March 5, 2021

Estate Planning in Uncertain Times

By Mitch Miller, John Collins, Jamie Carter and Joe Collins

With the Senate controlled by Democrats, Congress may propose major changes to the estate and gift tax rules soon. The changes could reverse parts of the Tax Cuts and Jobs Act of 2017 ("TCJA") passed early in President Trump's term. Some of the changes proposed by President Biden are: (1) restore the estate and gift tax exemption rates to 2009 levels ($3.5 million estate tax exemption and $1 million gift tax exemption, and maximum tax rate increased from 40% to 45%) and (2) eliminate basis step-up for inherited assets.

The current gift and estate tax exemption is $11,700,000 per person ($23,400,000 for a married couple); these amounts reflect increases from $5,000,000 per person in 2017 as part of TCJA and are scheduled to revert to about $6,000,000 per person in 2026 if no other action is taken by Congress.

Historically, changes in our tax laws have become effective either on the date the law passes or the date the proposal was filed, but there are no constitutional prohibitions against Congress making changes retroactive to January 1, 2021. Although many commentators believe that such legislation will become effective upon becoming law or at the start of 2022, there is no guarantee that a gift made in January of 2021 will not result in gift tax if the amount exceeds the donor's revised gift tax exemption as established in that legislation.

For clients who want to take advantage of their current gift tax exemptions but mitigate the risk of a retroactive application of a reduced exemption amount, there are some transactions they can consider. In addition, there are other estate planning transactions that can be used to reduce, freeze, or control the growth of their estates.

1. Gift by a Spouse to a Trust for the Other Spouse.

You could transfer assets to a trust for the benefit of your spouse and retain flexibility to (1) apply your gift tax exemption to the gift (so the trust will not be taxed when you die nor will it be taxed when your spouse dies), or (2) elect to treat the trust as a marital deduction trust, so that the gift is not treated as a taxable gift now (for example, because the gift tax exemption has been substantially reduced on a retroactive basis), and in that event the trust will be subject to estate tax when your spouse dies. Making a gift to this kind of trust provides you with several choices:

(a) If it does not appear there will be a retroactive decrease in the gift tax exemption, your spouse could execute a "disclaimer" within nine months after the date the trust is established, and the trust assets would then be held in a trust that could benefit your children; or

(b) If there is still no clarity within nine months after the gift, the time for making a disclaimer would pass, but you will still have the opportunity to decide to treat the gift as a marital deduction gift when you file your gift tax return in 2022, by which time we should know whether there was a retroactive reduction in the exemption. In fact, by extending your income tax return and gift tax return, that decision could be made as late as October of 2022 (assuming extensions have been properly filed).

2. **Riskier Planning; Formula Gift Tied to Exemption**.

If you think Congress will not be able to be to pass any significant tax reform legislation that will be effective January 1, 2021, you may want to take advantage of the current exemption amount of $11,700,000 per person, by making gifts now. Since there is still a risk of retroactive application of the exemption reduction, such a gift should be a "formula" gift, which states that you are making a gift (to children, to a trust for family members, etc.) of an amount up to the maximum gift tax exemption you have available on the date of the gift, including any legislative changes with retroactive effect. If legislation passes that reduces the exemption retroactively, the amount in excess of the new exemption amount could pass to a charity (including donor-advised fund), or to a marital deduction trust for your spouse, or to a grantor retained annuity trust.

To maximize the value of your gift exemption, you could make gifts of business interests or other assets with the potential for appreciation to a trust for children and grandchildren for which you would pay all income taxes of its income (a "grantor" trust). If you want to retain a right to access trust assets in the event of an emergency in the future, you could consider making such a gift to a Spousal Lifetime Access Trust ("SLAT"), which benefits your spouse and descendants.

3. Annual Gifting.

The annual gift tax exclusion of $15,000 per donee is unlikely to change.

4. Loans.

Considering the current low-interest rate environment, a loan to family members or trusts can effectively "freeze" the value of part of your estate. The minimum interest rate ("AFR") for short-term loans in March is 0.11% (up to 3 years), the mid-term AFR is 0.62% (between 3 and 9 years), and the long-term AFR is 1.62% (greater than 9 years).

a. **Intra-Family Loan**. If your liquidity permits, you may consider making a low-interest loan to your children, to a trust for your children, or to a business owned by your children. The children will have all of the risk and reward on the investment of the funds, with a very low annual interest payment.

b. **Loans or Sales to Grantor Trust**. In brief, a "grantor trust" is a trust in which you (the grantor) have retained certain powers which cause you to be treated as the "owner" of the trust property for income tax purposes, and, therefore, responsible for the taxes associated with the property owned by the trust. These trusts may be used to purchase other assets (which have appreciation potential) from you in exchange for a note at the preferred AFR. Because the trust is treated as if it is owned by you, the sale will be ignored for income tax purposes, as will the interest payments; for purposes of the gift tax, however, if you sell the property to the trust for its full fair market value, you will not be treated as having made a gift. As you are taxed on income or gain on the assets owned by the trust, your estate is reduced, while effectively making a tax-free gift to the trust beneficiaries.

5. **GRAT**.

A variant of the sale to a trust is the grantor retained annuity trust ("GRAT"). The GRAT works well in a low-interest rate environment because a GRAT is successful if its assets appreciate at a rate that exceeds the discount rate applied in determining the present value of the annuity (currently that rate is .80%). GRATs can be effective at transferring wealth without gift tax to children, but is not effective for avoiding the generation-skipping transfer tax for grandchildren.

You would establish and fund a trust in exchange for a “fixed” amount that is payable to you at least annually over a term of years. Because the trust is typically a grantor trust, it enjoys the same benefit of the settlor paying tax on income or gain. The amount of the gift is determined by subtracting the value of the retained annuity interest from the fair market value of the assets transferred to the trust; the value of the gift can be negligible (a few dollars) or more sizeable if you want to use some of your gift tax exemption. One advantage of the GRAT is that a challenge by the IRS on the valuation of the amount contributed should only require an increase in the retained annuity, not payment of gift tax.

6. **Corporate Transactions**.

In appropriate circumstances, certain business transactions may be utilized to shift appreciating assets to the younger generation. For example, if a corporation, a partnership, or a limited liability company is engaged in two or more lines of business, it may be possible to separate the lines of businesses on a tax-deferred basis by distributing to the younger generation the faster-growing line.

Alternatively, a parent-owner may reduce his or her interest in a business—e.g., by a partial redemption or liquidation—such that the owner is no longer in a position to control such business, or to block action by other owners, which reduces the value of the retained interest.

7. **Potential Further Regulations Under New Administration**.

(a) Attack on Discounting Gifts of Business Interests. Some commentators expect the reintroduction of the 2016 proposed changes to the valuation rules applicable to transfers of interests in a closely held business, which were subsequently withdrawn by the Trump administration. As originally drafted, the regulations were overbroad (e.g., the regulations treated investment entities the same as operating businesses).

(b) Other Proposed Transfer Tax Reforms. Among potential gift and estate tax reforms that have been discussed over the past 5-10 years are the following: (i) requiring a minimum term (10 years?) for a GRAT (reducing the benefits of such trusts)); (ii) requiring a minimum value for the remainder interest of a GRAT that is taxed as a gift (thereby eliminating tax-free GRATs); (iii) eliminating (at least in part) the inconsistent treatment of transactions involving irrevocable grantor trusts for income tax vs estate and gift tax purposes (for example, sales to grantor trusts); and (iv) limiting the use of dynasty trusts, e.g., by applying the generation-skipping transfer tax after a specified number of years.

If you want more information on any of these techniques, you should consult your tax advisor.

Contacts:

Mitch Miller

John Collins

Jamie Carter

Joe Collins