MONEY MATTERS

FINANCIAL NEWS UPDATE
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MARKET CHALLENGES CREATE WEALTH TRANSFER PLANNING OPPORTUNITIES

The COVID-19 pandemic has impacted all areas of our lives from travel to dining to sports gatherings. Almost no aspect of our daily lives has proven immune to the new normal created by the coronavirus. Financial markets and the value of almost all assets have been reset, mostly lower, during this period of uncertainty. These reduced valuations present attractive opportunities for those seeking estate and wealth transfer opportunities to mitigate the impact of the federal transfer tax system. If your net worth exceeds $5MM, review your current estate plan and balance sheet to evaluate whether your present arrangement for passing assets to heirs still aligns with and accomplishes your goals.

A Changing Regulatory Landscape

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act that, along with other important provisions, changed the laws for estate, gift, and generation-skipping transfer taxes. This law doubled the lifetime exemption amount and now allows American citizens to transfer up to $11,580,000 to a non-spousal beneficiary without paying taxes on the transfer. A married couple can combine their lifetime exclusion amounts and transfer $23,160,000 down to their heirs without gift, estate, or generation-skipping transfer tax consequences. With the new law in place, less than one percent of all Americans will be subject to the transfer tax system of estate, gift, and generation- skipping transfer taxes. Unfortunately, this provision of the law will expire on January 1, 2026. When the law expires, the lifetime exemption amount will return to $5MM plus an inflation adjustment—projected at approximately $5.8MM.

On December 20, 2019, the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019, was signed into law and changed some aspects of retirement plans and strategies used to pass assets, held within qualified retirement plans, to heirs. Specifically, the SECURE Act eliminated the use of a common wealth transfer technique informally called the Stretch IRA. This technique facilitated tax-deferred growth of inherited IRA and 401(k) accounts for multiple generations. With the elimination of the Stretch IRA, a key strategy for transferring wealth held within qualified plans has gone away.

On March 27, 2020, the Coronavirus Aid, Relief, and Economic Security (CARES) Act, was signed into law. This $2 trillion aid package covered a wide variety of regulatory activities aimed at helping offset the economic distress caused by the COVID-19 pandemic.

While this Act did not directly change transfer tax laws, the passage of such a sizable piece of legislation demonstrates the concern the U.S. government has for the economy and the citizens suffering both directly and indirectly from the virus. Given the size of the package, and the magnitude of the economic harm caused by the virus, many commentators believe individual tax rates will increase in the future.

These three pieces of legislation together have changed the landscape for wealth transfer planning, but they have also created new opportunities. Based on the various changes resulting from these laws, Zions Bancorporation recommends that all clients revisit their estate plans and confirm that they still align with their goals. If transferring wealth to heirs or to a charity is a goal, we recommend you have a conversation with a wealth management team member to determine how to best achieve your goal in light of the new laws and impending expiration of the enhanced lifetime exemption in 2026.

Conditions are ideal for transferring wealth.

Current Market Conditions Create Opportunities

While the current economic landscape has created financial hardships for many, it provides unique opportunities for high net worth individuals to mitigate wealth transfer taxes and maximize the value of assets received by heirs and/or charities.

These opportunities can be used in two ways. First, taxes are based on the value of assets at the time of transfer. Gifting assets that have declined in value (e.g., an apartment building worth $3 million last year may only be worth $1.5 million this year) also lowers the taxes owed on such a transfer. If the asset returns to its previous value, then that appreciation occurs on the gift recipient's balance sheet.

Second, specific gifts in a trust are valued according to the Internal Revenue Code Section 7520 rate. The section 7520 rate is used to calculate the present value of annuities, life estates, and remainders for gift or estate tax purposes. This rate is informally known as the "hurdle rate" since the gifted assets must achieve a rate of return greater than the hurdle rate to result in any transfer tax savings. The hurdle rate is currently at an all-time low, .60 percent, which makes certain types of trusts more likely to succeed in generating transfer tax savings for those who create such trusts.

The increased lifetime exemption amount, lower valuations caused by COVID-19, and historically low interest rates provide ideal conditions for transferring wealth but also create a level of urgency, given the potentially limited window of opportunity.

Do you plan to bestow your wealth to individuals? If so, trusts such as the Grantor Retained Annuity Trust (GRAT) and the Intentionally Defective Grantor Trust may be appropriate. These types of trusts capitalize on low interest rates and relatively low valuations. If charitable legacy planning is of interest to you, consider a Charitable Lead Trust (CLT).

Grantor Retained Annuity Trust (GRAT)

A Grantor Retained Annuity Trust is an irrevocable trust that pays the creator of the trust (the grantor) an annuity—based on the market value of the GRAT—for a specified term. At the end of the term, the remaining trust assets are passed to the beneficiaries or held in trust for their benefit.

If the GRAT assets rise in value more than the hurdle rate (a reasonable likelihood given the low hurdle rate of .60 percent), the excess wealth remaining in the GRAT at the end of the term may pass to the beneficiaries tax-free.

High income-producing assets expected to increase in value are ideal candidates for funding a GRAT. A common estate planning strategy is "zeroing out" the gift made to the GRAT by structuring the annuity payments to equalize their present value with the value of the assets transferred to the trust, reducing the gift tax to (or near) zero.

GRATs are thought of as safe strategies, but there are a few things to keep in mind. If the appreciation of the GRAT assets fails to exceed the hurdle rate, there will be no tax-free gift to pass to the grantor's beneficiaries. Also, if the grantor dies during the term of the trust, a portion of the trust assets may be included in the grantor's estate and subject to estate taxes. Finally, GRATs are typically not the best option for multi-generational gifts, such as gifts to grandchildren. Intentionally defective grantor trusts (IDGTs) are more suitable for multi-generational wealth transfer.

Intentionally Defective Grantor Trust (IDGT)

An IDGT can be an efficient planning tool during a low interest rate environment. It is another irrevocable grantor trust that features an "intentional defect" to make it a grantor trust for income tax purposes (grantor pays income taxes on the assets) while simultaneously removing the assets from the grantor's estate for estate tax purposes. In short, the transfer of assets to the trust is "effective" for estate tax purposes but "defective" for income tax purposes. This strategy is beneficial for a business or other assets expected to increase in value. The IDGT freezes the asset value for federal estate and gift tax purposes on the date the asset is gifted or sold to the trust, so any appreciation occurs outside the grantor's taxable estate.

This trust is initially funded ("seeded") with a gift, which is followed by a sale of assets to the trust at fair market value in exchange for a promissory note from the trust. The gifted assets serve to legitimize the transaction as a bona fide sale by providing a payment source.

Since the IDGT is a grantor trust for income tax purposes, the sale will not be considered a taxable event for the grantor and, as such, will not incur capital gains taxes, nor will income taxes be due on the interest received from note payments. This also means the grantor must continue to be responsible for the taxes due on the earnings of the IDGT assets. While this may not sound like a benefit to the grantor, paying taxes on behalf of the IDGT allows the trust assets to grow tax-free, plus the tax payments are not deemed taxable gifts made by the grantor, thereby providing a mechanism for shifting additional wealth to the trust free of transfer taxes.

Charitable Lead Trust (CLT)

A CLT is a split-interest trust where a charitable beneficiary is entitled to the "lead" interest in the trust property, and a noncharitable beneficiary receives the remainder. The donor chooses the charitable and noncharitable beneficiaries when establishing the trust, then transfers property to the CLT and specifies how much the charity will receive annually for a defined time period, at the end of which remaining assets pass to the noncharitable beneficiary. The noncharitable beneficiary may be the donor, the donor's spouse, or any other individual.

Payments to the charity may either be a fixed annuity based on the initial fair market value of the trust assets or a unitrust amount, which is a specified percentage of trust asset value based on an annual revaluation. A CLT that makes annuity payments is called a Charitable Lead Annuity Trust (CLAT), whereas a CLT that makes unitrust payments is called a Charitable Lead Unitrust (CLUT).

A CLAT may be more advantageous in a low interest rate environment, as the donor has the ability to maximize the value of the charitable contribution deduction. However, there are tradeoffs between the income, gift, and estate tax benefits for each type of CLT that should be evaluated based on the donor's objectives.

Consult with Advisors

It is advisable for individuals to consult with an experienced estate planning attorney and their financial advisor to establish a strategy that will best meet their unique needs.

Our team of wealth advisors can help you develop a wealth management plan customized to your objectives, risk tolerance, and both your short-and long-term financial needs. Call your relationship manager to discuss ways in which we may help.

Educating, advising and implementing

holistic plans for today and beyond. Our team of multidisciplinary professionals are dedicated to helping our high net worth clients achieve their financial goals.

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Christopher specializes in helping clients develop and implement multi-generational wealth plans in the areas of trust & estates, income and estate tax, retirement planning, philanthropic planning, cash flow and net worth planning, asset protection, and business succession planning.

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