Wealth Planning Insights

Strategic Estate Planning Opportunities During Market Volatility

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Our thoughts are with those impacted by COVID-19. While health and safety concerns remain paramount for all of us at this unprecedented time, we are also well aware of the potential financial impact of the current crisis. Volatility in the markets and nearly historically low interest rates reflect the significant economic and other challenges confronting us right now. At the same time, our long experience with market disruptions enables us to recognize tax opportunities emerging within the market turmoil, and we feel it is important to bring them to your attention.

Below are six techniques that could be applicable in today's volatile market. One or more may fit your situation. If so, we encourage you to speak with your client advisor, who will be happy to organize the expertise to guide you in thoroughly analyzing your particular opportunities.

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

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 slightly above 5%. In comparison, the April 2020 Section 7520 rate will be a very low 1.2%. 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) would be transferred tax free (avoiding a potential future 40% estate tax).

Sophisticated transfer 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.

2. Low Interest Rate Loans

In most circumstances, the tax code requires that loans be made with a minimum amount of interest. If no or a lesser interest rate is charged, the tax code imputes the necessary amount and requires taxes to be paid by the lender on this hypothetical interest amount. The relevant minimum rates, known as Applicable Federal Rates (AFRs), are established each month but can be fixed for term loans.

Three AFRs are 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 (for more information, see our *A Closer Look*, "Interest Rates Will Impact Your Estate Plan"). Not surprisingly, this April brings a very low set of rates. (For April, the short- and mid-term rates are both under 1.0%. By the way, the Section 7520 rate noted for GRATs is 120% of the mid-term AFR, rounded to the nearest 20/100ths.)

As these rates are so low, clients should consider techniques that are more advantageous with low rates. These include, from the simple to the complex, techniques such as the following:

- Making a low-rate loan to a child or grandchild
- Refinancing an existing loan to reduce the rate
- 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-tax-exempt trust)
- Selling assets to a trust in exchange for a promissory note

3. Annual Exclusion Gifts

Annual exclusion gifts of up to $15,000 (the 2020 amount) per donor/per donee are "outside" the gift tax and do not require use of gift/estate or GST exemptions.

Many clients make these gifts annually at the beginning of the year, so that any increase in value during the year will be outside their estates. Others wait for the year-end holidays to make them. If that is you, consider making them now with publicly traded securities suffering from a reduced value. Yes, basis for capital gains will carry over (i.e., when sold, the recipient will use your basis to compute capital gains), but the growth reflecting the return to normal value directly will benefit the donee at no tax cost to you. Also, you simply can give cash and allow your child (or other donee) to invest.

4. Full Use of Gift and GST Exemptions

As shared previously (see our *A Closer Look*, "Why You Need to Review Your Estate Plan Today"), the current tax law permits a very favorable $10,000,000 exemption for gift tax and generation-skipping transfer tax (GST tax) purposes. These values are indexed for inflation, and in 2020, this amounts to $11,580,000, each. The law that doubled the exemption to $10,000,000 is schedule to sunset, and the exemptions will revert to $5,000,000, indexed, on January 1, 2026.

We encourage clients to consider whether they should use the enhanced amount before 2026. Given the recent market decline, this advice is suddenly 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.

5. 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. 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 was included in the December 20, 2019, budget legislation, and as a result, stretch IRA planning has been eliminated for account owners who die on or after January 1, 2020. This entails a detailed review of your IRA beneficiary designations, but doesn't impact the conversion opportunity presently available (for more information, please see our *Wealth Planning Insights,* "Year-End Tax Law Impacts Every Taxpayer With an IRA or Other Retirement Account").

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.

6. 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 the client is deemed to be the taxpayer, reporting the trust's earnings on her tax return.

Assets may be exchanged with such trusts tax free. Given the market changes, it makes sense to review the assets in your name as well as those in your 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.

We at Bessemer wish everyone the best of health and encourage you to speak with your client advisor about which planning techniques could be worth considering at this time.

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