Client Alert Trusts and Estates

Ten Estate Planning Tips as We Emerge from a Pandemic and Head into a Presidential Election

Introduction

No one can say that 2020 has been an ordinary year – from the outbreak of COVID-19 in the first quarter of 2020 to the death of Supreme Court Justice Ruth Bader Ginsburg to the upcoming Presidential election.

So, amidst such an unusual year, why *not* think about estate planning? These times provide an exceptional backdrop to engaging in thoughtful consideration about planning, and the economic environment provides unique opportunities.

Here are ten estate planning tips worth considering, right here, right now, during the final three months of 2020:

1. **Planning with Continued Low Interest Rates.** The Federal Reserve's decision to keep interest rates historically low, even at the risk of inflation, has created a fertile environment of estate planning freeze strategies which utilize the IRS's published interest rates. The Grantor Retained Annuity Trust (or "GRAT") and the Charitable Lead Annuity Trust (or "CLAT") are two techniques which, when most successfully deployed, allow for the transfer of wealth at a reduced gift tax cost and provide that the future appreciation on the assets transferred passes without exposure to the individual's estate tax. The GRAT pays a defined sum back to the creator for a fixed number of years, and the remainder passes to family; the CLAT pays a fixed sum to a named charity for a defined number of years, and then the remainder passes to the creator's family. The current applicable Federal interest rate for determining the gift tax value of these techniques is currently 0.4%, having dropped from 2.2% in February. Normally a GRAT or CLAT is most successful when a client transfers an asset which has significant appreciation potential, such as a closely-held entity where the owner expects a successful sale in the future. However, funding a GRAT with securities (or swapping them into an existing GRAT, as described below), given

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the relatively depressed and volatile capital markets and the low interest rates, means that more long term growth resulting from the rebounding stock market will be able to be passed to family.

2. **Lower Values in Commercial Real Estate.** If your commercial real estate holdings have recently decreased in value, this could be an ideal time for making a gift of interests in these assets to family. When gifts are made in the form of interests in limited liability companies or limited partnerships, discounts continue to be appropriate for lack of marketability and lack of control even on top of lower real estate appraised values. The result is that owners of commercial real estate may be in a position to move quickly by transferring that property now to family trusts before the value rebounds in coming years. Such transfers may be most effective in the form of an outright gift or a gift to an irrevocable trust which is not considered to be owned by the creator for income-tax purposes or perhaps using promissory notes to family members.

3. **Checking the Existing Basic Estate Plan.** Now is the time to review your will or your revocable living trust agreement (or both) to see if they still accurately reflect your wishes.

   Testamentary Provisions. Reconsider whether inheritances should be outright or placed in trust for the benefit of children and more remote descendants. Parents have a unique ability to provide meaningful asset protection for children by utilizing trusts for their benefit, to shield children from claims in divorce and other predatory maneuvers. Simple wills can overlook nuances that perhaps now during this period have become magnified, particularly in younger families struggling economically and emotionally with the pandemic. Review and reconsider choices for executors, trustees and guardians.

   Testamentary Tax Strategies and the 2020 Presidential Election. Tax strategies and language contained in the will need to be reviewed as the Presidential election approaches and in its aftermath. Most sophisticated estate plans are framed around optimizing an individual's estate tax "applicable exclusion amount" (or "AEA") using a credit shelter trust, and his or her generation-skipping transfer ("GST") tax exemption amount using a "dynasty" or descendants' trust. Attorneys draft for these strategies in wills or living trusts using a formula meant to maximize the allowance. For many wills, after the Tax Cuts and Jobs Act of 2017 that formula was impacted by the increase of the AEA and the GST exemption from $5,000,000 to $10,000,000. (Increased for inflation, that amount is $11,580,000 today.) Barring Congressional action, the AEA and the GST exemption is set to retreat to $5,000,000 (again indexed for inflation) on January 1, 2026.

   Clients and their advisors should evaluate these formulas on a case-by-case basis, with an eye towards the 2020 Presidential election. Vice President Biden has spoken of his intention to repeal the 2017 Tax Cuts and Jobs Act, which, presumably, means restoring the AEA and the GST exemption to the $5,000,000 level, as indexed. A long-standing Democratic agenda item has been to restore the AEA to the Clinton-era $3,500,000. Curiously, the Trump campaign lacks a definitive statement either to eliminate the Federal estate tax or even take decisive action to make permanent the exemption increases in the Tax Cuts and Jobs Act. The one secure tax take-away is that there is no telling what Congress and the President will do in 2021 and the years following, and so having the flexibility in a will or living trust to optimize the wealth tax environment, should death occur during this period of uncertainty, is essential.

How is this accomplished? Avoid or revisit formula clauses for credit shelter trusts where a surviving spouse is involved. These clauses might result in an unexpected and disproportionate benefit passing to a trust which is not exclusively for a spouse's benefit. Better planning suggests drafting to set up a marital trust for the surviving spouse to hold the estate's financial assets, which, through elections made during the period of administration and the ability to divide it into different shares, can provide the same benefits of planning with the AEA but offer more flexibility to achieve the best tax strategy overall.

4. **Check Advance Directives and Durable Powers of Attorney.** Usually an integral part of the basic estate planning package, advance directives for health care and durable powers of attorney tend to gather dust as years wane. Unlike wills, which only take effect at death, these documents state an individual's wishes regarding financial decision-making and health care decision-making while he or she is alive but unable to act or express intentions. These documents should be reviewed and refreshed at least every ten years, even if there is no change.

Advance Directive for Health Care. Different practitioners may use different forms, but at its core, this documentation sets out wishes about health care decisions and end-of-life views (end-of-life decisions are sometimes set out in a separate document known as a *living will*), and the appointment of a health care representative to act as the agent to make medical decisions including end-of-life decisions (sometimes set out in a separate document known as a *health care proxy* or *proxy directive*). Are these choices and wishes still accurate? Is the agent's information up to date? Have the wishes been discussed with the agent? If the pandemic has taught many families one thing about estate planning, it has stressed the importance of having this document prepared, properly executed, and having the agent informed and ready with decision-making knowledge and resolve.

Durable Power of Attorney. A durable power of attorney as created by most practitioners immediately grants authority to an agent to conduct business or financial transactions in the name of the individual who executes it. That being said, these documents can often be the most difficult to use. Many banks and financial institutions will insist on their own forms, whenever possible. In view of these hurdles, these documents should be reviewed and updated, if necessary, to avoid a costly confrontation with an uncooperative bank representative should the need arise to have them implemented. Check the names and addresses of the named agent. If there are co-agents, can they act independently or is unanimity required? Is there a power in the agent to make gifts? Is there authority to deal with digital assets? What is the relationship between the agent and the named executor in the client's will?

5. **Check Existing Estate Planning Strategies.** Individuals should take stock and review their other irrevocable strategies implemented in years past which may be impacted by the current economic and political climate. Existing life insurance trusts, spousal lifetime access trusts (described below), dynasty trusts, GRATs, qualified personal residence trusts, and charitable trusts, to name the most common, all may be accomplishing a desired goal of minimizing a client's exposure to estate tax, but they need care and feeding, and a proper audit from time to time is essential. For example:

   Insurance Trusts. Are *Crummey* notices being sent faithfully to trust beneficiaries in the case of insurance trusts where transfers are being made to the trust to pay premiums? Are the trust provisions still desirable? Are the successor trustees still acceptable? Are beneficiary designation forms up to date?

   GRATs. Is the property in an existing GRAT subject to volatility such that it might be appropriate to freeze the fluctuation by having the creator substitute the property for a less volatile asset class (like cash) having an equivalent value? Have the required GRAT payments been made faithfully as prescribed in the trust agreement? If a GRAT has terminated, has the remaining property been transferred to the beneficiary of the remainder?

   Dynasty Trusts and Spousal Lifetime Access Trusts. Are the provisions in the governing instruments regarding trust benefits and distributions and trustees still desirable? How are the assets performing? Is there an opportunity to do income tax planning for an asset otherwise excluded from the creator's estate by swapping it out, as described above with the GRAT?

   In many instances, upon reviewing these existing strategies, clients or their counsel have identified concerns or issues which need immediate attention, either because the provisions are no longer desirable or the technique has lost its purpose relative to size of his or her estate. Many states, including New Jersey, have adopted in one form or another, the Uniform Trust Code, which can help practitioners address changes needed to outdated or out-of-touch trusts. Decanting, combining or merging may also present viable options.

6. **Renegotiate Family Loans.** Intra-family loans can often be a pragmatic solution for individuals looking to transfer wealth using the technique of an estate freeze. The transfer itself is not a gift, but the value of the transfer is frozen at the time it takes place, meaning that the expected return of the principal amount is fixed by the value of the loan, whereas the asset or funds in the hands of the borrower is allowed to appreciate free of estate tax. For example, assume in 2015 a parent lends $1,000,000 to a child to purchase a home. If the parent had the child sign a promissory note and mortgage with a market rate of interest, no gift occurred. In

October 2015, the applicable Federal interest rate (i.e., the minimum rate the parent must charge to avoid characterizing the loan as a gift) was 2.44%. In October 2020, the AFR for the same term loan is 1.12%. By refinancing the indebtedness, the child can lower his/her payments of interest by more than half. And if the parent is forgiving the interest as part of an annual gifting program, the annual gift tax cost has dropped from $24,400 to $11,200. Consideration should be given, however, to determine if refinancing to a lower rate and the benefit which the child realizes is, itself, a taxable gift. This may be avoided if the child pays to the parent the points associated with the adjustment to the lower interest rate at the time of the refinancing.

7. **Using (or Losing) Your AEA before 2021 (or 2026).** As mentioned above, the AEA is currently $11,580,000 per person and, absent any legislative overhaul, will continue to be adjusted for the next five years with inflation and then disappear, reverting to the base amount of $5,000,000. Neither candidate seems to have mentioned gift, estate or GST taxes directly in any public discourse, but the Biden tax platform does include ending the income-tax benefit of the step-up in basis on appreciated property at death. The step-up at death currently allowed under the tax laws offers pragmatic and economic benefits for all taxpayers, regardless of affluence. Although not entirely clear as yet, a Biden administration agenda item appears to suggest that previously-unrealized gains are to be taxed at an individuals death, regardless of whether they are sold. Similarly, if Republicans were to revive their efforts at full-blown estate tax repeal, it is likely that the measure would follow the pattern of the repeal which occurred in 2010, namely that outside of an exemption, most of a decedent's assets would not be allowed a step-up in basis.

   Sunsetting and "Clawback." Putting aside these possibilities, the enhanced AEA will, absent any legislative action, sunset on January 1, 2026, thereby eliminating a meaningful amount of tax-free wealth which an individual can pass to family. Individuals planning for this increasingly-likely situation are being encouraged to make taxable gifts immediately which use their AEA (i.e., gifts of up to $11,580,000 for individuals or $23,160,000 for married couples). In addition, the IRS has confirmed that taxpayers who make such gifts during this period will not be penalized even if the base amount of the AEA reverts to $5,000,000 as a result of the sunset in 2026. Prior concerns of this "clawback" have discouraged gifts in the past, but with this pronouncement, there is no downside for making the gifts today and, potentially, no time like the present.

   Techniques. While any irrevocable family dynasty trust can be effective to make a lifetime gift of AEA, the most pragmatic technique which keeps the assets within the creator's reach is the spousal lifetime access trust (or "SLAT"). SLATs are appealing for married individuals because, when properly set up, SLAT property remains accessible to the creator of the trust through their spouse as the beneficiary. However, the growth on the assets in the SLAT not consumed is passed on to the lower generation without further exposure to estate tax. Obtaining a policy of insurance on the life of the beneficiary (in an irrevocable trust) can be a way to insure for the creator that the death of the spouse-beneficiary does not compromise the access to funds otherwise being enjoyed by the couple prior to the creation of the trust. Spouses can set up SLATs for each other, but care must be taken to avoid the IRS's "reciprocal trust doctrine" and the "step transaction doctrine," both of which can cause undesirable consequences. Clients who are considering the technique but not sure if or when they want to pull the trigger should take steps now to prepare for the eventual transfer of assets by making a substantial gift to the spouse who may not have sufficient assets in her or his own name, in order to enable that spouse to create the gift. In this way, there is a meaningful amount of time which has passed and allows the gift to "cure" in the hands of the spouse before being moved into a trust. Just how much should be considered to be placed in the trust? The answer will vary from client to client and will likely depend upon resources outside of the SLAT, but ultra-high net worth couples are advised to take a large bite of their unused exemption, using the SLAT, while it is still available.

8. **Don't Forget about the GST: Are Existing Trusts Being Optimized?** Many family wealth portfolios already have in existence trusts which provide benefits in the form of income, savings or potential future educational funds for children. Such trusts may have been created by parents or grandparents or even by the clients themselves during the last "fiscal cliff" estate planning crisis of 2012. Many of these trusts present challenges and opportunities for multi-generational wealth planning which, in this dynamic tax environment, require attention. Many individuals are unaware of the impact of the Federal generation-skipping transfer (or "GST") tax, which, when applicable, creates an additional tax of up to 40% on transfers which land in the laps of beneficiaries who are two or more generations removed from the creator of the trust. In reviewing these trusts clients should be aware of the following:

   "Grandfathered Trusts." Is the trust even subject to the GST tax? In general, any trust which was already in existence and irrevocable prior to September 25, 1985, enjoys the status of being a so-called "grandfathered trust," meaning it is not subject to the tax at any point. Trusts of this nature should be carefully administered to avoid potential unintended exposure to the tax resulting from the exercise of certain rights or powers by beneficiaries or the modification of the terms (using certain statutory techniques or judicial actions). Such actions have the potential to cause the trust to be subject to the tax.

   "Non-Exempt" Trusts Fully Subject to the Tax. As wealth from "the greatest generation" passes down to baby boomers, many sophisticated estate plans have irrevocable trusts that are literally GST tax ticking time bombs. These trusts were created with an individual's wealth which, at the time of transfer, exceeded his or her GST exemption amount available. By definition, these trusts upon termination will suffer the full blow of the 40% GST tax, thereby depleting the wealth otherwise intended to be passed to the family. Trustees have a fiduciary duty to minimize all taxes – including GST taxes – consistent with the intent of the creator. In many cases there are options available which should be considered at this time, particularly in

the face of potentially shrinking estate tax exemptions. For example, assume the principal trust beneficiary is a child of the creator who has personal assets which fall below the AEA. Here, a trustee might do well to consider making a large principal distribution to the beneficiary to enable him to create a SLAT or a dynasty trust using the beneficiary's own AEA so the trust escapes both the GST tax as well as estate tax when the beneficiary dies. Another strategy might include granting the beneficiary a testamentary general power of appointment which changes the impact of the GST tax and causes the trust to be included in the beneficiary's estate for estate tax purposes.

Capital Gain Taxes and GST-Exempt Trusts. Apart from the GST tax planning opportunities and obligations, trustees should also consider the fact that many generational trust strategies may be victims of their own success in another way: appreciated assets – particularly in GST-exempt trusts such as dynasty trusts – may be harboring large unrealized gains. Family members may be pleased to receive appreciated assets free of GST tax, but that good feeling may soon dissipate if the appreciated asset is sold and the individual is subject to income tax on a large, long-term capital gain. Such gains by definition are not stepped up (as they are in the case where the underlying assets are subject to estate tax) because they bypass the beneficiary's estate. Trustees, therefore, need to consider strategies which might be employed to minimize the potential gain. Unlike the GST strategies above, these income tax-driven techniques are more complex and need to be vetted against the individual variables of a client's tax picture.

9. **Strategize about Business Succession and Long-Range Planning.** The national lock-down which began in March not only locked down the economy, but it created a unique environment for business owners to stop and reflect about their enterprises and the future. Is this the time to liquidate a business? A division? Sell certain assets to raise cash and redeploy in a different line of products or services? Professional advisors are essential because they can help provide perspective and options. And if a business owner is looking to stay the course and transition the business to the next generation, an important consideration will be the fitness of the family to continue the legacy in the "new normal." Business succession experts and consultants are well aware of the expression "shirtsleeves to shirtsleeves in three generations," meaning an entrepreneur's ability to have a business thrive multi-generationally is a direct function of the ability of the family members in the next generation to work hard, continue to innovate and adapt to new challenges.

10. **Consider State Estate and Income Tax Effects on Your Domicile.** One of the unintended silver linings of the past six months has been the surprising ease with which certain businesses can conduct their operations in a remote capacity. The increased reliance on web-based video conferencing technology has revolutionized the way employees can accomplish tasks. The long-range effect of this shift in employment platforms may be that companies no longer need employees to

remain in a centralized locale. Indeed, many individuals fled their homes and urban apartments to take refuge in the Berkshires, the Jersey Shore and Florida, where they continue to work productively. If business in the post-pandemic age permits migration, individuals now have a unique opportunity to re-evaluate their domicile in terms of tax and estate planning. Florida, for example, affords the benefits of no state income or estate tax and a generous homestead exemption. New Jersey has – for the moment – repealed its estate tax but has retained its inheritance tax. Residing in other jurisdictions could have other benefits. This may be the time to consult a tax advisor to determine if shifting domicile creates an overall tax reduction. In so doing, clients need to remember that a residence maintained in a former domicile renders them vulnerable to tax challenges by that jurisdiction. A legal domicile is a factual consideration made up of a series of intent-driven indicators which go beyond an individual's physical presence in a jurisdiction. Factors include the individual's driver's license, voter registration, club and religious affiliations and the like. If social contacts relating to the former domicile become more prevalent, that state might be able to prove that the individual ultimately intended to *return* to that jurisdiction and negate even a temporary change in domicile. Here again, a legal advisor can assist in advising which steps are best to accomplish the desired result.

Conclusion

Neither the pandemic nor the upcoming Presidential election promises us any certainty anytime soon. In the midst of this climate, it is important to remember that certain opportunities for shifting wealth down to lower generations may be expiring within the next few years. The pandemic and its effect on the economy continue to keep interest rates at historic lows, which make this an ideal environment to engage in all aspects of estate planning, from the simple to the comprehensive. Now is the time to take stock of what is driving your estate planning, to think through existing choices and options with the help of legal and financial advisors, and then decide how best to optimize the strategies going forward.

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