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Sentinel Trust

Together, families prosper℠

OnWatch

In This Issue:

GRATuitous Transfers

"In the middle of difficulty lies opportunity"
— Albert Einstein

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What Einstein actually said was, "Out of clutter, find simplicity. From discord, find harmony. In the middle of difficulty, lies opportunity." We think he meant that when you face a set-back or problem, find an opportunity and learn from the experience. Markets in recession are a set-back, but they also present some unique estate-planning opportunities. One example is the Grantor Retained Annuity Trust (GRAT).

It may sound complicated, but it actually is a pretty simple technique. Generous Mom transfers property (often marketable securities) into an irrevocable trust for a specific period of time. During that time, the trust must pay her an annuity, which is a stream of fixed (usually annual) payments. To avoid a gift tax, the present value of the payments must be set to equal the initial value of the contributed property. "Present value" is a function of the current interest rate and the number of payments.

For example, assume Generous Mom creates a GRAT in April 2020 and makes a gift to it of $10 million of marketable securities. If she retains a 10-year annual annuity of about $1.1 million, the value of the annuity "zeros out" the $10 million gift. There is no gift tax or use of her lifetime gift/estate tax exemption at inception. Whatever is left in the GRAT after all payments have been made to Mom passes to the children with no gift tax. If the GRAT earns 5% on the securities, there will be over $2.4 million left for the kids. If the GRAT earns 8% annually, $5.6 million passes to the kids with no gift or estate tax!

Markets in recession may be a set-back, but they provide two things that make GRATS work very well:

- Low interest rates, which translate into relatively low annuity payments required to avoid gift tax, and

About Sentinel Trust Company

Sentinel Trust Company, LBA is an independent wealth management firm and multi-family office that provides comprehensive wealth and succession planning, fiduciary, investment management, philanthropic, and family office services to a select group of affluent families and their closely held entities and foundations. Founded in 1997 as the successor to two 40-plus-year old single-family offices, Sentinel Trust currently serves more than 30 multi-generational families nationwide and is responsible for approximately $4.2 billion in assets as of December 31, 2019.

Learn more at
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- Low asset prices, which translate into greater future appreciation potential, thereby maximizing the opportunity for future wealth transfer at the end of the GRAT.

If the assets don't increase in value as expected, there may be nothing left for the kids because all of the GRAT's assets wind up being used to pay the annuity to Generous Mom. That sounds bad, but actually it's more like nothing ventured, nothing gained. For the tremendous potential benefits discussed above, the only costs were the hassle and expenses to create and administer the GRAT.

Valuation Costs

There are some special concerns and possible problems Generous Mom must keep in mind. For example, it is very important to properly determine the value of the property contributed to the GRAT. That value is used in determining the amount of the gift, which in turn is reduced by the present value of the annuity. This is easy if Mom contributes marketable securities, but if she contributes closely held stock (or other nonmarketable assets), she will need an appraisal prepared by a valuation professional. That adds to the cost of creating the GRAT.

The annuity can be paid "in kind," meaning it can be paid using assets other than cash. However, if shares of closely held stock (or other hard-to-value assets) are used, another appraisal will be needed to determine how many shares equal the required annuity value which means more costs to use the GRAT strategy.

Death and Taxes

If Generous Mom dies before the annuity payments are complete, the GRAT's remaining assets are included in her estate, potentially subject to estate tax. That defeats the GRAT's purpose of avoiding gift tax. But again, nothing ventured, nothing gained.

GRATs aren't very useful for transferring wealth to grandkids. The reason is that anything passing to grandkids at the end of GRAT becomes subject to generation skipping tax, although you may have exemption available to reduce or eliminate that tax.

A Longstanding Technique

GRATs aren't a new idea. The most generous mom may have been Audrey Walton, Sam Walton's sister-in-law. She set up GRATs for her daughters funded with $100 million worth of Wal-Mart stock. The IRS took issue with her attempt to "zero out" the $100 million gift. Mrs. Walton prevailed in a Tax Court decision all the way back in December 2000.

GRATs work best when you expect substantial appreciation, like in anticipation of a private company's initial public offering (IPO) or sale. For example, Mark Zuckerberg famously put pre-IPO Facebook stock into a GRAT in 2008 for children he didn't yet have. Eric Friedman, a co-founder of Fitbit, reportedly put 2.4 million shares of that company into a GRAT before the company's IPO in 2015.

Not everyone needs a GRAT, of course. The current lifetime exemption from estate and gift tax is roughly $11.5 million per person; a married couple can give $23 million to descendants without any complex planning. However, that high exemption is scheduled to be dramatically reduced for people dying after 2025. Many states also impose their own death taxes with much lower exemptions.

As with all things tax (or just all things, really) change is constant. Congress has been eyeing GRATS for years and proposals have been made to dramatically reduce the benefits of GRATs. So, we have a perfect confluence of events to consider GRATs: markets are down, interest rates are low, and the tax law is favorable.

Despite starting this article by quoting Einstein, GRATs aren't rocket science but they can be tricky. So a final word of caution: Don't try this at home alone. A GRAT should be prepared by an estate planning attorney working with your CPA, investment advisor, professional trustee, and perhaps an appraiser. Your team will choose the assets, make the calculations, draft the terms carefully, and provide flawless administration. ■

Roth Conversions
IN TODAY'S MARKET ENVIRONMENT

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Current low tax rates, the potential for higher rates in the future, and depressed market values make now a better time than ever to evaluate planning options for retirement accounts. One of those options may be to convert part or all of your traditional IRA to a Roth IRA. Let's dive in and take a look at some of the things to consider.

IRA Basics

Traditional and Roth IRAs have many similarities, the most powerful of which is that income and gains are not taxed in either account. However, there are some key differences:

Traditional IRA

- Contributions are generally deductible
- Distributions are taxable as ordinary income
- Owners are required to start taking distributions at age 72

Roth IRA

- Contributions are not deductible
- Qualified distributions are income-tax free
- The contributing owner is not required to begin taking distributions at any particular age

What is a Roth conversion?

A Roth conversion is simply taking all or part of the balance of your traditional IRA and moving it over to a Roth IRA. By doing so, you will pay ordinary income tax on the fair market value of the cash and securities that you convert just as you would if you took a distribution while in retirement. The benefit is that future distributions (including post-conversion income and appreciation) made to you and those who inherit your Roth IRA will be income-tax free.

Importance of Tax Rates

The starting point for any conversion evaluation is current and anticipated tax rates at the time of future distributions. The ideal scenario is lower tax rates at the time of conversion than at the time of distributions. The following rate-related considerations favor conversions:

- Historically low tax rates and wide tax brackets exist today and through 2025 (at least as the tax law currently reads).
- Beginning in 2026 (under current tax law), rates increase significantly and the amount of income taxable in the lower rate brackets decreases substantially.

- A change in control of Congress and/or the presidency to Democratic leadership could result in dramatic increases in tax rates, potentially much sooner than 2026.
- State tax rates are important to the analysis. Moving, whether to or from a high-tax state, can significantly impact the analysis.
- High budget deficits (of both the federal and state governments), including those resulting from the current coronavirus pandemic, can create additional pressures for tax rate increases.

Be sure to consider your current federal and state tax rates as well as possible future tax rates of both you and potential inheritors of your IRA. Note that people with erratic income might benefit from partial conversions in low-income years to use the low brackets.

Other Considerations

The currently depressed market environment also suggests that now might be a good time for a Roth conversion. The reason is that a lower IRA account value means a) less income to recognize and tax to pay on the conversion and b) greater potential for future appreciation that will be income-tax free when subsequently distributed from the Roth IRA.

It always is best to use non-IRA funds to pay the income tax on the conversion; don't hold back part of the distribution for that purpose.

Of course, conversions are not right for everyone. For example, if you plan to contribute your traditional IRA to charity (whether through the $100,000 annual-distribution-to-charity rules or by bequest at death), you may never pay any income tax on it – that's the best of all worlds!

There is both science and guess work in the conversion analysis. Given the unpredictability of future tax laws, investment markets, and personal situations, some of our clients have chosen to hedge their bets by converting only part of their traditional IRAs into Roth IRAs. Some are planning a series of conversions over coming years. Everyone is different, so it's best to discuss the pros and cons with your tax and investment professionals.

Can we talk?

This phrase is probably not how you expect us to begin a communication. It feels more like an opening line to a "relationship" conversation, doesn't it? But we've spent some time recently worrying about what you are worrying about. After all, "investment" and "interest" are financial terms, but they also are relationship terms. And financial communications, like relationship communications, are most effective if both parties talk and both listen.

In this issue of *OnWatch,* we've chosen articles on a variety of topics we believe will be interesting, useful, and relevant. Unlike the many "canned" newsletters offered by others, *OnWatch* is made from scratch and written by our own team members. We address practical topics that might not be in other publications. In this edition, we focus on planning opportunities created by the current depressed markets.

We want to know what's on your mind. So, if there is something you would like to see addressed in future editions, please let us know. Share, and we'll see if we can help.

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Intra-Family Loans in a LOW-INTEREST-RATE ENVIRONMENT

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Vice President

At a time when market turmoil has caused us to feel anxious, dismayed and uncertain, there is a silver lining. With interest rates at historic lows and asset values arguably depressed, intra-family loans should be considered as a viable wealth-transfer planning strategy.

What are Intra-Family Loans?

An intra-family loan is simply a loan of cash from one family member (usually a senior-generation member) to another (usually a younger-generation member). If the borrower can invest the funds and earn a higher rate-of-return than the interest rate on the note, he makes money. Conversely, the lender benefits only from the interest. Absent the loan, the lender might have invested in high-return assets. So, the lender can be viewed as shifting wealth equal to the excess investment return to the borrower. That shift is generally gift-tax free.

However, if the loan is interest free, the IRS will view the foregone interest as a taxable gift. You can avoid the gift by charging a minimum interest rate known as the "Applicable Federal Rate" (AFR), which is set by the IRS each month. The AFR varies based upon the duration of the loan and the frequency of interest-rate payments (or compounding). For example, for loans made in April 2020 that require annual interest payments, the AFRs are as follows:

- Short-term AFR (loans of 3-years duration or less) - 0.91%
- Mid-term AFR (loans between 3- and 9-years duration) - 0.99%
- Long-term AFR (loans greater than 9-years duration) - 1.44%.

How Does it Work?

Let's look at an example. Suppose Parent is planning to invest $10 million in a portfolio of assets expected to generate a 5% annual investment rate of return. Instead, Parent loans the $10 million to Child for 5 years (interest compounded annually) at the mid-term AFR of 0.99%. Assume Child invests the funds in the same portfolio of assets. At the end of 5 years, Child will have $12,762,816 and will owe Parent $10,504,899, resulting in the equivalent of a gift-tax-free transfer of $2,257,917.

The wealth transfer benefit only occurs if Child invests at a higher rate of return than the interest rate on the loan. If the investments turn out badly, or Child spends the money, the loan still must be repaid. A more sophisticated approach involves Parent loaning the money to a trust rather than directly to Child. Consult your financial and tax advisors for additional considerations.

With interest rates depressed, a loan can substantially "freeze" the value of a portion of the senior generation's wealth and shift upside investment opportunity to the younger generation. With investment markets at depressed levels, now could be a great time for using low-interest loans to shift wealth gift-tax free.

Sentinel Trust Company is a family-owned, multi-family office focusing on the unique needs of affluent families and their closely held companies and foundations. Sentinel Trust provides advice on investment, tax, and estate strategies, serves as corporate trustee, and provides lifestyle services with a personal touch.

Together, families prosper SM

Founded in 1997 as the successor to two established, investment-focused single family offices, Sentinel Trust offers the stability of an institutional firm, the entrepreneurial spirit of a young firm, the personal feel of a family office and the in-house technical skills of independent planning and investment management firms.

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