Family Office Insights

Approaches to wealth transfer in the age of COVID-19

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It's always the right time for estate planning

COVID-19 has had a profound impact on almost all aspects of life—both business and personal. But one facet remains unchanged: the importance of estate planning. Understandably, it may be more difficult to find the time and energy to focus on estate planning when there are so many other issues to contend with. But as you'll see in this article, there are compelling reasons for—and potentially significant benefits to be gained by—taking action now.

When you think of estate planning, one of the first things that may come to mind is federal estate taxes. And while taxes are undoubtedly a significant concern for everyone, including wealthy families, there's much more to the estate planning story. In fact, if you think of it as **family succession planning**, rather than estate planning, you get a broader, more accurate picture of what's involved.

While family succession planning involves estate taxes, it also encompasses a far broader number of issues, including who will own or manage a family business, how a parent's assets are divided and passed on, and which heirs are able to manage money and which need guidance and perhaps restrictions.

Another essential component of this type of planning is obtaining an accurate assessment and valuation of assets owned or controlled by the family. Because many wealthy families own businesses, investments, and other assets that may have recently declined in, value due to COVID-19, it may be an especially opportune time to do estate planning—or modify the plan you already have. The historically low interest

rates currently allowed by the Internal revenue Service (IRS) for certain estate planning transactions[1] also make this a potentially favorable time to explore your estate planning options. However, these opportunities may disappear sooner than you might think given the volatility of the financial markets, the uncertainty regarding future performance, and the potential of the IRS raising interest rates.

Wealth transfer considerations and approaches—from both tax and nontax perspectives—are the focus of this article. We hope you find it interesting and informative.

Make the most out of the enhanced gift and estate tax exemption

Unless you act quickly, you might be jeopardizing your ability to benefit from a major change that was made available under tax reform.

Among the many changes made by the tax reform law enacted in 2017[2] was the doubling of the so-called lifetime gift and estate tax exemption from $5 million to $10 million.[3] This means that over the course of your lifetime you can give away more than $10 million to your children, other family members, trusts, and so on, free of any tax consequences. And if you're married, that amount rises to over $20 million.

[1] The Internal Revenue Service recently lowered the interest rates to be used in connection with certain estate planning transactions, including Grantor Retained Annuity Trusts, Sales to Intentionally Defective Grantor Trusts, and Charitable Lead Annuity Trusts.
[2] The Tax Cuts and Jobs Act of 2017. https://www.congress.gov/bill/115th-congress/house-bill/1/text
[3] This figure is indexed for inflation each year.

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But there's a catch: This tax benefit—the doubling of the exemption—is set to expire and return to $5 million in 2026. What's more, it's very possible that this reduction may be accelerated if there is a shift in political control following the 2020 election.

So it's important that you at least start thinking about whether to capitalize on this potential $20 million opportunity. And if you miss out, it can be quite costly: transfers above the exempt amounts are currently taxed at a hefty 40 percent tax rate.

Some gift and estate tax law basics

The federal government imposes three types of wealth transfer taxes:

1. Estate tax on transfers of property at death
2. Gift tax on transfers during your lifetime
3. Generation-skipping transfer (GST) tax on transfers made—during life or at death—to grandchildren or other individuals who are two or more generations below your generation.

There are, however, several exclusions and exemptions from these wealth transfer taxes.

Gift tax exclusion: You can make a gift of up to $15,000 per year[4] to as many people as you like without being subject to the gift tax. If it's a joint gift made by you and your spouse (for which a gift-splitting election is made), the gift amount can be $30,000 per recipient. Note that gift amounts that don't exceed the $15,000/$30,000 exclusion aren't counted against the lifetime exemption.

Lifetime gift and estate tax exemption (lifetime exemption): As noted above, the lifetime exemption allows you to transfer up to $10 million during your lifetime or afterwards without being subject to estate or gift tax. Because this amount is adjusted for inflation, for 2020 the exemption is $11.58 million for individuals and $23.16 million for couples. (A separate exemption of the same amount applies for GST tax purposes when a gift is made to grandchildren or trusts for their benefit.)

Is the time to act now?

If you are fortunate enough to be in the position to part with up to $11.58 million (or $23.16 million if you're married), you should be considering estate planning that will allow you to achieve your objectives from a tax and nontax perspective. By delaying, you run the risk of having the expanded exemption dropped back to $5 million ($10 million if married). And it's possible that this tax benefit could be lost even sooner through additional legislation depending on the outcome of the election this fall.

There are a number of lifetime giving options you can adopt:

Make direct gifts to your children or grandchildren: This is perhaps the easiest way to go about doing it. However, simply giving large sums of money to individuals who are not prepared or mature enough to handle it may have a host of potential drawbacks.

Establish and fund trusts for their benefit: A trust arrangement can allow you to retain some control over the assets used to fund it or allow the assets to benefit multiple generations. There are many different types of trust arrangements you can use, each with different tax and nontax implications. A trust arrangement can also provide significant state income tax savings in some situations if structured correctly. You should consult with an estate tax planning professional to discuss your options and determine which ones are more suitable for your financial situation and family dynamics.

Forgive outstanding loans to children or grandchildren: You may have made loans in the past to your children; for example, $500,000 seed money to start a business or $100,000 for a new home. Forgiving that debt is considered to be a taxable gift that counts towards your lifetime exemption (to the extent it exceeds the $15,000 annual gift tax exclusion).

[4] This amount is for 2020 and is indexed for inflation. Note: The annual exclusion is not available for a gift of a future interest.

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On the other hand

Here are some factors to consider before gifting property:

No step-up in basis: Assets gifted during your lifetime don't get the same "step-up" in basis to fair market value that applies to assets held until death. Instead, your beneficiaries or trust will take gifted assets with a carryover basis (e.g., generally, what you paid for them with some adjustments). So when they eventually sell the assets, they'll be subject to income tax on any gain over the carryover basis.

Death before sunset: If the donor dies before the expanded exemption amount ($10 million; $11.58 million as adjusted for inflation) sunsets at the end of 2025 (or earlier), then there was no real benefit to the gift giving planning in terms of the increased exemption. In other words, you would still have been able to benefit from the enhanced exemption at death. (However, there may have been other advantages to making the gifts during life rather than waiting until death.)

No sunset: The same applies if the sunset provision is extended or the federal estate tax is completely repealed, which remains a possibility depending on the impacts of politics.

Final word: better to be prepared

Despite the caveats in the above section, many wealthy individuals may benefit by at least exploring their options for employing the increased lifetime exemption. And the sooner you start, the better off you may be in light of the future expiration of the expanded exemption, the decline in some asset values, and the historically low interest rates currently allowed by the IRS for certain estate planning transactions.

Get more value out of your valuations

Knowing the factors that go into valuing a business or other assets is critical in helping to develop an estate planning approach that mitigates payment of unnecessary taxes. This is particularly important now, as many assets—whether marketable securities, collectibles, or an interest in a closely held business—have declined in value as a result of COVID-19.

By knowing the true value of your estate, and the potential estate tax consequences, you and your family can take steps to determine if there are sufficient funds available to pay the taxes and that no more is paid than required. For example, gifting assets with depressed valuations today that are expected to increase in value in the future can mitigate your potential estate and gift tax liability. At the same time, the related future income and appreciation is removed from your taxable estate, again mitigating any potential estate tax liability.

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Valuations: How, what, and why?

For gift and estate tax purposes, valuations are required to establish the worth of assets that are transferred (other than cash, of course). Some common, but potentially difficult to value, assets include business interests, certain public and private investments, real estate, and all types of personal property (e.g., jewelry, classic automobiles, art, and stamp and coin collections)

What is the fair market value of an asset? That generally is considered to be the price at which property would change hands between a willing buyer and a willing seller who are unrelated, under no compulsion to buy or sell, and who have reasonable knowledge of relevant facts.

On the face of it, this standard seems pretty clear cut. But in reality, it has led to many disputes between taxpayers and the IRS.

There are three basic approaches to valuing an asset:

Income approach: This is based on present value of future cash flows that an asset will generate over its remaining useful life.

Market approach: This reflects the price at which comparable assets are bought and sold.

Cost approach: This is the estimated cost to replace or re-create the asset.

The ultimate valuation of an asset may be based on one or a combination of all three approaches, and often depends on the nature of the asset being valued and availability of market data. For example, a market-based approach may be most appropriate when there are an ample number of comparable transactions available. On the other hand, an income approach may be more suitable when valuing a unique business with predictable cash flows.

There also are several factors that might reduce or "discount" the value of an asset. For example, if you're a minority owner of an asset or entity, then your lack of control or certain restrictions on transferability or voting rights would likely decrease the value of your share as compared to the majority owner's. A similar discount might apply if the asset, while potentially valuable, has similar restrictions or limitations on marketability (e.g., certain collectibles like art and antiques). Keep in mind that discounts can be subjective and can have a wide range, depending on the nature of the asset.

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Working with an appraiser can be beneficial

Because valuation of assets—particularly when it comes to business interests—can be difficult, controversial, and lead to IRS inquiries, families with significant wealth may benefit from using a third-party valuation specialist. It may be particularly important to consider using the services of a qualified, independent appraiser now given the current economic uncertainty and added complexity for valuations as a result of COVID-19.

The person or firm selected should, among other attributes:

- Have the qualifications and experience to value your particular assets (e.g., if a business, the appraiser should be familiar with ownership structures and the potential impact of control restrictions)
- Be independent and objective
- Be familiar with relevant appraiser practices and court/IRS decisions.

Having an independent specialist weigh in on the reasonable value of a business or other assets can help you better understand those values and, potentially, the more suitable estate planning approaches to employ. In addition, a third-party appraiser's opinion may be more credible than your own in the event the IRS decides to take a look at your tax returns and challenge the valuations. Similarly, basing your valuation on a third-party specialist's opinion can bolster an argument for waiver or reduction of potential IRS penalties.

Family succession planning is about more than just taxes

Tax considerations are clearly an important aspect of estate planning and wealth transfer considerations. But for high-net-worth individuals and families whose wealth has been built on the foundation of a family business, taxes are only one consideration, and not necessarily the most important one.

Family succession planning can be a difficult topic to address as you're dealing with issues of mortality. But it's a necessary one since it can involve assets that potentially can help support multiple generations. This is why the process is often referred to as family continuity planning rather than estate or succession planning.

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Consider the assets and the people

Leading family continuity plans take into account both the assets as well as individual family members. Making an accurate accounting of your assets is necessary of course. But it's also critical to take a long, hard look at your family members—their strengths, weaknesses, capabilities, and idiosyncrasies—in order to help determine that your approach accomplishes what you intend.

Maybe you want to take steps that increase the likelihood your family business continues to be run successfully for generations. Maybe you feel that one child needs extra assistance—or motivation. Perhaps you're concerned that certain items—jewelry, antiques, heirlooms, residences—go to one family member rather than another.

Gather the family: Because of the stakes involved, especially when a family business is part of the picture, involving your family members in the decision-making-process can, although potentially challenging, be helpful and productive. It can also help avoid misunderstandings and possibly costly litigation down the road. These discussions may not always be easy ones, but getting the "stakeholders" to buy in ahead of time can go a long way to contributing to a successful family continuity plan.

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Checklist of critical questions

When you sit down—alone, with your family members, and/or with an estate planning professional, here are some questions to ask:

- What assets do you currently own? How might this change in the future?
  - If the foundation of your wealth is a family-owned business, are there structures in place to support the founder's retirement when ownership is transferred to another generation or sold to a third party?
  - Has COVID-19 altered the outlook for the business? If so, what course of action should you take?
  - Who is more suited to manage and control the assets, particularly if a family business is involved?
- Do you have shared family values or a sense of purpose for your wealth?
  - Are you or your family members involved in philanthropy/charity, and to what extent?
  - Does this factor into the succession or continuity plan? For example, would you consider establishing a foundation or a charity?
- How does your thinking about succession planning align with your family members' current expectations?
  - A family sit down can be beneficial in setting expectations and avoiding future surprises that can lead to litigation.
- What are your views about passing significant assets and wealth down to younger generations?
  - At what age are family members likely to inherit, and what do you want them to receive?
  - Do you want to place some structure and restrictions on their inheritance (e.g., through trust arrangements)? Or are you willing to pass on assets with no restrictions, and have beneficiaries learn lessons from the mistakes they may make?
- Who's dependent on the family's wealth to support their lifestyle? To what extent are they dependent on it?
  - Are you willing to support a family member's lifestyle indefinitely or do you want to impose some limitations that can influence their behavior (e.g., go to college, seek employment)?

Final thought: Professional help can be beneficial
COVID-19 has affected all aspects of life; however, and particularly for wealthy families, there are certain persistent issues that need to be addressed. Estate (and succession) planning is one of them. And for high-net-worth individuals, a simple, do-it-yourself approach may not be the answer.

You should consider knowledgeable advisers—estate planning, valuation, and tax—who are going to collaborate and work as part of a team. They'll have the knowledge and means to assemble a complete balance sheet of all of your assets and calculate the true value of your wealth. Then they can help you design a family continuity plan that delivers on both your financial and nonfinancial objectives.

They can help you and your heirs plan for and pay no more in federal or state gift and estate taxes than necessary. Finally, they will be able to guide you on modifying your family succession plan based on on changing tax laws and regulations as well as changing family dynamics, both of which can be complex and unexpected.

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