WHITE PAPER

Estate Planning in the Time of COVID-19

The coronavirus has turned our world upside down with the fear of getting sick, the imposition of safer- at-home policies and the volatility of the stock market. While these are upsetting events, they do create an impetus to review your current estate plan and make any necessary changes. This review should include an evaluation of your lifetime documents, testamentary documents, the titling on your assets, as well as any beneficiary designations on life insurance policies or retirement plans. While evaluating your current plan, there are several planning opportunities which are enhanced by the current environment that you may want to consider utilizing.

BROOK H. LESTER, CPA
PRINCIPAL &
CHIEF WEALTH STRATEGIST

Fundamental Documents of an Estate Plan

A well-structured estate plan has two components. The first is a series of documents that will help take care of you during your life, and the second is your testamentary documents which will govern your estate at your death.

Lifetime Documents

Sometimes this part of an estate plan is overlooked. The lifetime documents focus on taking care of an individual during periods of incapacity. Incapacity can be temporary (during surgery) or permanent (dementia). The three lifetime documents are: a durable power of attorney, a health care power of attorney and a living will. Each serves a distinct purpose and principally involves you appointing people to make choices for you when you are not able to make decisions for yourself.

Durable Power of Attorney - Enables a trusted person to handle your financial affairs. This document authorizes someone to act on a broad range of matters, such as buying and selling real estate and personal property, managing your banking and investments, handling taxes and lawsuits, and applying for government benefits.

Health Care Power of Attorney - Designates someone to be your representative, or agent, in the event that you are unable to make or communicate decisions about aspects of your health care. It is very important to trust your attorney-in-fact for healthcare purposes, as they may be charged with making life-or-death decisions on your behalf.

Living Will - Allows individuals to state their wishes for end-of-life medical care. Also called an advance directive or directive to physicians. Facilitates making one's own choices about life support and helps prevent confusion about the type of care desired or not desired in the event that one is incapable of communicating.

There are some instances where the Health Care Power of Attorney and the Living Will are combined into one document.

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Testamentary Documents

While the lifetime documents of your estate plan are sometimes overlooked, people also often fail to execute a will, and if they do, they fail to keep it updated to reflect the changes in their life. Additionally, many people do not understand or simply forget the disposition of their assets under their will and end up with unintended outcomes.

A will can do many things, but the basic function is to name someone called the executor or personal representative who is charged with gathering all your assets, paying your creditors and distributing your remaining assets according to the terms of the document while under the supervision of the court. Wills can also be used for estate tax planning, creation of trusts and naming guardians for minor children.

In addition to a will, some people will combine a will with a revocable trust. Utilization of a revocable trust can promote privacy related to disposition of assets since it is not filed with the probate court at death, can reduce administrative costs at death and can be advantageous during your life if you should become incapacitated.

All these documents should be reviewed every 3 to 5 years and the current environment we live in makes this even more important.

Asset Titling

Even with a complete set of documents, an estate review is not complete without considering how the property that you own is titled. All assets should be titled in accordance with your estate plan to ensure the plan will function properly. Someone may own their house with their spouse as "joint tenants" or "tenants-in-common." Those terms create particular rights for the co-owner, and should be reviewed to make sure that they are appropriate for your situation. Some people put a "transfer on death" (TOD) or "payable on death" (POD) designation on their bank account, which will override what was in their will and could disrupt an otherwise well thought out plan. For individuals utilizing a revocable living trust, they must make sure that their homes, bank and investment accounts, and any other items are titled in the name of the revocable living trust so that those items are governed by the trust at their death. A revocable living trust that is not funded with the relevant assets wastes many of its benefits.

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Beneficiary Designations

Certain assets, namely retirement plans and life insurance policies, require beneficiary designations, which allow them to pass directly to the named beneficiary, bypassing the owner's will. When creating new testamentary documents, an individual must recognize that their beneficiary designations have the potential to alter their estate plan if they do not include these assets' beneficiaries as a part of their overall plan. Beneficiary designations may name individuals or trusts to receive assets at the death of the owner. However, account valuations will continue to fluctuate, so owners must consider how their changes will impact the overall distribution of their estate.

Planning Opportunities – Discounted Values and Low Interest Rates

In addition to being an impetus to review your estate planning documents, the current environment has created some unique gifting opportunities. The values of both public and private companies have gone down and interest rates are at historic lows. The combination of these two make many of the traditional estate planning techniques more effective. Details about these techniques and how they are impacted by low values and interest rates are explained below.

Gifts

The most basic estate planning strategy is to make gifts during your lifetime. Current gifts allow future income and appreciation from the asset to accrue for the benefit of others outside the donor's taxable estate. Gifts can be in the form of gift tax annual exclusions ($15,000 per donee) or using a donor's lifetime gift tax exclusion ($11,580,000 for 2020). Lifetime gifts can be made directly to individuals or can be made to an existing or newly created trust that benefits one or more people.

The most basic estate planning strategy is to make gifts during your lifetime.

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Intra-Family Loans

Another basic planning technique that takes advantage of low interest rates is intra-family loans. This technique can be implemented with a simple interest bearing note between family members. The notes are typically structured for a term of years with interest due annually and principal due at the end of the term. Each month, the IRS publishes minimum interest rates that must be charged to avoid gift tax implications on the loan, and the interest rate may remain the same for the term of the loan. These rates are at historic lows with June 2020 rates as follows:

Loans with a duration of 3 years or less	0.18%
Loans with a duration of more than 3 years but not more than 9 years	0.43%
Loans that are longer than 9 years	1.01%

Loans are typically made from a senior generation to a junior generation with the proceeds used to make investments (though the proceeds could be used for any purpose). Assuming a $1 million, 3-year loan that was used to make an investment that returned 10% annually, the pre-income tax benefits are illustrated below:

	YEAR 1	YEAR 2	YEAR 3
Loan/Investment	1,000,000	1,098,200	1,206,220
Appreciation	100,000	109,820	120,622
Note Payable	(1,000,000)	(1,000,000)	–
Note Payment	(1,800)	(1,800)	(1,001,800)
Ending Value	**98,200**	**206,220**	**325,042**

Under this example, $325,000 has been transferred to the junior generation with no gift tax consequences. While this has great potential to transfer wealth to future generations, the parties should keep in mind that the interest on the debt must be paid at least annually and the principal balance must be satisfied at the end of the term to avoid gift tax implications.

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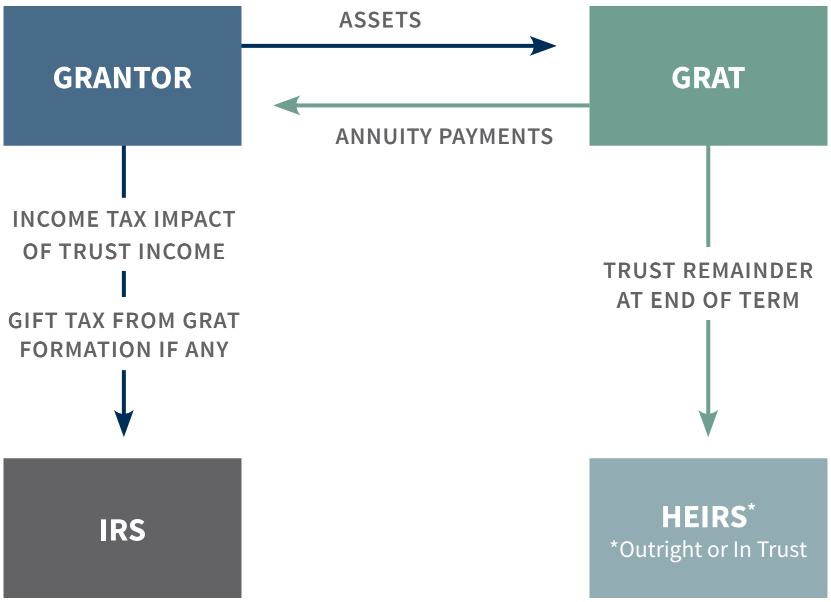
GRATS

Another common estate planning technique whose effectiveness is enhanced by the current interest rate and valuation environment is a Grantor Retain Annuity Trust or GRAT. GRATs are created by a grantor transferring property to a trust in exchange for an annuity payment over a specified term of years. At the conclusion of the term, any property remaining in the trust after all annuity payments have been made is distributed to a designated beneficiary.



Most GRATs are structured to have little or no gift tax consequences by using the IRS mandated interest rate (Sec. 7520 Rate that is 0.60% in June of 2020) to make the annuity payment high enough to cause the current value of the remainder interest to be zero. The function of GRATs is easiest to demonstrate through an example. Assuming a $1M transfer that grows at 10% and a Sec. 7520 rate of 0.60% which produces the following result over a three-year period:

	YEAR 1	YEAR 2	YEAR 3
Beginning Value	1,000,000	762,664	501,594
Appreciation	100,000	76,266	50,159
Annuity Payment	(337,336)	(337,336)	(337,336)
Ending Value	**762,664**	**501,594**	**214,418**

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Based on the facts of our example, $214,000 would be transferred to the remainder beneficiary with no further gift tax consequences. The net effect of this technique is to allow a grantor to remove appreciation of assets over the IRS interest rate from their estate with little to no gift tax consequences. This technique does not decrease someone's estate, but prevents the estate from growing as quickly.

An additional benefit to this technique is that the income earned by the GRAT during the term of trust is taxed to the grantor. Since the trust does not have to pay income tax, the value of the assets that ultimately benefit future generations will grow faster as well as reducing the size of the Grantor's estate. Finally, GRAT's are best utilized when the grantor wants to benefit children rather than grandchildren.

Installment Sales

Another potentially timely technique given the current economic environment is an installment sale to an intentionally defective grantor trust (IDGT). This technique is particularly useful when a grantor has an estate that is much larger than the estate/gift tax exemption and would like grandchildren to be permissible beneficiaries of the assets. Additionally, IDGTs function similarly to GRATs in that the trust's income is taxed to the grantor causing a further reduction in the grantor's taxable estate and allowing the trust assets to grow unencumbered by income taxes.

To implement the technique, the grantor will either use an existing trust that has assets or create a new trust and make an initial gift to the trust. If the grantor wants the trust to last multiple generations, Generation Skipping Tax ("GST") exemption will also be allocated to the initial gift to the trust. The initial funding ("seed capital") is typically 10% or more of the expected value of the assets to be sold to the trust.

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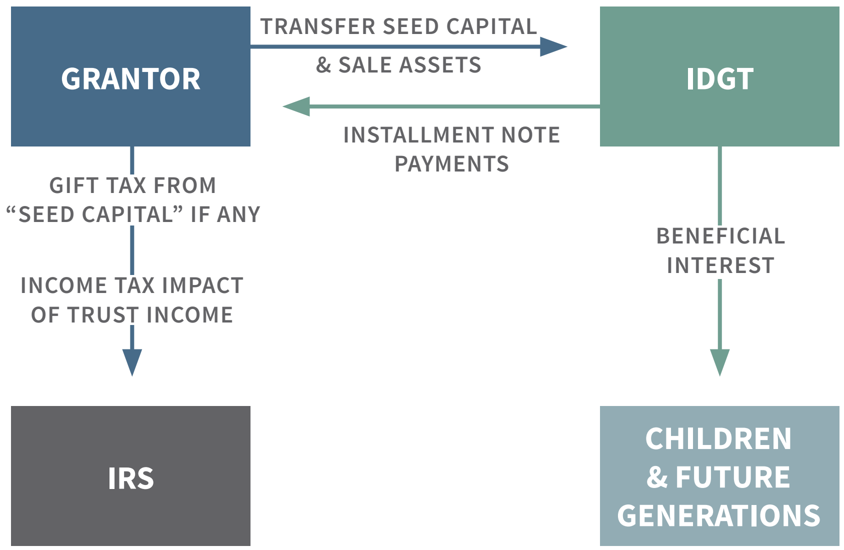
Next, the grantor will sell assets to the trust in exchange for an installment note. The note will use the Applicable Federal Rate ("AFR") to determine the payment schedule, and the IDGT will make interest and principal payments to the grantor over the term of the note. The transaction does not result in capital gain being recognized by the grantor since the trust is taxed as a grantor trust. The transaction is illustrated below.



The effectiveness of the plan depends on the interest of the note and the growth of the assets gifted and sold to the trust. Below is an example of the structure assuming total assets currently worth $1M that will appreciate 10% annually with $100K gifted to the trust and the remaining $900K sold to the trust in exchange for a 9-year balloon note with an interest rate of .48%.

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	YEAR 6	YEAR 7	YEAR 8	YEAR 9
Beginning Balance	0	1,095,680	1,200,928	1,316,701	1,444,051	1,584,136	1,738,230	1,907,733	2,094,186
Gifts/Sales	1,000,000	0	0	0	0	0	0	0	0
Appreciation	100,000	109,568	120,093	131,670	144,405	158,414	173,823	190,773	209,419
Note Payable	(900,000)	(900,000)	(900,000)	(900,000)	(900,000)	(900,000)	(900,000)	(900,000)	
Note Payment	(4,320)	(4,320)	(4,320)	(4,320)	(4,320)	(4,320)	(4,320)	(4,320)	(904,320)
Ending Value	**195,680**	**300,928**	**416,701**	**544,051**	**684,136**	**838,230**	**1,007,733**	**1,194,186**	**1,399,284**

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Under this example, approximately $1.4M in assets are transferred to future generations while using $100,000 of unified credit and GST exemption. The combination of extremely low interest rates and the potential for significant growth in the valuation of the assets can result in a large transfer of wealth using this technique. In most instances, this transaction is implemented with closely held assets that are subject to valuation discounts further enhancing the transfer of assets to future generations.

Conclusion

Estate planning can take on many different forms. On its most basic level, estate planning is making sure you have a documented, up to date and well thought out plan that protects your family. The next phase is limiting the impact of estate and gift taxes during life and death by engaging in additional planning to reduce the size of your taxable estate. The uncertain times we are currently experiencing, along with the reduction in the value of assets and interest rates caused by the times, creates an opportunity to review all aspects of your estate plan. These examples highlight the benefits of starting your planning early.

DIVERSIFIED TRUST

ATLANTA

400 Galleria Parkway, Suite 1400
Atlanta, GA 30339
Phone: 770.226.5333

GREENSBORO

701 Green Valley Road, Suite 300
Greensboro, NC 27408
Phone: 336.217.0151

MEMPHIS

6075 Poplar Avenue, Suite 900
Memphis, TN 38119
Phone: 901.761.7979

NASHVILLE

3102 West End Avenue, Suite 600
Nashville, TN 37203
Phone: 615.386.7302