Experience tells the author that the number of potential donors was much larger at the end of 2019 (coming off one of the most successful investment return years ever) than it is at the end of the first quarter of 2020, which ended the worst first-quarter performance ever. However, that shouldn’t mask the sound of a potential opportunity knocking. Simply stated, if one buys into the notion that recovery follows a correction, as inevitably as geese flying north in the spring (one simply doesn’t know how long that migration might take), then giving now can be the lemonade made from the current economic lemons. Best yet, you don’t even have to borrow the required cup of sugar.

If one buys into the notion that recovery follows a correction, then giving now can be the lemonade made from the current economic lemons.

Under the TCJA, the applicable exclusion amount (AEA)—the amount that can be left to others by gift or bequest without incurring a gift or estate tax—was increased from $5 million to $10 million, indexed for inflation. In 2020, the AEA is $11.58 million. The TCJA states that the increased $10 million exclusion will only be in place until the end of 2025, when it will revert to the previous $5 million limit indexed for inflation. Under current law, the increased AEA is a “use it or lose it” proposition. Once it sunsets, it will be as if it had never existed.

Thus, those in a position to make gifts should consider making gifts that absorb part or all of the AEA. For those concerned that future changes in the law might somehow simply defer any gift tax but leave the donor exposed to a higher estate tax later, on November 26, 2019, the IRS released final regulations, clarifying that when the AEA amount reverts back to $5 million at the end of 2025, the AEA amount governing the computation of the estate tax will be the greater of the AEA at the date of death or the AEA actually used before 2025.

Those in a position to make gifts should consider making gifts that absorb part or all of the applicable exclusion amount.
WEALTH TRANSFER

The second sweetener

Gifting “hard-to-value” assets where a valuation discount can be taken is another planning consideration to enhance the performance of gifted assets relative to a simple gift of cash. Examples of hard-to-value assets include minority interests in closely held business and investment entities and fractional interests in real estate. While a discussion of the nature and depth of discounts is beyond the scope of this article, conveying discounted assets allows the gift transfer of “more” assets for the same quantum of AEA and, as a result, improves the possibility of greater returns to the donee since more property is at work. For this and other reasons, the depth of any discount is often challenged by the IRS and has been the object of regulatory control as recently as 2017. It is reasonably foreseeable that future focus on the ability to discount appropriate assets will occur.

One measure of the current economic downturn is extraordinary volatility in the securities markets. Since 2004, the Volatility Index (VIX) has been employed to project volatility over the short term. Measures of volatility play a vital role in several valuation models with a higher volatility correlating with lower asset values. Similarly, the VIX score is directly correlated with higher marketability discounts, which are generally applied to the valuation of interests in closely held companies.
Perhaps an example might help. Let’s assume three identical taxpayers (the three little pigs) all with the same identical estates on October 31, 2019, of $25 million, and all of whom have a fateful appointment with the Big Bad Wolf on January 1, 2026 (Figure 1). Assume, even considering recent market swings, that the $25 million will grow to $30 million by January 1, 2026.

- The first little pig doesn’t believe in estate tax planning and does nothing, leaving an estate worth $30 million.
- The second little pig made a gift of $11 million in December 2019.
- The third little pig was still planning an $11 million gift when the recent market correction occurred.

At the end of April 2020, each had lost 20 percent of his net worth, leaving the first and third little pigs with $20 million and the second with $11.2 million. It is at this time that the third little pig structured his $11 million gift, leaving him with an estate of $9 million on May 1, 2020.

As indicated, total wealth will recover to $30 million by January 1, 2026, implying appreciation of 50 percent. The accompanying figure reflects the after-tax wealth left to each family as of January 1, 2026. The moral of the story? A gift utilizing the enhanced AEA will always preserve more family wealth, but the timing of the gift, from a tax perspective, is better when values are depressed—assuming that a recovery ultimately follows.
WEALTH TRANSFER

Consider transferring assets now (cont.)

Figure 1

<table>
<thead>
<tr>
<th></th>
<th>Little Pig 1</th>
<th>Little Pig 2</th>
<th>Little Pig 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Estate Assets</strong></td>
<td>30,000,000</td>
<td>16,800,000</td>
<td>13,500,000</td>
</tr>
<tr>
<td><strong>Adjusted Taxable Gifts</strong></td>
<td>-</td>
<td>11,000,000</td>
<td>11,000,000</td>
</tr>
<tr>
<td><strong>Taxable Estate</strong></td>
<td>30,000,000</td>
<td>27,800,000</td>
<td>24,500,000</td>
</tr>
<tr>
<td><strong>Gross Estate Tax (40%)</strong></td>
<td>11,945,800</td>
<td>11,065,800</td>
<td>9,745,800</td>
</tr>
<tr>
<td><strong>Less Applicable Credit Amount</strong></td>
<td>(2,185,800)</td>
<td>(4,345,800)</td>
<td>(4,345,800)</td>
</tr>
<tr>
<td><strong>Net Estate Tax</strong></td>
<td>9,760,000</td>
<td>6,720,000</td>
<td>5,400,000</td>
</tr>
<tr>
<td><strong>Transferred Wealth ($30 million estate value at date of death less net estate tax)</strong></td>
<td>20,240,000</td>
<td>23,280,000</td>
<td>24,600,000</td>
</tr>
<tr>
<td><strong>Benefit from gifting in 2019</strong></td>
<td>3,040,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Benefit from gifting in 2020</strong></td>
<td></td>
<td></td>
<td>4,360,000</td>
</tr>
</tbody>
</table>

CONSIDERATIONS:

• Doing nothing will result in the most estate tax liability upon the taxpayer’s death, resulting in less of the estate going to the heirs

• If the taxpayer gave in 2019 before the estate value decreased, the heirs will receive $3.04 million more upon the taxpayer’s death than if no gifts were made during life (an increase in their inherited wealth of 15 percent)

• If the taxpayer gifts in 2020 while the estate value is decreased, the heirs will receive $4.36 million more upon the taxpayer’s death than if no gifts were made during life (an increase in their inherited wealth of 21.54 percent) and $1.32 million more than if the gift was made in 2019
The third sweetener

For those that have already used their AEA and would like to transfer more, but are uninterested in paying gift taxes, consider selling assets in exchange for a note or using grantor retained annuity trusts (GRATs). While the legal rights and interests are different, both of these techniques share similar economics— in a sale, the seller monetizes the current value of the sold property and, if cash is not paid at closing, takes back a note that compensates her for the time value of money; in a GRAT, the donor actually retains the full value of the contributed property to be returned to her over an established annuity period (figure 2).

Another measure of the recent economic downturn has been a rapid decline in minimum interest rates mandated by the IRS. These rates have been mandated since 1984 and are adjusted monthly. June 2020 will see the lowest applicable federal interest rates in the 36-year history of such rates. The interest rate on the note and the discount rate applied in determining the value of the retained annuity are both mandated by the aforementioned government-dictated interest rates. In the end, what is left for the buyer (in a sales transaction) and the remainderman of the GRAT is the appreciation in the transferred property over and above the prevailing interest rate. Thus, the lower the interest rate, the more effective these planning considerations are likely to be—provided an economic recovery ultimately follows.

Figure 2

1. Grantor contributes property to GRAT
2. GRAT makes annual annuity payments to grantor
3. At the end of GRAT annuity term, any remainder passes to remainder beneficiaries
WEALTH TRANSFER

Consider trusts as the lemonade receptacles

The use of trusts can provide a number of benefits when it comes to gift and estate tax planning. Trusts have been around since the Crusades\(^3\) and settlers have been motivated to set them up, fundamentally to separate the beneficiary from the property and to impose professional asset governance. Typically, a transfer to an irrevocable trust is considered a completed gift, and the assets contributed to the trust are out of the grantor’s estate, assuming the grantor has retained no interest in the trust assets or the ability to dictate changes to the beneficial enjoyment of trust assets. An outcome of gifts in trust is that the trust’s net asset value, including all subsequent appreciation and all accumulated income (subject to the GST rules discussed below) is outside the reach of the estate and gift tax rules while such assets remain in trust.

A second potential benefit of a trust arises if, for income tax purposes, it is structured as a grantor trust. Grantor trust status arises where the grantor retains either an economic interest or power over trust property, which are significant enough to require the income of the trust to be taxed to the grantor as if the trust’s assets were owned by the grantor. Thus, the trust is disregarded for income tax purposes, with two significant outcomes. First, the trust grows income tax–free, since the grantor is legally obligated to report and pay tax on the trust’s tax attributes; and second, transactions between the trust and the grantor are disregarded.

If the grantor trust is structured in a manner that precludes estate inclusion, these two outcomes allow a gift in trust to convey more wealth for the same AEA than is possible for an outright gift.

Grantor trust status ends when the grantor dies or revokes the grantor trust powers. The income tax paid by the grantor is not considered an additional gift to the trust since the payment of the tax is in satisfaction of the grantor’s legal obligation.

For example, consider our taxpayer who contributes $11 million to a grantor trust structured not to give rise to estate inclusion. The grantor uses $11 million of the AEA to make a gift of property to a grantor trust. Assume the trust generates income of $500,000 annually, resulting in a combined federal and state income tax liability of $200,000 each year. After five years, the grantor passes away. At the date of death, relatively speaking, the grantor’s taxable estate will be $1 million less than it might have been because of the income taxes paid. Correspondingly, the value of the trust will be $1 million greater because of the income tax obligation it was not required to pay. Similarly, we previously mentioned sales transactions as effective means of moving appreciation to younger family members. Because the sale is disregarded for income tax purposes (meaning no gain recognition) if transacted with a grantor trust, sales to grantor trusts are frequently encountered in estate tax planning.

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Thirdly, as noted above, assets that remain in trust fall outside the estate and gift tax regimes until they are ultimately distributed to beneficiaries. Thus, the longer the trust exists, the greater the wealth retention. The generation-skipping transfer (GST) tax is a separate tax regime put in place to impose a transfer tax at each generational level. How this is accomplished is complicated and beyond the scope of this article, but it is quite effective at preventing the accumulation of wealth in trusts over an extended period. However, each taxpayer is granted a GST exemption. Since 2010, the AEA and GST exemption have been equal. The 2020 GST exemption of $11.58 million is also scheduled to sunset at the end of 2025. Judicious application of the GST exemption to a trust can make such a trust, funded with not more than the GST exemption, exempt from GST until such time as the trust terminates. Thus, there is a limited opportunity to respond to the increased GST exemption to benefit multiple generations by making gifts equal to the GST exemption to a GST trust and allocating the GST exemption to that trust. So-called dynasty trusts are GST trusts set up to benefit children and more remote descendants for so long a period as the state’s laws permit. Dynasty trusts are permitted in all 50 states; however, the laws on the duration of the trust vary from as little as 80 years to trusts that can exist in perpetuity. Make sure to investigate what your specific state laws are when setting up a dynasty trust.

One item of caution: A dynasty trust must reflect the flexibility to govern a trust for a significant period. Therefore, dynasty trusts have the tendency to be relatively more complex than other common types of trusts. While a meaningful example of the economics of a GST trust is difficult to illustrate, it isn’t hard to appreciate the compounding effect of such a trust.

Assume a grantor sets up a 100-year dynasty trust with the entire $11.58 million exemption. If the trust generates 4 percent annually, after income taxes and modest distributions, the value of the trust in 100 years will have grown to roughly $585 million. While purposeful investing is required for such an outcome, it is almost as important that the corpus of the trust will not have been disturbed by an estate tax for three or four generations.
Final considerations

When engaging in estate and gift planning, don’t forget about the tried-and-true planning, including:

• annual exclusion gifts
• gifts to 529 plans
• or paying medical and education expenses directly to the institution.

Finally, where one’s wealth makes the estate tax a certainty, the most tax-efficient gift is one that includes paying gift tax (as discussed in the 2019 Guide, Part 2). The system was purposefully constructed to make this so.

When the economy offers you lemons, make lemonade. The lemons today seem particularly sour, but properly squeezed and sweetened in a trust receptacle, the outcome may be the ultimate preservation of greater wealth for many future generations. Where do you find the necessary sugar? In the sunsetting applicable exclusion amount, the valuation protocols that now yield lower values, and the lower prevailing interest rates. However, that requires planning, now since these too will “sunset” with the passage of time. Call your advisers—it’s time for a candid conversation.