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Estate Planning Before 2020 Election: Maybe Only One Spouse Should Make Gifts

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I write about charitable giving and estate planning ideas.

One of the most common estate planning tools is right now are non-reciprocal spousal lifetime access trusts (“SLATs”). We’ll explain that common planning technique and then why the way many folks implement it might not be the best approach (i.e., maybe only one spouse should set up a trust, not both). But first some background on why you might consider this technique and the broader planning picture that is involved. The key take home lesson is just because everyone else is using a particular technique, doesn’t mean its right for you. Planning must be tailored to your unique circumstances to work best. Why are so many people considering SLATs as part of their plan? Elizabeth and Bernie!

No predictions about the 2020 election, but if the Dems win, and if they get enough control over Congress, they’ll try to pass harsh estate tax reforms. Many Dem hopefuls have spoken about increasing taxes on the wealthy to pay for health care, student loan forgiveness, and more. Whatever might be proposed may well follow the provisions in Bernie Sander’s estate tax changes he proposed earlier this year. These could reduce the gift tax exemption from \$11.4 million (2019) to a mere \$1 million gift exemption. The estate tax exemption might be reduced from \$11.4 million to \$3.5 million. A myriad of other harsh changes might emasculate many of today’s favorite planning tools. Whatever your views on all of this, and however, this all shakes out in the end, it certainly seems sensible for those of means to undertake estate tax planning now.

While most taxpayers will probably take a wait and see approach (if the Dems win and if they propose harsh changes.....then I’ll do something) that could be a loser. What might the effective date of that legislation be? Will you even have the opportunity to plan before harsh changes become effective? Is it really worth waiting? The bottom line for many taxpayers seems pretty simple. Plan now don’t wait.

Plan smart so, that regardless of what happens with the election or estate tax changes, you’ll be happy with what you’ve done. This might require that you consider three key goals:

- Use exemption before it changes.
- Get other benefits from the planning – asset protection, management, control, state income tax savings, etc.
- Preserve access to the assets you’ve given away.

How can you increase the odds of being happy with planning today if the law doesn’t change after the 2020 election? Plan to achieve goals other than just estate tax minimization. Gifting

assets to an irrevocable trust can provide great planning to minimize liability exposure (malpractice risks, lawsuits arising from accidents and more....think those 1-800-SUE-THEM billboards). If you get valuable asset protection, even if the estate tax laws don't change, that's a winner. Very important, for most wealthy folks is maintaining the ability to access assets given away. If you might possibly need to access some of the funds you give away be sure you can. What if you need additional cash flow for medical costs in your golden years? What if you find that dream vacation home? If your planning is done cleverly you will be able to access assets given away to address those unexpected costs and vacation pad. You can both plan and not harm your financial position, so you can proceed without worrying whether or not the law changes.

What this all means is being more prudent about planning than many taxpayers were in 2012.

In 2012 many feared that the gift tax exemption would drop from about \$5 million to \$1 million in 2013 (kinda like what we face now with the 2020 election, or the reduction in the exemption by 2026 to half without any law changes). Too many people who tried to use gift tax exemption in 2012 before the exemption was supposed to drop in 2013 gave assets outright to kids (that's rarely wise) or to trusts for kids or grandkids. That wasn't too swift either because they lost the ability to ever access their money. That wasn't necessary to accomplish the intended estate tax planning results.

So, what do you do to accomplish your goals of using exemption before it drops, protecting assets, and yet still having access? Lots of options:

- If you set up a grantor trust (a trust whose income you report on your personal return and pay income tax on) be sure to give a trustee the right to reimburse you for income taxes paid. Be careful as you might need to set up such a trust in a state where that power won't undermine your plan.
- Include a provision in the trust document that permits a person to loan trust money to you. If you can borrow money from a trust you made gifts to that can provide access to assets you've given away. If you can borrow trust money without adequate security that may cause the trust to be taxed as a grantor trust. Just be sure that is the result you want.
- If you're married set up a spousal lifetime access trust ("SLAT"). With your spouse as a beneficiary you may indirectly benefit from assets in the trust by the trustee making distributions to your spouse.
- If you're not married, or just prefer, you can instead set up a self-settled domestic asset protection trust ("DAPT"). So you can make gifts to a trust, remove those assets from your estate, have those assets protected from creditors, yet still be a beneficiary. That accomplishes all planning goals while retaining access. 19 states now permit these types of trusts, but there are still risks if you live in a state that does not permit these trusts and set up such a trust in a state that does permit it.

So with that background on pre-2020 election planning, a twist on the SLAT planning may be useful to understand. But first, a final piece of background. Traditional SLAT planning often is set up as illustrated below.

Example: Husband sets up a trust for wife and all descendants. Wife sets up a trust for husband and all descendants. Differences are baked into the trusts (set up at different times, different assets in each trust, different distribution standards, different state laws for governing and administering the trust, differ powers of appointment over trust assets, etc.). This is important so that the IRS and creditors cannot “uncross” the trusts and pierce them. If trusts are too similar they could be argued to be “reciprocal” and subject to that risk. The beauty of a properly structured SLAT plan is that assets can be moved out of the couple’s estate, perhaps protected from an Elizabeth Warren estate tax plan, protected from creditors, and the husband is a beneficiary of the wife’s trust. And the wife is a beneficiary of the husband’s trust. So, the couple can move significant wealth outside their estate yet still access 100% of that wealth as beneficiaries of each other’s trust. Do understand that many SLATs are created in trust friendly jurisdictions (the 19 states that permit DAPTs) with independent institutional trustees (not Aunt Jane or cousin Sam as trustees). So if you want a distribution from you’re the SLAT your spouse set up for you, you’d have to ask the trust company and submit a formal request to the trust company’s distribution committee. It would be hoped that gifts to such trusts now might avoid any harsh Dem estate tax proposals if they sweep in 2020 and perhaps even the wealth tax that some candidates have suggested. None of that is certain as no one can predict the format of such proposals, but isn’t it worth trying to avoid those taxes by acting now?

So now that you understand why estate planning is so important to pursue now, some of the many fundamentals you should consider in planning, and a few of the myriad options to get there, what is wrong with the traditional SLAT plan above for some taxpayers? The answer lies in maximizing the use of exemption and preserving the most exemption if the law changes. Many wealthy people do not have nearly enough assets to be able to use all their exemptions now. So while the uber wealthy might well consider having each spouse set up a non-reciprocal SLAT (or really one of the many variations of SLATs, DAPTs or other such trusts), the merely wealthy may not find that to be the optimal approach. Let’s explore why.

In 2019 and 2020, transfers might need to be quite substantial before any benefit of the temporary \$11.4 million (it increases by an inflation adjustment in 2020) exemption is preserved. The reason is that, if (and when) the exemption drops to \$5 million (adjusted for inflation) in 2026 (or earlier if the Dems sweep), the prior use of the exemption may not allow the new (lower) exemption to be used.

Example: You make a taxable gift in 2019 of \$5 million to a SLAT and die in 2026 when the inflation adjusted exemption will be reduced to \$5 million (ignoring inflation adjustments). You would have an estate (or gift) tax exemption of zero left because your 2019 exemption used all your exemption. In other words, the gift in 2019 uses the bottom tier of your exemption not the top tier, so when the exemption is reduced in 2026 (or by Dem legislation) that top tier of exemption you did not use with the gift is just lost. So, this means that, if you want to use the part of the current exemption above \$5 million you would have to make a taxable gift equal to more than what the exemption will be when it is reduced in the future.

So, consider now the commonly touted non-reciprocal SLAT plan explained above.

Example: Husband and wife have a combined estate of \$16 million and are willing to make \$8 million in total gift transfers in 2019 to safeguard a portion of their temporary exemptions. If each of husband and wife transfer \$4 million to a non-reciprocal spousal lifetime access trust (“SLAT”) they will have safeguarded \$8 million of exemption (and any future growth on those assets) in case the law changes. In 2026 when the exemption declines by half, to \$5 million each (ignoring inflation adjustments) each spouse will be left with \$1 million of exemption. So if you add the \$4 million each spouse used in the 2019 planning and the \$1 million each has left in 2026, the couple will have preserved \$10 million of exemption. Good, but they can do better. If Elizabeth is elected in 2020 with a Dem sweep and the estate tax exemption is reduced to \$3.5 million, the couple will have no further exemption left, but they’ll be hugging their estate planning for having helped them safeguard \$8 million before those changes. But then the total exemption safeguarded is only \$8 million. Is that optimal? Maybe. But perhaps not.

Consider having one spouse, not both, use current exemption thereby preserving more exemption for future planning.

Example: Assume the same facts as in the above 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 their temporary exemptions. But instead of setting up two non-reciprocal SLATs as in the above example, the wife gifts \$8 million to a DAPT. Her husband and all descendants are beneficiaries of the trust. So with husband as a beneficiary, so long as he is alive and they remain married she has indirect access to the \$8 million through husband. She even has her estate planner incorporate a mechanism into the trust to add her in as a beneficiary in the future just in case her husband dies prematurely or divorces, so that in those eventualities she can become a beneficiary and have access to the assets transferred. Now what happens if there is no Dem sweep but the exemption drops to \$5 million in 2026 as the law currently provides. Wife used \$8 million of her exemption so she’ll have none left. But, since husband did not use any of his exemption in the plan, he will still have \$5 million of exemption left in 2026. So his \$5 million of exemption and the \$8 million of exemption the wife used in 2019 means the couple has preserved \$13 million of exemption, \$3 million more than had they used the non-reciprocal SLAT approach in the prior example. Now consider what happens if the Dems sweep and a \$3.5 million exemption is enacted. Wife will have used and safeguarded \$8 million of exemption in the 2019 plan and husband will have \$3.5 million remaining so that they will have safeguarded \$11.5 million. That is \$3.5 million more than the SLAT plan above.

So, be sure to seriously consider planning before the 2020 election. Plan in a way that you’ll be satisfied and benefited regardless of what happens with the election, and be certain that the planning is tailored to fit your circumstances, not some hypothetical planning situation your golf buds are boasting they used.

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