Planning Strategies

October 2020

Year-End Estate Planning Update

As always, thought and care are essential ingredients to a well-planned estate. Below we discuss the estate planning opportunities and strategies that are before us this year (2020). Because several of these may be curtailed next year with a new administration, this year (and especially this year-end period of 2020) presents us with a unique opportunity for estate planning like no other, thus creating a sense of urgency.

Since December 2017, the federal government has passed three major pieces of tax legislation that affect high-net worth families:

1. The Tax Cuts and Jobs Act (Dec. 2017)
2. The SECURE Act (Dec. 2019)
3. The CARES Act (Mar. 2020)

In the past year, we have published several planning updates on these topics:[1]

- Planning in a Low Interest Rate Environment (Sep. 2019)
- 2019 Year-End Tax Planning (Dec. 2019)
- 2020 Tax Update (Jan. 2020)
- Financial Planning During Volatile Markets (Mar. 2020)
- An Update on Planning in a Low Interest Rate Environment (Mar. 2020)
- Tax Update: Coronavirus Relief (Mar. 2020)
- The Great Thing about GRATs (Apr. 2020)
- 2020: The Year of the SLAT (Jun. 2020)
- Q/A: Update on RMD Rules and IRA Planning in 2020 (Jul. 2020)
- Portability of a Spouse's Unused Exemption (Sep. 2020)

It is clear that 2020 is a pivotal year for estate planning. Many opportunities available today may not be around much longer if the political landscape changes. Depending on how the election goes and what your objectives are, you may be more or less inclined to take steps now to lock in certain tax advantages. This update will explain what estate planning options you may have as the year comes to a close.

What's going on?

The drivers behind estate planning are multi-faceted and are often fact-dependent. Making a large gift or leaving a legacy is a very personal decision. Ideally, it's done thoughtfully and after much deliberation. However, sometimes an urgency exists to address the planning need right away. The catalyst could be personal health or other life event. In certain instances the cause is legal in nature, such the expiration of a tax benefit. In 2020, the main drivers behind the flurry of estate planning are:

- The 2020 election and political change
- The current high estate and gift tax exemption ($11.58 million)
- The COVID-19 pandemic
- Very low interest rates
- Tax changes that could come in 2021

Using your exemption this year

Perhaps the most important planning step that high-net worth individuals can take before December 31, 2020, is to use their estate and gift tax exemption. The reason is that 2020 offers the highest exemption amount ever available. When a new Congress takes over in 2021, there are many ways that it could attack perceived tax loopholes that will foreclose on the ability to do tax-efficient estate planning. Lowering the exemption will be the easiest one to do.

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[1] *Copies are available at https://1919ic.com/resources/library/.*

Congress can do other things as well, such as

- Limit annual exclusion gifts
- Limit the efficiency of GRATs
- Limit GST planning
- Eliminate valuation discounts
- Reform the grantor trust rules
- Eliminate stepped-up basis at death
- Increase tax rates

Most of these reforms can be enacted effective as of January 3, 2021 (or even January 1st). These proposed tax changes are not new ideas; they have all been floated before by politicians. Despite the awareness of what's going on, many people have not yet taken action, which is understandable since it is still uncertain what will actually happen. Once we have more clarity after the election on November 3, 2020, more people will likely contact their advisors and attorneys about year-end planning. However, that will leave less than two months to accomplish some complex planning maneuvers. During this year-end timeframe, we expect that advisors and attorneys will be inundated with similar requests. For that reason, we think it's wise to start the process sooner rather than later.

Start the process sooner rather than later.

What is the effect of using the exemption?

As we have said, the idea is to use your exemption in 2020, if you can do so. One problem with this advice is that it doesn't apply as well for people who cannot make a large taxable gift. Congress isn't going to lower the estate tax exemption to zero. It will likely reduce it to the 2017 amount, which is $5 million (or $5 million plus some inflation adjustment). It is also possible that the exemption could go as low as $3.5 million, which is what it was in 2009, just before the estate tax "repeal" in 2010. So, the marginal difference above these thresholds is what's in play. The federal estate tax rate is 40%. Assuming that rate is held constant, the potential estate tax savings is over $2.2 million per person if you can make the gift this year.

The number grows for married couples and if you can successfully use valuation discounting to magnify your exemption. Making a gift today also shelters the future growth from potential estate tax.

Can I have my cake and eat it too?

Using your exemption means making a gift that absorbs your available estate and gift tax exemption, which is currently $11.58 million per person. Planners recognize that you may not really want to make such a large irrevocable gift. As a work-around, they have come up with some clever ways to allow you to recover some or all of the money after you make the gift if you need it. As we said in our earlier advice pieces this year, two ways to use your exemption are to make a gift to a SLAT or a DAPT. A GRAT is also a great way to pass on future appreciation tax free. Let's review these strategies.

SLATs and DAPTs

"SLAT" is shorthand for Spousal Lifetime Access Trust. [2] The term is a bit of a misnomer since benefitting your spouse isn't the main point of a SLAT. A SLAT is better understood as a lifetime credit shelter trust. Credit shelter trusts, which are typically found in wills and revocable trusts, are designed to absorb the estate tax exemption available at death. However, because estate and gift taxes fall under a unified tax system, a credit shelter trust can also be funded during life. The beneficiaries of the trust can be anyone you choose *other than yourself*. Since your spouse *may* be a beneficiary and since married couples *can* comingle their personal finances, it's not difficult to see how having a spouse as a beneficiary of a trust might inure to the benefit of the other spouse, *i.e.*, you.

After both you and your spouse have died, the trust will run for the benefit of other beneficiaries, such as your descendants. In addition, you can make the trust exempt from the generation-skipping transfer (GST) tax so that it can benefit grandchildren and more remote descendants.[3]

SLATs can also be created by both spouses with each of them being a beneficiary of the other's trust. This is where the word "spousal" takes on more meaning.

[2] *Refer to* ***2020: The Year of the SLAT*** *(June. 2020).*

[3] *The GST exemption is also $11.58 million in 2020 and could be reduced next year. Allocating GST exemption to a SLAT may or may not be tax efficient. The answer will depend on your situation.*

However, the two trusts cannot be reciprocal and, thus, need to have some material differences.[4]

Despite the tax advantages, many people have difficulty creating a SLAT. Some reasons include loss of control, irrevocability, restricted access to the capital, and in the event of a divorce or death, both spouses would be cut off from the trust's assets. Since we're talking about a material amount of money, some people just aren't comfortable with the strategy. The SLAT is much more compelling in terms of tax savings for those who can double the gift by creating a SLAT for both husband and wife thereby using $23.16 million of exemption. However, anyone living in a state that has an estate tax can achieve tax savings by funding "smaller" SLATs.

Another way to achieve a similar result is to create a self-settled Domestic Asset Protection Trust (or "DAPT"). This type of trust is also a bit of a misnomer. Of course, some people use them to protect assets from creditors (their ostensible purpose), but DAPTs have gained popularity lately because the IRS has ruled that a transfer to a DAPT is considered a completed gift even though the trustee has a power to make distributions back to the grantor. That means funding a DAPT can use up exemption. However, in granting that ruling, the IRS left open the question of whether a DAPT is includable in the estate of the grantor at death. Despite that, many practitioners believe that a DAPT would not be includable at death if it is set up and managed correctly. A DAPT also must be created in one of 19 states that allows self-settled asset protection trusts and must have a trustee located in that state, which might entail hiring a corporate trustee.

GRATs

We have previously written about Grantor Retained Annuity Trusts (or "GRATs") as a great way to transfer the future upside in assets such as marketable securities.[5] And unlike a SLAT, much of the GRAT's assets come back to the grantor. For the past twenty years or more, GRATs have been used to transfer future appreciation (less a small interest factor) to the next generation free of gift tax. GRATs have worked especially well in the type of market conditions we have experienced in the last 10 years where we have had low interest rates and a rising stock market. Sophisticated planners often advised donors to set up a series of cascading short-term GRATs. This strategy even allowed the donor to use the same assets to transfer wealth repeatedly. Even if a GRAT failed due to an asset's decline in value over the short term, the asset could be "re-GRATed" to capture the next market upswing. The grantor trust rules also offered a tax-efficient way to lock in appreciation by allowing the grantor to exercise a power by swap in cash for the security.

One big difference between then and now is the political climate and the potential for a crackdown on the GRAT strategy. Congress could attack GRATs by requiring a minimum term and a minimum remainder amount. Both of these changes would curtail the GRAT's tax benefits. Therefore, we advise clients interested in GRATs now to set up laddered GRATs (*e.g.*, 5, 7 and 10-year terms). In the past, longer-term GRATs were out of favor due to the risk associated with the donor dying during the term. (An unexpired GRAT is includable in the grantor's estate at death.) However, today we feel that shorter term GRATs offer minimal advantage given the possibility of a change in the law and the fact that, despite the mortality risk, the donor is in no worse a position than not having created a GRAT (apart from legal fees).

Traditional gifting

The advantage to making a straightforward gift is that it can be done quickly and easily. Gifts of cash or marketable securities can be made directly to individuals or to trusts. Even real estate can be transferred easily in many cases. Given the relative of ease of making these types of gifts, many people may be looking to make such transfers come December 2020.

As we approach the end of the year, and as you consider your own situation, you may decide to move ahead with a major gift to your descendants or trusts for their benefit. If any part of that plan requires legal work, such as drafting a trust instrument, then we strongly suggest starting the

[4] For example, the trusts can have different terms and trustees, and be funded at different times or with different amounts. There are many techniques that can be used to satisfy this requirement.

[5] Refer to The Great Thing about GRATs (April 2020).

process now. The legal work can be done ahead of time even before you make your final decision, but it will be the legal work that will be the principle bottleneck as we get closer to December 31. Those who wait too long may be precluded from setting up trusts and year-end.

Reporting taxable gifts

Taxable gifts must be reported on a federal gift tax return (IRS Form 709). The return is due on April 15 of the year following the gift. A 6-month extension of time to file is also available. As long as your total lifetime gifts do not exceed the exemption amount ($11.58 million in 2020) then you should not owe any gift taxes. A married couple can give twice the exemption amount. If the donated asset is a closely-held business or parcel of real estate, or some other illiquid asset, then a full appraisal of the item is required to be annexed to the gift tax return. Filing a gift tax return also starts the statute of limitations running on the IRS to audit the return. Note that Connecticut is the only state that still has a gift tax.

As you can see, there are many decisions to make and the rules can be complex and somewhat daunting. Given the limited time left in the year, we recommend that you consider your wealth transfer objectives, and other factors such as your life expectancy, lifestyle, and overall assets before taking any action. Based on these and other factual considerations, we can help you evaluate what your best options are.

We invite you to contact your 1919 Investment Counsel Portfolio Manager or Client Advisor or your attorney about the planning strategies mentioned in this bulletin.

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Warwick M. Carter, Jr. is a Principal at 1919 Investment Counsel based in New York. As a Senior Wealth Advisor, his primary focus is generational wealth planning for high net worth individuals and families. He also advises on philanthropic planning. When giving advice, Warwick takes a comprehensive approach to assessing all aspects of a client's tax, financial and family situation. Warwick works closely with Portfolio Managers and Client Advisors in all of our offices to integrate wealth strategies with a client's investments. He regularly meets with outside advisors to devise appropriate solutions that will help grow wealth in a tax-aware way over the long term.

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About 1919 Investment Counsel

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