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Survey: Possible tax changes and what to do about them

By James B. Gust, Esq.*

In 2012, on the eve of a scheduled sharp reduction in the amount exempt from the federal estate tax, estate planners advised their clients to make substantial taxable gifts to use up the larger exemption before it was lost, to "lock it in." It turned out that reduction was cancelled, replaced by an increase in the amount exempt, much to the surprise of many. We may be on the cusp of a similar situation today. We have a reduction in the exemption scheduled for 2026, and the possibility of earlier tax changes if there is a change of control in Washington, D.C. Herewith, we review what a number of commentators have said about the situation, including:

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Process

Tax publisher Tax Notes hosted a webinar discussion on October 21, 2020, titled "Tax Policy After Election Day: What's Next?" The participants were Jon Talisman and Mark Prater, each with extensive tax policy experience in the federal government.

Although the need for more federal tax revenue is great, and although candidate Joe Biden has stated that he would raise the corporate tax rate "on day one," both men cautioned that the tax writing process can't be rushed. Tax legislation is not likely to be acted upon in the lame duck session after the election. When Congress convenes in January, five questions will be crucial to the direction that will be taken.

What is the state of the economy? If the economy remains weak, major new tax burdens that might hamper the recovery are not likely. On the other hand, if there is a spending program, tax increase provisions could be included as offsets. Even if the economy is doing better, the recovery has been very uneven, which argues against tax initiatives.

What has been left undone? If a second package of COVID-19 relief has not yet been enacted, that may well take priority over looking at tax legislation. Both parties are on the record favoring more spending on infrastructure.

Which party controls the Senate? The Senate can be a major bottleneck for tax legislation. Neither party is likely to have 60 seats, so some amount of bipartisan compromise will be needed whoever has control. What's more, because of a quirk in the Georgia Senate race, we may not even know which party controls the Senate until January 5.

The Senate requires 60 votes to break a filibuster and move legislation, except for budget reconciliation, which can pass with a simple majority. But that approach comes with the proviso of the Byrd Amendment of no net deficit increase within the budget window.

What other priorities are urgent? Health care and immigration issues, for example, may be more important to many Congressmen than tax reform.

Who are the players? The speed of the process for tax legislation often turns on the mix of the personalities involved—the heads of the tax-writing committees and the Treasury Secretary.

There is one more factor that is going to come into play in mid-2021—the expiration of the debt limit. There are still a few deficit hawks in the Congress, and they may offer resistance to writing a blank check for spending. The party out of power is likely to use the deficit as a club in negotiations.

Should President Trump be re-elected, his priority is likely to be to repeal the sunsets that were included in the Tax Cuts and Jobs Act. However, he will have to address some concerns of the Democrats to achieve that. If a President Biden takes office in January, the Democrats will likely want to roll back many elements of TCJA, especially the deduction cap for state and local tax payments. Although candidate Biden has called for a 28% tax rate, there is general agreement that the federal tax rate can't go above 25%. If it does, then when combined with the state corporate taxes, the U.S. corporate tax burden becomes too far out of balance with the rest of the developed world.

With all the talk from Democrats of new wealth taxes and growing economic inequality in the country, a boost to the federal estate tax might seem like a natural alternative. However, Mr. Prater cautioned that it actually may not be so easy. A recent House spending bill included the "pay for" of moving up the expiration of the $10 million federal estate tax exemption (plus inflation adjustments) from 2026 to 2023. It turned out that the Democrats could not muster the votes for even so mild an increase in estate taxes.

Conferences

During the American Institute of CPAs ENGAGE conference in July, estate planner Andrew M. Katzenstein compared 2020 to 2012 and the urge to lock in tax benefits before they disappear. He suggested that the federal transfer tax rate could go as high as 80%, and that the exemption amount might fall as low as $3.5 million. That would make 2020 a great year for tax-saving moves, assuming that a future administration does not try to claw back those tax benefits.

"What some people are actually doing to plan for this is, instead of making gifts to trusts, they're doing sales to trusts in exchange for notes, or they're just loaning money to trusts with a promissory note," Katzenstein said. With that approach, no taxable gift has yet occurred. At a later date, when the policies become somewhat more certain, the grantor might then forgive the loan, triggering a gift tax to lock in the higher exclusion.

Speaking at the Practicing Law Institute's 51st estate planning symposium, Blanche Lark Christerson endorsed the idea of straightforward intra-family loans. Today's low interest rates make such loans very attractive. However, at the same conference Sanford Schlesinger warned that promissory notes tend to draw IRS scrutiny. There must be an enforceable note, and if the note calls for interest payments they must actually be paid and documented. Christerson warned that if the lender uses the annual exclusion to forgive a portion of the principal, the entire transaction might be attacked as a disguised gift.

Both lawyers commented that it is surprising how many clients are unaware that directly paying for tuition or medical expenses is also tax free, apart from the annual gift tax exclusion.

Comprehensive overview

Estate planners Carlyn McCaffrey and Jonathan Blattmachr gave a comprehensive review of the tax environment and the available strategies in LISI Estate Planning Newsletter #2820 (September 3, 2020) from Leimberg Information Systems.

Revenue-raising ideas. Recently floated ideas for boosting federal transfer tax revenue include:

- boosting the tax rate (the top rate was 77% as recently as 1976);
- accelerating the 2026 expiration of the doubled federal exemption;
- taking the federal exemption back to $3.5 million, with a $1 million gift tax exemption;
- restricting flexibility with GRATs; either by requiring a minimum 10-year term, a 25% minimum remainder interest, or both;
- limiting the life of trusts utilizing the generation-skipping transfer tax exemption to 50 years;
- expanding family attribution rules to reduce valuation discounting;

New estate and gift tax numbers

The IRS has announced the inflation adjustments to tax boundaries for 2021. For the federal estate and gift tax, the exemption equivalent rises to $11.7 million, from the $11.58 million in 2020. The gift tax annual exclusion is unchanged at $15,000 per donee.

- eliminating the basis step-up at death; and
- including grantor trusts in the grantor's estate.

If stepped-up basis is repealed, the question becomes: what replaces it? Carryover basis was tried in the late 1970s and abandoned for being too difficult to administer. It was in place temporarily in 2010, subject to complicated rules to exempt most taxpayers from its application. One alternative suggested by Mr. Blattmachr might be making death a moment to recognize capital gains and pay tax on them; a similar rule would have to apply to gifts. Another alternative would be to put all gifts and bequests into the income tax system, and tax them there.

In any event, there are plenty of scary possibilities to fuel conversations with estate planning clients in the coming months.

Backfires. There are several risks associated with making a large gift to lock in today's federal transfer tax exemption.

The value of the gift will be included in calculating the donor's eventual estate tax. If the property goes down in value, there is no adjustment when it comes time to determine the federal estate tax—the higher value is locked in.

If the property does not grow in value, it is possible that the savings in transfer taxes will not be as large as the costs of carryover basis for the asset.

Finally, there is the risk that, as in 2012, bad things don't materialize in 2021 so that the actions prove unnecessary. However, that 2026 deadline remains.

The authors offer this simplified example of the tradeoff between income and estate taxes.

"The income tax basis of $11.58 million worth of X stock given by D is $1 million before the gift. The X stock was worth $12.58 million when D died. The gift saved D's beneficiaries estate tax of $400 thousand, 40% of the $1 million appreciation. Assume that the trust that holds the X stock is in the top federal income tax bracket. When the stock is sold, the trust will pay tax of 23.8% on the gain, or $2,756,040. The gift has cost the family additional taxes of $2,356,040. If the gifted X stock had been included in D's taxable estate, the estate would have paid additional estate taxes of $400 thousand but would have saved income taxes of $2,756,040."

A menu of strategies. The article reviewed several trust-based strategies to be considered that don't completely cut the donor off from access to gifted property.

Dual Spousal Lifetime Access Trusts (SLATs) divide assets between spouses but need to be sufficiently different to avoid being snared by the reciprocal trust doctrine.

Domestic Asset Protection Trusts (DAPTs) are now permitted in 19 states.

Hybrid DAPTs do not include the grantor as a beneficiary, except in limited circumstances.

Special Power of Appointment Trusts (SPATs) are DAPTs that provide a special power of appointment to a non-beneficiary that can only be exercised with the consent of a third party in favor of a class of persons that includes the grantor.

Grantor-Retained Annuity Trusts (GRATs) are an especially attractive choice in this low-interest-rate environment. Interest rates are provided by IRC §7520. When those rates are low, the value of the retained interest is high, which reduces the value of the taxable gift.

Spousal Lifetime Access Trusts (SLATs). In cases of very stable marriages, the SLAT offers an excellent opportunity for making a transfer that uses up the federal exemption while keeping the assets within reach in the family. The transfer should not be qualified for the gift tax marital deduction, and the donee spouse should not have a general power of appointment. In this way, the assets will avoid both estates when the spouses die.

By setting up two such trusts, it would be possible to secure the exemptions for both spouses, more than $23 million. However, avoiding the reciprocal trust doctrine is important for this to work. The authors suggest "it is generally recommended that the trusts be created at different times, with different trustees, with different assets and under the laws of different jurisdictions, among other differences. In fact, it may be best if one spouse creates a trust for the other spouse and delays even advising the beneficiary spouse of the creation of the trust, much less having them created at the same time, to reduce the risk of any claim of an implied understanding."

GRAT variations. Grantor-retained annuity trusts succeed when the income and growth of assets exceeds the §7520 interest rate. With that rate now at historic lows, that is a very low bar to clear. The authors reviewed several different approaches to designing a GRAT.

Short-term GRATs. Reducing the term of a GRAT reduces the risk that the grantor will die during the term of the trust, triggering estate inclusion. To some extent shorter terms may also reduce the risk of volatility of investment return. There is no minimum term for a GRAT at this time; two-year and three-year GRATs are fairly common. The grantor may roll the annuity payments received into additional short-term GRATs.

Asset-splitting GRATs. Another approach to mitigating investment risk is to have separate GRATs for different assets. In this way the poor return from one asset won't offset the gains from the other. However, there is a risk of such an arrangement being challenged by the IRS, treating multiple GRATs as one. To reduce that possibility, GRATs should be funded at different times, have differing payouts, and have different beneficiaries.

Declining annuity payment GRATs. The retained annuity from a GRAT may be increased or decreased over time. Having a low initial payment leaves more money in the GRAT to grow for the remaindermen. However, the IRS has ruled that the growth in the payment may be no more than 20% over the life of the GRAT.

On the other hand, there is no limit to how much an annuity payment may decline during the trust term. The authors posit the creation of a $1 million GRAT with a $990,000 payout after one year and $15,000 after two years. If the investments do poorly, the entire corpus is returned to the grantor as the GRAT fails, and he or she starts again. But if the assets do well, the growth is what stays in the GRAT.

The 99-year GRAT. At the other end of the time spectrum is the GRAT that will certainly last longer than does the grantor. The amount that will be included in the estate is the lesser of the value of the trust assets or the value of the annuity payment divided by the §7520 interest rate in effect at the grantor's death.

The math on the second limitation is startling. The authors look at a $1 million GRAT created in August 2020 paying $12,250 per year for 99 years. The §7520 rate was then 0.4%, so the value of the remainder would be $200. Now say that the grantor dies several years later when the §7520 rate is 3%, closer to historical norms. The amount included in the estate would be $12,250 divided by 0.03, or $408,333. Should the interest rate go to 5%, the inclusion would fall to $245,000. If the trust was still worth $1 million at that time, some $755,000 would pass to heirs free of estate tax.

Getting a GRIP

The grantor trust rules were created to curb perceived income tax abuses, but through a kind of legal jujitsu those same rules are now routinely used by planners to help clients reduce their estate taxes. In much the same way, the anti-abuse rules governing intra-family transfers embodied in IRC §2701 can be used to create tax savings in some situations.

Stephen M. Breitstone, Mary P. O'Reilly, and Joy Spence wrote about the strategy of a Grantor Retained Interest Partnership, or GRIP, in LISI Estate Planning Newsletter #2827 (September 29, 2020). A partnership is created with preferred and common interests. The grantor retains the Preferred Interest while the common interest is given to the next generation, or perhaps to a dynasty trust. If the Preferred Interest is properly designed, it will fail the IRC §2701 requirements for a qualified interest and so be valued at zero. The taxable value of the transfer of the common partnership interest will be the entire value of the partnership, which should be approximately equal to any unused federal transfer tax exemption that the grantor still has.

The Preferred Interest may include the right to a non-cumulative fixed return or the ability to get back the grantor's initial investment. The grantor must have an applicable retained interest that is not a "qualified payment right" in the partnership. Qualified payment rights include a cumulative dividend or distribution right, payable on a periodic basis and at a fixed rate or amount. The Preferred Interest may include control of the partnership and its assets. In this arrangement all the asset appreciation flows to the holders of the common interest. The common interest must be carefully crafted so as to avoid being included in the grantor's estate.

The Preferred Interest will be included in the grantor's estate. Because the value of the Preferred Interest has effectively already been taxed by attributing it to the value of the transferred common interest, Section 2701 and its regulations include a provision to mitigate against double taxation. Under Reg. § 25.2701-5, an adjustment to the

transfer tax base is made for §2701 interests. As the authors explain: "The amount of the reduction (the "Adjustment") equals the lesser of (i) the increase in the Grantor's taxable gifts caused by the application of Section 2701 (the "Deemed Gift") and (ii) the duplicated amount. The "duplicated amount" is the excess of (x) the fair market value of the Preferred Interest at the date of death (reduced by any deduction that would have been available had the Section 2701 interest been included in the transferor's transfer tax base) over (y) the value of the Section 2701 interest at the date of the initial transfer, as determined under the Section 2701 special valuation rules (which is generally zero, since the entire value of the Preferred Interest is allocated to the Common Interest under the special valuation rules)." See Example 2 of Reg. §25.2701-5(d) for an illustration of how this works.

Risks. The value of the Preferred Interest in the grantor's estate may be affected by changes in the interest rate environment. For example, if interest rates rise, the value of the retained dividend right will fall, which creates a cap on the change in the transfer tax base. A portion of the attempted use of the federal estate tax exemption will have been wasted. Conversely, should interest rates fall (unlikely from today's very low-rate environment), the value of the Preferred Interest could rise, leading to additional estate taxes. It may be possible to mitigate these risks by tying the dividend determination to an external interest index such as LIBOR or the IRS' AFR numbers.

Existing arrangements. What about the client who has an existing traditional "freeze partnership" in place? The authors suggests that such an arrangement may be easily converted to a GRIP. "This can be done by an amendment to the partnership agreement to create a new class of Preferred Interest (with a value that does not exceed the remaining exemption of the Preferred Interest holder) that lacks the cumulative feature of the traditional Section 2701-compliant Preferred Interest." This would trigger a new deemed gift of the value of the new Preferred Interest.

Real estate gifts

In LISI Estate Planning Newsletter #2821 (September 8, 2020), attorneys David Pratt and Jeffrey Baskies observe that many clients will be reluctant to make gifts of income-producing property that they may need to provide for a financially secure retirement. They may be more willing to part with a personal residence or vacation home, making those assets better vehicles for using up some of the federal estate tax exemption amount. Such gifts tend to be more painless from the clients' perspective.

For this to work, a proper lease arrangement needs to be in place, complete with payment of fair market rent. Otherwise there is a significant risk that the IRS will successfully argue for full inclusion in the taxable estate under IRC §2036.

The transfer may be to a SLAT or a grantor trust.

The authors contend that making fractional gifts of interest in real estate may be a good way to lock in discounts for intra-family transfers. Such discounts could be impaired or eliminated in any reform of the federal estate and gift tax. There is considerable authority of such discounts today, although the IRS does tend to contest them. Among the key decisions:

• *Samuel J. LeFrak v. Commissioner,* T.C. Memo 1993-520 (1993), in which the donor transferred a less than 10% interest in apartment buildings and office buildings to each of several children. The Tax Court allowed a 20% minority interest discount and a 10% lack of marketability discount.

• *Estate of Brocato v. Commissioner,* T.C. Memo 1999-424 (1999), where the Tax Court allowed a 20% valuation discount on a 50% interest in multi-family residential properties.

• *Estate of Forbes v. Commissioner,* 81 T.C. Memo 1399 (2001), which involved a tenancy in common. Taking into account the minority interest, the lack of marketability, and the possibility of conflicts among the owners (even though they were all family members), the Tax Court allowed a 30% discount.

• *Ludwick v. Commissioner,* T.C. Memo 2010-104 (2010), allowed a relatively low 17.2% discount for the transfer of a 50% interest in a Hawaiian vacation home to a qualified personal residence trust.

• *Estate of Mitchell,* T.C. Memo 2011-94 (2011), secured notably larger discounts from the Tax Court. A transfer of a 5% in beachfront property was granted a 32% discount, and the retained 95% was discounted 19%. The transfer of a 5% interest in ranch property was discounted by 40%, and the retained 95% discounted 35%.

Creating fractional shares in property may be a good way to lower the overall value of lifetime transfers, but except in

very large estates, it is working at cross-purposes with the goal of locking in the larger federal estate tax exemption. Under the "clawback" rules, simply making a first gift of $5 million locks in nothing (assuming that the exemption falls back to $5 million plus inflation adjustments, as scheduled). To lock in the larger exemption, the taxpayer actually has to use that larger exemption for a gift transfer.

Undoing a major gift

Qualified disclaimers are a tried-and-true method of doing post-mortem estate planning to correct some wealth management issues that were overlooked or ignored during life. In LISI Estate Planning Newsletter #2831 (October 19, 2020), Ed Morrow suggests planning for disclaimers in the context of gifts.

The requirements for a qualified disclaimer are given by IRC §2518(b):

"(b) Qualified disclaimer defined. For purposes of subsection (a), the term "qualified disclaimer" means an irrevocable and unqualified refusal by a person to accept an interest in property but only if—

(1) such refusal is in writing,

(2) such writing is received by the transferor of the interest, his legal representative, or the holder of the legal title to the property to which the interest relates not later than the date which is 9 months after the later of—

(A) the day on which the transfer creating the interest in such person is made,

or

(B) the day on which such person attains age 21,

(3) such person has not accepted the interest or any of its benefits, and

(4) as a result of such refusal, the interest passes without any direction on the part of the person making the disclaimer and passes either—

(A) to the spouse of the decedent,

or

(B) to a person other than the person making the disclaimer."

The key point for federal transfer tax is that if a disclaimer meets the requirements, the disclaimant has not made a taxable gift.

That raises the potentially thorny question of what happens to the gifted property if a disclaimer is made. State law questions may be implicated in the answer, according to Mr. Morrow. However, it may be possible to include a stipulation with a gift that if it is disclaimed the property returns to the donor. If the property does so return, that eliminates the original taxable gift by the donor under the gift tax regulations. The disclaimer renders the original transfer incomplete.

Accordingly, a donor could make major transfers in December 2020, and the donees would have until August 2021 to take action to reverse the gifts. Presumably if the estate tax exemption has been or seems likely to be reduced, they would keep the gifts. Presumably the donees are cooperative enough so that if the gifts do need to be reversed they will execute the necessary disclaimers.

If the donees are minors, the window for making a disclaimer is much wider, potentially as wide as 21 years and nine months. Mr. Morrow notes that for donees between the ages of 18 and 21, the use of funds to pay for higher education expenses has generally not been treated as an acceptance of the property, and so a disclaimer may still be possible for nine months after the 21st birthday.

Making the transfer to a trust raises additional complications, warns Mr. Morrow, and a potential for abuse which could attract IRS scrutiny. The trust typically has multiple equitable owners, including remainder beneficiaries, making a disclaimer that vests the property back to the donor more problematic.

What if the donor dies within nine months? Private Letter Ruling 9043050 considered a situation in which a donor made a substantial gift, later died, and the donee disclaimed the gift, causing it to return to the donor and to be

included in the donor's estate. The property then passed to the same donee through the estate. Presumably the reason for the disclaimer was to obtain a basis step-up for the property. The ruling provided the hoped-for tax consequences.

Mr. Morrow concludes with the observation that state law concerning disclaimers also must be taken into account when doing this sort of planning.

Who is the prospect?

A subject not touched upon in these presentations was the profile of the client who might be ready to execute transfers to lock in the $11.58 million federal exemption this year and keep that fortune protected from tax changes. Someone with only $11 million is unlikely to part with his or her entire fortune, and for someone with $100 million or more the tax saving may not be worth the trouble. What's more, the uncertainty hanging over the economy at the moment may be a larger consideration for many than the possibility of future transfer taxes. Although stock market indices are in positive territory for the year as this is being written, the p/e ratios are well above average. Someone who expects that another correction is coming is unlikely to compromise on near-term financial security over a hypothetical long-range tax savings.

In a webinar last April, Mr. Blattmachr admitted, "I know from past experience that going to someone and saying, 'Man! This is a fantastic time to do estate planning because values are low, the IRS doesn't have the resources to do much auditing, or whatever it may be; give, give, give!'—that just isn't going to happen."

But even if aggressive tax planning is not the end result, estate planning for nontax purposes remains vitally important this year.

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