

# ESTATE PLANNING AND COVID-19: NOW IS THE TIME TO ACT

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# Topics for Discussion

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1. Immediate Action Items
2. Fabulous Five Techniques To Use in a Bear Market and/or When Interest Rates Are Low (Intra-Family Loans, GRATs, Outright Gifts to SLATs, Sales to SLATs, and CLATs)

# Immediate Action Items

# Steps to take RIGHT NOW

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- Fund revocable trusts as soon as possible. Probate courts in many states are shut down. Even if they reopen soon, it could take months to probate a Will due to the backlog. Holding assets in a Revocable Trust avoids probate and enables the successor Trustees to use the assets to pay ongoing expenses after the Settlor's death.
- The same principle applies for guardianship/conservatorship purposes i.e., if you become incapacitated.
- If your current estate plan does not include a Revocable Trust, consider enhancing it immediately to incorporate one, and then fund it.
- Review your estate plan to make sure it reflects your wishes (including Executor, Trustee and Guardian/Conservator appointments).
- Make sure your health care proxy/living will and power of attorney are current.
- Prepare a list of all accounts and passwords.
- Locate all deeds, titles, etc. to real property and any relevant business agreements.
- Update letters distributing personal property and letters of intent.

# Estate and Gift, and Generation-Skipping Transfer Tax Exemptions

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1. The estate, gift, and generation-skipping transfer tax exemption (the “Exemptions”) is \$11.58 million.
2. The Exemptions will continue to be indexed for inflation through 2025.
3. On January 1, 2026, unless the law changes sooner, the Exemptions will revert to \$5.6 million, indexed for inflation from 2018.
4. The federal estate, gift and generation-skipping transfer tax rate is 40%.
5. Some states impose an additional estate tax (and CT still has a gift tax).
6. Some states have exemptions that are less than the federal Exemptions.

# Why You Should Use Exemption Now

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- As a result of the coronavirus epidemic, Federal and state budgets will be stretched beyond the breaking point. All taxes will likely rise, perhaps materially, regardless of the outcome of the presidential election.
- There will be no appetite for “giveaways” to the wealthy, so the Exemptions are likely to be reduced, perhaps substantially.
- Biden has proposed eliminating the “step-up” in basis rule at death and treating all transfers as realization events, resulting in immediate capital gains tax.
- And, the capital gains rate for taxpayers with more than \$1 million in taxable income would be the proposed top income tax rate – 39.6%.
- Regardless, the Exemptions should be used now because we could well be facing a “use it or “lose it” situation.
- Don’t wait until November to decide. There may be a flood of planning activity in the run up to or the wake of the election, and it may be difficult to open new trust accounts during the last 8 weeks of the year due to increased volume.

# How to Make Volatility and Low Interest Rates Work for Your Estate Plan

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- When you transfer assets to a trust, the value of the gift is the “fair market value” on the date of the transfer.
  - For publicly-traded securities, that is the mean of the high and the low stock price on the date of transfer.
  - For privately-held companies, the fair market value is the price at which the property would change hands between a **willing buyer** and a **willing seller**, neither being under any compulsion to buy or to sell and **both having** reasonable **knowledge of relevant facts**. A professional appraiser will write a report to determine this value.
- When asset values are low, the amount of the gift correspondingly is lower, so you need to apply less Exemption to the same transfer. In other words, when the price of an asset is halved, you can transfer twice as much of that asset at the same gift tax “cost”.
- All future appreciation in the asset value will occur outside your estate.

# How to Make Volatility and Low Interest Rates Work for Your Estate Plan, cont'd

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- Some estate-planning strategies are much more effective with low interest rates.
- The interest rate applied to intra-family transfers is the “Applicable Federal Rate” (“AFR”) issued monthly by the IRS.
- The AFRs that apply to intra-family transfers made in April 2020 are extremely low, and the rates for May are even lower.
- Thus, the combination of low values and low interest rates provides a unique opportunity to transfer assets to the next generation at little or no current gift tax cost.

# The Fabulous Five

# Intra-family Loans

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1. An intra-family loan “freezes” the value of the parent’s assets and transfers the appreciation to descendants.
2. The senior generation lends assets to children, or to trusts for their benefit, in exchange for a promissory note bearing interest at the AFR.
3. The borrower then invests the assets for a higher return. The borrower keeps all excess return over the amount borrowed plus the AFR, and the lender pays no gift tax.
4. There must be a written promissory note, and interest must be paid (or forgiven) timely.
5. If there are intra-family loans already in place, they can be refinanced at today’s lower rates.
6. Works particularly well when interest rates are low. In May 2020, the lowest rate that can be used for a mid-term loan (3-9 years) is 0.58%.

# Grantor Retained Annuity Trust (GRAT)

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## 1. How it Works

- Grantor transfers assets to an irrevocable trust.
- Trust pays grantor an annuity for a fixed number of years (selected by the grantor).
- The annuity is stated as a percentage of the initial fair market value of the assets contributed to the trust.
- The annuity need not be paid in cash – it can be paid “in-kind”.
- Any appreciation in the assets in excess of the annuity amount passes to the ultimate beneficiaries of the trust, free of gift tax.

## 2. Tax Benefits:

- The GRAT is structured so that no gift tax is owed (and no gift tax exemption is used) when the gift is made to the trust.
- The IRS assumes the value of the property will grow at a rate set in the month of transfer (0.8% for May 2020), so the strategy is particularly effective with assets that you believe will outpace that rate of return over time.

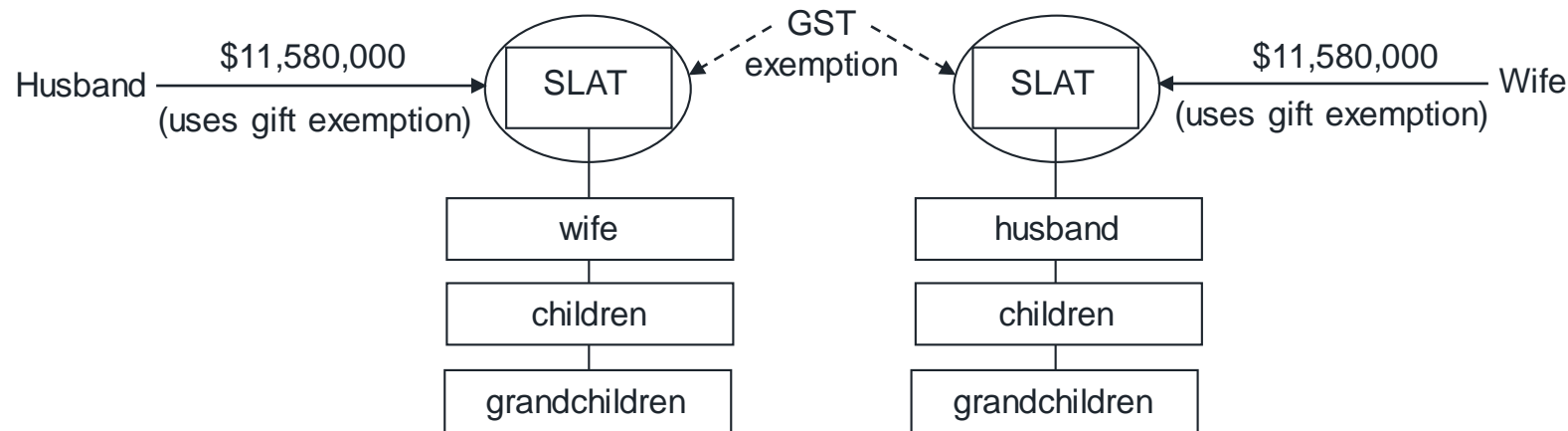
# Save Failed GRATs

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- Clients who set up GRATs in the last year are likely now looking at "failed GRATs" – i.e., the assets are unlikely to appreciate in value from the date of contribution. For example, if client contributed shares worth \$100,000 and now the shares are worth \$60,000, the client would love to have those shares back to transfer them to a new GRAT that has a chance to succeed.
- The client can simply purchase those shares back from the GRAT in exchange for cash or a note. There is no gain or loss on the sale of those shares back to the client because the GRAT is a "grantor trust" and ignored for income tax purposes. The client can then re-GRAT those shares to new GRATs.
- When the failed GRATs have to make the annual payments to the client, the trustees will make those payments in cash or all or a portion of the note. In the meantime, the re-GRAT-ed shares have an opportunity to transfer appreciation without transfer tax cost.

# Outright Gifts

- How Can You Get Comfortable in Using Exemptions Now? (Pain-free giving)
  - Make gifts of things that won't be missed, i.e. homes (more later).
    - Forgive loans that were never going to be repaid anyway.
    - Give away unproductive property -- art, vacant land, life insurance.
  - Create non-reciprocal trusts (“SLATs”) for each spouse.



# Outright Gifts to SLATs (“Spousal Lifetime Access Trust”)

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- Terms of the SLATs:
  - Beneficiary-spouse can be trustee for all purposes during grantor-spouse’s lifetime except to make distributions.
  - Grantor-spouse can keep power to remove and replace trustee so long as no “related or subordinate party” can become trustee as a result of the exercise of this power.
  - During grantor-spouse’s lifetime, distributions to beneficiary-spouse should be in discretion of non-spouse trustee -- and distributions for beneficiary-spouse’s support must be prohibited.
  - When grantor-spouse dies, then beneficiary-spouse may become sole trustee; in that case, distributions must be limited to a support standard to avoid inclusion in beneficiary-spouse’s estate.
- SLATs must be created using the separate property of the grantor-spouse to avoid estate tax on any of the SLAT’s assets when the beneficiary-spouse dies.
- SLATs are grantor trusts. Grantor’s payment of the trust’s income tax each year is equivalent to an additional tax free gift to the trust.
- Note: best if beneficiary-spouse doesn’t take distributions, but since distributions may be received (typically if all other funds are exhausted) by the spouse, the “Reluctant Giver” may feel more comfortable making the gift to use up exemption before the end of 2020.

# Sale to SLAT

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1. Another commonly used technique is the sale of assets to a SLAT, which also works especially well when values are low.
2. This transaction enables the client to freeze the value of the assets he/she sold, so that all the appreciation occurs outside of his or her estate.
3. The SLAT is a so-called “grantor trust”, meaning it is the grantor’s alter ego for income tax purposes.
4. When a trust is treated as a grantor trust, all transactions between the grantor and the trust are ignored, so the client does not recognize any gain on the sale.

## Sale to SLAT (cont'd)

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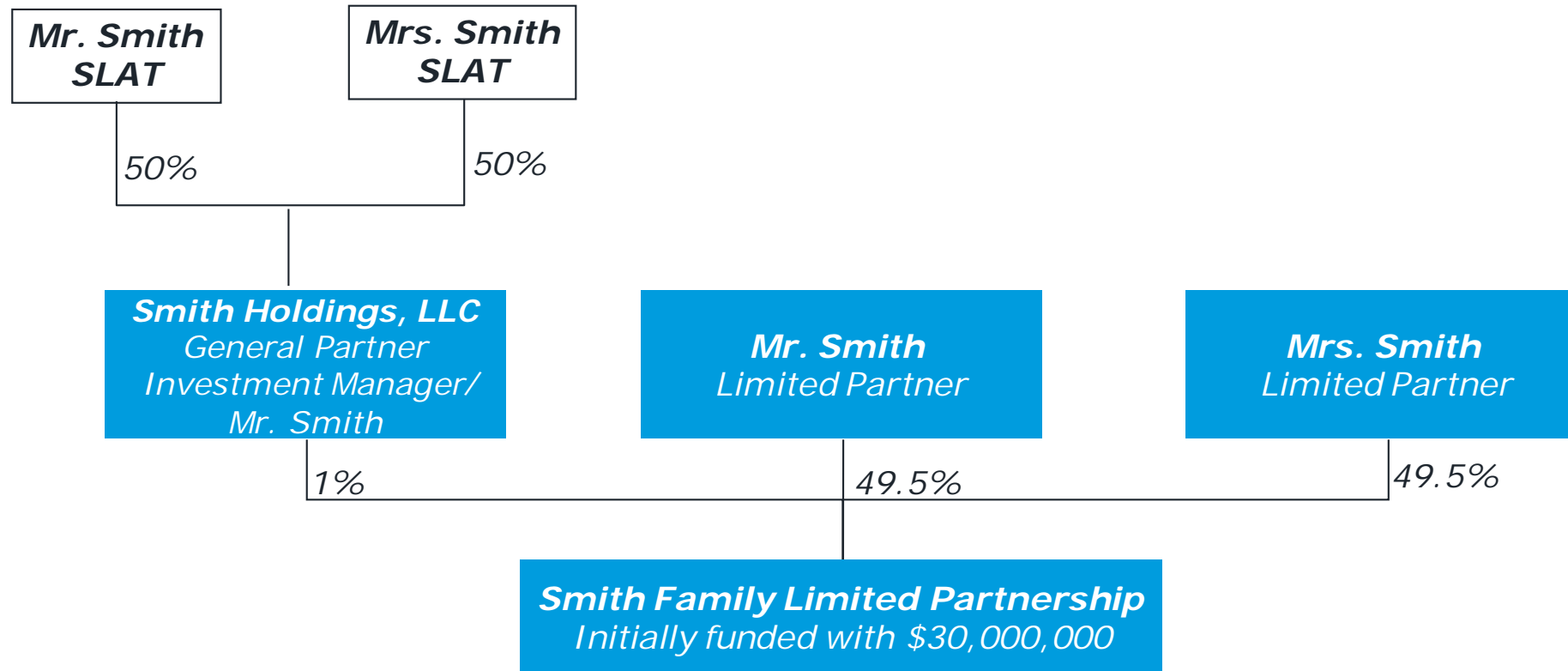
1. Client sells asset to SLAT for an interest-only promissory note with a balloon payment at the end of the term.
2. The sale price is the fair market value of the assets as of the date of the transfer.
3. The interest rate applicable to the note is the AFR for the month of transfer (in May 2020, this is 0.58% for a note with a term of 3 to 9 years).
4. The trust will pay interest from the earnings on the asset.
5. At the end of the term, the trust will repay the principal to the client. All appreciation in the asset during the term of the note, in excess of the original principal amount plus the AFR, remains in the trust without any gift tax.
6. Strategy can also be combined with a family limited partnership or family limited liability company, which enables the sale price to be discounted.

# Family Limited Partnership Example

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- Among other assets, Mr. and Mrs. Smith have a significant portfolio of securities and interests in various limited partnerships and LLCs. The Smiths will contribute \$30 million of their investment portfolio to the Smith Family Limited Partnership. Initially, Mr. and Mrs. Smith will each own 49.5% of the limited partnership interests. The 1% general partner of the Smith Family Limited Partnership will be Smith Holdings, LLC, a limited liability company of which the owners will be SLATs created by Mr. and Mrs. Smith. Mr. Smith will be the investment manager of the GP entity; thus, he will control the investments of the Smith Family Limited Partnership.

# Mr. and Mrs. Smith Initial Partnership Structure

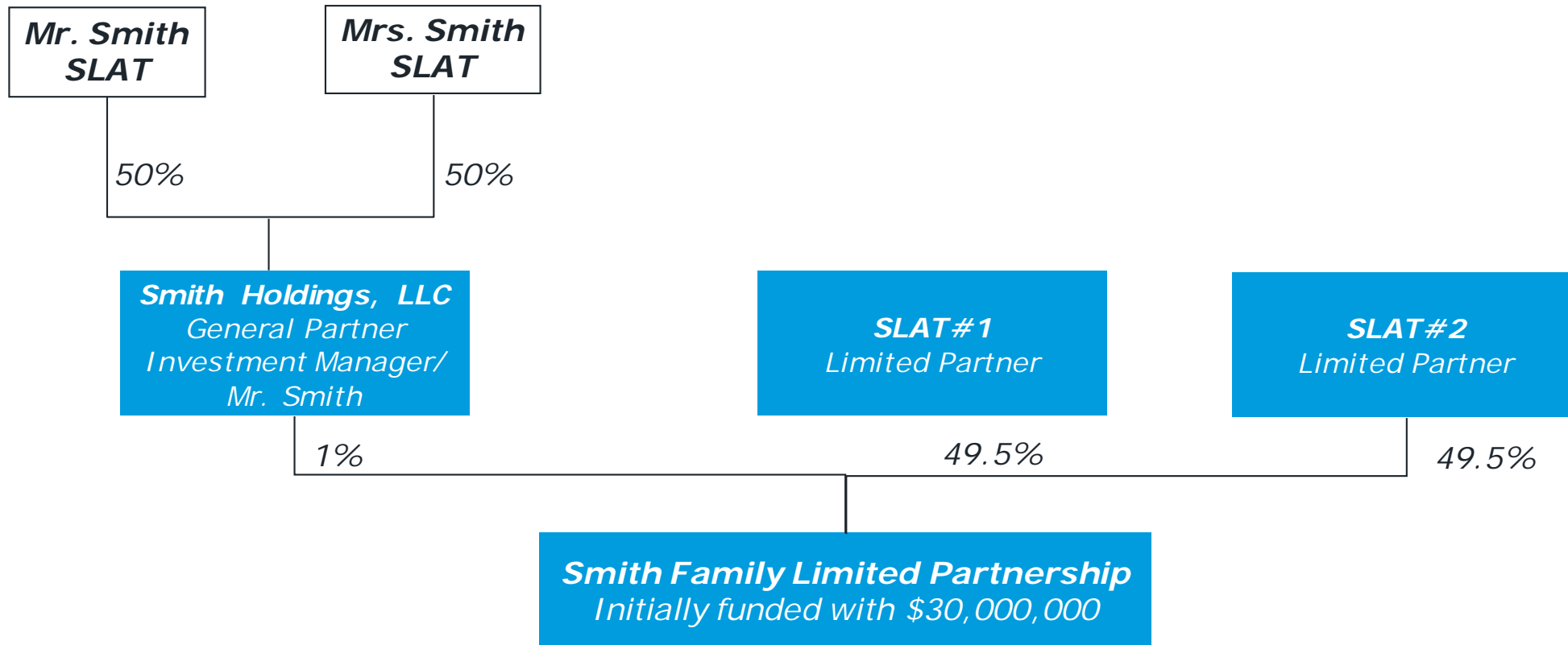


# Gift of Limited Partnership Interests

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1. For gift tax purposes, the value of Mr. and Mrs. Smith's respective partnership interests will be subject to discounts for minority interest and lack of marketability.
2. If a 33.3% discount is applied, the value of the gift would be \$20 million (\$30 million  $\times$  .667 = \$20 million).
3. Accordingly, Mr. and Mrs. Smith can use their gift tax exemptions to make a tax-free gift of their entire limited partnership interests to SLATs for the benefit of their descendants.
4. All future appreciation in the value of the partnership's investments will occur inside the SLATs, not in the Smiths' personal estate, so those assets will not be subject to estate tax on the death of either spouse.

# Mr. and Mrs. Smith Post-Gift Partnership Structure



# Charitable Lead Annuity Trust (CLAT)

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## 1. How it works:

- Grantor transfers assets to a trust for a term of years (or somebody's life).
- Trust makes payment each year to charity or charities (or private foundation) equal to either a fixed percentage or increasing percentage of the value of the assets contributed to the trust.
- At the end of the term, the trust's assets are distributed to the non-charitable beneficiaries, i.e., the children and/or grandchildren.

## 2. Benefits:

- As with a GRAT, all appreciation above the applicable interest rate (0.8% in May 2020) is removed from the estate, tax-free.
- If the trust is a grantor trust, the grantor receives an immediate up-front charitable income tax deduction for the amount contributed to the trust.

# Combining All Strategies into One

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