

What To Expect After the Inauguration

DC Estate Planning Council
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Possible New Tax Legislation in 2021 and Beyond



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Biden's Guiding Principles

"A guiding principle across our tax agenda is that the wealthiest Americans can shoulder more of the tax burden, including in particular by making investors pay the same tax rates as workers and bringing an end to expensive and unproductive tax loopholes."

-- Biden-Sanders Unity Taskforce Report (July 8, 2020)

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Historic Norms

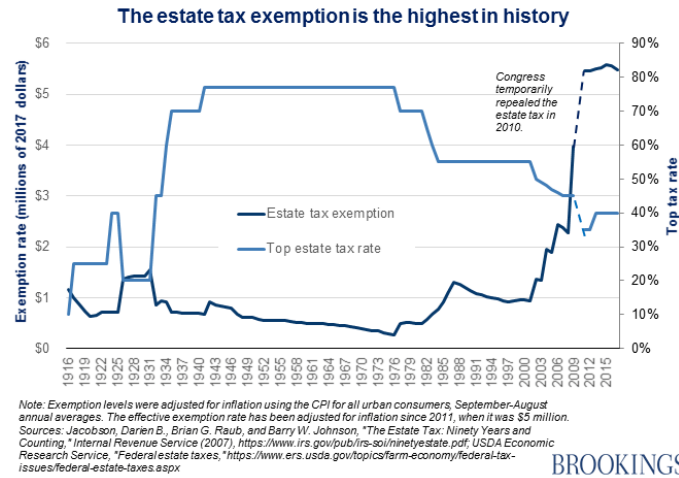
"Estate taxes should also be raised back to the historical norm." -- Biden-Sanders Unity Taskforce Report (July 8, 2020)

- Historic norm = 2009 parameters:
 - 45% top marginal rate
 - \$3.5m exemption estate and GST taxes
 - \$1.0m exemption gift tax
 - No indexing for inflation
 - Portability?

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Historic Top Rate and Exemption Levels



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Projections for 2021-2030: Percent of Decedents Subject to Estate Tax

| Law/Year | 2022 | 2023 | 2024 | 2025 | 2026 | 2027 | 2028 | 2029 | 2030 |
|---------------------|------|------|------|------|------|------|------|------|------|
| Current Law | 0.09 | 0.09 | 0.09 | 0.09 | 0.3 | 0.3 | 0.3 | 0.29 | 0.29 |
| TCJA Made Permanent | 0.09 | 0.09 | 0.09 | 0.09 | 0.09 | 0.1 | 0.1 | 0.1 | 0.1 |
| 2009 Parameters | 0.59 | 0.59 | 0.61 | 0.6 | 0.61 | 0.63 | 0.63 | 0.63 | 0.65 |

► Source: Urban-Brookings Tax Policy Center

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Death as a Realization Event

- Tax capital gains at death
 - Death as a realization event
 - Unrealized gains taxed on decedent's final return or a separate return
 - Gifts as a realization event
 - Gain taxed to donor
 - Exceptions for spouse and charity
 - Some asset class and/or threshold exceptions (presumably \$400,000)

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Increased Income/Capital Gains Tax Rates

- Restore pre-2018 tax brackets, including a 39.6% top marginal tax bracket
- Continue NII (3.8%)
- Eliminate benefit of preferential capital gains and qualified dividend tax rate for taxpayers with income >\$1 million

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Meanwhile on the Hill

- Sanders' "For the 99.8% Act" is a laundry list for estate/gift tax reform
 - Basic exclusion amount: \$1m for gifts, \$3.5m for estates; no indexing
 - Rates: adds 45%, 50%, 55% and 77% brackets
 - Limitations on valuation discounts
 - New GRAT restrictions
 - New wealth transfer tax on certain grantor trusts
 - GST exempt trusts can only last 50 years
 - Reign in gift tax annual exclusion
- Mark-to-Market Tax
- Wealth Tax

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Expected GOP Proposals

- Make TCJA changes (e.g. doubled estate tax exemption) permanent
- Repeal of estate/gift/GST taxes (with or without substitution of deemed realization of gains at death)

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What Everyone Wants to Know:

When Will The Changes Happen and Will They Be Retroactive?

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Planning Options



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Current Planning Environment

- **Interest Rates:** Interest rates are at historic lows (the Section 7520 rate for January 2021 is 0.6%).
- **Good Techniques:** Family loans, note sale transactions, and GRATs are techniques that work well when interest rates are low.

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Options for Action Through 2022

- Use current \$11.7 million exclusion amount and possibly make gifts subject to gift tax.
- Implement potentially endangered techniques that permit gift tax free transfer of future investment return such as Grantor Retained Annuity Trusts and Split Purchase Annuity Trusts.

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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


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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



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Gifts

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

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Possible Downside of Gifts

The value of the gifted property could decline.

Loss of control over and benefit from the gifted property

Depending on future circumstances, gifts in 2020 or later could result in higher future taxes.

Gift of appreciated property could fail to appreciate sufficiently to offset disadvantage of loss of basis step up at death.


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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



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Gifts:

Retaining possible benefits from gifted property:

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

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Gifts

Making gifts without parting with assets:

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



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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.

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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.

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Dual SLATs – Spousal Lifetime Access Trusts

Benefitting Each Spouse Without Creditor Issues or Estate Tax Inclusion

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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.

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SLATs: How to Make Them

- 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.

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DAPTs: What They Are Now

- Gaining greater acceptance
- Now nineteen states protect self-settled trusts from claims of the Grantor's creditors.

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DOMESTIC ASSET PROTECTION TRUST EXAMPLE:

A creates a domestic asset protection trust in Delaware in 2020 and funds it with \$10 million. This gift escapes gift tax because it is sheltered from gift tax by A's lifetime \$10 million inflation adjusted exclusion from gift tax. A, A's spouse, and his children are discretionary beneficiaries of the trust. Because creditors cannot reach the assets in the trust, the gift is complete. A dies in 2035 when the assets in the trust are worth \$40 million. Up until the time of his death, A has been a discretionary beneficiary and received distributions from the trust. By using a domestic asset protection trust, according to its proponents, the \$30 million of appreciation after funding of the trust will escape estate taxation from the estate of the creator.



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Variations

Hybrid DAPTS

Special Power of Appointment Trusts

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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.

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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



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Loans instead of Gifts

- ▶ Loans are attractive in a low interest rate environment
- ▶ Refinance existing intrafamily notes
- ▶ Useful for those who have already used their exemption and those who can't afford to use their exemption

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GRATs – Grantor Retained Annuity Trusts

How They Work in Low-Rate Environments

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GRATs: What and When Useful

- Background: Section 2702 permits a donor to give property to a trust and reduce the value of the gift for gift tax purposes by the value of a retained annuity interest in the trust determined under Section 7520.
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- These trusts are generally referred to as GRATs.
- GRAT downside: (1) possibly no GST Exemption leverage, (2) some estate tax inclusion potential (difficult to use for client with short life expectancy).

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GRATs: What and When Useful

- Good news: low Section 7520 rates mean high value for the retained annuity interest. A high value for the annuity interests means a lower taxable gift.
- A GRAT will deliver a tax free gift when it terminates if its investment return is greater than the Section 7520 rate and if the donor outlives the term of the GRAT.
- Typical structure: Short-term Rolling GRATs.

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Zeroed Out GRATs

- ▶ By structuring the GRAT so the value of the annuity equals the value of the property transferred, the taxpayer can avoid using applicable exclusion or paying gift tax
- ▶ A zeroed-out GRAT often works best when the annuity term is short (such as two or three years) and the GRAT is funded with one stock

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Zeroed Out GRAT Example

- ▶ Dan transfers 4 different stocks each worth \$500,000 to a 3-year GRAT with an annuity payment of 33.73% per year. The value of the annuity is \$2,000,000, so the gift to the GRAT is zero. For the 3-year term, Stock 1 returns an average of 30% per year, Stock 2 returns 10% per year, Stock 3 returns (-10%) per year and Stock 4 averages 5% per year
- ▶ After 3 years, \$365,992 is left in the GRAT and passes to the remaindermen

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Value of Multiple GRATs

If Dan instead set up 4 separate GRATs, the result would be as follows:

| | |
|-----------------------|-----------------------------------|
| Stock 1 GRAT (30%) | \$425,514 |
| Stock 2 GRAT (10%) | \$107,208 |
| Stock 3 GRAT (-10%) | \$ 0 (all assets returned to Dan) |
| Stock 4 GRAT (5%) | \$ 47,086 |
| Total to remaindermen | \$579,808 |

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GRATs: Planning for Modification of GRAT Rules

- Obama had proposed changes to the GRAT rules that would make them unattractive as a planning option.
- To provide some protection against possible changes, consider:
 - Creation of long-term GRATs
 - If legislation has prospective effective date, consider transferring annuity interest in existing GRATs to long term GRATs
 - Consider creating “shelf-GRATs” funded with cash, to which assets expected to appreciate can later be sold.

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Illustration of a Successful 99 Year GRAT

- 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.

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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 $\$12,250 / .1$ (\$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.

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Charitable Gifts

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CHARITABLE REMAINDER UNITRUSTS

- ▶ May be effective strategy if capital gains tax rates are increased.

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ZERO-OUT CLAT EXAMPLE:

If an individual transfers \$100,000 to a charitable lead annuity trust in November 2020 to pay one or more charities a \$7,000 annuity each year for fifteen years, and the applicable interest rate at the time is .60 percent, the annuity interest will be valued at \$100,000 for gift tax purposes, and the trust remainder will be valued at zero. However, assuming the trust will in fact earn at least 7.0 percent, the entire \$100,000 will pass to the remainder beneficiary at the end of the annuity term free of gift tax. The remainderman will also receive any underlying appreciation in the trust property, plus any income earned in excess of 7.0 percent. To the extent that investment performance is less than 7.0 percent, trust principal must be used to pay the annuity amount, and the remainderman will ultimately receive less property.

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| Number of Years | .40 Percent Table Zero-Out Annuity Rate | .60 percent Table Zero-Out Annuity Rate | 1 percent Table Zero-Out Annuity Rate | 2 percent Table Zero-Out Annuity Rate | 3 percent Table Zero-Out Annuity Rate | 4 percent Table Zero-Out Annuity Rate | 5 percent Table Zero-Out Annuity Rate | 6 percent Table Zero-Out Annuity Rate | 7 percent Table Zero-Out Annuity Rate | 8 percent Table Zero-Out Annuity Rate |
|-----------------|---|---|---------------------------------------|---------------------------------------|---------------------------------------|---------------------------------------|---------------------------------------|---------------------------------------|---------------------------------------|---------------------------------------|
| 8 | 12.7 | 12.7 | 13.1 | 13.7 | 14.3 | 14.9 | 15.5 | 16.1 | 16.8 | 17.4 |
| 9 | 11.3 | 11.5 | 11.7 | 12.3 | 12.9 | 13.4 | 14.1 | 14.7 | 15.4 | 16.0 |
| 10 | 10.2 | 10.4 | 10.6 | 11.2 | 11.7 | 12.3 | 12.9 | 13.6 | 14.2 | 14.9 |
| 15 | 6.9 | 7.0 | 7.3 | 7.8 | 8.4 | 9.0 | 9.6 | 10.3 | 11.0 | 11.7 |
| 20 | 5.2 | 5.4 | 5.6 | 6.2 | 6.7 | 7.4 | 8.0 | 8.7 | 9.4 | 10.2 |
| 25 | 4.2 | 4.4 | 4.6 | 5.2 | 5.7 | 6.4 | 7.1 | 7.8 | 8.6 | 9.4 |

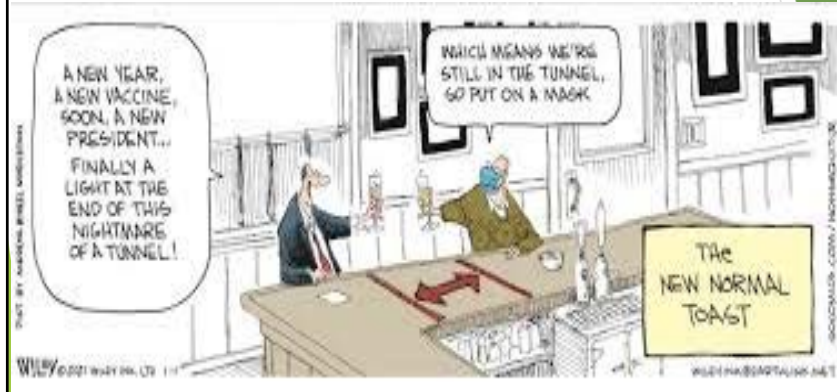
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Conclusions

- 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

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Questions



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