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Hard Times in the Land of Plenty: Depressed Asset Values Create Opportunities for Wealth Transfers for U.S. Persons (Part 2)

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This is the second part of an article focusing on estate planning opportunities arising from the COVID pandemic. Part One focused on planning for individuals who are neither U.S. citizens nor domiciled in the United States (''non-U.S. persons'').[1] This part focuses on planning for U.S. citizens and non-citizens domiciled in the United States (''U.S. persons''). As observed in the first part of this article, the opportunity for tax-effective estate planning as the result of depressed asset values is enhanced by historically low gift tax rates and historically high gift tax exemptions. Depressed asset values allow more assets to be conveyed through the window created by the temporary increase in the gift tax exemption. For taxpayers who exhaust their gift tax exemption, depressed asset values coupled with reduced gift tax rates allow more assets to be transferred at a reduced gift tax. This trifecta of wealth transfer planning circumstances — depressed asset values, increased gift tax exemptions, and low gift tax rates — work to the advantage of both non-U.S. persons and U.S. persons who are concerned about the amount of U.S. estate taxes which will be paid at their deaths.

TWO WEALTH TRANSFER PLANNING PRACTICE PRINCIPLES

The same principles guide wealth transfer planning for U.S. and non-U.S. persons. First, actions taken at the time an asset is acquired to avoid direct ownership are the most efficient and tax-effective measures to avoid U.S. estate taxation. Second, when those measures were not taken, assets owned should be transferred as soon as possible: before further appreciation and before income accumulates. Gifts shift not only post-transfer appreciation, but also post-transfer income to the transferee.

DISTINCTIONS IN WEALTH-TRANSFER PLANNING FOR U.S. AND NON-U.S. PERSONS

Notwithstanding commonalities in planning to reduce the amount of U.S. estate taxes paid by estates of both U.S. and non-U.S. persons, there are significant differences. First, while the provisions of the Internal Revenue Code and some U.S. tax treaties offer non-U.S. persons limited relief from U.S. estate taxation but no relief from U.S. gift taxation, U.S. persons enjoy an $11.58 million gift and estate tax exemption which may be used while alive to make tax-free gifts and (to the extent not previously exhausted) to make tax-free bequests at death.[2] The ability of U.S. persons to make significant gifts without paying a gift tax greatly facilitates wealth transfer planning to avoid U.S. estate taxes. Second, although exemption relief for non-U.S. persons is far more limited, so is the scope of U.S. gift and estate taxation. As discussed in the first part of this article, in the case of non-U.S. persons, only tangible assets physically present in the United States and intangible assets deemed to be present in the United States are subject to U.S. estate taxation. U.S. gift taxation is limited to tangible assets

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[1] *See* 49 Tax Mgmt. Int'l J. 368 (July 10, 220).

[2] Accordingly, in this article the exemption is referred to as either the ''gift tax exemption'' or the ''estate tax exemption'' depending on the context in which the exemption is used. However, in reality, these are one-in-the-same exemption.

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physically present in the United States. Intangible assets (such as shares of U.S. corporations) can be transferred without any U.S. gift tax effect, even though those same assets would be subject to U.S. estate taxation if retained by a non-U.S. person until death. In contrast, U.S. persons are subject to U.S. gift tax on transfers of all worldwide assets while alive and estate tax on transfers of all worldwide assets at death, subject to certain exclusions, exemptions, and deductions.

USE OF AN EXPIRING EXEMPTION

The current U.S. gift and estate tax exemption is a result of a temporary doubling of the base exemption amount from $5 million to $10 million.[3] This increase will expire at midnight on December 31, 2025. It is applicable only to gifts made before January 1, 2026 or estates of decedents dying before that date. As also observed, nothing prevents Congress from accelerating the sunset of the increased exemption, nor does anything prevent Congress from reducing the amount of the exemption. There is concern that a change in the political composition of Congress as a result of the November 2020 elections will result in either or both of these taxpayer-unfriendly actions. Consequently, there is an urgency to use the increased exemption before the end of 2020.

The current exemption may be used in one of two ways: either by dying and making testamentary transfers or by making gifts prior to death. In both cases (death perhaps considerably more obvious), unless the entire exemption is exhausted by the testamentary or inter vivos transfer, as the case may be, any unused portion of the increased exemption amount which is currently available will be forfeited when the exemption reverts to the pre-2018 base amount. Since most taxpayers prefer less dramatic steps than death to enjoy a tax benefit, gifts prior to death will likely be the preferred strategy. Gifts may be made directly or in trust. The beneficiaries of the trust must be someone other than the transferor for the gift to be immediately effective to prevent inclusion of the transferred assets in the transferor's gross estate. Post-transfer appreciation and revenue generated by the transferred assets is shifted to the transferee free of further gift or estate tax.[4] Trusts are typically preferred as the means of making significant gifts because trusts enable the transferor to retain control of the transferred assets either directly by acting as trustee or indirectly by selecting the trustee.

For most taxpayers, the most significant impediment to making gifts — substantial gifts, the kind of multi-million-dollar gifts which are necessary to use an $11.58 million gift tax exemption — is the loss of financial benefit from the assets which were the subject of the gift. This is not necessarily the case with respect to every gift. For example, a gift may relieve a parent of a financial obligation the parent would otherwise incur, such as a gift used by a child to pay educational expenses. The closer the relationship to the transferor, the more likely an indirect financial benefit will inure to the transferor. In the case of many married couples, the least financially consequential way to use both spouses' gift tax exemptions is to make gifts to one another.

In a context in which the objective is to transfer significant wealth yet retain the benefit of the transferred assets, few solutions are as elegant as the creation of a trust for the benefit of one's spouse (particularly if it is anticipated that the transferee will create a similar trust for the benefit of the transferor). Direct gifts to one another result in no reduction in the couple's net worth or gross estates at death.[5] In contrast, gifts with a total value equal to each spouse's exemption amount to a properly designed irrevocable trust for the other (commonly referred to as a spousal lifetime access trust or ''SLAT'') can reduce the couple's net worth and assets subject to estate tax by over $23 million. SLATs are customarily drafted to provide the beneficiary spouse with the broadest possible access to the trust assets without crossing the line at which the assets of the SLAT would be included the beneficiary spouse's gross estate. The tax objective (a completed gift that will not be included in the transferee's gross estate) must be balanced with the financial objective (preserving the couple's enjoyment of the transferred assets). That balance requires limiting the

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[3] §2010(c)(3)(C). The increase in the base amount combined with indexing produce the $11.58 million gift and estate tax exemption amount for 2020. To the extent taxable gifts were made in prior years and sheltered from gift tax by the exemption, the $11.58 million amount for 2020 is reduced by the amount of those prior-year gifts.

All section references are to the Internal Revenue Code, as amended, or the Treasury regulations thereunder, unless otherwise indicated.

[4] To fully appreciate the importance of this statement, it must be understood that a gift sheltered by the transferor's gift tax exemption does not save estate taxes at the transferor's death because the amount of the gift reduces the transferor's gift and estate tax exemption on a dollar-for-dollar basis. A gift is tax-effective only when accompanied by post-transfer appreciation or income.

[5] While spousal gifts are often designed to qualify for the gift or estate tax marital deductions of §2523 or §2056, such gifts do not reduce the amount of estate taxes the couple will pay. The *quid pro quo* of the marital deduction is inclusion in the transferee's gross estate. As an example, *compare* §2056(b)(7) and §2523(i) *with* §2044.

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beneficiary spouse's access to trust assets.[6] Nonetheless, the beneficiary spouse's access can be quite broad.

- All of the net income realized from investment of the trust assets may be paid to the beneficiary spouse.
- Alternatively, net income can be distributed as necessary to pay for the beneficiary spouse's living, medical, and educational expenses.
- Similarly, principal may be freely distributed to the beneficiary spouse as required for living, medical, and educational expenses.
- Finally, the beneficiary spouse may withdraw up to 5% of the trust assets each year (in addition to distributions required for the beneficiary spouse's living, medical, and educational requirements).

When the parameters set forth above govern distribution of income and principal to the beneficiary spouse, either the beneficiary spouse, the transferor spouse, or both may act as trustees. Doing so enables the couple to invest assets of the SLATs in ways that benefit the beneficiary spouse (and indirectly the transferor spouse) by purchasing primary or seasonal residences or making debt or equity investments in privately held businesses in which either spouse participates as a principal. As long as the residences and business interests are retained by the SLAT, the desired estate tax effect is achieved: the residences and business interests will not be subject to inclusion in either the transferor or beneficiary spouse's gross estate nor subject to U.S. estate taxation at their deaths.[7]

INTEREST-SENSITIVE WEALTH-TRANSFER TRANSACTIONS

The pandemic circumstances, which have depressed asset values, have also resulted in sharply reduced interest rates. This is highly advantageous in that most wealth transfer transactions are interest rate-sensitive and produce more dramatic tax savings in low-interest-rate environments. By way of example, GRATs, GRUTs, and QPRTs (discussed in part one of this article) are effective to ''stretch'' the gift tax exemption by reducing the value for gift tax purposes of the assets transferred to those trusts. Beneficial use of a personal residence in the case of a QPRT or an annuity in the case of a GRAT or GRUT can be assigned a value which is subtracted from the value of the assets transferred to the trusts. The value of the annuity or usufruct is directly affected by the interest rate environment at the time the transfer occurs. This is most apparent in the case of a GRAT or a GRUT, as those trusts involve deferred payments, but is also true of a QPRT because of the way in which the value of the settlor's retained use of the residence transferred to the QPRT is measured. The deferred payments made over the term of the GRAT or GRUT and the settlor's use of the residence held by the QPRT have a greater value when interest rates are low.

Installment Sales to Grantor Trusts

GRATs, GRUTs, and QPRTs are not the only wealth transfer techniques which are sensitive to interest rates. Any economically similar transaction will benefit from the current reduction in interest rates. For example, a sale of assets in exchange for a promissory note providing for installment payments of principal and interest over the term of the note relies on an arbitrage between the interest which the purchaser must pay for the privilege of deferring payment of the purchase price and the income realized by investment of the purchased asset. If investment returns are constant, the arbitrage will be greater when interest rates are low. When an installment sale occurs in an intrafamily context, parents sell assets to children in exchange for a promissory note providing for payments of principal and interest over a term of years. The children are able to service the debt commemorated by the note using the revenues produced by the assets they have purchased. A lower interest rate on the deferred payments is beneficial in two respects. First, it reduces payments the transferor receives which increase the transferor's gross estate. Second, lower debt service facilitates post-transfer wealth accumulation by the transferee by permitting more of the revenues generated by the purchased assets to be retained and reinvested.

An intrafamily sale is as much subject to gain recognition as a sale among unrelated parties. However, if the sale is restructured so that instead of children buying their parents' assets the assets are purchased by a trust for the children's benefit, the trust may be designed to qualify as a grantor trust under the provisions of §671 through §679, thereby allowing gain on sales to the trust to go unrecognized.[8] Use of the grantor trust in this context carries with it the advantage of allowing the parents to either act as trustees or choose the trustees so as to maintain control over the transferred wealth. Although the settlor of the trust may not be a beneficiary without forfeiting the desired gift and estate tax effect, the continued ability to control the transferred wealth significantly softens the loss of the assets conveyed to the trust and removes

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[6] *See generally* §2041.

[7] Success in this endeavor requires avoiding the reciprocal trust doctrine. *See Estate of Grace v. United States*, 395 U.S. 316 (1965).

[8] *See* Rev. Rul. 85-13, 1985-1 C.B. 184.

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one of the concerns that often discourages making significant gifts.

The Grantor Trust Bonus

Grantor trusts bring with them another tax efficiency. The settlor remains taxable on the income of the trust whether that income is accumulated by the trust or distributed to a beneficiary. This creates a dual estate tax benefit. First, the income tax attributable to the trust assets reduces the settlor's gross estate. Second, because taxes on trust income are paid by the settlor, the assets of the trust are able to compound income-tax-free, creating a greater accumulation of wealth in the trust and beyond the reach of the estate tax.

Intergenerational Loans

Just as taking advantage of a temporary increase in the gift tax exemption provides an opportunity to transfer increased amounts of wealth in a tax-effective manner, similarly historically low interest rates also create an opportunity to transfer greater amounts of wealth in a tax-advantaged manner. GRATs, GRUTs, QPRTs, and intergenerational installment sales lock-in historically low interest rates. Intergenerational loans do the same. Loans of cash to entrepreneurial children allow the children to invest the amounts borrowed not just in stocks, bonds, and mutual funds but also privately owned businesses and real estate. Flexibility in the duration of the loan and the rate of interest allows an arbitrage between the cost of capital and the return on investment.

AVOIDANCE OF STATE TAXES

As observed in the first part of this article, a compelling reason for non-U.S. persons to make gifts of intangible assets (such as shares of U.S. companies) before death is that non-U.S. persons are not subject to U.usc\26S. gift taxation on transfers of intangible assets but are subject to U.S. estate taxation on certain of the same intangible assets if owned at death. This is a feature of U.S. revenue laws which is uniquely beneficial to non-U.S. persons. In the case of a U.S. person, a gift of shares of a U.S. corporation is as much subject to gift tax as those shares would be subject to estate tax when retained until death. There is, however, a comparable opportunity for many U.S. persons: avoidance of state estate taxes. The District of Columbia and 17 states have some form of tax on transfers made at death.[9] In contrast, Connecticut is the only U.S. jurisdiction which has a state gift tax. Thus, residents of U.S. jurisdictions that impose estate and/or inheritance taxes can avoid those taxes at no state gift tax cost by making significant gifts prior to death.

CONCLUSION

The principles and transactions described in this article are far from a complete list of strategies commonly used to avoid or minimize U.S. estate taxes. This article has focused on wealth transfer techniques which are particularly useful in the current tax and financial environment. Each is subject to advantages and disadvantages, variations in design, and technical issues beyond the scope of this article.[10]

This is the second part of an article focusing on estate planning opportunities arising from the COVID pandemic. Part One focused on planning for individuals who are neither U.S. citizens nor domiciled in the United States (''non-U.S. persons''). This part focuses on planning for U.S. citizens and non-citizens domiciled in the United States (''U.S. persons''). As observed in the first part of this article, the opportunity for tax-effective estate planning as the result of depressed asset values is enhanced by historically low gift tax rates and historically high gift tax exemptions. Depressed asset values allow more assets to be conveyed through the window created by the temporary increase in the gift tax exemption. For taxpayers who exhaust their gift tax exemption, depressed asset values coupled with reduced gift tax rates allow more assets to be transferred at a reduced gift tax. This trifecta of wealth transfer planning circumstances — depressed asset values, increased gift tax exemptions, and low gift tax rates — work to the advantage of both non-U.S. persons and U.S. persons who are concerned about the amount of U.S. estate taxes which will be paid at their deaths.

Two Wealth Transfer Planning Practice Principles

The same principles guide wealth transfer planning for U.S. and non-U.S. persons. First, aActions taken at the time an asset is acquired to avoid direct ownership are the most efficient and tax-effective measures to avoid U.S. estate taxation. Second, when those measures were not taken, assets owned should be transferred as soon as possible: before further appreciation and before income accumulates. Gifts shift not only post-transfer appreciation, but also post-transfer income to the transferee.

Distinctions in Wealth-Transfer Planning for U.S. and Non-U.S. persons

Notwithstanding commonalities in planning to reduce the amount of U.S. estate taxes paid by estates

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[9] Has an inheritance tax: Iowa, Kentucky, Maryland (also has an estate tax), Nebraska, New Jersey, Pennsylvania. Has an estate tax: Connecticut, District of Columbia, Hawaii, Illinois, Maine, Maryland (also has an inheritance tax), Massachusetts, Minnesota, New York, Oregon, Rhode Island, Vermont, Washington. Washington has the highest estate tax rate at 20%.

[10] For an excellent treatise on the income, gift, estate and generation-skipping transfer tax consequences of the planning structures discussed in this article, as well as dozens of others, see John R. Price, *Price on Contemporary Estate Planning* (2020 ed).

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of both U.S. and non-U.S. persons, there are significant differences. First, while the provisions of the Internal Revenue Code and some U.S. tax treaties offer non-U.S. persons limited relief from U.S. estate taxation but no relief from U.S. gift taxation, U.S. persons enjoy an $11.58 million gift and estate tax exemption which may be used while alive to make tax-free gifts and (to the extent not previously exhausted) to make tax-free bequests at death.[11] The ability of U.S. persons to make significant gifts without paying a gift tax greatly facilitates wealth transfer planning to avoid U.S. estate taxes. Second, although exemption relief for non-U.S. persons is far more limited, so is the scope of U.S. gift and estate taxation. As discussed in the first part of this article, in the case of non-U.S. persons, only tangible assets physically present in the United States and intangible assets deemed to be present in the United States are subject to U.S. estate taxation. U.S. gift taxation is limited to tangible assets physically present in the United States. Intangible assets (such as shares of U.S. corporations) can be transferred without any U.S. gift tax effect, even though those same assets would be subject to U.S. estate taxation if retained by a non-U.S. person until death. In contrast, U.S. persons are subject to U.S. gift tax on transfers of all worldwide assets while alive and estate tax on transfers of all worldwide assets at death, subject to certain exclusions, exemptions, and deductions.

Use of an Expiring Exemption

The current U.S. gift and estate tax exemption is a result of a temporary doubling of the base exemption amount from $5 million to $10 million.[12] This increase will expire at midnight on December 31, 2025. It is applicable only to gifts made before January 1, 2026 or estates of decedents dying before that date. As also observed, nothing prevents Congress from accelerating the sunset of the increased exemption, nor does anything prevent Congress from reducing the amount of the exemption. There is concern that a change in the political composition of Congress as a result of the November 2020 elections will result in either or both of these taxpayer-unfriendly actions. Consequently, there is an urgency to use the increased exemption before the end of 2020.

The current exemption may be used in one of two ways: either by dying and making testamentary transfers or by making gifts prior to death. In both cases (death perhaps considerably more obvious), unless the entire exemption is exhausted by the testamentary or inter vivos transfer, as the case may be, any unused portion of the increased exemption amount which is currently available will be forfeited when the exemption reverts to the pre-2018 base amount. Since most taxpayers prefer less dramatic steps than death to enjoy a tax benefit, gifts prior to death will likely be the preferred strategy. Gifts may be made directly or in trust. The beneficiaries of the trust must be someone other than the transferor for the gift to be immediately effective to prevent inclusion of the transferred assets in the transferor's gross estate. Post-transfer appreciation and revenue generated by the transferred assets is shifted to the transferee free of further gift or estate tax.[13] Trusts are typically preferred as the means of making significant gifts because trusts enable the transferor to retain control of the transferred assets either directly by acting as trustee or indirectly by selecting the trustee.

For most taxpayers, the most significant impediment to making gifts — substantial gifts, the kind of multi-million-dollar gifts which are necessary to use an $11.58 million gift tax exemption — is the loss of financial benefit from the assets which were the subject of the gift. This is not necessarily the case with respect to every gift. For example, a gift may relieve a parent of a financial obligation the parent would otherwise incur, such as a gift used by a child to pay educational expenses. The closer the relationship to the transferor, the more likely an indirect financial benefit will inure to the transferor. In the case of many married couples, the least financially consequential way to use both spouses' gift tax exemptions is to make gifts to one another.

In a context in which the objective is to transfer significant wealth yet retain the benefit of the transferred assets, few solutions are as elegant as the creation of a trust for the benefit of one's spouse (particularly if it is anticipated that the transferee will create a similar trust for the benefit of the transferor). Direct gifts to one another result in no reduction in the cou-

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[12] §2010(c)(3)(C). The increase in the base amount combined with indexing produce the $11.58 million gift and estate tax exemption amount for 2020. To the extent taxable gifts were made in prior years and sheltered from gift tax by the exemption, the $11.58 million amount for 2020 is reduced by the amount of those prior-year gifts.

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ple's net worth or gross estates at death.[14] In contrast, gifts with a total value equal to each spouse's exemption amount to a properly designed irrevocable trust for the other (commonly referred to as a spousal lifetime access trust or ''SLAT'') can reduce the couple's net worth and assets subject to estate tax by over $23 million. SLATs are customarily drafted to provide the beneficiary spouse with the broadest possible access to the trust assets without crossing the line at which the assets of the SLAT would be included the beneficiary spouse's gross estate. The tax objective (a completed gift that will not be included in the transferee's gross estate) must be balanced with the financial objective (preserving the couple's enjoyment of the transferred assets). That balance requires limiting the beneficiary spouse's access to trust assets.[15] Nonetheless, the beneficiary spouse's access can be quite broad.

- All of the net income realized from investment of the trust assets may be paid to the beneficiary spouse.
- Alternatively, net income can be distributed as necessary to pay for the beneficiary spouse's living, medical, and educational expenses.
- Similarly, principal may be freely distributed to the beneficiary spouse as required for living, medical, and educational expenses.
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Interest-Sensitive Wealth-Transfer Transactions

The pandemic circumstances, which have depressed asset values, have also resulted in sharply reduced interest rates. This is highly advantageous in that most wealth transfer transactions are interest rate-sensitive and produce more dramatic tax savings in low-interest-rate environments. By way of example, GRATs, GRUTs, and QPRTs (discussed in part one of this article) are effective to ''stretch'' the gift tax exemption by reducing the value for gift tax purposes of the assets transferred to those trusts. Beneficial use of a personal residence in the case of a QPRT or an annuity in the case of a GRAT or GRUT can be assigned a value which is subtracted from the value of the assets transferred to the trusts. The value of the annuity or usufruct is directly affected by the interest rate environment at the time the transfer occurs. This is most apparent in the case of a GRAT or a GRUT, as those trusts involve deferred payments, but is also true of a QPRT because of the way in which the value of the settlor's retained use of the residence transferred to the QPRT is measured. The deferred payments made over the term of the GRAT or GRUT and the settlor's use of the residence held by the QPRT have a greater value when interest rates are low.

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[18] Has an inheritance tax: Iowa, Kentucky, Maryland (also has an estate tax), Nebraska, New Jersey, Pennsylvania. Has an estate tax: Connecticut, District of Columbia, Hawaii, Illinois, Maine, Maryland (also has an inheritance tax), Massachusetts, Minnesota, New York, Oregon, Rhode Island, Vermont, Washington. Washington has the highest estate tax rate at 20%.

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