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As discussed in the second installment of the Guide, the truly transformative nature of the 2017 Tax Act with respect to the estate tax is how relatively few people remain subject to tax. We also discussed how wealth is generated at an exponentially quicker pace than the inflation adjustment, thus propelling a growing population into the reach of the estate tax, and how the statistics do not include those persons who actively plan themselves out of the estate tax by engaging in affirmative, inter vivos (lifetime) gift tax planning. Most importantly, we noted how the opportunity provided by the 2017 Tax Act is fleeting—because it is to sunset in 2026, leaving the exclusion amount for each taxpayer roughly half of what it is currently. In this installment, we will discuss more subtle uses of the enhanced applicable exclusion amount—including “tuning up” prior planning transactions, transfers structured to avoid “donor’s remorse,” transfers that concentrate on the generation-skipping transfer tax, and state estate and inheritance tax considerations.
Wealth transfer planning

Tuning up prior planning

If you have prior wealth transfer transactions that have not performed as forecasted, you are not alone; few plans develop as modeled for any number of reasons. As was described in the second installment of the Guide, intra-family debt—for example, notes issued by trusts to purchase assets from a senior family member, or simply loans from a senior family member to children, trusts for children, or businesses of children—often plays a role in estate plans. Not surprisingly, one of the most common issues in troubled estate plans is disturbed debt service when either economics or other priorities intervene to preclude the payment of the debt as scheduled.

Failure to act when a note is in default raises issues regarding the propriety of the original sale or loan transaction and, in itself, raises gift tax issues. In such situations, consider foreclosing if the borrower is unlikely to meet its debt obligations because its underlying assets are unlikely to generate sufficient cash flow or otherwise recover their value. Alternatively, if the borrower’s underlying assets are likely to recover but not in a fashion that permits the original terms of the note to be met, consider renegotiating the formal terms of the note including, perhaps, forgiving the note in whole or in part. Keep in mind, though, that the forgiveness of a bona fide loan that subsequently became troubled may be subject to the income tax rules governing bad debts and cancellation of indebtedness. Use caution when forgiving a note to a business entity; it will likely be considered a gift to each entity owner equal to the face amount of the note properly apportioned among the owners. A better use of the increased applicable exclusion amount ($11.4 million, or $22.8 million per couple, in 2019) might be to subscribe for a new or increased interest in the entity for cash and then use the increased working capital to cure the default on the nonperforming loan. Similarly, with respect to loans involving individuals and trusts, consider additional gifts to the borrower to increase the probability of the original transaction’s success.

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Basic blocking and tackling

While the unexpected increase of the $11.4 million exclusion amount has greatly increased planning flexibility and opportunity, it should not detract from the use of other estate planning alternatives that do not require use of the exclusion amount:

• Shift wealth down generational lines through use of the annual gift tax exclusion ($15,000 in 2019).

• Make a cash gift to a child or grandchild who has earned income, which the donee(s) may then use to make contributions to a traditional or Roth IRA.

• Make payments on behalf of others directly to the providers of medical and educational services. These direct payments are not treated as taxable gifts.

• Consider funding future education expenses through gifts into a Section 529 educational plan for children or grandchildren. A special election allows you to fund up to five years of annual exclusions into these plans in one year without incurring a taxable gift or GST tax. Note that, if you make other gifts to your children or grandchildren during 2019 through 2025, these gifts would use some of your $11.4 million gift tax exclusion and, if set up for a grandchild, your $11.4 million GST tax exemption.
Because of the anticipated sunset of the increased exclusion amount, we point out again that the failure to fully utilize the existing exclusion amount may lead to an otherwise avoidable and potentially substantial estate tax liability. Yet, to so give requires one to relinquish all “dominion and control” over the transferred property. In other words, one’s access to previously transferred assets is generally eliminated or, where permitted, is at the discretion of another, such as an independent trustee. Failure to eliminate the donor’s access to and control over previously transferred assets will result in their inclusion in the donor’s taxable estate as if no gift planning had occurred.

In addition, recall the relative income tax disadvantage of lifetime gifts relative to testamentary bequests: The donee of a lifetime transfer takes the donor’s income tax basis, whereas the beneficiary of a bequest receives the transferred asset with a basis equal to its fair market value at the time of the decedent’s death. Thus, if the basis of gifted property is relatively low and it is anticipated that the donee will dispose of the property soon after the gift occurs, then the donee’s after-tax proceeds will be significantly less than the gift tax value of the transferred asset.

What has made it possible to bridge the competing considerations regarding affirmative use of the increased exclusion amount and income tax basis is the IRS’s guidance on how the exclusion amount available at death is affected by prior gifts that used up the exclusion amount during life but are nevertheless included in the taxable estate because of retained access to (or control over) the gifted property at the donor’s death. Specifically, the guidance holds that while the previously transferred assets are included in the estate (and receive fair market value basis for income tax purposes), the applicable exclusion amount previously used at the time those gifts were made will remain available to the decedent to offset estate taxes unless the prevailing inflation-adjusted exclusion amount at the date of death is greater.

Armed with this realization, variations of existing gift plans have started to emerge—specifically, techniques that utilize the currently large exemption, but are deliberately structured to cause estate tax inclusion of the transferred assets to achieve the income tax basis step-up. Such planning assumes that there is a good possibility that the donor will pass away before the inflation adjusted post-2025 exclusion amount has exceeded the current exemption of $11.4 million per taxpayer. Remember, the post-2025 exclusion amount, while roughly half of the current exemption, is still to be inflation adjusted under current law. Thus, at some future point in time it will grow beyond what the exemption is today. While that year cannot be known, given recent inflation adjustments, a 25-year life expectancy is likely to leave one with a greater exclusion amount than exists currently.
Wealth transfer planning

On the topic of donor’s remorse

Perhaps a simplified example might help. Prior to 1991, the most popular estate planning vehicle was the grantor retained income trust (GRIT), which had three prevailing characteristics. First, the grantor retained the right to all future income produced by the trust during a defined period of years; consequently, the actuarial value of the income interest reduced the value of the taxable gift because it had not been transferred. Second, the actuarial value of the income interest had nothing to do with the amount of income actually produced or expected to be produced, rather it was based on three factors: The prevailing interest rate in the month the GRIT was funded, the actuarial life expectancy of the donor, and the period of time over which the income was retained. Stated differently, the trust could produce no income at all and the same reduction in gift value would apply. Third, the GRIT was subject to a profound mortality risk. If the grantor died during the retained income period, the entire value of the GRIT’s assets would be included in the grantor’s taxable estate at their date of death value.

In 1990, the law was changed to require a sum certain to be distributed annually, thus preventing the manipulation of the retained income feature. Thus, the GRIT became the GRAT. If one failed to express the retained interest in the trust as an annuity, then the value of the retained right to cash flow was statutorily set at zero, and thus arbitrarily increased the size of the gift. Yet, notwithstanding declaring a gift of the full value of the property contributed to the GRAT, one still had the risk of full inclusion of the trust property in the taxable estate if one’s death occurred during the period the cash flow was being received.

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In a very simplified form, what advisers are now contemplating is a GRIT that deliberately lasts for life with the result that:

1. The grantor keeps all the cash flow produced during life,
2. The grantor uses up more of the exclusion amount during life (since the full value of the assets contributed to the GRIT is considered a taxable gift), but,
3. The value of all trust assets will be included in the grantor’s taxable estate (for which they will receive fair market value basis), and
4. The larger amount of exclusion used will still be available to offset the value of the GRIT assets, unless the exclusion available in the year of the grantor’s death is higher than the amount that had been used in the year the GRIT was formed.

Thus, the grantor has hedged against donor’s remorse: Investment control and income distribution are retained (but not the ability to fully liquidate the trust in the grantor’s favor), fair market value basis at death is achieved, and the full amount of the utilized tax exemption is preserved for use against the estate tax even if the exemption amount actually available at the date of death is a lower number. However, one must consider that, if the GRIT is highly successful, the assets that might have been out of the estate at death if a classic GRAT had been used are now back in the estate and a much greater estate tax obligation will arise notwithstanding the grantor kept the higher exclusion amount actually used in the year the GRIT was formed.

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EXAMPLE:
An upstream gift from Daughter (Joan) to Father (James)

The planning alternative illustrated below allows for a partnership interest, any future appreciation, and cashflow to be excluded from the daughter’s estate. After the father’s passing, the trust beneficiaries (not the daughter) may achieve income tax savings via a depreciation deduction. Significant estate tax savings may be achieved if there is significant appreciation between the time of the father’s passing and the time of the daughter’s passing. Note that the outcomes illustrated are very fact specific.

Joan owns an interest in a partnership holding commercial property, currently worth $11.4M with a cost basis of $1M.

Joan passes away. Upon James’ death, Joan’s gift to the trust becomes complete using Joan’s lifetime gift tax exclusion. In addition, the trust assets are included in James’ estate (assume no appreciation for this example) and therefore get a step-up in basis to $11.4M and the estate tax may be offset by James’ unused lifetime gift and GST tax exclusion.

A CLOSER LOOK AT THE POTENTIAL ESTATE TAX SAVINGS:
- Appreciation (2%, 15 years): $6.36M
- Cash flow (13 years): $1.30M
- Total value excluded from Joan’s estate: $7.66M
- Estate Tax Savings: $3.06M

Joan passes away. Upon Joan’s death, the appreciation and the cashflow since James’ death are not included in Joan’s estate. The $11.4 million gift value is included in the estate tax base as an adjusted prior gift.

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A CLOSER LOOK AT THE POTENTIAL INCOME TAX SAVINGS:
The basis is stepped up from $1M to $11.4M. Assuming 60% improvements and a 15-year asset life, that represents a depreciation expense of $456,000 per year. At the current top tax rate of 37%, the annual income tax savings is $168,720 and 15-year savings is $2,530,800. Note that this accelerates the re-depreciation of the property by a generation.
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This isn’t an isolated example. Many forms of existing estate tax planning, usually involving trusts, originally designed to keep their assets out of the grantor’s taxable estate at death can be modified to accomplish estate inclusion and use up the current exemption. But these modifications can be complicating and are, as yet, untested. Thus, as with all tax planning, there are both real economic risks and tax risks arising from such plans. One should go into the planning process with open eyes and obtain a real understanding of where difficulties might arise.

There are other options to assuage potential donor’s remorse, such as enjoying, within limits, indirect access to the transferred assets. For example, if you are married, you could consider transferring $11.4 million in property to an inter vivos trust that provides for income distributions (and periodic or discretionary corpus distributions) primarily for the benefit of your spouse. Such a trust, so long as you remain married, would indirectly help preserve much of your cash flow as it existed prior to any planning. This planning, however, has limits. The law does not respect trusts set up by each spouse for the benefit of the other spouse if the trusts’ dispositive terms are substantially identical. Where “reciprocal” trusts are important to the overall estate plan, you and your advisers must take care to differentiate the dispositive provisions of the trusts so that each trust will avoid inclusion in the donor’s gross estate. Further, this option does not give rise to estate inclusion and thus there will be no fair market value basis available at death. Lastly, this option responds poorly to a divorce.

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The GST tax is a separate tax regime that augments the gift and estate taxes. It provides a mechanism to collect a transfer tax at each generational level by imposing a tax when a gift, bequest, or trust benefit acts to skip a generation. For example, a gift from a grandparent to a grandchild, while subject to a gift tax, avoids the tax that would have been imposed upon a transfer of the same assets from child to grandchild. The prior sentence should not be read to imply that gifts to unrelated persons may not also be subject to GST tax. A gift to an unrelated person 37.5 or more years younger than the transferor is also subject to GST tax. But, GST is only imposed upon the value of transfers in excess of a statutory amount—the GST exemption amount. The 2017 Tax Act increased the GST tax exemption to $11.4 million in 2019, coinciding with the estate and gift exclusion. If legislators take no action, the GST exemption will revert to $5 million indexed for inflation from 2010 (which is expected to be about $5.6 million in 2026). The GST tax rate remains equal to the highest estate tax rate in effect—40 percent through 2025.

The GST tax is elaborate in scope, particularly as it relates to transfers to trusts that will extend over multiple generations. However, if a taxpayer applies his or her GST exemption to a trust in an amount equal to his or her gifts to the trust, then under current law all future distributions from that trust, whether during its term or upon its termination, will be exempt from GST tax.

Leveraging the GST exemption: Dynasty trusts

A typical GST tax-exempt dynasty trust—a trust to which the transferor has allocated his or her GST exemption in an amount equal to his or her gifts to the trust—transfers income and/or principal to multiple generations, including children (hence the title “dynasty trust”), while paying estate or gift tax only upon the initial gift to the trust. The wealth accumulated in the trust thereafter avoids both estate tax and GST tax at each subsequent generation until such time as the trust terminates. Because dynasty trusts are intended to skip multiple generations, they represent the most tax-efficient use of a taxpayer’s GST exemption.

Dynasty trusts are permitted in all states, but laws in many states limit the duration of a trust to a term from 80 to 110 years. Most states allow the trust to continue until 21 years after the death of the last descendant of the transferor who was living at the time of the trust’s creation. Other states have recently amended their trust statutes to permit trusts to exist in perpetuity. An individual may create a trust in a state other than his or her state of residence; consequently, perpetual dynasty trust planning is substantially open to everyone. (The relative merits of availing oneself of such a perpetual trust is a topic beyond the scope of this chapter.)

The most leveraged form of such a transaction would have each spouse fund a dynasty trust, each in the form of a grantor trust, with $11.4 million. Thereafter each trust would engage in a purchase of property, at a reasonable multiple of the $11.4 million value of the trust, from the grantor (a planning consideration described in the second installment of this Guide). Without belaboring the math of the example, assuming a leveraged purchase over 20 years, for a trust with a term of 110 years and an after-income tax yield of 4 percent, the value of each such trust would have grown to $3.4 billion, even assuming that all cash receipts were distributed. Although a trust leaving its corpus intact for the entire 110-year term is unlikely, the example demonstrates the wealth accumulation possibilities inherent in a dynasty trust where the undistributed wealth is subject only to income taxes—not transfer taxes—and the income taxes are only imposed after the grantor’s death when the trust’s grantor trust status terminates.
Wealth transfer planning

A cautionary note on state estate and inheritance taxes

Many states do not now and will not in the future conform to the federal estate tax exclusion amount. Consequently, an immediate state estate/inheritance tax may arise where the $11.4 million federal exclusion amount is being utilized in a testamentary transfer and it exceeds the corresponding state applicable exclusion amount. Most states have started to adjust their exclusions upward from the universal $1 million in place in 2000, but none are likely to match the federal inflation-adjusted exclusion. Thus, in a state that does not provide for its “own” state-only marital deduction protocol, fully funding a bypass trust with the federal $11.4 million federal exclusion amount would give rise to a considerable state estate tax.

State estate and inheritance tax rate and exemptions in 2018

<table>
<thead>
<tr>
<th>State</th>
<th>Estate tax</th>
<th>Inheritance tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Connecticut</td>
<td>$2.6M; 7.2%–12%</td>
<td></td>
</tr>
<tr>
<td>Hawaii</td>
<td>$11.2M; 10%–15.7%</td>
<td></td>
</tr>
<tr>
<td>Iowa</td>
<td>0%–15%</td>
<td></td>
</tr>
<tr>
<td>Illinois</td>
<td>$4M; 0.8%–16%</td>
<td></td>
</tr>
<tr>
<td>Kentucky</td>
<td>0%–16%</td>
<td></td>
</tr>
<tr>
<td>Maine</td>
<td>$5.6M; 8%–12%</td>
<td></td>
</tr>
<tr>
<td>Maryland</td>
<td>$4M; 16%</td>
<td>0%–10%</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>$1M; 0.8%–16%</td>
<td></td>
</tr>
<tr>
<td>Minnesota</td>
<td>$2.4M; 13%–16%</td>
<td></td>
</tr>
<tr>
<td>Nebraska</td>
<td>1%–18%</td>
<td></td>
</tr>
<tr>
<td>New Jersey</td>
<td>0%–16%</td>
<td></td>
</tr>
<tr>
<td>New York</td>
<td>$5.25M; 3.06%–16%</td>
<td></td>
</tr>
<tr>
<td>Oregon</td>
<td>$1M; 10%–16%</td>
<td></td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>0%–15%</td>
<td></td>
</tr>
<tr>
<td>Rhode Island</td>
<td>$1.538M; 0.8%–16%</td>
<td></td>
</tr>
<tr>
<td>Vermont</td>
<td>$2.75M; 16%</td>
<td></td>
</tr>
<tr>
<td>Washington</td>
<td>$2.193M; 10%–20%</td>
<td></td>
</tr>
<tr>
<td>District of Columbia</td>
<td>$11.2M; 6.4%–16%</td>
<td></td>
</tr>
</tbody>
</table>

Note: Exemption amounts are shown for state estate taxes only. Inheritance taxes are levied on the posthumous transfer of assets based on the relationship to the descendant; different rates and exemptions apply depending on the relationship.

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Thoughtful marital deduction planning may postpone the problem noted above, but at a price. Specifically, if all assets pass to the surviving spouse in a manner qualifying for the marital deduction and the trust described above is not funded, there is no transfer subject to state estate taxation until the surviving spouse dies. At that time, for federal estate tax purposes, both the decedent’s exclusion and the deceased spouse’s unused exclusion is also utilized; however, many states do not permit the use of state exclusion amounts other than that of the decedent. The question then is whether the subsequent gain in the size of the estate subject to state estate tax will produce a tax result that would suggest that paying the state estate tax at the death of the first spouse might have been more tax efficient. By paying state estate tax at the first death, all future appreciation on the trust’s assets is not subject to state estate taxation upon the death of the surviving spouse. Whether that future savings justifies a current state estate tax liability is ultimately a function of nontax factors.

If you are domiciled in a state with a state estate or inheritance tax or you own assets in such a jurisdiction, consider whether lifetime gifting will remove assets from your state taxable estate. With the exception of Connecticut, states do not currently levy a gift tax. States other than Connecticut may not include prior taxable gifts in the state estate tax base, notwithstanding they are an element in the federal estate tax base.
What does the future hold for the transfer tax system? Hard to say, but since it has now survived for more than a century, its continued survival would appear more likely than not, particularly since a review of its history indicates its frequent use as a means to raise quick revenue when politically expedient. What of the current exclusion amounts? Harder to say. It will depend on which direction the political winds blow between now and 2025. However, given expected federal budget constraints, to assume that the exclusion amounts will remain at current levels entails substantial risk. This is the type of uncertainty that has paralyzed taxpayers and their advisers before. Yet, there is an important reason to resist the planning paralysis now—the rare opportunity to employ the enhanced gift and estate tax exclusion and GST exemption amounts under the 2017 Tax Act. This chapter and the related chapter in the second installment of the Guide is intended to inform you of the possibilities to do just that. If the current rules sunset, it is unlikely that you will see a similar circumstance rise again.

So, to reiterate, if you are in a position to do so, consider doing something now, before the end of 2025. At the same time, you and your advisers should remain vigilant as the 2020 election season approaches given the possibility that in 2021, the future of the federal estate, gift, and GST taxes may once again become unclear. Keeping informed of tax legislative developments will give you a more effective opportunity to plan ahead and react quickly as more changes transpire.

Seeking the advice and guidance of an experienced tax professional in implementing a wealth transfer plan that reduces your estate, gift, and GST tax liabilities is a prudent course of action. Now, in these times of unprecedented wealth-transfer opportunity (but also significant longer-term uncertainty), obtaining planning guidance is imperative. As with any aspect of wealth transfer, you should work closely with your advisers to identify and evaluate opportunities relevant to your situation, goals, and needs.