McLaughlin & Stern Client Alert

2020 FEDERAL GIFT AND ESTATE TAX PLANNING

Introduction

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 before the benefits may disappear, possibly effective as early as January 2021.

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 is $11,580,000, annually adjusted for inflation. 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 IRS has provided guidance 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.

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.[1]

2020 Planning Options

The future legislative uncertainty creates a planning environment where higher 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. Gifting along these lines should be implemented before 2021 in order to avoid the risk that future tax legislation may have an effective date as early as January 2021. Because these gifts might otherwise not be made before death, trusts may be structured to provide control over gifted funds, which for some donors

[1] The current federal rate of gift and estate tax is 40%, which is lower than rates in the past. The gift and estate 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.

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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/or 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 generation-skipping transfer ("GST") tax for larger trusts may be reduced through use of the taxpayer's GST exemption.[2]

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 spouse's death, may be structured as a dynasty trust for the benefit of descendants. For a couple whose overall net worth supports the creation of only one SLAT, 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, special rules will apply regarding the terms of each of the trusts.[3] At the death of the beneficiary spouse, the trust property may be held in continuing trust for or pass outright to children/grandchildren. If properly structured, a SLAT can 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 non-marketable, non-voting LLC membership interests.

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

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[2] A trust established to last through lives of children allows assets to pass to subsequent generations free of estate tax by the use of the GST exemption ($11,580,000 in 2020), which is subject to the same potential early sunset/reduction issues as the gift and estate tax exemption.

[3] In situations where each spouse creates a separate SLAT for the other spouse, the "reciprocal trust rule" for estate tax purposes requires that there be meaningful differences between the trust terms contained in the separate SLATs which each spouse creates for the benefit of the other spouse.

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 or sell assets from or to the trust without recognition of capital gain on the transaction. [4]

Conclusion – Action in 2020

The prospect of change in the current gift and estate tax law raises special estate planning opportunities to be considered 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 — to consider the impact of and planning opportunities created by these unusual circumstances.[5] Each family situation is unique, and planning in earnest for 2020 gifting typically will involve many tax and non-tax issues. While it is always important to keep in mind that the "tax tail should not wag the dog," use of these techniques may now result in significant tax benefits to the family that may well disappear in the near future. In any event, the results of the November election will influence individual planning decisions that should be considered before year end 2020. Because, as year end approaches, it may be difficult to obtain valuation assessments, open new accounts, and satisfy other technical requirements in a timely fashion, we recommend that these techniques be considered and implemented now.

For high net worth clients, the planning ideas discussed in this memorandum 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 so as to reduce tax exposure. Separately or in combination with "dynasty" and "SLAT" trust planning, 2020 gift exemption planning may utilize other techniques, such as charitable "lead" or "remainder" trusts, GRAT planning, and life insurance trusts. The depth and breadth of our firm's trusts and estates practice allows our lawyers to advise on the details and nuances of a wide variety of sophisticated tax planning techniques. Our lawyers may be contacted through our website at www.mclaughlinstern.com.

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[4] This can be useful for low basis trust assets where the grantor wishes to acquire them so that, under current law, their basis may be stepped up to fair market value at the grantor's death. In general, carryover basis applies to assets that are gifted (whether in trust or outright), which should be taken into account in selecting assets that are gifted – ideally, high tax basis assets that also have potential for future value appreciation. Capital gain tax may be reduced when high basis gifted assets are sold by the donee, and retention (rather than gifting) of low basis assets -- or their re-acquisition from a grantor trust -- allows for a step up of basis of those assets at the donor's death under current law.

[5] The impact of state estate tax under current law should also be considered. For residents of many states -- including Florida, New Jersey and many others -- there is no state estate tax. Other states, such as New York and Connecticut, impose state estate tax on their residents (and real and tangible property located within the state). New York levies an estate tax at rates up to 16% (deductible against the federal estate tax, but with an issue relating to gifts within 3 years of death, which are included in the estate tax base) and has with an exemption in 2020 of $5,850,000. Connecticut has a state estate tax with rates up to 12% and an exemption of $5,100,000 (scheduled to increase by $2,000,000 in each of the next 2 years, and then match the federal exemption) and also levies a gift tax.