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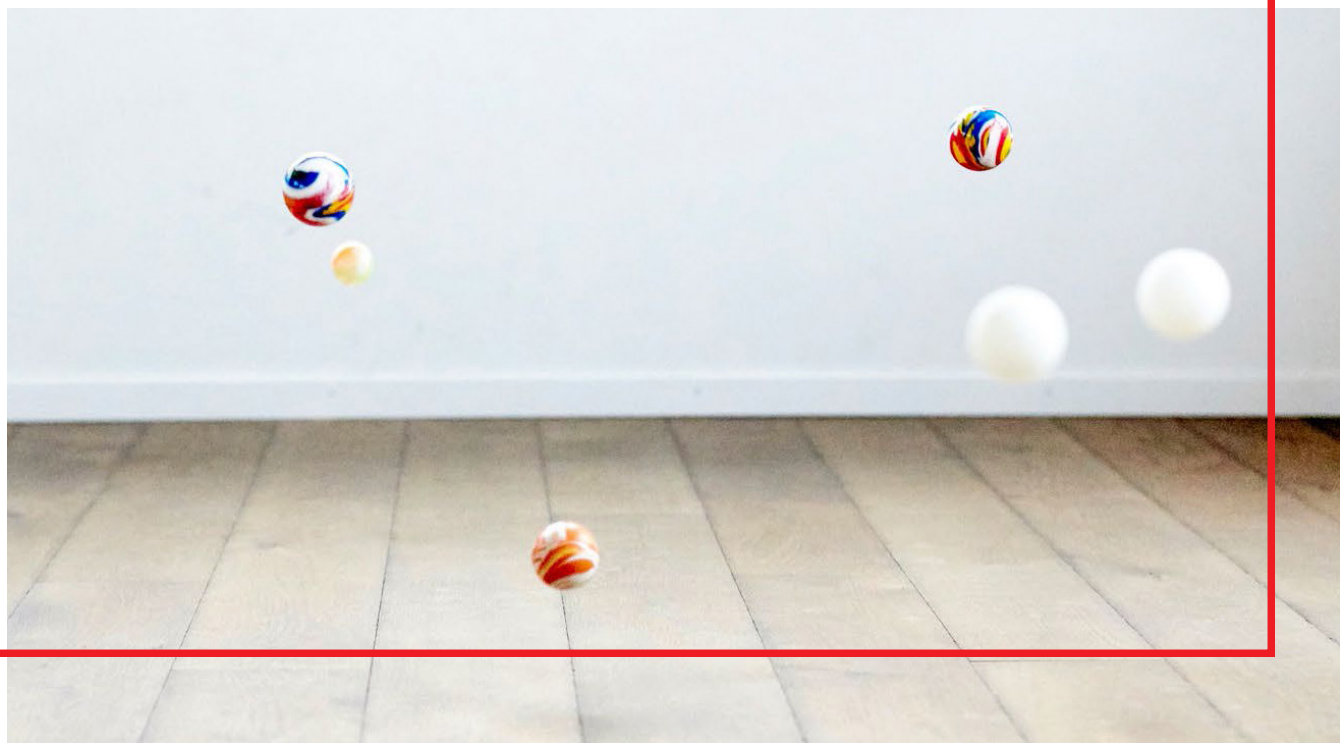
Planning opportunities when asset values decline



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A sharp pullback in the stock market can bring anxiety to investors. Business owners and investors in the private sector similarly become fearful of what market volatility could mean for their future. Although market uncertainty may leave some individuals with a growing fear of the unknown, many others believe that, as in the past, downturns are just part of a cycle and higher values and happy days will come again.

No matter your outlook during a market pullback, the depressed values of assets do shed some light on otherwise difficult circumstances—this may lead to an opportune time to take advantage of certain estate planning strategies using assets when prices are low and possibly undervalued. The Internal Revenue Service (IRS) limits the ability to make lifetime gifts to heirs (e.g., children, grandchildren, other family members, and friends). Generally, the two main tools we have are the annual exclusion and the lifetime exemption. In 2023, the annual exclusion allows a taxpayer to give up to $17,000 to any number of individuals ($34,000 per married couple). Any gifts in excess of this amount count against the taxpayer's $12.92 million lifetime gift tax exemption in 2023 ($25.84 million for married couples).[1] Utilizing assets that have decreased in value to make a lifetime gift, and capturing the rebound in an asset outside of one's taxable estate, can be extremely beneficial and tax efficient. This whitepaper focuses on why estate planning in an uncertain market environment may be something to consider.

How comfortable are you in your expectation that values will rise?

The first step in determining whether you should explore one or more estate planning strategies in a depressed value environment is to clarify your personal view on the direction that these assets will take: will they increase in value, or will they be rendered insignificant? Your mental and emotional comfort with the current situation and your expectations of where values are likely to be in the future are critical in deciding whether one or more wealth transfer strategies might make sense.

Additionally, even if you believe there will be a strong comeback in certain assets and are willing to find opportunities to enhance or jumpstart your estate planning, it must also feel like the right thing to do for your family. In other words, the potential tax planning benefits must be coupled with a desire to transfer wealth to or for the benefit of your other family members (your spouse, children and grandchildren, for example).

Wealth transfer options

If you think that certain assets are likely to increase in value, and you believe it is prudent to take advantage of depressed values to transfer assets from your estate for wealth transfer purposes, the first step is to confirm the ownership structure of the asset and whether the asset can be transferred. Next, you must determine the value of the asset, and decide what type of planning strategy might make sense to accomplish your goals.

How is the asset held and can it be transferred?
The ownership structure of an asset can affect what planning strategy might make the most sense, and thus, you should be certain of exactly how you hold your interest in the asset in order to assess what and how much you may transfer, and how best to do so.

For interests in a private company, you should confirm whether the company is structured as a C corporation, S corporation, limited liability company, or limited partnership because each classification can affect what strategies might make sense to pursue. S corporations in particular can only be transferred to certain types of trusts so the corporate structure should be determined before having any in depth discussions about planning strategies[2]. Additionally, many corporate operating agreements contain restrictions on a stockholder's ability to transfer shares, and you should determine whether you even have the ability to engage in planning. If an operating agreement does place very strict prohibitions on transfers, it might be worth determining whether the corporate documentation can be amended to allow for transfers for family estate planning purposes.

Publicly traded securities are typically freely transferrable unless the stock is subject to a lockup period. In such a situation, often there are exceptions for transfers for family estate planning purposes. Even though publicly traded shares might be transferrable, you should confirm how your ownership of the stock is held—whether in your

[1] Under the Tax Cuts and Jobs Act of 2017, the lifetime gift tax exemption is scheduled to revert back to $5 million, indexed for inflation to 2010, in 2026.
[2] See Jennifer Lan, *Transfers of S Corporation stock* (a publication of the UBS Advanced Planning Group).

individual name, in the name of a trust, or through an investment entity. Title might affect transferability and also might determine what additional steps might need to be taken before any transfer.

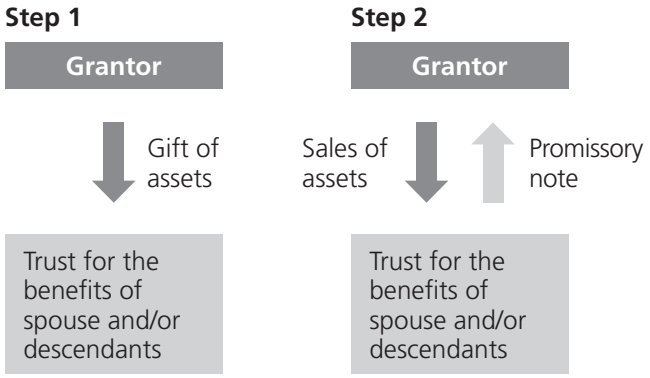
What is the value of the asset?
When transferring assets in the context of wealth transfer planning, it is essential to determine the value of the asset for transfer tax purposes. Typically, the appropriate value to use is the fair market value. The fair market value of an asset is the price at which property would change hands between a willing buyer and a willing seller, with both having knowledge of the relevant facts and neither being under a compulsion to buy or sell. For assets other than shares in a publicly traded company, such as privately held business interests, a qualified appraiser should be engaged to prepare a report that determines the current fair market value of the asset prior to transferring the asset to another individual or a trust for their benefit. The value of publicly traded shares for transfer tax purposes is typically the mean of the high and low price on the day the stock is transferred.

Strategies for wealth transfer

Assets can be transferred using various wealth transfer techniques. Following are some of the methods most widely used by estate planners, any one of which may be used to transfer various types of assets.

Outright gifts
Although often not the best technique for multigenerational or asset protection planning, an individual could give assets outright without restriction. One circumstance when outright giving is sometimes used is to take advantage of an individual's gift tax annual exclusion amount, which in 2023 is $17,000 ($34,000 for married couples who elect gift splitting) to any individual. This annual exclusion doesn't use an individual's lifetime gift tax exemption amount and applies to each recipient separately, so an individual can give an annual exclusion gift to any number of recipients. The annual exclusion can be given in cash or other assets. In an environment when stock prices are low, individuals could use marketable securities for annual exclusion giving, especially if they believe the stock has high potential for growth. However, keep in mind that under current law cost basis of the asset remains the same in the hand of the recipient as it did with the donor.

Gift to grantor trust
Assets may be given to a trust for an intended recipient, rather than outright. The trust can be structured as a grantor trust for income tax purposes[3]. With a grantor trust, all items of income, deduction, credit, and loss will flow through to the grantor's (the creator of the trust) personal income tax return, as opposed to the trust paying its own taxes from the trust's own assets. By paying the income tax liability of the trust from the grantor's own assets, the grantor allows the trust assets to grow free from income tax liability. Since significant cash flow (and potentially, taxable income) may be generated from assets in the trust, a grantor trust provides a way to enhance the wealth transfer impact of the gift.



Additionally, the trust may provide protection from the beneficiary's creditors (including divorcing spouses) if certain provisions and restrictions are included in the trust agreement. This allows an individual to transfer assets to trusts for the grantor's children, or to the grantor's spouse, while maintaining a measure of asset protection for the beneficiary.

Sale to grantor trust
Rather than a gift to a trust as outlined above, the grantor may sell assets to the grantor trust in exchange for a promissory note. The grantor may start by creating an irrevocable trust for the benefit of their descendants. The trust should hold assets prior to the sale transaction in order for it to be considered a bona fide purchaser in the subsequent sale. Therefore, the grantor will typically make an initial gift of cash or liquid assets to the trust having a value equal to at least 10% of the value of assets to be sold to the trust.

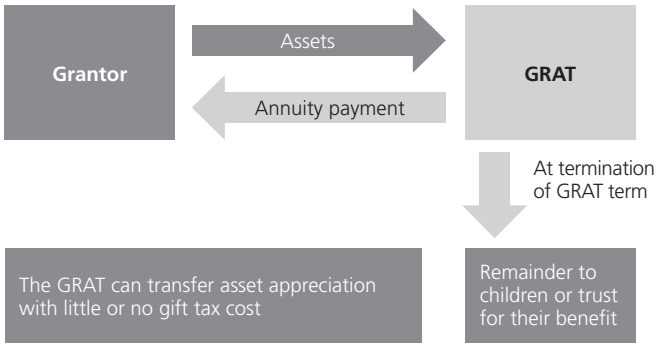
[3] See Casey Verst, *Using Irrevocable Grantor Trusts to Transfer Wealth* (a publication of the UBS Advanced Planning Group).

Unlike a gift, which transfers not only the current value of the transferred property but also the future income and appreciation, in a sale transaction the current value of the transferred property will be returned to the grantor via principal payments on the promissory note. However, the sale still allows the value of future growth to accumulate and grow in the trust rather than in the grantor's estate for estate tax purposes. Since the grantor is treated as the owner of the trust assets for income tax purposes, under current law the sale to the trust is not a taxable event, and the interest payments on the note, which are typically based on the applicable federal rate (AFR) as determined by the IRS, are not taxable to the grantor for income tax purposes.

Grantor retained annuity trust

A grantor retained annuity trust (GRAT)[4] is an irrevocable trust designed to transfer future appreciation to individuals (typically children or other family members) or trusts for their benefit, with little or no transfer tax cost. The grantor initially funds the GRAT with assets that are expected to appreciate. The GRAT then pays a predetermined annuity to the grantor for a fixed number of years.

A GRAT can be structured so that there is little or no transfer tax cost if the present value of the stream of annuity payments from the GRAT is designed to be equal or almost equal to the value of the property with which the GRAT is initially funded and the IRS's growth rate assumption (the 7520 rate[5]). If the assets in the GRAT appreciate at a rate that exceeds the IRS's growth rate assumption, all appreciation in excess of this threshold passes free of gift tax and is not included in the grantor's estate for estate tax purposes. The 7520 rate is provided by the IRS on a monthly basis.



This strategy can work extremely well when there is an expectation, but no certainty, of appreciation. A GRAT allows the owner of a depressed asset to transfer the appreciation while retaining the underlying value. If the asset appreciates in value more than the 7520 rate, it's a win because the appreciation is transferred out of the grantor's estate without significant gift tax consequences. If the assets do not appreciate in value, then the grantor receives all the assets back in satisfaction of the annuity payment. The grantor would be out legal fees for preparation of the GRAT, but there should not be any negative tax consequences if the GRAT fails. It should be noted that the grantor cannot allocate Generation-Skipping Transfer (GST) tax exemption to the GRAT until the completion of the initial term. As a result, this strategy is sometimes not as effective for multigenerational planning as other strategies.

Spousal lifetime access trust

What if you are not certain that your family will not need to retain access to the assets? A spousal lifetime access trust (SLAT)[6] may enable you to take advantage of effective wealth transfer planning while maintaining indirect access to the assets.

[4] See Jennifer Lan, *Grantor retained annuity trusts* (a publication of the UBS Advanced Planning Group).

[5] More specifically, the 7520 rate is 120% of the federal midterm rate (subject to rounding). IRC § 7520(a)(2). The federal midterm rate is based on the average market yield on outstanding marketable obligations of the United States with a remaining maturity period of more than three years and not more than nine years. IRC § 1274(d)(1)(C)(ii). When valuing the annuity interest, the grantor must use the 7520 rate that's in effect for the month in which the grantor contributes money or other property to the GRAT.

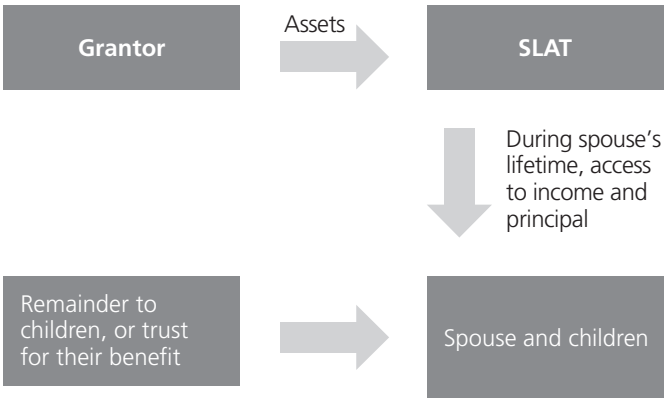
[6] See Catherine McDermott, *Spousal lifetime access trusts* (a publication of the UBS Advanced Planning Group).

Here's how it works: the grantor transfers the grantor's separate property assets to an irrevocable trust for the benefit of the grantor's spouse. Additional considerations must be made if you live in a community property state. Their descendants may also be named as beneficiaries of the trust. During the beneficiary-spouse's lifetime, the trustee may make distributions of income and principal to such spouse and their children as needed for health, education, maintenance and support.

To maximize the wealth transfer benefits, the trust should be considered a resource of last resort, and any distributions should be limited to children and descendants. However, needs may arise that require distributions to the beneficiary-spouse, who may then choose to use those funds not only for the beneficiary-spouse's own benefit but also for the indirect benefit of the grantor. At the beneficiary-spouse's death, the assets of the trust would pass free of transfer tax to the remaining beneficiaries (e.g., children) or continue on in trust for their benefit. If the beneficiary-spouse passes away before the grantor-souse, then the grantor will potentially lose indirect access to the assets. A SLAT is typically drafted as a grantor trust for income tax purposes as discussed above.

If you wish for the assets ultimately to pass to grandchildren and more remote descendants (so that the assets are not included in the children's estates), grandchildren may also be included as beneficiaries of this trust, in which case the grantor should allocate a portion or all of the grantor's GST tax exemption to the trust upon funding.

Assets transferred to the trust should be made from the grantor's separate property and not from jointly titled or community property. For an individual with wealth consisting mostly of community property who wants to fund a SLAT, the individual could consider converting assets into separate property prior to the gift.



Using business entities

Another way to give without giving up complete control is to use one or more family business entities created for the purpose of consolidating, managing and growing family assets. Even certain publicly traded securities may be ripe for consolidation, management and growth. Keep in mind that the business entity must have a non-tax related business purpose and should not be created for the sole purpose of facilitating wealth transfer tax strategies. If structured properly, a family business entity can facilitate the transfer of equity interests while allowing the transferor to maintain control as the manager, managing member, or sole voting shareholder.

If you choose to create a family business entity to hold, manage and grow your assets, you may choose to give or sell interests in the entity to family members or to trusts for their benefit. You could use the strategies discussed above—a gift to an irrevocable grantor trust, a sale to an irrevocable grantor trust, a GRAT, or a SLAT—to transfer ownership interests in the family business entity. Of course, keep in mind that any interests transferred generally should be valued by a qualified appraiser to determine the appropriate fair market value of the interest at the time of the gift or sale.

[7] See Joanna Morrison, *Intra-family loans* (a publication of the UBS Advanced Planning Group).

Taking advantage of low interest rates

In months when the AFR and 7520 rates are low, the combination of depressed asset values and low interest rates is an especially attractive time for these wealth transfer planning strategies.

Even if not coupled with another strategy, intra-family loans[7] themselves can be an effective way to transfer wealth. A properly structured bona fide intra-family loan results in no transfer tax consequences, and if the loan is structured as a balloon note that provides for only interest payments currently, the recipient will receive the loan money without having to make substantial payments during the term of the loan. Intra-family loans are a good technique for parents to use if a child is in needs of funds to buy a house or start a business.

Another strategy is to use intra-family loans to allow the child to invest the funds and ideally yield income and appreciation that outperforms the interest rate on the loan. Over the course of the loan's term, the investments grow and when the loan matures, the principal will be returned to the parents, who will have effectively transferred the appreciation free of transfer tax.

Takeaway

While the methods discussed in this article are not new, cutting edge, or flashy, they may be of great value to individuals who are interested in transferring wealth to other family members at a lower transfer tax cost.

As you consider these strategies, keep in mind that any wealth transfer planning exercise must not be purely tax motivated but must feel like the right move for you and your family to make in order to further your financial and estate planning goals. However, you should consider acting while the time is right…and that time may be now.

About the Advanced Planning Group

The Advanced Planning Group consists of former practicing estate planning and tax attorneys with extensive private practice experience and diverse areas of specialization, including estate planning strategies, income and transfer tax planning, family office structuring, business succession planning, charitable planning and family governance.

The Advanced Planning Group provides comprehensive planning and sophisticated advice and education to ultra high net worth (UHNW) clients of the firm. The Advanced Planning Group also serves as a think tank for the firm, providing thought leadership and creating a robust intellectual capital library on estate planning, tax and related topics of interest to UHNW families.

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