New York Law Journal

SERVING THE BENCH AND BAR SINCE 1888

WWW.NYLJ.COM

An ALM Publication

VOLUME 264—NO. 66

FRIDAY, OCTOBER 2, 2020

TRUSTS AND ESTATES

Expert Analysis

Alert—2020 Federal Gift and Estate Tax Planning, Part I

Hollis F. Russell

John C. Novogrod

Barbara A. Sloan

T. Randolph Harris

We are all watching the developments of the coming November election, in an environment of great uncertainty. But one thing is clear. If the election results in the Democrats controlling the White House and both houses of Congress, it is likely that taxes of all kinds will be increased, particularly the overall tax burden on higher net worth individuals. As a result, it is important that wealthy taxpayers carefully and promptly assess their opportunity to take advantage of current tax benefits as those benefits may disappear, possibly effective as early as January 2021. This article focuses on federal estate and gift tax law provisions that may be affected by potential near term legislative change enacted in 2021 and describes certain planning techniques that might be implemented before year end.

Current Law. Under 2017 federal tax legislation, the amount of the federal gift and estate tax exemption set in 2010 of $5,000,000, annually indexed for inflation, was doubled. The current amount of the exemption in 2020 is $11,580,000, annually adjusted for inflation. The gift and estate tax exemption is "unified," meaning that lifetime gifting in excess of the annual gift tax exclusion amount reduces the amount of the estate tax exemption available at death to protect assets from the estate tax, and is in addition to the annual gift tax exclusion, which remains at $15,000 for each donee. Assets transferred during lifetime or at death in excess of the gift and estate tax exemption are subject to the current federal rate of gift and estate tax of 40%, which is lower than rates in the past. Regardless of the election outcome, this doubled exemption is scheduled under current tax law to "sunset"—that is, end—at the end of 2025 and return to its level in 2010—$5,000,000, adjusted for inflation in intervening years. The Internal Revenue Service (IRS) has issued regulations confirming that, if a taxpayer makes gifts of his or her exemption amount and thereafter the exemption amount is reduced, the taxpayer will not lose the tax benefit of using the higher amount.

> If the election results in the Democrats controlling the White House and both houses of Congress, it is likely that taxes of all kinds will be increased, particularly the overall tax burden on higher net worth individuals.

Risk of Legislative Change. Given the current economic climate, whether or not the Democrats prevail in both houses of Congress, the increased government spending to restart our sluggish economy due to the impact of COVID-19 is likely to require prompt legislation to increase taxes. If the November election results in a Democratic sweep, we should expect legislation to "accelerate the sunset" of the doubled gift and estate tax exemption, possibly reducing it to as low as $3,500,000, and the legislation also may include other more burdensome tax provisions, including a higher estate and gift tax rate.

2020 Planning Options. The future legislative uncertainty creates a planning environment in which higher

HOLLIS F. RUSSELL, JOHN C. NOVOGROD, BARBARA A. SLOAN *and* T. RANDOLPH HARRIS *are partners at McLaughlin & Stern. Diana Chen, an associate at the firm, contributed to this report. Russell is resident in the firm's Florida and New York offices, and Novogrod, Sloan, Harris and Chen are resident in the firm's New York offices.*

net worth individuals should consider making substantial gifts before the end of 2020—either outright or in trust—for the ultimate benefit of their children and other family members. For those with children, gifts made to long-term trusts designed to last longer than the lives of their children and beyond, such as the "dynasty" trust described below, allow assets to pass to subsequent generations free of estate tax otherwise imposed at each generation—using the generation-skipping transfer (GST) tax exemption, currently $11,580,000 in 2020 and subject to the same potential early sunset/reduction issues as the gift and estate tax exemption. Whether outright or in trust, gifts should be completed before 2021 to avoid the risk that the estate and gift tax and GST tax benefits may be substantially reduced by future tax legislation that could have a retroactive effective date as early as January 2021. Because these gifts might otherwise not be made before death, trusts may be structured to provide some control over the gifted funds, which for some donors may be preferable to outright gifting. Alternatively, control over an outright gift may be achieved through creation of an entity, such as a limited liability company (LLC), as described below. As appropriate, a trust and LLC structure may allow the donor to act as investment advisor of the gifted funds without risk of adverse tax consequences.

Dynasty Trust. For gifts made in trust for children or grandchildren, an irrevocable long-term trust, sometimes known as a "dynasty" trust, may be created with flexibility in the terms of the trust to address changes that may occur over time. An independent trustee typically is preferable but not required, and a family member may act as trustee. The trust grantor may retain authority to change trustees, and the trust terms may permit lending of trust monies to the grantor. Other options to provide for flexibility may include, for example, giving a beneficiary the right to designate which of his or her descendants will be beneficiaries following his or her death, authorizing the trustee to modify certain of the trust terms in the future, and permitting the trustee to add beneficiaries, such as charities or spouses of beneficiaries. The long-term potential impact of the federal GST tax for larger trusts may be reduced through use of the taxpayer's GST exemption. Among a myriad of trust funding options, a dynasty trust may be designed to hold life insurance for a grantor who wishes for the trust to acquire substantial coverage with an up-front premium payment structure (subject to the modified endowment contract rules) for 2020 gift planning purposes.

SLAT. In the case of a married couple, one spouse may create a trust for the lifetime benefit of the other spouse (sometimes known as a spousal lifetime access trust or SLAT) which, after the beneficiary spouse's death, may continue as a dynasty trust for the benefit of descendants (and also possibly including the transferor spouse). For maximum tax benefit, if a couple's overall net worth supports the creation of only one SLAT, then only one of the spouses should create and fund it with assets having a value up to the current federal gift and estate tax exemption. In the event that the couple has sufficient assets for each spouse to create a SLAT, a special rule, the "reciprocal trust rule," will require that the two SLATs have meaningful differences between the trust provisions in each of them. If properly structured, a SLAT could be funded with the gift of a personal residence, which is particularly useful when liquid assets are insufficient to use up the exemption.

LLC. An entity, such as an LLC, may be created and used for gifting to family members or trusts for their benefit. To avoid adverse tax consequences, however, the donor may not retain direct control over the LLC assets, so a family member or an independent person should serve as the manager of the LLC. The manager has control over distributions from the LLC to its members. Out of an abundance of caution, the donor should not retain any equity interest in the LLC. Where appropriate, making gifts of interests in an LLC provides an opportunity to "leverage" the gift and estate tax exemption through valuation discounts, which are generally applicable to value gifts of nonmarketable, non-voting LLC membership interests.

This is Part 1 of a two-part article and has addressed the current federal gift and estate tax law provisions, the risk for legislative change to those provisions and certain planning opportunities that may be significantly less advantageous in 2021 to make gifts using a "dynasty" trust, a SLAT, or LLC structure. Part 2 will address additional planning techniques and considerations, such as the selection of assets to gift, the use of a grantor trust and/or self-settled trust, state estate and gift tax law provisions and other potential changes to federal law.

Reprinted with permission from the October 2, 2020 edition of the NEW YORK LAW JOURNAL © 2020 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. For information, contact 877-257-3382 or reprints@alm.com. # NYLJ-10082020-462853

New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
OCTOBER 15, 2020

TRUSTS AND ESTATES

Expert Analysis

2020 Federal Tax and Gift Planning, Part 2

Hollis F. Russell

John C. Novogrod

Barbara A. Sloan

T. Randolph Harris

In Part 1 of this two-part series, we addressed the current federal gift and estate tax law provisions, the risk for legislative change to those provisions and certain planning opportunities that may be significantly less advantageous in 2021 to make gifts using a "dynasty" trust, a "SLAT," or an LLC structure and was published in the previous issue. Part 2 addresses additional planning techniques and considerations, such as the selection of assets to gift, the use of a grantor trust and/or self-settled trust, state estate and gift tax law provisions and other potential changes to federal law to be considered by taxpayers in 2020.

Selection of Appropriate Assets to Gift. In general, donees receive the same basis—known as carry-over basis—in gifted assets as the donor had in them (whether the gift is made in trust or outright). As a result, in the event that the donee then sells the gifted asset, the donee will pay tax on any capital gain in the asset just as the donor would have had to do. Alternatively, assets owned at death receive an adjustment in basis to make it equal to the fair market value of the asset on date of death. This permits the beneficiary of an estate to sell the bequeathed asset without recognition of gain in the value of the asset that occurred prior to the decedent's death. This difference in treatment of an asset's basis requires that basis should be taken into account in selecting which assets to gift—although part of the calculus should be the possibility of future law change (one of many in additional proposed changes—see below) that would apply carry-over basis to inherited assets. To minimize capital gain tax, gifts should be made of high tax basis assets and low basis assets should be retained by the donor so that the appreciation in these assets would under current law escape capital gain taxation following the donor's death. In addition, assets that are likely to appreciate in value are often the best candidates for gifting so that the future value appreciation is not subject to gift or estate tax in the donor's estate.

Use of Grantor Trust. Almost every trust created during the grantor's life for estate planning purposes can be structured as a "grantor trust" for income tax purposes which enhances the gift and estate tax advantages of the trust. A grantor trust treats the grantor as the owner of the assets of the trust for income tax purposes, but not for gift and estate tax purposes. As a result, the grantor is required to personally pay the income tax attributable to trust income—without having to treat such tax payments as additional gifts. Grantor trust status also permits the grantor to buy and sell assets from or to the trust without recognition of capital gain on the transaction. This flexibility can be useful to permit gifts of low basis assets to a grantor trust with the intention that the grantor will be able to reacquire them prior to death so that, under current law, their basis may be stepped up to fair market value at the grantor's death. A caveat, however, is to take into account in the calculus that changes to the grantor trust rules have been proposed that might restrict their advantageous treatment for future income tax years—for example, to restrict or eliminate the long-term ability for the grantor to buy low basis assets gifted to trusts in 2020 without capital gain recognition in a future tax year.

Self-Settled Trust. For the more aggressive taxpayer who would like to create a trust but also maintain access to the trust funds, an option to consider is for the trust to be created in a state with a "self-settled" trust law—such as Delaware—so as to allow for the grantor to be included as a discretionary trust beneficiary. For this strategy to be

HOLLIS F. RUSSELL, JOHN C. NOVOGROD, BARBARA A. SLOAN *and* T. RANDOLPH HARRIS *are partners at McLaughlin & Stern. Diana Chen, an associate at the firm, contributed to this report. Russell is resident in the firm's Florida and New York offices, and Novogrod, Sloan, Harris and Chen are resident in the firm's New York offices.*

effective, a number of pitfalls must be avoided. For example, there should be no express or implied agreement that trust funds will be available to the grantor (either via loan or trust distribution) in the future (although this may be difficult to support if the grantor is included as a discretionary beneficiary for the purpose of maintaining access to the trust funds). The availability of grantor trust treatment for income tax purposes—that is, for the grantor to be subject to income tax on the trust income—is an additional advantage. The law is not entirely settled on the effectiveness of this technique.

Other Techniques. For high net worth individuals, the planning ideas discussed in this article are a part of a mosaic of tax planning techniques designed to reduce the overall transfer tax burden to a taxpayer's estate, including compressing asset values to reduce gift and estate taxes. Separately or in combination with "dynasty" and "SLAT" trust planning, 2020 gift exemption planning may utilize other techniques, such as charitable "lead" trusts and grantor retained annuity trusts (GRATs), that are especially effective in the current low interest rate environment. For example, the section 7520 rate of the Internal Revenue Code, which is the annual rate of return that the IRS assumes an investor will be able to achieve on the investor's assets, is set monthly and is currently 0.4% for September 2020. For a GRAT, any growth in trust assets above that rate of return will pass to the GRAT remainder beneficiaries free of gift and estate tax. In addition, intra-family loans are also an attractive planning opportunity due to the low interest rates. The current mid-term interest rate promulgated by the IRS, which is applicable for intra-family loans with a repayment term between three and nine years, is 0.35%. Because of the current low interest rate environment, consideration also should be give to making gifts using borrowed funds.

State Estate and Gift Tax Law. The impact of state estate tax under current law should also be considered. Many states—including Florida, New Jersey and many others—have no state estate tax. Other states, such as New York and Connecticut, impose state estate tax on their residents (and also real and tangible property owned by nonresidents located within the state) and have exemption amounts that are substantially below the federal amount. New York has no gift tax but levies an estate tax at graduated rates up to 16% on estates in excess of $5,850,000. This state estate tax is deductible against the federal estate tax if the estate is large enough to be subject to federal estate tax. To avoid losing estate tax on gifts made immediately before death, New York also includes the amount of gifts made within three years of death in the decedent's taxable estate. Connecticut imposes an estate tax with rates up to 12% and allows an exemption of $5,100,000 (scheduled to increase by $2,000,000 in each of the next two years, and then match the federal exemption), and also levies a gift tax. For some taxpayers residing in states that impose estate tax—such as New York—change of residence to a state without an estate tax—such as Florida—may be attractive. Establishing a change of residence usually requires careful planning to be sure to avoid taxation in the original state.

Other Proposed Changes to Tax Laws. In addition to the possible change in the gift and estate tax exemption and rates, a variety of other proposals to change federal tax laws have been made that would restrict planning transactions. Two of those proposals—carry-over basis at death and changes to the grantor trust rules—may affect the 2020 tax planning structures in a future income tax year, as discussed above. Other proposals have included an annual wealth tax, an unrealized capital gain tax, increase in capital gain tax rates, repeal of portability of unused estate tax exemption, restrictions on GRAT and LLC/partnership planning structures, valuation discount limitations, and other adverse changes may also be proposed.

Conclusion—Action in 2020. The prospect of changes in the current gift and estate tax law presents special estate planning opportunities to be considered and implemented as soon as possible in 2020. Higher net worth individuals should have their existing estate plans reviewed—allowing enough time to take action before the end of 2020. Each family situation is unique, and planning in earnest for 2020 gifting typically will involve many tax and non-tax issues. While it is important to be mindful that "the tax tail should not wag the dog," use of one or more of the techniques discussed in this article could result in significant tax benefits that may well disappear in 2021. In any event, the results of the November election will influence individual planning decisions that are made before the end of 2020. Timely action is particularly important because it is expected there may be a "tsunami" (as some commentators have called it) of tax planning transactions at year end, which may make it become difficult to obtain valuation assessments, open new accounts, and satisfy other technical requirements before year-end. We recommend that these techniques be considered and implemented before year-end 2020—and for many reasons, the sooner, the better.

Reprinted with permission from the October 15, 2020 edition of the NEW YORK LAW JOURNAL © 2020 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. For information, contact 877-257-3382 or reprints@alm.com. # NYLJ-10082020-462853