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WEALTH TRANSFER

Wealth transfer: Staying the course and seizing the day

The beginning of every year is often a time for setting goals and reconsidering priorities. While 2020 may have started off on a familiar path, there have been many unexpected turns. In the prior installment, "When given lemons, make lemonade," we discussed that, if one buys into the notion that recovery follows a correction (one simply doesn't know how long that might take), then giving now can be the lemonade made from the current economic lemons. Although there are economic and social issues that may have a higher level of priority this year, it is still important to pause at year-end to recommit to staying the course with an effective wealth transfer plan and to consider whether or not there are opportunities that should be considered before 2020 comes to a close.

With this in mind, consider the following four year-end wealth transfer alternatives.

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One: Being mindful of how wealth opportunities are pursued

It is important to remember that providing a business or investment opportunity to an heir or trust is not a gift. From a family wealth perspective, the investment opportunities that attend a market correction should be undertaken not by senior family members, but by their heirs or trusts for the benefit of their heirs. To do so may require senior family members to assist heirs and trusts in financing the acquisition of investments or the pursuit of business opportunities. Additionally, assuming investments are pursued through an existing entity, an individual could consider being redeemed out at fair market value.

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Two: Using the enhanced applicable exclusion amount (AEA)

As discussed in our prior installment, under the TCJA, the applicable exclusion amount (or AEA, the amount that can be left to others by gift or bequest without incurring a gift or estate tax) was increased from $5 million to $10 million, indexed for inflation. In 2020, the AEA amount is $11.58 million. The TCJA states that the increased $10 million exclusion will only be in place until the end of 2025 (although political exigencies may give rise to an earlier sunset), when it will revert to the previous $5 million limit indexed for inflation. Under current law, the increased AEA is a "use it or lose it" proposition. Once it sunsets, it will be as if it had never existed.

Therefore, if an individual has any unused AEA, they should consider using it in 2020 or soon thereafter. Having resolved to make a gift, the questions then turn to what the gift should be and how the gift should be made. A transfer could be as simple as gifting cash or marketable securities, but it could also involve other types of investments. Additionally, a gift can be outright to the donee or indirect through use of a trust. For a more detailed discussion about potential wealth transfer planning to utilize any unused AEA, please refer to the **prior edition** of the *Guide*. For those interested in tax policy and prospective legislation issues, refer to Deloitte's ***Tax News & Views***.

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Three: Fine-tuning one's annual gifting plan

In addition to the lifetime AEA, though, there may also be significant impact in making annual exclusion gifts, which are neither subject to gift tax nor offset one's AEA. Additionally, while most uncompensated transfers of property during life are subject to federal gift tax, there are specific exceptions related to the payment of tuition to educational institutions and the payment of necessary medical and dental expenses, which, if paid directly to the educational or medical institution, do not offset the annual exclusion for the benefited party or use the donor's AEA.

Gift tax annual exclusion

In 2020, qualifying gifts of up to $15,000 per recipient are not subject to gift tax. Qualifying gifts are those that convey a present interest in the gifted property to the donee. A present interest exists when the donee has a substantial present economic benefit arising from the gift property, meaning that the assets received are readily convertible to cash or are income-producing from the outset (such as gifts of cash, marketable securities, and income-producing real estate). However, unless expressly permitted by statute, transfers encumbered by restricted access generally will not qualify (for example, most transfers in trust cannot qualify as a present interest unless the beneficiary is given the immediate right to withdraw value from the trust when transfers are made to the trust). Similarly, in our experience, the IRS has been successful in asserting that transfers of interests in family investment entities that do not consistently distribute earnings to their owners do not represent present interests. However, while highly restricted, transfers under the Uniform Transfer to Minors Act and funds contributed to section 529 educational savings plans qualify as present interests by statute.

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Three: Fine-tuning one's annual gifting plan

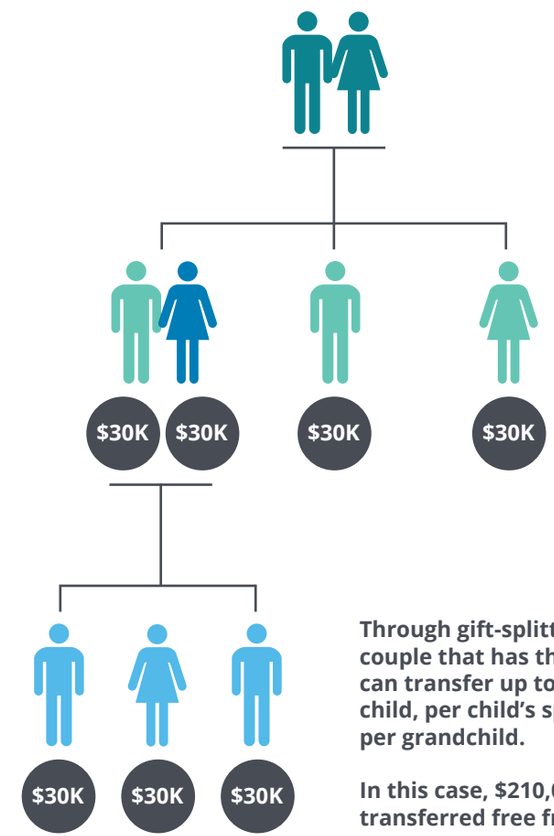
Make annual gifts

Consider shifting wealth down generational lines through an annual gifting program. There may be additional benefit if the gifted asset:

- Can be valued on a discounted basis;
- Is likely to appreciate and/or generate income in the hands of the donee; or
- Is given to a grantor trust that permits the trust assets to grow income-tax free because the grantor, who is required to report and pay income tax on the trust's income, further reduces their estate by the amount of any income tax paid. Because the tax is the donor's legal liability, it is not an indirect gift to the trust.

To demonstrate the power of annual gifting, assume a couple has three children. In 2020, this couple can transfer up to $30,000 per child, or $90,000 in the aggregate to all three children. If each child has a spouse, then the maximum amount that can be given to the children and their spouses is $180,000 without incurring a taxable gift. Additionally, if the couple has grandchildren, then the ability to further reduce their taxable estates through annual gifts expands arithmetically.

Annual gifting scenario



Through gift-splitting, a married couple that has three children can transfer up to $30,000 per child, per child's spouse, or per grandchild.

In this case, $210,000 could be transferred free from gift tax.

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Three: Fine-tuning one's annual gifting plan

Make direct payments to educational institutions or medical providers

Such direct payments are not taxable gifts. For example, a grandmother who wishes to help pay for a granddaughter's education can write tuition checks directly to the school without making a taxable gift. However, if she writes the check to the granddaughter, she will have made a taxable gift to the extent the amount gifted exceeds the $15,000 annual exclusion. Tuition is not limited to college tuition; any qualified school's tuition can be excluded. Medical expense does not just mean those for doctors and hospitals; any qualified medical expense, including health insurance premiums, can be paid under this exclusion.

Make future educational gifts through a Section 529 plan

Using a special election, a donor can fund up to five years of annual exclusions into these plans in year one. Specifically, in 2020, one can contribute $75,000, or $150,000 per married couple, to each child's (or grandchild's) Section 529 plan without incurring gift or generation-skipping transfer (GST)[2] tax. If other gifts are made by the donor to that child or grandchild from 2020–2024, however, those gifts would use some of the donor's AEA, as well as some of the donor's GST tax exemption, with respect to any gift made for a grandchild. By funding these plans in advance, the growth in the fund occurs in an income tax-exempt environment.

Make transfers to grantor trusts

Grantor trusts are trusts in which the grantor has retained either an economic interest or powers over trust property that are significant enough to require the income of the trust to be taxed to the grantor, thus making the trust a disregarded entity for income tax purposes. Interestingly, the retention of some powers over trust property will not also cause the trust to be disregarded for transfer tax purposes. Properly employed, these powers can cause the grantor to be legally liable for the income taxes arising from the trust's tax attributes, but not in a manner that causes estate tax inclusion. From an estate tax perspective, such trusts represent the gifts that keep on taking (from the grantor's estate)—a situation that can be perpetuated for as long as the grantor is willing to pay the continuing income tax liability.

[2] GST tax is imposed on transfers during life and at death that are made to a "skip person"—a recipient who is at least two generations younger than the donor or decedent, such as a grandchild. If there were no GST tax, a transfer to a grandchild would be subject to the gift or estate tax once, while a gift to a child who then gifts or bequeaths those assets to a grandchild would be subject to transfer tax twice.

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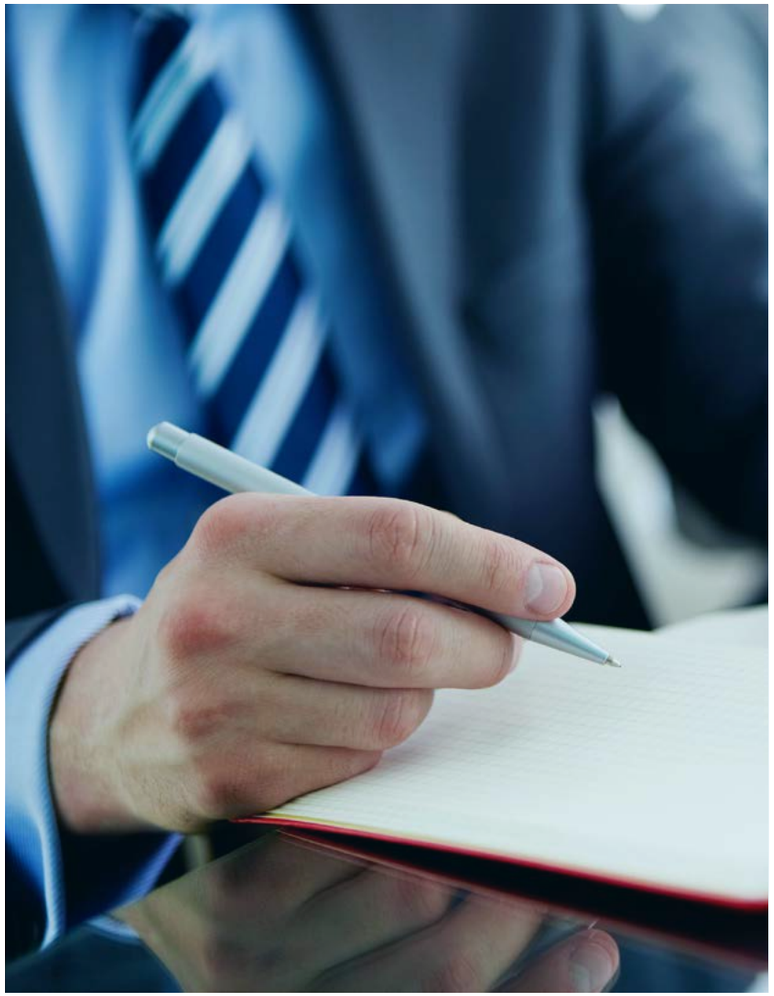
Four: Tuning up prior planning

There are many reasons to consider tuning up prior planning now. For example, prior planning may have occurred in a higher-interest-rate environment or contemplated economic outcomes did not materialize, the tax law may have further developed, or personal circumstances may have changed. In any event, it is always important to determine if current circumstances still support prior wealth planning decisions and whether wealth transfer planning goals have changed.



Reflecting the effects of the current economic climate

The general economic downturn has affected many businesses, but not consistently. Some companies have been challenged, but some companies, such as those in the technology industry, may be thriving. Many wealth transfer plans are particularly sensitive to asset performance (such as grantor retained annuity trusts), other plans may be sensitive to interest rate fluctuations (such as intrafamily loans), and some plans are sensitive to both (for example, sales to grantor trusts). Perhaps modifications might be contemplated.

- Many grantor trusts permit the grantor to substitute assets for those of the trust if the exchanged assets have equivalent value. Rebalancing the trust's portfolio in this manner may prove helpful to the overall wealth transfer plan.

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- Debt can, in appropriate circumstances, be modified to reflect the current lower interest rates. However, this should not be done in a vacuum without considering potential gift (and sometimes income tax) consequences.
- Some wealth plans where intrafamily debt plays a large role are simply no longer viable. In certain circumstances, a new infusion of transferred wealth (using the AEA) will be enough to "right" the plan and allow it to function as designed. In other cases, rather than risk other tax exposures, consideration may be given to foreclosing on the old debt and starting fresh.
- Some wealth transfer plans involved the use of grantor trusts. Perhaps consideration should be given to terminating grantor trust status so that the trust begins paying its own income taxes.

Reflecting the evolution of tax law and tax policy

Tax law is never static. With time, laws or the interpretation of existing laws may change, and opportunities may arise to change undesirable tax attributes. Current wealth transfer objectives may be improved by making changes, such as the following nonexclusive list of considerations:

- Time (and tax policy) often catches up with prior wealth plans. For example, family investment partnerships have evolved considerably since they were first introduced in the mid-1980s. Many of these earlier partnerships are no longer conducive to effect wealth management, and consideration should be given to carefully excising them from the overall plan.
- The GST footprint of certain trusts could be improved. Given the greater GST tax exemption currently available, if an existing GST trust has an inclusion ratio between zero and one (that is, a trust where a distribution to a skip person would be partially subject to GST tax), consider allocating the increased exemption to those trusts. When a trust has an inclusion ratio between zero and one, the amount of GST tax exemption required to obtain an inclusion ratio of zero (thus making the trust thereafter fully exempt from GST tax) is a function of the value of the trust's assets at the time the additional GST tax exemption allocation is made.
- The state taxation of nonresident trusts has been a focus of change over the past decade. The tests applied to determine a trust's status as a resident have also changed in many states. A comprehensive review of a nongrantor trust's exposure to state income taxes should be considered, particularly if parties

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that are relevant to the trust (the grantor, trustees, and beneficiaries) have resided in different places in 2020 due to quarantine or other personal circumstances.

Determine whether recent life changes may necessitate document revisions

Wealth transfer documents such as revocable trusts, wills, and powers of attorney should be reexamined frequently. As 2020 has brought unprecedented new pressures to bear, the case for reevaluating testamentary documents is especially strong. What is frequently forgotten is updating the beneficiary designations of contract property (such as life insurance; retirement plans, including individual retirement accounts (IRAs); and deferred compensation regimes) to coordinate them with beneficiary designations under the last will and testament. It may also be a good time to consider whether you have a need or desire to alter fiduciary designations, such as a proposed trustee or trust protector, a guardian of minor children, or an executor or the identity of an attorney if there is a springing power of attorney built into the current wealth management plan.

As 2020 has brought unprecedented new pressures to bear, the case for reevaluating testamentary documents is especially strong.

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2020 year-end presents potential opportunities

While the circumstances of 2020 may be unprecedented, the need for an effective wealth transfer plan for efficient and orderly distribution of assets has not changed. It is always very important to pause and consider the effect of the economy, tax law changes, or changes in personal circumstances on your wealth transfer goals and plans; any changes to those plans may have unintended tax consequences. However, while life may have brought lemons, it is important not to miss the opportunity to enjoy some lemonade. Review the prior article about potential planning considerations to utilize any remaining AEA while the fair market value of your assets may have decreased and the AEA has not been reduced by potential tax policy changes. Consider transferring assets in a manner that does not utilize a gift (or GST) tax exemption or exclusion. Moreover, if your priorities have changed or your existing wealth transfer plan is not performing as hoped, then be sure to pull out your existing wealth transfer documents and consider, with your advisers, any necessary fine-tuning to achieve your goals. In the end, perhaps 2020 presents us with the opportunity to reflect and refresh to better prepare for the future of your family's wealth.

It is always very important to pause and consider the effect of the economy, tax law changes, or changes in personal circumstances on **your wealth transfer goals and plans**.

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