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ALERT

May 2020

Estate Planning In 2020

MH&H Trusts & Estates Team

The current state of affairs reminds all of us that we live in a time of uncertainty. We must be mindful that estate plans are fluid and need to be altered to reflect current realities. Now, more than ever, clients should be proactively (and possibly boldly) adjusting their estate plans.

For some, these adjustments may mean simply updating their estate plan documents to revise fiduciaries designated under their Last Will and Testament and agents under their Durable Power of Attorney and/or Health Care Proxy. As we have previously indicated in our April 7 alert Issues To Contemplate Post-Coronavirus (COVID-19), we believe that the use of Revocable Trusts will greatly replace the use of a Will.

For others, these adjustments will include taking advantage of low interest rates as well as depreciated market values for their real estate, business interests and marketable securities.

To get a sense of available adjustments, the following is a summary of basic gift tax and estate tax concepts, planning tools for a low-interest rate, depreciated value economy and other items to consider.

I. Basic Gift Tax and Estate Tax Concepts

Under current law, lifetime gifts may be taxable if the beneficiary has the ability to use the gift immediately and the donor has relinquished control of the asset given. Certain gifts (e.g., gifts to charity, gifts to spouses who are US citizens, gifts for tuition made directly to the educational institution and gifts to cover medical expenses for someone else made directly to the provider of the medical services) are not taxed. Under current law, depending on one's wealth, a decedent's estate is taxed upon death on the federal (and, in some cases, the state) level for the privilege of transferring property on death. The amount of the tax depends, among other things, on the amount transferred during life and upon death as well as the applicable exemption amount for the year the transfer was made.

Several relevant monetary thresholds for calendar year 2020 are set forth below:

- Federal Estate and Gift Tax Lifetime Exemption: A single person can give away a total of $11,580,000 during life and upon death without incurring a tax. For a married couple, the exemption is $23,160,000. Moreover, the concept known as "portability" allows a surviving spouse to claim the unused portion of the federal estate tax exemption of their deceased spouse and add it to the balance of their own exemption.

- Federal Annual Gift Tax Exemption: A single person can also give up to $15,000 to as many donees as he/she wants without incurring a gift tax. A married couple can gift up to $30,000 per person. This gift does not count against the lifetime exemption.

- Federal Gift Tax Exemption for Non-Citizen Spouses: As mentioned above, gifts among spouses who are both US citizens are not taxable. Gifts to a non-citizen spouse are taxed once the gift exceeds $157,000.

- Federal Estate and Gift Tax Rate: Depending on the size of the taxable estate, the rate can be between 18% to a maximum of 40%.

- New York State Estate Tax Exemption: In addition to the federal estate tax, the death of a single person who dies a resident of New York State will create a NYS estate tax if the decedent's estate exceeds $5,850,000. For a married couple, the exemption is $11,750,000. However, New York does not recognize portability. Moreover, New York has a unique system of estate tax which is detrimental to its residents. Under the systems of other states and the federal government, if an estate is large enough to be subject to the tax, the amount exceeding the exempt amount is taxed. In New York, if the estate is valued between 100% and 105% of the exemption amount, the benefit of the NY exclusion amount is “phased out”. Moreover, there is no exemption available for taxable estates in excess of 105% of the exemption amount. In such event, the entire value of an estate that exceeds the exempt amount is taxed. Finally, while there is no gift tax, New York also includes the value of certain gifts of property made within three (3) years of death as part of a decedent's estate for estate tax purposes.

The New York estate tax rate is capped at 16%.

- New Jersey: New Jersey has no gift tax and no estate tax. New Jersey does have a separate inheritance tax (a tax imposed on siblings and certain non-related heirs but which generally excludes inheritances received by a spouse, a civil union partner, domestic partner, child, grandchild and certain other close family members). The rate begins at 11% and is capped at 16%.

- Connecticut: The Connecticut estate and gift tax exemption is $5,100,000. The top estate tax rate is capped at 12%. Connecticut is the only state in the country that levies its own gift tax. In 2020, the exclusion is equal to the federal exemption of $11,580,000.

- Florida: The State of Florida does not impose a gift tax, estate tax or inheritance tax. Federal estate and gift taxes still apply to Florida residents. Florida estate planning emphasizes the reduction of federal transfer taxes and minimizing probate expenses and delays.

Practical Takeaways
The current downturn in the market value of assets means you can give away more assets than usual. Getting low-valued assets out of your estate now can save you significant estate taxes in the future. Outright gifts, Intra-Family Sales/Loans and GRATs are especially effective planning tools in today's financial climate.

II. Transfers to Take Advantage of Low Interest Rates/Depreciated Values

A. Outright Gifts. Gifting is a simple way to reduce your taxable estate. As mentioned above, gifts in excess of the annual exclusion amount are counted against the amount you can give away on death without estate tax consequence. Gifts can be made outright to individuals or gifts can be made to irrevocable trusts to benefit loved ones. If structured correctly, gifts to trusts can be designed where the donor actually continues to pay the income tax liability of the asset(s) in trust. This payment has no gift tax consequence to the individual making such payment and is often referred to as a "hidden gift".

B. Intra-Family Sales. Selling assets to family members is an effective planning tool. In practice, you sell an asset and, in return, you are paid via the delivery of a Promissory Note (a "Note"). Typically, the terms of the Note include payment of interest only for a number of years with a balloon payment due at maturity of the Note's term. To keep your estate from growing, you typically sell appreciating assets and charge as low an interest rate as possible. The federal government offers guidance as to these rates by issuing Applicable Federal Rates ("AFR") on a monthly basis. The Note can be modified at any time (e.g., to take advantage of lower interest rates or to extend the term if expiration is near). The appreciation in the asset's value is charged to the buyer as the seller now only owns a Note. For estate tax purposes, the seller "freezes" the value of the asset at its sales price.

The current interest rate to be imposed is remarkably low. AFRs are calculated based on the term of the loan. Short-term rates are for loans which are less than 3 years; mid-term rates are for loans of 3 years but less than 9 years long and long-term rates are for loans of

9 years or more. To see how far AFRs have decreased, look at this comparison of the May AFRs for the past 3 years:

	Short term	Mid-term	Long term
2018	2.18%	2.69%	2.94%
2019	2.39%	2.37%	2.74%
2020	.25%	.58%	1.15%

C. Modifying Existing Notes. If you have an existing loan and do not need the annual income it presently supplies, now is a great time to modify your Note to take advantage of the extremely low interest rates. There is no tax consequence to such a modification.

D. The Grantor Retained Annuity Trust ("GRAT"). A grantor retained annuity trust (a "GRAT") is created by an individual (a "Grantor") who transfers one or more high-yield assets into an irrevocable trust and retains the right to an annuity interest for a fixed term of years or for the shorter of a fixed term or life (a "Retained Interest"). When the retention period ends, assets in the trust (including all appreciation) pass to non-charitable beneficiaries named in the trust (the "Remaindermen") – typically, the Grantor's children. At such time, the property remaining in the GRAT passes to the Remaindermen free of additional gift tax (even if the property has appreciated in value).

Without getting too technical, when the Grantor of a GRAT transfers property to the GRAT, he/she is treated as having made a gift to the Remaindermen of a remainder interest in the property. Under the IRS valuation tables, the value of the remainder interest is less than the total value of the property at the time the gift was made. The value is based on (i) the term of the GRAT, (ii) the age of the Grantor, (iii) the fair market value of the property placed in the GRAT, (iv) the number of times payments are made during the year (e.g., annual, semiannual or monthly), and (v) the interest rate in effect under IRS Code Sect. 7520 (the "7520 Rate") for the month the GRAT is created.

A GRAT should be used when, like now, you expect the trust assets to produce earnings at least equal to the 7520 Rate in effect for the month in which the GRAT is created. The greater the rate by which the GRAT assets outperform the 7520 Rate, the greater the value of the property that will pass free of transfer tax to the Remaindermen. Accordingly, the GRAT becomes more effective when (i) the 7520 Rate decreases and (ii) it is funded with especially high-yielding assets. In today's climate, both of these outcomes are likely.

For estate tax purposes, if the Grantor is still living when his Retained Interest terminates, the property in the GRAT will not be included in the Grantor's estate for estate tax purposes when he dies because the Grantor no longer has any interest in the property. If the Grantor dies during the term of his Retained Interest, part or all of the property will be included in his estate for estate tax purposes. However, the Grantor will be in no worse estate tax position than if he didn't try to use the GRAT tax-saving technique at all.

A GRAT is a grantor trust for income tax purposes. This means that the Grantor will be taxed on all of the income of the GRAT even if the income is greater than the annuity amount the Grantor actually receives. Thus, the Remaindermen get the benefit of the excess income without paying a tax. Moreover, the payment of the tax by the Grantor in this situation is not considered a gift to the Remaindermen for gift tax purposes because the Grantor is legally obligated to pay the tax (i.e., it is a hidden gift).

If the Grantor survives the trust term, the Remaindermen's basis in the trust property will be the Grantor' basis when he transferred the property to the Trust (plus or minus adjustments to basis during the GRAT's term). There is no stepped-up basis on the Grantor's death, thus, if the Remaindermen sell the property after the trust terminates, they will pay income tax on any appreciation in the value of the property over the Grantor's original basis in the property (plus or minus adjustments). Accordingly, it is wise to place higher basis assets in a GRAT if possible.

III. Asset Protection

The coronavirus has caused many businesses to shut down. Many workers have lost their jobs. Marriages are being tested. The financial pressures on many individuals will be great for the foreseeable future. Now, more than ever, asset protection planning is worth investigating.

In essence, asset protection planning is a method of lawfully protecting assets from claims of creditors. Via the use of trusts, creation of business entities, re-allocation of wealth and gifting strategies, planners are able to assist their clients in protecting their assets from "creditors and predators". Please consider asset protection for your loved ones.

IV. Beneficiary Designations

For those clients who have not updated their estate plan in a while, it is imperative to review your beneficiary designations to insure that the beneficiaries reflect your current desires. Contact each institution and ask to be advised who is designated as beneficiary. If need be, make the appropriate corrections. Unfortunately, we have seen monies passing to the wrong people due to outdated designations and even missing designations. A little leg-work now can go a long way in protecting your intended heirs.

V. Retirement Account Planning

A. The SECURE ACT. On December 20, 2019, President Trump signed into law the Setting Every Community Up for Retirement Enhancement Act (now known as the "SECURE ACT"). For all clients, the SECURE ACT allows account owners to delay the taking of required distributions from age 70½ to age 72. Contributions to traditional IRAs are permitted past age 70½ as long as the contributor is still receiving employment income.

Prior to the SECURE ACT, beneficiaries were able to stretch out the distribution from the account over their life. However, under the SECURE ACT, most beneficiaries eligible are now required to draw down accounts by the end of the 10th calendar year following the account owner's death. Certain beneficiaries still can take advantage of the "stretch rule". These include a surviving spouse, minor children (until such child attains the age of majority), disabled or chronically ill beneficiaries and beneficiaries less than 10 years younger than the account owner (e.g., a brother, sister, nephew or niece depending on age difference).

Please see our April 2 alert Important Tax Relief for Required Minimum Distributions for other relevant retirement account information.

B. Impact on Coronavirus on Retirement Accounts. For certain individuals, it may be prudent to consider converting IRAs or 401ks to Roth IRAs or Roth 401ks.

A "Roth conversion" triggers immediate income tax. However, Roth accounts do not require mandatory distributions during the owner's lifetime and any distributions from a Roth account are free of income tax. Roth accounts are subject to the same 10 year rule as set forth above.

The cost of converting (i.e., paying income taxes now) should be weighed against the benefit of having future distributions escape income taxes. If the account value has significantly decreased, the income tax effect of conversion may be palatable ibn light of the future benefit. We urge clients to consult with their financial advisor and accountant to analyze the costs and benefits of a Roth conversion.

VI. Impact of the Election

During President Trump's term he signed into law the Tax Cuts and Jobs Act (the "Act") which took effect on January 1, 2018. The Act significantly changed the federal estate, gift and generation skipping tax exemption amounts. Under the Act, the current exemptions end on December 31, 2025 and revert back to 2017 thresholds.

During the democratic campaign this year, Senator Sanders proposed to reduce the estate and gift tax exemption to $3,500,000 and raise estate tax rates in a progressive manner from 45% to 77% depending on the size of the estate. Joseph Biden, the prospective Democratic nominee has proposed eliminating the well-established law that provides "stepped- up basis" on assets inherited from an estate. If implemented, this change will

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significantly increase the amount of capital gains taxes paid on the disposition of inherited assets.

We cannot say what will happen if President Trump wins re-election and while it is way too early to predict what will happen; it seems that the election of a Democratic President would likely alter the present estate and gift tax landscape. In either event, it is clear that the spread of coronavirus and its effects on minority groups has highlighted the great disparity of wealth in our country. Moreover, the costs of coronavirus will undoubtedly lead to large federal and state budget deficits. Accordingly, it is not unreasonable to believe that the wealthier citizens will be taxed at a higher rate than the present. We urge everyone who is capable of taking advantage of the current laws to minimize the impact on future tax increases.

If you wish to commence a discussion concerning your estate tax liability and possible techniques to address same, please do not hesitate to contact us. Our information is set forth below:

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