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COVID-19 and Presidential Election Have Significant Effect on Estate Planning

Recent events have had a significant effect on the viability and urgency of certain estate planning strategies. The economic havoc wreaked by the COVID-19 crisis along with the Federal Reserve's aggressive interest rate cuts have made certain estate planning tactics extremely attractive. These include grantor retained annuity trusts (GRATs) and sales to intentionally-defective grantor trusts (IDGTs).

At the same time, with Bernie Sanders no longer in the primaries and the more moderate candidate Joe Biden becoming the presumptive nominee, the odds of a Democrat winning the 2020 presidential election have increased. Part of Biden's tax plan is to repeal the tax cuts that were put in place in 2018. If successful, that would accelerate by as many as five years the halving of the estate and gift tax exemption from its current level of \$11.58 million to approximately \$5.8 million in today's dollars. For married couples, the exemption reduction would be from \$23.16 million to about \$11.6 million.

Even for those wealthy enough to be able to fund this level of gifting, there are concerns about potentially needing the money themselves someday and the effect that the gifts may have on the development of their children's and grandchildren's work ethic. Strategies that address these concerns include gifts to spousal lifetime access trusts (SLATs), gifts using illiquid assets, and gifts to quiet trusts.

Gifts Only Future Appreciation: GRATs and Sales to IDGTs

For people not ready or able to make gifts of many millions of dollars to family members but who nevertheless feel that they have enough now to be comfortable for the rest of their lives, GRATs and sales to IDGTs are worth considering. These strategies are also appropriate for people who have already used all of their gift tax exemption because they can be structured so that they do not require using any additional exemption.

With both of these strategies, the donor transfers assets into a trust that distributes back to him or her 100% of the original value of the gift over a period of years, plus interest. With interest rates now at historical lows, this interest can be minimal. During this same period, the trust assets will hopefully appreciate far more than the interest being paid to the donor. At the end of that period, the remaining trust assets can pass to beneficiaries free of gift tax and will not be taxed at the donor's death, regardless of how much the assets have appreciated.

The key with each of these strategies is that a low interest rate effectively lowers the bar in terms of how much appreciation can pass to family members. In addition, the economic crisis has significantly reduced the value of nearly all types of assets. This means that future appreciation potential is larger than it otherwise would have been.

Each of these strategies has advantages and disadvantages. For example, a GRAT does not work well for a gift intended to pass down two or more generations whereas a sale to an IDGT can accomplish that goal. However, a GRAT can be funded with a single, illiquid asset whereas an IDGT may require an additional gift of cash. And while both are compelling options in the



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current economic climate, neither is aimed at making use of the gift and estate tax exemption before it is reduced by 50%. Rather, both strategies tend to require only modest amounts of tax exemption, if any.

Preserving Potential Access to Gifted Assets: Spousal Lifetime Access Trust (SLAT)

As the name suggests, SLATs can be set up by married couples. Unlike the previous two strategies, SLATs do not automatically return the gifted asset to the donor, but they do allow one to make a large gift that uses tax exemption while still preserving potential access to the gifted assets. Thus they address the concern that you might someday need these assets and may make you more comfortable making large gifts before the gift and estate tax exemption is reduced by half.

Under this strategy, one spouse creates and funds the SLAT, naming the other spouse and their descendants as the trust's beneficiaries. Naming a spouse as a beneficiary creates a safety net of sorts that can enable the couple to reclaim trust assets if necessary. Of course, distributing trust assets to the spouse means that they will be included in the spouse's taxable estate at death. For that reason, most couples typically access SLAT assets only if they have drawn down other available resources.

Although SLATs can be a great solution in the right situation, they also carry some risks. If the beneficiary spouse dies, only the children and grandchildren remain as beneficiaries and the donor loses any possibility of benefiting from the trust. The same result may occur if a couple divorces after creating a SLAT.

Finally, because one spouse is a beneficiary of a SLAT, the couple can only use the tax exemption of the donor spouse. Therefore, to make full use of both spouses' exemptions, each spouse must create their own SLAT naming the other as beneficiary. In doing that, care must be taken to avoid triggering the "reciprocal trusts" rule, which disregards trusts that are essentially mirror images of each other (thereby nullifying the tax benefits).

Gifts That Don't Affect Your Cash Flow: Illiquid Assets

Gifts of illiquid assets can accomplish a number of different goals: (i) it is less likely to affect your cash flow, (ii) the gift recipients typically cannot go on a spending spree; and (iii) discounting the value of the gift when reporting it on a tax return is typically allowed, which means it uses less exemption than gifting the same amount of liquid assets. Illiquid assets can include privately-held companies, real estate, artwork and other collectibles, limited liability company ("LLC") interests, alternative investments such as hedge funds, private equity and venture capital funds, and others.

Perhaps the most common illiquid asset used for gifting is real estate. A property owner can give real estate to an irrevocable trust of which children are the beneficiaries or to an LLC owned by children, in both cases using exemption on the gift. Assuming the real estate is not income producing, the gift would not affect the donor's cash flow. If the donor wants to continue using the property, he or she must rent it back for fair market rent. Although paying rent affects the donor's cash flow, the donor would no longer have to pay for ownership expenses such as property tax and insurance. Instead, the children can use rental income to pay those expenses. Having said that, the donor must be very careful to formalize the



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landlord/tenant relationship with lease agreements that charge fair market rent (updated regularly) and must always act in accordance with that landlord/tenant relationship. Failure to do so will risk an IRS claim that the donor retained the right to use and enjoy the property, which could result in the real estate being included in the donor's estate at death.

Encouraging a Strong Work Ethic: Quiet Trusts

A quiet trust can address the concern that large gifts into trusts may have a negative effect on the development of a young person's work ethic and their sense of personal, financial and social responsibility. There may also be a concern that the beneficiary will be taken advantage of by creditors, friends or even other family members if there is a perception that they are a "trust funder."

A quiet trust can take different forms, but essentially it directs the trustee not to communicate with the beneficiary about certain aspects of the trust, such as its value or the circumstances in which distributions are to be made. It can even prohibit the trustee from informing the beneficiary about the existence of the trust.

The ability to set up a quiet trust can vary from state to state. Our clients have typically set up quiet trusts under New Hampshire law, which has thoroughly modernized its trust laws and become one of the best states in the nation in which to establish a trust. Most clients have provided that the beneficiary be made aware of the trust's existence upon reaching a certain age, at which point they hope he or she will have developed enough maturity to handle that knowledge responsibly. Of course, the donor is free to let the beneficiary know about the trust at any time, but the trustee must wait until authorized under the trust terms.

Conclusion

The COVID-19 crisis has enhanced estate planning strategies that benefit from low interest rates and low asset values, but recent election developments may lead to accelerating the reduction of tax exemptions, thereby significantly reducing the time within which to take advantage of an historic estate tax saving opportunity. Your Hemenway & Barnes advisor can help you determine whether any of these strategies is appropriate for you and your family.

CONTACT US

For further information, please feel free to contact Hemenway & Barnes LLP's Private Client Group or the authors of this alert:

Dennis R. Delaney
Partner, Chair Private Client Group
617.557.9722
ddelaney@hembar.com

Paul M. Cathcart
Associate
617.557.9737
pcathcart@hembar.com

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