7 Strategic Estate Planning Techniques For Right Now

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Our thoughts are with all those impacted by COVID-19. We do not diminish the health and financial impact on anyone, but market disruptions trigger tax planning opportunities.

Volatility in the markets and nearly historically low interest rates reflect the economic and other challenges presented to us right now. Further, sophisticated transfer tax planning often revolves around being able to convince the IRS to accept valuation discounts for lack of control or lack of marketability. The current market raises the opportunity to use "discounts" that cannot be questioned by the IRS.

Below are seven techniques applicable right now.

1. Alternate Valuation

If you are, or are advising, a Personal Representative or other fiduciary responsible for preparing a federal (or state) estate tax return, remember alternate valuation. Under Internal Revenue Code § 2032, an estate may elect to pay estate tax based not on the value of assets on the date of death, but on their value six months after death.[1] This is referred to as the Alternate Valuation Date ("AVD"). To qualify, a two-pronged test must be satisfied:

1. the value of the gross estate must decrease, and
2. the combined amount of federal estate tax (reduced by allowable credits) and generation skipping transfer tax must decrease.

With market volatility, it is possible that the value of a recent decedent's portfolio will drop dramatically on the AVD. This brings to mind another rule, and one that can be used strategically. If an asset is sold between date of death and the AVD, the sales price will be the measuring value.[2] So, if your estate has two assets, a home and shares of Exxon (XOM) stock, and you see that before the AVD the stock has dropped, but the financial advisor believes it may recover by the AVD, the PR could sell at the reduced market value to freeze that value for alternate valuation purposes. Although there is no express prohibition on the immediate repurchase of the stock, a more prudent approach might be to purchase a sector ETF, or a similar stock (such as Chevron), to maintain exposure to the industry.

And what about the home? The use of the AVD is an "in for a penny, in for a pound" proposition. If not disposed of before the AVD, the estate tax value of the home will be its fair market value on the AVD.

What if your estate has formula transfers such that no estate tax is triggered? Clearly, if no tax is due because of say an optimized credit shelter and marital trust arrangement, the second prong of the test cannot be met. In such case, there is another technique that could provide access to alternate valuation – the disclaimer. It may be possible to disclaim a small amount, or exercise a partial QTIP disclaimer, resulting in a modest estate tax liability; thereby potentially allowing the use of the AVD.

One of the authors was involved with an estate that highlights the importance of considering the AVD election. The decedent died March 12, 2001, owning over $600 million of real estate in New York City. The AVD for the estate was September 12, 2001, one day after the 9/11 attacks. The AVD value for New York City real estate the day after was starkly lower (less than $100 million), protecting almost half of a billion dollars from exposure to a 55% Federal estate tax rate.

Of course, your analysis of whether to use the AVD is not complete without thinking through the impact on basis from the point of view of the beneficiaries (and their intention regarding holding or selling the properties). The basis "step-up" rules provide that if alternate valuation is elected one uses the AVD value as the basis of each asset.[3]

2. GRATs

Grantor retained annuity trusts (GRATs) are an effective technique for wealthy families to transfer wealth free of estate, gift, and income taxes. They involve transferring wealth into a

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trust (usually short term, such as two years), while retaining an annuity repayment equal to most or all of the original principal plus an interest rate set by statute. Any growth in the assets beyond the interest rate "hurdle" will be transferred tax-free to the ultimate beneficiaries (often children or trusts for children).

Two components make GRATs potentially timely:

First, the interest-rate hurdle is a rate based on a provision in the tax code. It is known by the code section creating it, Section 7520. Established in 1989, and reset every month, the Section 7520 rate has averaged above 5%. In comparison, the April 2020 Section 7520 rate is a very low 1.2%.[4] GRATs funded in April will need only to outperform this very low hurdle in order to pass a tax-free gift to the remainder beneficiaries.

Second is market volatility. Imagine a stock that, based on fundamentals, should be trading at $100 per share. If market disruptions temporarily push down the value to $70 per share, one can transfer the stock at $70 into a GRAT, and if it were to revert to its $100 expected value once the market disruption has passed, this $30 increase (minus the Section 7520 rate interest cost) will avoid a potential future estate tax of 40% or more).

A further refinement to this technique is the timely use of a swap or substitution power.[5] Imagine your client has an existing GRAT originally funded with a concentrated position in an asset or asset class that has dramatically dropped in value. One cannot commute the term of a GRAT (do an actuarial division between the income and remainder beneficiaries). Can anything be done to "capture" the current depressed valuation?[6] Absolutely! Your client can swap into the trust a low-volatility asset, such as cash or fixed income, and use the retrieved stock to fund a new GRAT. Thus, like the above, reversion to the mean will serve as pure gain in the new GRAT. This technique allows you to achieve a successful GRAT for your clients off of the original asset.

3. Low interest rate loans

In most circumstances, the Internal Revenue Code requires that intra-family loans be made with a minimum amount of interest. The relevant minimum rates, known as the Applicable Federal Rates (AFR), are established each month. The rate floats monthly with demand loans, but can be fixed for term loans. If no (or a lesser) interest rate is charged, the Code imputes the difference and requires taxes to be paid by the lender on the actual and additional imputed interest.

There are three AFR rates used for term loans, depending on whether they are for less than three years (short), three to nine years (mid), or nine years or longer (long). They reflect, to a degree, relative term bond yields. Not surprisingly, April brings a very low set of rates.[7] Accordingly, clients (and their advisors) should consider strategies thereby advantaged. These include techniques from the simple to the complex, such as:

1) making a low rate loan to a child or grandchild;
2) refinancing an existing loan to reduce the rate;
3) lending to a family member or a grantor trust for the family member, who invests the proceeds in fixed income or other investments (the positive arbitrage is thereby outside your taxable estate and even could be in a GST-exempt trust);
4) selling assets to a trust in exchange for a promissory note; and
5) charitable lead trusts.

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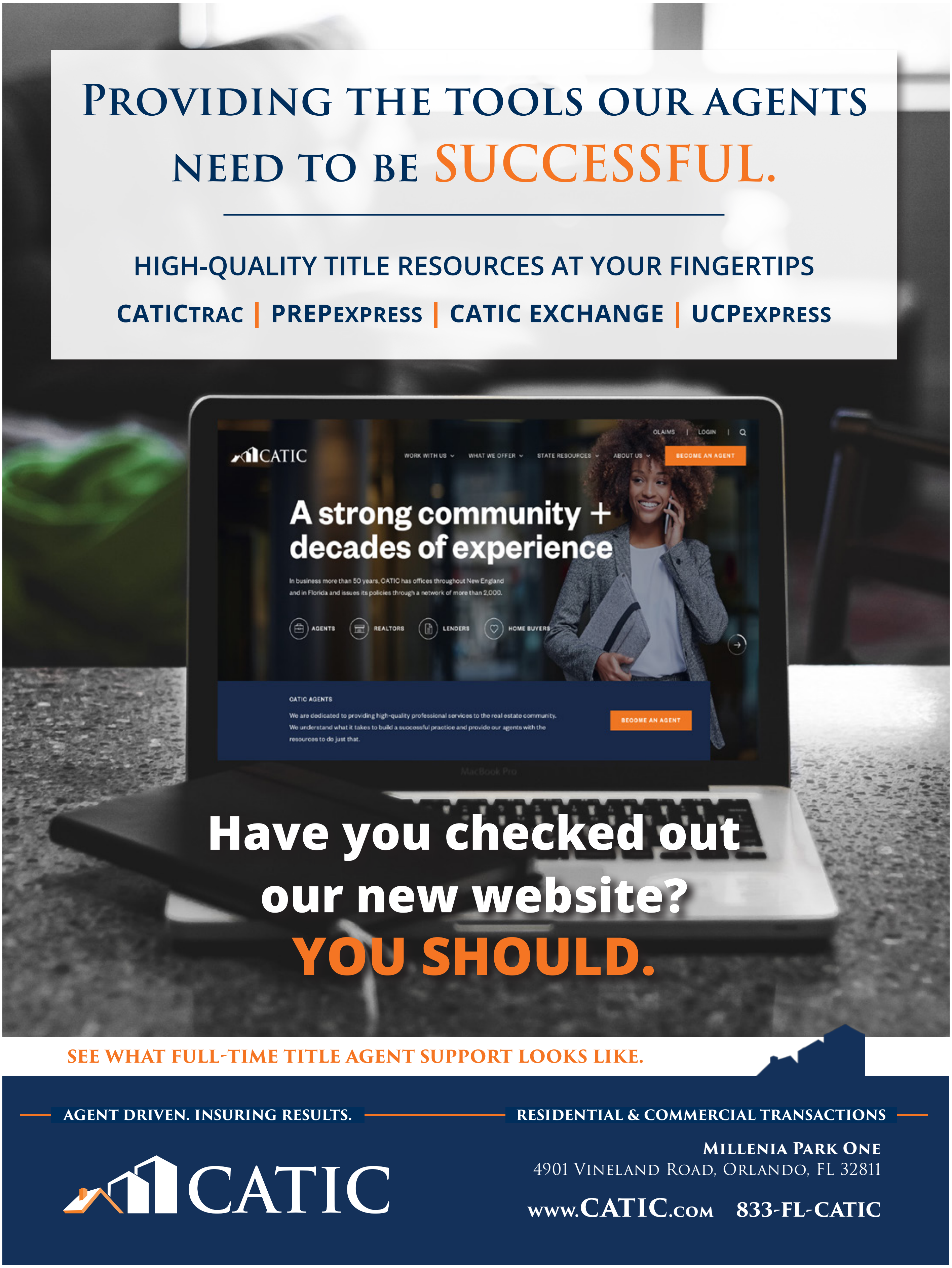
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4. Annual Exclusion Gifts

It is customary for advisors to guide clients on making annual exclusion gifts. These gifts of up to $15,000[8] (2020 amount) are per donor/per donee and do not require the use of gift/estate or GST exemptions.

Many clients make these gifts every year at the beginning of the year, so that increases in value during the year are outside their estate. Others wait for the year-end holidays to make them. If that is your client, they should consider making them now with assets, such as publicly traded securities, suffering from a reduced value. Yes, basis for capital gains will carry-over (i.e., when sold, the recipient will use the donor's basis to compute capital gains or the value on the date of the gift, if lower), but the growth reflecting the return to normal value directly will benefit the donee at no tax cost to your client. More simply, clients can give cash and allow their child (or other donee) to invest and capture the hopeful swing back to normal valuations.

5. Full use of enhanced gift and GST exemptions

As we all are aware, the current tax law permits a very favorable $11,580,000 exemption for gift tax and generation skipping transfer tax (GST tax). The law that doubled the exemption to $10,000,000 in 2016 (with annual cost of living increases) is schedule to sunset and the exemptions will revert to $5,000,000, indexed, on January 1, 2026. Many predict that amount indexed will be between $6 million and $6.5 million.

Without a doubt, you have encouraged your clients to use the enhanced amount before it is lost. But it is time to revisit that advice, perhaps with some urgency. Now, given the recent market decline, this advice suddenly is even more timely because when values are depressed, the effect can be to give away even more in the long run when asset values increase.

6. Converting Traditional IRAs to Roth IRAs

Tax law permits conversion of traditional IRAs to Roth IRAs, thereby gaining more favorable tax treatment (for example, the same tax-free growth, but also tax-free withdrawals after age 59 ½ and no required minimum distributions). There have been two critical IRA tax law developments over the last few years, but conversion remains a viable technique; and especially now, given market volatility.

What has changed? First, the 2017 Tax Act ushered in the elimination of the ability for a taxpayer to recharacterize a converted IRA.[9] This means that prior to 2018, one could convert to a Roth, and later undo the conversion – recharacterize back to a traditional IRA – before the timely filing of the tax return for the year of the conversion. Conversion is still permitted, but this cancellation of the conversion is no longer an option.

Second, the SECURE Act, included in the December 20, 2019, budget bill, has all but eliminated stretch IRA planning for account owners who die on or after January 1, 2020 (ten-year stretch under most circumstances). This entails a detailed review of your client's IRA beneficiary designations but doesn't impact the conversion opportunity presently available.

So why is conversion timely? The account owner must include in taxable income the value of the traditional IRA assets on the date of conversion to a Roth IRA. When the market forces those values lower, less tax is triggered.

7. Tax-Free Substitution of Growth Assets into Grantor Trusts

Many clients have established irrevocable trusts that for income tax purposes, qualify for grantor trust treatment. This means that, even though the transfer is a completed gift, the client is deemed to be the taxpayer of the trust and reports its income on his or her tax return.

As noted earlier, assets can be exchanged with such trusts tax-free. Given the market changes, clients should review the assets they own directly as well as those in their grantor trusts to determine whether those with higher growth potential should be swapped into the trust (after considering basis and other factors).

Conclusion

Market volatility is unsettling. Staying true to an established, tailored investment policy can be particularly challenging; however, within this chaos, estate and income tax planning opportunities exist in what we may look back upon as a window of opportunity.

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Endnotes

1 The AVD for an asset disposed of within six months is the date of its disposition.

2 The actual sales price of a publicly traded security, not the median between the high and low on the date of sale is used. Rev. Rul. 70-512, 1970-2 C.B. 192.

3 IRC §1014(a)(2).

4 The Section 7520 rate is 120% of the mid-term AFT, rounded to the nearest 20/100ths.

5 As a grantor trust, substitutions can be made without triggering an income tax event. Rev. Rul. 85-13.

6 The term of a GRAT cannot be commuted. Treas. Reg. §25.2702-3(d)(4).

7 The rates are stated for term and compounding (annual, semi-annual, quarterly and monthly). The April AFR rates for annual compounding are: short term, 0.91%; mid-term, 0.99%; and long-term 1.44%.

8 The 2020 amount under IRC §2503(b).

9 Originally, recharacterization was permitted under IRC §408A(d)(6). *See* Notice 2000-30.