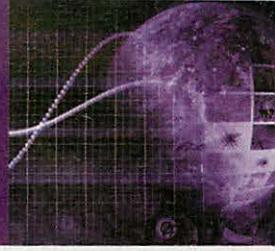

By **Jonathan G. Blattmachr** & **Martin M. Shenkman**

Planning in a Time of Uncertainty: Part II

Factors to consider moving forward

The election of Donald J. Trump as President, along with a Republican-controlled House and Senate, may lead to the most radical changes to the estate tax since it was first enacted. In Part I of this two-part article, we discussed the general background practitioners should consider in evaluating the potential changes that might occur so that they can better advise their clients. That article also suggested that while the initial reaction of many clients and practitioners has been to hit the planning "pause" button and adopt a wait-and-see approach, that may not be the most optimal option. Now, we'll further explore planning considerations.

Possible Transfer Tax Scenarios

The discussion of potential transfer tax changes in Part I suggested a number of iterations for the new planning environment. Possible tax scenarios are:

- Immediate permanent repeal of the gift, estate and generation-skipping transfer (GST) taxes, with the possibility of them being reinstated later.
- Permanent repeal of all wealth transfer taxes to take effect over some phase-out period, for example, 10 years, similar to what occurred in 2001. This scenario would also present the risk that the tax may be changed again during such phase-out period as happened in the past. It isn't clear that President Trump would be satisfied with such a lukewarm version of repeal.
- Repeal of the estate tax but retention of the gift tax as a backstop to the income tax.
- Repeal of the estate tax (with or without a repeal of the gift tax) and the implementation of carryover basis.
- Repeal of the estate tax (with or without a repeal of the gift tax) and a capital gains tax on death.
- Repeal of the estate tax (with or without a repeal of the gift tax) and inclusion of gifts and inheritances in gross income.
- Characterization of inheritances as income. From an economic perspective, a lottery winning is treated as income, so it may not be unreasonable to treat an inheritance in a similar manner.

Practitioners will have to contemplate these possibilities, and perhaps others, while advising clients, especially those in the midst of planning, until there's more certainty as to what the law may provide.

Planning at Different Stages

What clients might be willing to do with respect to planning, and how practitioners approach and advise different clients, will in part depend on how far client planning has progressed.

Planning hasn't started. The most enticing path many clients who haven't begun planning in earnest might opt for is a wait-and-see approach. For clients who'd been discussing planning, for example, to address the proposed Internal Revenue Code Section 2704 regulations (proposed regs) or to prepare for what was anticipated to be a Hillary Clinton victory and roll back of estate tax laws to the 2009 harsher levels, and who still haven't progressed in their planning, doing nothing is likely the most enticing option. "Why plan now if I can wait and see what the law will be so I'll know what to do?" Further, if the client was unwilling to address the significant tax worries that

Jonathan G. Blattmachr, left, is a principal at ILS Management LLC in Melbourne, Fla. **Martin M. Shenkman** is an attorney in Fort Lee, N.J.

the proposed regs or the anticipated Clinton victory might have brought, now that the proposed regs are, as suggested by attorney Steve Akers, "DOA,"[1] these clients may be completely disinterested in planning until the results of the Trump administration's tax proposals are known. Unlike clients who are already well into the planning process, these clients have limited commitment (that is, money and time) invested in the planning process. While the wait-and-see approach has had significant risks and costs associated with it during past periods of uncertainty (for example, late 2012), does it now? One potentially costly downside to not beginning planning now is if the client doesn't survive the political process of repeal (or whatever else might occur). What if the estate tax isn't repealed? In 2012, practitioners advised clients about the risk of the estate tax exemption dropping from approximately $5 million to $1 million in 2013. A wait-and-see approach in 2012 could have resulted in little downside as the exemption wasn't reduced. But, what's the downside of waiting to see what 2017 brings? In contrast to what practitioners believed in Fall 2016, the risk of the proposed regs becoming effective and planning opportunities being lost isn't significant. What's the possibility of a capital gains tax at gift and death being enacted and the failure to plan now resulting in the lost opportunity to avoid those taxes? It's difficult to forecast how most clients will "dollarize" those risks. But, the calculus is fundamentally different from 2012. In 2012, the risk was a significant tangible lowering of the exemption, a tax concept understood by many. Now, the risk is an elimination of the estate tax that might obviate the need for interim planning. Also unknown is whether a capital gains tax on death and retention of the gift tax could be more costly for some clients than the current system permitting a step-up in basis at death under IRC Section 1014.

> Trusts provide income tax planning opportunities by sprinkling income to whichever beneficiary is in the lowest income tax bracket.

What that might mean for planning that hasn't yet begun is that unless there's either a significant non-tax motive or a tax motive for a client in a terminal or other extreme situation, perhaps a wait-and-see approach isn't unreasonable. Nonetheless, if a client is motivated to action by either the retention of the estate tax system or the potential adoption of a capital gains tax at death, he probably should consider acting promptly while the playing field is known and the client can control tax costs and financial risks.

Apart from the tax issues, those who haven't yet started their estate plan should still act now. Estate planning never should have been only about estate taxes. For most people, more wealth is dissipated from elder financial abuse, lawsuits, divorce, spendthrift heirs and other risks than from estate taxes. Properly crafted modern trusts can address almost all of these goals and provide more flexibility no matter which way the tax winds blow.

Planning in process now. The most seductive planning approach for clients in the process might be the same wait and see. For example, many clients are midstream in the planning process, forming non-reciprocal, spousal lifetime access trusts (SLATs) to which gifts might be made. They're also structuring note sale or similar transactions to secure valuation discounts that were undertaken in light of the proposed regs reducing or eliminating discounts and the concern that a Clinton victory would have led to a rollback in gift exemptions to the 2009 $1 million level. What do those clients do now? If the plan is well along the way, is it advisable to complete it? One approach is to stop the planning and do nothing, and await the outcome of any Trump tax plan. That, however, may not be the optimal approach as explained above.

Example 1: Client began a plan to create two non-reciprocal SLATs in late 2016 out of concern about adverse tax changes. Now that the proposed regs are of much less concern, and the Clinton rollback of the estate tax to 2009 levels a memory, is there a benefit to completing the planning that's lingered on and not yet concluded? If the gifts contemplated to each trust are under the exemption amount, this planning might be viewed as having no downside gift tax risk, so there should be no reason not to complete the planning. The non-tax benefits of the structure also remain intact.

Example 2: Client is a physician and has an estate of approximately $25 million. The client's attorney drafted non-reciprocal SLATs to which the clients contemplated gifts of discountable assets prior to the effective date of the proposed regs. Part of the motivation is asset protection planning. While the need to secure those discounts might appear academic in light of the election, the clients will assuredly take advantage of the asset protection benefits of the irrevocable trusts regardless of whether there are estate and gift tax benefits. Because the transaction is reasonably close to completion, the trusts might be modified to reflect some of the planning ideas discussed in this article (for example, naming a non-fiduciary to hold a power to give the grantor an IRC Section 2038 power) and the transaction concluded. Perhaps the level of transfers might be reduced somewhat to lessen the gift tax exposure until more is known about the future tax legislation. However, if the client resides in a decoupled state, perhaps the planning should continue unabated.

Example 3: Client owns a valuable building held in a limited liability company (LLC). Planning had begun to shift the LLC interests to irrevocable trusts to secure discounts before the anticipated proposed regs become effective. The client is quite old and ill and is domiciled in a decoupled state. Consider the discussions above as to the 20 percent capital gains tax impact and the timing of possible repeal. If the likelihood of the client dying before repeal is significant, the planning, perhaps at least in modified form, should be completed. If the risk is viewed as not that significant, then perhaps planning could be deferred as it isn't clear whether planning will prove advantageous. But, how could that be reasonable in light of the current almost 50 percent marginal state and federal estate tax rate? There are no non-tax benefits to consummating the transactions, as the client's wills would bequeath the assets to long-term protective trusts for the children without further lifetime planning. The practitioner could order a life expectancy analysis for the client to endeavor to gain better information on his current health status. However, as explained above, if there's indebtedness on the client's assets or they're appreciated, the client should also consider action in light of the Trump plan for a capital gains tax at death.

Example 4: Client owns a large family business. The family is involved in a complex note sale (installment sale to a grantor trust) transaction that involves several tiers of transactions. Should the plan be abandoned? Perhaps not. Safeguarding and preserving the family business was the prime directive of the founding patriarch. Leaving stock in the family business exposed to possible transfer taxes under a current, repeal or un-repeal system, remarriage, creditor risks, etc. is neither prudent nor acceptable to the family. Stock that's held in an irrevocable trust that isn't GST tax-exempt might be better protected in a dynastic trust. Because the transaction has progressed reasonably far down the planning continuum, and regardless of the outcome of the estate tax repeal, it may be advantageous to have the family business stock shifted to the dynastic GST tax-exempt trust. While the risk of death before repeal occurring may not be viewed as significant, and the risk of a worsening estate tax environment (for example, with the proposed regs) not as material as when planning began, the efforts and cost to complete the transaction are worthwhile for the benefits to be obtained and are insignificant relative to the value of the business. Most important, it would be advantageous to have the stock held in the intended trust. With interest rates poised to rise, delaying the transaction may make it more difficult to implement.

Complete low risk gift planning: Some commentators have suggested that it's advisable to conclude planning steps that are low risk in terms of triggering a current gift tax cost. But, what might that mean? How low risk should planning be if the transfer of assets to an irrevocable trust prior to the possible enactment of a 20 percent capital gains tax on gifts might be avoided?

Further, the use of the defined value mechanism in the note sale transaction might be evaluated in light of recent developments such as *True v. Commissioner*.[2] The IRS has, however, reinvigorated its attack on defined value mechanisms and seems to have pursued *True*, a case that isn't merely a *Wandry*-type clause case and that used a reputable appraisal firm.[3] So, the suggestion of pursuing low risk transactions isn't clear. Another question to consider is whether it's really low risk for a large estate not to plan and merely wait for resolution as to future estate tax legislation.

Example 5: Client has a $15 million dollar estate and has made no taxable gifts. She gifts $5 million of marketable securities to a self-settled trust. This gift is likely to be low risk in terms of gift tax. There are no valuation issues, and the gift is well below the client's exemption.

Example 6: Clients have a $25 million dollar estate, $10 million of which is comprised of an LLC that owns marketable securities and $10 million of which is a real estate LLC that owns commercial rental property. They've made no taxable gifts. Wife gifts $5 million of discounted membership interests in the marketable securities LLC to a SLAT. Thirty days later, she sells $5 million of discounted interests to the SLAT. Is this likely to be low risk in terms of gift tax exposure? There are potential valuation issues. If the transaction is protected by a *Wandry* clause, will that suffice? The IRS is presently challenging the application of a *Wandry* clause in the *True* case and may well continue to pursue these cases. What if the estate tax is repealed but not the gift tax? If the client is audited and faces an audit adjustment, the gift tax exposure on that audit may have been for naught because if the client had waited, the repeal of the estate tax may have obviated the need for planning. Should this planning be pursued? Does a *Wandry* clause make the transaction lower risk? What if a different type of defined value mechanism were used instead? Does lowering the discount rates lower the risk profile of the plan? What if the 30 days were increased to 75 days? The reality is that determining the risk profile of any transaction is quite subjective, fact sensitive and will vary as each practitioner weighs these factors.

It doesn't seem that adopting a wait-and-see estate tax planning strategy is wise in most situations.

Already existing planning. Until something more definitive is known about a Trump estate tax plan, it might be premature to modify existing planning, but practitioners should consider apprising clients of the possible unintended consequences and planning considerations. If the estate tax is repealed, a myriad of issues will be raised:

- Practitioners might encourage all clients to revisit will and revocable trust dispositive schemes. In particular, how might language in existing documents be interpreted under various possible scenarios for future legislation? Might the client's intended dispositive plan be disrupted? Even if uncertainty abounds, might it be advisable in some instances to take a precautionary stance and revise documents now?
- If a client has a long-term grantor-retained annuity trust (GRAT) or note sale transaction in place, the contractual obligations to continue payments may or may not be affected by repeal. If a court-ordered modification is obtainable, for example, as the GRAT no longer serves its purpose, will that trigger a gift tax as of the inception of the transfer if the gift tax isn't repealed? Will the result differ if the gift tax is repealed? What about the fiduciary duty of the trustee? Would a court even permit the modification of an irrevocable trust that's valid under state law because of a post-funding change in tax law?
- What will happen with audits in process under current law? If the estate tax is repealed and prior audits continue, what resources would the IRS have to allocate to such audits?
- What, if anything, should be done about existing will and trust provisions?

Future Trust Planning

Many clients will opt for simplistic outright bequests if there's no tax incentive. Practitioners will have to educate clients as to the obvious (to the practitioner, but not necessarily to the client) benefits of continued trust planning:

- Trusts can provide valuable divorce and asset protection benefits. In the absence of any transfer taxes, this may become the primary goal for many trust plans. With increased longevity, the likelihood of remarriage following the death of a prior spouse likely will increase. The need for trusts on the first death to protect those assets is more important than many realize.
- Trusts provide income tax planning opportunities by sprinkling income to whichever beneficiary is in the lowest income tax bracket. The distributions carry out income under the distributable net income rules of IRC Sections 651-652 and 661-662. Even if the beneficiaries are all in the maximum income tax bracket, there still might be significant state income tax differences or the ability to offset a trust gain by a beneficiary loss.

- Elder financial abuse is burgeoning. Trusts provide control as a client ages or as the client's health wanes. While some may suggest that using a revocable trust could mitigate the dissipation of wealth, that may not be correct, particularly as a client's cognitive abilities wane. The transition period from the client serving as sole trustee to a successor trustee can be dangerous. While the risks can be mitigated with a trust protector, co-trustee or requiring consent of another party to modify or revoke the trust, irrevocable trusts provide another option. And, a trust can be made irrevocable without making transfers to the trust taxable gifts.[4]
- Trust planning may also be modified to reflect the potential repeal of the estate tax:
  - Discretionary trust distribution standards should replace mandatory income distribution standards because these won't be required to meet qualified terminable interest property (QTIP) requirements under IRC Sections 2056(b)(7) and 2523(f) although, perhaps, a QTIP-type trust will qualify for a spousal exemption (postponement) under a capital gains tax at death system.
  - Consider including powers of appointment so that assets can be revested in the grantor (or perhaps another person) if it proves advantageous under the new post-repeal planning rules to obtain a basis step-up. The provisions should permit inclusion but not mandate or force inclusion; if retaining assets in the trust might avoid a capital gains tax on death and that proves more advantageous, pursue that approach.
  - The trust could give the trustee, or perhaps better yet, a trusted third party acting in a non-fiduciary capacity, a power later to give the grantor the right to control beneficial enjoyment to cause estate tax inclusion in the grantor's estate under IRC Section 2038. A corporate trustee may be unwilling to exercise such a power, so it may be advisable to grant the power to an individual. It may also be advisable for that person not to act in a fiduciary capacity. When the grantor dies, a step-up in basis under IRC Section 1014 for trust assets could be realized if those assets were included in the estate under estate tax rules in effect as of date of repeal. Therefore, it can be advantageous to create and fund a trust, not have it included (automatically) under IRC Section 2036(a) and structure it so that creditors can't attach trust assets. If the trustee doesn't grant the power, no estate tax inclusion will occur. If the trustee does grant the power, there will be estate tax inclusion. It might be advantageous to grant the trustee or other person the right to select assets over which to grant this power to the trust's grantor. If an asset has declined in value, it may be preferable to avoid changing the basis at death.
- How might practitioners contemplate the repeal of repeal, or the reinstatement of an estate tax, in drafting new documents? With so much uncertainty, is it even advisable to endeavor to anticipate reinstatement in documents? What might be done with a tax apportionment clause for documents anticipating a future reinstatement of an estate tax? This situation is similar to what practitioners considered as 2010 approached with the law providing for no estate tax in that year. Practitioners had to construct their documents to say, in effect, "I leave my assets this way if there is an estate tax in effect when I die, but that way if there is none." This will require careful thought in structuring and drafting. As indicated above, even if the estate tax is repealed, the repeal may disappear after 10 years, if not earlier, by a change in the White House and the Congress.
- If the estate tax might be reinstated, planning that removes assets from the client's estate (with the powers to cause inclusion if that proves advantageous) might protect the family from the estate tax if it comes back in the future.
- Another virtually risk-free option is a GRAT described in IRC Section 2702(b). Although designed to eliminate some estate tax, the grantor probably can structure one with little or no gift tax effect. Having the remainder of the GRAT pass into a trust from which the grantor may benefit seems relatively riskless if the trust is created in a jurisdiction that protects self-settled trusts from the grantor's creditors.
- A married taxpayer might create a "QTIP-able" trust for his spouse at the beginning of 2017 and wait until October 2018 to see if QTIP (marital deduction) treatment under IRC Section 2523(f) should be elected. That will depend in part on whether the gift tax is repealed along with the estate tax. However, it's appropriate to ensure that

the client can regain any significant assets transferred for at least two reasons: (1) the client may want those assets back if there's no estate tax (or at least the benefit from them or the continued control over them) and to obtain a step-up in basis if that happens; and (2) lifetime transfers, at least those in trust, can be reclaimed for estate tax inclusion.[5] One way is to permit the trustee to grant the grantor at a later time some control over the trust assets, even asset by asset, causing estate tax inclusion under Section 2038. However, if the estate tax is repealed, there will presumably be no Section 2038, so how the step-up in basis would be impacted under a repeal regime is uncertain.

Virtually all taxpayers should consider undertaking arrangements that have low gift and income tax risk and low cost. These options, including an installment sale to a grantor trust or a GRAT as described above, are two of many that can be implemented. Obviously, these will work best to remove assets from an estate tax system and probably a capital gains tax on death system, if the assets perform well from a financial viewpoint. Consider creating these arrangements under the laws of a domestic asset protection state so the grantor may be able to continue to enjoy them if desirable.[6]

Business Planning Matters

The corporate tax rate likely will be reduced, perhaps, down to 20 percent or 15 percent. The difference between the maximum corporate and individual tax rate may be significant such that evaluating business structures may be advisable. That means that C corporations may be more favorable to use then in the recent past. One important issue may be whether an S corporation should elect C corporation status or whether an entity taxed as a partnership (or proprietorship) should elect C corporation status. Of course, dividends from C corporations are taxable, but the rate on them may decline to 16.5 percent, so the combined rate on earnings distributed from a C corporation may be in the 30 percent or more range. Advisors probably should consider:

- The optimal form of business may change for some clients. It's anticipated C corporation rates may decline from 35 percent to 15 to 20 percent. What about dividends? There's a proposal for this under the Trump/Republican plan as well. There would be a 50 percent exclusion of dividends for income tax purposes. This exclusion might cover capital gains, dividends and interest, which would result in an effective tax rate of one-half of 33 percent or 16.5 percent.
- Would a C corporation be better, especially if income will be accumulated? What will become of the accumulated earnings tax? At present, there are many uncertainties.
- There's a proposal that tax rates on pass-through entities would be capped at 25 percent. So, leaving an LLC, S corporation or partnership might be advantageous because the maximum rate may be 25 percent, and the equity owners can take funds immediately.

Low Risk Planning Steps

While there seems to be a realistic possibility of estate tax repeal, it's not a certainty. It seems much less likely for there to be repeal of the gift tax. The fact that any repeal may be accompanied by a capital gains tax at death or on gift complicates planning further. It doesn't seem that adopting a wait-and-see estate tax planning strategy is wise in most situations. Rather, it seems appropriate to take planning steps that have little or no tax risk (such as gift or income tax) and that involve small financial cost or risk. These steps might be a GRAT with small gift tax risk (and perhaps a self-settled trust as the remainder beneficiary) or an installment sale to a grantor trust, both involving assets that the client believes will perform well financially.

Endnotes

1. Steven R. Akers, "*True v. Commissioner*, Tax Court Docket Nos. 21896-16 and 21897-16 (petitions filed Oct. 11, 2016): IRS Attack on '*Wandry*' and Price Adjustment Clauses," Bessemer Trust (November 2016), *http://bit.ly/2io6rdt.*
2. *Wandry v. Comm'r*, T.C. Memo. 2012-88 (defined value formula to determine amount of a transfer respected).
3. *See True v. Comm'r*, Tax Court Docket Nos. 21896-16 and 21897-16 (petitions filed Oct. 11, 2016).
4. *See* Treasury Regulations Section 25.2511-2(b) (fourth sentence).
5. *See* Madeline J. Rivlin and Jonathan G. Blattmachr, "Searching for Basis in Estate Planning: Less Tax for Heirs," 41 *Estate Planning* 3 (August 2014).
6. *See www.shaftellaw.com/docs/tenth_annual_comparison_dapt_statutes_2016.pdf* to see comparisons of these states. And, in particular, *see* Private Letter Ruling 200949012 (Aug. 17, 2009) discussed in detail in Gideon Rothschild, et al., "IRS Rules Self-Settled Alaska Trust Will Not Be in Grantor's Estate," 37 *Estate Planning* 1 (January 2010).

TRUSTS & ESTATES

The WealthManagement.com journal for estate-planning professionals

Traffic Ahead—"New York Bridges" (30 in. by 24 in.) by Julian Trevelyan, sold for $12,410 at Sotheby's A Painter's Paradise: Julian Trevelyan & Mary Fedden at Durham Wharf sale in London on Nov. 23, 2016, p. 3.

Powered by Penton

FEBRUARY 2017
$35.00

PULL-OUT SPECIAL SECTION: **Valuations**

www.trustsandestates.com