Steve Leimberg's Estate Planning
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Subject: Joy Matak, Sandra D. Glazier & Martin M. Shenkman - Estate Planning Six-Part Series for Late 2020, Part 3: Transfers for Taxpayers with Limited Exemption Remaining; Upstream and Downstream Planning

"At this point in 2020, all we know for sure is that nothing is certain. Practitioners would do well to forewarn clients how these uncertainties might create more chaos for them, their finances and their estate plans. Even after the results of the runoff races in Georgia are known what, if any, tax legislation might be enacted and the possible effective dates of such legislation, will remain an uncertainty. It's advisable to caution clients that all the tax planning efforts may be for naught and could even leave them in a position that is less favorable, depending on political developments and future legislation, than had they done nothing. Nonetheless, planning that incorporates asset protection benefits, succession planning, etc. may be worthwhile regardless of uncertainty tax changes.

Despite all of this uncertainty, opportunities abound to accomplish significant wealth transfers before year end – even for those taxpayers who have already used up most (or all) of their lifetime exemptions of $11.58 million. Some opportunities discussed in this third installment of this six-part series, are as follows:

1. *Consider 'Downstream' Planning*
2. *Be Wary of – and Consider Revisiting – 'Upstream' Planning*
3. *Insurance Trusts*
4. *Grantor Retained Annuity Trusts ('GRATs') in the Current 2020 Environment*

The next installments of this series will explore other opportunities for planning before year-end."

Joy Matak, JD, LLM, Sandra D. Glazier, Esq. and **Martin M. Shenkman, Esq.** provide members with important and timely commentary in the form of a six-part series, Part 3 of which is a discussion of transfers for taxpayers with limited exemption remaining, including upstream and downstream planning.[i]

Joy Matak, JD, LLM is a Partner at **Sax** and Head of the firm's **Trust and Estate Practice**. She has more than 20 years of diversified experience as a wealth transfer strategist with an extensive background in recommending and implementing advantageous tax strategies for multi-generational wealth families, owners of closely-held businesses, and high-net-worth individuals including complex trust and estate planning. Joy provides clients with wealth transfer strategy planning to accomplish estate and business succession goals. She also performs tax compliance including gift tax, estate tax, and income tax returns for trusts and estates as well as consulting services related to generation skipping including transfer tax planning, asset protection, life insurance structuring, and post-mortem planning. Joy presents at numerous events on topics relevant to wealth transfer strategists including engagements for the ABA Real Property, Trust and Estate Law Section; Wealth Management Magazine; the Estate Planning Council of Northern New Jersey; and the Society of Financial Service Professionals. Joy has authored and co-authored articles for the Tax Management Estates, Gifts and Trusts (BNA) Journal; Leimberg Information Services, Inc. (LISI); and Estate Planning Review The CCH Journal, among others, on a variety of topics including wealth transfer strategies, income taxation of trusts and estates, and business succession planning. Joy recently co-authored a book on the new tax reform law entitled Estate Planning: Estate, Tax and Other Planning after the Tax Cuts and Jobs Act of 2017.

Sandra D. Glazier, Esq., is an equity shareholder at **Lipson Neilson, P.C.**, in its Bloomfield Hills, MI office. She was also the 2019 recipient of Bloomberg Tax's Estates, Gifts and Trusts Tax Contributor of the Year Award and Trusts & Estates Magazines Authors Thought Leadership Award and has been awarded an AEP designation by the National Association of Estate Planners and Councils. Sandra concentrates her practice in the areas of estate planning and administration, probate litigation and family law.

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Here is their commentary:

EXECUTIVE SUMMARY:

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6. Be Wary of – and Consider Revisiting – "Upstream" Planning
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COMMENT:

Consider Downstream Planning (not Upstream) for UHNW Clients

Upstream planning has received a lot of attention in recent years, but little attention has been given to downstream planning. This type of planning presents a potentially unique and valuable opportunity that may be quickly implemented in the waning days of 2020.

A valuable “asset” of many ultra-high-net worth (“UHNW”) families is the unused exemption of their children. In those cases where the adult children do not have sufficient resources to make gifts to use their exemptions, the older generation (G1) may need to get assets to the younger generation (G2) so that G2 can take advantage of their remaining lifetime exemption, particularly before year-end.

Consider that this is about much more than just capturing unused exemption of G2 or even G3. Creating a grantor, GST exempt, irrevocable, dynastic trust for each heir may prove valuable to their future estate planning. Further, if the laws change but those trusts created in 2020 are grandfathered, trusts created this year could prove incredibly valuable especially if those tax attributes are restricted or eliminated by future legislation.

By making a long-term loan using an interest rate that matches the long-term applicable federal rate (the “AFR”), G1 may be able to transfer cash to G2 (or G3) without making a taxable gift. The December 2020 long-term AFR is 1.12% for loans with a term of ten years or more. For context, the annual interest due on a loan of $1 million with a 1.12% interest rate would only be $11,200. The rate for December 2020 is up to only 1.31%.

If the intention is for G2 to make gifts upon receipt of funds borrowed from G1 to facilitate using up G2’s lifetime exemption and create GST exempt grantor trusts to benefit future generations, the practitioner might consider additional safeguards, as follows:

1. It may be important to ascertain if G2 has creditors who might try to attach funds received before G2 is able to fund the trust or whether such funding might be subject to attack as a fraudulent conveyance. Also, if G2 is married, it may be prudent to ascertain potential implications that downward planning may have in the event of

divorce. Given the limited time before the end of the year, it may still be feasible to have the G2 sign a solvency affidavit confirming their belief that there are no claims that would render G2 insolvent, etc.

2. It may be important for G2 to provide a financial statement or other documentation that demonstrates that G2 can continue to make the payments due on the Note after any gift transfers by G2, to the extent feasible.

3. The Note may be secured by an existing dynasty trust that had been previously set up by G1 for the benefit of G2, this may be particularly important if G2 does not have the resources to support the transfer as constituting a viable loan.

4. It would be prudent for G2 to make a gift of an amount that is different than the amount that is borrowed from G1 in order to avoid implicating the step transaction doctrine which holds that "a series of transactions designed and executed as parts of a unitary plan to achieve an intended result … will be viewed as a whole regardless of whether the effect of so doing is imposition of or relief from taxation."[ii] For example, G1 may loan G2 $10 million and G2 may gift $8 million. Also, consider that the amounts might be much smaller. Even a $500,000 funding of a GST exempt grantor trust, if grandfathered, could prove to be the keystone of that family member's future planning.

5. G2 might want to consider making gifts that would benefit individuals who are not the natural objects of G1's bounty. By way of example, G2 may use some part of the funds borrowed from G1 to fund a spousal lifetime access trust for the benefit of G2's spouse, using some of the protections outlined in Newsletter #2.

Loans from G1 to G2 are relatively easy to implement quickly, but it is important for the parties to follow economic formalities in order to avoid possible re-characterization of the loan as a gift.

The loan should be memorialized in a Promissory Note instrument. Both parties should sign it and adhere to any other requirements of applicable state law for validity. Payments should be made in accordance with the note instrument and there should be economic consequences if payments are not made timely, such as a late payment penalty.[iii]

Be Wary of Risks of Upstream Planning

Upstream planning has been touted for its possible basis step-up benefits, but a reduced exemption could make such well-intended planning a tax trap depending on how the planning was formulated.

Once the Tax Cuts and Jobs Act of 2017 more than doubled the federal basic exemption amount from $5.49 million in 2017 to $11.18 million in 2018, there was a marked shift in planning discussions for many clients from estate tax minimization to the income tax benefits of a basis step-up on death under Code Sec. 1014. Commentators began discussing more frequently the benefits of so-called “upstream planning” to shift values to a higher generation family member not otherwise subject to the estate tax. With fewer individual estates subject to tax on death, upstream planning became more common as practitioners incorporated general powers of appointment into trust instruments in order to cause trust assets to be included in the client’s estate or in the estate of an older generation family member whose estate is less than the exemption.

This type of planning has been given considerable attention as a result of the currently large temporary exemptions. Clients who have a net worth substantially in excess of the approximately $23 million per couple exemption, might consider upstream planning if, for example, the clients’ parents have a combined net worth of well under the current exemption, e.g. only $2 million.

Upstream general power of appointment (“GPOA”) planning might raise creditor issues. Confirm that the existence and exercise of the GPOA will not subject the trust assets to the claims of the creditors of the powerholder. If that is a risk, might conditioning the exercise of the power on the powerholder being solvent limit such risk? A GPOA may also subject the assets to a parent’s or other powerholder’s Medicaid claim for reimbursement.[iv]

If there is a dramatic decline in exemption amounts before the powerholder dies, it will remain important for practitioners to now, in 2021, and in the future, review existing client estate plans to evaluate the need to modify or eliminate general powers of appointment that might cause estate inclusion and potentially create an unintended estate tax (e.g. if the powerholder has only a $5 million exemption instead of an $11.58 million exemption[v]).

Although many practitioners have touted the use of “upstream” planning to salvage otherwise unusable exemptions of clients’ elderly relatives, the planning is not assuredly beneficial. Consider the consequences of upstream planning if the lifetime exemption is substantially reduced. For example, assume that a parent had an estate of only $4 million, and the child created a trust with $7 million, granting his parent a GPOA over that trust. The intent of the plan was that the parent’s estate would include the assets of the trust and those assets would garner an estate tax free adjustment (hopefully step-up) in income tax basis on the parent’s death. If the exemption is reduced to the $3.5 million (as has been proposed by some Democrats), the plan intended to garner a basis step-up at no tax cost may instead trigger a substantial estate tax cost that was unintended. If basis step-up is eliminated (as President elect Biden has proposed) there may be no tax benefit for that estate tax cost.

Practitioners should carefully review any upstream planning. For example, the elderly parent could be granted a limited power of appointment with someone given the right to convert it to a GPOA. If the exemption is reduced, the conversion would not be triggered. While some upstream plans were likely crafted to only include in the senior generation’s estate an amount that does not trigger an estate tax (e.g. using a formula inclusion), the more prudent course of action would be to confirm that any such clauses are properly drafted in order to avoid inclusion if exemptions are reduced. Clients who only recently had planning updated to address the inclusion of GPOAs to a higher generation will likely be frustrated by yo-yoing tax law changes and ongoing planning updates.

Funding Life Insurance Trusts

Another common planning tool has been for clients to make gifts to trusts from which a class of beneficiaries are allowed to withdraw a pro-rata portion of the gift made by the grantor (commonly known as a “Crummey power”), up to the annual gift exclusion amount for that beneficiary (or limited perhaps by what is commonly referred to as a 5 and 5 hanging Crummey power).[vi] This has facilitated the ability for clients to make large gifts to a trust (e.g. used to buy and hold life insurance) and not incur any gift tax cost related to the gift.

A current proposal would restrict combined annual (Crummey) gifts to a maximum of $50,000 <u>per donor</u>. Another proposal would have restricted it to $20,000 per donorr. If these restrictions are applied to all trusts after enactment, the results could hamstring the common Irrevocable Life Insurance Trust ("ILIT") which has been ubiquitous in estate plans. In light of such proposals clients might consider making maximum annual (Crummey) gifts, and even large gifts now (using exemption that might also disappear) of income producing assets that could have the potential to generate sufficient income to pay any premiums that become due after any change in law. This way, clients may not have to rely on annual gifts to fund their life insurance premium payments.

> <u>**Example**</u>: Client has a typical ILIT with Crummey powers. Premiums are $75,000/year and are easily covered by the annual demand powers available to children and grandchildren who are beneficiaries of the trust. If tax reform is enacted and Crummey powers are prospectively eliminated (even for trusts predating the law change), the client will not be able to fund annual premiums without incurring a costly current gift tax. The client might be able to transfer a sufficient amount of marketable securities to the trust now, using current exemption, so that the future premiums might be paid from a combination of the income and principal of the gift made. If this technique is pursued, it might also be worthwhile to inquire about the availability to prepay future premiums currently in order to minimize future income tax costs to the client. Practitioners might also wish to analyze and address the effects of making a policy a so-called "modified endowment contract" as described in Code Sec. 7702A.

Alternatively, a client may consider making a large low-interest loan to an existing ILIT that could be used to pay premiums going forward. If no changes are made to the tax laws, the ILIT can use the cash borrowed to pay off the loan at some point in mid-2021. Given that the vast majority of ILITs are structured as grantor trusts, there should be no income tax consequences associated with such a payoff. As indicated earlier, it is recommended that all formalities be followed with regard to such intrafamily loans. It’s advisable for all such transactions to be disclosed on a timely filed gift tax return.

> **<u>Another Example</u>**: Since Grantor Retained Annuity Trusts (“GRATs”) may also be on the chopping block, a wealthier client who does not have adequate exemption remaining to complete a large gift (such as that discussed in the prior example to sufficiently fund future premiums) might consider creating and funding a GRAT that pours the remainder interest into the ILIT. Consider the GST implications of this before proceeding. If the ILIT is GST exempt the GRAT will not be and will pour non-GST exempt assets into the ILIT resulting in a mixed inclusion ratio.

While a more detailed discussion of GRATs follows later in this newsletter, as long as GRATs remain a viable planning option, a GRAT/ILIT plan might entail creating a two-year GRAT with the ILIT as the remainder beneficiary. Each time the annuity payment is made to the grantor, the grantor could re-GRAT it into a new GRAT for which the ILIT is designated as the remainder beneficiary.

However, if both two-year GRATs and Crummey gifts are eliminated, as has been proposed, this type of GRAT/ILIT plan would have to be structured differently. Perhaps a tier of GRATs with different durations might be created now, before any new GRAT restrictions are enacted, so that the existing GRATs might be grandfathered and continue to fund insurance premiums for years to come despite proposed restrictions on *Crummey* powers.

Practitioners may want to consider (in the current environment which some view as creating an increased risk of harsher tax legislation to pay for the current bailouts) using GRATs to “pre-fund” future life insurance premiums in ILITs. If the insurance trust is not GST exempt, a GRAT could be structured to pour into the insurance trust as its remainder beneficiary and thereby infuse capital now before restrictions are created on ILIT Crummey trust funding. If the ILIT is GST exempt, it might borrow funds at the low applicable AFR from the successful GRAT without income tax effect if each GRAT is a grantor trust as to the same grantor.

Grantor Retained Annuity Trusts ("GRATs") In the Current 2020 Environment

Introduction to GRATs

Grantor retained annuity trusts ("GRATs")[vii] have been a popular planning tool. In the current planning environment, GRATs may be a powerful planning tool for three primary reasons:

- Suppressed asset values due to a volatile and uncertain economic environment. Funding a GRAT when asset values are low but may rise significantly in future years shifts all the appreciation above the applicable Section 7520 rate outside the grantor's gross estate for federal estate tax purposes, unless, perhaps, the grantor dies during the retained annuity term). For example, assuming the grantor survives the annuity term and if the GRAT is funded with $1 million and the taxable remainder is valued at only $1,000, any remainder passing to the successor beneficiaries in excess of $1,000 results in a gift tax free transfer.

- Interest rates, used to value interests in GRATS, are at historic lows (the Section 7520 rate for April 2020 was 1.2% and has dropped to 0.4% for October 2020 and .58% for December 2020). For comparison, in 1989, the Code Section 7520 hurdle interest rate was at a high of nearly 12 percent. In March of 2009, it was almost 3 percent. GRATs are a technique that shines brightest when lower interest rates are in effect, all other things being equal. Simply put: the lower the interest rate the lower the annuity payment that has to be made periodically back to the grantor to minimize the taxable gift made with funding a GRAT, and hence the greater the potential for value to be shifted outside the estate. Going back to the above example, if the Section 7520 was 1.2%, any growth and income above that rate passes gift tax free to the successor beneficiaries (assuming the grantor survives the term of the GRAT).

- The federal bailouts may eventually require that taxes be raised. While no one can forecast what tax law changes may occur, it seems

> logical that estate taxes will increase, perhaps, markedly so. Therefore, shifting assets out of an estate using current favorable laws, such as by using GRATs, may prove very advantageous.

However, while the current environment may be the so–called “perfect storm” for GRAT planning, practitioners need to be aware of a number of nuances to this planning. In many instances, it will not be GRAT planning as usual. This newsletter will explore some of the differences in how practitioners may choose to plan for GRATs in the current environment.

Only Use GRATs for Appropriate Situations

GRATs may not the most effective tool for clients who have remaining gift and GST exemption. The current exemption of $11.58 million is the highest in history and may well be reduced, perhaps substantially, by future legislation and is slated under current law to be halved effective 2026 (if Congress does nothing before then). Thus, clients with remaining exemption might be well served to consider gifts to GST exempt trusts, and other planning techniques that use exemption, before focusing on GRATs.

GRATs are a not a technique that secures remaining GST exemption. The ETIP rules generally prevent allocation of GST exemption until after the GRAT ends (i.e., will no longer be included in the grantor’s estate). At the end of the GRAT the GRAT assets would be anticipated to have appreciated making that later allocation inefficient. Further, if the tax laws change and exemptions are reduced there may be no GST exemption remaining to allocate. [viii]. In an attempt to avoid ETIP limitation imposed on GST planning for GRATs, some suggest that sometime after a GRAT is funded an old and cold GST exempt trust purchase the remainder from the GRAT to thereby shift future appreciation into a GST exemption solution. However, at the present time the IRS has indicated it will not respect such a purchase of the remainder in a GRAT to provide GST exemption. Nonetheless, it remains important to consider GST planning implications when determining whether to use a GRAT in the current environment in contrast other planning techniques.

Overview of the GRAT Technique

The common application of the GRAT technique has been to structure a short-term, typically a two-year GRAT, designed to capture upside market volatility. The annuity paid to the grantor is generally set high enough so that the GRAT has a nominal value for gift tax purposes--a so-called "post-Walton zeroed out" GRAT. There are different perspectives on whether or not to use a zeroed out GRAT. Some practitioners think that it is perfectly acceptable while others prefer to structure the GRAT so there's a very modest initial gift value that can appropriately be reported on a United States Gift Tax Return (Form 709).[ix] In any case, it may be possible to draft for a minimum gift value.

The result of this traditional GRAT approach is that a substantial portion of the assets of the GRAT (principal plus the Section 7520 mandated return) would be paid back to the grantor. Market returns above the mandated federal interest rate would inure to the benefit of the grantor's "heirs" (or a trust for their benefit). This could result in the client "re-GRAT-ing" the large annuity distributions received in each year from the GRAT to a new GRAT. In other words, if a million-dollar GRAT were created, the first one-year annuity payment (of, perhaps, $500,000+) would be paid back to the client as the grantor, who could then gift that payment into a new GRAT. This is why the technique of using repetitive short-term GRATs has been referred to as "rolling" or "cascading" GRATs. The concept of re-GRAT-ing each year's distribution to a new GRAT has been a common part of the GRAT technique. However, it has two important implications to GRAT planning in the existing environment.

As the GRAT assets are repaid to the grantor, in the form of periodic required annuity payments, he or she might continue the plan by re-GRAT-ing the assets received as the annuity payment into new GRATs. The implications to how one might choose to structure these new GRATs is discussed below and this may be different than the historical application of the GRAT technique.

While the risk of a grantor not outliving the term of a GRAT exists (in which case some or all of the assets will be included in the grantor's estate), it may be important to be mindful that certain tax proposals might eliminate the viability of the GRAT technique by requiring a minimum 10-year term for any GRATs created after enactment of such proposals. This could dramatically decrease the risk of a GRAT succeeding. There is also a proposal which would require a minimum gift amount of at least 25% of the value of the assets contributed to the trust, effectively removing the ability to have a zeroed out GRAT and likely retard the successful use of many

GRATs. These two changes could potentially make GRATs impractical for taxpayers who have traditionally used GRATs because they no longer had gift tax exemption remaining. It would also seem to restrict the commonly used “rolling-GRATs” technique.

These proposals are not new. President Obama’s Greenbooks included proposals to restrict GRATs by requiring a minimum 10-year term for GRATs that would have eliminated short term rolling GRATs. Regardless of who controls the Senate, any tax proposals may include one that restricts GRATs in this way. Thus, when structuring new GRATs, in the current environment, consider the potential implications that the elimination or severe restriction of the GRAT technique could have on the ability to roll or cascade a GRAT set up today when annuity payments are paid out in the future.

Some Thoughts on Rolling/Cascading GRATs

As mentioned above, a common GRAT technique has been the use of short-term rolling or cascading GRATs which are intended to capture upside market volatility. The historical mathematical superiority of short-term rolling GRATs over a single long-term GRAT has been documented. However, in the current environment there are a few additional points to consider:

- What is the likelihood of the next administration making the estate tax rules tougher? Might GRATs be eliminated? Or might a required minimum 10-year term and a specified 25% minimum gift value on GRAT funding be enacted? As discussed earlier, either of these restrictions would have a chilling effect on post-enactment GRAT plans and effectively undermine the assumptions of rolling GRATs for currently funded GRATs, if the successor GRATs are so fundamentally altered. If the next administration wants to raise revenues on the wealthy, or if there really is no choice in order to fund the very large bailouts during the coronavirus crisis, the availability of GRATs as an effective planning technique may disappear. Note also that restrictions on GRATs could be coupled with the elimination of discounts on related party transactions and/or elimination or restriction on so-called Crummey powers (which are used to allow gift tax annual exclusions for transfers to trust), etc. The result may be a substantial enhancement of estate tax revenues.

- If a rolling GRAT plan is being funded with discounted interests in a family or other closely held business, what impact might a legislative repeal or restriction on such discounts have on the plan? Short-term GRATs require high payouts to minimize or eliminate gift tax. That may mean that a significant portion of the equity in the family business may be repaid to the grantor in the form of GRAT annuity payments. If so, when the grantor wishes to re-GRAT, the assets may not, at that future date, qualify for discounts. Therefore, it may be advisable to lock in the discounts by using a longer term GRAT now (i.e., not the traditional two-year GRAT term). Query, if discounts are eliminated by future legislation might that permit the payment of annuity amounts in kind (e.g. stock in a closely held business held in the GRAT), valued without discounts even though discounts applied to the valuation of the interests when gifted to the GRAT?

- What about creating a long-term GRAT, instead of a series of short-term GRATs, on account of the possibility that Congress may restrict GRATs? Although many have demonstrated the superiority of short-term GRATs compared to longer-term GRATs, the assumption underlying those findings was that the short-term GRAT would be one in a series. Short term GRATs may not be allowed in the future.

The more granular you make the GRAT, the more likely to capture upward market swings. Creating several GRATs, each funded with one sector of the market, is more likely to result in at least one of the GRATs exceeding the annuity payment assumptions than one GRAT funded with all sectors of a market. The reason is that with one GRAT good performance in one sector will be offset by negative performance in another. But each GRAT funded with its own sector of the market can stand alone without erosion by other sectors.

GRAT Immunization

GRAT immunization refers to the process of substituting a nonvolatile asset (such as cash) for the assets inside the GRAT. So, if the GRAT holds Zoom stock which appreciates dramatically the grantor could swap in cash and swap out an equivalent value of Zoom stock. The rationale for this is that if the GRAT, whatever the term, realizes a significant uptick in value, the client may want to lock in that uptick by substituting less volatile assets. The application of this technique is discussed in the section that follows.

GRAT Immunization May Have to Change with 2020 Longer Term GRATs

The preceding factors do not change the fact that use of short-term rolling GRATs is a better strategy when they work. But what happens if that strategy isn't given a sufficient duration to succeed because the GRAT rules are changed by new legislation. Perhaps, a safer long-term strategy might be to create a series of longer-term GRATs. If the GRAT technique is repealed, GRATs that have been executed and funded might be grandfathered from these adverse changes. But with longer-term GRATs, the traditional approach of immunization using cash or Treasury bills won't make economic sense. The reason is that swapping cash or treasuries into a two-year GRAT, and typically after some time is already run on that GRAT term, may leave significant wealth unproductive for a long period of time. By opting into, for example, a ladder of six, eight and 10-year GRATs, the GRAT arrangements will be locked in for a longer time. In case future legislation restricts or eliminates short term GRATs, immunization has to be looked at differently. If in the second year of a 10-year GRAT there is a spike is the stock market, immunization may make sense but, in contrast to a two-year GRAT that may have mere months to run, this six, eight or ten-year GRAT may have five or more years left to run. Holding assets idle in cash or treasuries for that long a period of time is not likely to be desirable. Thus, a more sophisticated investment technique may have to be implemented in order to immunize longer-term GRATs.

> **Example**: A client establishes a series of ten $1 million ten-year term GRATs, each for a different asset class. One of the 10-year GRATs experiences a substantial gain in year one, doubling in value. Under the historical rolling GRAT paradigm, this would have been a 2-year GRAT, not a 10-year GRAT. The client likely would have been advised to substitute Treasury bills for the $2 million in the GRAT, thus locking in the large gain. This strategy will not be acceptable in a 10-year GRAT unless the client retains Treasury bills for the nine remaining years. However, a 2-year GRAT will not work either if GRATs

> are restricted next year by new legislation, or if it takes 3 or more years for that asset class to recover from the current coronavirus recession. Instead, while historically less advantageous, the 10-year (or some other term longer than the traditional 2-year) GRAT might prove the only practical effective technique. There are several approaches to consider. One might be to substitute a diversified portfolio with a nine-year time horizon for the $2 million appreciated GRAT property. Although clearly not as secure as locking in the gain with Treasury bills on a 2-year GRAT with 1 year remaining, it will be more secure for purposes of retaining that gain than, perhaps, the ten year-long term overall asset allocation of assets comprised of a heavily weighted sector. Assume that the client generally has a 20+ year investment horizon and an overall asset allocation consisting of 60 percent equities, 25 percent bonds, and 15 percent alternatives. Perhaps, the nine-year remaining GRAT might be given, as substitute property, a more conservative allocation designed to minimize downside risk of giving up the $1 million initial gain, but still consider the long 9-year time horizon and the need for growth inside the GRAT. The client's wealth manager might recommend a 40 percent equity, 45 percent bond, and 15 percent alternative strategy. Perhaps, option techniques can be used to hedge the downside risk in the highly successful GRAT while leaving some upside potential for growth in light of the nine years remaining. Although that strategy will come at a cost that will reduce the upside, it can, perhaps, be viewed as insurance on preserving the large gain in the early years of a long term GRAT.

Long-term GRATs are not as efficient as a series of short-term GRATs can be. However, the budget deficit that the next administration will have to address, the uncertainty of whether GRATs will survive, and the unknown timing of market improvements make them worth reconsideration.

Very Long Term GRAT

A concept that has been discussed for a number of years is often called a "99 – year GRAT." This technique is really an interest arbitrage and it is a technique whose time may have come. Many practitioners are under the misconception that if the grantor dies during the term of a GRAT the entire

GRAT principle will be included in the taxable estate. That is not correct. Rather, to determine what portion of a GRAT's assets are included in the grantor's estate one must take the required annuity payment and divide it by the Section 7520 rate at the date of the grantor's death. If the AFR interest rates are higher at the date of death less than the full value of the GRAT may be included in the grantor's estate if he or she dies during the GRAT term. With interest rate at historic lows, it may be a reasonable bet to assume that interest rates will be higher, perhaps substantially higher at the date of death. So, for clients that have used all of their estate and gift tax exemption a bet now that asset values will grow substantially and interest rates will be much higher at the grantor's death may make a 99-year GRAT a valuable planning tool. If the Section 7520 rate rises before the grantor dies, he or she could sell the remaining annuity payment before death and exclude a significant part of the trust's value from his or her estate.

Conclusion

Practitioners need to be alert to possible broad changes to the wealth transfer laws and factor them into any planning that might still be completed before the end of the year. The plunging economy and rising deficit may force federal and state governments to consider additional tax legislation, making it all the more possible that legislative changes imposed after the new year could reduce the efficacy of planning using so-called "freeze" techniques like zeroed-out grantor retained annuity trusts.

The late 2020 planning environment and potential for massive tax changes is unpredictable but yet vital for many clients to consider, even those who have already done extensive planning and possibly used up most of their lifetime exemption amounts.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Joy Matak

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CITATIONS:

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[i] This newsletter is an adaption of a portion of a paper submitted to the Notre Dame Tax and Estate Planning Institute, which was an adaption of Martin M. Shenkman, Jonathan G. Blattmachr, Joy Matak, & Sandra D. Glazier, Steve Leimberg's Estate Planning Newsletter #2745 03-Sep-19, "Estate and Tax Planning Roadmap for 2019-2020."

[ii] FNMA v. Commissioner, 896 F. 2d 580, 586 (D.C. 1990), cert. denied, 499 U.S. 974 (1991) (citing Kanawha Gas & Utilities Co. v. United States, 214 F.2d 685, 691 (5th Cir. 1954).

[iii] Some of the potential issues that might arise based upon the maker's failure to repay the loan according to the terms of the Note or as a result of insolvency are discussed in Estate of Mary P. Bolles v. Commissioner: Loan, Gift and/or Advancement, by Sandra D. Glazier, Estate Planning Newsletter #2814 (August 11, 2020).

[iv] Acknowledgement to Bernard Krooks, Esq. for this caution.

[v] The exemption is scheduled to increase to $11.7 million as of January 1, 2021, if congress does nothing to modify the same. Additionally, should congress do nothing between now and December 31, 2025, the exemption is set to automatically reduce to $5 Million, adjusted for inflation, on January 1, 2026.

[vi] Some discussion of the implications of withdrawal vs. waiver vs. lapses of such Crummey powers was address in Part 2 of this series of newsletters.

[vii] Adapted from “Shenkman & Blattmachr, “Using Grantor Retained Annuity Trusts In The Current Environment,” ActionLine 38 (Florida Bar Association), Summer 2020. Acknowledgements to Jonathan Blattmachr for several of the ideas discussed in this section.

[viii] Section 2642(f). There are some who have suggested that GST exemption might be allocable to the remainder in a GRAT by selling it to a GST exempt trust. See David A. Handler and Steven J. Oshins, The GRAT Remainder Sale, Trusts & Estates (December 2002).

[ix] Because these matters are uncertain, some commentators suggest word formula safeguards. See, e.g., Blattmachr & Zeydel, “Comparing GRATs and Installment Sales”, 41st Annual Heckerling Institute on Estate Planning (2007).