2019 Southern Arizona Estate Planning Council

Planning for the 99%: With No Estate Tax Due, Consider Income Tax, Financial and Personal Objectives

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Federal Transfer Taxes Have Become Irrelevant for Most Americans

- In 2019, the applicable exclusion from federal transfer taxes is $11.4 million per person
- **This number will be indexed annually for inflation per the "Chained-CPI"**
- The tax rate remains at 40%
- Estimate: Only 1,800 decedents in 2019 will be required to pay estate tax
- These exclusions will sunset after 2025, and revert to the 2017 exclusion amounts, indexed for inflation
- The concept of "portability" remains in the law, allowing the unused federal tax exclusion of a deceased spouse (the "DSUE") who died after 2010 to be used by the surviving spouse

Basis of Assets at Death

- The basis of property received from a decedent remains the fair market value of the property as of the decedent's date of death.
- Community property states have the advantage of having a date of death basis ascribed to both halves of the community property.
- Planning for separate property remains a challenge.

The 'New Normal' in Estate Planning Simplicity and Client Resistance?

- If clients no longer fear the imposition of costly transfer taxes and the complex planning needed to avoid such taxes, will clients be willing to embrace complex planning and professional fees often associated with such complexity?
- The clients may want to opt for the most simple (and least expensive) of plans
  - May be a serious mistake when other planning considerations are raised
- It is certainly likely that many persons will take a "do it yourself" approach to planning
- Consider planning issues in light of the sunset of the enhanced exclusion and the "political risk" of an earlier change in the law
- Key Considerations for all planners: Use the generous exclusions while they are available; strive for flexibility in planning

A New Emphasis in Planning

Refocused Planning

- The major focus for estate planning for persons having assets under $11.4 million and married couples with assets under $22.8 million will turn to:
  - Core dispositive planning
  - Income tax planning
  - The preservation and management of assets
  - Assuring that the available exclusions are used while still available

Refocused Planning

- If concerned about a reduced transfer tax exclusion, married clients should consider forming non-reciprocal, spousal lifetime access trusts ("SLATs") to which gifts or sales transfers might be made
- These trusts can use the donor's transfer tax exclusion now, to avoid its decline in the future
- Include a contingent general power of appointment (to be granted by a trustee or trust protector) to protect a basis step-up opportunity if needed
- A moderate wealth client will not want to make a gift transfer that cannot be accessed. The SLAT provides protection through the spouse's entitlement to income. Protect against the spouse's death with a life insurance policy. Careful of a divorce?
- A SLAT can avoid estate inclusion, protect against creditors and elder financial abuse

Gift Tax Exclusions & Planning Opportunities

- The annual exclusion gift - $15,000 in 2019
- Marital deduction spousal gifts
- Direct payment of tuition to the educational institution
- Direct payment of medical expenses to the medical care provider
- Gifts to charity
- Lifetime gift exclusion
- Protect against a reduced exclusion: If a gift of $10 million is to be made – do not split it – have it be from one spouse only. That way, if the exclusion is returned to $5 million, the other spouse still has a $5 million gifting opportunity. Risk: The spouse who has not gifted dies first. But: Portability now can "save the day".

Gift Planning Opportunities

- Protect the family from GST Tax – Gifts to Dynasty Trusts
- Caution: Be wary of making lifetime gifts of low basis assets
- Gifts may save state estate taxes where applicable (most states don't count gifts toward the exemption amount)

Core Dispositive Planning

- There should be a review of the clients' existing estate planning documents
  - Do formula clauses that made sense in a different tax environment still work?
  - Are formulas still needed if the client lives or does not live in a "decoupled state?"
  - Is there still a need for a credit shelter trust that no longer will generate federal estate tax savings?
  - Draft plans with alternative formulas based on the size of exclusions? Leave a specific amount rather that any formula? Consider: Not less than; Not greater than clauses?
  - Draft alternative year of death/change in law clauses: If I die when the exclusion is X, do this; If Y, do that; If Z, something else

Checklist of Areas Where Estate Planning Is Still Required

- Planning for the disposition of the client's assets at his or her death
- Asset protection planning
- Business succession planning (give interests away with low basis – or keep until death and get fair market value basis)
- Planning for possible divorce
- Life insurance planning

Checklist of Areas Where Estate Planning Is Still Required

- Retirement planning
- Planning to minimize state death taxes where applicable
- Planning for children with disabilities and special needs
- Planning for spendthrift beneficiaries
- Dynastic planning to take advantage of the increased GST tax exclusion. The GST exclusion is not portable.

Checklist of Areas Where Estate Planning Is Still Required

- Planning to pay education expenses (529 Plans)
- Identifying guardians for minor children
- Considerations arising with respect to eldercare planning
- Protection from elder financial abuse

Checklist of Areas Where Estate Planning Is Still Required

- Charitable planning – But re-examine how charitable planning should be accomplished
- In most estates, there will be no benefit of a charitable deduction unless the decedent's assets exceed the federal transfer tax exclusion
- Consider bequests to individual family members, allow them to make lifetime gifts to the desired charities and receive an income tax deduction
- Consider instead funding a trust with mandatory distributions of income to charity over a number of years. Properly drafted, the IRC 642(c) charitable income tax deduction will offset the trust income

Portability Must be Addressed by Every Married Person

Why Portability?

- The primary motive for enacting portability of the federal estate tax exemption was simplifying estate planning for married couples
- An issue all married clients will face at all levels of wealth is whether to make the portability election at the death of the first spouse
  - Filing a federal estate tax return (Form 706) that makes the portability election will be preferable in most cases

Why Portability?

- The law allows portability of any unused applicable exclusion amount for a surviving spouse of a decedent who dies after 2010
  - The unused exclusion amount is referred to as the "DSUE" amount
  - The surviving spouse can use the DSUE amount either for lifetime gifts by the spouse or for estate tax purposes at the surviving spouse's subsequent death

Why Portability?

- There is a "use it or risk losing it" point
  - Gifts made by a surviving spouse will first use the DSUE amount from the last deceased spouse before using the surviving spouse's own basic exclusion amount
  - If there is a subsequent marriage, the DSUE from the first deceased spouse remains available so long as the most recent spouse remains alive
  - If the second spouse dies, the unused DSUE of the first spouse is lost

Why Portability?

- It is suggested that every estate of a deceased married person should make a portability election. Making the election while the exemption is high should leave the surviving spouse with the full DSUE even if the exclusion decreases later. Reg. 20.2010-2(c)
- Rev. Proc. 2017-34 allows filing Form 706 until two years after a person's death to make a portability election if there was not a failure to file an otherwise required Form 706
  - Otherwise, where a return should have been filed, or the return will be filed late, a private letter ruling must be requested and, in 2019, a $10,900 user fee paid to permit a late election

'Simple' Wills Are More Likely to be Favored Now
Is That the Right Call?

'Simple' Wills More Likely to be Favored Now

- Married clients may be more inclined to proceed with fairly simple "all to spouse" will planning
  - The "I Love You" Will
    - Relying on portability to take advantage of both spouses' estate exemptions, rather than using more complicated bypass trust planning
    - Is that the correct decision from the planner's perspective?

The By-Pass Trust May Still Make Sense

- Why Still Use a Bypass Trust at the First Spouse's Death in a Portable World?
  - The DSUE amount is not indexed for inflation
    - **Is there concern about long-term appreciation between the first and second deaths?**
- Growth in the assets in a bypass trust is excluded from the estate of the survivor
- A bypass trust at the first death passing ultimately to skip persons can secure the benefits of the first decedent's GST exclusion
- Only Hawaii and Maryland allow portable state estate tax exclusions

The By-Pass Trust May Still Make Sense

- A bypass trust could be funded with discounted hard to value assets
- The use of a bypass trust can avoid unequal treatment that might otherwise occur in a blended family situation
  - **Compare the By-Pass with the QTIP Trust – With the QTIP, appreciation will be taxable at the second death – but there will be a basis adjustment**

Income Tax Planning
The New Essential Planning Focus

Income Tax Planning Will Replace Transfer Tax Planning as a Primary Focus

- Income tax issues will overtake transfer taxes as the primary area of planning concern for persons of moderate wealth
- A key issue for clients in this range will be preserving a step up in basis at the death of each spouse
  - The potential 20% federal capital gains tax, supplemented by the 3.8% net investment income tax, and possible state income taxes as well, could result in some clients facing a capital gains rate approaching or exceeding 30%
  - The 2017 Tax Act makes state taxes over $10,000 no longer deductible

Income Tax Planning The New Essential Planning Focus

- A simple will or revocable trust leaving all the assets outright to the surviving spouse will achieve a basis adjustment at the deaths of both spouses
- Using a QTIP Trust will allow a basis adjustment to take place at the surviving spouse's death
- Lifetime gifts may no longer be recommended as a planning technique, if the donor's basis in the asset to be given away is low

New Planning Considerations Will Focus on Income Tax Issues

- Avoidance of both capital gain taxes and net investment income taxes and passing assets with a stepped-up basis becomes a primary concern
- Traditional estate planning techniques used to reduce the value of assets on death may be counter-productive to planning
  - In a sense, **estate planning is upside down** from what has been traditionally favored

New Planning Considerations Will Focus on Income Tax Issues

- Consider **"upstream planning"** – Gifts of low basis assets to older family members – who then leave them at death to the donor. Gives the donor a fair market value basis when the donee dies
- Donee must hold asset at least one year to get the basis adjustment to the donor on return of the asset IRC 1014(e)
- Hedge the one year – have the donee leave the asset to anyone but the donor (consider a grandchild?). Then the basis to the heir is FMV on the donee's date of death, regardless of the holding period
- Sometimes referred to as the "mother-in-law trust"

New Planning Considerations Will Focus on Income Tax Issues

- With the majority of clients no longer facing a federal estate tax
  - Claiming valuation discounts at death will provide no estate tax benefit whatsoever
  - But will reduce the value of the basis step up and thereby increase the future capital gains costs the client's heirs will face
  - Decrease emphasis on complex defined value transfers (Wandry case) – the gift tax exclusion may be sufficient
- Will the practitioner and the IRS reverse roles in these situations
  - With the practitioner arguing for lower (or no) discounts
- Consider whether there are provisions in the governing documents of an entity that was crafted to allow or encourage discounting
  - Consider amending the governing document to minimize or eliminate the discounting opportunity

New Planning Considerations Will Focus on Income Tax Issues

- The new post-ATRA planning environment will give rise to a new approach to appraisals of property owned by a decedent
  - Maximizing the valuations of all estate assets so long as the person's estate remains under the federal exemption will provide the decedent's heirs with the most favorable income tax basis
- For those persons whose estates fall under the federal estate tax exemption but over their state estate tax exemption
  - The most difficult issues will arise
    - What will be the marginal tax impact of the state estate tax compared to the possible capital gains tax savings that high values (and high income tax basis) will result to decedent's heirs?

New Planning Considerations Will Focus on Income Tax Issues

- Address the limitation of the state and local tax deductions (“SALT”)
- Consider creating an “ING” trust (incomplete non-grantor trust) in a state that does not have an income tax. Transfer an investment portfolio to that trust and avoid income tax in your home (high tax) state. Distinguish a state’s source and non-source income. Will your state allow you to avoid grantor treatment? (not NY).
- Consider relinquishing grantor trust powers in a trust where the grantor is taxed to allow the spread of income tax liability among multiple beneficiaries – to possibly maximize SALT deductions

New Planning Considerations Will Focus on Income Tax Issues

- Another planning tool to consider is the Code Section 754 election
  - This election is available for partnerships and LLCs taxed as partnerships
  - If the entity makes an election to have Section 754 apply, the inside basis of the decedent partner or member’s share of the entity’s assets is also stepped-up
  - There may be administrative complications in partnerships with multiple partners and assets

Special Planning Concerns Where Trusts Are Used

- Retaining income within a trust is not a favorable income tax planning decision
  - Due to the highly compressed income tax rates for trusts
  - Distributing trust income currently can be tax advantageous
  - “Sprinkling” Trusts
- Compare the compressed rate threshold for trust distributions to thresholds for individual taxpayers
  - While distributing income is a favored planning alternative, it may not always be an available option
    - What does the governing instrument require with respect to distributions?
    - What about state law?

Special Planning Concerns Where Trusts Are Used

- In preparing new trusts
  - It is suggested that the trustee be at least given discretion to distribute capital gains to the income beneficiaries
- Planning should not lose sight of why a trust was created in the first place
  - Appropriate consideration must be given to any relevant non-tax factors that weigh against making a distribution
  - Consider the new kiddie tax rules using trust rates for taxation. Will multiple complex trusts be a planning opportunity?

Special Planning Concerns Where Trusts Are Used

- Take advantage of the 65-day rule for complex trusts
  - This election can be used in a number of helpful planning situations
    - Shifting income to a lower bracket taxpayer
    - Shifting income to avoid an underpayment of estimated taxes by the trust
    - Moving income to a beneficiary to take advantage of a beneficiary's net operating loss or excess capital loss
  - Reduce the trust's exposure to the net investment income tax

What Should be Done with Life Insurance?

Why Was Life Insurance Acquired?

- Persons of moderate wealth will no longer need life insurance to fund the federal estate tax
- If life insurance was acquired for more "traditional" planning reasons
  - It remains a viable asset for the purposes acquired
- The "core" reasons that most persons acquire life insurance were never to use it as a source of tax payment
  - Create an estate for the financial support and security of a family in the event of premature death
  - Provide financial support for a surviving spouse and educational funding for young children
  - Provide a readily available source of liquidity

The Role of Life Insurance in Any Estate Plan

- There may be a need to preserve permanent life insurance to pay for state estate tax liabilities for those clients domiciled in decoupled states
- Life insurance can be used to provide direct bequests to children from a prior marriage without having to address the blended family concerns of trusts or dividing assets between the current spouse and the children of an earlier marriage

The Role of Life Insurance in Any Estate Plan

- Access to cash values within a life insurance policy is possible even if the policy is held in an irrevocable trust
  - Assuming the trust is properly drafted
- There is less reason to feel compelled to transfer a life insurance policy to an irrevocable trust
- Compare the return generated by a permanent life insurance policy with other investment returns realized by a client through his or her portfolio

Use Life Insurance in Planning

- Using life insurance to “equalize” benefits among heirs becomes an even more attractive option when the life insurance proceeds left to heirs will avoid estate tax
- Life insurance left to family members is protected from claims of creditors
- Life insurance is typically an “easy” asset to persuade clients to gift
- Corporate entity buyouts funded by life insurance no longer are concerned with the corporate AMT

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What Should be Done with Survivor Life Insurance ?

- Survivor life insurance policies to have a fund to pay federal estate taxes at the second death of a married couple may no longer be needed
- Consider a tax-free exchange of the policy for a qualified annuity or another insurance policy that could offer more attractive terms
- Keep the existing policy but stop paying additional premiums and make the policy a paid-up policy based on the premiums paid to date

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What Should be Done with Life Insurance Trusts?

- Assuming the client followed the correct *Crummey* notice procedures
  - Is it necessary to continue to do so?
    - Typical client will never have to pay gift tax or other federal transfer tax, so dispensing with the “*Crummey* dance” may be administratively favored with no adverse consequence
    - Consider a written waiver of all future withdrawal rights
    - Alternatively, sign a one-time waiver stating that all *Crummey* rights in the future need to be only given verbally
- Another suggestion could be to simply fund the trust with enough cash to pay the annual premiums for a number of years and ignore the present interest gift tax concerns that the *Crummey* power is intended to address
- Include provisions in a life insurance trust to have it classified as a grantor trust (suggestion: power of substitution)

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What Should be Done with Retirement Plan Benefits?

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What Should be Done with Retirement Plan Benefits?

- Examine and update the client's beneficiary designations
- The surviving spouse has always been the favored beneficiary of a decedent's retirement plans
  - A rollover of the decedent's qualified plan or IRA to a surviving spouse enjoys the marital deduction to avoid the estate tax and special rules to defer the income tax on the roll over

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What Should be Done with Retirement Plan Benefits?

- In the post-2017 Act planning world
  - Recommended planning strategy would be to leave the retirement and IRA benefits directly to the surviving spouse to gain the advantages of income and estate tax deferral at the first death
  - And then to rely on portability to be able to utilize the deceased spouse's unused estate tax exclusion amount at the surviving spouse's subsequent death
- The issues addressed earlier regarding beneficiary control, management, blended families, etc. should also be considered in the context of a retirement plan distribution
  - Where the protection of a trust is desired
    - The retirement plan assets could be left to a QTIP Trust

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What Should be Done with Retirement Plan Benefits?

- Distributions from a retirement plan are income in respect of a decedent
  - There is no basis step-up when the decedent dies
  - The distributions are not considered net investment income
  - If age 70 ½ or older, take advantage of the transfer of IRA funds directly to charity – not included in AGI of the donor, and counts as or toward the required minimum distribution

What Should be Done with Retirement Plan Benefits?

- Roth IRAs: Caution: The 2017 Act eliminates the opportunity to recharacterize the conversion to a Roth IRA once it has been done
- 2017 conversions could have been recharacterized in 2018 – the last time

Changes in the Way Title to Property Should be Designated

Changes in the Way Title to Property Should be Designated

- Traditional planning for a married couple, especially in a common law state, involved an uncomfortable discussion about how assets should be titled
  - Ideally an amount of assets in the name of each spouse up to the amount of the applicable exclusion
- As the exclusions grew in size
  - It became increasingly difficult for many couples to retitle assets
- Title to property can now be used to address other important goals
  - Is one spouse an asset protection risk?

Changes in the Way Title to Property Should be Designated

- Did the client create a QPRT (Qualified Personal Residence Trust) that still has years to run?
  - Consider having the client "violate" the QPRT terms by continuing to live in or use the residence once the term has expired without paying any rent
- Have the trust grantor and the beneficiaries acknowledge there is a "retained interest" in the trust

Address the Status of Limited Liability Companies (LLCs), Family Limited Partnerships (FLPs) and Sales to Defective Grantor Trusts

LLCs and FLPs

- LLCs and FLPs were formed to remove assets from the transferor's estate and obtain a valuation discount in doing so
  - In the post-2017 Act upside-down planning world for the client of moderate wealth, the estate exclusion of the asset and the discount are both negatives
- File an estate tax return and concede the inclusion of the value of the enterprise in the decedent's estate
  - Consider if the operating agreement or partnership agreement can be modified to assure inclusion of the value of the entire entity in the decedent's estate

LLCs and FLPs and IDGTs

- If the client utilized the planning technique of the sale to the intentionally defective grantor trust, consider the client's federal estate tax status
- If the client utilized the technique but is not likely to be a federal estate tax payer, consider toggling off grantor trust status – but first pay attention to income tax basis
  - If the grantor retained the power of substitution as the power to make the trust a grantor trust, have the grantor swap property of equivalent value to what is in the trust
  - Grantor reacquires low basis property – holds until death – FMV value at death basis to family members
- If there is a note outstanding, use the increased gift tax exclusion to gift funds to the trust, pay off the note, and simplify future potential planning review

Planning for Persons in Decoupled States

More Difficult Considerations to Address

- The family of moderate wealth may still have to address estate tax considerations when their state of residence is decoupled from the federal estate tax system and maintains its own estate or inheritance tax
- Will the surviving spouse remain a resident of the decoupled state?
- Will the state repeal its estate tax?

More Difficult Considerations to Address

- Planning in decoupled states suggests using a bypass trust at the first death to capture the amount of the available state exclusion so that it avoids taxation at both deaths
- Consider mandatory funding of a bypass trust or funding by the survivor's disclaimer or by the fiduciary's election
  - The disadvantage of this choice is the lack of a stepped-up basis at the death of the surviving spouse and the possibility of future capital gain taxation at a rate higher than the state death tax rate
  - Lifetime gifting in decoupled states is a favored planning technique
  - Some states permit a state-only QTIP election to be made to take advantage of the marital deduction for state estate tax purposes, even if no such election has been made for federal purposes

Additional *Estate Planning Techniques in the Post-2017 Act Environment*

Drafting Considerations

- Be sure the plan at the first death results in making a basis step-up available at the survivor's death.
- Estate inclusion at both deaths is favored, since no estate tax will be due; income tax planning is most important
- Outright transfers work, but consider protections of a trust that will require inclusion of the trust property at the survivor's death. Blended family concerns?
- Power of Appointment Trust Plan (Limit appointment to creditors)
- QTIP Trust Plan – Even if not necessary to avoid tax – IRS won't disregard a valid QTIP election unless executor disavows it. Rev. Proc. 2016-49
- Be sure to make the portability election at the first death. File Form 706. View as "death tax insurance"
- Re-examine and possibly re-draft older formula clauses (spouse, children, grandchildren)

Drafting Considerations

- In some estates: consider the Credit Shelter Trust –
- Use it where substantial asset appreciation reasonably expected – portability not indexed; survivor may live many years; law may change
- Use it where client wants to use the GST exclusion
- Use it to address a decoupled state's death tax exclusion
- Downside: No basis step-up at second death – unless additional advanced planning considerations employed

Drafting Considerations

- Alternative: Avoid the credit shelter – go with the marital deduction/portability combination (outright, power of appointment trust or QTIP all work)
- Longevity of surviving spouse may be limited
- Basis adjustment at second death important
- Address the planning unknowns: When will deaths occur? What will the assets be worth at death? What will the law be at each death?
- No definite answers??? – Then address Flexibility in drafting

Flexible Planning Drafting Considerations

- Flexibility Options:
- When the first spouse dies – Consider using an outright gift with a disclaimer path – so the survivor can disclaim into an appropriate trust arrangement (credit shelter? Decoupled state exemption?)
- Concerns about Disclaimer: Too much control for survivor; Won't happen; Timing not met; Survivor accepts benefits and voids disclaimer
- Alternative: Clayton QTIP Trust: Independent executor controls funding of QTIP and credit shelter – can optimize allocation based on knowledge at the time of the first death. With 9 months to file Form 706 and the automatic 6 month extension, the executor has 15 months to decide what to do. Drafting: Provide broad exculpation to the fiduciary who must make the QTIP election
- Allow trustees or trust protectors discretion to convey general powers of appointment for trusts otherwise not included in the beneficiary's estate

THANK YOU