2021 Income and Estate Tax Planning Steps to Recommend to Clients – In Depth

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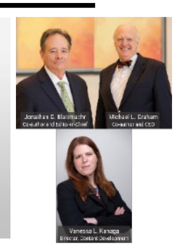

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Estate Planning Post-GA Runoff Election

Use exemption and more despite uncertainty but with formula clauses

Post-Election Planning

Introduction and Overview

Introduction

- Biden is the President elect, and the House is Democratic. At this juncture we now know that the Senate is split so that the tie vote is cast by Vice President elect Harris.
- There could be massive tax increases on the wealthy, including income and estate taxes. Clients that did not complete planning in 2020 should be advised to use their gift and GST exemptions before they may be changed, but there is more to it then that.
- There are many strategies (planning vehicles) and various options for each that practitioners should recommend clients consider now. These include: Domestic asset protection trusts (DAPTs and variations of them), spousal lifetime access trusts (SLATs), special power of appointment trusts (SPATs), Note sale transactions, GRATs, GRIPs and more.
- How might this planning be modified considering the significant unknown of what will happen and when it may be effective?

Where We Are Early 2021?

- What is the landscape of the post-election environment?
- US Senate – the GA run-off resulted in the Democrats getting both seats so it will be 50/50 in the Senate and VP Kamala Harris will break any tie vote.
- Senate has rule that any Senator can filibuster but 60 Senators can end a filibuster. But there are exceptions for judges and budget reconciliation. You do not need 60 votes, but a simple majority.
- 2001 Tax Act was passed in the same way with a 50/50 split and the VP Dick Cheney casting the final vote.
- The Republicans in 2017 passed tax legislation opposed by Democrats with a slim majority in the Senate through a budget reconciliation process which bypassed the 60-vote filibuster threat.
- It is unclear what tax changes may occur.

Early 2021 Planning Environment Post-GA Election

- **Values**: Suppressed asset values remain for many businesses and equities. Discount rates may be higher because of uncertainty.
- **Interest**: Interest rates are at near historic lows (the Section 7520 rate for January 2021 is .6%). For comparison, in 1989, the Section 7520 rate was at a high of nearly 12 percent, and in March of 2009, it was almost 3 percent. Family loans and note sale transactions are a techniques that are enhanced when interest rates are low.
- **Deficits and Taxes**: The massive federal bailout – and more may be coming especially with Democratic control. This may eventually require that taxes on the wealthy (and the not-so-wealthy) be raised. While no one can forecast what tax law changes may occur, it seems logical that income and estate taxes will increase, perhaps markedly so. Therefore, shifting assets out of an estate using current favorable laws, such as by using note sales to grantor trusts, etc., may prove very advantageous.

Goals to Address Post-Election

- **Protection from a retroactive tax change**: If you make a gift in February and the exemption is reduced for gift tax to $1M effective 1/1/21 what do you do? What if you do a 1031 exchange but before the transaction is consummated 1031 exchanges are eliminated?
- **Access:**
  - Most clients will not shift significant wealth if they cannot have access to that wealth
  - The techniques to use now are more robust and different than what many practitioners did in 2012 (and we all recall some "buyer's remorse" with 2012 planning)
- **Exemption**: Use of exemption and estate reduction before laws become less favorable. Plan to reduce client's estates before tax laws are changed to be harsher.
- **Asset protection**: All planning should protect assets for the client as well. This will help motivate clients to act. It's not just about helping heirs but protecting the client as well.
- **Wealth Tax**: Possibly avoiding a future wealth tax – thought might that be less likely without a Democratic sweep? But if the Democrats win the runoff races might that still be a possibility?

Forecasts, Insurance and More!

- Ideally before consummating any plan have the client's wealth adviser create a forecast to identify how much can be transferred, that the client can support their lifestyle without access to trust assets (even if it's a trust to which the client will have direct or indirect access), etc. That forecast can give the client comfort with the plan, deflect a challenge that there had to be an implied agreement with the trustee to make distributions, and counter a challenge that the transfers were a fraudulent conveyance.
- Recommend insurance. Before transfers are made if the client has adequate liability insurance, long term care coverage and life insurance, that may help support that the client was not making a fraudulent conveyance and that the client had adequate resources after the transfer. Review life insurance to insure the mortality risks of the plan. Consider life insurance to address premature death of a spousal beneficiary of a SLAT and the mortality risk of longer term GRATs.
- **Better planning is always a team effort not an activity for any one siloed professional**.

Practitioners Should be Cautious

Take Steps to Protect the Client and The Practitioner

Practitioners Should be Cautious

- Should you structure a plan to be able to unwind it if the tax law results are different than anticipated? What if giving a beneficiary the right to **disclaim** on behalf of an entire trust? What of a gift to a QTIP trust that will not use exemption if the marital deduction is not made. Might this suggest that the client is not comfortable with the planning? Or is the client comfortable and just hedging against uncertainty?
- Should you use a promise to pay to avoid transferring assets? Perhaps but consider why the client is not willing to transfer assets? If the client is uncomfortable with the planning is substituting a "**promise**" the right approach or perhaps the client should go back to their wealth adviser for forecasts to be certain that can comfortably make transfers? Perhaps more access has to be provided to the client for the client to be comfortable transferring assets.

Practitioners Should be Cautious

- What is the reason the client is uncomfortable committing? Does the client appreciate the asset protection benefits the plan may provide? Why would the client then want to retain assets and use a promise or build in a disclaimer? There are certainly circumstances where these mechanisms make sense, but they may not make sense in all cases and in fact in some instances may indicate an underlying discomfort or even problem.
- Is the client so focused on using exemption to save taxes that they are not addressing whether the quantum of transfers are prudent?

Practitioners should be Cautious

- Have clients sign a solvency affidavit even if the trust is not a DAPT and even if there is no state law requirement for such an affidavit.
- Have the client prepare and sign a balance sheet.
- Have lien, judgement, credit report and other due diligence completed to demonstrate that there are no outstanding issues.
- Have the client's wealth adviser prepare forecasts modeling out planning scenarios for decades to come.
- Offer the client options not one plan. Let the client choose.
- Apprise the client that every plan and technique has risks. Nothing is certain.

Formula and Other Estate Planning Techniques to Address Retroactivity

Unwinding Planning To Avoid an Unintended Gift/GST Tax

Might Changes be Retroactive?

- Retroactive effective date to 2021 legislation back to January 1, 2021 is still possible if the Democrats get equal representation in the Senate.
- To be retroactive the law must be rationally related to a legitimate legislative purpose.
- See Pension *Benefit Guaranty Corporation v. R. A. Gray & Co.*, 467 U. S. 717 (1984); *United States v. Carlton*, 512 U.S. 26 (1994).
- Consider this possibility in all wealth transfers.

Can you Avoid a Failed 1031 Because of a Retroactive Law Change?

- Can you incorporate into the transaction documents a termination of the transaction if there is a retroactive change to Code Section 1031?

Avoiding an Unwanted Transfer via Disclaimer

- Consider including in irrevocable trusts a provision permitting one beneficiary to disclaim on behalf of all trust beneficiaries. That should give 9 months for clients to disclaim which under Sec. 2518 would result in the exemption not being used and the assets being restored and assets reverting to the settlor.

Avoiding Unintended Transfer via QTIP Election

- Make transfers to a trust that will qualify for the marital deduction if a QTIP election is made on a gift tax return by the 2021 extended filing date. If the election is not made the assets would pass to a non-qualifying trust for the surviving spouse that would use exemption.

Use a Formula

- Make a Formula Gift.
- You make a gift to a trust that fractional share of assets the numerator is my available exemption, and the denominator is the full value as finally determined for gift tax purposes.
- Put assets into LLC and make a transfer of a fractional interest in the LLC. The Numerator should consider the possibility of retroactive changes in exemption amount.
- This is based on the Wandry case. In Nelson did not use the phrase “for gift tax value as finally determined”.

Sample Formula Gift for 2021-1

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Assignment

- I, [DONOR NAME], in consideration of $10 cash received from [TRUSTEE NAME], as Trustee, of the trust dated [TRUST DATE] (known as [TRUST NAME]) and its successors and assigns, the receipt of which is hereby acknowledged, and $10 cash received from [SPOUSE'S NAME], my spouse who is a United States citizen, the receipt of which is hereby acknowledged, hereby make the following assignments of all of my right, title and interest in [PROPERTY DESCRIPTION] ("the Property") as follows:
- Alternatively, this gift of the amount, if any, in excess of the donor's gift tax exemption, could pass to a trust for the spouse which is designed to qualify for the QTIP election, or to an "incomplete gift" trust created by the donor. The latter may provide a way to use this technique for a client who is not married.

Sample Formula Gift for 2021-2

- To the Trustees of [TRUST NAME] that fractional share of the Property (a) the numerator of which is the lesser of (i) the entire fair market value of the Property as finally determined for Federal tax purposes as of the date of this instrument, or (ii) the amount of my Remaining Gift Tax Exemption, and (b) the denominator of which is the fair market value of the Property as finally determined for Federal tax purposes as of the date of this instrument.
- To [SPOUSE'S NAME] the remaining fractional share, if any, of the Property not assigned above to the Trustees of [TRUST NAME];
- I authorize [SPOUSE'S NAME], individually as assignee of any interest in the Property and as the principal beneficiary of [TRUST NAME] to renounce and disclaim any of the Property assigned above and to the extent, if any, my spouse makes any such renunciation and disclaimer the property so renounced and disclaimed that otherwise would pass to my spouse directly or to the trust shall be revested in me.

Sample Formula Gift for 2021-3

- For purposes of this instrument, the following terms shall have the following meaning:

1. The "Gift Tax Exemption" shall mean an amount equal to the maximum fair market value of property which, if transferred by gift (within the meaning of Section 2501 of Code) as of the date of this instrument, would generate a tax equal to the amount allowable as a credit under Section 2505 of the Code, taking into account any amendments to the Code made by legislation enacted after the date of this instrument but which is applicable to transfers made on the date of this instrument.
2. My "Remaining Gift Tax Exemption" shall mean an amount equal to the Gift Tax Exemption reduced by the amount of such Gift Tax Exemption I have used or been deemed to have used by any prior transfers by me before this transfer including those made earlier this calendar year.
3. The "Code" shall mean the Internal Revenue Code of 1986, as amended.

- IN WITNESS WHEREOF I have executed this Assignment as of the ___ day of ___________, 202__.

____
[DONOR'S NAME]

Post-Election Planning

Income Tax Changes

Income Tax Planning Opportunities

Overview

- Income Deferral
  - Charitable Remainder Trusts
  - §453 Installment Sales
  - Opportunity Zones
  - §1031 Exchanges
- Income Shifting
  - Charitable Remainder Trusts
  - Family Limited Partnerships
- Income Acceleration
  - Roth Conversions
  - Capital Gain Harvesting
- Income Avoidance
  - Opportunity Zones
  - §1202 Qualified Small Business Stock
  - Incomplete Gift Nongrantor Trusts
  - Charitable Lead Trusts

Big Picture Shift in Tax Policy

1. No IRC § 1031 exchanges
2. 39.6% LTCG
3. Carryover basis or recognition at death
4. Charitable Deductions and 28% benefit
5. Retirement Deductions and 28% benefit
6. Estate Tax Exemption
7. Estate Tax Techniques & Rates

Retro-Activity Risk

- Congress may have the ability to enact retro-active tax legislation thereby limiting the ability to front-run changes
- Retroactive taxation of transactions is possible if rationally related to a legitimate legislative. *Pension Benefit Guaranty Corporation v. R. A. Gray & Co.*, 467 U. S. 717 (1984); *United States v. Carlton*, 512 U.S. 26 (1994).

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President Biden's Campaign Tax Policy Proposals

- Tax increases on over **$400,000** of income
  - Expand the 12.4% Social Security tax
  - Restore the 39.6% marginal rate
  - Cap the itemized deduction tax benefit to 28%
  - Restore the 3% PEASE limitation
  - Add a new Section 199A Deduction Phaseout

President Biden's Campaign Tax Policy Proposals

- **Taxes on Capital**
  - 39.6% rate applied to capital gains over $1,000,000
  - Eliminate the basis "step-up" at death
  - Possible recognition event at death

Objective will be to "smooth out" income

President Biden's Campaign Tax Policy Proposals

- **Proposal to Expand Social Security Tax**
  - Applies to earned income over $400,000
  - The established 12.4% rate & employee/employer split retained
  - Creates a tax-free gap between the Social Security base and the $400,000 threshold

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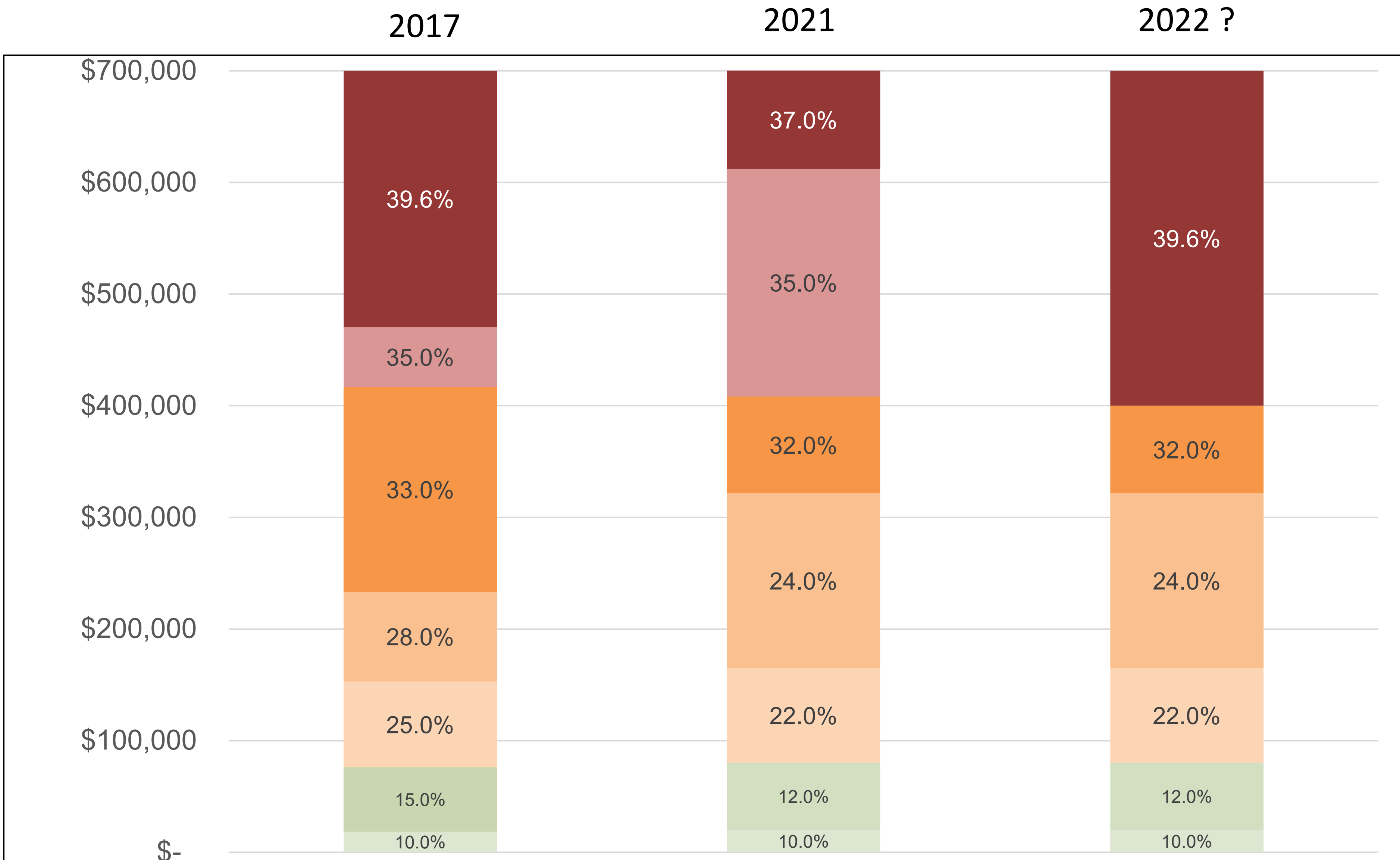
President Biden's Campaign Tax Policy Proposals

- **Proposal to Restore the 39.6% marginal rate**
  - Would apply to income over $400,000
  - Unclear how it is affected by filing status

Married Filing Jointly



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President Biden's Campaign Tax Policy Proposals

- **Accelerating 2021 income to plan for a 39.6% rate:**
  - Roth conversions
  - IRA relocation
  - Harvest gains
  - Defer loss harvesting
  - Defer business expenses

President Biden's Campaign Tax Policy Proposals

- **Return of the SALT Deduction**
  - Not specifically proposed by President Elect Biden, but an often discussed Democrat agenda item
  - Reconsider state income tax minimization strategies
  - Consider deferring tax payments until 2022
  - May even consider incurring late payment penalties

President Biden's Campaign Tax Policy Proposals

- **Proposal to eliminate the preferential rate for long-term capital gains and qualified dividends on income over $1,000,000**
  - Most significant proposal & a fundamental shift
  - Basically an increase from 20% to 39.6%
  - Expect many people to sell assets if it's set to take effect

Consider, for example, how risky funding a substantial sale CRT may be in 2021.

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President Biden's Campaign Tax Policy Proposals

- **Eliminate capital gains rate – deeper thinking**
  - A 39.6% capital gains rate will disrupt holding periods
  - If the "step-up" in basis at death is retained, many people will be substantially more encouraged to hold onto assets until death
  - If the "step-up" in basis at death is repealed in-favor of a forced-recognition event, people will be encouraged recognize gains before death to:
    - (1) Find better investments and
    - (2) Avoid a 39.6% applying in the year of death instead of a 20% rate during life, for example

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President Biden's Campaign Tax Policy Proposals

- **Proposal to eliminate the Section 1014(a) Basis Adjustment at the – "The STEP-UP"**
  - *Most significant proposal & a fundamental shift in the taxation of wealthy individuals*
  - Unclear whether the proposed 39.6% rate would apply to gains in excess of $1,000,000
  - Unclear whether the proposal includes a income tax deduction for estate tax paid (or vice versa)
  - Presumably, gifting assets would also be a recognition event
  - Expect huge gifts & sales if it's set to take effect

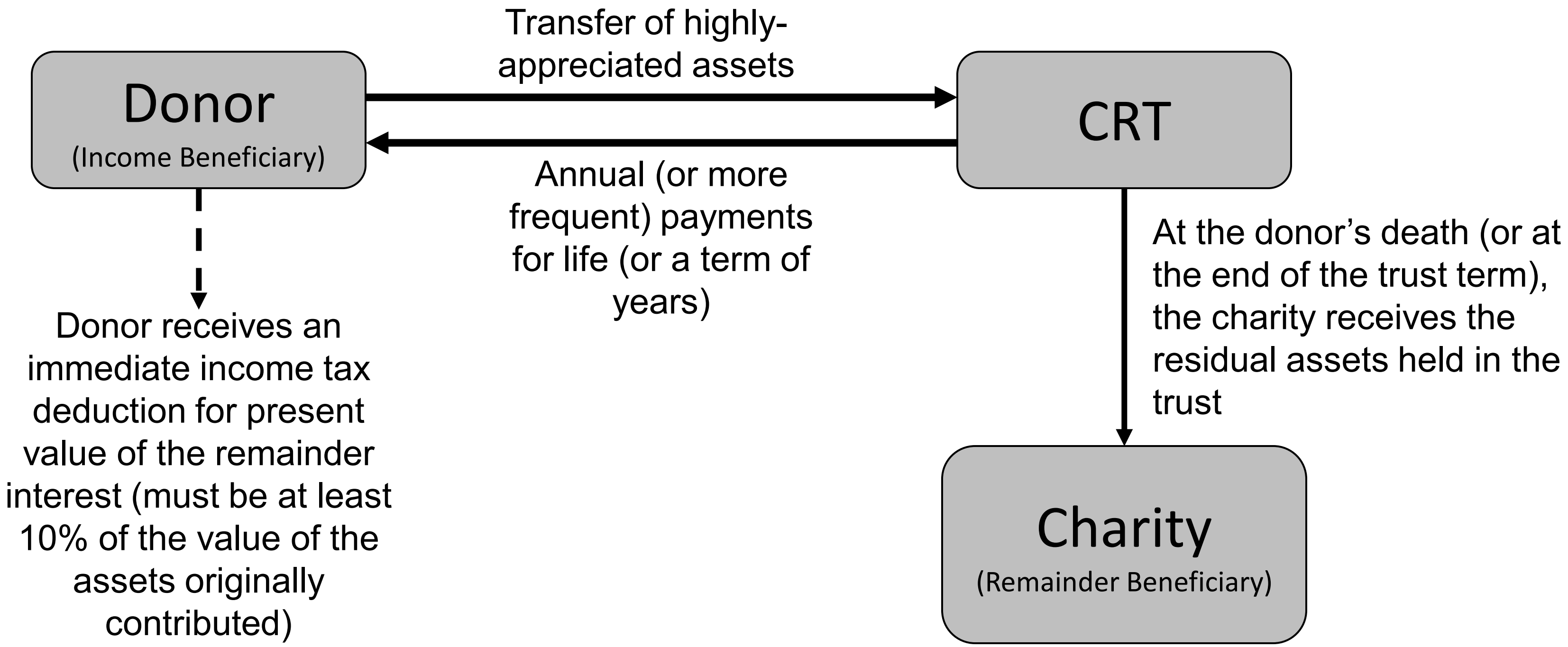
Income Deferral

Charitable Remainder Trusts

Charitable Remainder Trusts

- **Potential Opportunity:**
  - Charitably inclined taxpayer contributes a low basis business equity interest to a CRT.
  - Trustee later sells the interest tax-free.
  - Grantor (or other beneficiary) receives a series of payments which are taxed as paid.
  - Income tax is deferred.
  - State income tax may be avoided.

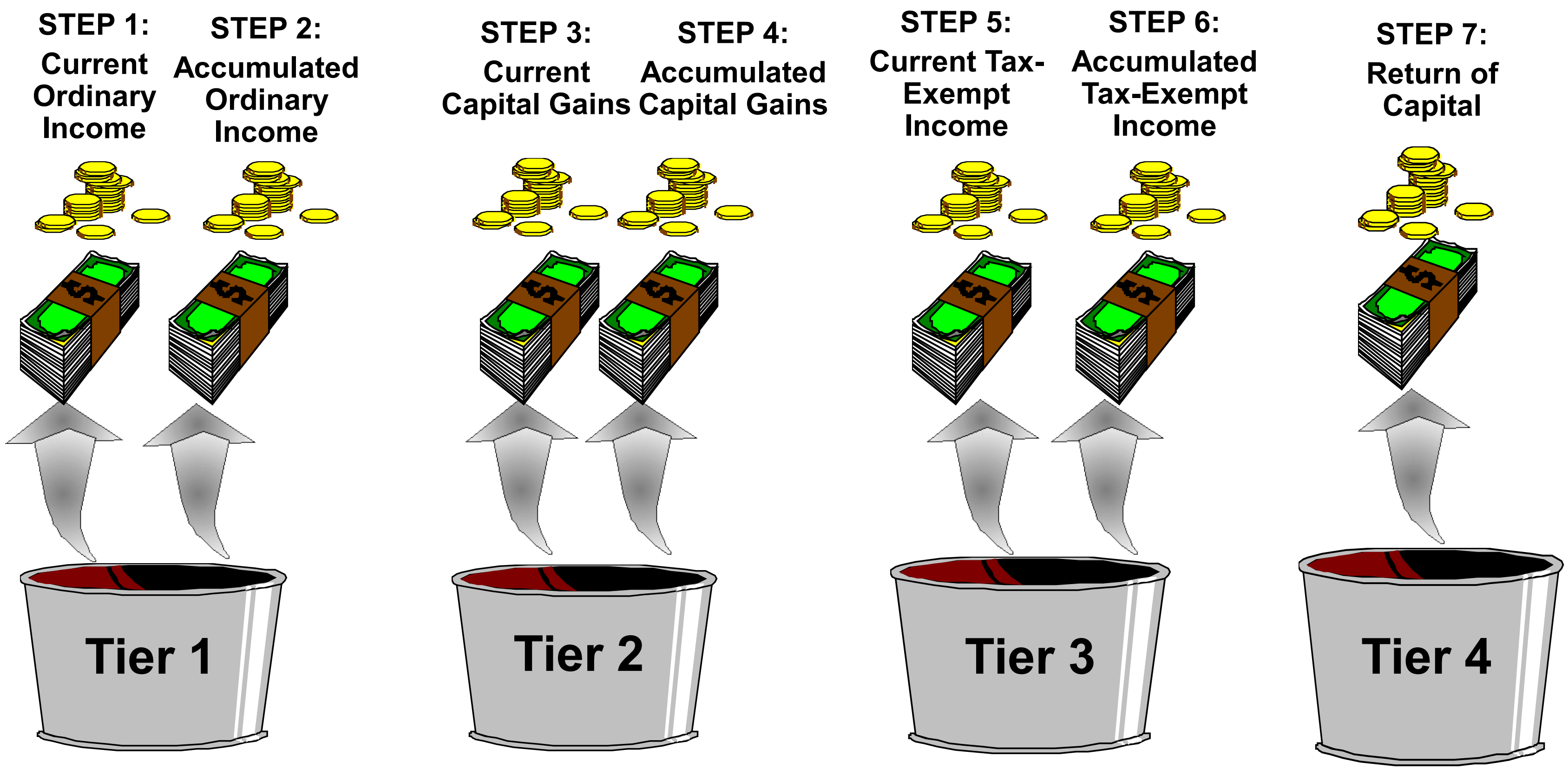
Charitable Remainder Trusts



Charitable Remainder Trusts

- **Taxation of Distributions**
  - The character of income received by the recipient is subject to and controlled by the tier rules of IRC §664(b):
    - First, distributions are taxed as ordinary income
    - Second, distributions are taxed as capital gains
    - Third, distributions are taxed as tax-exempt income (e.g. municipal bond income)
    - Finally, distributions are assumed to be the non-taxable return of principal

Charitable Remainder Trusts



IRC § 453 Installment Sales

Reporting Income from an Installment Sale

- **IRC § 453** - Installment Method
  - Installment sale defined
    - The term "installment sale" means a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs.
    - The term "installment sale" does not include dealer dispositions or a disposition of personal property of a kind which is required to be included in the inventory of the taxpayer if on hand at the close of the taxable year.

26 U.S.C. § 453(b)

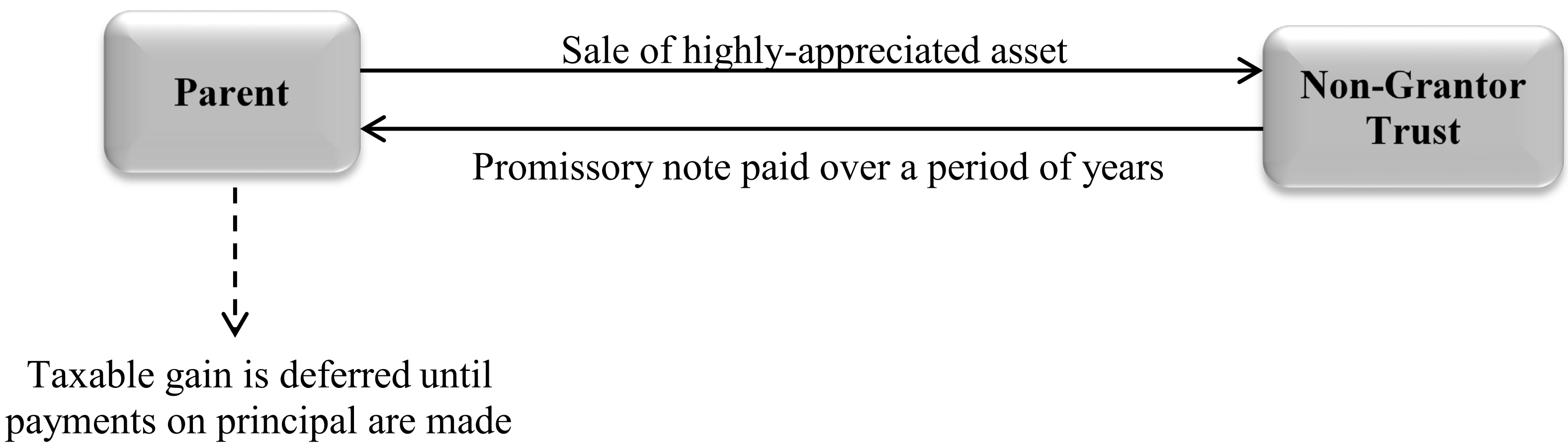
Reporting Income from an Installment Sale

- **IRC § 453** - Installment Method
  - Installment method defined
    - For purposes of this section, the term "installment method" means a method under which the income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.

26 U.S.C. § 453(c)

Reporting Income from an Installment Sale

- **IRC § 453** - Installment Method



26 U.S.C. § 453(c)

Reporting Income from an Installment Sale

- **IRC § 453** - Installment Method
  - Election Out
    - ➢ Taxpayer can elect out of the installment method
    - ➢ Must be made on the return of the taxable year in which the disposition occurs
    - ➢ IRS must consent to revoking the election

26 U.S.C. § 453(d)

Reporting Income from an Installment Sale

Bracket Management

- Install sale benefits
  - Avoids a "spike" in income and allows it to be spread-out
  - **In the extreme, it can convert long-term capital gains taxed at 23.8% to 0%**

Income Shifting

Family Limited Partnerships

Family Limited Partnership

Strategy

- One or both parents create the FLP and serve as the general partner(s), while the children and/or grandchildren serve as the limited partners.

- Initially, the parents hold both the general partner interests and the limited partner interests.
  - Typically, the general partner interest will be as little as 1% of the total equity in the FLP and the limited partner interest will be the remainder of the equity in the FLP so it can be divided up among the children and/or grandchildren by the parents.

Family Limited Partnership

Strategy (continued)

- The parents, as general partners, maintain full and complete control over the FLP while gifting as many of the limited partner units to their children as they desire; thus, reducing their taxable estates.

- Furthermore, gift tax and use of the applicable exclusion amount can be avoided if the value of the units transferred to each child does not exceed the annual exclusion amount

- If Parents wish to transfer assets faster, they can still avoid gift tax by using their AEA.

- Valuation discounts allow even more value to be transferred

Income Acceleration

Gain Harvesting

Gain Harvesting

Overview

- Strategy:
  - Taxpayer expects to be in a higher tax bracket in the future
  - Sell assets and pay
  - Repurchase same or similar assets
- Effect: Shifts recognition of capital gain from a higher future bracket tax year a the lower bracket

Gain Harvesting

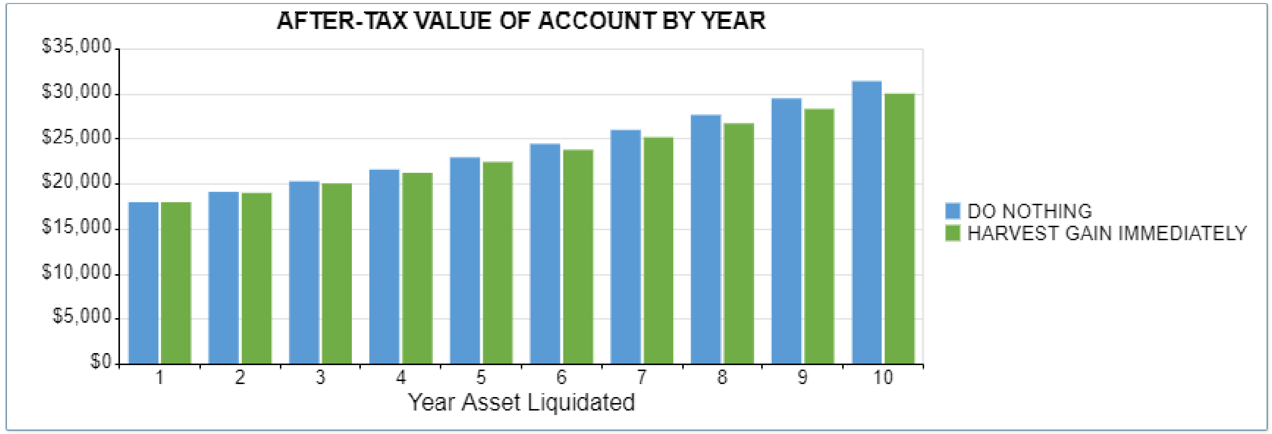
Tradeoffs

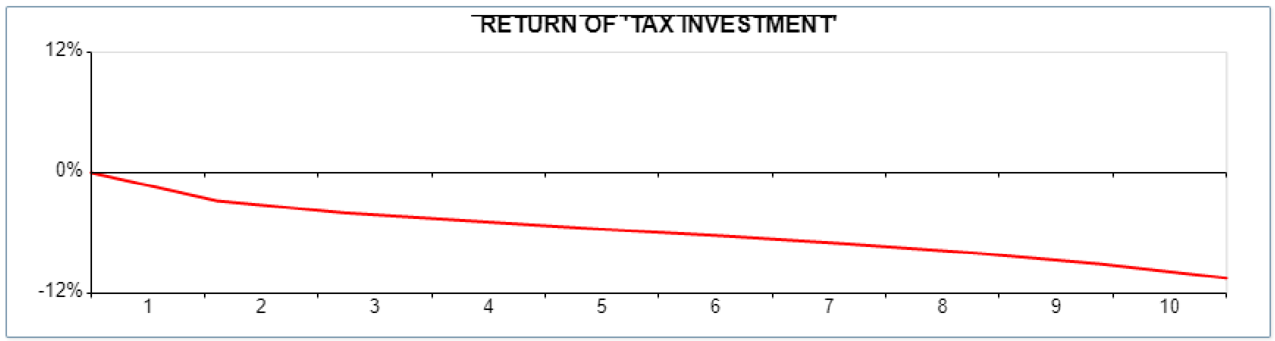
- On the surface, it appears that taxpayers should always harvest gains
- However, harvesting gains introduces a tradeoff between lower tax rates versus the loss of tax deferral
  - Tax is paid at a lower rate, but it is paid sooner
  - Need to determine a crossover point at which selling sooner makes more sense; A way to conceptualize this would be to use a return on investment (ROI) approach

Input & Summary | Detail

GAIN HARVESTING CALCULATOR

CURRENT CAPITAL GAINS TAX RATE	20.0%
FUTURE CAPITAL GAINS TAX RATE	20.0%
BASIS OF ASSET	10,000
FMV OF ASSET	20,000
ASSUMED GROWTH RATE	7.0%





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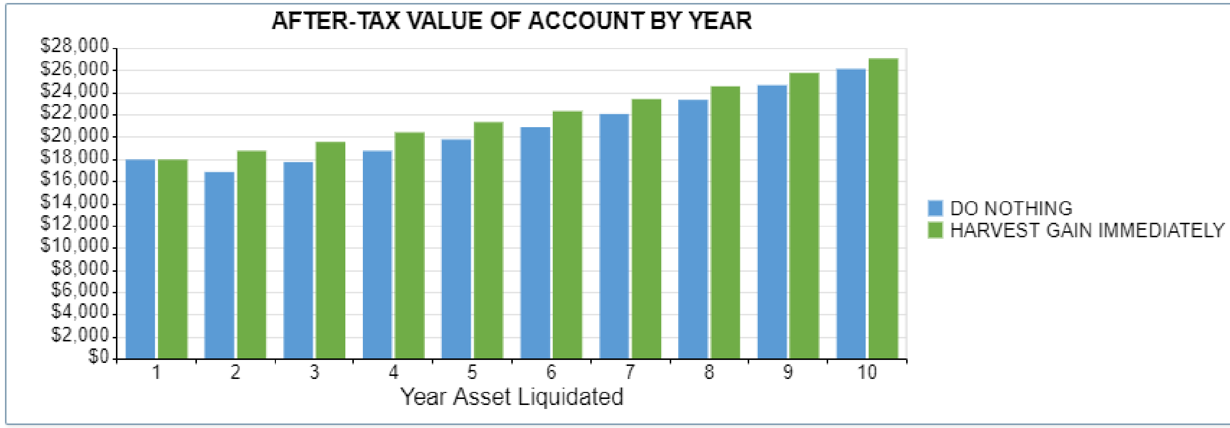

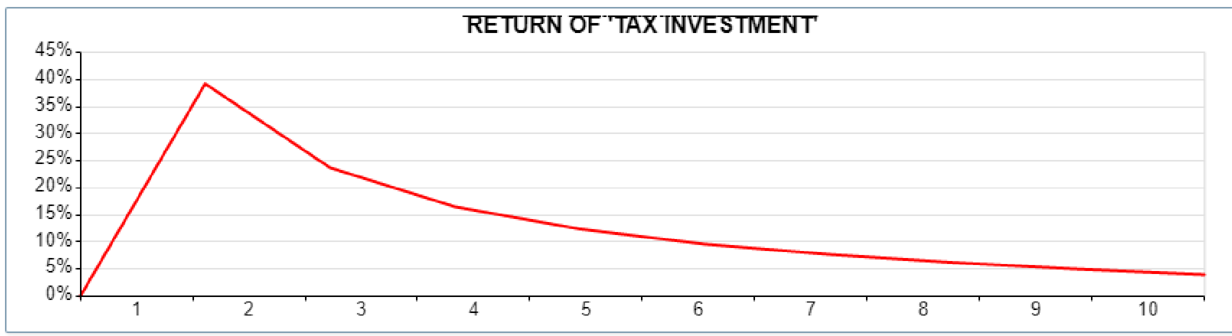

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Mathematics of Roth IRA Conversions

Mathematics of Roth IRA Conversions (No Estate Tax)

	Traditional IRA	Roth IRA	Life Insurance
Current Account Balance	$ 1,000,000	$ 1,000,000	$ 1,000,000
Less: Income Taxes @ 40%	-	(400,000)	(400,000)
Net Balance	**$ 1,000,000**	**$ 600,000**	**$ 600,000**
Growth Until Death	300.00%	300.00%	300.00%
Account Balance @ Death	$ 3,000,000	$ 1,800,000	$ 1,800,000
Less: Income Taxes @ 40%	(1,200,000)	-	-
Net Account Balance to Family	**$ 1,800,000**	**$ 1,800,000**	**$ 1,800,000**

Mathematics of Roth IRA Conversions

- Tactical considerations
  - Unused charitable contribution carryovers
  - Current year ordinary losses
  - Net Operating Loss (NOL) carryovers from prior years
  - Alternative Minimum Tax (AMT)
  - Credit carryovers
  - Dollar-cost averaging to reduce the risk that the amount converted will decrease in value

Mathematics of Roth IRA Conversions

- Critical decision factors
  - Tax rate differential (year of conversion vs. withdrawal years)
  - Use of “outside funds” to pay the income tax liability
  - Need for IRA funds to meet annual living expenses
  - No RMDs
  - Tax-free post-mortem distributions
  - Time horizon
  - Estate tax considerations
  - Ten Year “Roth Coast” period

SECURE ACT

Basically, requires all IRAs, Roth IRAS, and Qualified Plans to be distributed within 10 years of death

10-Year Rule

ROTH CONVERSIONS

As it relates to the new 10-year rule, the purpose of Roth Conversions is to spread distributions over many years and lower brackets

Mathematics of Roth IRA Conversions – Income Tax Planning

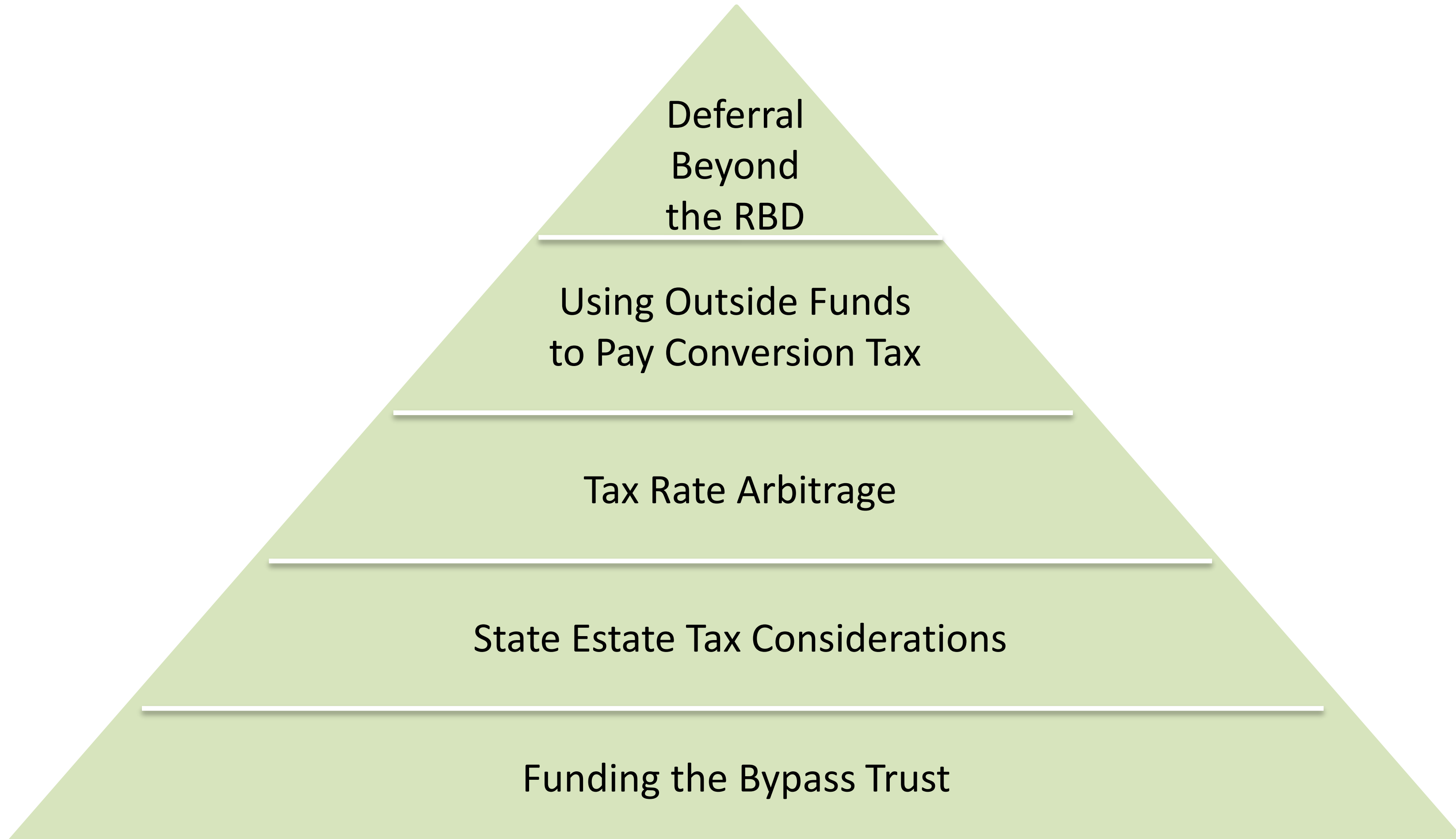
Deferral
Beyond
the RBD

Using Outside Funds
to Pay Conversion Tax

Tax Rate Arbitrage

10-Year Post-mortem Tax-free Growth
"Roth Coast Period"

Mathematics of Roth IRA Conversions – Estate Tax Planning



Mathematics of Roth IRA Conversions

- The key to successful Roth IRA conversions is usually to avoid large jumps in brackets (e.g. converting at a 32% when distributions will likely be subject to a 24% rate will often be ineffective)

- Although brackets are the primary consideration, there are others: capital gains, AMT, NIIT, 199A, etc.
- Timing conversions is critical

Estate Tax Considerations

- “Missing” IRC § 691(c) deduction
  - When a taxpayer dies with an item of Income in Respect of a Decedent (IRD), such as a traditional IRA, in his/her taxable estate the estate (and/or its beneficiaries) must not only pay estate tax on the IRD but also pay income tax on the IRD
  - To prevent double-taxation of IRD, the federal income tax law allows an income tax deduction (on IRS Form 1040, Schedule A), for **federal** estate taxes paid on IRD
  - This is typically known as the “IRC § 691(c) deduction”

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Estate Tax Considerations

- “Missing” IRC § 691(c) deduction
  - The dilemma with the IRC § 691(c) deduction is that it only is available for **federal** estate taxes paid on IRD, not state death/estate taxes
  - Thus, the state death/estate tax portion is subject to tax twice (i.e. “missing” IRC § 691(c) deduction)

Estate Tax Considerations

- "Missing" IRC § 691(c) deduction example

	Traditional IRA	Roth IRA
IRA balance	$ 1,000,000	$ 1,000,000
Less: Federal and state income taxes on Roth IRA conversion (40%)	-	(400,000)
Taxable Estate	$ 1,000,000	$ 600,000
Federal estate tax (40%)	$ 400,000	$ 240,000
State death tax (10%)	100,000	60,000
Total estate taxes	$ 500,000	$ 300,000
Post-death traditional IRA balance	$ 1,000,000	
Less: IRC §691(c) deduction	(400,000)	
Post-death traditional IRA balance subject to income tax	$ 600,000	
Federal and state income taxes on IRA distributions (40%)	$ 240,000	$ -
Net IRA balance to beneficiaries	**$ 260,000**	**$ 300,000**

Reconciliation: $100,000 state death tax x 40% post-death income tax rate = $40,000 (double-tax component) *OR* $400,000 income tax on conversion x 10% state death tax rate = $40,000 (estate tax savings)

Estate Tax Considerations

- "Fading" IRC § 691(c) deduction
  - Another dilemma with the IRC § 691(c) deduction is that it is only calculated on the value of the IRD at the time of death
  - Thus, post-death appreciation is not sheltered against income tax by the IRC § 691 deduction, resulting in additional income tax being incurred (i.e. "fading" IRC § 691(c) deduction)

Frozen-in-Time

Estate Tax Considerations

- "Fading" IRC § 691(c) deduction example

	No Planning	Roth IRA Conversion at Death
Traditional IRA balance at death	$ 1,000,000	$ 1,000,000
Less: IRC §691(c) deduction	-	(450,000)
Taxable portion of Roth IRA conversion	$ 1,000,000	$ 550,000
Federal and state income taxes on Roth IRA conversion (40%)	$ -	$ 220,000
IRA balance available for future distributions	$ 1,000,000	$ 780,000
Total future IRA distributions	$ 2,000,000	$ 1,560,000
Less: IRC §691(c) deduction	(450,000)	-
Less: Amounts not subject to income tax	-	(1,560,000)
Taxable portion of future IRA distributions	$ 1,550,000	$ -
Federal and state income taxes on future IRA distributions (40%)	$ 620,000	$ -
After-tax total future IRA distributions	**$ 1,380,000**	**$ 1,560,000**

Reconciliation: $1,560,000 - $1,380,000 = $180,000 *OR* $620,000 future income tax liability - $440,000 future value of income tax liability on Roth IRA conversion (i.e. $220,000 x 2).

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Incomplete Gift Nongrantor Trusts

Incomplete Gift Nongrantor Trusts

- **Potential Opportunity:**
  - Resident of state with state income tax contributes low basis business equity interest to a NING Trust.
  - Trustee later sells the interest.
  - State income tax may be avoided.

26 U.S.C. § 453(b)

Incomplete Gift Nongrantor Trusts

- **NING Trust**
  - Non-grantor trust for income tax purposes
    - ➢Distribution Committee made up of adverse parties
  - Incomplete gift for gift tax purposes
    - ➢Retained testamentary power of appointment
    - ➢Retained non-fiduciary inter vivos power of appointment for HEMS
    - ➢Chief Counsel Advice Memorandum 201208026

26 U.S.C. § 453(b)

Incomplete Gift Nongrantor Trusts

- **The NING Trust doesn't work if you can't work around the resident's state income tax rules**
  - Source income
  - Non-source income
    - ➢Grantor's residency?
    - ➢Administered in state?
    - ➢Resident trustee?
    - ➢Resident beneficiary?

26 U.S.C. § 453(b)

End

Questions

Appendix I
Advanced Securities Strategies

Bonds Selling at a Premium

- When bonds are purchased at an amount above their face value, the excess amount is referred to as a premium
- This premium can be amortized over the life of the bond (IRC §171(c))
- Bond premium is allocated to accrual periods based on a constant yield (scientific) method
- The deduction is treated as an itemized deduction not subject to the 2% floor
- The amount amortized each year reduces the bond's basis
- When the bond is sold, the taxpayer has a capital gain equal to the difference between the sale or redemption price and the taxpayer's original basis, reduced by the amount of amortization claimed

Tax Planning—Sale and Repurchase of a Bond Selling at a Premium

- If a taxpayer owns a bond that is selling at a premium, he may wish to sell the bond, repurchase the same bond shortly thereafter and elect to amortize the bond premium

- This enables the taxpayer to offset capital gain with an ordinary deduction

Sale and Repurchase of a Bond Selling at a Premium--Example

- Art is in a combined 40% state + federal tax ordinary income bracket and a 17% capital gain bracket
- He owns a $100,000, 8% non-callable bond with a 10-year maturity he purchased at par over a year ago
- The bond is selling for $110,000
- Art sells the bond and buys back a similar bond for $110,000 a week later

Sale and Repurchase of a Bond Selling at a Premium—Quantifying the Economic Benefit

Tax Cost of Selling

Amount Realized		$110,000
Less: Basis		(100,000)
Amount Recognized		$10,000
Capital Gain Tax	**17%**	**$1,700**

Tax Benefit Value of Amortized Premium

Deduction		$2,000
Tax Value	40%	$800
Years		5
Discount Rate		6%
PV	**6%**	**$3,370**

Advanced Securities Strategies

IRC Section 1259

(c)CONSTRUCTIVE SALE For purposes of this section—

(1)IN GENERAL A taxpayer shall be treated as having made a constructive sale of an appreciated financial position if the taxpayer (or a related person)

(A) enters into a short sale of the same or substantially identical property,

(B) enters into an offsetting notional principal contract with respect to the same or substantially identical property,

(C) enters into a futures or forward contract to deliver the same or substantially identical property,

(D) in the case of an appreciated financial position that is a short sale or a contract described in subparagraph (B) or (C) with respect to any property, acquires the same or substantially identical property, or

(E) to the extent prescribed by the Secretary in regulations, enters into 1 or more other transactions (or acquires 1 or more positions) that have substantially the same effect as a transaction described in any of the preceding subparagraphs.

Advanced Securities Strategies

IRC Section 1092

(a) RECOGNITION OF LOSS IN CASE OF STRADDLES, ETC.

(1) Limitation on recognition of loss

(A) In general

Any loss with respect to 1 or more positions shall be taken into account for any taxable year only to the extent that the amount of such loss exceeds the unrecognized gain (if any) with respect to 1 or more positions which were offsetting positions with respect to 1 or more positions from which the loss arose.

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IRC Section 1092

(c) Straddle defined For purposes of this section—

(1) In general The term "straddle" means offsetting positions with respect to personal property.

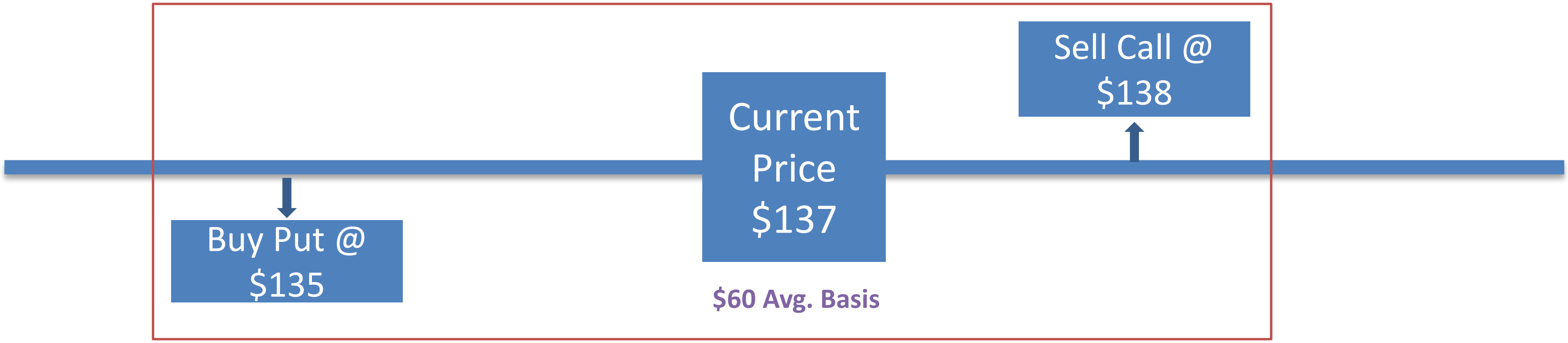
(2) Offsetting positions

(A) In general A taxpayer holds offsetting positions with respect to personal property if there is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of his holding 1 or more other positions with respect to personal property (whether or not of the same kind).

(B) Special rule for identified straddles In the case of any position which is not part of an identified straddle (within the meaning of subsection (a)(2)(B)), such position shall not be treated as offsetting with respect to any position which is part of an identified straddle.

Advanced Securities Strategies

IRC Section 1092



- The Straddle Rules could treat a tight collar as a constructive sale.
- A constructive sale would require the taxpayer to recognize the unrealized gain of $77 ($137-60).
- However, the basis in the position is “stepped-up” for the gain realized.
- A straddle could be structured to allow the taxpayer to optionally force a recognition event to capture a lower bracket.
- If a straddle is closed within 30-days of year-end the gain from a constructive sale is not recognized.
- This could provide a taxpayer a way to “buy time” in order to make a good decision

Appendix II
Income Avoidance

Tax Incentives for Equity Investments in Small Business Corporations

Tax Incentives for Equity Investments in Small Business Corporations

- IRC § 1244 - Ordinary losses
- **IRC § 1202 - Partial exclusion for gain**
- IRC § 1045 - Rollover of gain

IRC § 1202
Partial Exclusion For Gain

- Taxpayers (other than corporations) may be able to exclude certain percentages of gain on qualified small business stock provided the stock meets the following requirements:
  - Dollar limitation on the amount of gain
  - The stock must be issued after August 9, 1993
  - Must be a C corporation
  - Taxpayer must have acquired the stock at its original issue
  - The stock must be held for more than five years
  - The corporation must at all times have gross assets of $50 million or less
  - Must be an active business
  - Must be a qualified trade or business

26 U.S.C. § 1202

Partial Exclusion For Gain

Acquisition Period	Exclusion Amount
Aug 9, 1993 - Feb. 17 2009	50%
Feb. 18, 2009 – Sept. 27, 2010	75%
Sept. 28, 2010 and after	100%

Note, there is a 60% exclusion for “empowerment zone businesses”

26 U.S.C. § 1202

Partial Exclusion For Gain

Acquisition Period	AMT Add-Back Amount
Aug 9, 1993 - May 6, 2003	42%
May 6, 2003 – Sept. 27, 2010	7%
Sept. 28, 2010 and after	0%

26 U.S.C. § 1202

Partial Exclusion For Gain

- The first time the exclusion is claimed it is capped to the greater of:
  - $10,000,000 ($5,000,000 for a married filing separately taxpayer)
  - **Ten times** the aggregated adjusted basis of the corporations qualified stock disposed by the taxpayer during the tax year
- The $10,000,000 limit is reduced in following years by the amount claimed in previous years
- Adjusted basis is determined without considering any additions to basis after the stock was issued

26 U.S.C. § 1202(b)

Partial Exclusion For Gain

- The stock must be in a C corporation
  - "Must be a C corporation during substantially all of the taxpayer's holding period"

26 U.S.C. § 1202(c)

Partial Exclusion For Gain

- Qualified small business
  - The corporation must at all times have aggregate gross assets of $50 million or less
  - the term “aggregate gross assets” means the amount of cash and the aggregate adjusted bases of other property held by the corporation
  - the adjusted basis of any property contributed to the corporation shall be determined as if the basis of the property contributed to the corporation were equal to its fair market value as of the time of such contribution
  - members of a parent-subsidiary controlled group (using a more-than-50% ownership test) are treated as a single corporation

26 U.S.C. § 1202(d)

Partial Exclusion For Gain

- Qualified trade or business requirement
  - any trade or business other than—

(A) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees,

(B) any banking, insurance, financing, leasing, investing, or similar business,

(C) any farming business (including the business of raising or harvesting trees),

(D) any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A, and

(E) any business of operating a hotel, motel, restaurant, or similar business.

26 U.S.C. § 1202(e)(3)

Partial Exclusion For Gain

- **Use trusts to Create Additional Taxpayers**
  - Additional $10,000,000 exemption per trust
  - 5-year holding period requirement tacks to the gift
  - Using an Incomplete Gift Non-grantor Trust allows the grantor to retain use and control of the proceeds

Appendix III
Charitable Lead Trusts

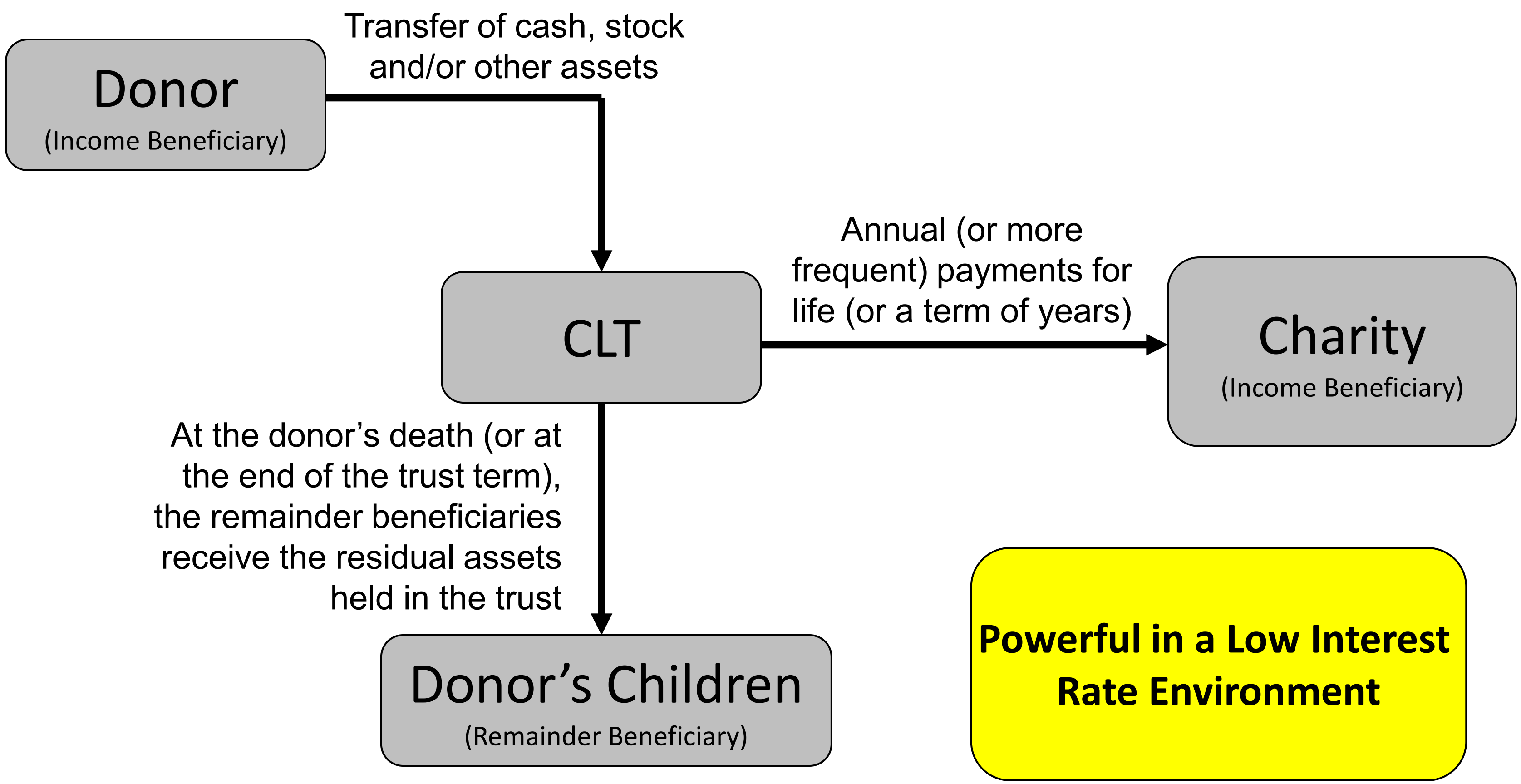
Charitable Lead Trusts

Overview

- A Charitable Lead Trust (CLT) is a split interest trust consisting of an income interest and a remainder interest.
- During the term of the trust, the income interest is paid out to a named charity.
- At the end of the trust term, the remainder (whatever is left in the trust) is paid to non-charitable beneficiaries (e.g. children of the donor) that have been designated in the trust document.

Charitable Lead Trusts

Overview



Charitable Lead Trusts

Types

- Charitable Lead Annuity Trust (CLAT)
  - The charitable beneficiary receives a stated amount of the initial trust assets each year
    - The amount received is established at the beginning of the trust and will not change during the term of the trust regardless of investment performance (unless inadequate investment performance causes the trust to run out of assets)
- Charitable Lead Unitrust (CLUT)
  - The charitable beneficiary receives a stated percentage of the trust's assets each year.
    - The distribution will vary from year to year depending on the investment performance of the trust assets and the amount withdrawn

1. SLATs – Spousal Lifetime Access Trusts

Benefitting Grantor's Spouse With Less Issues then a DAPT, and Perhaps No Estate Tax Inclusion

SLATs: How They Work

- Each spouse creates a trust for the other spouse, avoiding the 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.
- If the goal is to complete planning before the effective date of any tax law change, that goal may outweigh any benefit of separating each trust's creation by time.

SLATs: How to Make Them Work

- Create each SLAT in a different state. This is simple with document generation software as you merely select the state for each. (But it likely is best to use only DAPT jurisdictions in case the reciprocal trust doctrine applies.)
- 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 is not even a current beneficiary), 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. In fact, it may be best for the second trust to be a SPAT.
- A detailed checklist follows at the end of this section of the PowerPoint.

SLATs: Additional Ways to Provide Grantor Access - 1

- **Loans**: Consider granting to someone the power, in a non-fiduciary capacity, to force the trustee to make loans the grantor trust assets. Some might refer to this as a "loan director," but other titles might be used as well. A loan director can determine to loan funds to grantor of the SLAT without adequate security for the loan which will cause the trust to be a grantor trust (but the loan director could be required to charge adequate interest to avoid tax issues). This mechanism provides the grantor another means to access trust assets should the grantor require them.
- **Charity**: You might also infuse another means of the grantor indirectly "accessing" funds in a SLAT. Give someone, in a non-fiduciary capacity, the power to add charitable beneficiaries. This person might be called a "charitable director," but other titles might be used as well. A charitable director can determine to add charitable beneficiaries to a SLAT. This provides the grantor an indirect means of "access" to the SLAT by making a charitable donation the charitable director can add the charity to the SLAT and the donation can be made out of SLAT funds not the grantor's funds. This too will cause grantor trust status. However, the SLAT should not be authorized to pay a charitable pledge of the grantor.

SLATs: Additional Ways to Provide Grantor Access - 2

- **Vacation Home**: A SLAT could own an interest in a vacation home. And if the grantor's spouse/beneficiary uses the vacation home, the grantor presumably can as part of the spouse's family. Bear in mind if that is to be done with a home in another state, a limited liability company ("LLC") should be formed in the state where the SLAT is governed and administered. That LLC should be authorized to do business in the state where the vacation home is located. That LLC would own the vacation home property and in turn the trust could own some or all of the interests in the LLC. Watch out for Section 2036 and consider that if a home is transferred into the trust if rent should be paid.
- **Income Tax Reimbursement**: If the SLAT is structured to be a grantor trust (i.e., the grantor pays the income tax on trust income) consider including a discretionary income tax reimbursement clause if that will not allow the grantor's creditors access to the trust. This permits the trustee of the SLAT, in the trustee's discretion (it cannot be mandatory) to reimburse the grantor for income tax paid on trust income. A tax reimbursement provision can add valuable flexibility and access to the grantor.

Sample SLAT Provisions – Spouse as Beneficiary

- **<u>Distributions to Spouse During Grantor’s Lifetime</u>**
- The Trustee may, but shall not be required to, distribute as much of the net income and/or principal of the Lifetime Trust as the Trustee (excluding, however, any Interested Trustee) may at any time and from time to time determine to the Grantor’s Spouse and the Grantor's descendants in such amounts or proportions as the Trustee (excluding, however, any Interested Trustee) may from time to time select, for any purpose.
- Any net income not so distributed shall be accumulated and annually added to principal.

Sample SLAT Provisions

- **<u>Spouse's Lifetime Power of Appointment During Husband's Lifetime (Wife's SLAT for Husband would modify or exclude this Power)</u>**
- Trustee shall distribute such income and/or principal of the trust to such one or more persons out of a class composed of the Grantor's descendants and surviving spouses of the Grantor's descendants on such terms as the Grantor's Spouse may appoint by a signed writing that is acknowledged before a notary public specifically referring to this power of appointment and delivered to the Trustee provided, however, that any such appointment by the Grantor's Spouse shall only be effective if a trustee, who is non adverse within the meaning of Reg. § 25.2511-2(e), consents to the appointment in an acknowledged written instrument, and provided further, however, that this power of appointment may be exercised on the Grantor's Spouse's behalf by a guardian or attorney-in-fact appointed to represent the Grantor's Spouse and expressly authorized to do so.

Checklist of Differences to Integrate into SLATs - 1

- Draft the trusts pursuant to different plans. A separate memorandum or portions of a memorandum dealing with each trust separately may support this.
- Don’t put each spouse in the same economic position following the establishment of the two trusts. For example, the husband could create a trust for the benefit of his wife and issue, and the wife could create a trust for the benefit of her issue, in which her husband isn’t a beneficiary. Or one spouse could be a beneficiary of the trust he creates, if the trust is formed in an asset protection jurisdiction such as Alaska, Delaware, Nevada or South Dakota, and the other spouse could create a trust in which he isn’t a beneficiary (that is, a trust that’s not a domestic asset protection trust although using DAPT jurisdictions for both may be best).
- Use different distribution standards in each trust. For example, one trust could limit distributions to an ascertainable standard, while the other trust could be fully discretionary. However, limiting distributions to an ascertainable standard reduces flexibility may prevent decanting and may expose the trust assets to a beneficiary’s creditors.

Checklist of Differences to Integrate into SLATs - 2

- Use different trustees or co-trustees. If each spouse is a trustee of the trust the other spouse creates, add another trustee to one or both trusts. If adding another trustee to each trust, consider adding a different trustee for each trust and using different institutional trustees.
- Give one spouse a noncumulative “5 and 5” withdrawal power, but not the other. This power permits the holder to withdraw up to the greater of $5,000 or 5 percent of the trust principal each year without the annual lapse being a taxable gift. The amount the powerholder could have withdrawn at the time of death is includible in his estate. However, the lapse of the power, not in excess of the greater of $5,000 or 5 percent of the trust assets each year, isn’t considered a release of the power includible in the powerholder’s estate or a taxable gift. However, this power may expose assets of the trust to the powerholder’s creditors in some states.
- As in *Levy,* 1983-453, and PLR 9643013 (not precedent), give one spouse a lifetime special power of appointment, but not the other. However, the absence of a power of appointment reduces the flexibility of the trust. This might be viewed as particularly significant in light of the continued estate tax uncertainty, although the power might be granted later through a decanting.

Checklist of Differences to Integrate into SLATs - 3

- Give one spouse the broadest possible special power of appointment and the other spouse a special power of appointment exercisable only in favor of a narrower class of permissible appointees, such as issue, or issue and their spouses.
- Give one spouse a power of appointment exercisable both during lifetime and by will and the other spouse a power of appointment exercisable only by will.
- In the case of insurance trusts, include a marital deduction savings clause in one trust, but not the other. A marital deduction savings clause provides that if any property is included in the grantor’s estate because the grantor dies within three years after transferring a policy on his life to the trust (or for any other reason), some or all of the proceeds of the policy is held in a qualified terminable interest property trust or is payable to the surviving spouse outright. Alternatively, if each trust has a marital deduction savings clause, the provisions of the two could be different.

Checklist of Differences to Integrate into SLATs - 4

- Create different vesting provisions for each trust. For example, the two trusts could mandate distributions at different ages, or in a state that has repealed or allows a transferor to elect out of the rule against perpetuities, one trust could be a perpetual dynasty trust. However, mandating distributions severely reduces the flexibility of the trust, throws the trust assets into the beneficiary's estate for estate tax purposes and may expose the assets to the beneficiary's creditors and spouses.
- Instead of mandating distributions, give the beneficiaries control or a different degree of control, at different ages. For example, the ages at which each child can become a trustee, have the right to remove and replace his co-trustee, and have special powers of appointment be different in each trust.
- Vary the beneficiaries. For example, one spouse could create a trust for the spouse and issue, and the other spouse could create a trust just for the issue. Note that if, for example, the husband creates a trust for his wife and their first child, and the wife creates a trust for her husband and their second child, the gifts could still be viewed as reciprocal. Consider a SPAT for one of the spouses.

Checklist of Differences to Integrate into SLATs - 5

- Create the trusts at different times. In *Lueders' Estate v. Commissioner*, 164 F 2d. 128 (3d Cir. 1947), a husband and wife each created a trust and gave the other the power to withdraw any or all of the trust assets. Inasmuch as the trusts were created 15 months' apart, the Third Circuit, in applying *Lehman*,109 F 2d. 99 (2d Cir. 1940), cert. denied, 310 U.S. 637 (1940) held that there was no consideration or *quid pro quo* for the transfers. However, it should be noted that *Lueders* preceded *Grace*, in which, while the trusts were created two weeks apart, the Supreme Court held that the motive for creating the trusts wasn't relevant. If the difference in time is a factor, a short time might be sufficient in light of *Holman v. Comm'r*, 601 F 3d. (8th Cir. 2010) in which a gift of partnership interests six days after the formation of the partnership wasn't a step transaction. The closer we get to the end of 2012 and the possible end of the $5.12 million gift tax exempt amount, the more difficult it will be to interpose any meaningful time difference between the formation of the two trusts. Practitioners should also bear in mind that if the same transaction includes funding an LLC, then making gifts to the trusts that are to qualify for fractional interest or other discounts, they will be dealing with the challenge of two dating issues: the difference between the trusts, and the maturation period of assets in the LLC prior to gift or sale.

Checklist of Differences to Integrate into SLATs - 6

- Contribute different assets to each trust, either as to the nature or the value of the assets. However, if the purpose is to contribute $11.7 million to each trust, it may not be feasible to contribute assets of different value, and in any event varying the value of the trust only serves to reduce the amount to which the reciprocal trust doctrine may apply. Contributing different assets may not negate the application of the reciprocal trust doctrine, since the assets in a trust may be susceptible to change over time. However, if one trust is funded with non-liquid assets, or assets subject to contractual restrictions on sale (e.g., operating agreement restrictions on transfer of interests in an LLC) that may be viewed as a more meaningful difference in assets that may not be susceptible to ready modification.

Should Both or Only One Spouse Fund a SLAT? - 1

- **Example - 1**: Husband and wife have a combined estate of $16 million and are willing to make $8 million in total gift transfers in 2021 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 2021 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 in 2021 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.

Should Both or Only One Spouse Fund a SLAT? - 2

- **Example - 2**: 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. You could incorporate a mechanism into the trust to add wife in as a beneficiary in the future (see hybrid DAPT below) just in case her husband dies prematurely or divorces. If 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 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.

2. DAPTs – Domestic Asset Protection Trusts

Now 19 States Permit These Trusts

DAPTs: What They Were

- General rule throughout the US before 1987: any trust from which a distribution may be made to the Grantor by the Trustee is considered “self-settled” and the trust property was permanently subject to the claims of the Grantor’s creditors regardless of the motivation for creating the trust. It is just a rule.
- New York EPTL 7-3.1 says “A disposition in trust for the use of the creator is void as against the existing or subsequent creditors of the creator.”
- Section 548(e) of the US Bankruptcy Code pulls into the bankruptcy estate any self-settled trust or similar device if it was created to hinder, delay or defraud a creditor and bankruptcy is commenced within ten years.

DAPTs: What They Are Now

- Alaska enacted AS 34.40.110 providing complete asset protection for a self-settled trust if the Grantor was not trying to defraud a known creditor (plus other requirements).
- Now 19 states protect self-settled trusts from claims of the Grantor's creditors.
- Does this work in other states? It's not certain, but likely if all "Ps and Qs" are followed—e.g., all persons and assets involved are in a "DAPT" state.
- The trust should be excluded from the Grantor's gross estate if the gift to the trust is complete. See Rev. Rul. 76-103, Rev. Rul. 2004-64, and PLR 200944002 (not precedent). This may provide a complete "bullet proof" reason for creating the trust.

DAPT Planning and Drafting Options

- Have assets held in underlying LLC that DAPT holds only a non-controlling interest in.
- Perform lien and judgement searches, have a balance sheet, and have client sign a solvency affidavit regardless of whether state law requires.
- Consider client changing domicile to DAPT jurisdiction if feasible. With 19 states having DAPT legislation there may be a nearby state.
- Prohibit distributions for 10 years plus 1 day to avoid 548(e) of the Bankruptcy code.
- Prohibit distributions if grantor is married as spouse can receive distributions.
- Prohibit distributions if grantor's net worth is in excess of some stated amount.
- Provide a non-fiduciary the power to remove the grantor as a beneficiary.
- Using document generation software makes it easy and efficient to select from a range of options that might be appropriate for any particular client's circumstances.

Sample DAPT Provisions - 1

- **<u>Distributions to Grantor, Spouse and Descendants During Grantor's Lifetime</u>**
- During the Grantor's life, the Trustee shall administer the trust (the "Lifetime Trust") pursuant to this paragraph:
- The Trustee may, but shall not be required to, distribute as much of the net income and/or principal of the Lifetime Trust as the Trustee may at any time and from time to time determine to such one or more of the Grantor, the Grantor's Wife and the Grantor's descendants in such amounts or proportions as the Trustee may from time to time select for the recipient's health, education, maintenance or support in his or her accustomed manner of living.
- However, no distribution shall be made to the Grantor during any period that the Grantor is married to and living with another person as a married couple and provided, further, however, that no distribution shall be made to the Grantor until one year after the initial contribution to this trust.

Sample DAPT Provisions - 2

- **Power to Eliminate Grantor as Beneficiary**. The Trust Protector may, by acknowledged instrument delivered to the Grantor, permanently and irrevocably eliminate the Grantor as a beneficiary of each trust hereunder.

- **Note**: Consider also adding a restriction on no distributions until 10 years + 1 day after funding.

3. Hybrid DAPTs – A DAPT Without a Grantor as Current Beneficiary

Improving the Odds of Protection

Hybrid DAPTs: What They Are

- A Hybrid DAPT is a DAPT created for other family members (e.g., Grantor's spouse and descendants) but with some ability to add the Grantor in as a beneficiary.
- The power to add can be made conditional by time (e.g., only after 10 years in an attempt to avoid Bankruptcy Code 548(e), or when grantor is not married and is not living with another as the Grantor's spouse).
- Does it work? *Ianotti*, 725 NYS 2d 866 (2001) suggests not if the person who can add the Grantor (e.g., Trust Protector) is acting under a fiduciary duty, the trust will be consider self-settled. Unclear if the person is not a fiduciary. Consider, therefore, a SPAT.
- Hence, if you try this, make sure the person who can add is not acting under a fiduciary duty.

Hybrid DAPTs

- If the grantor may be added as a beneficiary have the trust divided into two separate trusts and add the grantor as a beneficiary of only that portion of the trust that is necessary.
- Sample Language:
  - **Division of Trusts.** The Trustee may divide any trust into two or more separate trusts and administer them as separate trusts, either before or after the trust is funded.

4. SPATs – Special Power of Appointment Trusts

A Safer Form of DAPT "Equivalent"

DAPT and Hybrid DAPT Limitations Suggest SPATs

- DAPTs are self-settled trusts and, therefore, potentially subject to claims of the Grantor's creditors, foiling asset protection and estate tax avoidance
- So why not avoid using a self-settled trust, and which is a trust from which the trustee can make a distribution to the Grantor?
- And instead create a trust for the Grantor's family that prohibits the Trustee from ever making a distribution to the grantor or "Decanting" to a trust of which the grantor is a beneficiary.

SPATs: Safer for Asset Protection and Estate Tax Exclusion

- One or more individuals, who are not beneficiaries, are granted special “collateral” lifetime powers of appointment, which can be exercised in favor of members of a class that includes the Grantor (such as descendants of the Grantor’s mother).
- Make the power exercisable only with the consent of a trusted third party (e.g., the client’s lawyer or cousin).
- Exercise should be made outright only and exercised only if the Grantor has a need.

SPAT – Sample Provision - 1

- Notwithstanding anything to the contrary herein, from and after one (1) year from the date of this Trust Agreement and until the Grantor's death, Carol Roberts shall have the power acting solely in a non-fiduciary capacity, to appoint some or all of the then remaining income and principal of the trust to or for the benefit of any one or more persons who are descendants of the Grantor's grandparents, by a signed writing acknowledged before a notary public specifically referring to this power of appointment; provided however, that no such exercise of this special power of appointment may be made without the written consent of Molly Smith, acting in a non-fiduciary capacity.

SPAT – Sample Provision - 2

- Notwithstanding anything to the contrary herein, no powerholder shall have the power to appoint the principal of this trust during the Grantor's lifetime to himself or herself, to his or her estate, to his or her creditors, or to the creditors of his or her estate if such powerholder is otherwise a permissible appointee of this special power of appointment. The exercise of this power of appointment shall be effective upon delivery of the written exercise to the Trustee and the execution of a written consent to the exercise by Molly Smith. No powerholder shall have an obligation to exercise, or not to exercise, the power of appointment given in this paragraph nor shall any person whose consent is required for the effectual exercise of such power of appointment have an obligation to give such consent.

5. GRATs – Grantor Retained Annuity Trusts

Great In Low-Rate Environment but there Is So Much More to Consider

GRATs: What and When Useful

- Background: Under Section 2702 a retained interest in a trust, or a split purchase, has zero value if family members hold the remainder interest.
- A special rule (not an exception) applies if the retained interest is an annuity, resulting in “GRATs.”
- GRAT downside: (1) no GST Exemption leverage, (2) some estate tax inclusion (difficult to use for client with short life expectancy).
- Good news: low Section 7520 rates mean high value for the retained annuity interest, so a lower taxable gift.
- GRATs work only when the return is greater than the Section 7520 rate – they slice off upside volatility above that amount.
- Typical structure: Short-term Rolling GRATs. However, these could be “outlawed” by requiring a minimum 10-year term and a gift of at least 25% of the value contributed to the GRAT.

GRATs: ILIT Funding Tool

- Irrevocable life insurance trusts (ILITs) are a ubiquitous planning tool. Many ILITs are funded using annual exclusion gifts. This technique is also on the chopping block under proposed legislation. The Sanders tax proposal, for example, includes a cap on annual exclusion gifts of $20,000 per donor (not per donee). That could undermine the funding in many traditional life insurance trusts.
- Practitioners may want to consider, in the current environment given what some view as an increased risk of harsher tax legislation to pay for the current bailouts, using GRATs to “pre-fund” future life insurance premiums in ILITs. If the insurance trust is not GST exempt, a GRAT could be structured to pour into the insurance trust as its remainder beneficiary and thereby infuse capital now before restrictions are created on ILIT Crummey Trust funding. If the ILIT is GST exempt, it could borrow at the low applicable Federal rate (AFT) from the successful GRAT and without income tax effect if each is a grantor trust as to the same grantor.
- See, IRC Section 2503(b); S. 309 §10(a).

GRATs: Should Structure Change?

- Consider whether longer term GRATs should be used instead of short-term.
- Consider laddered GRATS (e.g., 4, 6, 8, and 10 year). But note that this will change GRAT administration and in particular how GRATs are immunized when successful.
- Will GRATs provide asset protection? Choose the jurisdiction carefully.
- Consider asset splitting GRATs, each started at a different date, with different duration, different annuity retention, and different remainder beneficiaries

Illustration of a Successful 99 Year GRAT Continued

- Client Funds GRAT with $ 1 Million When the Section 7520 Rate Is One Percent to Pay $11,000 a Year to the Client or Her Estate for 99 Years. The Value of Remainder Is Nearly Zero.
- When the Client Dies, What Is Included in Her Estate Is the Lesser of the Whole Trust or the Annuity/Section 7520 Rate In Effect When She Dies.
- Client Dies When the Section 7520 Rate Is Still One Percent. Hence, the Amount Includible No More than $11,000/.01 or $11,000 x 100 or $1,100,000 (or the Value of the Trust If Less than That).

Illustration of a Successful 99 Year GRAT

- Client Dies When the Section 7520 Rate Is Five Percent. Hence, the Amount Includible Is $11,000/.05 or $11,000 x 20 or $220,000 (or the Value of the Trust If Less than That).
- Client Dies When the Section 7520 Rate Is Ten Percent. Hence, the Amount Includible Is $11,000/.1 or $11,000 x 10 or $110,000 (or the Value of the Trust If Less than That).
- If the Section 7520 Rates Goes Up Before Death, the Client Could Sell Her Annuity Interest (Without Gift Tax) for Its Value As So Determined to a GST Exempt Trust (Perhaps, the Trust That Is the Remainder Beneficiary of the GRAT and May Be a Grantor Trust).

6. Note Sale Transactions

Why and How Clients Might Use Note Sales in Early 2021

Beyond the Exemption

- Interest rates are at historic lows, values of many assets remain depressed, discounts may be available now but eliminated in the future, grantor trusts may be impacted, and more.
- The traditional use of a note sale transaction to freeze values at low levels and lock in discounts before uncertain changes in the law may be a valuable benefit for some clients.
- Consider a note sale to lock in discounts on a large QTIP trust but watch out for 2519 issues.

Is a “Double Wandry” Twice as Good as a Mere Wandry?

- A Wandry clause, if successful, could leave significant equity in the client’s estate. That could be a costly mistake if the Democrats secure the two GA runoff spots in the Senate and push through tax changes. Perhaps a better approach might be to use a double or two tier Wandry.
- Tier one applies like any typical Wandry.
- Simultaneously sign a sales contract effective on the same date as the initial transfer that sells any equity remaining in the client’s estate as a result of the Wandry clause at the gift tax value as finally determined.

7. Intentionally Defective Deferred Interest

How Clients Might Use A Defective Preferred Interests under 2701

Intentionally Defective Gift of Deferred Interest

- This permits a taxpayer to secure in the current high gift tax exemption amount for the full value of property transferred to a partnership while retaining an income stream for life, the ability to liquidate the income stream if necessary, the flexibility to do future planning with the retained income interest to address future developments, a basis step up for the retained assets at death.

Conclusion and Additional Information

Conclusions

- Practitioners should be proactive to advise clients whether and how to proceed with planning to address possible, perhaps likely income and transfer tax changes.
- For clients who did not plan in 2020, or did not complete as much planning as perhaps desired, it may be advantageous to undertake planning as quickly as possible.
- Warn clients that not only are the actual changes uncertain but there is considerable uncertainty over the effective date of any changes.
- The possibility of retroactive tax change is possible, and a factor practitioners should caution clients about.
- Consider using one or several techniques to be able to reduce, or to mechanical limit, possible gift transfers to the exemption amount in effect on the date of the gift after consideration to a possible retroactive reduction.
- Possible increases in income taxes might be planned for through Roth conversions, sale of appreciated assets and other steps, that may warrant evaluation now.

Additional information

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A KEY ESTATE PLANNING GUIDE

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CLE Credits

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