Leimberg Information Services, Inc.

Steve Leimberg's Estate Planning
Email Newsletter Archive Message #2813

Date:10-Aug-20

Subject: Alan S. Gassman, Jerome B. Hesch & Martin B. Shenkman on the Biden 2-Step for Wealthy Families: Why Affluent Families Should Immediately Sell Assets to Irrevocable Trusts for Promissory Notes Before Year-End and Forgive the Notes If Joe Biden Is Elected, A/K/A What You May Not Know About Valuing Promissory Notes and Using Lifetime Q-Tip Trusts

"Wealthy individuals who postpone taking appropriate action to eliminate estate taxes may not be able to use the $11,580,000 gift tax exemption after 2020. A political change in November 2020 could lead to lower estate and gift tax exemptions effective as early as January 1, 2021. In Quarty v. U.S., the ninth Circuit Court of Appeals ruled that a retroactive tax increase does not violate the Constitution. The court held that the increase in the estate and gift tax rates was a rational means to raise revenue, noting that an increase in tax rate was merely an increase of an existing tax, not a wholly new tax, citing other court decisions as precedent. Reducing the exemption is not a new tax. The time to act is now!

Implementation of the planning process can take several months. Consideration of the step-transaction doctrine and the reciprocal trust doctrine might suggest planning for time between various components of a plan. Using valuation discounts often requires time for an appraisal. Changing the ownership of assets, may require getting approval from co-owners or lenders with due on change in ownership provisions, complying with terms of governing documents for the entities to be transferred, and more. Determining planning decisions, which can take time. Additionally, valuation discounts, note sale transactions, and other techniques, may be subject to gift tax return audits and possible IRS challenges. What is not always addressed is that the stress, costs, and risks of discount planning can be reduced significantly by using the '2-Step Process' described below.

This newsletter is designed to explain the fundamental legal and financial principles underlying the concepts we will discuss and why those concepts should be implemented over two calendar years (2020 and 2021), or better in 2020, to best position clients for a possible reduction in the estate tax

exemption. Moreover, the techniques we discuss can position families to reduce estate and gift tax exposure even if a reduction in the exemption does not occur until 2026."

Alan S. Gassman, Jerome B. Hesch and **Martin B. Shenkman** provide members with commentary that reviews why they believe affluent families should immediately sell assets to irrevocable trusts for promissory notes before year-end and forgive the notes if Joe Biden is elected President. On August 18th @ 3PM ET, the authors will be presenting a free **LISI** Webinar titled "The Biden 2-Step PLUS Martin Shenkman's Review of Topics and Planning Opportunities from the 46th Notre Dame Tax and Estate Planning Institute." Click this link to learn more.

Alan Gassman, JD, LL.M. is the founding partner of the law firm of **Gassman, Crotty & Denicolo, P.A.** in Clearwater, Florida. Alan is a frequent contributor to LISI, and has authored several books and many articles on Estate and Estate Tax Planning, Trust Planning, Creditor Protection Planning, and associated topics. Alan is on the Board of Advisors of the Notre Dame Tax and Estate Planning Institute, which will be the first virtual edition of the Institute on October 29-30, 2020, which will be covering a wide span of very pertinent and innovative topics with the best speakers in the country. Click here to see the agenda. You can contact Alan at agassman@gassmanpa.com.

Martin M. Shenkman, CPA, MBA, PFS, AEP, JD is an attorney in private practice in Fort Lee, New Jersey and New York City who concentrates on estate and closely held business planning, tax planning, and estate administration. He is the author of 42 books and more than 1,200 articles. He is a member of the NAEPC Board of Directors (Emeritus), on the Board of the American Brain Foundation, and the American Cancer Society's National Professional Advisor Network, and is on the Board of Advisors of the Notre Dame Tax and Estate Planning Institute.

Jerome M. "Jerry" Hesch is the **Director** of the **Notre Dame Tax and Estate Planning Institute**. Jerry also serves as an income tax and estate planning consultant for lawyers and other tax planning professionals throughout the country. He is also Special Tax Counsel to Oshins & Associates in Las Vegas, Nevada and Meltzer, Lippe, Goldstein & Breitstone, in Mineola, NY. He is on the Tax Management Advisory Board, a Fellow of American College of Trusts and Estates Council and the

American College of Tax Council, has published numerous articles, Tax Management Portfolios, and co-authored a law school casebook on Federal Income Taxation, now in its fourth edition. He was elected to the National Association of Estate Planning Counsel's Estate Planning Hall of Fame. Jerry has presented papers for the University of Miami Heckerling Institute on Estate Planning, the University of Southern California Tax Institute, the Southern Federal Tax Conference, the New York University Institute on Federal Taxation, NAEPC and the AICPA, among others. He has participated in several national and local bar association projects, including the Drafting Committee for the Revised Uniform Partnership Act. He received his BA and MBA degrees from the University of Michigan and a JD degree from the University of Buffalo Law School. He was with the Office of Chief Counsel, Internal Revenue Service, Washington, D.C. from 1970 to 1975, and was a full-time law professor from 1975 to 1994, teaching at the University of Miami School of Law and the Albany Law School, Union University. He is currently an adjunct professor of law, teaching courses at the Florida International University Law School and the on-line LL.M. program at the University of San Francisco Law School.

Here is their commentary:

EXECUTIVE SUMMARY:

Wealthy individuals who postpone taking appropriate action to eliminate estate taxes may not be able to use the $11,580,000 gift tax exemption after 2020. A political change in November 2020 could lead to lower estate and gift tax exemptions effective as early as January 1, 2021. In *Quarty v. U.S.,* the ninth Circuit Court of Appeals ruled that a retroactive tax increase does not violate the Constitution. The court held that the increase in the estate and gift tax rates was a rational means to raise revenue, noting that an increase in tax rate was merely an increase of an existing tax, not a wholly new tax, citing other court decisions as precedent. Reducing the exemption is *not* a new tax. 170 F.3d 961, 969 (ninth Cir. 1999). The time to act is now!

Implementation of the planning process can take several months. Consideration of the step-transaction doctrine and the reciprocal trust doctrine might suggest planning for time between various components of a plan. Using valuation discounts often requires time for an appraisal. Changing the ownership of assets, may require getting approval from co-

owners or lenders with due on change in ownership provisions, complying with terms of governing documents for the entities to be transferred, and more. Determining planning decisions, which can take time. Additionally, valuation discounts, note sale transactions, and other techniques, may be subject to gift tax return audits and possible IRS challenges. What is not always addressed is that the stress, costs, and risks of discount planning can be reduced significantly by using the "2-Step Process" described below.

This newsletter is designed to explain the fundamental legal and financial principles underlying the concepts we will discuss and why those concepts should be implemented over two calendar years (2020 and 2021), or better in 2020, to best position clients for a possible reduction in the estate tax exemption. Moreover, the techniques we discuss can position families to reduce estate and gift tax exposure even if a reduction in the exemption does not occur until 2026.

FACTS:

Many wealthy families have either procrastinated getting their estate tax planning done, or are working with advisors who are not familiar with the planning opportunities using promissory notes.

Procrastination of planning occurs for a number of reasons:

a. General procrastination and the desire to avoid spending time and money now.

b. Aversion to planning complexity.

c. A lack of understanding with respect to how serious the 40% federal estate tax and state inheritance tax exposure can be.

d. Not addressing that values increase over time.

e. Not knowing that the $11,580,000 exemption may be significantly reduced to $3,500,000.

f. Not understanding the asset protection benefits that estate tax minimization planning might afford.

g. As people get older, they are often less willing to transfer assets into irrevocable trusts they cannot control or receive distributions from.

COMMENT:

What Spurs Individuals Into Action?

Estate tax planning is often an "impulse buy" fueled by one or more of the following things:

1. A health scare.

2. The death - or near death - of a spouse, especially if the surviving spouse has a significant net worth and recognizes the risk.

3. Recommendations and prodding from professional advisors, children or others reading about possible tax increases.

4. The anticipation of a positive economic event such as the sale of a business or that current assets are performing well, even during an economic downturn.

5. A national election that may cause the exemption to come down faster and even lower than the 2026 scheduled reduction to $5,000,000.

6. Realization of the real risks that malpractice, divorce or other lawsuits might bring.

7. Liquidity concerns. Lower estate tax exemptions may not be the only harsh tax obstacle faced by wealthy families. Many businesses are in a negative cash flow position, although they

are still valuable and will be subject to federal estate tax. The Biden tax changes could include his suggestion that there be no step-up in basis for appreciated assets on the death of an individual, and much higher income taxes to be imposed upon items such as pension, IRA, and annuity income that becomes taxable after the death of a decedent. Also, many families have not yet taken into account that they will pay higher income tax rates on all forms of income, including pension and IRA distributions that will commonly be subject to the new 10-year Rule.

Where Do We Stand Today, And Why Is The "2-Step Process" An Attractive Solution For Many?

There is a meaningful possibility that Joe Biden may become the next President of the United States, and that the Democrats will not only retain control of the House of Representatives, but also capture control of the Senate.

A newly-elected President Biden would not take office until January 20, 2021. Even though a change for the worse in the estate tax would not occur until after legislation is passed, tax laws passed during the calendar year 2021 might retroactively be effective January 1 of 2021, as a way to keep the "cows in the barn" for the integrity of a robust estate tax system to help plug deficits without raising income taxes on the lower and middle class. There has been significant discussion in political circles about wealth disparity. Making a retroactive effective date would cut-off much of the last minute planning that many taxpayers might try to accomplish. This means that a change in the estate tax exemption amount could retroactively apply as soon as of January 1, 2021.

So Why Is It Essential To Plan In 2020?

Planning to use a significant portion of their remaining $11,580,000 exemptions can be significantly more effective if this is a two-step process:

Step One----Sell assets to an irrevocable grantor trust for a promissory note.

Step Two----If the Democratic sweep occurs in November forgive the note in whole or in part as a taxable gift.

STEP ONE . . . "AH ONE AND AH TWO AND AH THREE" (AS LAWRENCE WELK WOULD SAY)

In 2020, the client contributes assets to a family limited partnership or limited liability company. The client can manage the assets in the family entity under a fiduciary standard, without estate tax exposure.

Also in 2020, after waiting a reasonable time after funding, the client sells a significant portion of ownership interests (up to 99%) to a preexisting or new irrevocable trust under a special rule, there is no taxable gain or loss for income tax purposes, and the trust is held for the benefit of a spouse and/or descendants. The sale price is satisfied by the trust issuing a long-term, low interest note. If this transaction occurs during the Coronavirus crisis, significant valuation discounts might be considered because willing buyers and willing sellers are taking economic uncertainty into consideration in setting prices for many comparable transactions. Hence the discount rates used to value future cash flows may be higher, and the interest rate on the long-term note can be as low as 1.12% annual interest if entered into before November, 2020.

The rates that can apply to an interest-only note given in exchange for LLC (voting or non-voting, depending on how the transaction is structured) or family limited partnership ("FLP") interests can bear interest at the following rates (for August of 2020) without the issuance of the note being considered a gift:

Not more than 3 years: 0.17 %

More than 3 years but not more than 9 years: 0.41 %

More than 9 years: 1.12%

Ideally, the trust or FLP should be preexisting and funded in a prior taxable year. That obviously will not be possible for many of the transactions to be completed before year-end 2020. The trust that buys the non-voting interest for a note should, according to some views, be funded with its own assets, sometimes called a "seed capital gift." When a substantial seed gift is not practical, or if the practitioner views the quantum of seed gift too small for the contemplated transaction a guarantee may be used in conjunction with a small seed capital gift.

Disclosure of the intra-family sale is not required on a gift tax return because the seller is replacing the asset sold with a note equal to the value of the asset sold. In effect, there is no gift if the value of what is received equals the value of what is transferred. There is a gift only if the transfer reduces one's net worth. As discussed below, there is no gift if the note received bears interest at the Applicable Federal Rate even if the market value of the note is lower that the AFR.

However, if a gift of seed capital is transferred to the trust, except for the $15,000 annual exclusion gift, it needs to be disclosed on a gift tax return. The seed capital can consist of cash or other assets. Caution might need to be exercised if the same entity sold to the trust is also gifted as a seed gift.[i] It may be preferable to gift an asset other than the asset sold. However, no doubt with the crush of time pressure in 2020 that may not always be feasible. In those situations, practitioners might caution clients of the potentially increased risk. Some practitioners might decide to use existing trusts, or to limit seed capital gifts to the $15,000 per donor/donee exclusion (or use guarantees), to avoid the need to file any gift tax return at all. Other practitioners prefer the opposite approach.

To assure that the note has economic substance, trust beneficiaries can guarantee the trust's obligation. For example, if the promissory note is for $5,000,000 and the trust making the purchase only has assets with a net value of $90,000, another trust or trust beneficiary/beneficiaries having reasonable net worth may guarantee the trust's obligation. A beneficiary may receive a guarantee fee from the trust in exchange for such guarantees. Although a fee is not always necessary depending on the circumstances involved (e.g. does the borrower trust benefit the same

beneficiaries as the guarantor trust?) and how practitioners view the law on these matters.[ii]

If a gift tax return is filed to report the seed capital gift, the taxpayer should consider also disclosing the sale. This is recommended to start running the three (3) year statute of limitations on the IRS's ability to challenge such sales. If the sale is disclosed, then full disclosure of valuation reports should be attached. This can be an expensive and time-consuming process.

For gifts given in 2020, the taxpayer has until September 31, 2021 to file a gift tax return, assuming that a proper extension is filed. This means that the family has until then to decide what to disclose on the gift tax return, and what valuation reports will be procured to facilitate such disclosure. Although, it may be advisable, or even necessary, to obtain an independent valuation report at the time of the gift, especially if a valuation adjustment mechanism is used.

There is generally no penalty for a late-filed gift tax return if there is no gift tax due upon filing. So, gift tax returns can be filed after they are due, with the practical concern that the three (3) year statute of limitations does not start until the late gift tax return is filed. There are other good reasons to file a gift tax return by the due date, including the ability to have a spouse sign a split gift election, if this is desired.

Even if the 3-year statute of limitations has run on the gift tax return, the seller now has a promissory note that is an asset exposed to the estate tax, at its fair market value, if the seller dies while the note is outstanding.

If Trump is re-elected, and the estate tax exemption remains at $11,580,000, the installment sale can be unwound, and assuming stable values, the client can receive some or all of their assets back from the trust and cancel the note with no income or gift tax consequences. Only the seed capital gift to the trust will remain in trust. And, the trust can distribute the seed capital to the children and grandchildren instead of what the client would have paid to them directly.

If Biden is elected, and the Democrats sweep the House and Senate, then the client should consider before year-end using what remains of the client's $11,580,000 exemption. If the note, or a portion of it, is cancelled by a gift in 2020 or 2021, a gift tax return will need to be filed disclosing the note cancellation, but no appraisal or other disclosure will need to be provided with the gift tax return if the value used for the gift equals the principal amount of the note. Practitioners might consider structuring the sale for two notes. One note would be equal to the taxpayer/seller's remaining gift and GST exemption, and the second note would be for the balance of the purchase price. That might make it easier to forgive the desired amount of the note to use the taxpayer's remaining exemption and avoid the complications of a note that was only in part forgiven.

What Is The Client Thinking?

Despite the human motivation and cost issues that often come up, involved professionals should suggest a gift tax return for the 2020 seed capital gift. And, the gift tax return should also disclose the sale, with appraisals for the assets sold. The family may decide not to follow this advice, to save the time and expense, and what they might view as a greater likelihood of audit.

The advantage of implementing the note sale portion of this plan is that it is best for clients to do this sooner rather than later, while they still have sufficient time to complete the process. Furthermore, this Coronavirus wave has really shown how sudden life circumstances can change for a family. After the November election, estate planners will be incredibly busy.

For slower moving clients, it is worthwhile to at least have a thorough consultation in the coming months so that decisions can be made based upon education and thinking that took place before deadlines were imminent. That education will hopefully convince the clients to move forward with the first step for planning, being the sale of assets in exchange for a note.

Valuation Discounts And Planning Strategies For Notes.

Given the effectiveness and relative simplicity of having wealthy taxpayers issue promissory notes to family trusts, it is surprising that some advisors are not fully versed on the estate and gift tax treatment of such instruments.

For example, many believe that a long-term promissory note bearing interest at the Applicable Federal Rate is worth its face value for estate and gift tax purposes, but this is actually not the case. The value of such note, as supported by both case law and statutes, is to be valued based upon what a willing buyer would pay an unrelated willing seller in the marketplace. The fact that IRC Section 7520 provides that there is no gift considered to have been made when a note is used for assets and bears interest at the Applicable Federal Rate does not mean that the note is worth its face amount. This has been very thoroughly documented in a recent Bloomberg Article, Michael S. Strauss and Jerome M. Hesch, "A Noteworthy Dichotomy: Valuation of Intra-family Notes for Transfer Tax Purposes" 45 Bloomberg Tax Management Estates, Gifts and Trust Journal 4 (Jan. 9, 2020).

A summary of the analysis and information from the article can be found in the following table, which demonstrates that AFR notes may be able to be discounted when they are long term because the AFR rate is below lending rates used by commercial lenders or by companies and governmental entities that issue bonds. Note that in the current environment, with rates at historic lows, the opposite might be true with respect to notes from the past that bear interest at higher than the current market rates. That may not, however, necessarily suggest a premium value if the note can be repaid at any time without penalty pursuant to its terms.

A chart showing the cases summarized in the article and the primary characteristics of each note along with a copy of each case can be obtained by emailing agassman@gassmanpa.com.

One lesson to be learned from the above-referenced article and chart is that it is better to issue longer term notes than shorter term notes for valuation discount purposes. While some commentators advise that notes issued by taxpayers in sale transactions should have a maturity date roughly equivalent to the taxpayer's life expectancy as of the date the note is issued, there is no specific reason notes cannot be issued for 20 years or

longer so that family members may inherit the note. This should be considered even where the taxpayer's life expectancy is lower than 20 years. There is simply no logical reason that a note cannot substantially exceed the taxpayer's life expectancy. Some have expressed concern that when a note term exceeds the taxpayer's life expectancy the IRS may recharacterize that note as an annuity or other arrangement.

By issuing and discounting a long-term note, decedents with large notes may come under the estate tax filing level and the estate tax exemption level. Without the note sale, the value of their assets would have exceeded their exemption.

Example. Edna is 80 years old, has an $11,000,000 remaining gift and estate tax exemption and has $12,000,000 in assets, she can sell $9,000,000 in assets for a 20-year $9,000,000 note bearing interest at the long term Applicable Federal Rate. Upon Edna's death, the note is valued at less than $8,000,000 so no estate tax return will have to be filed (assuming no change in exemption). Of course, if she puts $9,000,000 into an LLC and sells a non-voting LLC interest for a $6,300,000 note she will have even a smaller estate (if the discount is respected). As an aside, if Edna's assets consist of highly appreciated leveraged rental real estate then her family may be better off paying estate tax in the equity and getting a new fair market value income tax basis for the entire property value upon death. This presumes Edna dies before a time that a future administration, e.g. Biden, may eliminate the step-up on death.

Another alternative is to sell assets for a self-cancelling note, or a private annuity, that will by its terms cancel on death. This will require a much higher rate of interest rate if a self-cancelling installment note is used (or a commensurate principal adjustment), and can backfire if the taxpayer lives a good many years and has received back large payments which add to the estate as the years go on. Some taxpayers enter into self-cancelling installment sales during "health scares," such as before undergoing open heart surgery or contracting COVID-19, as long as they still have an "average or better" life expectancy at the time that the note is entered into. Once the health scare is over, the note might be converted to a conventional note at the Applicable Federal Rate in effect at the time of the conversion, or may be purchased from a family member. Alternatively, the

principal of the note may be negotiated downward in exchange for a market interest rate being paid, as further discussed below. None of these alternative changes should cause any gift to be considered "given" for tax purposes if properly structured.

Many planners will make the entire note self-cancelling, even though only a part of the note would need to be eliminated to avoid Federal Estate Tax. It is better to have two notes, with one being self-cancelling to the extent needed to assure that the taxpayer will be under the estate tax exemption amount, and the other note being at the Applicable Federal Rate to allow for lower interest payments, so that smaller payments can be made to reduce the size of the note holder's estate. Difficulty with this planning in the current environment is that in addition to the sunset of the exemption in 2026 a change in administration in Washington could result in a dramatic reduction in exemption as soon as January 1, 2021.

A Discount For Part Ownership Of A Promissory Note

A fractional interest discount may be applied when there are multiple holders of a promissory note.

In the 1996 Federal District Court decision of *Smith v. U.S.*, the IRS challenged an estate tax return note valuation that was based upon first determining the value of the note itself based upon a discounted present value of future cash flow calculation, and then taking a 20% discount because the decedent only owned 2/3 of the note. The Court accepted both discounts as being reasonable and appropriate.

If a taxpayer gifts part ownership of a note to an irrevocable trust, the retained part ownership should qualify for a similar discount when the taxpayer dies. There are many legitimate reasons to share ownership of a promissory note, as further discussed below.

STEP 2 IF BIDEN IS ELECTED, CANCEL, PARTIALLY FORGIVE, OR GIFT THE NOTE OR NOTES—IMPORTANT CONSIDERATIONS

If Biden is elected and there is a sweep of the House and Senate, then the likelihood of a reduction in the estate and gift tax exemptions will be real.

Taxpayers will need to decide whether to make use of their $11,580,000 exemptions in the “use it or lose it” situation to be faced.

By this time, the client will have been educated on what has already occurred in their planning, and may view the second step as being a necessary forgiveness of debt owed to the client in an amount equal to what remains of the client’s estate tax exemption.

While it may be as simple as that for some, for the high net worth taxpayer this leaves assets on the table for the IRS, given that note discounting and other strategies can be used, as described below. Another consideration may also arise for wealthy taxpayers, especially those that are older or infirm. Should they cancel notes beyond what is necessary to use their exemption? Perhaps. If it is anticipated that the marginal transfer tax rate under a Biden administration will be dramatically higher, perhaps incurring as a gift tax in 2020 may be preferable to a higher estate tax in 2021. Also, the gift tax is tax exclusive whereas the estate tax is tax inclusive.

Often it is unclear how much of the client’s exemption remains, or if the client’s remaining assets will still be over the estate tax exemption amount, especially if there has been a large sale transaction with an irrevocable trust that has been based upon discounts that may exceed what the IRS will readily accept upon audit. Also, the taxpayer may want to forgive more than the face amount that constitutes the exemption amount remaining based upon taking a discount from the face amount of the note.

For example, a taxpayer with a $20,000,000 note may have filed prior gift tax returns reducing the exemption to $8,000,000. If the IRS increases the prior gift by $2,000,000, her remaining exemption would be $6,000,000 in the event of an estate or gift tax audit. Assuming that the note can be discounted by 20% from face to $16,000,000, she would like to make a gift by reducing the note by $10,000,000 in face amount, which would be considered to be an $8,000,000 gift. Unfortunately, the IRS may not agree with this discount, and may also assert that her exemption amount is only $6,000,000 and that the discount rate on the note is only 10%, so that gift tax would be owed on a gift of $1,666,667. ($6,000,000 divided by .8% is $7,500,000. $7,500,000 divided by 90% is $8,333,333. $10,000,000 minus $8,333,333 is $1,666,667.)

The IRS may challenge a discount on a note, especially when that note was only recently created by the taxpayer in a sale transaction, but the law is clear in this area. Nevertheless, in planning for the possibility of such a challenge, the taxpayer may choose to reduce the note by a fraction of the amount owed, (a) the numerator of which is the amount of estate and gift tax exemption she has remaining, and (b) the denominator of which is the value of the note.

If this is handled with an appropriately drafted adjustment clause, which permits the percentage of the note to be corrected in the event of a later determination of inaccuracy, then the IRS may be less likely to challenge the discounts taken. One possible problem with using such a formula clause is that the gift, when disclosed on a gift tax return, may attract greater IRS scrutiny, as compared to if the gift is expressed as a set face amount owned on a note.

Trade Your Partner (Do-Si-Do), Or Exchange Your Notes (While The Rates Are Low)

One option is to first trade the existing long-term low interest rate note for a note with a lower face amount that bears interest at the market rate, and to then forgive the face amount of the market rate note, without disclosing the swapping of notes on the gift tax return.

For example, a $20,000,000 20-year note bearing interest at 1.12% may be worth only $16,000,000, so why not swap the note for a $16,000,000 five-year note bearing interest at a market rate, and then forgive $10,000,000 to reduce the replacement note's face amount to $6,000,000 and report this as $10,000,000 gift, Now the client holds a $6,000,000 note instead of a $20,000,000 long term low interest note. The taxpayer could be advised that the note swap may be disclosed on the gift tax return, and that if it not disclosed the 3-year statute of limitations will not apply to prevent the IRS from asserting that the swap was a taxable gift if and when the taxpayer's estate is ever audited.

Lifetime Q-TIP Trusts To The Rescue

An alternative strategy that married taxpayers may use to insulate themselves from these issues, and which will also give the client the ability to pull the plug on a large 2020 gift as late as September of 2021, would be to transfer the low interest long-term note in late December of 2020 to a "Lifetime Q-TIP Trust" that will qualify for the estate tax deduction to the extent necessary to avoid imposition of gift tax on the donor spouse.

A Q-TIP Trust is a trust that must pay all income to the spouse beneficiary, and can be used solely to benefit the spouse beneficiary during his or her lifetime. A trustee can be given the power to devise all assets under the trust to such spouse.

A Q-TIP Trust can be divided into two separate sub trusts, one of which can be considered to be a Credit Shelter Trust that will not be subject to estate tax on the death of the spouse beneficiary, with the other trust qualifying for the marital deduction and being considered to be a Grantor Trust owned by the spouse beneficiary during her lifetime.

The Grantor of the Q-TIP Trust can elect what portion of the trust will be treated as the Credit Shelter Trust, and what portion of the trust will be considered to be the Marital Deduction Trust, in the manner described above by an election that must be filed by April 15 of the calendar year following the contribution to the Trust, or by October 15, if the Grantor spouse files a timely extension. It is essential that the election be made on time, because there is no relief available if not. *See Creative Trust Planning Strategies for Using Lifetime Q-Tips, by Richard S. Franklin, ABA Section of Real Property Trusts and Estates Law Webinar April 7, 2018.* Richard Franklin can be contacted at rfranklin@fkl-law.com.

This mechanism allows a grantor who is uncertain as to whether he or she wants to use some or all of his or her remaining estate tax exemption amount, and also enables the Grantor to use a "Formula Clause", which may best be described by the following example:

> Harold has $10,000,000 of his $11,580,000 estate tax exclusion remaining in December, 2020. He also

has a $15,000,000 low interest rate promissory note that pays interest annually and will balloon in 20 years. The note may be worth $12,000,000.

Harold places the promissory note into a lifetime Q-TIP Trust for his wife, Dorothy in 2020 immediately after it is determined that Joseph Biden has won the presidential election. Harold then waits to see whether the estate tax exemption is reduced in 2021. On or before the due date in 2021 Harold may file an election to treat the entire Q-TIP Trust as a Marital Deduction Gift, and thus retain his exclusion amount, as if no gift was made. In that event, the trustee of the Q-TIP Trust may distribute the note to Dorothy, so that no large gift has essentially been made.

Alternatively, if the estate tax exclusion is reduced retroactively to January 1, 2021, then Harold can make the gift to the Q-TIP Trust effective in 2020 as a “retroactive” gift of his remaining exemption amount by making a Formula Election which says “have an amount of assets in Credit Shelter portion of the Q-TIP Trust equal in value to my remaining exclusion amount divided by the total value of trust assets, with the remaining trust assets to be held as a Marital Deduction Trust.”

The Trustee hires a valuation expert in 2021 after Harold has made his election, and the expert opines that 83.33% of the note should pass to the Credit Shelter portion of the Q-TIP Trust and 16.67% of the note should pass to the Marital Deduction portion. 83.33% of $15,000,000 is $12,500,000 in principal that the Credit Shelter Trust may receive if the note is paid off after a few years of having the trust receive interest payments. The remaining $2,550,000 portion of the note that is in the Q-TIP

Marital Deduction sub trust will be included in his spouse's taxable estate, and may be subject to both a time value of money discount for the low interest rate situation and a partial ownership discount, as per the *Smith v. U.S.* case, which is discussed above.

If the IRS audits a gift tax return more of the note may have to be allocated to the Marital Deduction portion, but no gift tax will be owed.

One disadvantage of the Credit Shelter Sub-trust feature of the Q-TIP Trust is that it must pay all income to the surviving spouse, which would mean all interest payments on the promissory note portion allocated to the Credit Shelter Trust will come out to the spouse, but the note may be paid in full, and then the money may be invested in growth stocks that pay no dividends.

In the 1992 5th Circuit Court of Appeals decision of *Estate of Clayton* (976 F.2d 1486), the Court held that the portion of the Q-TIP Trust designated as a Credit Shelter Trust (to not qualify for the marital deduction) would not have to pay income to the surviving spouse if drafted to provide for this. The IRS responded to this case by establishing the "Clayton Q-TIP Election" regulations at Sec. 20.2056(b)-7(d) to allow for this for a Q-TIP trust formed at death, but it is not clear whether this treatment can apply for a lifetime Q-TIP gift.[iii]

For an unmarried taxpayer, a similar strategy would be to transfer the note to a trust that divides upon inception into a Family Share and a Charitable Trust, with the Family Share being worth the amount that passes estate tax free and the Charitable Trust being worth the excess of such amount.

While use of such a formula in a non-Q-TIP Trust is not established by statute, there may be no problem with such an arrangement, as long as each share is properly calculated and administered from a fiduciary standpoint.

Other Uses Of Promissory Notes

It is “noteworthy” that promissory notes can be used to shift wealth between family members, to fund trusts, and to fulfill other objectives that are not normally considered.

For example, a high-risk physician married to an individual who has limited assets and a short life expectancy might execute a $5,000,000 promissory note payable to the Revocable Trust of such spouse, secured by the assets of the medical practice worth $6,000,000, which might otherwise be exposed to creditors.

After the non-physician spouse’s death, the note would be owed to the Credit Shelter Trust formed under the deceased spouse’s Revocable Trust, to make use of $5,000,000 of her estate tax exclusion (or whatever the exemption amount is at that time), and to provide continuing creditor protection, and protection from subsequent spouses, for the surviving physician spouse and common descendants of the marriage.

Such a note could bear interest at prevailing market rates for similar debt in order to have a fair market value equal to the amount owed. Alternatively, a wealthy individual with $20,000,000 worth of IRA and Pension accounts, and nominal other non-retirement assets might establish an Irrevocable Trust for a spouse and/or descendants and execute an $11,580,000 note owed to the trust, which would bear interest at market rates for similar indebtedness to use her $11,580,000 exclusion.

Conclusion

Tax and financial advisors should reach out to high net worth taxpayers, and taxpayers who may be concerned about asset protection, to point out the need to engage in estate tax planning before year end, which may include valuing assets, using FLPs or family LLC’s and installment sales to irrevocable trusts so that it can be handled after the November election and on or before December 31, 2020, if need be. Such preparation and completion of the first step described above will better situate these taxpayers, and provide an important structure for future planning, regardless of what the results of the November election and the future of the estate tax and a family’s wealth may be.

In reviewing possible planning techniques, the possibility that a long term promissory note bearing interest at the Applicable Federal Rate may be

worth much less than its face value, and what can be done to maximize gifting with note arrangements, possible exposure and filing strategies for gift tax returns, and other factors mentioned in this article should be understood and considered.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Alan S. Gassman

Jerome B. Hesch

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CITATIONS:

[i] Pierre v. Comm'r, US Tax Court, Aug 24, 2009133 T.C. 24 (U.S.T.C. 2009)

[ii] Shenkman, Role of Guarantees and Seed Gifts in Family Installment Sales, Estate Planning, p. 2 NOVEMBER 2010 VOL 37 / NO 11.

[iii] *See Akers, Planning Flexibilities with Inter-Vivos QTIP Trusts,* Heckerling Trust (workshop materials) January, 2004