2020 Estate Planning Challenges & Opportunities

Speakers:

Carlyn S. McCaffrey & Jonathan G. Blattmachr, Esq.

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Introduction & Overview

Planning in the Current Environment

Introduction

- Since 1976, when estate tax rates were 77% (on amounts above $10 million) and the exemption was $60,000, the effective impact of wealth transfer tax has been significantly eroded with an exclusion now over $11 million (until 2026) and tax rates no higher than 40%.

- The unlimited marital deduction has also reduced taxation; the income tax free “step up” in basis is allowed at the death of a decedent even if all of the decedent’s assets pass tax free to a spouse.

Introduction

- The Federal Government is likely to seek to raise taxes to avoid incurring further debt to pay for the economic cost of the COVID-19 epidemic, to boost the economy and to meet other needs (e.g., climate change).
- If this occurs, wealth transfer taxes may be increased.

More Background

- Columbia Law School professor George Cooper wrote in his 1977 book “A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance” that the US estate tax is voluntary and need not be paid by those who engage in proper planning.
- Although Professor Cooper overstated the case, it is true that attempts to close certain planning techniques, such as the enactment of Section 2702, have actually produced more estate tax erosion.
- Wealth transfer taxation seems ripe for reform.
- This webinar will provide an overview of strategies that clients should consider implementing now before the tax planning landscape is changed.

Current Planning Environment

- **Uncertain Economy**: Second quarter US 2020 GDP was down 32.9% following a 5% decline in the first quarter. Although the S&P 500 Index as of October 2nd, is up year to date by more than 3.5%, the increase does not reflect a vibrant economy. Its rise has been fueled largely by tech stocks, which comprise about 25% of the index. The prices of tech stocks have increased by more than 34% year to date, while energy stocks have declined by more than 40% and financials by more than 17%. Discount rates used to value closely held interests may be higher because of economic uncertainty.

- **Interest**: Interest rates are at historic lows (the Section 7520 rate for September 2020 is .4%). Family loans, note sale transactions, and GRATs are techniques that work well when interest rates are low.

Current Planning Environment

- **<u>Deficits and Taxes</u>**: The massive federal bailout may eventually require that taxes on the wealthy (and the not-so-wealthy) be raised. While tax law changes are not predictable, the transfer taxes seem a logical target.

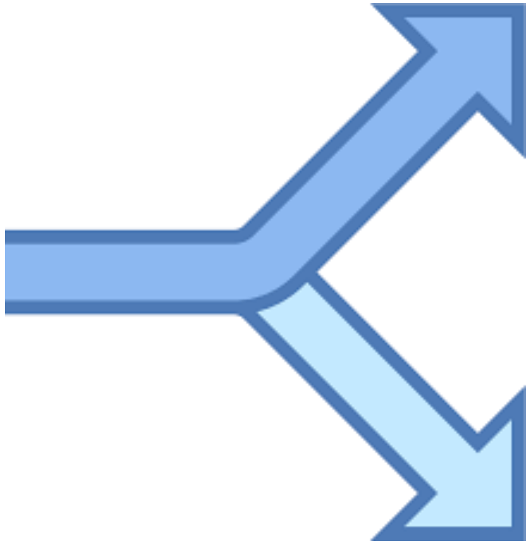
- Changes could include, a decrease in the exclusion amount, an increase in tax rates, tax recognition at death, and an end to planning with GRATs.

- Transferring assets now using current favorable laws, gifts, protected by the large exclusion amount, sales to grantor trusts, GRATs, etc., may prove advantageous.

Some Recent Proposals

- **Reduce the Wealth Transfer Exemptions:** Maybe $3.5 mm for estates and GST purposes and $1 million for gifts.
- **Increase in Rates**: No set cap.
- **Eliminate GRATs:** Require the value of the (taxable) remainder be at least 25% of the value of property added to the trust; requiring the annuity term be at least ten years limiting how long they may last.
- **Limit How Long GST Exemption Trusts May Last:** Maybe 50 years.
- **Expand Family Attributes to Minimize Valuation Discounting:** Uncertain what this would be and whether it is constitutional.
- **Eliminate Step Up in Basis at Death:** Could be carryover basis, gains tax at death (like Canada) or having inheritances included in income. (New life for life insurance?)
- **Include Grantor Trusts in the Grantor's Estate**: This could be very far reaching as likely most sophisticated estate tax arrangements use such trusts.

Options for Action Now



- Use current $11.58 million exclusion amount and possibly make gifts subject to gift tax.
- Implement endangered techniques that permit gift tax free transfer of future investment return such as Grantor Retained Annuity Trusts and Split Purchase Annuity Trusts.

The Basics

Methods of removing existing wealth from the transfer tax base:

- Outright gifts
- Gifts to grantor trusts
- Transfers of fractional interests in property
- Sales of assets for lifetime annuities

The Basics

Methods of removing future wealth from the transfer tax base:

- Transfers of property expected to produce a significant investment return
- Loans at low interest rates
- Use of devices that permit shift of future investment return on retained assets

Gifts

- Gifts in 2020 by donors who have not used their exclusion amounts should enable them to preserve the advantage of the current high exclusion amount even if it is reduced next year.

- Gifts in 2020 of appreciated property will also avoid the risk of future treatment of gifts of appreciated property as recognition events.

The Possible Downside of Gifts

- Depending on future circumstances, gifts in 2020 could result in higher future taxes.
- Loss of access to and control over gifted property.

Gifts

Three possible negative consequences:

- The value of the gifted property could decline.
- Gift of appreciated property could fail to appreciate sufficiently to offset disadvantage of loss of basis step up at death.
- New York domiciliaries who die within 3 years of making their gifts may pay higher combined estate taxes.

Gifts

Guarding against the potential negative consequences:

- Disclaimers
- Gifts to trusts eligible for a QTIP election
- Use of power to grant testamentary power of appointment to grantor

Gifts:

Retaining possible benefits from gifted property:

- The intentionally defective preferred interest
- Spousal Lifetime Access Trusts
- Domestic Asset Protection Trusts
- Hybrid Domestic Asset Protection Trusts
- Special Power of Appointment Trusts

Gifts

Making gifts without parting with assets:

- Gifts made with borrowed funds
- Gifts of promises to make gifts

Gifts Made With Borrowed Funds

- Donors without assets they are willing to part with or with only high basis assets could borrow funds to use to make gifts.
- In today's low interest rate environment, loans are not costly.
- In some cases, donors will be able to borrow from trusts of which they are beneficiaries.

Gifts of Promises to Make Gifts

- An enforceable promise to make a gift not based on adequate and full consideration in money or money's worth is treated as a taxable gift.

- If not paid before death, no estate tax deduction will be permitted but Rev. Rul. 84-25 will remove the promised amount from the promisor's adjusted taxable gifts.

- Donor of enforceable promise to make a gift should not split gift with spouse in year of gift

Shifting Future Investment Returns

Devices that permit shift of future investment return on retained assets:

- Grantor Retained Annuity Trusts
- Split Purchase Annuity Trusts

The Intentionally Defective Preferred Interest

- A donor can create an entity that has preferred interests that are not compliant with Section 2701 and participating interests.

- If the donor gifts or sells the participating interests to a trust for the donor’s children, the donor will be treated as having made a gift of the value of the retained preferred interest without parting with any actual interest.

The Intentionally Defective Preferred Interest

- If the donor retains the interest until death, its value will be included in the donor's gross estate. Reg. 25.2701-5 will permit the estate to reduce the estate tax base by the value on the donor's prior gift that was attributable to the application of Section 2701.

Dual SLATs – Spousal Lifetime Access Trusts

Benefitting Each Spouse Without Creditor Issues or Estate Tax Inclusion

Dual SLATs: How They Work

- Each spouse creates a trust for the other spouse, avoiding state law creditor and tax Reciprocal Trust Doctrines.
- This occurs by making the trusts sufficiently different so the doctrines will not apply.
- The trusts can be created at different times, with different assets and trustees, and with very different terms.

SLATs: How to Make Them Work

- In one trust, the beneficiary spouse can be entitled to distributions each year, have a lifetime broad special power of appointment, can change trustees (within Rev. Rul. 95-58 safe harbor), withdraw under HEMS.

- In the other trust, the beneficiary spouse would have no entitlement to distributions (perhaps, not even current beneficiary status), no power to change trustees, and no power of appointment, but could become eligible to receive a distributions only upon exercise by a trusted child of a power to add beneficiaries.

- Do not let child know of her right to receive distributions until after trust is created.

DAPTs – Domestic Asset Protection Trusts

No Longer Void Everywhere in the US

DAPTs: What They Were

- General rule throughout the US before 1987: any trust from which a distribution could be made to the Grantor by the Trustee is considered “self-settled” and the trust property was permanently subject to the claims of the Grantor’s creditors regardless of the motivation for creating the trust. It is just a rule.

- New York EPTL 7-3.1 says “A disposition in trust for the use of the creator is void as against the existing or subsequent creditors of the creator.”

- Section 548(e) of the US Bankruptcy Code pulls into the bankruptcy estate any self-settled trust or similar device if it was created to hinder, delay or defraud a creditor and bankruptcy is commenced within ten years of funding.

DAPTs: What They Are Now

- Alaska enacted AS 34.40.110 providing complete asset protection for a self-settled trust if the Grantor was not trying to defraud a known creditor (plus other requirements).
- Now nineteen states protect self-settled trusts from claims of the Grantor's creditors.
- Does this work in other states? It's not certain, but likely if all "Ps and Qs" are followed—e.g., all persons and assets involved are in a "DAPT" state.
- The trust should be excluded from the Grantor's gross estate if the gift to the trust is complete. See Rev. Rul. 76-103, Rev. Rul. 2004-64, and PLR 200944002 (not precedent). This may provide a complete "bullet proof" reason for creating the trust.

Hybrid DAPTs – A DAPT Without a Grantor as Beneficiary

Improving the Odds of Protection

Hybrid DAPTs: What They Are

- A DAPT created for other family members (e.g., Grantor's spouse and descendants) but with some ability to add the Grantor in as a beneficiary.
- The power to add can be conditional on the passage of time (e.g., only after 10 years in an attempt to avoid Bankruptcy Code 548(e), or when grantor is not married and living with another as the Grantor's spouse).
- Does it work? *Iannotti*, 725 NYS 2d 866 (2001) suggests not if the person who can add the Grantor (e.g., Trust Protector) is acting under a fiduciary duty.
- If you try this, make sure the person who can add is not acting under a fiduciary duty.

SPATs – Special Power of Appointment Trusts

A Safer Form of Domestic Asset Protection Trust

DAPT and Hybrid DAPT Limitations

- DAPTs are self-settled trusts, potentially subject to claims of the Grantor's creditors, if the Grantor lives in a state which does not permit DAPTS and therefore potentially subject to estate tax.

- So why not avoid using a self-settled trust, which is a trust from which the trustee can make a distribution to the Grantor?

- Instead create a trust for the Grantor's family that prohibits the trustee from ever making a distribution to the grantor or "Decanting" to a trust of which the grantor is a beneficiary.

SPATs: Safer for Asset Protection and Estate Tax Exclusion

- One or more individuals, who are not beneficiaries, are granted special “collateral” lifetime powers of appointment, which can be exercised in favor of members of a class that includes the Grantor (such as descendants of the Grantor’s mother).
- Make the power exercisable only with the consent of a trusted third party (e.g., the client’s lawyer or cousin).
- Exercise should be made outright only and occur only if the Grantor has a need.

GRATs – Grantor Retained Annuity Trusts

How They Work In Low-Rate Environments

GRATs: What and When Useful

- Background: Under Section 2702 a retained interest in a trust, or a split purchase, has zero value if family members hold the remainder interest.

- A special rule (not an exception) applies if the retained interest is an annuity, resulting in grantor retained annuity trusts (“GRATs”).

- GRAT downside: (1) no GST Exemption leverage, (2) some estate tax inclusion potential (difficult to use for client with short life expectancy).

GRATs: What and When Useful

- Good news: low Section 7520 rates mean high value for the retained annuity interest, so a lower taxable gift.

- GRATs work only when the return is greater than the Section 7520 rate.

- Typical structure: Short-term Rolling GRATs. However, these could be effectively "outlawed" by requiring a minimum 10-year term and a gift of at least 25% of the value contributed to the GRAT.

GRATs: Should Structure Change?

- Consider whether longer term GRATs should be used instead of short-term.
- Consider laddered GRATS (e.g., 4, 6, 8, and 10 year)
- Will GRATs provide asset protection? Choose the jurisdiction carefully.
- Consider asset splitting GRATs, each started at a different date, with different duration, different annuity retention, and different remainder beneficiaries.

Illustration of a Successful 99 Year GRAT Continued

- Client funds GRAT with $ 1 Million when the Section 7520 rate Is .4% to pay $12,250 a year to the client or her estate for 99 Years. The value of the remainder Is nearly zero
- When the client dies, the amount included in her estate Is the lesser of the value of the trust or the $12,250 divided by the Section 7520 Rate In effect when she dies.
- Client dies when the Section 7520 Rate is .4 %. The amount includible is no more than $12,250/.004 ($3,062,500) or the value of the trust If less than that.

Illustration of a Successful 99 Year GRAT

- Client dies when the Section 7520 Rate Is 5%. The amount Includible is \$12,250/.05 (\$245,000) or the value of the trust If less than that).
- Client dies when the Section 7520 Rate Is 10%. The amount includible is \$11,000/.1 (\$122,500) or the value of the trust If less than that).
- If the Section 7520 Rates increase before death, the client could sell her annuity interest (without gift tax) for its then value. If she lives for at least 3 years after the sale, no portion of the GRAT should be included in her gross estate.

Split Purchase Annuity Trusts

How and When They Can Work

Split Purchase Annuity Trusts

- Background: Under Section 2702 a retained interest in a trust, or an interest in an asset acquired in a split purchase, has zero value if family members hold the remainder interest.

- A special rule (not an exception) applies if the retained or acquired interest is a qualified annuity within the meaning of section 2702.

Split Purchase Annuity Trusts

- GRAT downside: (1) no GST Exemption leverage, (2) some estate tax inclusion (difficult to use for client with short life expectancy).

- Good news: low Section 7520 rates mean high value for the retained annuity interest, so a lower taxable gift.

Split Purchase Annuity Trusts

- GRAT estate inclusion risk can be avoided through a Split Purchase Annuity Trust.
- Client and a GST-exempt trust enter into an agreement by which client purchases an annuity for life (or a term of years) in an asset, and the GST-exempt trust purchases the remainder interest in the asset.
- Values are determined by standard actuarial tables meaning there is no gift if the underlying property is correctly valued.
- Because the Section 7520 rates are low, the client pays a significant amount for the annuity interest.

Split Purchase Annuity Trusts

- Can be used for clients with short life expectancy (if death is not imminent).
- No estate tax inclusion.
- GST exemption can be leveraged.
- Cannot “zero-out” the value of the remainder if annuity is retained for life.
- Value of the retained annuity will drop as the Section 7520 rates increase (as they are likely to).

Conclusions and Additional Information

Conclusions

- A wide array of strategies are ripe for planning now, particularly those that work well in low interest rate and low value environments.

- Be proactive with your clients.

- Remember, transactions can be structured to enable them to be reversed

Q&A

Carlyn S. McCaffrey

Partner, McDermott Will & Emery

cmccaffrey@mwe.com

Jonathan G. Blattmachr

Director of Estate Planning, Peak Trust Company: jblattmachr@hotmail.com

Matthew Blattmachr

President & CEO, Peak Trust Company

mblattmachr@peaktrust.com