Estate Planning Strategies When Using Exemptions

Ways to Act Now & Avoid Remorse Later

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Given the current economy and the uncertainty of today's political climate, many in the estate planning field have their eyes on Washington, D.C., looking to see if dramatic changes to the current transfer tax structure could be imminent. What effect should this have on the estate planning for high-net-worth clients? Should clients act now to use their remaining exemptions by the end of 2020? Might they regret it if the estate and gift tax laws do not change?

In this article, we discuss when it makes sense for certain individuals to make transfers to use exemptions before the end of 2020. We also cover alternatives for those who would want to "unwind" the transfer if anticipated changes to the transfer tax system do not occur, similar to the situation many faced in 2012. These alternative strategies include transfers in trust providing that property disclaimed by the trustee or by the principal beneficiary will revert to the grantor.

Background

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Federal legislation provided that the $5 million gift, estate and generation-skipping transfer (GST) tax exemptions were to be reduced to $1 million after 2012. To avoid losing that benefit, many property owners made gifts before the end of that year to use up the exemptions before they expired. Fortunately, or unfortunately, Congress enacted and the President signed a law right after the end of 2012 making the $5 million exemptions permanent.

The United States is currently facing a similar situation. Under the Tax Cuts and Jobs Act of 2017, the exemptions were increased to $10 million (inflation adjusted) and now stand at $11.58 million. But similarly to the prior provision effective in 2012, those exemptions are set to expire after 2025, reverting to $5 million (inflation adjusted) on January 1, 2026.

Where We Are Now on Exemptions

Some taxpayers will wait until 2025 to decide if they wish to use their exemptions before they are cut in half. However, President Elect Biden has proposed a significant and immediate reduction in the exemptions, either down to $5 million or to $3.5 million. Just as Congress and the President were able to increase the exemptions as part of the 2017 Budget Reconciliation Act (which the Tax Cuts and Jobs Act of 2017 was a part of), Congress could act with President Elect Biden to reduce these exemptions next year. There is no question that this change could be made retroactive to January 1, 2021.

Of course, this likely will depend on whether the Democrats gain control of Congress. This won't be known until the two Georgia U.S. Senate seats are determined by the special elections in that state which will happen on January 5, 2021. Given that the polls have been so poor at forecasting election results, we cannot predict the likely outcome with any certainty. This means we won't know for sure whether a change in the exemptions is likely until well into January, long after a retroactive reduction in exemptions back to January 1st would take effect.

What to Do Now?

So what should taxpayers do? If taxpayers choose to wait for the outcome of the Georgia elections, Democrats could take both Senate seats. That could mean that the enhanced exemptions will be permanently lost (unless some future legislation restores them). It also almost always makes sense to use an exemption as soon as it becomes available, even barring a likely change in the exemption amount. Not only will the assets transferred be permanently protected from gift, estate, and GST tax but income earned from and appreciation on those assets also will escape taxation. If we assume an asset is likely to appreciate, it makes sense to gift the asset earlier, so that any appreciation after the date of the gift is allowed to pass

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free of gift and estate tax (and GST tax, if the transfer is structured and completed correctly).

On the other hand, many will be hesitant to give up significant amounts of property to use the exemptions now. Even those who are inclined to make transfers now might not be willing to transfer the full exemption amount. At first glance, it may seem that using some portion of the exemption amount on lifetime gifts will help to preserve that amount as an exemption later at death. Unfortunately, this may not be true. For example, if it is assumed that the exemptions will not be reduced below $3.5 million, one might conclude that a smart thing to do is to use $6.5 million of the current $11.58 million, so about $5 million of exemption would still be available to use in the future. But that likely is not the case. Although the Treasury Department has indicated it will not "clawback" exemption used now if the exemption is later reduced by the time of the taxpayer's death, it has also indicated that one may not preserve part of the now temporarily enhanced exemption. In other words, if a taxpayer uses $6.58 million of exemption now (hoping to preserve the $5 million of exemption now available and not used) and it has been reduced from $11.58 million to $5 million when the taxpayer dies, the taxpayer will be deemed to use the $6.5 million in the calculation of later estate tax and have no available exemption remaining.

For individuals who decide to take advantage of the exemption by making lifetime gifts now, the smart thing may be to use it all now. However, some taxpayers will have giver's remorse, as some did after 2012 when the anticipated reduction in exemption did not occur. In other words, some taxpayers will regret making large gifts now, and would not have done so if they knew the exemptions would not be reduced.

How to Act Now and Avoid Remorse Later

Essentially, taxpayers have three broad ways to avoid such remorse.

The first is to do nothing. But as the adage goes, nothing ventured, nothing gained.

The second alternative is to make gifts (almost always in trust) from which the taxpayer can continue to benefit from the property. These gifts could take a variety of forms, including the following:

- **Spousal Lifetime Access Trusts (SLATs) -** In essence, the so-called spousal lifetime access trust is a lifetime irrevocable trust in which the grantor's spouse is a beneficiary. A married couple could create a set of "non-reciprocal" SLATs, providing each spouse some ability to benefit from the other's trust. Individuals who are not married could take the same non-reciprocal trust approach with a sibling (using just plain non-reciprocal lifetime access trusts).
- **Special Power of Appointment Trusts (SPATs) -** Another option, in lieu of non-reciprocal lifetime access trusts, is the special power of appointment trust from which distributions can be made to the grantor, not in the discretion of a trustee, but by the exercise of a lifetime special power of appointment exercisable by a trusted individual (generally not a beneficiary) in a non-fiduciary capacity. A SPAT can be used for married or single taxpayers, and can be structured as a grantor trust (in which the grantor pays the income tax on trust income) or non-grantor trust (in which income is taxed at the trust level).
- **Domestic Asset Protection Trusts (DAPTs) -** Taxpayers may also create trusts so-called self-settled or self-created trusts in a jurisdiction that allows the taxpayer to be a beneficiary of the trust while denying the taxpayer's creditors access to the trust assets. Nineteen US states now permit this form of trust, although the requirements

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for creating such a trust vary. Alaska, Delaware, South Dakota and Nevada seem to be the most popular DAPT jurisdictions. At least one trustee will need to be located in the DAPT jurisdiction, which generally involves engaging an institutional trustee unless the taxpayer happens to have other ties to an individual in the jurisdiction.

- **Other Options -** Other ideas for making gifts while also retaining the ability to benefit from the gifted property include a long-term grantor retained annuity trust (GRAT), or an installment sale to a grantor trust, although those techniques likely should be considered only after the exemptions are used. These and related ideas are discussed in detail in Blattmachr & McCaffrey, "The Estate Planning Tsunami of 2020," 47 Estate Planning 4 (Nov. 2020).

The other alternative is to make gifts, again in trust, but allow either the trustee or the trust's principal beneficiary to disclaim the gifted property, resulting in the property returning to the grantor as though the gift to the trust had never been made. In order for this approach to work, without unintended gift tax consequences, the disclaimer must be a qualified disclaimer within the meaning of Section 2518 of the Internal Revenue Code. In addition, the terms of the trust must redirect the trust assets back to the grantor in the event of such disclaimer.

More About Disclaimers on Behalf of a Trust

There is no question that a fiduciary may disclaim an interest in the property otherwise held in the fiduciary capacity, and such disclaimer will be respected for federal tax purposes. See, e.g., Estate of Hoenig v. Commissioner, 66 T.C. 471 (1976). Since the enactment of Section 2518 of the Code, effective January 1, 1977, the rules relating to disclaimers and their effects have been made much more certain. If a person makes a qualified disclaimer, as defined in that section, the property which has been so disclaimed is treated "as if the [property] interest had never been transferred." Section 2518(a).

In some cases, the disclaimed property will revert to the donor by operation of law. For example, a property owner executes a deed to property she owns to transfer it to her son. The son makes a qualified disclaimer. Unless state law provides otherwise, the property will revert to the property owner and treated as though it never had been transferred, so neither the donor nor the disclaimant would be treated as making a gift.

It can be more complicated where a gift is "offered" to a trust. Very often, if one beneficiary (e.g., the income beneficiary) makes a qualified disclaimer of his or her income interest in the trust, the property will pass to the trust's successor (e.g., remainder) beneficiaries. See, e.g., Treas. Reg. 25.2518-2(e)(5), Example (8).

Exactly what happens to the disclaimed property will be determined by the terms of the governing instrument. If the terms of the governing instrument do not provision, it will be determined by state law. See, e.g., Treas. Reg. 25.2518-2(e)(5), Example (4) ("[t]he *provisions of the will specify* that any portion of the...trust disclaimed is to be added to the [other] trust....") and Example 8 (*"[t]he will made no provisions for the distribution of property in the case of a beneficiary's disclaimer. The disclaimer laws of [the state involved] provide* that under these circumstances disclaimer property passes...as if the disclaiming beneficiary had died immediately before the testator's death." (Emphasis added.)

Hence, it seems quite certain that the terms of the governing instrument can specify what occurs if a qualified disclaimer is made. Therefore, the donor should be able to provide that if the trustee of the trust or the trust's principal beneficiary disclaims, the disclaimed property will revert to the donor.

Allowing the trustee to disclaim may be desirable in some circumstances; for example, when all beneficiaries are minors or the donor does not trust or want to place the burden of executing the disclaimer on a beneficiary.

Should the Disclaimer Be Made by the Trustee or by a Beneficiary?

As stated above, it seems quite certain that the trust can provide that property renounced by a qualified disclaimer will revert to the donor (grantor of the trust). It also seems quite certain that, for federal tax purposes, the trustee could be authorized to make the qualified disclaimer. Allowing the trustee to disclaim may be desirable in some circumstances; for example, when all beneficiaries are minors or the donor does not trust or want to place the burden of executing the disclaimer on a beneficiary. However, other issues should be considered and examined before giving the trustee the authority to disclaim.

First, it is important to check applicable law to ensure that a trustee, if so authorized in the governing instrument, may disclaim. In some jurisdictions, the statutory law clearly contemplates a trustee's authority to disclaim, while the law in other jurisdictions may not be as clear. See, e.g., Alaska Statute 13.70.030(b)(1); cf. New York EPTL 2-1.11 (which allows a personal representative of a decedent to renounce with court approval but not specifying whether a trustee may renounce although, as perhaps indicated by the Estate of Hoenig case cited above, a trustee might be able to disclaim under New York common law which is preserved.) In jurisdictions that have adopted the Uniform Disclaimer of Property Interests Act, the trustee may have authority to disclaim even without express authorization under the trust instrument, unless other statutes or provisions of the trust instrument expressly limit or prohibit the trustee's authority to disclaim (e.g., Va. Code § 64.2-2603(B)). Other jurisdictions may permit a trustee to disclaim but impose relatively onerous requirements, such as obtaining a court order or providing notice to the beneficiaries prior to disclaimer. (See, e.g., Texas Property Code § 240.0081). In addition, to the extent the governing law requires the Trustee to accept the trust (as opposed to the gift to be disclaimed) before the Trustee may disclaim, it may be necessary to make a smaller "seed gift" to the trust prior to the larger gift the Signer intends to make to the trust.

Second, it is also important to understand the trustee's fiduciary duty to the trust beneficiaries under applicable state law, and consider whether a trustee's disclaimer could be deemed a breach of fiduciary duty. Although the analysis of whether any particular action or inaction by a trustee is a breach of fiduciary duty is highly fact-specific, it is clear that at least some statutes authorizing a trustee's disclaimer contemplate the disclaimer as a potential cause of claim for breach. (See, e.g. Texas Property Code § 240.0081(h); see also the Comment to Section 8 of the Uniform Disclaimer of Property Interests Act (2002/2010), stating that "[e]very disclaimer by a trustee must be compatible with the trustee's fiduciary obligations.").

These considerations should be taken into account when drafting the trust instrument. The instrument should specifically provide that the trustee may make a disclaimer even though the assets will thereby never become assets of the trust and will revert to the grantor. The instrument also should specifically provide that the trustee will not be deemed to have violated the trustee's fiduciary duty in making the disclaimer, even though the trust beneficiaries will never benefit from the property under the terms of the trust. The instrument likely should provide that the trustee may disclaim if the trustee believes that the disclaimer will produce greater overall family harmony or benefit and may result in more ultimately be given or bequeathed to the trust beneficiaries (based upon discussions with the grantor or his or her legal counsel, or otherwise). If the trustee makes the decision to disclaim after taking such factors into account, it seems unlikely that the trustee could be charged with not acting in good faith.

One more point: Make sure the trust is funded by whatever small amount is appropriate to

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show the trust exists so the trustee is a trustee when the disclaimer occurs. Under the law of many jurisdictions, a trust is not deemed created until property has been transferred to it. So make sure it holds something (even the proverbial peppercorn) before the donor "offers" the big gift to the trust.

An alternative, as suggested by Example 4 of the regulation cited above, is to authorize in the governing instrument a named (or clearly identified) beneficiary to make a qualified disclaimer and further provide that any interest in property disclaimed by that person will cause the entire property (and not just the interest disclaimed) to revert to the donor. If the disclaimer meets the requirements of Internal Revenue Code Section 2518, neither the donor nor the disclaimant should be treated as making a gift.

Summary and Conclusion

The political uncertainty regarding the structure of the federal estate and gift tax system will linger into 2021. It may be appropriate for certain taxpayers to make transfers to use exemptions before the end of 2020. For those who would want the property returned if anticipated changes to the transfer tax system do not occur, it may be appropriate to consider the alternatives discussed above. This includes transfers in trust providing that property disclaimed by the trustee or by the principal beneficiary will revert to the grantor.

NOTE: *Many of the options that are touched on in this article are quite complex in nature and should be executed under the guidance of a skilled advisor. The brief general statements here cannot cover the many complexities of this subject. This information is not legal or tax advice and may not be relied upon as such. Every situation is unique, and individuals should consult with competent legal counsel for specific advice.*