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Rockefeller Insights

Planning in Dislocated Markets: Making the Best of a Bad Situation

We are currently experiencing particularly uncertain times in the United States. The political situation is in constant flux. The spread of the COVID-19 virus has caused markets to reel and asset values to plummet. We at Rockefeller Capital Management continue to monitor the developments in the pandemic closely and to assess the range of potential implications for the economy and the markets. As we move through this time of significant risk and uncertainty, the first priority is concern for your safety and the safety of your loved ones. At the same time, in these periods of market disruption, we also believe it can be prudent to consider whether they present opportunities to make adjustments to financial and estate plans that may add value for your family over the longer term. We write this communication to raise some ideas we have for your consideration in that regard.

Estate Planning and Wealth Transfer

As many are aware, the federal exemption from transfer taxes is at historic highs. Under current law (for 2020) each individual may transfer up to $11.58 million (indexed for inflation) of assets ($23.16 million for a married couple) during his or her lifetime without incurring federal gift, estate or generation-skipping transfer ("GST") tax. The current maximum federal gift and estate tax rate and the current maximum federal GST tax rate is in each case 40%. While the exemption level is not currently scheduled to be reduced until the end of 2025, it is anyone's guess whether it will remain intact through such date, due to the increasingly uncertain political climate in the United States. Depending on the results of the Presidential elections this year, it is even possible that the exemption is decreased effective 1/1/2021. As such, it is particularly important for clients to review their estate plans this year and consider using their increased exclusion amount before it may be reduced and, therefore, lost.

Additionally, the current market environment may be an opportune time to leverage this historically high exemption level. In other words, because many asset valuations may be unusually low at this point and because interest rates are extremely low, more of your wealth can be transferred free of gift, estate or GST tax. We will summarize some estate planning strategies to consider.

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Dynasty Trusts

A Dynasty Trust is a trust generally designed to benefit two or more generations of beneficiaries. These trusts may be structured to last in perpetuity, dependent on state law, to provide for successive generations of beneficiaries without diminution by additional gift, estate or GST taxes. Typically, a Dynasty Trust is funded with assets sheltered from the GST tax by virtue of the application of the GST tax exemption amount of the donor(s). The amount of your transfer tax exemption used will be determined based on the value of the assets contributed on the date of the gift. Any appreciation in those assets will then be available to the Trust beneficiaries free of any additional transfer tax.

Grantor Retained Annuity Trust ("GRAT") or an Installment Sale to a Grantor Trust

These are well-established techniques that become more advantageous for transfer tax purposes in low-interest rate environments.

A GRAT involves the irrevocable transfer of assets to a trust in which the donor retains an income interest for a term of years. The value of the remainder interest is ascertained when the GRAT is created and is treated as a taxable gift to beneficiaries designated by the donor. The interest retained by the donor is usually a dollar amount calculated as a percentage of the trust's initial value, but it can be a fixed percentage of the trust's annual value. The value of the interest retained by the donor, determined in accordance with IRS tables, reduces the value allocated to the remainder interest for gift tax purposes. At the end of the trust term, the trust distributes the assets to the beneficiaries or continues for their benefit, depending on the terms of the trust instrument. To the extent that investment performance of the GRAT exceeds the interest retained by the donor, wealth is transferred to beneficiaries without the imposition of additional gift tax. In other words, the lower interest rates are, the more likely it is that appreciation transfers to the remainder beneficiaries free of any additional transfer tax.

The installment sale of property to a grantor trust takes advantage of the differences between the transfer tax rules and the income tax rules governing property ownership. The trust is intentionally drafted so the creator is treated as the owner of the trust for income tax purposes (i.e., a "grantor-type" trust). In this way, the sale of assets to the trust by the donor will not trigger any gain recognition for income tax purposes. The donor then sells assets to the trust at fair market value in exchange for an interest-bearing note, typically at the "Applicable Federal Rate" ("AFR") (a low, "safe-harbor" interest rate prescribed by the tax code). Growth of the assets sold to the trust in excess of the AFR will pass to the beneficiaries free of gift, estate, and GST taxes. For income tax purposes, the donor will continue to be taxed on the income and gains of the trust, effectively making additional tax-free transfers to the trust's beneficiaries.

Consider Refinancing Loans

You may wish to consider refinancing intrafamily loans to take advantage of lower interest rates. This concept is dealt with in detail in the article "How Low Can You Go? Some Consequences of Substituting a Lower AFR Note For a Higher AFR Note" by Jonathan G. Blattmachr, Bridget J. Crawford and Elisabeth O. Madden, Journal of Taxation, July 2008.

Utilize Swap Powers

You may want to consider utilizing the grantor trust power to substitute assets (or "swap power") to exchange assets in trusts. This technique may be particularly advantageous if we see a quick recovery from current depressed values. Substituting marketable securities with cash or other less volatile assets can serve to protect gains on the value of assets excluded from your estate.

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Capitalizing Operating Businesses

The Covid-19 pandemic has put tremendous strain on the United States economy. Some businesses are experiencing dramatic reductions in revenue and are in many cases in need of capital infusions to fund operations during an uncertain time. While some businesses will look to banks or government assistance programs to provide this capital due, many business owners will want to fund these expenses themselves. Business owners looking to step in have two primary tools at their disposal: making an equity contribution to their business or making a loan to their business.

Equity Contributions

Perhaps the more straightforward of the two options, some owners will look to infuse capital into their business in the form of equity. In the case of businesses structured as pass-through entities (Partnerships, LLCs, S-Corporations), the contribution will increase the owner's capital account and tax basis in the business, thought being that once the business recovers it can return the capital as desired in the form of distributions.

While this method may provide some level of simplicity, business owners should be aware of potential risks. First, if there are other owners in the business an equity contribution of just one owner could prove dilutive for the other owners, which may or may not be appropriate or desired. Additionally, S-Corporation owners will want to be particularly careful not to create a second class of stock when structuring the capital contribution as it could revoke the businesses ability to be taxed at the partner level as a pass-through entity. Also, and importantly, if the business continues to struggle and is unable to recover, an equity interest could become fully worthless and the owner would have no recourse to recoup the additional investment made to keep the business operational.

Loans

Making a loan to your business, on the other hand, while at times being the more cumbersome option has several benefits when compared to equity contributions. For instance, in the event the business is unable to recover, debtholders are in some cases still able to recoup principal. If the loan is structured to be what is known as "Senior Debt", the issuer is among the most likely to be repaid in the event of bankruptcy, providing additional downside protection to business owners.

Additionally, the loan can be structured to provide an individual with a steady stream of cash flow in the form of debt repayment. The interest in connection with the loan will be taxable income to the owner and a tax deduction for the business. That said, the Tax Cuts and Jobs act of 2017 created rules that limit business interest expense in some circumstances and owners should consult with their tax advisors to confirm they can realize the deduction. It is also important to ensure that the loan is considered an "arm's-length" transaction between the company and its owner accompanied by a formal agreement with clear terms and a fair interest rate. Fortunately, interest rates are currently very low, making this type of arrangement easier to manage for cash-strapped companies.

[1] "How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note", Journal of Taxation, Vol. 109, No. 1, p. 22, 2008.

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Other Considerations

- Convert to Roth IRA at depressed values. This will minimize income taxes due on the conversion and can prove especially advantageous for those considering new plans after the passing of the SECURE Act.
- Reset basis in portfolio through tax loss harvesting. In the event some securities are now in a loss position, consider realizing losses and investing in similar securities. Advisors can assist in this process. Towards year end, take stock of the realized gain/loss position in your portfolio and realize some gains to reset basis.

We believe that in times like these of substantial disruption and uncertainty – on multiple fronts including the economy, the markets and the political arena – our proven capacity to provide individualized, holistic, and conflict-free advice is the value we deliver to our clients. Please reach out to your advisors to discuss whether any of these techniques might be right for you and your family.