Estate Planning in Light of Legislative Uncertainty

ABA Tax Section
Midyear Meeting
Young Lawyers Subcommittee
January 31, 2019

• Part 1: Trust Planning After Kaestner
  • Alyssa H. Depew
    • Kirton McConkie PC, Salt Lake City, Utah

• Part 2: IDIT and GRAT Planning in 2020
  • Katie B. Cooperman
    • Holland & Hart LLP, Denver, Colorado

• Part 3: Exemption Planning in 2020
  • Ashley B. Sawyer
    • Loeb & Loeb LLP, Washington, District of Columbia
Quick Recap of *Kaestner* (2019)

- Supreme Court identified facts that would not allow a state to tax a trust based on the beneficiary’s residency.

- Did not answer whether it is acceptable for a state to tax a non-grantor trust based on the residency of the beneficiary.

- Held that a trust should not be taxed as a North Carolina resident trust solely on the basis of the beneficiary’s residence where the beneficiary had no control over the assets of the trust, could not demand any trust income, and did not actually receive any income from the trust during the years in question.
1. Decant Trusts with Required Distributions

The *Kaestner* Court emphasized beneficiary’s ability to demand distributions, suggesting that:

- a state may be able to tax a trust based on the beneficiary’s residency when beneficiary can demand a distribution of the greater of 5% of the corpus or $5,000;
- N.C. or states with similar worded statutes may be able to tax trusts that require distributions for HEMS, even if trust has independent trustee; and
- a state may be able to tax trust where beneficiary is entitled to distributions on the achievement of certain ages or milestones.
1. Decant Trusts with Required Distributions (cont.)

Takeaway:
• It may be wise to decant a trust into one that only permits discretionary distributions as determined by an independent trustee, without distributions at a specific age.
2. Consider Judicial Modification without Beneficiary Approval

- A non-judicial modification to lessen beneficiary control might actually act as evidence of beneficiary control, in contrast to a decanting effectuated by the trustee.

- If the beneficiary must consent to a non-judicial modification, a court might view that as the beneficiary actively participating in or controlling the decision.
2. Consider Judicial Modification without Beneficiary Approval (cont.)

Takeaway:

• It might be possible for decanting to be effectuated by the trustee with no beneficiary involvement, thus eliminating further evidence of beneficiary control.
3. Avoid Making Distributions

- If a state determines taxability of trust based on residence of beneficiary, certain types of distributions to beneficiary could trigger state income tax:
  - Loans Made to Beneficiary:
    - the loan should carry adequate interest;
    - the loan should be memorialized by documents that evidence the intent to repay;
    - actual loan payments to the trust should be made;
    - loan may need to be secured by beneficiary’s property; and
    - loans should not be periodic or regular, because they would look more like distributions.
3. Avoid Making Distributions (cont.)

- Property Acquisition
  - As an alternative to a distribution, under *Kaestner*, a trust could potentially acquire property for the beneficiary to use if the property is located outside the beneficiary’s home state.

- Directed Payments by Non-Fiduciary?
  - Unclear how a trust will be taxed if a person in a non-fiduciary capacity directed a trustee to transfer funds from the trust to a named person, pursuant to a power of appointment.
  - Payment may not be deemed a distribution and the recipients not a beneficiary in a traditional sense since only a fiduciary can make distributions to a beneficiary.
3. Avoid Making Distributions (cont.)

Takeaway:

- Non-traditional distributions such as loans, acquisition of property for beneficiary use, and directed payments by non-fiduciaries may be more heavily scrutinized by a taxing state after Kaestner, and should be avoided without close precautions.
4. **Choose Institutional Trustee in a Tax-Friendly Jurisdiction**

- The residence of an individual trustee is a crucial factor in determining a state’s ability to tax income of a trust.

- Consider choosing an institutional general trustee based in a tax friendly jurisdiction in lieu of a friend or family trustee in the taxing jurisdiction.

- The Benefit?
  - Less costly in the long run because trustee can ensure that trust adheres to formalities that bolster trust’s defenses against state tax challenges.
4. **Choose Institutional Trustee in a Tax-Friendly Jurisdiction (cont.)**

- Family members can still be involved, even if institutional trustee is named.

- Ensure that the family member is not a resident of a jurisdiction where such residency would be used to create a state tax which would not otherwise be owed by the trust and name that person as Trust Protector.

- Give such person the power to act in a non-fiduciary capacity.

- Organize an LLC in a tax-friendly jurisdiction. Name the LLC as trust protector and outline the specific powers and responsibilities such entity would have over the trust. Identify one or more family members to serve as manager(s) of the LLC, with the power to make decisions on behalf of the LLC.
4. Choose Institutional Trustee in a Tax-Friendly Jurisdiction (cont.)

Takeaway:

- Naming an institutional trustee based in a tax-friendly jurisdiction can strengthen the defense against a challenge from the taxing state, without isolating family members from the administration of the trust.
5. Avoid Certain Contacts with Taxing Jurisdiction

- Although not dispositive, the following contacts could weigh in favor of state taxation of a trust:
  - Trust records physically located in the taxing state;
  - Trust asset custodians located in taxing state;
  - Trustee engages investment advisors physically located in the taxing jurisdiction, or that have other locations within the jurisdiction;
  - Trust rents or owns offices in the taxing state;
  - Trust owns real or tangible personal property in the taxing state;
  - Trust has direct investments in taxing state; and
  - Trustee meets frequently with beneficiary.
Trust Planning After Kaestner

5. Avoid Certain Contacts with Taxing Jurisdiction (cont.)

Takeaway:

- A safe course for a trust seeking to minimize state income taxation is to avoid physical contacts with the taxing jurisdiction.
- If trust acquires property for the benefit of beneficiary in the taxing jurisdiction, consider dividing the trust, if permitted, to avoid tainting the entire trust corpus.
- Beneficiary/Trustee meetings should be conducted in a tax neutral location.
IDIT Planning in 2020

- Potential for a “use it or lose it” scenario.
- Current laws are favorable for discounting and freezing transactions.
  - Some proposals significantly limit the ability to undertake such transactions.
- Taxes are likely to be increased in the future to offset increasing deficits.
- Economic Factors:
  - Current low interests rates, and
  - Recession indicators.
IDIT Planning, Continued

- IDIT Planning is designed to take advantage of three key wealth transfer planning techniques:
  - **Discounting**;
  - **Freezing**; and
  - **Amortization**.
- Additional transfer tax benefit from utilizing grantor trust structure.
- Clients with sufficient wealth should consider getting the structures in place in the first half of 2020 so that they are able to move quickly to effectuate transfers if:
  - There is a political shift in Washington;
  - There are economic indicators that make 2020 a favorable time to effectuate wealth transfers.
Forming and Funding IDITS

Husband

Seed Gift
($3 MM)

Husband's Dynasty Trust

Wife

Seed Gift
($2 MM)

Wife's Dynasty Trust
Discounting
Forming the Family LLC

- Husband
- Husband’s Dynasty Trust
- Wife
- Wife’s Dynasty Trust

- 44% ($22 MM) to Family, LLC
- 6% ($3 MM) to Husband’s Dynasty Trust
- 46% ($23 MM) to Wife
- 4% ($2 MM) to Wife’s Dynasty Trust

Family, LLC $50 MM
Discounting

- Holding family investment assets in a family-owned LLC is a common structure for discounting purposes.
- Under current law, merely by transferring assets to an LLC, clients can lower the fair market value of assets for transfer tax purposes significantly (~30%).
  - *Actual discounts determined by a qualified appraiser.*
- Discounts available for: lack of marketability, lack of control and restrictions on transfer, all of which are common in the closely-held family business context.
Freezing Selling LLC Interest to IDITs

- Husband
- Husband's Dynasty Trust (50%)
- Family, LLC $50MM
- Wife's Dynasty Trust (50%)
- Wife

Promissory Note
Freezing

- Clients can freeze the value of their assets and transfer future appreciation to their heirs at *no transfer tax cost*.
- Installment sales to IDITS accomplish this goal.
  - Husband and wife sell the LLC interests they hold individually to their trusts in exchange for a promissory note.
  - The amount of the promissory note is the amount they are able to “freeze” for transfer tax purposes.
  - Goal is to use promissory note payments to fund current consumption thereby reducing the client’s gross estate.
  - This technique freezes value for purposes of inclusion in the client’s gross estate and transfers all of the appreciation to future generations.
Amortizing
Paying Down the Promissory Note(s)
Amortization

- As the LLC generates income and makes distributions to the IDITS, the IDITs uses these funds to pay down the promissory note to husband and wife.
- Husband and wife benefit from cash flow from investment property during the term of the promissory note.
- Husband and wife should try to consume this cash during their lifetimes.
- Competing views as to whether or not to disclose or not to disclose the sale transaction on a gift tax return.
GRATs allow grantors to transfer appreciation to their heirs at no (or immaterial) transfer tax cost.

Two requirements for a successful GRAT:
- Grantor must outlive the term of the GRAT, and
- Assets in the GRAT must appreciate a rate in excess of the §7520 rate.

Annuity payments provide financial security to the grantor.

Best assets for GRATs are easy to value asset that are likely to appreciate.

GRATs are more likely to be successful in a low interest rate environment because the §7520 hurdle rate will be lower.
GRAT Planning

**Step 1:** Transfer assets from Grantor to GRAT.
- Gift is the FMV of the asset transferred less the value of interest retained.

**Step 2:** Pay annuity amount to Grantor each year of the term.

**Step 3:** Remainder at the end of the GRAT term is paid to remainder beneficiary.

- **GRANTOR**
- **GRAT**
- **GST NON-EXEMPT TRUST**
What this means for 2020

- Financial advisors are aware and flagging this issue for their clients.
- Impossible to predict political outcomes, but for clients with significant net worth, it may be worthwhile to get these structures in place in the first half of 2020.
- Even if there is no administration change this year, it is still beneficial to get clients thinking about these issues and strategies because the laws and economic environment are currently favorable to these transactions and these issues will be relevant in the coming years under current law.
Disappearing Transfer Tax Exemptions

- For gifts made or estates of decedents dying after Dec. 31, 2017, and before Jan. 1, 2026, the Tax Cuts and Jobs Act increased the basic exclusion amount to $10 million (up from $5 million), which is also indexed for inflation.

- With the anticipated sunset of the enhanced basic exclusion amount on or before December 31, 2025, practitioners and clients should be familiar with planning opportunities for utilizing available transfer tax exemptions, and also with IRS guidance regarding the treatment of estates of decedents dying after January 1, 2026.
Under T.D. 9884, final regulations confirmed that a taxpayer’s use of the inflated gift tax exemption amount (based on a basic exclusion amount of $10 million per individual) will not result in clawback or recapture when the temporary increase in the basic exclusion amount sunsets.

The regulations also include examples for calculating the deceased spouse unused exclusion (DSUE) under the rules, which ensures that a DSUE amount elected during the period of the increased basic exclusion amount will not be reduced when the basic exclusion amount declines.
The regulations provide special rules for calculating a decedent’s estate tax after the increase in the basic exclusion amount declines - specifically when the portion of the credit as of the decedent’s date of death is less than the sum of the credit amounts attributable to the exclusion amount allowable in computing the gift tax on gifts made at the time of the inflated gift tax exemption.

Under these circumstances, the special rules allow the portion of the credit against estate tax to be based on the greater of those two credit amounts.
Example

If an unmarried individual makes lifetime gifts of $8 million, all of which were sheltered from gift tax by the increased basic exclusion amount of $10 million, and the individual dies after 2025, when the basic exclusion amount is $5 million, the special rule allows the applicable credit amount against estate tax to be based on a basic exclusion amount of $8 million.
Special Rules for Calculating the DSUE

Under the new guidance, the DSUE amount available to the surviving spouse is the lesser of the basic exclusion amount at the time of the predeceasing spouse’s death or the unused portion of that spouse’s applicable exclusion amount, so as to not reduce the DSUE amount after the increased basic exclusion amount sunsets.
Go Big or Go Home

- Following the temporary increase in exemptions, gift transfers need to be substantial to achieve a benefit.

- When the exemption drops to $5 million (adjusted for inflation) in 2026, the prior use of the increased exemption amount may affect the use of the lower exemption starting in 2026.

- For example, if a taxpayer makes a gift in 2020 of $5 million, then following the sunset of the increased exemption, the taxpayer would only have a remaining gift tax exemption amount equal to the inflation on the $5 million basic exclusion amount.
Avoid Donor’s Remorse

• If a taxpayer desires to use all of the temporary increased amount of the transfer tax exemptions, he or she would have to make taxable gifts equal to the current enhanced exemption ($11.58 million for 2020) before the basic exclusion amount reverts to $5 million.

• One obstacle to maximizing gifting during this time is the concern that a taxpayer may give too much away and negatively affect future financial needs.

• Certain trust planning options may pose a solution by giving the settlor either indirect or direct access to gifted property if necessary.
Consider Gifts by Only One Spouse

• If a taxpayer is unable or unwilling to make a large enough gift to utilize the increased exemption amount for both the taxpayer and his or her spouse, then consider recommending that only one spouse make the gift.

• For example, husband and wife have a combined estate of $18 million and are willing to make $9 million in transfers to irrevocable trusts in 2020. If husband transfers $9 million to a trust for the benefit of descendants and husband and wife elect to split gifts in 2020, they have each used $4.5 million of their respective exemptions. Then, in 2026 when the exemption declines to approximately $6 million, each spouse will be left with only $1.5 million of exemption. If wife had not elected to split the $9 million gift then she would still have the entire $6 million exemption left in 2026.
Power to add Spouse and Floating Spouse Provisions

- Ensuring that a settlor has indirect access to assets gifted to an irrevocable trust may alleviate some concerns over making a significant gift.
- Spousal lifetime access trusts, or appointing a Selector who may add the spouse as a beneficiary at a later date, can enable the settlor to indirectly benefit from the trust assets.
- A floating spouse clause provides that whoever is married to the settlor at any particular point in time shall be a beneficiary of the trust, thus providing the settlor to indirect access, even in the event of one or more divorces.
A domestic asset-protection trust (DAPT) is an irrevocable self-settled trust in which the settlor is designated a permissible beneficiary.

Increasing in popularity as the settlor may still directly benefit from the assets after the substantial wealth transfer.

DAPTs are a particularly attractive planning option for single individuals who cannot indirectly benefit from a trust of which a spouse is or could be a beneficiary.

Alaska, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming are self-settled trust jurisdictions.
Thank you for your time and attention!