

## Don't Forget the Fundamentals

### Summary

- Moving significant wealth to beneficiaries doesn't require complex transactions.
- Strategic estate planning often starts small with transfers detailed in the Internal Revenue Code.
- Limit the growth of your taxable estate while growing your assets.

### Start small, stay steady: Fundamental planning in 2021

It is likely we will see tax law changes in 2021, including changes that will raise estate taxes. Nevertheless, there is still a great deal of sensible planning that can be done. Start small, and stay steady by relying on the tried-and-true techniques that have helped families transfer wealth tax-efficiently for generations.

Consistent execution of straightforward planning strategies is always a best practice. To determine the techniques that can optimally support your objectives, begin with a Goals-Based Wealth Review to assess whether your lifestyle needs are sufficiently protected. Once confident, your focus can shift from lifestyle to legacy and the pursuit of transferring wealth.

The gifting techniques outlined below can facilitate the transferring of significant wealth across multiple generations.

### Education and health care

Unlimited payments of medical expenses made directly to a health provider, or policy premiums transferred to a health insurer, are accorded special status in the Internal Revenue Code.

So are payments of tuition made directly to an educational institution. These transfers are not considered taxable gifts and do not diminish an individual's lifetime exemption amount. With rising medical costs and increasing tuition expenses, an individual could indirectly pass thousands of dollars to children and grandchildren without using his or her lifetime exemption. It is unlikely this exception will be deleted from new tax laws and should remain an option for tax-free gifting.

### Annual exclusion: \$15,000

Each taxpayer may give up to \$15,000 per year to an unlimited number of individuals, free of gift tax. Since education and health care payments receive special status, individuals may give an additional gift to someone they may have aided previously. Spouses can both make gifts to a child totaling \$30,000 together.

If that child is married, and his parents feel comfortable doing so, another \$30,000 could be given to his spouse, for a total of \$60,000 to the couple. Throw in grandchildren and it doesn't take long for annual exclusion gifts to add up to hundreds of thousands of dollars, keeping a growing net worth in check.

Annual exclusion gifts don't have to be made in cash. Giving away stock with built-in gain to family members in a lower (or even 0%) capital gains bracket can save not only estate tax but income tax for the family as well.

A meaningful way to accelerate the benefits of the annual exclusion is to fund state-sponsored educational 529 plans. An individual or couple can fund a 529 plan with up to five years' annual exclusion gifts upon opening. In 2021 this would allow a couple to gift \$150,000 to a new 529 plan, allowing the assets to accumulate for future educational costs. Further, this growth will escape income taxation if distributions are used for allowable education expenses. This is a straightforward strategy that saves estate and income tax.

## Gifts in trust

While the annual exclusion can be given to anyone, not everyone is prepared to receive such gifts. Perhaps the intended recipient is a minor, a spendthrift, disabled or not adept at managing money. A trust can be used to protect and grow annual exclusion gifts for future use. Consistent gifting of the annual exclusion amount to a beneficiary from the time of birth could result in assets of over \$1 million by the time the beneficiary reaches their early 20s. By making the gifts in trust, benefactors need not worry the recipient(s) will spend the monies unwisely.

Depending on the grantor's age, health and long-term intentions, annual exclusion gifts to a trust might be further leveraged through the purchase of life insurance on the life of the grantor. Life insurance policies owned by properly structured trusts can receive insurance

proceeds free of estate tax and produce an even larger legacy for beneficiaries.

## Protect principal, gift growth

If systematic annual exclusion gifting does not distribute enough money to beneficiaries, or if you worry your estate may be subject to future taxes that would be burdensome to beneficiaries, you should consider more advanced estate planning techniques beyond annual exclusion gifts. Revisit your goals-based planning documents to determine your ability to gift assets from your portfolio without undermining your financial security. If making large gifts of principal lowers the probability of maintaining your desired lifestyle, you can consider techniques that allow you to retain ownership of principal while transferring appreciation of those assets to beneficiaries. These techniques effectively cap the growth of your estate and limit future exposure to hefty estate tax liabilities.

## Intra-family loans

This technique can be a convenient, low-cost way to assist family members with purchasing a home, starting a business or affording living costs. However, loans can also be used by the borrower to invest in the market. Consider the following scenario:

- Parent lends \$1 million to child using a nine-year note, interest only, at the Internal Revenue Service prescribed interest rate of 0.38% (October 2020).
- Child invests cash into a diversified portfolio that produces a 7% annualized return.
- After repaying the note in year 9, child is left with approximately \$850,000.

Using a low-interest-rate loan, the parent has retained legal right to the \$1 million principal and passes \$850,000 of appreciation to the child — tax free.

What if you own a low-cost-basis portfolio of stocks and don't have the cash to lend your child? Is it possible to "lend" assets to your child? Consider the following:

- Parent creates trust for child that allows parent to reacquire trust assets in the future by swapping in different assets of equivalent value.
- Parent funds the trust with cash or marketable securities using a small amount of parent's lifetime exemption.
- Next, parent transfers the low-cost-basis assets of \$1 million into the new trust in exchange for a note like the nine-year note at 0.38% previously described.
- At the end of the note term, the trust repays the note by passing a portion of the low-basis-stock back to Parent. The trust would retain the value of assets in excess of the note with the balance free of estate or gift tax. Additionally, parent could "swap" assets into the trust that have a higher basis than the assets now sitting in the trust.
- Assuming the same 7% annualized return above, child is left with \$850,000 of value in trust.

Using intra-family loans preserves principal for donors, transfers appreciation to family heirs and maintains flexibility for future planning opportunities.

## Grantor retained annuity trusts

The Grantor Retained Annuity Trust (GRAT) is another efficient technique to transfer asset appreciation to beneficiaries with minimal gift or estate tax consequences without undermining the grantor's long-term financial security. Often GRATs are designed to last two to three years to leverage historically low interest rates and market volatility. Consider the following:

- Grantor transfers \$1 million of assets to a two-year trust and retains an annuity totaling \$1,015,463 (April 2021, 1.0% interest rate as set monthly by the Internal Revenue Code).
- Assets remaining in the trust after the annuity payments have been made to the Grantor will pass to beneficiaries, tax free.
- If asset values decline, all assets will pass back to Grantor as if never created.
- Assuming an annual portfolio growth rate of 8%, this GRAT would transfer \$114,011 to beneficiaries.

Compared to the family loan technique, GRATs can be more effective during long periods of market volatility. If the asset values within the GRAT spike, the grantor is permitted to "swap in" more stable assets to lock in gains for future beneficiaries. Since varying asset classes often move out of step, GRATs can be created with a single asset class or even a single concentrated stock position.

Creating several GRATs at the same time can diversify exposure and increase the odds of overall success. Success is also increased by employing a cascading or rolling GRAT strategy which moves each annuity from an existing GRAT into a newly established GRAT.

By doing this, the grantor increases the odds of capturing asset appreciation for intended beneficiaries.

A systematic GRAT program can move a substantial amount of wealth to the next generation while providing principal preservation for the grantor. Once the grantor has decided enough wealth has been earmarked for the next generation, the GRAT program can unwind

and return the principal to the grantor through any remaining annuity payments.

While 2021 planning will keenly focus on whether the \$11.7 million lifetime exemption amount will remain intact, successful estate planning begins by focusing on the fundamentals. The key is to start now and stay steady.

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