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Estate Planning in the COVID-19 Era

By David W. Woodburn

While no one can diminish the seriousness of the COVID-19 pandemic, it is important to note that there are certain tax planning opportunities that now exist due to low interest rates, depressed stock values, and a likely reduction in the federal estate tax exemption. For those facing a potential federal estate tax, the factors above make now an attractive time to reduce potential estate tax exposure.

Background for Gifting

Under the current law, each individual has a federal estate tax exemption of $11.58 million, which can be applied against lifetime gifts and gifts upon death. Unfortunately, the current estate exemption is scheduled to sunset at the end of 2025 and revert back to $5 million (indexed for inflation). Given the stated positions of the leading Democratic candidates for President, a Democratic victory in the next presidential election could possibly result in an accelerated reduction in the exemption. The IRS has recently stated that it will not “claw back” lifetime gifts when the exemption is reduced. Thus, if you are in a federal estate tax situation, it may be advisable for you to make sizable gifts at this time using the remaining balance of your estate tax exemption.

Many clients are opting to use one of the following two techniques to leverage their estate and gift tax exemption dollars:

1. **Grantor Retained Annuity Trust (“GRAT”)**

   A GRAT enables a donor to fund a trust with highly appreciating securities while retaining the right to an annuity in the form of a fixed percentage of the initial value of the trust. Often the term for the GRAT is set as two years to increase the likelihood that the donor will survive the trust term. At the end of the trust term, any remaining assets are distributed to the GRAT’s remainder beneficiaries.

   The amount of the annuity is calculated based upon the IRS prediction of annual trust income, which is based upon a federally determined rate of interest required by Internal Revenue Code Section 7520 for the month in which the trust is created. If the trust achieves growth greater than the 7520 rate, the appreciation will pass to the beneficiaries, and the donor will have used virtually none of their estate tax exemption. With interest rates being extremely low, and assets being depressed in value, the likelihood that the stock will appreciate more than the 7520 rate is great. GRATs make an excellent vehicle for transferring stocks and passing the future stock appreciation out to desired heirs with virtually no risk.

2. **Intentionally Defective Grantor Trust (“IDGT”)**

   An IDGT is an irrevocable trust that specifically contains provisions causing the creator to be treated as the owner for income tax purposes (i.e., “defective”) although the assets of trust generally will not be includable in the donor’s estate. The defective nature of the trust allows the donor to pay the income tax liability generated by the trust assets without forcing the trustee to deplete the trust assets to pay the taxes. By paying the income tax liability, the donor essentially is making an additional tax free gift to the trust as the assets transferred into trust can grow for the benefit of the desired beneficiaries outside of the donor's estate.

IDGTs can be funded either through outright gifts or by a sale. While an outright gift would use a larger portion of the donor's estate tax exemption, a sale can be utilized so that the stock is transferred into the trust in return for an installment promissory note, with interest calculated based on the current Applicable Federal Rate (AFR), which is extremely low at this time. There is no gift tax due with respect to an installment sale to the IDGT because it is treated as a "sale" from the donor to himself or herself for income tax purposes. As long as the assets appreciate in excess of the AFR, the appreciation passes estate tax free to the trust beneficiaries and the donor is able to receive a return on the value of assets sold to the trust. This creates a great planning opportunity to be utilized while interest rates are low and assets can be sold for less than what they may be worth in the near future when the market hopefully corrects itself.

Now is an excellent time to take advantage of the low interest rates and depressed stock values to engage in GRATs or sales to IDGTs.

Please consult with your Roetzel estate planning attorneys to discuss these and other options that may be available during this limited period.

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