefit greatly from market volatility. First, funding a GRAT when asset values are low enhances the effectiveness of the GRAT, as the annuity payments are based on the fair market value of the GRAT assets as of the date of funding. In addition, when values of GRAT assets spike during the annuity term, the GRAT can be ‘‘immunized’’ to protect against any future downside risk and the high value maintained by substituting cash for the newly appreciated assets and locking in a return well in excess of the §7520 rate. In addition, if the grantor reacquired the appreciated GRAT assets to immunize the GRAT and those assets once again declined in value, the grantor could contribute those assets to another GRAT and repeat the same technique if their value spikes a second time.

In addition to planning for volatility, GRATs generally are a good strategy for planning with risky investments that are likely to be either wildly successful or to fail. This is because creating a zeroed-out GRAT has no transfer tax costs (i.e., it does not require the use of gift tax exemption), and nothing is lost if the GRAT fails (other than the costs of setting up the GRAT). If the investment is extremely successful, however, the difference between the actual return on the investment and the §7520 rate can be transferred to the remainder beneficiaries of the GRAT free of gift and estate tax. With interest rates (including the §7520 rate) at historic lows and high volatility, the likelihood of a successful GRAT and the effectiveness of GRAT planning is much greater.

Besides increasing the effectiveness of certain planning strategies, market volatility may affect how trustees invest trust assets. Trustees are bound by fiduciary duties to invest trust assets prudently and may be liable to beneficiaries for losses caused by mismanagement. Attorneys drafting trust instruments during the pandemic should discuss with their clients whether they wish to specifically authorize trustees to take certain investment risks (or retain risky assets received from a donor) so as to reduce or eliminate any dampening effect that liability concerns may have on trust investment returns. In some cases, clients may wish to choose to create trusts in jurisdictions that allow more extensive waivers of fiduciary duties to allow trustees to take on a greater level of investment risk without fear of liability.

CONCLUSION

The true extent of economic impact of the Covid-19 pandemic, which has lasted longer than many expected, remains unknown. The tendency to postpone planning until periods of economic uncertainty have subsided is understandable, but ultimately may prove to be a missed opportunity. Just as businesses have had to adapt to an altered economy in order to continue to profit, estate planners must adjust their strategies to leverage those aspects of the current circumstance that allow for more effective planning. While no one can predict the future, it is almost certain that there will continue to be highs and lows as the pandemic runs its course. The challenge will be to see them not as obstacles but as opportunities.

[12] In order to avoid Generation-Skipping Transfer (GST) tax, GST exemption should be allocated to the assets remaining in the GRAT after the last annuity payment is made to the grantor.

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