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ARE WE HAVING FUN YET?
THE BOVE & LANGA REPORT | DECEMBER 2020

Readers of the Bove & Langa report are familiar with our philosophy of estate planning – we work in collaboration with your other advisors to maximize the creation, enjoyment, and preservation of your capital in all its various forms: human, intellectual, social, and economic. Over the course of a lifetime, one type of capital may take priority over another, triggering adjustments and refinements to an existing plan. The birth of a baby prompts a focus on human capital, and the need to select a guardian to protect the baby should its parents be unable to do so themselves. In the last Report we focused on ways to maximize the first three types of capital in a pandemic mandated quarantined environment, and those continue to be important focus points. For this Report we turn to economic capital. First, we propose a new trust, the FUN Trust, which you can use to educate the younger generation on the ins-and-outs of wealth management. More fun than even an Octopus's Garden! We'll then turn to some tried and true estate planning techniques suited to these times of low interest rates and high transfer tax exemptions.

THE FUN TRUST

It's odd. As parents, grandparents, aunts, and uncles we try to teach the younger generation how to live in the world yet often we treat as taboo discussions of financial literacy: what is wealth, how it is obtained, how it is managed, and how might it be used for personal and societal good. Into this educational void comes the Financial Understanding Now Trust, or FUN Trust, an original idea from Bove & Langa. Here is how it works.

Let's assume a member of an older generation ("Elder") and two members of a younger generation ("Youngsters"). Again, Elder might be anyone in the family who has a few dollars to spare and is interested in enhancing the financial literacy of one or more Youngsters:

- Elder gifts $200,000 of stock (or cash) into an irrevocable FUN Trust for the benefit of two Youngsters, ages 18 and 20. Could be more, could be less. Additions to the FUN Trust in subsequent years is also possible.
- The Youngsters are the trustees of the FUN Trust with responsibility for investment of the $200,000.
- The trustees (the Youngsters) must work with a wealth manager selected by the Elder, and the FUN Trust contains parameters regarding how often the trustees must meet with the wealth

manager (say, twice per year). The purpose of these meetings is to expose the Youngsters to how the wealth manager actually manages investments, giving the Youngsters the opportunity to participate in managing money.

- The FUN Trust could provide that the Elder receives a copy of the wealth manager's quarterly financial reports as they are provided to the trustees.
- On the last business day of the year, the FUN Trust assets are valued.
- In January, 5% of that value is distributed to the Youngsters in equal shares. So here, assuming no growth, each Youngster would receive $5,000 ($200,000 x 5% ÷ 2). If Elder has been providing an allowance to the Youngsters, the FUN Trust payment could be in lieu of further allowances.
- The FUN Trust will grow in value to the extent the trustees can grow the trust in excess of 5% each year.
- The FUN Trust requires each Youngster to prepare a small report to the Elder (a Budget) explaining how the Youngster plans to use its distribution in the coming year (personal spending, saving, philanthropy). The FUN Trust can have a Schedule which sets forth a "fill in the blank" Budget (or not).
- A Youngster that fails to provide a Budget within a certain period of time forfeits the right to participate in the 5% distribution the following year.

At some point in time, the FUN Trust might terminate and the assets be distributed over time to the Youngsters. Or, depending upon the funding level, it could continue down the generations. There are several other factors that would need to be discussed in designing a FUN Trust for a particular Elder and set of Youngsters but the fundamental structure of the FUN Trust remains one designed to transmit the financial knowledge and understanding of one generation to another. Now that's fun.

LOW INTEREST RATES AND ESTATE PLANNING

The United States is experiencing historically low interest rates. Each month the Internal Revenue Service issues a Revenue Ruling in which the Ruling's "Table 1" establishes the short-term, mid-term, and long-term interest rates for the following month. For December 2020:

- The annual short –term interest rate is 0.15% (for obligation of less than three years duration)
- The annual mid-term interest rate is 0.48% (for obligations of three years duration up to nine years duration)
- The annual long-term interest rate is 1.31%. (for obligations of longer than nine years duration)

There is also a special rate referred to by estate planners as the “7520 rate” which is 120% of the mid-term rate. For December 2020 the 7520 rate is 0.6%. This Report discusses planning techniques which depend upon low interest rates for maximum success. You may find one or more of interest to you.

HIGH EXEMPTIONS AND ESTATE PLANNING

Over the past twenty years the federal estate tax has taken taxpayers on quite a roller coaster ride. For many years the government levied the estate tax on all of a decedent’s wealth in excess of $600,000. Then came a period of gradually increasing exemptions, with a cap of $3.5 million, and then $5 million (indexed for inflation). And then, astonishingly, there was no federal estate tax in 2010. Today, the federal estate tax has been resurrected with a historically high exemption. The exemption amount is set at $10 million, indexed annually for inflation. This year a decedent’s wealth must be in excess of $11.58 million to trigger an estate tax (assuming the decedent did not make any taxable gifts prior to death – see “Resources” on our website for a primer on all the transfer taxes). In 2021 the exemption will be $11.7 million. This indexed $10 million exemption amount will most likely increase each year until January 1, 2026, when the exemption amount drops back to $5 million. And, of course, Congress can change the rules at any time as it has so often in the past. The fact of a very high exemption coupled with the knowledge that it will disappear, come 2026, or earlier, has fostered a focus on planning that can be done now to “lock in” the ability to pass vast wealth to the next generation free of the federal estate tax. This Report will focus on a few of those planning techniques.

INTRA-FAMILY LOANS: A low interest rate environment is a great opportunity for intra-family loans. To ensure that such a loan is respected as an actual loan and not a gift from the lender to the borrower, the lender needs to ensure that the loan is properly structured, which includes charging interest on the loan amount. With the December interest rate for mid-term loans being only 0.48%, a parent can structure a loan to her child at an interest rate far below a rate offered by a bank.

> Rita’s daughter, Sally, wants to borrow $100,000 to buy a home. Sally has the ability to pay back this loan amount within eight (8) years. Rita can make a loan of the $100,000 to Sally with a current interest rate of 0.48% rather than just gifting the funds to Sally. Over the course of the loan, Sally will only pay about $2,000 in interest plus the original loan amount for a total of about $102,000, which is both a good deal for Sally and a way for Rita to preserve the assets for her later use for when she retires as a meter maid.

For families who previously loaned money to a child at a higher interest rate, they may now consider renegotiating the loan to take advantage of the now lower interest rates and benefit the child with a lower total repayment amount. Keep in mind, however, to avoid the lower interest rate from being treated as having a gift component, the borrower should also provide additional consideration to the lender as part of the renegotiation.

GRANTOR RETAINED ANNUITY TRUSTS: Grantor Retained Annuity Trusts, commonly called "GRATs" are a useful vehicle to pass wealth to others during a low interest rate environment. A grantor establishes and funds the GRAT. Over the term of the GRAT, the grantor receives back annual payments totaling almost the original principal funding amount and interest calculated at the rate applicable on the date of funding. At the end of the GRAT term, any additional appreciation of the assets is passed on to the ultimate beneficiary of the GRAT. Since the grantor received back almost the entire original funding amount along with interest at the 7520 rate, the grantor is considered to have made only a small gift to the ultimate beneficiary. Low interest rate environments, where the GRAT assets are likely to earn more than the required repayment amount, can permit a grantor to pass a significant amount to a beneficiary with minimal tax liability.

> Desmond Jones is interested in passing some wealth to his son, JoJo, so JoJo can set up his own market stall. Desmond, however, has little lifetime exemption left so he does not want to make JoJo an outright gift. A two year GRAT to the rescue! Desmond funds the GRAT with $2 million for a term of two years, and the annuity to Desmond from the GRAT is such that over the two year period Desmond is returned the $2 million plus the amount required by the section 7520 rate (about $18,000). The taxable gift to JoJo is negligible (often called a "zeroed out GRAT"). Not terribly exciting, however, things get interesting when you consider during this time the GRAT assets were earning income in excess of the 7520 rate, for purposes of this example, let's say at 6%. The ultimate result is that Desmond will get back his $2,000,000 funding amount with section 7520 interest, have made a negligible taxable gift to JoJo <u>and</u> the excess earning of the GRAT in the amount of over $168,000 will pass to JoJo at the end of two years with little to no tax consequences. Multiple two year GRATs over time pass wealth in a very tax advantaged way.

CHARITABLE LEAD TRUSTS: What if you are philanthropically inclined? Don't worry, the low interest rate environment has something for you too! Charitable Lead Trusts ("CLTs") are a form of trust where a charity receives payments from the CLT for a period of years and at the end of the charitable term, the remainder of the trust assets are passed to family members.

> Sargent Pepper is very fond of his local community orchestra, the Lonely Hearts Club Band, and would like to benefit the Band with a sum of money at this time. He is also, however, looking to leave a bequest to his niece, Loretta Martin, in the future. Sargent Pepper can establish and fund a CLT, often receiving an income tax charitable deduction at that time. During the initial charitable term, the CLT will make payments to the community orchestra, thereby fulfilling Sargent Pepper's philanthropic goals. At the end of the initial charitable term, the remainder of the trust assets will be held for the benefit of Loretta. Since the required payments to the orchestra will have been calculated with a low interest rate, the sum ultimately

passing to Loretta will be higher than it would have been in had Sargent Pepper funded the CLT during a high interest rate period.

THE TAXMAN GIVETH: For our purposes here, a grantor trust is an irrevocable trust that does not exist for income tax purposes, but does exist for gift, estate, and generation-skipping purposes. The taxman simply does not see it when imposing the income tax on gains within the grantor trust. The person who created and funded the trust, the grantor, pays all the income tax (and takes all the income tax deductions and credits).

> Mr. Heath and Mr. Wilson are spouses who own a successful fruit delivery company, Strawberry Fields LLC. The assets in the LLC produce a positive cash flow, and are appreciating in value. Heath and Wilson wish to transfer a portion of the LLC to their children to remove the appreciation from the reach of the estate tax and will use a trust to receive the LLC interest. Heath and Wilson are not ready to give up the income associated with the LLC interest moving into the trust. They decide that Mr. Heath will sell a portion of his LLC interest into an irrevocable grantor trust he creates for the benefit of the children in return for a low interest promissory note, payable over twenty years. The Taxman cannot collect capital gains on the sale because Mr. Heath is treated as selling the LLC interest to himself.

At Mr. Heath's death, the Taxman may require the pennies on his eyes to be declared on the estate tax return, but the LLC interest in the grantor trust escapes the Taxman's reach.

SIMPLY GIFT: There are many ways to take advantage of the high exemption. You might simply hand over large sums of money to your beneficiaries. So what's the catch? There isn't one! If simplicity rules your roost, this might be a good technique for you to consider.

THE GIFT THAT KEEPS GIVING: But not all beneficiaries will be effective at managing an outright gift (unless they have learned about wealth management via a FUN Trust!). To ensure the funds are around to benefit the family over a lifetime, an irrevocable gift trust is a perfect vehicle.

> Paul does not want to make a multi-million dollar gift to his twenty-two year old daughter, Lucy, who might spend the gift on diamonds, nor does Paul want to make an outright gift to his daughter, Penny Lane, as she is too young to hold property individually. Instead of making gifts outright, Paul could set up an irrevocable trust and use it as a gifting vehicle. He would be able to control the terms of the trust and therefore the amount of access the beneficiary or beneficiaries have to the gifted property. He can determine who will serve as trustee and how the property is managed (and can even remove and replace the trustee under certain circumstances). Paul can even ensure the trust funds will remain beyond the reach of creditors (including ex-spouses). Lucy and Penny Lane can sit back and eat marshmallow pies without a care in the world!

HOW DO YOU HAVE YOUR CAKE AND EAT IT TOO? Spousal Lifetime Access Trusts, commonly known as "SLATs", are currently a hot topic in the estate planning community, due to their ability to utilize the inflated exemption amount while still benefiting the donor. For high net worth individuals who want the benefit of removing assets from the reach of the estate tax while keeping the assets within the marital unit this estate planning technique may be ideal.

> Rocky can make gifts in an irrevocable SLAT for the benefit of his wife Magill, who calls herself Lil, but is known as Nancy, and may indirectly receive a benefit. The wealth stays in the marital unit while Nancy is living and is used for her benefit (she can even serve as trustee – and therefore make all investment and distribution decisions). There are other benefits as well. If Rocky works in a high-risk field (such as a pediatric cardiology), he might want to fund a SLAT for Nancy to remove assets from his estate, so the gifted assets are not available to satisfy a judgment creditor. Although Rocky no longer has control or access to the gifted assets, Nancy does. If she uses the SLAT to pay some living expenses, such as the mortgage on their Black Mountain Hills home, Rocky benefits as well. Sounds great right? Well, not always. Rocky will continue to pay the income tax on income generated by the SLAT. And, if Nancy and Rocky get divorced, Rocky still pays the income tax, and Nancy will continue to be the beneficiary of the SLAT and may continue to serve as trustee. Rocky may regret funding it. But all is not lost, Nancy could fund a non-reciprocal SLAT for his benefit so if there was a divorce, each of them would walk away with a SLAT. And if only on SLAT is contemplated, the divorce issue can be discussed in the planning stages, or dealt with at the time of the divorce.

IT'S ALL IN THE NUMBERS… So, Ringo and Barbara are turning 64 and have decided to make gifts in trust for the benefit of Ringo's children, Zak, Jason, and Lee, using $10 million of their exemption. Groovy! So what's next? Who makes the gift? Do Ringo and Barbara each make a gift of $5 million, or does one of them make a gift of $10 million. If the exemption does not change, it may not make a difference, and in fact, it might make the most sense for each of them to make a $5 million gift rather than have one of them make single larger gift. In that case, each of them would be preserving the exemption to make gifts in the future. In times of uncertainty, however, when the lifetime exemption is expected to change (and decrease), one of them might choose to make a single gift to allow the other to preserve exemption.

> If Ringo and Barbara each make a gift of $5 million now, they will have used a total of $10 million of exemption and will have no exemption left to use come 2026. In contrast, if one of them makes a $10 million dollar gift in 2020 and the exemption reverts $5 million in 2026, the other will still have $5 million of exemption available for future gifts (so in total they will be able to use $15 million of exemption).

This technique is not one that works for everyone, but when used correctly, can give you some "extra" exemption.

WHERE DO YOU BELONG? Most of us do not have millions of dollars lying around to give away. For the rest of us, we might look to make small gifts using assets in our portfolios which are depressed in value due to COVID-19.

> Eleanor lives in a dream, putting her unopened mail in a jar by the door. Who is it for? Thinking of her nieces, she opens her latest stock portfolio report and sees that her real estate investments have taken a COVID-19 dive – down 30%. Rather than gift each niece $15,000 in cash as she does each year using her gift tax annual exclusion, she gifts each niece shares of a REIT. Eleanor is able to gift more shares due to the low values. Note that if Eleanor instead intends to make a gift to support the cemetery at Father McKenzie's church, she might pick more robust stock with lots of unrealized appreciation to gift. The church sells the stock without paying any capital gain. Father McKenzie can go back to darning his socks. For all anyone cares.

BABY YOU'RE A RICH MAN! In our laundry list of ways to take estate planning advantage of the present low interest rate environment, there is a tried and tested technique that can offer not only significant state and federal estate tax savings, but also probate avoidance and even asset protection. The private annuity.

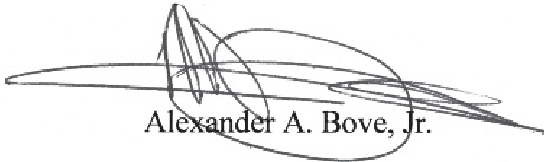
The private annuity (PAN) is simply a contract between any two parties (family or otherwise, but not an insurance company), where one party (the "annuitant") transfers an asset to another (the obligor) in return for the obligor's promise to make periodic payments to the annuitant for her lifetime or for a term of years at least equal to her life expectancy (under IRS tables). How will this save estate taxes? Here's a brief example:

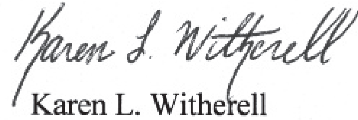
> Karl, age 77, owns a two-family home, worth $200,000, that he would like to keep out of his large estate. He enters into a PAN with his daughter, Kim, providing that Kim will pay her dad about $2,000 per month for the rest of his life in exchange for the home. The rentals from the home will adequately cover the annuity payments. Two years later, Karl expires from a heart attack. Even though he has only received $48,000 annuity payments for the $200,000 home, the PAN contract was fulfilled, and the entire value of the home will be excluded from Karl's estate. There are, however, other tax consequences to consider, such as Karl's capital gain based on his cost of the home and the value of the annuity, and Kim's capital gain, as she paid only $48,000 for a $200,000 home. Nevertheless, in Karl's large estate, the net savings would still be substantial. For instance if the home were worth $300,000 when Karl died, estate taxes in excess of $120,000 would be saved, far in excess of Kim's and Karl's capital gains tax.

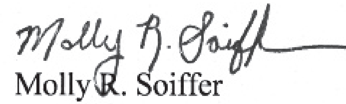
CONCLUSION

You can imagine that there are many variations to the above techniques that would be explored in detail with anyone undertaking one or more of the transactions. As was famously said "We can work it out." That's the FUN part.

Our warmest wishes to you and yours for a healthy and peaceful 2021 filled with love and laughter.







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