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Estate Planning Continues to be Affected by Recent Events: Low Valuations, Lower Interest Rates, Great Opportunities, and the Great GRAT Giveaway

by Michael D. Whitty

A FREEBORN & PETERS LLP CLIENT ALERT

Estate Planning in the second quarter of 2020 continues to be impacted by recent events. This Client Alert provides information on **five hot topics:**

1. Market Conditions Affecting **Valuations** for Estate and Gift Tax Transfers
2. Potential Estate and Gift Tax Savings From Intrafamily Loans and Loan Refinancing using **Low Interest Rates**
3. The **Great GRAT Giveaway**: Grantor Retained Annuity Trusts (“GRATs” Are Ideally Suited For Current Market and Interest Rate Conditions
4. Formalities of Execution of Health Care Documents and Estate Plans Adapted to Reflect Separation Required by **Coronavirus**
5. **Life Insurance** Affected by Market Conditions and Interest Rates

All of our clients who are serious about reducing estate tax exposure should arrange a call to discuss how to best take advantage of the opportunities presented by current conditions of low valuations and lowest-ever interest rates.

Our recent March 2020 Client Alert (accessible here) addressed five current topics:

- Health Care Documents and Estate Plans in the face of **Coronavirus**
- Planning for Retirement Accounts After the **SECURE Act** of 2019
- The new **Illinois Uniform Trust Code** and Its Effects on Trust Design
- Planning for Possible Changes in **Estate and Gift Tax Exemptions**
- Gift and Intrafamily Loan Refinancing Opportunities with **Low Interest Rates**

Also as mentioned in the March 2020 Client Alert, tax returns that would have been due April 15, 2020 have all been extended to July 15, 2020 (including the deadline for filing an automatic extension to October 15, 2020). This applies not only to income tax returns but also to gift tax returns.

If any of these topics raises concerns or questions for you, contact one of the Freeborn & Peters attorneys listed below (Email would be best under current conditions, as most of us are working remotely for at least the balance of April 2020).

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1. Market Conditions Affecting Valuations for Estate and Gift Tax Transfers
Professional appraisers have reported that current market conditions are substantially affecting their valuations of closely held businesses and real estate. Enterprise-level **valuations of companies have decreased** to reflect adverse effects on sales and supply chains. Valuation discounts have increased, especially the discount for lack of marketability.

While these adverse conditions reflect real-world economic distress and hardship, they represent **estate planning opportunities** to transfer assets by gift or by installment sale at depressed valuations, thus saving estate and gift tax. Transfers by installment sale are further enhanced by today's current **low interest rates**. Estate and gift tax savings are potentially VERY high for a gift in the second quarter of 2020 using gift tax exemption or a non-gift transfer such as an intra-family installment sale or a GRAT (discussed below).

2. Potential Estate and Gift Tax Savings From Intra-family Loans and Loan Refinancing Low Interest Rates
The Treasury Department recently issued its monthly announcement of applicable federal rates that establish a floor for transactions between family members. These interest rates function as a safe harbor and avoid the argument that an installment sale or loan is partly a gift due to having an insufficient interest rate. A related rate, the Section 7520 rate, is used in actuarial calculations for several estate planning techniques.

The May 2020 applicable federal rates announced on April 15 are the ***lowest in modern times***.

May 2020: The 7520 rate is 0.8%

The AFRs are as follows	Annual Compounding	Semi-annual Compounding	Quarterly Compounding	Monthly Compounding
Short-term (up to 3 years)	0.25%	0.25%	0.25%	0.25%
Mid-term" (3 to 9 years)	0.58%	0.58%	0.58%	0.58%
Long-term (over 9 years)	1.15%	1.15%	1.15%	1.15%

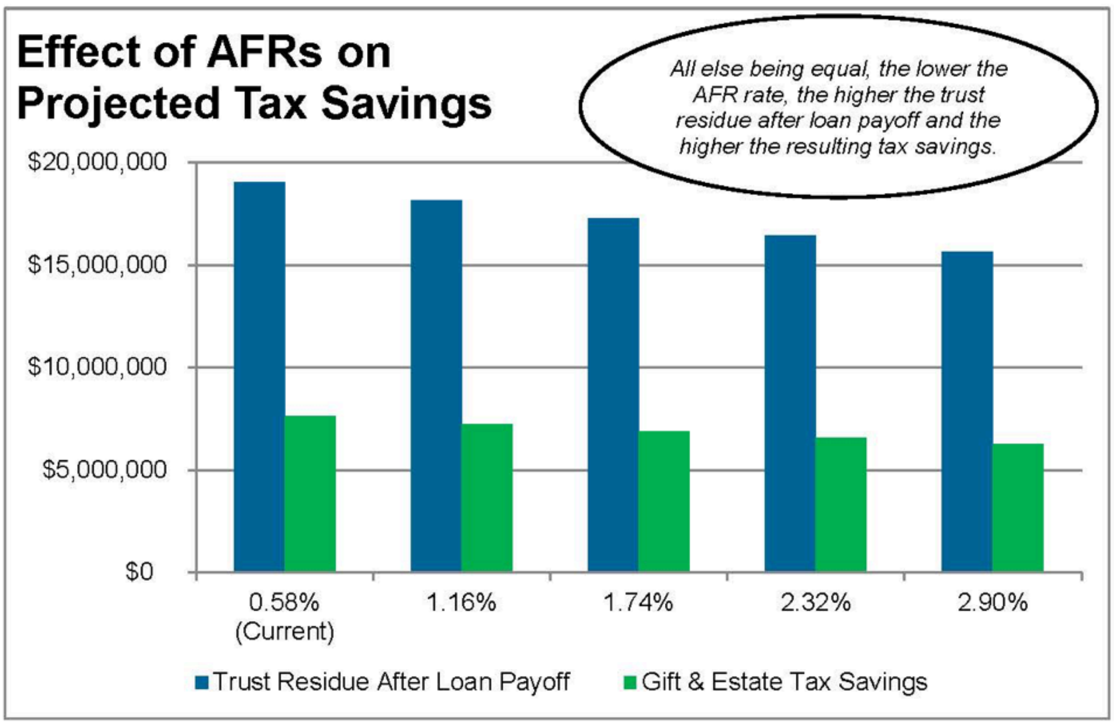
These **extremely low interest rates** create a great planning opportunity for families, whether or not they have sufficient assets to be concerned about estate and gift taxes. Even modestly wealthy families could benefit from making intra-family loans at low interest rates to enable younger family members to refinance and restructure their debt. Families concerned about **estate taxes** can not only help younger family members with refinancing, but can also make cash loans or installment sales to trusts for family beneficiaries, with excellent chances that those trusts can invest for higher returns than the trusts are paying on their debt, allowing the "spread" to grow within the trust free of gift taxes.

Installment Sales to Grantor Trusts—A transferor can sell growth assets to a grantor trust created by the transferor for beneficiaries in a manner that avoids current capital gains taxes and reduces or eliminates gift taxes by having the transferor take back an installment note. The "spread" between the growth assets' rate of return and the low interest rate on the installment note is retained in the trust for the beneficiaries. (See chart on following page)

Intra-Family Loans—One of the simplest wealth transfer techniques involving leverage is a loan to family members, or trusts for their benefit, at the lowest allowable rates that will not result in gift taxes. These minimum allowable rates are often substantially lower than the family member could obtain from a commercial lender. Over time, the interest rate savings and cash flow benefits for the family member can be substantial.

Illustration of Installment Sale to Grantor Trust

Comparative Effects on Installment Sale of Applicable Federal Rates		Sec 1274 Mid-Term AFR	Trust Residue After Loan Payoff	Gift & Estate Tax Savings
Common Assumptions:		**0.58% (Current)**	$ 19,044,358	$ 7,617,743
Term of Note	9 years	1.16%	$ 18,138,648	$ 7,255,459
Debt Service	Interest-only to maturity	1.74%	$ 17,271,430	$ 6,908,572
Growth Rate	8.0%	2.32%	$ 16,441,265	$ 6,576,506
Funding Amount	$ 10,000,000	2.90%	$ 15,646,761	$ 6,258,704



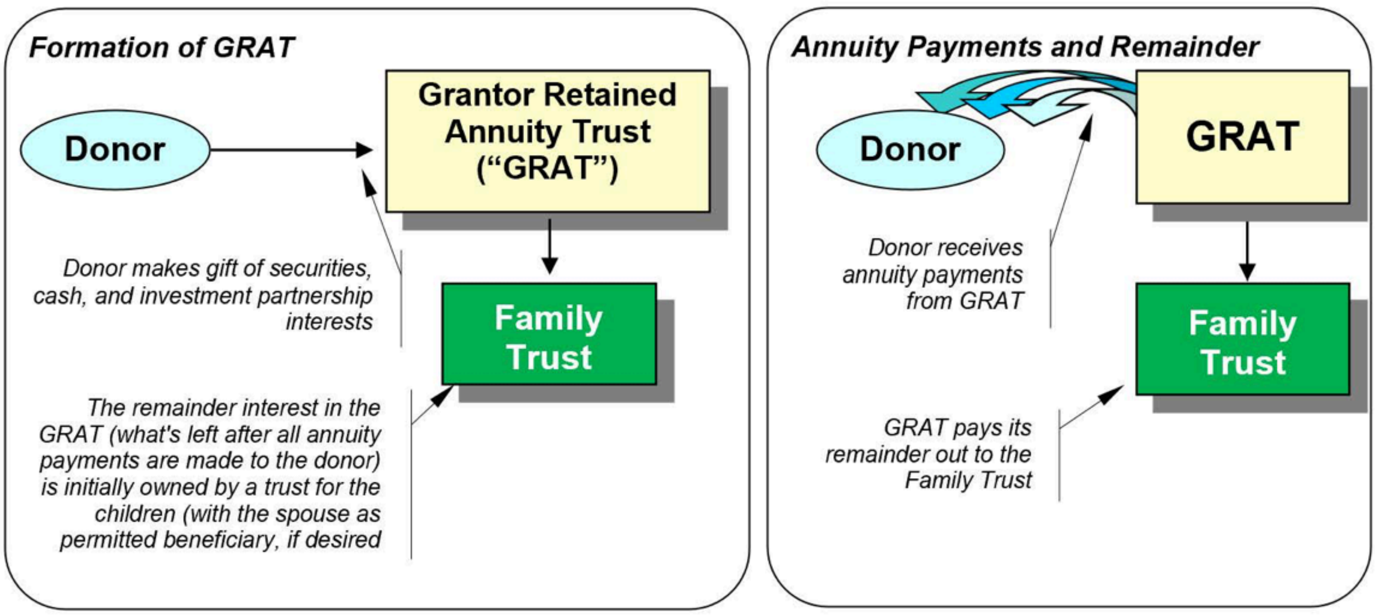
3. The Great GRAT Giveaway: Grantor Retained Annuity Trusts ("GRATs") Are Ideally Suited For Current Market and Interest Rate Conditions

As previously mentioned, the May 2020 applicable federal rates are the lowest ever, and that also applies to the Section 7520 Rate. This makes the **grantor retained annuity trust**, or GRAT, more powerful than ever. A GRAT functions like a non-recourse loan to a trust for children or other beneficiaries. The donor retains a fixed annuity payment right with a present value that offsets the value of the property contributed to the GRAT, so that there is **no taxable gift**. The present value of the annuity is calculated using the Section 7520 Rate, and when that rate is low, the annuity that has to be paid back to the donor is smaller. After the final annuity payment is made to the donor, whatever remains in the trust is paid to one or more remainder beneficiaries (possibly individuals, but usually a trust for individual beneficiaries).

The donor retains the downside investment risk, and if the GRAT's assets shrink or simply do not grow enough to fully pay the annuity back to the donor, the trust simply terminates with nothing paid to the remainder beneficiaries.

The donor can retain flexibility and some degree of control while still accomplishing a completed gift or sale. For example, transfers can be made using non-voting stock in a closely held company, while the donor retains voting stock. A company that does not have non-voting stock can usually be restructured to have it. As another example, GRATs can be designed with one specified trust for beneficiaries designated to receive the remainder, but give a person other than the donor the power to designate a different trust to receive some or all of the remainder at any time before the GRAT terminates.

ILLUSTRATION OF GRANTOR RETAINED ANNUITY TRUST



The flowchart above and the tables and graphs on the following page visually illustrate how a GRAT works. For further illustration, see Bill Russell's white paper with a case study based on an actual client result using a GRAT.

4. Life Insurance Affected by Market Conditions and Interest Rates

As is often the case during periods of financial and economic distress, adverse macroeconomic conditions have serious negative effects on many **cash value life insurance policies**. (Term policies are not always directly affected, unless an insurer's general fund is particularly distressed.) Earnings credited to policies will be declining due to portfolio losses and lower interest rates.

While the current economic conditions may be affecting most people more directly, persons owning life insurance (including trustees holding insurance on the trust's grantor or beneficiaries) should not neglect to **perform reviews of their policies' condition**. At a minimum, insurance policy owners should request an updated in-force illustration of each policy. For those policy owners who need assistance in conducting insurance policy reviews, independent insurance advisors can perform policy reviews at a low or even nominal cost. **If an insurance policy is in trouble, it is better to find out sooner rather than later.** Owners of insurance policies with the option of selecting investment accounts should consider reallocating among those accounts to achieve higher returns, as their investment advisors may recommend. Private split-dollar insurance funding arrangements should be **refinanced** in light of lower interest rates.

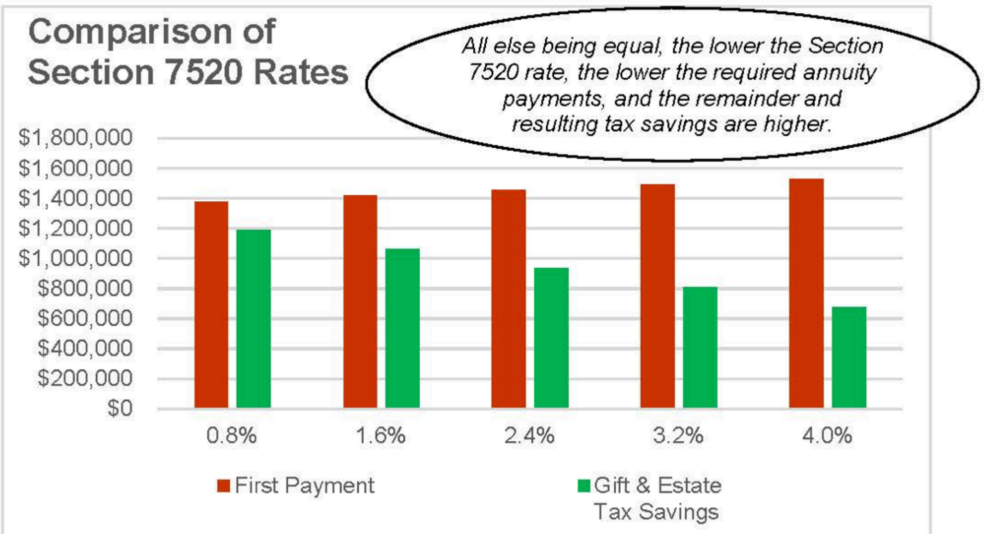
5. Formalities of Execution of Health Care Documents and Estate Plans Adapted to Reflect Separation Required by Coronavirus

Under the current conditions imposed by the Coronavirus pandemic, it is **more important than ever** that people **have current and updated estate planning documents**, in particular healthcare related documents such as powers of attorney, Living Wills, and Medical Disclosure Authorizations. If these need to be updated, Freeborn & Peters can help, despite the greater difficulty of executing documents under current conditions.

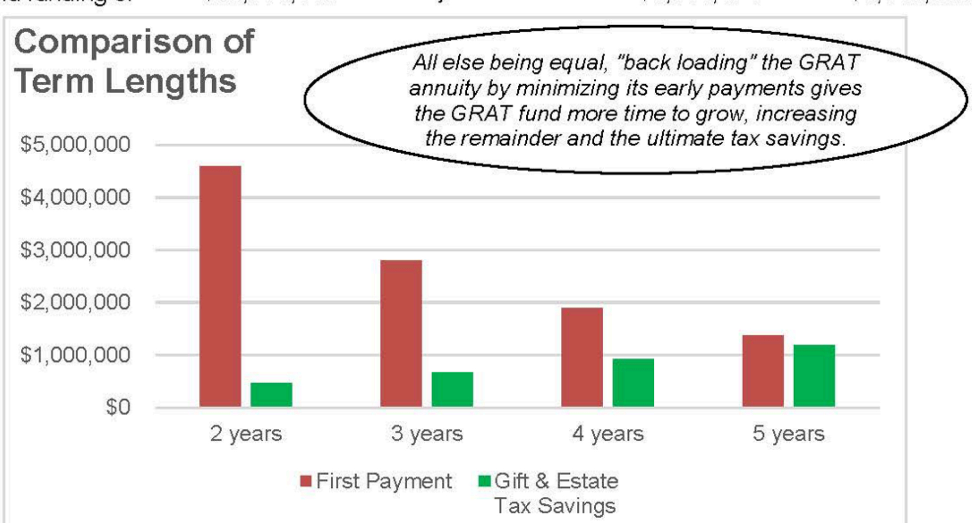
Client Example — Example 2020 Annuity Trust (GRAT) (May 2019)

Comparisons of Term Lengths, Sec 7520 Rates

Comparison of Section 7520 Rates		Sec 7520 Rate	First Payment	Gift & Estate Tax Savings
All Using Term of	5 years	0.8%	$1,380,171	$1,189,369
		1.6%	$1,417,059	$1,064,073
All assuming asset		2.4%	$1,454,459	$937,040
growth rate of	8.0%	3.2%	$1,492,367	$808,278
and funding of	$10,000,000	4.0%	$1,530,782	$677,799



Comparison of Term Lengths		Term	First Payment	Gift & Estate Tax Savings
		2 years	$4,601,739	$468,814
All assuming asset		3 years	$2,794,016	$677,500
growth rate of	8.0%	4 years	$1,903,721	$916,740
and funding of	$10,000,000	5 years	$1,380,171	$1,189,369



In recent years, many legal documents including contracts have adapted to electronic signatures. Estate planning documents have resisted this trend due to the higher evidentiary standards established by case law or statutes, although electronic execution of wills and other estate planning documents has been adopted by a handful of states (NV, IN, FL) and is under consideration in a few others.

During the forced separation and social distancing required by the current Coronavirus pandemic, those of us in states retaining requirements for witnesses, notaries, or both for the execution of estate planning documents using physical ink signatures have faced greater difficulty in executing those documents with all the proper formalities as required by law.

Attorneys have been creative in setting up arrangements for executing estate planning documents while retaining sufficient separation. Using conference rooms with glass walls so that only one person at a time is actually in the room signing, while the others witness through the glass, has been one solution. Having the principals sign their documents while sitting in a car while the witnesses watch through the windshield or windows has been another solution.

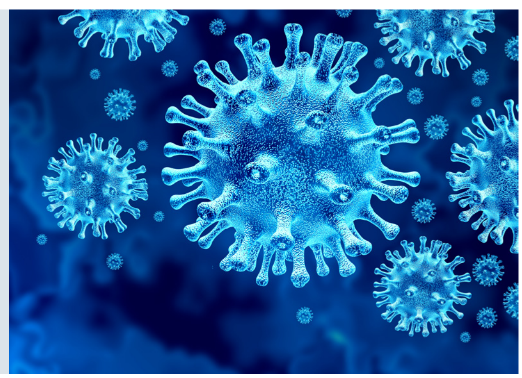
To address the continuing need for proper and full legal execution of estate planning documents while maintaining social distancing and not having to take extreme or complicated measures, most states have now adopted ***temporary*** rules to allow witnessing by video. Under these rules, such as those adopted in Illinois, the witnesses and notary may watch the principal execute a document by video and then sign their names as witnesses or notary on a separate page (or the same page, at a later date), ***provided that*** the video is recorded and saved for a substantial period of time, such as three years.

The estate planning attorneys at Freeborn & Peters LLP are familiar with these solutions and are able to adapt to our clients' needs for executing documents under these unusual conditions.

Freeborn's Response to COVID-19

Freeborn & Peters COVID-19 Task Force, with dozens of COVID-19 related Client Alerts and links:
https://www.freeborn.com/practice/covid-19

Bill Russell's white paper on client result using a GRAT:
https://www.freeborn.com/perspectives/real-life-example-transferring-growth-without-gift-tax



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Michael Whitty is a Partner in the Corporate Practice Group. He concentrates his practice in estate planning, taxation, and estate and trust administration. Michael represents business owners, principals of venture capital and private equity funds, key executives, investors, and other highnetworth individuals in planning for the preservation and transfer of their wealth.

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