Why Every Estate Planner Needs to Urge All Clients to Use Their Wealth Transfer Exemptions Now

Using the Temporary Exemption and Other Planning for 2020

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A KEY ESTATE PLANNING GUIDE

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Advise Clients About Exemption Planning in 2020

Planning before the 2020 (2024) Election and 2026 having of the exemption

[redacted]

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Advise Clients About Exemption Planning in 2020

Introduction

[redacted]

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Introduction

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- With a possible shift of control in Washington on the horizon (whether 2020 or 2024) growing budget deficits, and the reduction in 2026 of the exemption to $5 million (inflation adjusted), estate planning has become ever more complex.
- This presentation will explore various planning strategies that practitioners may employ to help clients capitalize on the estate tax environment created by the 2017 tax act, with consideration of these newer developments and trends.
- What follows is a discussion of a wide range of planning considerations in this challenging planning environment.
- This Powerpoint addresses more complex trust planning and planning techniques to be considered for larger estates in the current planning environment.

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Advise Clients About Exemption Planning in 2020

Planning Before the 2020 (2024) Election

[redacted]

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Clawback of Temporary Exemption

Why wait to use it?

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Clawback of Temporary Exemption

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- Regulations were issued confirming that a taxpayer's use of the temporarily enhanced gift tax exemption will not result in a recapture or clawback when the exemption declines.
- The "off the top" gift tax issue was negatively resolved. Assume that a taxpayer makes a gift of $5M in 2019 and makes no further gifts. If the taxpayer dies after 2025 and the enhanced exclusion no longer provides benefit. Some had speculated that that the gift might have been treated as if made off the top of the exclusion amount. That could have left the remaining exclusion intact, but it appears that this is not an appropriate interpretation and clients cannot make a gift of the top portion of the exclusion.
- Prop. Regs. 20.2010-1(c); Reg-106706-18.

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Clawback of Temporary Exemption - Planning

- The fact that the clawback issue has been resolved may serve as a strong incentive for "moderate wealth clients ("moderate" relative to the current high exemptions) to plan and make gifts before 2026 when the exception is set to decline if nothing happens before then.
- If the "blue wave" of the 2018 mid-term election continues (whether in 2020 or 2024), the exemption amount could be reduced before the 2026 scheduled sunset reduction of the exclusion. For example, the estate tax proposal by Bernie Sanders proposes a mere $1 million gift exemption and a $3.5 million estate tax exemption.
- Practitioners may wish to proactively educate and encourage clients to plan and thereby hopefully avoid a repeat of the 2012 deluge of clients trying to get planning done just prior to a possible change in the exemption. Client's may also wish to, consider more robust plans than many executed in 2012.

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Clawback of Temporary Exemption - Democrats

- But will claw back really be avoided?
- If the Democrats gain control in 2020, what might they make the effective date of any new estate tax legislation?
- Will they change the status of no-clawback?
- Practitioners might also caution clients about the risks of gifts not succeeding because of this uncertainty.
- Practitioners might also caution clients about the risks that gifts may not accomplish their intended goal if laws change.

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Estate Tax Proposal – Bernie Sanders

"For the 99.8 Percent Act"
A Template for Dem Tax Proposals?

Thanks to Bob Keebler from some of the slide info

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Template for Democratic Proposals

- The Bernie Sanders estate tax proposal follows in many respects the Obama Greeenbook proposals and may be the model for a Democratic tax proposal if the Dems gain control in 2020. Gomez has introduced similar legislation in the House.
- Bottom line – clients may choose to act now to secure benefits before the election.
- By planning in 2020 you may be able to implement planning options that could mitigate step transaction and reciprocal trust challenges. This may not be as readily feasible if clients wait until the election to "see what happens."

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"For the 99.8 Percent Act" Exemptions

- Gift Tax Exemption:
  - $1,000,000 in 2020
  - Not indexed for inflation
- Estate and GST Exemption:
  - $3,500,000 in 2019.
  - Indexed for inflation.
  - "Portability" retained.
- Would radically transform current planning options for clients who may be ignoring planning given the current high exemptions.
- It is advisable for clients consider planning options before a Dem proposal might ever become law.

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SG14

"For the 99.8 Percent Act" New Basis Consistency Rule

- Basis consistency rules.
  - Basis must also be consistent with the amount reported on gift tax returns.
  - Similar reporting regime as under § 1014(f). This might add substantial costs to gift tax return filings which, with a $1M exemption could expand substantially.

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Slide 15

SG14 Similar reporting regime as under § 1014(f). Given the potential decrease in the exemption, this might add substantial costs to gift tax return filings as well as increase the number of returns that might be required.

Sandy Glazier, 10/7/2019

"For the 99.8 Percent Act" Help For Small Business/Farms

- Sec. 2032A - Special Use Valuation Changes.
  - Increase to reduction in FMV from $750,000 to $3,000,000.
  - Applies after 12/31/19.
- Sec. 2031(c) - Conservation Easement Changes.
  - Increase reduction in FMV from $500,000 to $2,000,000.
  - Increase to reduction in fair market value from 40% to 60%.
  - Applies after 12/31/19.
- These changes could be helpful for some taxpayers.

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"For the 99.8 Percent Act" Valuations and Discounts

- General Valuation Rules.
  - The "Non-business" assets of an entity transferred are valued as if the asset were transferred directly (non-actively traded interests) – no discounts of any nature.
  - Non-business assets means any asset not used in the active conduct of a trade or business. What of working capital?
  - "Passive assets" not treated as used in active business.
- Discounts.
  - No discount allowed if the transferee and family members have control or majority ownership (non-actively traded interests). This eliminates the discount "elixir" that has propelled much of modern estate planning.
- Clients needing discounts to make a transaction succeed might proceed before a law change.

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"For the 99.8 Percent Act" GRATs No Longer GREAT

- GRAT changes
  - Minimum 10-year term. This eliminates the common rolling or cascading GRAT technique. Taxpayers cannot count on re-GRAT'ing payouts from existing GRATs.
  - Maximum term of the life expectancy of the annuitant plus 10-years. This eliminates the so-called 99-year GRAT that is used under current law as an interest and valuation play.
  - Remainder interest not less than an amount equal to the greater of:
    - 25% of trust value.
    - $500,000.
    - This eliminates the Walton or Zero'ed out GRAT.
- Is there any benefit to GRATs left?

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"For the 99.8 Percent Act" Grantor Trusts Emasculated

- Grantor trust changes are harsh and appear to emasculate a favored planning tool.
  - Estate will include:
    - Assets in grantor trusts.
    - Distributions from grantor trusts during the life of the deemed owner.
    - The assets of a grantor trust when the trust changes to a nongrantor trust.
- This effectively would eliminate the use of grantor trusts after the effective date of the act. When might that be?
- Should taxpayers create grantor trusts now hoping for grandfathering? Might the possible benefit of a grandfathered grantor trust outweigh the current income tax benefits of a non-grantor trust?

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"For the 99.8 Percent Act" GST Tax

- GST changes
  - Inclusion ratio of any trust other than qualifying trust must be 1, meaning no GST benefit.
  - Qualifying trust must terminate not later than 50-years after the trust is created. That eliminates the tax benefit of long term/perpetual trusts.
  - Pre-existing trusts must terminate within 50-years of enactment. Might this eliminate grandfathering? Might this suggest that the earlier a trust is created perhaps the greater the likelihood that it might be permitted to be grandfathered?
  - This could radically change trust and intergenerational planning as we know it.

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"For the 99.8 Percent Act" Annual Exclusion Gifts Restricted

- Annual Exclusion Gifts.
  - $10,000 limit per donee.
  - $20,000 limit per donor.
- This could transform planning for clients of all wealth levels including the ubiquitous irrevocable life insurance trust ("ILIT") and front loaded 529 plans.
- Clients with ILITs and other trusts that are accustomed to using annual gifts should evaluate making a larger gift now using available exemption to fund those trusts to avoid the need for future gifts which would require the filing of a gift tax return and which after $20,000 would reduce the $1M lifetime gift exclusion.

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"For the 99.8 Percent Act" Rethink Upstream Planning

- Many practitioners have touted the use of "upstream" planning to salvage otherwise unusable exemptions of the client's elderly relatives.
- Example parent has an estate of only $4 million, child could create a trust with $7 million, and give parent a general power of appointment ("GPOA") over that trust. The intent of the plan was that parent's estate would include the assets in the trust and those assets would garner an estate tax free adjustment (hopefully step-up) in income tax basis on parent's death.
- If the exemption is reduced to the $3.5 million as in the Sanders' Act, the benefit of most or all upstream planning would be obviated. If that occurs practitioners might want to review that planning to be certain that the estate inclusion in the upstream plan does not inadvertently trigger an unintended estate tax on the senior generation's death. While many such upstream plans were likely crafted to only include in the senior generation's estate an amount that does not trigger an estate tax, the more prudent course of action would be to confirm that. Clients who only recently had planning updated to address the inclusion of GPOAs to a higher generation will likely be frustrated by the yo-yo tax law changes and ongoing planning updates.

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Dem Possible Tax Proposals and 2026 Exemption Sunset – Steps to Take Now

Clients may wish to consider completed gift transfers to lock in exemption, and trusts that provide access

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Downstream Planning

- A valuable "asset" of many ultra high net worth ("UHNW") families is the unused exemption of their children. But in many cases children of even UHNW families do not have sufficient resources to make gifts to use their exemptions.
- If the parents endeavor to loan funds to the child so that the child can make gifts to use exemption those loans may be re-characterized as a gifts, triggering gift tax on recharacterized loan (i.e. a purported loan re-characterized as a gift).
- Perhaps an alternative might be for an existing dynasty trust, of which the children are beneficiaries, to guarantee the loan so that it may in fact be characterized as a loan. The child/borrower may then use the funds to consummate a gift.

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Only One (Not Both) Spouses Should Make Gifts?

- **Example**: Husband and wife have a combined estate of $16 million and are willing to make $8 million in transfers to irrevocable trusts to secure a portion of the temporary exemption. If each of husband and wife transfer $4 million to a non-reciprocal spousal lifetime access trust ("SLAT") in 2026 when the exemption declines by half, to perhaps $6 million, each spouse will be left with $2 million of exemption, or a total of $4 million.
- If instead husband alone transferred $8 million to a trust for wife and descendants, wife would still have her entire $6 million exemption left. For taxpayers with estates of a size where there is no need to preserve the new GST exemption, it might be prudent to make late allocations of GST exemptions to existing trusts so that if a future administration rolls back the 2017 Act's benefits, those trusts will already be exempt.

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DAPTs more Important then Ever

- Access to assets to be transferred in order to use the temporary large exemptions may be critical for many clients other than certain UHNW (ultra-high net worth) clients. Many single clients, and even many married clients, will want or insist on being able to access the assets transferred. With historically high exemptions, very large transfers (relative to the net worth of moderate wealth clients - perhaps, defined as those having estates between $5 million to $40 million) are necessary to make a meaningful impact in securing the large temporary exemption.
- Consider recent cases.

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Self-Settled Domestic Asset Protection Trusts - DAPTs

- Modern trust planning techniques provide an array of options to permit a client to benefit from assets transferred to completed gift trusts that can use exemption. Access is key for most clients. These include:
- DAPTs – 19 states now permit DAPTs. Consider having the client move to a DAPT jurisdiction.

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Self-Settled Domestic Asset Protection Trust Issues

- Self-Settled Trusts. Whenever Someone Creates a Trust from Which He or She *May Receive* Distributions *in the Discretion of the Trustee* Is a Self-Settled Trust—That Is, a Trust a One Has Created (or "Settled" as the English Say) for One's Self.
- In many jurisdictions, a self-settled trust is void as to the settlor's creditors. In New York, for example, EPTL 7-3.1 provides: "(a) A disposition in trust for the use of the creator is void as against the existing or subsequent creditors of the creator."
- Restatement (Second) of Trusts, Section 156(2) (1959) provides in part "[w]here a person creates for his own benefit, a trust for support or a discretionary trust, his transferee or creditors can reach *the maximum amount which the trustee under the terms of the trust could pay to him* or apply for his benefit." (Emphasis added.

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Self-Settled Domestic Asset Protection Trust Issues

- Comment f to Section 60 of the Restatement (Third) of Trusts provides that creditors of the settlor may attach the maximum interest the settlor retained in the trust or the *trustee* could transfer to the settlor.
- US Bankruptcy Code 548(e) provides:
- (1) In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if—
  - (A) such transfer was made to a self-settled trust or similar device;
  - (B) such transfer was by the debtor;
  - (C) the debtor is a beneficiary of such trust or similar device; and
  - (D) the debtor made such transfer with an actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.

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DAPT Variations – The Hybrid DAPT

- Hybrid-DAPTs where someone in a non-fiduciary capacity can name the settlor as a beneficiary.
- In Iannotti v. Commissioner of New York State Dept. of Health, 283 AD 2d 645, 725 NYS, 2d 866 (2001), a trust protector had the power to amend the trust and thereby make the grantor a beneficiary. Based on this power, the court ruled that the grantor' creditors could reach the trust assets. Note, however, that the trust protector was subject to a fiduciary duty.

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DAPT Alternative – Special Power of Appointment Trust – SPAT

- Avoiding Self-Settled Trust Status with a SPAT.
- Property owner creates a trust for his or her loved one (perhaps, including a person who is the settlor's spouse at the time in question)
- The trust prohibits the settlor from becoming a beneficiary of the trust by any means, including but not limited to a decanting. (Hence, the trustee can never make a distribution to the settlor).
- However, one of more persons, acting solely in a non-fiduciary capacity, hold a lifetime special power of appointment exercisable in favor of a class (e.g., the descendants of the settlor's mother, which will exclude the power holder). Someone, such as counsel to the settlor, could veto the exercise of the power.
- The power holders should be advised of the power only after the trust is creates.
- The trust is not self-settled.

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SLAT/DAPT Variations Provide Options For Client Plans

- Variations of non-reciprocal SLATs
  - e.g. non-reciprocal SLATs that include hybrid DAPT or SPAT provisions).
  - This is a powerful variation of the more traditional non-reciprocal SLATs and deserves more attention.
  - Rather than focusing on the SLAT acronym focus on maximizing access while controlling the perceived risks of estate inclusion.
  - The plan could be non-reciprocal SPATs, or perhaps a traditional SLAT for one spouse (e.g. a spouse with significant wage income or large IRAs that cannot be transferred), and a hybrid DAPT or SPAT for the other.

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Variations/Access May Add Flexibility to Client Plans

- Restrict the trust so that no distributions can be made to the grantor for ten years and one day after transfers are made to the trust to address the rights of a bankruptcy trustee to disavow a self-settled trust under the Bankrupt Code 548(e).
- Some practitioners provide that the Grantor cannot be added or appointed to be a beneficiary unless there is a divorce or death of a spouse.
- Reasonable compensation from entity interests owned by the trusts may in some instances provide another means of accessing trust assets.

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Other Means of Providing Access

- Loan powers not to primarily assure grantor trust status but to provide access.
  - If the trust is structured so as not to be a grantor trust, loan provisions may provide a means of access before turning on DAPT status.
  - But if the loan may be made without the requirement of adequate security or adequate interest, grantor trust status will also ensue. Indeed, loans to the grantor from a trust, regardless of the terms of the loan, may cause the trust to be taxed as a grantor trust under Section 675(3).
- Floating spouse-clauses.

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Revise Power of Attorney and Revocable Trust Gift Provisions

- Consider that Dem proposals include a cap on annual gifts and/or Crummey powers of $20,000/donor.
- Fund ILITs and other irrevocable trusts now to avoid the detriment of a gift tax cap. That may also use current exemption.
- Modify POA and RLT gift provisions to permit funding existing ILITs even if the gifts have to exceed annual exclusion amounts. Many standard forms cap gifts based on annual exclusions which may be too low to fund many existing life insurance plans.

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Life Insurance, ILITs, Credit Shelter Trusts

- Some clients have terminated or are in process of terminating Life Insurance, ILITs, Credit Shelter Trusts because there is no benefit with current high exemptions. If the Dems win in 2020 that may change dramatically.
- Consider modifications to such trusts instead of terminating them.

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Slide 35

SG46 "maintain" as opposed to "fund"
Sandy Glazier, 10/7/2019

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Planning for Larger Estates to Leverage Exemption and More

[redacted]

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Advise Clients About Exemption Planning in 2020

Do GRATs Make Sense? Sometimes

[redacted]

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GRATs in the Current Environment

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- For many, if not most, wealthy (not uber wealthy) clients GRATs are not an optimal tool in the current environment because they do not use the current high but temporary exemption.
- If you believe that there is any risk of a Dem victory and harsher estate tax, i.e. reduced exemptions, GRATs may not be advisable for clients with unused exemption.
- If GRATs do make sense for the particular client consider that the Dem proposals emasculate GRATs so that the traditional application of GRATs as rolling or cascading GRATs may not be possible. Don't count of being able to roll a GRAT as that may be eliminated. Make sure the plan works even under that scenario.

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Do GRATs Make Sense? - 1

- For many if not most only wealthy (not uber wealthy) clients GRATs are not an optimal tool in the current environment because they do not use temporary exemption.
- For uber wealthy clients that have used all of their exemption, GRATs may be an appropriate tool to freeze value, lock in discounts, etc. before a possible 2020 Dem change. However, GRATs perhaps should not be planned in the traditional or historic application of the technique.

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Do GRATs Make Sense? - 2

- If GRATs do make sense for the particular client consider that the Dem proposals emasculate GRATs so that the traditional application of GRATs as rolling or cascading GRATs may not be possible. Don't count of being able to roll a GRAT as that may be eliminated. Make sure the plan works even under that scenario.
- Might longer term GRATs make more sense to be part of a plan if rolling them may be eliminated by future legislation?
- If longer term GRATs are used consider the impact on GRAT immunization. Cash may not be a viable immunization agent in a longer term GRAT.
- Consider very long term say 99-year GRATs as an interest play. That may be a useful application for wealthy clients that have no remaining exemption.

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Community Property Trust

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Community Property Trust for Basis Step-up on First Death

- Consider planning to use community property rules to obtain a full basis step up on the death of the first spouse to die (subject to the normal exceptions, such as for income in respect of a decedent).
- While there are 11 states with community property laws, three of the states provide elective community property laws that anyone can avail themselves of: Alaska, Tennessee and South Dakota, with others contemplating adding such provisions to their statutes.
- Some commentators have different views as to the effectiveness of these statutes for non-residents of those states.
- Residents of non-community property states, for example, might create a community property trust in Alaska in an attempt to obtain a full basis step up on the first spouse's death on all assets held in that community property trust. In reality, it is not a step up but more akin to a mark to market regime as basis can be stepped down as well.

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Limiting 2519 Risks

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Limiting 2519 Risks Generally

- The longer the time period between a distribution from a QTIP to the surviving spouse and a subsequent transfer the better.
- Have legal documentation, e.g. amended and restated Shareholders Agreement, signed after distribution.
- An independent economic event during the intervening period may be helpful, e.g. a dividend.
- Differentiate from bad facts in the Kite case which involved a distribution from a QTIP followed by a contribution to a deferred CLAT and the spouse/beneficiary/transferor died before any payments.

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Limiting 2519 Risks – Bifurcate QTIP

- Consider a division of marital trust to proactively to insulate against a Section 2519 attack if the QTIP trust is selling an asset.
- Assume, for example, that an irrevocable trust that qualifies as a QTIP trust (e.g. a failed GRAT structured to qualify for a marital deduction) is, pursuant to the terms of the governing instrument, to be combined or poured into the primary QTIP trust. If that first trust is to engage in a sale or transaction that might pose a 2519 arguments, perhaps the two QTIPs can be bifurcated to prevent a 2519 attack from reaching the second QTIP. I
- n other words, one might wish to take steps to prevent the otherwise intended combination of the two QTIP trusts (e.g. the failed GRAT/QTIP merging into the primary QTIP at the end of the term of that failed GRAT).
- The same governing instrument might include powers to divide trusts and even not to merge trusts.

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Advise Clients About Exemption Planning in 2020

BDT (Beneficiary Deemed Owner Trust)

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BDT

- **Example**: UHNW clients if they have, for example, large non-GST exempt trusts, might create new GST exempt trusts. A family member may create a new irrevocable trust that is a so-called Section 678 grantor trust as to the existing non-GST exempt trust, funding that new trust using a portion of her current enhanced gift and GST exemptions. If the old and the new trusts are both grantor trust, then the old non-GST exempt trust might engage in transactions that attempt to shift value to the GST exempt trust, before the laws change unfavorably. One approach to this might be for the non-GST exempt trust to sell assets in a note sale transaction to the new GST exempt trust thereby freezing the value in the non-GST exempt trust.
- Consider risks.

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Differentiate Collateral; Differentiate Guarantee

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Differentiate Collateral on Sale to Old Trust

[redacted]

- Selling assets to an existing irrevocable trust that has significant assets from prior planning, consider using assets other than the assets being sold in the current transaction as collateral.
- **Example**: ABC, LLC interests were sold to a trust years ago and that transaction has been completed and any note repaid. Now, the taxpayer is contemplating selling XYZ, LLC interests to the same trust. Instead of using XYZ, LLC interests as collateral on the note the trust gives the selling taxpayer, what if instead ABC, LLC interests are used as collateral for the note? Might that reduce the potential strings attached to the asset sold that the IRS might use to argue for estate tax inclusion?

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Different Application of Guarantee

[redacted]

- What if a guarantee is used and the terms require that the seller/lender/donor must first proceed against the guarantor before proceeding against the collateral? While unconventional, might that create more distance from the asset sold if there is no collateral in the trust other than the original asset? How would the guarantee fee have to be adjusted to reflect this increased risk? Since the guarantor would be first "in line" before the collateral, the fee to be charged would have to be greater than in a traditional guarantee arrangement. In such instances, it might be prudent to have an independent appraiser evaluate what a fair guarantee fee might be for the transaction.

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Defined Value Mechanisms

Drafting Wandry Clauses Post-Powell and Using Other Techniques

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Non-Wandry Defined Value Mechanisms

- Non-Wandry types of mechanisms are based on the entirety of the intended value being transferred away from the transferor.
- If there is an excess value over what the buyer in the transaction is paying, as a result of an IRS audit adjustment, that excess value is poured into a non-taxable receptacle.
  - Charity (but, be cautious if a private foundation is used since this may not be a feasible mechanism).
  - A grantor retained annuity trust ("GRAT").
  - Marital trust (other than a "QTIP" which requires the election to be made on the gift tax return by the due date for the year the gift was deemed to have been made).
  - An incomplete gift trust.
- There is little agreement amongst practitioners as to which spillover or structure is best.

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Wandry Clause

- In W*andry* the tax court upheld an approach that relied on the transfer of a fixed value of assets to a trust rather than a specified portion of equity.
- **Example**: "Taxpayer hereby transfers $100 worth of stock to XYZ trust."
- While many practitioners prefer a *Wandry* approach over a *King* approach, the IRS has non-acquiesced to the *Wandry* decision.
- Another variation of a *Wandry* approach is for the beneficiaries to execute a disclaimer of any value in excess of the specified value. The concept behind this approach is that this would make it difficult for the IRS to argue more was transferred if the recipient trust is prohibited by the disclaimer from accepting the incremental value. This idea is attributable to Stacy Eastland.

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Wandry Post-Powell

- Wandry – Reconsider Classic Wandry Clauses in light of Powell?
- Many practitioners believe a Wandry clause provides security to deflect a valuation challenge by the IRS of a transfer to, for example, an irrevocable trust. Other practitioners might view the protection as less secure
- A response to this uncertain and potentially expansive view of Code Sec. 2036(a)(2) under Powell/Cahill might be to reconsider the traditional Wandry adjustment mechanism and use a different approach to assure that no equity remains with the transferor in order to assure that the transferor cannot "in conjunction with" control any of the entity interests transferred.
- Consider a secondary sale of any interests remaining with the seller as a result of the Wandry clause effective on the date of the primary sale at a price pegged at the gift tax value as finally determined. Consider signing a secondary purchase agreement to govern this.

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King Price Adjustment

- The *King* case might provide a planning option to consider for a price adjustment clause. *J. King*, CA-10, 76-2 USTC ¶13,165.
- **Example**: "Taxpayer hereby transfers $100 worth of stock to XYZ trust for a note. If the value of the stock is finally determined for gift tax purposes to be greater than $100 the face amount of the note shall be adjusted accordingly." Some practitioners report what they described as favorable results on audits using this approach.
- Other practitioners are less optimistic and are simply not comfortable with a *King* type approach. Some object to *King* based on the structure of the adjustment. For example, might the adjustment of the note be viewed as an impermissible condition subsequent under a *Procter* analysis? On the other hand, some view *King* as an "outlier" not to be relied upon because it is only a 10th circuit case.
- King might require a business purposes or motive not merely estate planning.

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King Price Adjustment

- The *Ward* case rained a bit on the *King* parade according to some views. *C. Ward*, 87 TC 78, CCH Dec. 43,178.
- A variation of a traditional *King* type approach might be for the note's face value to be defined as being the gift tax value as finally determined. This idea is attributed to Steven Gorin, Esq.

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Be Careful with S Corp Stock

- **Example**: On March 1, 2019, Jack transfers all of his shares in his S corporation with an aggregate fair market value of $1 million to the Jack Family Trust, which is a valid S corporation shareholder (it is either an ESBT, QSST, or grantor trust). Jack believes that he has transferred all of his S corporation shares but, if it turns out that the aggregate value of all of Jack's shares were worth more than $1 million, Jack will be deemed to have sold the excess shares to the Jack and Jill Trust, which is a non-grantor trust. The Jack and Jill trust does not own any S corporation shares. In 2022, the IRS picks up Jack's gift tax return for audit and determines that the value of the shares transferred to the Jack Family Trust was $1.2 million. As a result, Jack is deemed to have sold $200,000 worth of shares of S corporation stock to the Jack and Jill Trust on March 1, 2019. However, the time for the Jack and Jill trust to make an ESBT election or otherwise qualify as a valid S corporation shareholder has long since passed. As a result, the entity itself could be deemed to have lost its S corporation status.

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Be Careful with S Corp Stock and BDOTs

- What if a sale is made of S corporation stock by a non-GST exempt ESBT to a GST exempt BDOT?
- If all stock is sold the selling ESBT's status as an ESBT ends.
- If the BDOT is grantor a to the ESBT does the ESBT election cover and apply to the BDOT and the stock the BDOT purchased?
- If one share of stock is retained in the ESBT that may assure ESBT status remains intact.
- The new BDOT could make an ESBT election as well but if it is grantor then grantor trust status supersedes the ESBT election.

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Sale to Non-Grantor Trust – 2 Tier Defined Value Mechanism - 1

- In some instances, use of a non-grantor trust might be advantageous as the buyer in a note sale or other transaction, even if unusual. The basis step-up on the death of the first spouse's might permit avoiding capital gain on a sale. Also, an old no-longer grantor trust may have substantial assets and avoid the need for seed gifts or guarantees and make the perceived risk of the transaction lower.
- How should a defined value mechanism be structured for such a transaction?
- A two-tier defined value mechanism would be necessary to address both income tax audit results as well as gift tax audit results, since a sale to a non-grantor trust could trigger both income and gift tax audit adjustments.

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Sale to Non-Grantor Trust – 2 Tier Defined Value Mechanism - 2

- The income tax audit adjustment could be based on an IRS argument that the value of the asset (e.g., stock in a closely held corporation) was understated so that the transaction is in reality a part gift/part sale with less shares having been sold.
- This adjustment could be independent from a later gift tax audit that argues that the valuation was low, and hence a gift made. Thus, in contrast to the economic adjustment clause illustrated above for a sale to a grantor trust, a two-tier adjustment might be necessary to conform the economics to the ultimate result of the transaction.

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Consider Economic Adjustment Provisions

- Inherent in many defined value mechanisms is that an adjustment might be made at a future date and affect which taxpayer owns the LLC interests from the inception of the transaction.
- While defined value mechanisms routinely address the allocation of these equity interests, how are the economic implications of the adjustment provided for? If five years pass from the date of a transaction until the interests sold are determined definitively, how will the economic consequences of that five-year period addressed?
- The consequences might include dividends or distributions that need to be repaid from the recipient to the correct party, e.g., the seller.
- Also, what mechanism will be used to assure that the equity interests are properly adjusted? Will merely providing for an adjustment clause alone suffice?

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Consider Economic Adjustment Provisions

- Sample Clause: "….. the Buyer [trust] and the GRAT have determined the number of Shares to be sold to the Buyer (i.e., the Actual Sale Shares) and the number of Shares to be gifted to the GRAT (i.e., the Actual Gift Shares") and …. It is understood that the CPA Report will corroborate the amount of dividends, other distributions, or other economic benefits that accrued to the Buyer prior to the Distribution Date (as defined in the Transfer Agreement), and that are properly allocable to the GRAT, if any. The Escrow Agent shall not submit the Existing Stock Certificate, the Sale Stock Power or the Gift Stock Power to the Corporation (or its transfer agent) pursuant to Section X until after the Escrow Agent receives written notice signed by the Buyer and the GRAT, in form and substance satisfactory to the Escrow Agent, that the Buyer has reimbursed the GRAT, or made adequate arrangements to reimburse the GRAT as permitted under the Transfer Agreement, for any amounts payable to the GRAT pursuant to the CPA Report."

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Use an Escrow Agent - 1

- If a sale occurs subject to a defined value mechanism and/or a deferred payout supporting the note, who holds the collateral for the note? Who holds what documentation pending the resolution of the defined value mechanism? In most cases these documents are held by the estate planner crafting the transaction. Might there be a better option? The *Ward* court noted:
- "Furthermore, since there is no assurance that the petitioners will either recover the excess shares or, at the time of their deaths, possess the power to recover such shares, and since the shares are not worthless, the petitioners' estates may be reduced by the transfer of the shares."

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Use an Escrow Agent - 2

- Might having title documents held in the hands of an independent escrow agent who assures that necessary adjustments are made, deflect this concern? Using an independent law firm, not a firm otherwise involved in the transaction, with a detailed escrow agreement specifying which documents should be held, and how they should be handled, might add additional credibility to the arrangement and negate the issue raised by the *Ward* court. Endeavoring to adhere to all relevant formalities could be important.

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Loans

Step or Deferred Interest?

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Stepping/Deferring Interest Payments under a Note

- Assume a client is going to engage in a note sale to a grantor dynasty trust (a so-called Intentionally Defective Irrevocable Grantor Trust or "IDIGT"). But the entity whose interests are being sold has current cash flow needs for business research and development. As a result, distributions will be difficult/limited for several years.
- Can the purchasing trust backload the scheduled payment dates of the interest that accrues under the term of the note? During the first X years of the note, the purchaser pays interest every year at a rate of say 1%. The remaining and unpaid 2% interest (assuming a 3% AFR) will compound at the same 3% AFR rate until it is paid. Thus, the note will have negative amortization during the first X years of its term. After the first X years, the purchasing trust will pay the full interest that accrues every year on a current basis (or if advisable from a cash flow perspective another "step" in rate can be used). During the remaining term of the note, the purchaser also will pay the compounded shortfalls in interest payments that arose during the first X years of the note.

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Stepping/Deferring Interest Payments under a Note

- The delayed payment during the first X years of the note of the interest that accrues should not by itself cause the note that the purchaser gives to the seller to be recharacterized (e.g. as an invalid indebtedness, a gift, as equity instead of debt, etc.).
- Code Sec. 7872 provides rules for the tax treatment of loans with below-market interest rates. Code Sec. 7872(a)(1) recharacterizes the below-market-rate demand loan as a two-step transaction: (1) The lender treated as having transferred on the last day of the calendar year an amount equal to the forgone interest (the prevailing federal rate of interest less the loan's actual interest rate) to the borrower; and (2) The borrower/trust is then treated as retransferring that amount back to the lender as imputed interest.
- if interest accrues and is not paid the original issue discount (OID) rules will apply. The OID rules would have the taxpayer report a pro rata amount of the overall amount of the OID over the life of the loan using a constant yield method under the Regulations under Code Sec. 1272. But on a sale to a grantor trust the OID complications appear to be obviated. So, while these rules should apply, they should have no income tax significance.

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Advise Clients About Exemption Planning in 2020

Administer Trusts Properly

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Administer Trusts Properly

- The *SEC v. Wyly* case continues to serve as a reminder about the importance of proper trust operation. In *Wyly* the trust had trust protectors for each of 17 inter-vivos trusts. None of the persons serving as trust protectors were related or subordinate. Nonetheless the trustees followed all investment recommendations made by the protectors including with regard to collectibles, etc. The conduct of the trust protectors and settlors was such that the court imputed all actions of the trust protectors to the settlors since there was a pattern of action. *SEC v. Wyly et al*, No. 1:2010cv05760 - Document 622 (S.D.N.Y. 2015).

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Administer Trusts Properly

- Have annual trust meetings.
- An Investment Policy Statement ("IPS") might be created for each trust.
- Consider having power holders, fiduciaries and others sign a written acknowledgement of understanding their role, confirming actions taken, etc.
- Prepare a trust balance sheet.
- Confirm all payments (note interest, GRAT annuity payments, etc. are made timely).
- Adhere to all formalities. Be certain deposits and payments are made from correct trust accounts.
- Be certain assets are properly titled in the name of the trust. Consider bank truncation of trust names and impact.

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Conclusion and Additional Information

Advise Clients About Exemption Planning in 2020

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Conclusion

- Many clients, even moderate wealth clients, could be planning aggressively now in advance of the 2020 (and if not the 2024) election.
- Regardless of the election outcome which is unknown the exemption declines to $5M inflation adjusted in 2026 and current deficits might not permit Congress to make the current high exemption current
- Clients should not wait as starting the planning gives more time and may negate step transaction and reciprocal trust doctrine challenges.
- Planning is similar to 2012 – use exemption, but with the high exemptions, preserving access to assets is more important then ever.

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Conclusion

- Wealthy clients should be planning aggressively now. It is not worth the risk, however it is estimated, that Dems may win in 2020 and dramatically alter the transfer tax system.
- Planning should begin in earnest now if it has not already begun.
- Make gifts between spouses early to reduce the risk of a step transaction challenge.
- Set up new irrevocable trusts and make seed gifts early in 2020 follow by note sales or similar transactions later in 2020 to reduce step transaction risks.
- If non-reciprocal SLATs (or variants) are to be used consider setting up one SLAT early in 2020 and another later in 2020.

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Elevated Trust & Wealth Management Solutions

A KEY ESTATE PLANNING GUIDE

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